



**George Mason
Journal of International
Commercial Law**

Vol. 3, Issue 1

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The Journal Staff would like to express our profound appreciation for the George Mason University School of Law faculty and administration, without whom this publication would not have been possible.

We would like to thank our Board of Advisors, and in particular our Faculty Advisor Professor James E. Byrne. Words cannot express the value of your guidance, insight and assistance.

From Forum Non Conveniens to Open Forum: Implementing the Hague Convention on Choice of Court Agreements in the United States

Carolyn Dubay *

Introduction

Globalization can either be viewed as an unparalleled opportunity to reap the economic rewards of the global marketplace or as an unmitigated threat to state sovereignty. Embedded in this debate is the structural tension in the United States between the power of the states and the federal government. These complexities are particularly apparent in private international law, which transcends the state-to-state obligations of public international law and aims to infuse international legal obligations into private dispute resolution at the domestic level. Notwithstanding these sovereignty concerns, the United States has continued its trajectory towards concluding international agreements that facilitate international cooperation in private legal disputes.

Most recently, in 2009, the United States ended more than a decade of negotiations and became a signatory to the Hague Convention on Choice of Court Agreements (“COCCA”), an international agreement mandating the recognition and enforcement of foreign judgments resolving certain international business disputes.¹ COCCA complements the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards (“New York Convention”)² and gives businesses involved in

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1 See RONALD A. BRAND & PAUL M. HERRUP, *THE 2005 HAGUE CONVENTION ON CHOICE OF COURT AGREEMENTS COMMENTARY AND DOCUMENTS* (Cambridge University Press 2008) (providing a comprehensive history of negotiations leading up to COCCA); *Convention on Choice of Court Agreements*, THE HAGUE CONFERENCE ON PRIVATE INTERNATIONAL LAW, <http://www.hcch.net/upload/conventions/txt37en.pdf> (last visited Oct. 23, 2011). The COCCA negotiations took place primarily between the United States and the European Union (“EU”), which followed the Brussels Convention on jurisdiction and enforcement of commercial judgments in the EU, later replaced by Brussels Regulation I in 2002. BRAND & HERRUP, *supra*, at 4-6; see also Hannah L. Buxbaum, *Forum Selection in International Contract Litigation: The Role of Judicial Discretion*, 12 WILLAMETTE J. INT’L L. & DISP. RESOL. 185, 207-08 (2004) (describing the Brussels Convention and later EU regulations on forum selection clauses).

2 See United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards, June 10, 1958, 21 U.S.T. 2517, 330 U.N.T.S. 38. The New York Convention

international trade more predictability and flexibility in negotiating dispute resolution agreements. The general objective of COCCA is to “promote international trade and investment through enhanced judicial co-operation”³ by enforcing judgments in international “civil or commercial matters” where the parties have entered into a valid and exclusive choice of court agreement.⁴

COCCA affects international business litigation in three primary ways. The first component dictates the obligations and procedures to be used in courts designated in choice of court agreements, referred to in the Convention as “chosen courts.”⁵ The second component establishes the obligations of non-chosen courts when a party to a dispute subject to COCCA files an action in that court, despite an exclusive choice of court agreement dictating a different forum.⁶ The third component concentrates on procedures to enforce the judgments of chosen courts.⁷ Each of the three components of COCCA must be implemented in a manner consistent with the Convention’s language and intent, while simultaneously balancing the political and structural limitations of American federalism. This article

requires the enforcement of international arbitration agreements and provides a framework for the recognition and enforcement of arbitration. *Id.*

3 *Convention on Choice of Court Agreements: Preamble*, THE HAGUE CONFERENCE ON PRIVATE INTERNATIONAL LAW, <http://www.hcch.net/upload/conventions/txt37en.pdf> (last visited Oct. 23, 2011) [hereinafter COCCA].

4 *See Recent International Agreement*, 119 HARV. L. REV. 931, 933 (2006) (“[C]onsumer contracts and contracts of employment are specifically excluded,” as are purely domestic disputes); *see also* BRAND & HERRUP, *supra* note 1, at 18 (explaining the exclusion included in COCCA Article 2); COCCA, *supra* note 3, art. 2(1).

5 *See* COCCA, *supra* note 3, art. 5; *see also* BRAND & HERRUP, *supra* note 1, at 11-12 (detailing the roles and responsibilities COCCA Article 5 gives to chosen court).

6 *See* COCCA, *supra* note 3, art. 6.

7 *Id.* art. 8. Under the third pillar of COCCA, courts asked to enforce judgments of chosen courts are required to do so. *Id.* Under Article 8(1), a judgment entered by a chosen court “shall be recognized and enforced in other Contracting States.” *Id.* This requires a basic reciprocity rule: if a judgment is valid and enforceable in the chosen State, then it is valid and enforceable in the State where the judgment is to be enforced. *See* BRAND & HERRUP, *supra* note 1, at 13-15. To avoid the common problem of objections to the validity of foreign judgments based on jurisdictional issues, under COCCA, conclusions of the chosen court as to its jurisdiction may not be challenged under Article 8(2). BRAND & HERRUP, *supra* note 1, at 13-15. Rather, defenses to enforcement are limited to those provided in Article 8 and Article 9 of COCCA. BRAND & HERRUP, *supra* note 1, at 13-15.

focuses on the particular problems associated with the implementation of the obligation of courts in the United States to enforce forum selection clauses in cases subject to the Convention. Specifically, COCCA mandates the exercise of personal jurisdiction by chosen courts and restricts a chosen court's ability to dismiss cases on the grounds of *forum non conveniens*.⁸ Non-chosen courts in the United States are required to dismiss or suspend proceedings, unless one of five defenses to enforcement is established.⁹ As a result, COCCA lays the groundwork for the recognition and enforcement of judgments of chosen courts by eliminating potential future challenges based on lack of personal jurisdiction over the defendant and by discouraging parallel litigation in non-chosen courts. COCCA's procedural provisions do not mandate a particular standard for determining the overall validity of exclusive choice of court agreements; instead COCCA leaves that determination to existing domestic law.¹⁰

Although COCCA's mandates are seemingly straightforward, two complicating factors have quickly emerged in determining the best approach for implementation. First, under COCCA, chosen courts in signatory states are to enforce forum selection clauses regardless of whether

⁸ See BRAND & HERRUP, *supra* note 1, at 12.

⁹ COCCA, *supra* note 3, art. 6. Under COCCA's second pillar relating to obligations of a non-chosen court, Article 6 requires that the court where the action is filed "shall suspend or dismiss proceedings to which an exclusive choice of court agreement applies." *Id.* Article 6 identifies only five defenses to enforcement of the forum selection clause that would allow proceedings in the non-chosen court to go forward: (1) the agreement is null and void under the law of chosen court; (2) a party lacked capacity to form a contract under the law of court where the action was filed; (3) giving effect to agreement would be "manifestly contrary to the public policy" of the State where the action was filed; (4) for exceptional reasons beyond the control of the parties, the choice of forum agreement cannot reasonably be performed; and (5) the chosen court decided not to hear the case. *Id.* art. 6(a)-(e). Under Article 7, a non-chosen court is not precluded from granting "interim measures of protection" (such as injunctions) as such procedures fall outside of COCCA. *Id.* art. 7.

¹⁰ *Id.* art. 5. This article adopts the position that COCCA's rules as to the enforceability of forum selection clauses in chosen courts are procedural in nature, leaving the issue of the substantive law on the enforceability of forum selection clauses untouched. *Id.* art. 5(1) (dictating jurisdiction in the chosen court so long as the choice of court agreement is not "null and void under the law" of the chosen forum); *id.* art. 5(3) (suggesting that the rules of previous paragraphs are not meant to alter rules about the subject matter of the underlying claim). See also *infra* Part II on the dispute among the courts as to whether, under existing law, interpretation and enforcement of forum selection clauses is a procedural matter or an issue of substantive contract law governing the entire agreement to which the clause applies.

the dispute or the parties have any geographic nexus to the chosen location for dispute resolution.¹¹ The United States may choose to invoke Article 19 of COCCA, which allows a state party to the Convention to “declare that its courts may refuse to determine disputes to which an exclusive choice of court agreement applies if, except for the location of the chosen court, there is no connection between that state and the parties or the dispute.”¹² This article will assume for purposes of analysis that no Article 19 declaration will take place, although issuing a declaration may alleviate state public policy concerns arising from the usurpation of state judicial resources to resolve disputes unconnected to the state.

The second, more vexing problem for implementation arises from the structural and political limitations inherent in the American federal system. The principle of dual sovereignty, the independence of state and federal courts, and the limited powers of Congress vis-à-vis the states creates a number of hurdles to effective and uniform implementation of COCCA.¹³ The fact that COCCA’s provisions for chosen courts are procedural and jurisdictional in nature ironically makes them more difficult to implement at the state level because of the complicated choice of law framework that has evolved under *Erie Railroad Co. v. Tompkins*¹⁴ and *Hanna v. Plumer*.¹⁵ As a result, the enforceability of forum selection clauses in the United States tends to turn on the procedural motions available in the federal or state court to enforce or avoid the agreement rather than the validity of the choice of court agreement itself.¹⁶ This

11 COCCA, *supra* note 3, art. 5(2).

12 *Id.* art. 19.

13 See Stephen B. Burbank, *Federalism and Private International Law: Implementing the Hague Choice of Court Agreement in the United States*, 2 J. PRIV. INT’L L. 287, 294 (2006) (stating that “the power of Congress to pre-empt state jurisdiction law in international cases in which jurisdiction is founded only on the parties’ choice of court agreement is less clear”).

14 304 U.S. 64, 78 (1938) (holding that “[e]xcept in matters governed by the Federal Constitution or by acts of Congress, the law to be applied in any case is the law of the state”).

15 380 U.S. 460, 468 (1965) (holding that the evaluation of the outcome-determinative nature of a state or federal procedural rule must be analyzed under the “twin aims of the Erie rule: discouragement of forum-shopping and avoidance of inequitable administration of the laws”).

16 Ryan T. Holt, *A Uniform System for the Enforceability of Forum Selection Clauses in Federal Courts*, 62 VAND. L. REV. 1918, 1930 (2009).

dichotomy occurs because the line between the procedural and substantive aspects of forum selection clause enforcement is often blurred when considering a choice of court agreement that designates a neutral forum with little or no connection to the dispute or the parties.¹⁷ Therefore, the public policy preferences of states opposed to forum selection clause enforcement may be expressed in procedural statutes, such as long-arm statutes, or statutes establishing contract formalities.¹⁸

With these difficulties in mind, the relevant inquiry then becomes determining the appropriate scheme for implementation of COCCA. Proposals have been put forward to adopt a federal implementation act that would preempt conflicting state laws as they relate to choice of court agreements subject to the Convention.¹⁹ At the same time, the Uniform Law Commission has been working to develop an implementation plan that would allow states to either adopt uniform mini-COCCA acts or face preemption of existing law.²⁰ There are valid and useful aspects of the state law approach, especially in other private international law subject matter areas where Congress lacks legislative authority at the domestic level. But, in the context of the enforceability of international commercial dispute resolution mechanisms, it would be better to adopt a federal implementation law that would complement the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards.

As set forth in this article, while state law and public policy will continue to have a role in resolving disputes subject to the Convention, federal policy favoring the enforcement of choice of court agreements in international commerce will be better served through a federal framework. A federal scheme can resolve continued disputes over applicable law, conflicting rules on personal jurisdiction, and the uneven enforcement of forum selection clauses depending on the procedural posture of the case. To

17 *Id.* at 1934 (stating that procedure and substance can be hard to differentiate in practice).

18 See *M/S Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1, 10-11 (1972) (citing *Nat'l Equip. Rental, Ltd. v. Szukent*, 375 U.S. 311 (1964) (holding that “in federal courts a party may validly consent to be sued in a jurisdiction where he cannot be found for service of process through contractual designation of an agent for receipt of process in that jurisdiction...”).

19 See, e.g., Burbank, *supra* note 13, at 309; *Recent International Agreement*, 119 HARV. L. REV. 931, 937-38 (2006) (opining that Congress could implement a narrow forum selection statute to serve as a basis for later legislation).

20 William H. Henning, *The Uniform Law Commission and Cooperative Federalism: Implementing Private International Law Conventions Through Uniform State Laws*, 2 ELON L. REV. 39, 50 (2011).

be effective, however, a federal implementation act needs to comprehensively incorporate standards to assess the validity of forum selection clauses and the procedural issues relating to personal and subject matter jurisdiction, venue and removal of cases to federal court. Existing law in the United States shows that the procedural and substantive issues in forum selection clause enforcement are inextricably linked, and thus a comprehensive federal scheme would promote clearer rules for forum selection validity and enforcement. This will serve the interests of American litigants in United States courts, as well as American firms sued abroad in contravention of a choice of court agreement subject to COCCA.

Part I of this article begins with an overview of COCCA's enforcement provisions for choice of court agreements. Part II examines existing law in the United States on the enforcement of forum selection clauses. This part highlights the difficulty in differentiating the substantive from the procedural aspects of the enforcement of forum selection clauses in the United States, which has resulted in disagreements as to whether federal or state law applies when such clauses are enforced in federal courts. Part II also examines the interplay of personal jurisdiction and *forum non conveniens* with forum selection clause enforcement, especially where state statutes do not allow a forum selection clause to serve as an independent basis for personal jurisdiction over the parties. Part III argues that the best route to implementing COCCA's provisions regarding the enforcement of forum selection clauses is to develop a comprehensive federal scheme, including substantive and procedural rules for federal or state courts to apply when interpreting or enforcing forum selection clauses subject to COCCA. Finally, Part IV urges lawmakers to codify the standard adopted in *M/S Bremen v. Zapata Off-Shore Co.*²¹ that validates choice of court agreements in international commercial cases and to consider the procedural framework of the Foreign Sovereign Immunities Act of 1976 ("FSIA")²² to address procedural issues such as personal and subject matter jurisdiction, service of process, venue and removal. By drawing from both the FSIA and *Bremen*, Part IV asserts that a federal implementing law would balance party autonomy in dispute resolution dictated by COCCA with public policy

²¹ 407 U.S. 1, 15 (1972) (holding that forum selection clauses are prima facie enforceable unless the other party can show evidence that enforcement would be unreasonable and unjust, or that there was "fraud or overreaching").

²² Foreign Sovereign Immunities Act of 1976, 28 USC §§ 1602-11 (2006).

references of states to play a role in determining the overall validity of the choice of court agreement.²³

Part I: An Overview of COCCA

When COCCA negotiations began in the early 1990s, the United States was not a party to any existing convention on the enforcement of foreign court judgments.²⁴ To achieve consensus, COCCA carved out a narrow category of cases in which enforcement of commercial judgments would be easier to realize. Based on a model proposed by American law professor Arthur von Mehren, enforcement of foreign judgments would be facilitated by focusing on the facets of commercial litigation that could later stand in the way of the validity of the judgment.²⁵ What emerged was a hybrid convention that applies to both the procedural fairness of the underlying litigation and the enforceability of the resulting judgment.²⁶ Under this approach, if the jurisdiction of a court chosen by the parties is conclusively established under COCCA, precluding parallel litigation in non-chosen courts, foreign courts will be more likely to enforce the judgments of chosen courts.²⁷

COCCA's provisions relating to chosen courts are contained in Article 5. Specifically, Article 5(1) states that a chosen court in a Contracting State "shall have jurisdiction to decide a dispute to which the [exclusive choice of court] agreement applies, unless the agreement is null and void under the law of that State."²⁸ Despite the generic reference to

23 *See id.*; *Bremen*, 407 U.S. at 15 (holding that forum selection clauses are prima facie enforceable unless the other party can show evidence that enforcement would be unreasonable or unjust, or that there was "fraud or overreaching").

24 *Recent International Agreement*, *supra* note 19, at 932 (noting that the United States is a signatory to the convention on enforcement of arbitral awards since 1958, but the United States, unlike many European countries, is not yet a party to any treaty regarding the enforcement of judgments).

25 *See* BRAND & HERRUP, *supra* note 1, at 7.

26 *Id.*

27 *Id.*

28 COCCA, *supra* note 3, art. 5(1).

“jurisdiction,” Article 5 only applies to *in personam* jurisdiction.²⁹ Article 5(3)(a) specifically provides that subject matter jurisdiction is not affected by the Convention.³⁰ The focus on personal jurisdiction is to eliminate the most common challenge to enforcement of foreign judgments based on lack of personal jurisdiction over the defendant.³¹

COCCA also addresses the continuing existence of *forum non conveniens* in United States jurisprudence which can defeat the enforcement of an otherwise valid forum selection clause.³² The *forum non conveniens* problem is heightened in the international commercial context, where parties may seek to find a neutral location for dispute resolution that offers expeditious resolution of cases in a competent and fair judicial system. In this context, COCCA is designed to promote the enforcement of forum selection clauses that choose a location for the resolution of future contract disputes with no geographic connection to the underlying dispute or the parties.³³ Article 5(2) provides that a chosen court “shall not decline to exercise jurisdiction on the ground that the dispute should be decided in a

29 BRAND & HERRUP, *supra* note 1, at 84 (“The Convention creates rules of *in personam* jurisdiction regarding persons party to an exclusive choice of court agreement It does not bestow subject matter jurisdiction or create venue. . . .”).

30 COCCA, *supra* note 3, art. 5(3)(a).

31 See BRAND & HERRUP, *supra* note 1, at 198.

32 Cf. Buxbaum, *supra* note 1, at 189 (“[O]ther legal systems, by contrast, reject judicial discretion to dismiss a case based on convenience, many entirely, and virtually all in cases in which the parties have negotiated an exclusive forum agreement.”). The notion of empowering judges to dismiss a case when the parties have properly established jurisdiction and venue is foreign to many legal systems; in civil law countries, courts rely on more restrictive jurisdictional rules to confine the plaintiff’s selection of a forum, whereas in many common law countries, doctrines based on convenience are recognized to prevent oppression of the defendant, and not to reduce the administrative burden on courts. See *id.* at 207.

33 See COCCA, *supra* note 3, art. 19; BRAND & HERRUP, *supra* note 1, at 229. Because the geographic nexus between the chosen court and the dispute may be controversial, COCCA Article 19 allows a Contracting State to declare that its courts may “refuse to determine disputes to which an exclusive choice of court agreement applies if, except for the location of the chosen court, there is no connection between that State and the parties or the dispute.” COCCA, *supra* note 3, art. 19; BRAND & HERRUP, *supra* note 1, at 229. Whether the United States opts to make an Article 19 declaration remains to be seen, though the political and policy downside of such a declaration would be to encourage countries in the EU to make similar declarations and restrict access to their courts.

court of another State.”³⁴ Article 5(3)(b) also provides that in cases of discretionary transfer of venue “due consideration should be given to the choice of the parties,” although non-discretionary venue rules are not affected.³⁵

Under COCCA’s provisions for the obligations of a non-chosen court, Article 6 requires that the court where the action is filed “shall suspend or dismiss proceedings to which an exclusive choice of court agreement applies...”³⁶ Article 6 identifies only five defenses to enforcement of the forum selection clause that would allow proceedings in the non-chosen court to go forward: (1) the agreement is null and void under the law of the chosen court; (2) a party lacked capacity to form a contract under the law of the court where the action was filed; (3) giving effect to the agreement would be “manifestly contrary to the public policy” of the state where the action was filed; (4) for exceptional reasons beyond the control of the parties, the choice of forum agreement cannot reasonably be performed; and (5) the chosen court decided not to hear the case.³⁷ Under Article 7, a non-chosen court is not precluded from granting “interim measures of protection,” such as injunctions, as such procedures fall outside of COCCA.³⁸

Not only does COCCA impose obligations relating to the procedural issues of jurisdiction and venue in chosen and non-chosen courts, but Article 3 also sets forth certain requirements on the formalities of choice of court agreements. Most significantly for United States practice, COCCA provides that courts are to presume that a selected forum is the exclusive forum for dispute resolution “unless the parties have expressly provided

34 COCCA, *supra* note 3, art. 5(2).

35 COCCA, *supra* note 3, art. 5(3)(b). Article 5(3) provides that choice of forum may not override rules on “internal allocation of jurisdiction among the courts.” *Id.* As a result, COCCA alone would not override existing state venue provisions that relate to forum selection clauses. *See id.* For example, in Texas, enforceability of forum selection clauses in commercial cases is subject to the Texas venue statute. TEX. CIV. PRAC. & REM. CODE ANN. § 15.020 (West 2009) (stating that under § 15.020, mandatory venue provisions may only be overcome by agreement of the parties in cases involving consideration equal to or above \$ 1 million, denoted as “major transactions”).

36 COCCA, *supra* note 3, art. 6.

37 *Id.* art. 6(a)-(e).

38 *See Id.* art. 7.

otherwise.”³⁹ This interpretative rule runs contrary to the general rule of construction used in United States courts.⁴⁰

Despite the procedural and interpretative rules embodied in COCCA, local substantive law on the enforceability of forum selection clauses remains unchanged. For example, Articles 5 and 6 specifically provide that the overall validity of the forum selection clause is to be determined under the law of the chosen court.⁴¹ If the choice of court agreement is void under the applicable law of the chosen court, none of the jurisdictional and procedural provisions apply and neither the chosen court nor the non-chosen court needs to consider the parties’ choice of forum in determining personal jurisdiction or *forum non conveniens*.⁴²

Part II: Enforcement of Forum Selection Clauses in the United States Under Existing Law

To understand how to implement COCCA’s provisions, it is necessary to also comprehend how forum selection clauses are enforced in the United States. In other unified legal systems, Articles 5 and 6 of COCCA provide a simple inquiry for courts: is the choice of court agreement valid under applicable law?⁴³ If so, then chosen courts must accept personal jurisdiction over the parties and deny motions to dismiss on *forum non conveniens* grounds. Non-chosen courts must suspend or dismiss the proceedings.⁴⁴ In the United States, however, this basic formula can become convoluted when applied in the dual system of federal and state

39 *Id.* art. 3(b).

40 *See* *IntraComm, Inc. v. Bajaj*, 492 F.3d 285, 290 (4th Cir. 2007) (“A general maxim in interpreting forum selection clauses is that ‘an agreement *conferring* jurisdiction in one forum will not be interpreted as *excluding* jurisdiction elsewhere unless it contains specific language of exclusion.’”).

41 *See* COCCA, *supra* note 3, arts. 5(1) & 6.

42 *Id.* art. 6. Under Article 6, a non-chosen court need not dismiss a case if it concludes that the forum selection clause would be void under the law of the chosen court. *Id.* art. 6(a). As set forth in Part III, if there is a uniform rule applicable in all cases in the United States, it would facilitate implementing Article 6 in other European countries that are parties to COCCA where a party might file an action in a non-chosen court. *See infra* Part III.

43 COCCA, *supra* note 3, arts. 5 & 6.

44 *Id.* art. 5(1)-(2).

courts. As former Chief Justice Rehnquist once wrote, “the idea of a federal judiciary sitting side by side with judiciaries in the 50 states, having concurrent jurisdiction over the same territory, is something of a rarity in the world.”⁴⁵

In the context of forum selection clause enforcement, the existence of concurrent jurisdiction in the United States has created a dichotomy in enforcement mechanisms available at the federal and state level. In federal courts, while forum selection clauses are generally valid under the Supreme Court’s formulation in *Bremen*, enforcement often turns on what procedural motions the defendant invokes to either defeat enforcement in a chosen court or to obtain dismissal or transfer in a non-chosen court.⁴⁶ These include motions to dismiss for lack of personal jurisdiction, *forum non conveniens*, improper venue, and lack of subject matter jurisdiction, and motions to transfer venue (where applicable).⁴⁷ Enforcement may also turn on the results of the complicated *Erie* choice of law analysis that courts use to determine whether federal or state law governs the enforceability of the choice of court agreement.⁴⁸

In state courts, similar issues arise in enforcing forum selection clauses, albeit under individual state rules of procedure. State courts may look to state statutes specifically pertaining to the enforceability of forum selection clauses against non-resident parties, especially state long-arm statutes that have specifically addressed this issue. State courts may also consider choice of law issues to determine the enforceability of a choice of

45 Chief Justice William H. Rehnquist, *Introduction*, in *THE FEDERAL APPELLATE JUDICIARY IN THE TWENTY FIRST CENTURY* 1, 12-13, (Cynthia Harrison and Russell R. Wheeler eds., 1989).

46 *M/S Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1, 15 (1972); Holt, *supra* note 16.

47 See *J.B. Harris, Inc. v. Razei Bar Indus., Ltd.*, 37 F. Supp. 2d 186, 188 (E.D.N.Y. 1998) (stating that different federal district courts have held various procedural motions to defeat a forum selection clause, but there is a lack of consensus on the issue); see also Holt, *supra* note 16, at 1922 (stating that courts with diversity jurisdiction are required to use 28 U.S.C. § 1404(a) when a defendant attempts to enforce a forum selection clause through transfer).

48 See, e.g., *Erie Railroad Co. v. Tompkins*, 304 U.S. 64, 78 (1938) (holding that “[e]xcept in matters governed by the Federal Constitution or by acts of Congress, the law to be applied in any case is the law of the state.”); *Hanna v. Plumer*, 380 U.S. 460, 468 (1965) (holding that the evaluation of the outcome-determinative nature of a state or federal procedural rule must be analyzed under the “twin aims” of the *Erie* rule: discouragement of forum-shopping and avoidance of inequitable administration of the laws).

court agreement.⁴⁹ Moreover, a defendant sued in a state chosen court may also seek removal to federal court if diversity or federal question jurisdiction exists.⁵⁰

1. Enforcement of Forum Selection Clauses in Federal Courts

At the federal level, the Supreme Court's decision in *Bremen* established a strong federal policy favoring enforcement of forum selection clauses in international commercial contracts.⁵¹ *Bremen* involved a foreign tow company that agreed to tow a rig from Louisiana to Italy according to a contract that contained a London forum selection clause.⁵² When the rig under tow was damaged in a storm, the owner brought an admiralty suit in federal district court in Florida, in contravention of the choice of court agreement.⁵³ The defendant moved to dismiss on the grounds of *forum non conveniens*, which the district court denied and the court of appeals affirmed.⁵⁴ The Supreme Court reversed, noting that:

[t]he expansion of American business and industry will hardly be encouraged if, notwithstanding solemn contracts, we insist on a parochial concept that all disputes must be resolved under our laws and in our courts We cannot have trade and

49 See, e.g., *Lease Finance Group v. Delphi, Inc.*, 266 Ga. App. 173, 174 n.1, 596 S.E.2d 691 (2004) (explaining that because forum selection clauses involve procedural and not substantive rights, the court must apply Georgia law to determine their enforceability notwithstanding a choice of law provision requiring that the laws of another State shall govern).

50 See 28 U.S.C. § 1441(b).

51 *Bremen*, 407 U.S. 1; George A. Davidson, *Jurisdiction Over Non-US Defendants*, in INTERNATIONAL COMMERCIAL LITIGATION, at 77 (PLI Commercial Law & Practice, Course Handbook Series No. A4-4539, 1998) (“[C]ourts appear particularly inclined to enforce forum selection clauses when the agreement is international in nature.”).

52 *Bremen*, 407 U.S. at 2-3.

53 *Id.* at 3-4.

54 *Id.* at 4.

commerce in world markets and international waters exclusively on our terms, governed by our laws, and resolved in our courts.⁵⁵

Under the *Bremen* standard, courts must enforce forum selection clauses unless the opposing party can “clearly show that enforcement would be unreasonable and unjust, or that the clause was invalid for such reasons as fraud or overreaching.”⁵⁶ Fraud can render a clause unenforceable only if the fraud relates directly to the choice of court clause.⁵⁷ As the Supreme Court stated in *Scherk v. Alberto-Culver Co.*⁵⁸:

[t]his qualification does not mean that any time a dispute arising out of a transaction is based upon an allegation of fraud . . . the clause is unenforceable. Rather, it means that an arbitration or forum-selection clause in a contract is not enforceable if the *inclusion of that clause in the contract was the product of fraud or coercion.*⁵⁹

The *Bremen* Court did not specify what factors would render a forum selection clause “unreasonable,” although the Court did find that a contractual choice of court clause should be held unenforceable if enforcement would contravene a strong public policy in the forum in which suit is brought.⁶⁰

Regarding the connection between the chosen forum and the parties to the dispute, the *Bremen* Court rejected the notion that any connection was required for a forum selection clause to be reasonable and enforceable. In the context of international business disputes, *Bremen* stressed that where

⁵⁵ *Id.* at 9; see also *Kawasaki Kisen Kaisha Ltd. v. Regal Beloit Corp.*, 130 S. Ct. 2433, 2448 (2010) (stating that forum selection clauses are indispensable in international trade, commerce and contracting).

⁵⁶ *Bremen*, 407 U.S. at 15.

⁵⁷ Davidson, *supra* note 51, at 77 (citing *Scherk v. Alberto-Culver Co.*, 417 U.S. 506, 519 n.14 (1974)). Cf. *Pearcy Marine v. Seacor Marine, Inc.*, 847 F. Supp. 57, 60 (S.D. Tex. 1993) (refusing to enforce a contractual forum selection clause providing for litigation in the High Court of Justice in London when the clause appeared to have been obtained by fraud or overreaching).

⁶⁰ 417 U.S. at 519 n.14.

⁵⁹ *Id.*

⁶⁰ *Id.* at 15.

the parties to a freely negotiated private international commercial agreement select a remote forum for resolution of their disputes, they clearly contemplate the claimed inconvenience at the time they enter into the contract; therefore, inconvenience alone will rarely render the forum selection clause unenforceable. Thus, the Supreme Court found in *Bremen*, and in its later decision in *Carnival Cruise Lines v. Shute*,⁶¹ that even where the choice of court agreement calls for litigation in a forum with no connection to the parties, or the dispute and litigation in the chosen court will be more costly and burdensome, the agreement may not be considered unreasonable or unenforceable on the grounds of the inconvenience of the location of the chosen forum.⁶²

In reaching this conclusion about geographic nexus, the *Bremen* Court dealt head-on with existing decisions in the lower courts, finding that a forum selection clause “may nevertheless be ‘unreasonable’ and unenforceable if the chosen forum is seriously inconvenient for the trial of the action.”⁶³ By approving the parties' choice of a neutral forum unconnected to the dispute itself, *Bremen* moved away from the notion of a “natural” or “appropriate” forum for international contract litigation.⁶⁴ As the Court stated:

We are not here dealing with an agreement between two Americans to resolve their essentially local disputes in a remote alien forum. In such a case, the serious inconvenience of the contractual forum to one or both of the parties might carry greater weight in determining the reasonableness of the forum clause. The remoteness of the

61 499 U.S. 585, 593-97 (1991) (holding that a forum selection clause was not unreasonable, and did not deny the individual plaintiffs their day in court, simply because they were Washington residents who purchased cruise tickets dictating a forum in Florida, even though the incident giving rise to the claim and the parties were not connected to Florida).

62 *Id.* at 594 (reasoning that “Florida is not a ‘remote alien forum,’ nor – given the fact that [respondent’s] accident occurred off the coast of Mexico is this dispute an essentially local one inherently more suited to resolution in the State of Washington than in Florida”).

63 *M/S Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1, 16 (1972).

64 *See* Buxbaum, *supra* note 1, at 194-95 (confirming the selection of a neutral forum unrelated to the parties and their transaction, despite any inconvenience resulting from litigation in a forum lacking such contacts, and finding that the question for reasonableness was whether the parties had a reason for selecting the neutral forum, such as London’s status as a center for maritime law).

forum might suggest that the agreement was an adhesive one, or that the parties did not have the particular controversy in mind when they made their agreement; yet even there the party claiming should bear a heavy burden of proof. Similarly, selection of a remote forum to apply differing foreign law to an essentially American controversy might contravene an important public policy of the forum. For example . . . it would quite arguably be improper to permit an American tower to avoid [United States law] by providing a foreign forum for resolution of his disputes with an American towee.⁶⁵

As a result, for a party to show that a selected forum is too remote and that the forum selection clause is unenforceable, the *Bremen* Court created a heavy burden of proof on the party seeking to avoid the chosen forum.⁶⁶ Although the *Bremen* decision dealt explicitly with the problem of non-chosen courts refusing to enforce agreements in admiralty cases,⁶⁷ *Bremen* has practical implications for all aspects of the enforcement of forum selection agreements in chosen and non-chosen courts, as well as enforcement in other federal question cases.⁶⁸

⁶⁵ *Bremen*, 407 U.S. at 17 (stating that even where the forum selection clause establishes a remote forum for resolution of conflicts, “the party claiming [unfairness] should bear a heavy burden of proof”).

⁶⁶ *Id.* at 18.

⁶⁷ *Id.* at 15.

⁶⁸ Michael Gruson, *Forum Selection Clauses in International and Interstate Commercial Agreements*, in INTERNATIONAL COMMERCIAL AGREEMENTS, at 87 (PLI Commercial Law and Practice, Course Handbook Series A4-4354, 1991) (“[F]ederal courts have universally agreed that the teaching of *Bremen* is not limited to admiralty cases nor to cases involving the selection of a foreign forum but applies to all forum selection clauses, even if they select a domestic forum and even if they arise in a suit between parties of different states.”); see also Davidson, *supra* note 51, at 75 (noting that although *Bremen* was an admiralty case, its holding has been applied in federal question cases). But see *Recent International Agreement*, *supra* note 19, at 935-36 (noting that current United States law on international forum selection clauses is “muddled” as the *Bremen* Court indicated that it intended its decision to apply to the federal courts only when they are exercising federal common law admiralty jurisdiction, yet later noted that the ruling might well be “instructive” in other circumstances); *TradeComet.com LLC v. Google, Inc.*, 647 F.3d 472, 476 (2d Cir. 2011) (“*Bremen*, therefore, did not create a narrow rule holding forum selection clauses to be *prima facie* valid solely in admiralty cases, or those involving international agreements, but rather approved of a pre-existing favorable view of such clauses.”).

Because *Bremen* involved federal question jurisdiction arising in admiralty, the Court did not clearly address whether the standard it announced was a substantive rule of decision applicable only in admiralty cases or a federal common law procedural doctrine. This ambiguity has led to disagreement among the federal circuit courts on the issue of what role the *Bremen* standard has in diversity cases filed in the federal courts.⁶⁹ If the *Bremen* rule is considered a federal procedural rule, a federal court hearing diversity cases would continue to apply the *Bremen* standard under the *Erie* doctrine, which provides that federal courts sitting in diversity apply state substantive law and federal procedural law.⁷⁰ The majority of circuits have concluded that the enforcement of a forum selection clause is a procedural matter affecting jurisdiction and venue, and thus the *Bremen* rule applies to determine the validity of such agreements.⁷¹ For example, the

69 Davidson, *supra* note 51, at 79; *see also* Carolyn A. Dubay, *Federal Court Enforcement of Forum Selection Clauses in Franchise Contracts*, 5 A.B.A. SEC. ANTITRUST L. FRANCHISE & DEALERSHIP COMMITTEE DISTRIBUTION 2 (2001) (noting that federal courts are split over whether the effect of a forum selection clause is a matter of federal procedural law or state substantive law); *Recent International Agreement*, *supra* note 19, at 935-36 (noting that the *Bremen* Court's lack of clarity raises distinct *Erie* questions over whether federal courts in diversity cases applying *Bremen* and ratification of COCCA would "finally lay to rest this uncertainty by requiring the recognition of international forum selection clauses in both state and federal cases").

70 *Hanna v. Plumer*, 380 U.S. 460, 465 (1965); *see also Klaxon Co. v. Stentor Elec. Mfg. Co.*, 313 U.S. 487, 496 (1941) (stating that a federal court applying state substantive law under the *Erie* doctrine must also follow state choice-of-law rules).

71 *See, e.g., Albemarle Corp. v. AstraZeneca UK Ltd.* 628 F.3d 643, 650 (4th Cir. 2010) (concluding that a federal court interpreting a forum selection clause must apply federal law because it waives venue of a federal court and implicates a procedural matter governed by federal law); *Fru-Con Constr. Corp. v. Controlled Air, Inc.*, 574 F.3d 527, 538 (8th Cir. 2009) ("[E]nforcement. . . of the contractual forum selection clause was a federal court procedural matter governed by federal law."); *Doe 1 v. AOL, LLC*, 552 F.3d 1077, 1083 (9th Cir. 2009) ("We apply federal law to the interpretation of the forum selection clause."); *Ginter ex. rel. Ballard v. Belcher, Prendergast & Laporte*, 536 F.3d 439, 441 (5th Cir. 2008) ("We begin with federal law, not state law, to determine the enforceability of a forum-selection clause."); *Phillips v. Audio Active Ltd.*, 494 F.3d 378, 384 (2d Cir. 2007) ("The rule set out in *M/S Bremen* applies to the question of enforceability of an apparently governing forum selection clause, irrespective of whether a claim arises under federal or state law."); *P & S Bus. Machs. v. Canon USA, Inc.*, 331 F.3d 804, 807 (11th Cir. 2003) ("Consideration of whether to enforce a forum selection clause in diversity jurisdiction cases is governed by federal law. . ."); *Jumara v. State Farm Ins. Co.*, 55 F.3d 873, 877 (3d Cir. 1995) ("The effect to be given a contractual forum selection clause in diversity cases is determined by federal not state law.").

Sixth Circuit in *Wong v. PartyGaming Ltd.*⁷² enforced an outbound forum selection clause after applying the federal *Bremen* standard, even though state law would provide the rule of decision as to the substantive contract claims.⁷³ In reaching this decision, the Sixth Circuit expressed concern that “recent state cases reveal the possible emergence of differences in how state and federal law treat the enforcement of forum selection clauses.”⁷⁴ Given the possibility of diverging state and federal law, the risk of inconsistent decisions in diversity cases, and the strong federal interest in procedural matters in federal court, the Sixth Circuit adopted the majority rule that questions of enforceability of forum selection clauses in diversity cases would be governed by federal law.⁷⁵ Nonetheless, several circuits have held that the enforceability of a forum selection clause in diversity cases turns on the law that governs the contract as a whole, whether through a choice of law clause in the agreement or according to state choice of law rules.⁷⁶

To further confuse the determination of what law applies to the enforceability of forum selection clauses in diversity cases, the procedural posture of the issue may be outcome determinative. As set forth below, the analysis of the forum selection clause depends on whether a party invokes *forum non conveniens*, moves to transfer a federal case under the federal venue statute, or moves to dismiss on the basis of lack of personal jurisdiction.

With respect to the existence and the use of the *forum non conveniens* doctrine in the context of forum selection clause enforcement,

72 589 F.3d 821, 825 (6th Cir. 2009) (explaining that the plaintiffs brought suit against a Gibraltar-based corporation in a district court in Ohio in violation of the forum selection clause designating Gibraltar courts for the resolution of any disputes).

73 *Id.* at 826.

74 *Id.* at 826-27.

75 *Id.* at 827.

76 *See, e.g.,* *Abbott Labs. v. Takeda Pharms. Co.*, 476 F.3d 421, 423 (7th Cir. 2007) (“Simplicity argues for determining the validity . . . of a forum selection clause . . . by reference to the law of the jurisdiction whose law governs the rest of the contract”); *Yavuz v. 61 MM, Ltd.*, 465 F.3d 418, 428 (10th Cir. 2006) (“We see no particular reason . . . why a forum-selection clause . . . should be singled out as a provision not to be interpreted in accordance with the law chosen by the contracting parties”). *But see* *Rivera v. Centro Medico de Turabo, Inc.*, 575 F.3d 10, 16 (1st Cir. 2009) (citing *Lambert v. Kysar*, 983 F.2d 1110, 1116 (1st Cir. 1993)) (“[W]e need not reach the unsettled issue of whether ‘forum selection clauses are treated as substantive or procedural for Erie purposes.’”).

the law remains muddled.⁷⁷ Absent a forum selection clause, the Supreme Court has long recognized the power of federal courts to decline to assume jurisdiction over disputes between foreign parties with no connection to the United States. In *Belgenland v. Jensen*,⁷⁸ Justice Bradley remarked that the question of “whether, and in what cases, the courts of one country should take cognizance of controversies arising in a foreign country, or in places outside of the jurisdiction of any country. . . is not a new one.”⁷⁹ It was not until 1947, however, that the Supreme Court formally recognized the inherent power of courts to dismiss a case pursuant to *forum non conveniens* in *Gulf Oil Corp. v. Gilbert*.⁸⁰

Gulf Oil sets out a number of private and public interests courts should consider in determining whether to decline to exercise jurisdiction in favor of another, more suitable forum abroad.⁸¹ In assessing the private interests at stake, the court “will weigh relative advantages and obstacles to fair trial.”⁸² This may depend on access to evidence, the availability of compulsory process for attendance of unwilling witnesses, the cost of obtaining willing witnesses, the enforceability of a judgment once obtained, and “all other practical problems that make trial of a case easy, expeditious and inexpensive.”⁸³ Courts may also consider the impact on the public of trying a case with no connection to the forum, including administrative difficulties, jury duty imposed in a community that has no relation to the litigation, and the difficulties attendant in applying foreign law.⁸⁴

⁷⁷ See generally RONALD BRAND & SCOTT JABLONSKI, FORUM NON CONVENIENS: HISTORY, GLOBAL PRACTICE, AND FUTURE UNDER THE HAGUE CONVENTION ON CHOICE OF COURT AGREEMENTS 66 (Oxford University Press 2007); Buxbaum, *supra* note 1, at 185, 188 (stating that although a clear trend in commercial litigation is to enforce the parties’ forum selection agreement, cases reflect substantial confusion in addressing the intersection between *forum non conveniens* doctrine and the law on enforcement of forum selection clauses).

⁷⁸ 114 U.S. 355 (1885).

⁷⁹ *Id.* at 361-62.

⁸⁰ 330 U.S. 501, 512 (1947).

⁸¹ See *id.*

⁸² *Id.* at 508.

⁸³ *Id.*

⁸⁴ *Id.* at 508-09.

When analyzing a forum selection clause, however, the continued use of the *forum non conveniens* doctrine in federal courts is limited. For example, federal courts applying the *Bremen* reasonableness standard to determine the validity of a choice of court agreement have rejected the continued use of *forum non conveniens*, finding that the reasonableness standard subsumes the *forum non conveniens* considerations.⁸⁵ In this regard, the *Bremen* standard may be considered a reformulation of the *forum non conveniens* analysis when an international choice of forum clause is at issue. At the federal level, therefore, implementing COCCA's mandate to eliminate *forum non conveniens* in circumstances where a valid forum selection clause exists may be straightforward given its limited application. Importantly, however, eliminating *forum non conveniens* will not prevent federal courts from considering the interest analysis as it is incorporated into the *Bremen* analysis of the overall validity of the forum selection clause. As will be discussed in Part IV of this article, COCCA's implementing legislation must address what role if any *Bremen* will continue to have in the enforcement of forum selection clauses in the federal courts.

The doctrine of *forum non conveniens* is further limited in the forum selection clause context because federal courts may only invoke the doctrine when the more appropriate forum is abroad.⁸⁶ When the more appropriate forum is in another district within the United States, federal courts are

⁸⁵ See, e.g., *Pelleport Investors, Inc. v. Budco Quality Theatres, Inc.*, 741 F.2d 273, 280 (9th Cir. 1984) (rejecting use of the "balancing of convenience test" in the *forum non conveniens* doctrine and holding, "[t]o establish unreasonableness of a forum selection clause the party resisting enforcement of the clause has a heavy burden of showing that trial in the chosen forum would be so difficult and inconvenient that the party effectively would be denied a meaningful day in court"); see also *Aguas Lenders Recovery Group v. Suez, S.A.*, 585 F.3d 696, 700 (2d Cir. 2009) (holding that where a forum selection clause exists, *Bremen* displaced the traditional *forum non conveniens* analysis, which only applies in the absence of a forum selection clause). Importantly, this rule only applies to exclusive choice of court agreements. Where the forum selection clause is merely permissive, and not mandatory, federal courts continue to apply *forum non conveniens* analysis. See, e.g., *Evolution Online Sys., Inc. v. Koninklijke PTT Nederland N.V.*, 145 F.3d 505, 509-10 (2d Cir. 1998).

⁸⁶ See *Am. Dredging Co. v. Miller*, 510 U.S. 443, 449 n.2 (1994) (holding that Congress codified the doctrine of *forum non conveniens* in domestic cases and has provided for transfer, rather than dismissal, when a sister federal court is the more convenient place for trial of the action).

guided by 28 U.S.C. § 1404(a),⁸⁷ which codified the *forum non conveniens* interest analysis for domestic purposes.⁸⁸ The impact of the distinction between § 1404(a) and *forum non conveniens* under COCCA is apparent when examining the Supreme Court's decision in *Stewart Organization, Inc. v. Ricoh Corp.*⁸⁹

In *Ricoh*, the Supreme Court held that when a defendant invokes § 1404(a) to enforce a forum selection clause through transfer to a chosen court within the federal system, the federal common law rule established in *Bremen* does not apply.⁹⁰ *Ricoh* involved a contract dispute between a dealer located in Alabama and a manufacturer located in New Jersey who were subject to a choice of court agreement calling for dispute resolution in New York.⁹¹ After the plaintiff filed suit in federal district court in Alabama, the district court refused to grant a motion to transfer to the chosen district court under 28 U.S.C. § 1404(a), finding that the forum selection clause was invalid under Alabama law.⁹² The Eleventh Circuit reversed, finding that the district court should have applied the *Bremen* standard and determined the reasonableness of the forum selection clause for enforcement purposes.⁹³

The Supreme Court in *Ricoh* disagreed with both the district court and the Eleventh Circuit, finding that neither Alabama law nor the *Bremen* standard applied. Instead, the Court concluded that the district court should have considered whether the interests of justice required the transfer as the relevant standard under § 1404(a).⁹⁴ Rather than granting a forum selection clause dispositive weight using the *Bremen* standard, the Court in *Ricoh*

87 See 28 U.S.C. § 1404(a) (“For the convenience of parties and witnesses, in the interest of justice, a district court may transfer any civil action to any other district or division where it might have been brought.”).

88 See *Miller*, 510 U.S. at 449 n.2.

89 487 U.S. 22 (1988).

90 *Id.* at 28-29.

91 *Id.* at 24.

92 *Id.* It is worth noting that the Supreme Court later ruled in *Miller* that § 1404(a) codified domestic application of the *forum non conveniens* doctrine. *Miller*, 510 U.S. 443.

93 *Ricoh*, 487 U.S. at 28.

94 *Id.* at 29.

held that the presence of such a clause is only a “significant factor that figures centrally in the district court's calculus.”⁹⁵ However, § 1404(a) requires a district court to consider not only the parties' private agreement but also to weigh “the convenience of the witnesses and those public-interest factors of systemic integrity and fairness that, in addition to private concerns, come under the heading of ‘the interest of justice.’”⁹⁶ Since *Ricoh*, at least one district court has permitted § 1404(a) to be used defensively to defeat enforcement of a valid forum selection clause in a chosen court based on the interests of justice apart from the convenience of the parties.⁹⁷

In addition to deciding whether the *Bremen* standard or another federal procedural statute, such as § 1404(a), applies to *forum non conveniens* defenses, courts must also determine motions to dismiss for lack of personal jurisdiction. The issue of personal jurisdiction over the defendant may have an impact on the enforceability of a forum selection clause in federal courts, especially in diversity cases. In determining personal jurisdiction, federal courts sitting in diversity must look to state long-arm statutes to determine whether personal jurisdiction is

⁹⁵ *Id.*

⁹⁶ *Id.* at 30.

⁹⁷ See *FUL Inc. v. Unified Sch. Dist. No. 204*, 839 F. Supp. 1307, 1313-14 (N.D. Ill. 1993) (finding that even though parties chose Illinois courts in a forum selection clause, § 1404(a) permitted transfer to another district that would be more convenient).

appropriate.⁹⁸ As the Seventh Circuit found in *IFC Credit Corp. v. Aliano Bros. General Contractors, Inc.*,⁹⁹ when

the issue is not the convenience of the forum selected by the plaintiff but whether the forum has personal jurisdiction over the defendant by virtue of a forum selection clause, application of federal law would collide with the countless decisions that hold that in a diversity case a federal court has personal jurisdiction over a defendant 'only if a court of the state in which [the federal court] sits would have jurisdiction.'¹⁰⁰

As will be discussed in more detail in this article, state long-arm statutes pose special challenges to enforcing forum selection clauses. Most states allow the exercise of personal jurisdiction over defendants to the same extent as permitted under federal constitutional analysis, and, thus, state long-arm statutes would pose no threat to the enforcement of a forum selection clause on personal jurisdiction grounds. However, where a state long-arm statute limits personal jurisdiction to a greater extent than the Constitution, this may prove problematic for the implementation of COCCA in federal courts. For example, in *Alexander Proudfoot Co. v. Thayer*,¹⁰¹ the Eleventh Circuit held that when the sole basis for personal jurisdiction over a party in a diversity case is a forum selection clause, the federal court

98 See *J. McIntyre Mach., Ltd. v. Nicastro*, 131 S. Ct. 2780, 2789 (2011) ("For jurisdiction, a litigant may have the requisite relationship with the United States Government but not with the government of any individual State. That would be an exceptional case, however."); see also *Intera Corp. v. Henderson*, 428 F.3d 605, 615 (6th Cir. 2005) (stating that in diversity actions, federal courts apply state law to determine questions of personal jurisdiction). Federal and state courts hearing federal claims may reach beyond state provisions and exercise personal jurisdiction over defendants found anywhere in the United States or the world pursuant to various statutory service of process provisions. See, e.g., Merle H. Weiner, *Half-Truths, Mistakes, and Embarrassments: The United States Goes to the Fifth Meeting of the Special Commission to Review the Operation of The Hague Convention on the Civil Aspects of International Child Abduction*, 2008 UTAH L. REV. 221, 240 (2008) (asserting that in an action based on a federal statute, Congress can subject a defendant to service of process that extends beyond the traditional reach of a court where it has authorized nationwide or worldwide service of process, such as under the False Claims Act, 31 U.S.C. § 3732; the Securities Exchange Act of 1934, 15 U.S.C. §§ 77aa, 78aa; and § 12 of the Clayton Act, 15 U.S.C. § 22).
99 437 F.3d 606 (7th Cir. 2006).

100 *Id.* at 609.

101 877 F.2d 912 (11th Cir. 1989).

must consider state long-arm provisions that limit the enforceability of forum selection clauses against non-resident defendants.¹⁰² Similarly, in *Preferred Capital, Inc. v. Sarasota Kennel Club*,¹⁰³ the Sixth Circuit held that state law controls the enforceability of a forum selection clause when the clause is the sole basis for personal jurisdiction over the defendant.¹⁰⁴

Notwithstanding state long-arm statutes applied in federal diversity cases, federal and state courts must also determine whether the exercise of jurisdiction over a non-resident defendant satisfies federal constitutional norms. In the federal context, personal jurisdiction is determined according to the “minimum contacts test” set forth in *International Shoe Co. v. Washington*¹⁰⁵ and its progeny.¹⁰⁶ In a traditional due process analysis of personal jurisdiction, inconvenience to a foreign defendant is of central importance.¹⁰⁷ The Supreme Court’s decision in *Asahi Metal Indus. Co. v.*

102 See, e.g., *id.* at 919 (holding that state law governs if forum selection clauses confer personal jurisdiction because state long-arm standards govern issues of personal jurisdiction in the federal courts); *Gen. Eng’g Corp. v. Martin Marietta Alumina, Inc.*, 783 F.2d 352, 357 (3d Cir. 1986) (holding that when a forum selection clause confers personal jurisdiction because of long arm standards, state law governs).

103 489 F.3d 303 (6th Cir. 2007).

104 *Id.* at 305-06. See also *Ahern v. Pac. Gulf Marine, Inc.*, No. 8:06-CV-2068-T-27MSS, 2008 WL 706501, at *5-6 (M.D. Fla. 2008) (ruling that in a personal jurisdiction analysis, federal courts are required to construe a long-arm statute according to the Florida Supreme Court, which has “unequivocally held that a [permissive rather than mandatory] forum selection clause is insufficient to confer personal jurisdiction over a non-resident defendant under the long-arm statute, absent an independent basis for jurisdiction under the Florida long-arm statute”).

105 326 U.S. 310 (1945).

106 *Id.* at 316 (holding that due process requirements are satisfied when in personam jurisdiction is asserted over a nonresident corporate defendant that has “certain minimum contacts with [the forum] such that the maintenance of the suit does not offend ‘traditional notions of fair play and substantial justice’”). See also *Goodyear Dunlop Tires Operations, S.A. v. Brown*, 131 S. Ct. 2846, 2853 (2011) (“The Due Process Clause of the Fourteenth Amendment sets the outer boundaries of a state tribunal’s authority to proceed against a defendant.”); *Helicopteros Nacionales de Colombia, S.A. v. Hall*, 466 U.S. 408, 413-14 (1984) (“The Due Process Clause of the Fourteenth Amendment operates to limit the power of a State to assert in personam jurisdiction over a nonresident defendant.” (citing *Pennoyer v. Neff*, 95 U.S. 714 (1878))).

107 A. Benjamin Spencer, *Jurisdiction to Adjudicate: A Revised Analysis*, 73 U. CHI. L. REV. 617, 627 (2006) (noting that the Supreme Court has clearly made inconvenience to defendants a “central concern of the Due Process Clause within the doctrine of personal

*Superior Court*¹⁰⁸ makes clear that the minimum contacts test is not satisfied in commercial disputes between two foreign entities where the dispute has no reasonable relationship to the United States, especially given the “unique burdens” on a non-United States defendant in defending itself in a foreign legal system.¹⁰⁹ However, in *Burger King Corp. v. Rudzewicz*,¹¹⁰ the Supreme Court recognized that when a defendant has agreed in a contractual forum selection clause to be subject to personal jurisdiction in a particular court, that court’s concern about inconvenience to the defendant is minimized.¹¹¹ As explained by the Supreme Court in

jurisdiction” based on the Supreme Court’s reasonableness requirement in considering “the burden on the defendant”).

108 480 U.S. 102 (1987).

109 *Id.* at 114-15 (concluding that a state court’s exercise of personal jurisdiction over a Japanese manufacturer in a dispute with a Taiwanese plaintiff was unreasonable). The Supreme Court found that an unreasonable burden would be imposed on the Japanese manufacturer as it would be required not only to travel to California to defend itself, but would also have to submit its dispute to California’s judicial system, which had little interest in the case. *Id.*

110 471 U.S. 462 (1985).

111 *Id.* at 472 n.14 (stating that because the personal jurisdiction requirement is a waivable right, there are a “variety of legal arrangements” by which a litigant may give “express or implied consent to the personal jurisdiction of the court,” including in the commercial context where the parties have entered into a freely negotiated forum selection agreement that meets the *Bremen* test). *See also* *Jacobsen Constr. Co. v. Teton Builders*, 106 P.3d 719, 728 (Utah 2005) (holding that “forum selection clauses need not make specific mention of a consent to jurisdiction when the language of the clause makes the parties’ intention to resolve disputes in a particular forum evident”); *Kennecorp Mortg. Brokers, Inc. v. Country Club Convalescent Hosp., Inc.*, 610 N.E.2d 987, 988-89 (Ohio 1993) (“In our view, however, a minimum-contacts analysis as set forth in *International Shoe Co. v. Washington* and its progeny, is not appropriate in determining the validity of forum selection clauses in commercial contracts.”); *Int’l Collection Serv., Inc. v. Gibbs*, 510 A.2d 1325 (Vt. 1986).

“By entering into a contract containing a forum selection clause, the defendant [a field representative located in Wisconsin] expressly waived any claim of lack of jurisdiction over his person in Vermont. A due process analysis of other minimum contacts between the [field representative] and the chosen forum is unnecessary as long as the forum selection clause is enforceable.” *Gibbs*, 510 A.2d at 1325.

See also *United States Trust Co. v. Bohart*, 495 A.2d 1034, 1039-40 (Conn. 1985) (rejecting the argument that the due process rights of the nonresident defendants would be violated if suit in Connecticut were permitted based on a forum selection clause). *But see* *Burger King*, 474 U.S. at 482 (“Nothing in our cases, however, suggests that a choice-of-law provision should be ignored in considering whether a defendant has ‘purposefully

Ruhrgas AG v. Marathon Oil Co.,¹¹² personal jurisdiction “represents a restriction on judicial power . . . as a matter of individual liberty” and “a party may insist that the limitation be observed, or he may forgo that right, effectively consenting to the court’s exercise of adjudicatory authority.”¹¹³ In the vast majority of federal cases, therefore, personal jurisdiction is rarely an obstacle to forum selection clause enforcement because the defendant has expressly or impliedly consented to personal jurisdiction in the chosen court.¹¹⁴

As *Bremen*, *Ricoh*, and the personal jurisdiction case law demonstrate, COCCA’s simple provision that the validity of the choice of court agreement is to be determined by the law of the chosen court requires an extremely complicated inquiry under United States law. Choice of court enforcement in the United States depends on whether the cause of action arises under federal or state law, as well as the procedural posture of the court in determining the issue. Furthermore, federal enforcement of forum selection clauses turns on whether the federal court is exercising its subject matter jurisdiction on the basis of a federal question or diversity among the parties. As remarked by the Sixth Circuit in *Preferred Capital, Inc.*, “[w]hen deciding to apply federal or state law to a forum selection clause, the context in which the clause is asserted can be determinative.”¹¹⁵

2. State Court Enforcement of Forum Selection Clauses

When enforcing forum selection clauses in state courts, many of the same complex issues of choice of law and personal jurisdiction are also apparent. As a substantive matter, most state courts have either adopted the

invoked the benefits and protections of a State’s laws’ for jurisdictional purposes . . . [a]lthough such a provision standing alone would be insufficient to confer jurisdiction.”).

112 526 U.S. 574 (1999).

113 *Id.* at 586 (citation omitted).

114 *Cf. J. McIntyre Mach., Ltd. v. Nicastro* 131 S. Ct. 2780, 2787 (2011) (“A person may submit to a State’s authority in a number of ways. There is, of course, explicit consent.”).

115 *Preferred Capital, Inc. v. Sarasota Kennel Club*, 489 F.3d 303, 306 (6th Cir. 2007) (stating that when a party moves to transfer a case on the basis of a forum selection clause, the federal statute governing transfer motions controls the clause’s interpretation rather than delving into if “‘the sticky question of which law, state or federal,’ should govern the interpretation of forum selection clauses in diversity cases” (citing *Stewart Org., Inc. v. Ricoh Corp.*, 487 U.S. 22, 29-30 (1988))).

Bremen reasonableness standard or follow something akin to it.¹¹⁶ In most state trial courts, therefore, an exclusive forum selection clause will be enforced unless the party opposing enforcement clearly shows that: (1) the clause is invalid for reasons of fraud or overreaching; (2) enforcement would be unreasonable or unjust; (3) enforcement would contravene a strong public policy of the forum where the suit was brought; or (4) the selected forum would be so seriously inconvenient for trial as to render the proceedings unfair.¹¹⁷

Some state courts have also looked to additional factors to determine whether a clause is unreasonable, such as: (1) which state law governs the

116 Gruson, *supra* note 68, at 87-88 n.59 (listing a number of states that have expressly adopted *Bremen*, citing, for example, *Kysar v. Lambert*, 76 Wash. App. 470, 484, 887 P.2d 431, 440 (1995), *review denied*, 126 Wash. 2d 1019, 894 P.2d 564 (1995); *Tandy Computer Leasing v. Terina's Pizza Inc.*, 105 Nev. 841, 784 P.2d 7, 8 (1989); *Abadou v. Trad*, 624 P.2d 287 (Alaska 1981); *Societe Jean Nicolas et Fils, J.B. v. Mousseux*, 123 Ariz. 59, 597 P.2d 541 (1979); *Hi Fashion Wigs Profit Sharing Trust v. Hamilton Inv. Trust*, 579 S.W.2d 300 (Tex. Civ. App. 1979); *Elia Corp. v. Paul N. Howard Co.*, 391 A.2d 214 (Del. Super. Ct. 1978); *Green v. Clinic Masters, Inc.*, 272 N.W.2d 813 (S.D. 1978); *Smith, Valentino & Smith, Inc. v. Superior Court*, 17 Cal. 3d 491, 551 P.2d 1206, 131 Cal. Rptr. 374 (1976)). *See, e.g., Kennecorp, supra* note 113, at 989 (“[I]n the light of present-day commercial realities, it has been stated that a forum selection clause in a commercial contract should control, absent a strong showing that it should be set aside.” (citing 407 U.S. at 15)); *Preferred Capital, Inc. v. Power Eng’g Group, Inc.* 112 Ohio St. 3d 429, 860 N.E.2d 741 (Ohio 2007) (noting that in *Kennecorp*, Ohio adopted a three-pronged test, “similar to the test in *Bremen*, to determine the validity of a forum-selection clause: (1) Are both parties to the contract commercial entities? (2) Is there evidence of fraud or overreaching? (3) Would enforcement of the clause be unreasonable and unjust?”).

117 *See, e.g., O'Neill Farms, Inc. v. Reinert*, 780 N.W.2d 55, 58, 61 (S.D. 2010) (stating that forum-selection clauses are “prima facie valid and should be enforced unless enforcement is shown by the resisting party to be ‘unreasonable’ under the circumstances,” and finding that the clause was invalid for such reasons as fraud or overreaching or if enforcement would contravene a strong public policy of the forum in which it is brought); *In re Int'l Profit Assocs., Inc.*, 274 S.W.3d 672, 675 (Tex. 2009) (citing *Bremen*); *Reiner, Reiner & Bendett, P.C. v. Cadle Co.*, 278 Conn. 92, 101-02 n.8, 897 A.2d 58 (2006) (revealing that the Connecticut Supreme Court has adopted the holding of the United States Supreme Court, that forum selection clauses are valid, unless the party seeking to preclude enforcement can meet the heavy burden of showing that its enforcement would be unreasonable, unfair, or unjust); *In re AIU Ins. Co.*, 148 S.W.3d 109, 111-13 (Tex. 2004) (adopting the legal standard from *Bremen*); *SR Bus. Servs. Inc. v. Bryant*, 267 Ga. App. 591, 592, 600 S.E.2d 610 (2004) (adopting the United States Supreme Court’s ruling in *Bremen*); *Manrique v. Fabbri*, 493 So. 2d 437, 440 (Fla. 1986) (adopting the three-pronged test announced by the United States Supreme Court in *Bremen*); *Crowson v. Sealaska Corp.*, 705 P.2d 905 (Alaska 1985) (noting that *Volkswagenwerk v. Klippan*, 611 P.2d 498, 503 (Alaska 1980) (rejected that the common law rule that forum selection clauses are *per se* invalid and adopted in its place the reasonableness approach set out in *Bremen*)).

contract; (2) the residence of the parties and witnesses; (3) the place of execution and/or performance of the contract; and (4) the availability of remedies in the selected forum.¹¹⁸ These factors differ somewhat from the federal standard, which does not consider “[a] difference in the nature of the proceedings and remedies sufficient to void a choice of forum provision.”¹¹⁹

The key distinction between *Bremen* and most state law reasonableness tests is the importance of a connection to the chosen forum. *Bremen* makes clear that, short of a litigant being deprived of a fair trial, the inconvenience of the chosen forum standing alone does not render a forum selection clause unreasonable in the international commercial context.¹²⁰ However, inconvenience may be an influential factor in state court forum selection decisions that purport to apply the *Bremen* standard.

For purposes of COCCA implementation, it is important to note that only a small handful of states continue to find forum selection clauses invalid as a matter of public policy, and usually only in certain limited circumstances.¹²¹ For example, several states have adopted anti-waiver statutes that prevent certain state statutory claims from being litigated outside the state, regardless of the existence of a forum selection clause. Courts in Idaho¹²² and Montana¹²³ have ruled that outbound forum selection

118 Gruson, *supra* note 68, at 121-22 (noting that several diversity cases, although purporting to follow *Bremen*, specify additional factors to the ones proposed by *Bremen*, that must be considered in determining whether a forum-selection clause is reasonable). These additional factors are: (1) the law which governs the formation and construction of the contract; (2) the residence of the parties; (3) the place of execution and/or performance of the contract; (4) the location of the parties and witnesses likely to be involved in the litigation; (5) availability of remedies in the chosen forum; and (6) conduct of the parties. *Id.* See, e.g., *Carefree Vacations, Inc. v. Brunner*, 615 F.Supp. 211, 214 (D. Tenn. 1985).

119 Davidson, *supra* note 51, at 77 (citing *Interamerican Trade Corp. v. Companhia Fabricadora De Pecas*, 973 F.2d 487, 489 (6th Cir. 1992)) (holding the forum selection clause providing for Brazil as the enforceable forum valid, even though the nature of Brazilian proceedings and remedies were different from those in the United States).

120 *M/S Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1, 16-17 (1972).

121 See Davidson, *supra* note 51, at 80 (citing *Davenport Mach. & Foundry Co. v. Adolph Coors Co.*, 314 N.W.2d 432, 437 (Iowa 1982); *Mont. ex rel. Polaris Indus. v. Dist. Court of the Thirteenth Judicial Dist.*, 695 P.2d 471, 472 (Mont. 1985)).

122 *Cerami-Kote, Inc. v. Energywave Corp.*, 116 Idaho 56, 59-60, 773 P.2d 1143, 1146-47 (1989).

123 *State ex rel. Polaris Indus., Inc. v. Dist. Court*, 215 Mont. 110, 111, 695 P.2d 471, 472 (1985).

clauses cannot deprive state residents of a local forum where state statutory law provides for judicial resolution of certain claims. In both states, the courts held that it would violate public policy to allow a state anti-waiver statute to be trumped by private contractual agreements.¹²⁴ Furthermore, in some states, an outbound forum selection clause is not enforceable *per se*, but the courts will consider the existence of such a clause on a motion to dismiss on the grounds of *forum non conveniens*.¹²⁵

The more significant hurdle to implementing COCCA in state courts is the existence of state statutes, including long-arm statutes, designed to prevent foreign cases lacking a connection to the state from usurping limited public resources of local court systems. As a result, although federal constitutional concerns do not prevent implementation of COCCA's personal jurisdiction mandate, state legislatures are free to restrict the reach of their courts through statute.¹²⁶ Generally, states control personal jurisdiction through long-arm statutes that either extend personal

124 See *Cerami-Kote*, 773 P.2d 1143, 1146 (1989) (finding that Idaho's anti-waiver statute expresses a strong public policy against the enforcement of foreign selection clauses that would require litigation outside of Idaho, for certain claims arising there, referring to *Polaris Industries*, 695 P.2d at 472, which interpreted a statute virtually identical to I.C. § 29-110, to void a forum selection clause in a contract which mandated an out-of-state forum; see also *Rose v. Etling*, 255 Or. 395, 399-400, 467 P.2d 633, 635 (1970) (ruling that a specific statute providing for protection of the usual remedies granted to the buyer by statute under a retail installment sales contract operated to void a venue selection clause included in the retail installment sales contract of the seller); *Morris v. Towers Fin. Corp.*, 916 P.2d 678, 679 (Colo. App. 1996) (finding that a contract's forum selection clause should be held unenforceable, if its enforcement would contravene a strong public policy of the forum in which suit is brought, whether declared by statute or by judicial decision, such as in the Colorado Wage Claim Act (CWCA), which provides that any employee aggrieved under that act may file a civil action in "any court having jurisdiction over the parties.").

125 *Davenport Mach. & Foundry Co. v. Adolph Coors Co.*, 314 N.W.2d at 437.

"We hold that clauses purporting to deprive Iowa courts of jurisdiction they would otherwise have, are not legally binding in Iowa. We further hold, however, that under a motion to dismiss an Iowa action without prejudice on the ground of *forum nonconveniens* such a clause, if otherwise fair, will be given consideration along with the other factors presented, in determining whether the Iowa court should decline to entertain the suit." *Id.*

126 See *Helicopteros Nacionales de Colombia, S.A. v. Hall*, 466 U.S. 408, 413-14 (1984); see also Douglas D. MacFarland, *Dictum Run Wild: How Long-Arm Statutes Extended to the Limits of Due Process*, 84 B.U. L. REV. 491, 493-95 (2004) (describing how in the post-*International Shoe* years, state legislatures codified rules in order to assert jurisdiction over non-resident defendants, in specific, limited situations, with the first comprehensive long-arm statute adopted in Illinois in 1955).

jurisdiction to the limits of due process,¹²⁷ limit personal jurisdiction to specific acts connected with the state,¹²⁸ or create “hybrid” schemes that include specifically enumerated acts and a due process “catch all provision” to govern personal jurisdiction questions.¹²⁹

Under state law, whether personal jurisdiction exists over non-resident parties to a forum selection clause when there is no other connection to the chosen state may depend on a number of factors. Rather than determine personal jurisdiction as a procedural issue, some courts may merge the question of personal jurisdiction into the overall assessment of the reasonableness and validity of the forum selection clause. For example, the Supreme Court of South Dakota recently ruled that the validity of a forum selection clause depended on a reasonable connection to the state, which simultaneously resolved the issue of personal jurisdiction because a valid clause amounted to consent to personal jurisdiction in the state.¹³⁰ The court was particularly persuaded by the fact that the contract at issue was entered into with a South Dakota corporation, making the designation of South Dakota as the chosen court reasonable and thus sufficient to confer personal jurisdiction.¹³¹

In other states, specific statutory provisions govern whether the court may exercise personal jurisdiction over non-resident defendants on the exclusive basis of a forum selection clause. Some of these statutes apply with no limitations on the amount in controversy and do not require a

127 See, e.g., ARIZ. REV. STAT. ANN. § 21-307(a) (1939); ARK. CODE ANN. § 16-4-101 (West 2011); CAL. CIV. PROC. CODE § 410.10 (West 2004); Nev. Rev. Stat. Ann. § 14.065 (West 2011).

128 See, e.g., COLO. REV. ST. § 13-1-124 (2005); CONN. GEN. STAT. § 52-59b (2004); DEL. CODE ANN. TIT. 10, § 3104 (2008); FLA. STAT. § 48.193 (1995); GA. CODE ANN. § 9-10-91 (West 2011); MD. CODE ANN. CTS. & JUD. PROC. § 6-103 (West 2000); MICH. COMP. LAWS § 600.705 (West 2011); N.H. REV. STAT. ANN. § 510:4 (2011); N.Y. C.P.L.R. § 302 (McKinney 2008); TEX. CIV. PRAC. & REM. CODE ANN. § 17.042 (Vernon 2011).

129 See MacFarland, *supra* note 126, at 497.

130 See O'Neill Farms, Inc. v. Reinert, 780 N.W.2d 55, 62 (S.D. 2010).

131 See *id.* at 61; see also LucidRisk, LLC v. Ogden, 615 F. Supp. 2d 1, 5-6 (D. Conn. 2009) (stating that under Connecticut law, “[a] party to a contract may voluntarily submit to the exercise of personal jurisdiction by agreeing to a contract’s forum selection provisions”); Solae, LLC v. Hershey Can., Inc., 557 F. Supp. 2d 452, 456 (D. Del. 2008) (stating that under Delaware law, “[w]hen [a] party is bound by a forum selection clause, [the] party is considered to have expressly consented to personal jurisdiction”).

geographic connection to the state. Under Michigan law, for example, state courts have general personal jurisdiction over foreign corporations that consent to Michigan jurisdiction through a forum selection clause that meets certain statutory requirements.¹³² Under Michigan's version of the Model Choice of Forum Act, courts "shall entertain the action" where the forum selection agreement provides the only basis for the exercise of personal jurisdiction so long as: (1) the court has subject matter jurisdiction; (2) Michigan is a "reasonably convenient place for the trial of the action;" (3) the forum selection agreement was not induced through fraud or "other unconscionable means;" and (4) the defendant is served with process as provided by court rules.¹³³ A similar standard is used under Nebraska law.¹³⁴ If the forum selection clause is not valid in these states, the inquiry moves to whether the defendant has the necessary minimum contacts, excluding the forum selection clause, to satisfy due process.¹³⁵

132 MICH. COMP. LAWS § 600.711(2) (West 2011). *See also* Belanger, Inc. v. Car Wash Consultants, Inc., 452 F. Supp. 2d 761, 764 (E.D. Mich. 2006) ("Even when personal jurisdiction may not be established pursuant to the Michigan long arm statute, a foreign corporation may consent to Michigan jurisdiction through a valid forum selection clause.").

133 MICH. COMP. LAWS § 600.745(2) (West 2011). *See also* MICH. COMP. LAWS § 600.745(3). § 600.745(3) provides that cases arriving in Michigan with a forum selection clause designating another state's court have proper jurisdiction if:

"the parties agreed in writing that an action on a controversy shall be brought only in another state and it is brought in a court of this state, the court shall dismiss or stay the action, as appropriate, unless any of the following occur: (a) The court is required by statute to entertain the action; (b) The plaintiff cannot secure effective relief in the other state for reasons other than delay in bringing the action; (c) The other state would be a substantially less convenient place for the trial of the action than this state; (d) The agreement as to the place of the action is obtained by misrepresentation, duress, the abuse of economic power, or other unconscionable means; (e) It would for some other reason be unfair or unreasonable to enforce the agreement." *Id.*

134 Applied Underwriters, Inc. v. Dinyari, Inc., No. A-07-058, 2008 WL 2231114, at *4-5 (Neb. Ct. App. May 20, 2008) (citing Polk Cnty. Recreation Ass'n. v. Susquehanna Patriot Leasing, 273 Neb. 1026, 734 N.W.2d 750 (2007) (holding that under Nebraska law, the enforceability of a forum selection clause is evaluated by the terms of the Model Uniform Choice of Forum Act (Choice of Forum Act), which applies where the Nebraska court would have no jurisdiction, but for the fact that the parties have consented to its exercise by the choice-of-forum agreement).

135 *See, e.g.,* Ameritas Inv. Corp. v. McKinney, 269 Neb. 564, 564, 694 N.W.2d 191, 194 (2005).

While the long-arm and statutory schemes in Michigan and Nebraska would not conflict with COCCA's provisions, other states have adopted more restrictive statutes concerning personal jurisdiction on the sole basis of a forum selection clause. These statutes may require a minimum amount in controversy or a choice of law clause in the contract dictating application of the chosen state's law to confer personal jurisdiction based on a forum selection agreement. In Florida, for example, parties may confer personal jurisdiction on the courts of Florida by contract, but only where the agreement: (1) includes a choice of law provision designating Florida law as the governing law; (2) includes a provision whereby the non-resident agrees to submit to the jurisdiction of the courts of Florida; (3) involves consideration of not less than \$250,000; (4) does not violate the United States Constitution; and (5) bears a substantial or reasonable relation to Florida *or* at least one of the parties is a resident of Florida or incorporated under its laws.¹³⁶ Applying this standard in *Johns v. Taramita*,¹³⁷ a federal district court in Florida determined that Florida's long-arm statute did not allow a forum selection clause to serve as the sole basis for Florida to exercise personal jurisdiction over objecting non-resident defendants.¹³⁸

New York has adopted a law similar to Florida's long-arm statute, but with several key differences. Under New York law, any person may bring an action against a "foreign corporation, non-resident, or foreign state," regardless of whether there is a reasonable connection to the state, so long as: (1) the action involves a contract that has a New York choice of law clause; (2) the contract involves consideration of at least \$1 million; and (3) the contract contains a forum selection provision whereby the defendant non-resident agreed to submit to the jurisdiction of the New York courts.¹³⁹

136 See FLA. STAT. §§ 685.101-102 (West 2011); see also *Jetbroadband W. Va., LLC v. MasTec N. Am., Inc.*, 13 So. 3d 159, 163 (Fla. Ct. App. 2009); *Venetian Salami Co. v. Parthenais*, 554 So. 2d 499, 500 (Fla. 1989).

137 132 F. Supp. 2d 1021 (S.D. Fla. 2001).

138 *Id.* at 1028-29.

139 N.Y. GEN. OBLIG. LAW § 5-1402 (McKinney 2011). The key difference from Florida law, which requires a reasonable connection to the State, lies in the wording of their respective choice of law statutes. See §§ 685.101-102; §§ 5-1401 to -1402 (revealing that while Florida law requires a reasonable connection for the choice of law to be valid, under N.Y. GEN. OBLIG. LAW § 5-1401, a valid choice of law provision requires only a minimum of one million in controversy "whether or not such contract, agreement or undertaking bears a reasonable relation to this state").

Unlike the statutory scheme in Florida, New York law does not demand a connection to the state. However, New York strips state courts of subject matter jurisdiction over cases between non-resident, foreign corporations where the dispute has no connection to New York and the statutory requirements of choice of law and choice of forum are not satisfied.¹⁴⁰

In addition to the problem of satisfying state rules on personal jurisdiction, most state courts continue to recognize *forum non conveniens* as a defense to litigation in a forum with no connection to the underlying dispute, regardless of whether the court is applying state or federal law to substantive claims.¹⁴¹ *Gulf Oil* recognized this power, noting that “a state court ‘may in appropriate cases apply the doctrine of *forum non conveniens*’ . . . [e]ven where federal rights binding on state courts under the Constitution are sought to be adjudged.”¹⁴² State courts consider similar factors in applying *forum non conveniens* as those set forth in *Gulf Oil*,¹⁴³ even when guided by state statute.¹⁴⁴

When applied at the state level, one of the primary concerns considered in a *forum non conveniens* analysis is avoiding usurpation of state judicial resources by cases unrelated to the state. For example, when

140 See N.Y. BUS. CORP. LAW § 1314(b) (McKinney 2003); see also Jill Miller, *Jurisdiction Lacking in Corporate Contract*, THE DAILY RECORD, Sept. 12, 2003), available at http://findarticles.com/p/articles/mi_qn4180/is_20030912/ain10068680 (describing the decision by a New York State trial court finding that in a case between two foreign corporations, absent a New York choice of law and choice of forum provision in contract, the court lacked subject matter jurisdiction under § 1314(b) of the Business Corporation Law).

141 See *Kedy v. A.W. Chesterton Co.*, 946 A.2d 1171, 1182-83 (R.I. 2008) (presenting a survey of state rules on *forum non conveniens*, and concluding with Rhode Island adopting the doctrine).

142 *Gulf Oil Corp. v. Gilbert*, 330 U.S. 501, 504 (1947) (citations omitted).

143 See, e.g., *Aveta, Inc. v. Colon*, 942 A.2d 603, 609 (Del. Ch. 2008) (citations omitted) (stating that the court considers (1) the applicability of local law; (2) the relative ease of access of proof; (3) the availability of compulsory process for witnesses (4) the pendency or non-pendency of a similar action or actions in another jurisdiction; (5) the possibility of a need to view immovable property; and (6) all other practical considerations that would make the trial easy, expeditious, and inexpensive).

144 *In re Omega Protein, Inc.*, 288 S.W.3d 17, 20 (Tex. Ct. App. 2009) (noting that in 2003, the Texas Legislature codified the *forum non conveniens* factors, which echo the doctrine of *forum non conveniens* factors that the United States Supreme Court applied in *Gulf Oil*).

Florida's Supreme Court adopted the doctrine of *forum non conveniens* in *Kinney Systems, Inc. v. Continental Insurance Co.*,¹⁴⁵ it did so to prevent foreign commercial litigants with no connection to Florida from filing suit.¹⁴⁶ In so doing, the *Kinney* court specifically commented that:

While Florida courts sometimes may properly concern themselves with a suit essentially arising out-of-state, they nevertheless must take into account the impact such practices will have if not properly policed—an impact with substantial effect on the taxpayers of this state and on the appropriation of public monies at both the state and local level to pay for the costs of judicial operations. We must rightly question expenditures of this type where the underlying lawsuit has no genuine connection to the state. Florida's judicial interests are at their zenith, and the expenditure of tax-funded judicial resources most clearly justified, when the issues involve matters with a strong nexus to Florida's interests. But that interest and justification wane to the degree such a nexus is lacking.¹⁴⁷

Despite the cautionary words in *Kinney*, the status of the *forum non conveniens* defense in the face of a valid forum selection clause remains unclear in certain state courts. Similar to federal courts, some state courts have replaced the *forum non conveniens* analysis with the *Bremen* test and look simply at the validity of the choice of court agreement and whether it is “unreasonable” and thus invalid.¹⁴⁸ Other states have adopted specific statutory schemes that address not only the validity of forum selection clauses involving non-residents, but also the procedural aspects of enforcing such agreements. In New York, for example, if a choice of court agreement

145 *Kinney Sys., Inc. v. Cont'l Ins. Co.*, 674 So. 2d 86 (Fla. 1996).

146 *Id.* at 87-88 (“Commentators generally have noted a growing trend in private international law of attempting to file suit in an American state even for injuries or breaches that occurred on foreign soil. There already is evidence the practice is growing to abusive levels in Florida.”).

147 *Id.* at 89-90.

148 *See, e.g., Aveta*, 942 A.2d at 603 (stating that “under Delaware law, forum selection clauses are *prima facie* valid and should be enforced unless the clause is shown by the resisting party to be unreasonable under the circumstances,” which subsumes the *forum non conveniens* doctrine “to ascertain whether enforcement of the clause is unreasonable under the circumstances”).

meets the statutory requirements for validity, *forum non conveniens* motions cannot be entertained.¹⁴⁹ Still other courts have followed the *Ricoh* approach and continue to apply *forum non conveniens* analysis to allow consideration of the public interest factors at stake in enforcing a forum selection clause.¹⁵⁰

As these state and federal cases demonstrate, the enforcement of forum selection clauses in the United States is a hodge-podge of procedural strategy, judicial prerogatives and, in rare cases, specific statutory guidelines limiting the enforceability of forum selection clauses where the dispute or parties are not connected to the chosen forum. Thus, while COCCA's mandates seem to reflect the majority view in the United States that forum selection clauses are presumed valid and serve as a basis for personal jurisdiction, implementation will in certain circumstances conflict with detailed statutory schemes in states such as Florida and New York, states that probably carry a significant burden in international dispute resolution because of their location and reputation.

Part III: Developing a Comprehensive Federal COCCA Implementation Scheme for Chosen Courts in the United States

Balancing the constraints of federalism and the efficiency of legal uniformity is a struggle that permeates almost every area of public policy. This struggle is no different when applying international legal obligations in the United States, especially when treaty obligations must be enforced in state court proceedings.¹⁵¹ In particular, the decision of how to implement

149 N.Y. C.P.L.R. Rule 327(b) (McKinney 2008).

“[T]he court shall not stay or dismiss any action on the ground of inconvenient forum, where the action arises out of or relates to a contract, agreement or undertaking to which section 5-1402 of the general obligations law applies, and the parties to the contract have agreed that the law of this state shall govern their rights or duties in whole or in part.” *Id.*

150 Buxbaum, *supra* note 1, at 197-99 (stating that courts vary in the weight they assign a forum selection clause in determining *forum non conveniens* motions depending on whether the clause is one of the factors to be balanced or whether it “heavily favors dismissal.”).

151 *Cf. Medellin v. Texas*, 552 U.S. 491, 504-05 (2008) (finding that, while some treaties are self-executing and automatically become federal law, Congress must enact federal legislation to make international obligations under the Vienna Convention on Consular Relations binding on state court proceedings).

international agreements in the area of private international law raises significant federalism concerns because traditional areas of state legislative competence and state court procedures are elevated to the international level. Not surprisingly, therefore, the Uniform Law Commission (“ULC”) has become actively involved in lobbying for a greater role of state law in treaty implementation.¹⁵² As a political matter, this approach makes eminent sense in many circumstances, especially where Congress lacks legislative authority and would encroach into state law-making solely by virtue of its treaty power.¹⁵³

It comes as no surprise, then, that implementation of COCCA’s mandates elicits these same federalism concerns and reflects a division of opinion on how to implement its provisions. On the one hand, the ULC has proposed implementing COCCA by adoption of uniform COCCA implementation acts on a state-by-state basis, subject to certain conditions imposed in a federal implementing law.¹⁵⁴ The ULC model is based on the idea of “conditional preemption” where states can take legislative action to adopt the uniform law or face preemption of existing state law through the federal provisions.¹⁵⁵ The other option is to adopt comprehensive federal legislation that preempts conflicting state rules relating to forum selection clauses and governs application of COCCA in its entirety.¹⁵⁶ Until this debate is resolved, the future effectiveness of COCCA remains in question.¹⁵⁷

152 Henning, *supra* note 20, at 41.

153 See *Missouri v. Holland*, 252 U.S. 416, 434 (1920) (“No doubt the great body of private relations usually fall within the control of the State, but a treaty may override this power.”).

154 See *Uniform International Choice of Court Agreement Act*, NAT’L CONFERENCE OF COMM’RS ON UNIF. STATE LAWS (July 2010) (Draft), http://www.law.upenn.edu/bll/archives/ulc/hccca/2010am_draft.htm.

155 Henning, *supra* note 20, at 49-50 (“[C]onditional preemption uses coercion to convince the states that it is in their best interests to adopt legislation designated by Congress. The coercive threat is that the area of law at issue will be preempted by federal law if the designated legislation is not adopted.”).

156 See Burbank, *supra* note 13, at 309.

157 See Guy S. Lipe & Timothy J. Tyler, *The Hague Convention on Choice Of Court Agreements: Creating Room for Choice in International Cases*, 33 HOUS. J. INT’L L. 1, 12 (2010) (noting that until the federal government decides whether to implement COCCA through the Uniform Law Commission’s uniform state law approach or a pure federal implementation mechanism, United States accession will not occur.)

While a state-by-state approach may be a politically attractive choice, there are numerous reasons why the adoption of a federal scheme is more effective as a matter of policy and a matter of enforcement. Moreover, the ULC's proposed provisions allowing states to strip their courts of subject matter jurisdiction over cases arising under COCCA raise significant constitutional concerns, especially in light of the Supreme Court's recent decision in *Haywood v. Drown* detailed below.¹⁵⁸

1. Policy Considerations Favoring a Federal Approach

While there may be a number of policy considerations favoring the ULC's state-by-state approach,¹⁵⁹ the balance of factors from a policy perspective weighs in favor of a purely federal approach. In particular, a federal scheme will better promote COCCA's goal to establish "uniform rules on jurisdiction and on recognition and enforcement of foreign judgments in civil or commercial matters."¹⁶⁰

First, as the existing case law in the United States shows, the *Erie* dichotomy between enforcement of forum selection clauses in federal and state courts will not be resolved through the promulgation of more state laws on the enforceability of forum selection clauses. Given the complicated nature of forum selection clause enforcement as a blend of substantive and procedural considerations and the disparity this confusion has caused between enforcement of such clauses at the federal and state level, a comprehensive federal implementation framework is needed to resolve the *Erie* issues that plague forum selection clause enforcement. Resolving the *Erie* issues would, therefore, better advance COCCA's preeminent goal of uniformity in the enforcement of international choice of court agreements.¹⁶¹

Second, state-by-state legislation to implement COCCA would not resolve the issue of the continued application of *Bremen's* forum selection clause analysis after the implementation of COCCA. For example, if COCCA is implemented only at the state level, would federal courts continue to apply *Bremen* to enforce choice of court agreements in

¹⁵⁸ 129 S. Ct. 2108 (2009).

¹⁵⁹ Henning, *supra* note 20, at 39-43.

¹⁶⁰ COCCA, *supra* note 3, Preamble.

¹⁶¹ See Buxbaum, *supra* note 1, at 190.

international cases? Would courts using the *Bremen* standard be able to simply shift the *forum non conveniens* analysis into the substantive reasonableness inquiry and potentially evade COCCA's mandate? Would states that currently follow the *Bremen* rule in international commercial cases be required to adopt a more restrictive rule on forum selection clause enforcement under the state-by-state approach? These questions exemplify why a federal statute that addresses the *Bremen* standard is needed to implement COCCA. State legislation cannot address the *Bremen* issues posed above, nor can it address the status of the *Bremen* rule in the post-*Ricoh* context.¹⁶²

Third, a federal approach to implementing COCCA will make it easier for United States firms to enforce cases filed in non-chosen courts abroad. COCCA's provisions allow a non-chosen court to hear a case if the forum selection clause is void under the law of the chosen court.¹⁶³ This is important because, while judges and attorneys in foreign countries will undoubtedly appreciate the choice of law issues that arise in contract interpretation, the added layer of *Erie* complexity creates confusion about the correct standard to apply to determine forum selection clause validity.¹⁶⁴ A federal approach to implementing COCCA will, therefore, promote uniform rules that will result in more consistent decisions in non-chosen courts abroad.

Finally, as a practical matter, federal implementation would be consistent with the implementation of the New York Convention and would solidify United States policy on the enforceability of negotiated dispute resolution mechanisms in international business-to-business contracts.

162 See *supra* text accompanying notes 90-97.

163 See COCCA, *supra* note 3, art. 6 (providing that a court may proceed to hear a case even if that court is not selected in the forum selection clause, if the court concludes that the forum selection clause would be null and void under the law of the chosen State).

164 See Peter D. Trooboff, *Proposed Principles for United States Implementation of the New Hague Convention on Choice of Court Agreements*, 42 N.Y.U. J. INT'L L. & POL. 237, 247 (2009).

"[G]reater complexity of 'cooperative federalism' puts a burden on the advocates of 'cooperative federalism' to make a compelling case and to show this approach can be accomplished without needless ambiguity and increased cost to litigants . . . We cannot ask middle-class litigants in this country or from elsewhere in the world to regard this Convention as a step forward if our implementing legislation creates new complexities and spawns litigation over interpretative issues, however interesting they may be to law professors." *Id.*

2. Constitutional Authority and Preemption

At first blush, constitutional constraints on the power of Congress to dictate state court judicial procedures seem to favor a state-by-state approach to implementing COCCA. Nonetheless, while COCCA presents complex issues of procedural rule implementation in state courts, Congress' federal treaty power and Article I power to regulate foreign commerce strongly support a comprehensive federal legislation scheme to implement COCCA. Significantly, once federal power is asserted in COCCA implementation, conflicting state laws and procedural rules will be preempted under the Supremacy Clause.¹⁶⁵ This will create a uniform national standard for the enforcement of international choice of court agreements subject to the Convention, while leaving the enforcement of forum selection clauses in other contexts subject to existing state or federal law.

Importantly, COCCA seeks to regulate dispute settlement in international commerce, an area that falls squarely within Congress' Article I powers, which include the power to regulate foreign commerce.¹⁶⁶ The foreign commerce power is broad, and includes, for example, the power to regulate federal and state court procedures involving foreign sovereigns under the FSIA.¹⁶⁷ As such, federal implementation of COCCA under the commerce clause avoids the difficult constitutional issues raised in the Supreme Court's controversial decision in *Missouri v. Holland*,¹⁶⁸ which held that Congress may legislate in areas outside of its Article I powers pursuant to treaty obligations.¹⁶⁹

165 See U.S. CONST. art. VI (“[T]he Laws of the United States. . . shall be the supreme Law of the Land;. . . any Thing in the Constitution or Laws of any state to the Contrary notwithstanding.”).

166 U.S. CONST. art. I, § 8, cl. 3 (“The Congress shall have power. . . [t]o regulate commerce with foreign nations.”).

167 See *Verlinden B.V. v. Cent. Bank of Nigeria*, 461 U.S. 480, 493 (1983) (“[B]y reason of its authority over foreign commerce and foreign relations, Congress has the undisputed power to decide, as a matter of federal law, whether and under what circumstances foreign nations should be amenable to suit in the United States.”).

168 *Missouri v. Holland*, 252 U.S. 416 (1920).

169 *Id.* at 433. See also Carlos Manuel Vazquez, *Missouri v. Holland's Second Holding*, 73 MO. L. REV. 939 (2008) (commenting that while the Supreme Court in *Missouri v. Holland* held that Congress has the power to pass a law to implement a treaty even if the law would not fall within Congress' legislative power in the absence of the treaty, essential

The success of a comprehensive federal scheme to implement COCCA depends on its ability to preempt conflicting state laws that either refuse to recognize the validity of forum selection clauses or otherwise limit the enforceability of these clauses through procedural rules relating to personal jurisdiction and *forum non conveniens*. The Supreme Court first recognized the federal power to preempt conflicting state laws in 1819 in *M'Culloch v. Maryland*,¹⁷⁰ holding that state law that conflicts with federal law is “without effect.”¹⁷¹ More recently, in *Cipollone v. Liggett Group, Inc.*,¹⁷² the Supreme Court added that consideration of issues arising under the Supremacy Clause “start[s] with the assumption that the historic police powers of the States [are] not to be superseded by . . . Federal Act unless that [is] the clear and manifest purpose of Congress.”¹⁷³ Congress' intent may be “explicitly stated in the statute’s language or implicitly contained in its structure and purpose.”¹⁷⁴

While federal legislation does not typically preempt state court procedures and jurisdictional rules, preemption can occur when those laws undermine the effectiveness of a federal statutory scheme specifically targeted at procedural issues. Case law relating to the Federal Arbitration Act (the “FAA”)¹⁷⁵ is particularly instructive because, as the Supreme Court noted in *Scherk v. Alberto-Culver Co.*, an arbitration agreement “is, in

to this holding were two distinct propositions: first, that the treaty-makers have the constitutional power to make treaties on matters falling outside Congress' enumerated powers, and second, the Necessary and Proper Clause gives Congress the power to implement non-self-executing treaties even if in the absence of the treaty the statute would be beyond Congress' legislative power).

170 17 U.S. (4 Wheat.) 316 (1819).

171 *Id.* at 399.

172 *Cipollone v. Liggett Group, Inc.*, 505 U.S. 504 (1992).

173 *Id.* at 545.

174 *Id.* (quoting *Fidelity Fed. Sav. & Loan Ass'n v. De la Cuesta*, 458 U.S. 141, 153 (1982)) (“In the absence of an express congressional command, state law is pre-empted if that law actually conflicts with federal law, or if federal law so thoroughly occupies a legislative field ‘as to make reasonable the inference that Congress left no room for the States to supplement it.’”).

175 Federal Arbitration Act, 9 U.S.C. § 3 (2006). The FAA requires federal and state courts to stay proceedings if they determine that the proceedings are subject to a valid written arbitration agreement. *Id.*

effect, a specialized kind of forum-selection clause that posits not only the situs of suit but also the procedure to be used in resolving the dispute.”¹⁷⁶ Just as the United States is now a party to COCCA, which aims to encourage the recognition and enforcement of forum selection clauses in international contracts, the United States is a party to the New York Convention, which aims “to encourage the recognition and enforcement of commercial arbitration agreements in international contracts and to unify the standards by which agreements to arbitrate are observed and arbitral awards are enforced in the signatory countries.”¹⁷⁷ The Supreme Court in *Scherk* thus concluded “that this country's adoption and ratification of the Convention and the passage of Chapter 2 of the United States Arbitration Act provide strongly persuasive evidence of congressional policy” to enforce arbitration agreements and awards.¹⁷⁸

Preemption under the FAA of conflicting state procedural and jurisdictional rules is broad. In *Southland Corp. v. Keating*,¹⁷⁹ the Court held that the FAA preempted a California statute that prevented parties to certain franchise agreements from waiving the right to litigate in California.¹⁸⁰ Chief Justice Burger found that “[i]n enacting Section 2 of the federal Act, Congress declared a national policy favoring arbitration and withdrew the power of the states to require a judicial forum for the resolution of claims which the contracting parties agreed to resolve by

176 *Scherk v. Alberto-Culver Co.*, 417 U.S. 506, 519 (1974).

177 *Id.*

178 *Id.* at 522 (Douglas J., dissenting).

179 *Southland Corp. v. Keating*, 465 U.S. 1 (1984).

180 *Id.* at 16 (noting in diversity cases applying state law, federal procedural rules would apply even if they act to preempt state law). See, e.g., *Stewart Org., Inc. v. Ricoh Corp.*, 487 U.S. 22 (1988) (holding that a federal court considering a contract dispute involving a forum selection clause could transfer the case to another federal district court designated in the choice of court agreement, notwithstanding a state anti-waiver law that invalidated forum selection clauses requiring certain disputes to be litigated outside the State).

“[T]he instructions of Congress are supreme ... where federal law’s ‘discretionary mode of operation’ conflicts with the nondiscretionary provision of Alabama law, federal law applies in diversity . . . Congress has directed that multiple considerations govern transfer within the federal court system, and a state policy focusing on a single concern or a subset of the factors identified in § 1404(a) would defeat that command.” *Ricoh*, 487 U.S. at 30-31.

arbitration.”¹⁸¹ Importantly, the Court further stated: “We see nothing in the Act indicating that the broad principle of enforceability is subject to any additional limitations under state law.”¹⁸² More recently, the Supreme Court also held in *Preston v. Ferrer*¹⁸³ that when parties agree to arbitrate all questions arising under a contract, state laws lodging primary jurisdiction in another forum, whether judicial or administrative, are superseded by the FAA.¹⁸⁴

Despite *Southland*, preemption issues are complicated when it comes to state court procedural rules. Famed law professor Henry Hart noted that when state courts adjudicate federal rights “[t]he general rule, bottomed deeply in belief in the importance of state control of state judicial procedure, is that federal law takes the state courts as it finds them.”¹⁸⁵ This is particularly important for purposes of eliminating *forum non conveniens* analysis in state procedures as required by COCCA. For example, in *American Dredging Co. v. Miller*,¹⁸⁶ the Supreme Court addressed whether federal rules on *forum non conveniens* preempted state law procedural rules regarding this doctrine, specifically in admiralty cases filed in state courts where federal law provided the rule of decision.¹⁸⁷ The Louisiana trial court dismissed the action under the *federal* doctrine of *forum non conveniens* as applied in maritime cases.¹⁸⁸ However, the Supreme Court of Louisiana reversed, holding that federal procedural rules on *forum non conveniens* did not preempt the Louisiana state rule in cases pending in Louisiana courts.¹⁸⁹

181 *Southland*, 465 U.S. at 10.

182 *Id.* at 11. Importantly, the Supreme Court found that the Arbitration Act’s substantive rules were to apply in state as well as federal courts. *Id.* at 15. The Court in *Southland* also found that the legislative history of the Act indicated the intent to apply its standards in more than only federal courts. *Id.* at 12-13.

183 552 U.S. 346 (2008).

184 *Id.* at 349-50 (citing *Buckeye Check Cashing, Inc. v. Cardegna*, 546 U.S. 440, 446 (2006)).

185 Henry Hart, *The Relations Between State and Federal Law*, 54 COLUM. L. REV. 489, 508 (1954).

186 510 U.S. 443 (1994).

187 *Id.* at 445-46.

188 *Id.* at 453.

189 *Id.* at 445-46.

In affirming the Louisiana Supreme Court, the Supreme Court held that, “[j]ust as state courts, in deciding admiralty cases, are not bound by the venue requirements set forth for federal courts in the United States Code, so also they are not bound by the federal common-law venue rule (so to speak) of *forum non conveniens*.”¹⁹⁰ Similarly, in *Missouri ex rel. Southern R. Co. v. Mayfield*,¹⁹¹ the Supreme Court held that a state court presiding over an action pursuant to the Federal Employers’ Liability Act (“FELA”) “should be free to decide the availability of the principle of *forum non conveniens* in these suits according to its own local law.”¹⁹²

Notwithstanding the holdings of *Miller* and *Mayfield*, there are exceptions to the principle of state court procedural autonomy that may require a state court to apply federal procedures when hearing a federal claim. Under the first exception, a state court must apply federal procedures that are “part and parcel of the remedy afforded” under federal law.¹⁹³ The second exception is that state procedures may be preempted if they unduly burden particular federal rights.¹⁹⁴ In implementing a comprehensive scheme under COCCA that combines the substantive and procedural rules that are so often intertwined in deciding forum selection clause issues, the procedural aspects would be “part and parcel” of the obligations arising under COCCA and would preempt conflicting state procedural rules.

Moreover, even beyond the FAA as discussed above, there are various examples of situations where Congress has enacted special procedural rules applicable in state court cases that support a finding that COCCA’s procedural rules would preempt conflicting state law. For

190 *Id.* at 453.

191 340 U.S. 1 (1950). *Mayfield* involved a FELA claim brought in Missouri state court by a non-resident plaintiff against a foreign corporation based on an accident that took place outside of Missouri. *Id.* at 2. The Missouri Supreme Court ruled that the case could not be dismissed on grounds of state *forum non conveniens* rules. *Id.* at 3. The United States Supreme Court reversed, finding that the state courts are free to apply neutral procedural rules that do not discriminate against federal claims, even where such rules result in denying access to the state courts for certain federal claims. *See id.* at 5.

192 *Id.* at 5.

193 *Dice v. Akron, Canton & Youngstown R. Co.*, 342 U.S. 359, 363 (1952) (quoting *Bailey v. Cent. Vt. Ry.*, 319 U.S. 350, 354 (1943)).

194 *See, e.g., Felder v. Casey*, 487 U.S. 131, 138 (1988) (explaining that only state procedural rules that discriminate against specific federal rights are preempted).

instance, in *Volkswagenwerk v. Schlunk*,¹⁹⁵ the Supreme Court held that the Convention on Service Abroad of Judicial and Extrajudicial Documents in Civil and Commercial Matters (“Hague Service Convention”) preempts state long-arm statutes to the extent they provide conflicting service procedures in cases subject to that Convention.¹⁹⁶ Other examples exist of Congressional authority to dictate state court procedures pursuant to international treaty obligations.¹⁹⁷ For instance, Congress has preempted state personal jurisdiction rules in cases that are decided exclusively under state law in state courts, such as in domestic relations proceedings.¹⁹⁸ The Uniformed Services Former Spouses Protection Act (“USFSPA”) limits the reach of state long-arm statutes to service members subject to divorce proceedings in state courts.¹⁹⁹ Several state courts have acknowledged the preemptive effect of USFSPA’s personal jurisdiction provisions, where Congress created a test for personal jurisdiction for proceedings specifically relating to the act.²⁰⁰

195 486 U.S. 694 (1988).

196 *Id.* at 699 (“By virtue of the Supremacy Clause, . . . the Convention pre-empts inconsistent methods of service prescribed by state law in all cases to which it applies.”).

197 *See* *Weiner*, *supra* note 98, at 240.

“Congress can authorize that an action arising under federal law be brought in any court, including a court located in a state in which the litigant does not live, so long as the respondent (1) is amenable to service of process and (2) has sufficient connections with the forum so that the federal court’s assertion of personal jurisdiction over the respondent is not constitutionally problematic.” *Id.*

198 Robert C. Casad, *Personal Jurisdiction in Federal Question Cases*, 70 TEX. L. REV. 1589, 1616 (1992) (stating that Congress can regulate the exercise of jurisdiction by state courts in appropriate cases, such as the Parental Kidnapping Prevention Act and the Uniformed Services Former Spouses’ Protection Act, which Congress made applicable to states as well as federal courts and which are binding on state courts and preempt the state’s long-arm statutes).

199 10 U.S.C. § 1408(b)(4) (2006) (explaining that a state court may acquire jurisdiction to divide a service member’s disposable retired pay in three circumstances: (1) if the member is domiciled in the State; (2) if the member is a resident of the State; or (3) if the member gives consent to the State’s jurisdiction).

200 *Blackson v. Blackson*, 579 S.E.2d 704, 713 (Va. Ct. App. 2003); *Wagner v. Wagner*, 768 A.2d 1112, 1117 (Pa. 2001); *Mortenson v. Mortenson*, 409 N.W.2d 20, 23 (Minn. Ct. App. 1987); *Sparks v. Caldwell*, 723 P.2d 244, 245 (N.M. 1986).

As set forth above, Congress has the power to determine the circumstances under which foreign commercial disputes can be litigated in American courts based on its broad Article I powers to regulate foreign commerce.²⁰¹ A carefully drafted and detailed federal scheme that incorporates substantive and procedural mechanisms to implement COCCA would preempt conflicting state substantive law and procedural rules regarding personal jurisdiction and *forum non conveniens*.

3. The ULC Jurisdiction-Stripping Approach Raises Constitutional Concerns

The primary difficulty with implementing COCCA in the United States is that it allows parties to international commercial agreements to designate a court in the United States for dispute resolution, regardless of whether the parties or the dispute have any geographic nexus to the chosen forum. In federal and state courts following the *Bremen* standard, the neutral location does not generally render the choice of court agreement invalid as a matter of law. As detailed in Part II, however, the lack of connection is problematic as a matter of procedure because some state long-arm statutes do not recognize a forum selection clause as the sole basis for personal jurisdiction absent compliance with state statutory guidelines for choice of court agreements.

To the extent COCCA Article 5 would preempt these long-arm provisions, the ULC state-by-state uniform law approach would accommodate state policy preferences in favor of a geographic nexus requirement, even if the United States decides not to issue an Article 19 declaration, undermining COCCA implementation. Under the ULC proposal, states that do not want to allow personal jurisdiction over COCCA cases can avoid this obligation by enacting legislation to strip their courts of general jurisdiction of subject matter jurisdiction to hear cases subject to COCCA where there is no relationship between the state and the parties or the disputes.²⁰² A similar provision exists under New York law, where courts lack subject matter jurisdiction over contract disputes involving

201 See U.S. CONST. art. I, § 8, cl. 3. These allowances are made so that foreign courts enforce the judgments of American courts in international business disputes. Cf. Burbank, *supra* note 13, at 305 (explaining that the exercise of federal legislative power may be necessary to ensure a “credible and efficient system to ensure that we honor an international agreement in which jurisdiction is the critical *quid* for a recognition and enforcement *quo*”).

202 See Henning, *supra* note 20, at 50.

foreign parties with no connection to the state unless the contract contains a choice of court agreement that meets the New York statutory standards.²⁰³ As a result, states can essentially make Article 19-like declarations under the ULC proposal, even where the United States has decided as a matter of foreign policy that such a declaration is contrary to its interests in promoting international commerce.

The fact that states can strip their courts of subject matter jurisdiction to hear cases arising under federal law, including treaties under the Supremacy Clause,²⁰⁴ based solely on policy objections, raises serious concerns. As a policy matter, lawmakers must consider the precedential value of allowing states to opt-out of declarations made to international treaties, even where such an opt-out is arguably permitted by Congress. This practice may have a significant impact on the negotiation of future private international legal instruments. More importantly, the jurisdiction-stripping provision raises potential constitutional concerns in light of the Supreme Court's recent decision in *Haywood v. Drown*²⁰⁵ discussed below.

While the Supreme Court has announced that Congress cannot "commandeer" a state's legislative or executive authority, the Supreme Court has never ruled that state courts of general jurisdiction have the constitutional power to refuse to hear federal claims where Congress has granted concurrent jurisdiction to the federal and state courts.²⁰⁶ Furthermore, under Article III, the founding fathers left open the possibility

203 See N.Y. BUS. CORP. LAW § 1314(b) (McKinney 2003) (stating that New York courts lack subject matter jurisdiction over cases between non-resident, foreign corporations where the dispute has no connection to New York unless requirements of the General Obligations Law as to choice of law and choice of forum have been satisfied); N.Y. GEN. OBLIG. LAW § 5-1402(1) (McKinney 2011) (explaining that New York courts have jurisdiction over incidents arising out of transactions that are less than one million dollars and contain a provision whereby the foreign corporation submits to jurisdiction).

204 U.S. CONST. art. VI, cl. 2.

205 129 S. Ct. 2108, 2112 (2009).

206 See, e.g., *New York v. United States*, 505 U.S. 144, 161 (1992); *Printz v. United States*, 521 U.S. 898 (1997). For example, Congress may not mandate States to pass state legislation that implements federal policy. See, e.g., *New York*, 505 U.S. at 161 (holding that federal law compelling states to enact legislation to provide for radioactive waste violated the Tenth Amendment). Nor can Congress demand action of state executive officers. See, e.g., *Printz*, 521 U.S. 898 (finding that Congress could not, in adopting interim provisions of the Brady Handgun Violence Prevention Act, dictate duties of state law enforcement officials to implement the restrictions imposed under the act).

that state courts would *have* to hear federal claims unless and until Congress created a system of lower federal courts.²⁰⁷ In addition, although federal district courts have full subject matter jurisdiction to hear federal question cases today, throughout the majority of American history state courts enforced most federal civil legislation and some federal criminal law.²⁰⁸

However, as Congress expanded the number of federal causes of action, some state courts began to balk at the notion of compelled adjudication of federal claims. With the resurgent power of the federal government in the aftermath of the Civil War, the Supreme Court upheld the power of Congress to demand that state courts enforce federal law under the Supremacy Clause.²⁰⁹ In *Testa v. Katt*,²¹⁰ the Supreme Court reaffirmed that state courts of “adequate and appropriate” jurisdiction “are not free to refuse enforcement” of federal claims.²¹¹ Even with the so-called “Rehnquist Revolution” to re-establish state sovereignty in the 1990s, the Supreme Court recognized the unique position of state courts as enforcers of federal law in our constitutional scheme.²¹² For example, in *Printz v. United*

207 See U.S. CONST. art. III, § 1 (“The judicial power of the United States, shall be vested in one Supreme Court, and in such inferior courts as the Congress may from time to time ordain and establish.”); see also *Howlett v. Rose*, 496 U.S. 356, 367 (1990). Justice Stevens wrote:

“Federal law is enforceable in state courts not because Congress has determined that federal courts would otherwise be burdened or that state courts might provide a more convenient forum - although both might well be true - but because the Constitution and laws passed pursuant to it are as much laws in the States as laws passed by the state legislature.”
Howlett, 496 U.S. at 367.

For a general history of the establishment of the federal courts, see *History of the Federal Judiciary*, FED. JUDICIAL CTR., <http://www.fjc.gov/history/home.nsf/page/index.html> (last visited Oct. 17, 2011).

208 See *Testa v. Katt*, 330 U.S. 386, 389-90 (1947) (describing how the first Congress that convened after the Constitution conferred jurisdiction on the state courts to enforce important federal civil laws and succeeding Congresses conferred on the states jurisdiction over federal crimes and actions for penalties and forfeitures).

209 See *Clafin v. Houseman*, 93 U.S. 130, 137 (1876).

210 330 U.S. 386 (1947).

211 *Id.* at 394.

212 See Erwin Chemerinsky, *The Rehnquist Revolution*, 2 PIERCE L. REV. 1 (2004), available at http://scholarship.law.duke.edu/faculty_scholarship/1133 (discussing the Rehnquist Revolution).

States,²¹³ the Court recognized the anti-commandeering principle as applied to Congressional action towards state executive officials.²¹⁴ Writing for the Court, Justice Scalia reasoned that “the Constitution was originally understood to permit imposition of an obligation on state *judges* to enforce federal prescriptions, insofar as those prescriptions related to matters appropriate for the judicial power.”²¹⁵

For purposes of assessing the constitutionality of the ULC jurisdiction-stripping approach, the Supreme Court’s recent decision in *Haywood v. Drown*²¹⁶ is instructive. In *Haywood*, the Court considered the validity of a New York state law that divested state courts of jurisdiction over § 1983 civil rights actions against state correction officers, a frequent target of prisoner litigation, although suits brought against other state officials were not within the scope of the statute.²¹⁷ The question presented was whether New York’s exceptional treatment of a limited category of § 1983 claims was consistent with the Supremacy Clause.²¹⁸ The majority 5-4 decision, written by Justice Stevens, found that the jurisdictional statute was an unconstitutional attempt to strip New York courts of general jurisdiction of the power to hear federal claims where Congress had granted concurrent jurisdiction.²¹⁹ In particular, the Court in *Haywood* found that

213 521 U.S. 898 (1997).

214 *Id.* at 907.

215 *Id.* One of the few limitations on state court enforcement of federal law was recognized in the Supreme Court’s decision in *Alden v. Maine*, 527 U.S. 706, 707 (1999) (holding that federal law could not compel state courts to hold state officials accountable for violations of federal law, as such an action would violate the Eleventh Amendment guarantee of state sovereign immunity).

216 129 S. Ct. 2108 (2009).

217 *Id.* at 2112.

218 *Id.*

219 *Id.* at 2116-17.(Justice Thomas dissenting) (arguing that neither Article III nor the Supremacy Clause *require* state courts to hear federal cases), Instead:

“[T]he States have unfettered authority to determine whether their local courts may entertain a federal cause of action. Once a State exercises its sovereign prerogative to deprive its courts of subject-matter jurisdiction over a federal cause of action, it is the end of the matter as far as the Constitution is concerned.” *Id.* at 2122.

New York had not proffered a “valid excuse” for declining to exercise jurisdiction over § 1983 claims against state correctional officers.²²⁰

The Court in *Haywood* also remarked that there are only a “handful of cases in which this Court has found a valid excuse” for state courts to decline to exercise jurisdiction over federal claims, all of which arose under FELA.²²¹ Because COCCA would require state courts to hear claims without a geographic connection to the state, it is important to note that some of the FELA cases cited in *Haywood* held that a state, by its own rules, could give its courts discretion to decline jurisdiction over FELA claims where neither party was a resident of the state or where proper venue was lacking because the cause of action arose outside the court’s territorial jurisdiction.²²² However, none of these cases suggest that states can strip their courts of jurisdiction to enforce a federal statute, which includes detailed procedural provisions as part of the enforcement scheme, based on policy disagreements. In such circumstances, states may not decline jurisdiction to hear claims arising under federal law by relying on a state law that has been expressly preempted.²²³

The ULC model has very important and beneficial provisions that undoubtedly work to implement COCCA in a manner customized to the American federal system. Nonetheless, the ULC jurisdiction-stripping

220 *Id.* at 2114. The New York Court of Appeals, applying the same test, found that New York did have a valid excuse for removing jurisdiction of civil rights claims against state corrections officers because it similarly granted immunity to corrections officers for state law civil rights claims and did not discriminate against the federal right. *Haywood v. Drown*, 9 N.Y.3d 481, 488, 491-93, 881 N.E.2d 180, 184, 187-88 (Jones, J., dissenting) (arguing that while the problem of baseless lawsuits by prisoners against corrections officers is a serious one, Congress decided that the threat of abuse of citizens by those acting under color of state law was more serious, and under the Supremacy Clause, the State of New York is not free to decide that DOCS employees must be immune from such suits and may not “selectively escape” the responsibility Congress gave its courts in § 1983).

221 *Haywood*, 129 S. Ct. at 2116.

222 *See Douglas v. New York*, 279 U.S. 377, 387-88 (1929) (finding that FELA itself did not mandate the exercise of jurisdiction under the privileges and immunities clause of the Constitution); *Herb v. Pitcairn*, 324 U.S. 117, 123 (1945). *But see McKnett v. St. Louis & San Francisco Ry. Co.*, 292 U.S. 230, 233-34 (1934) (holding that state law refusing jurisdiction over non-residents in FELA claims violates the Supremacy Clause where similar claims under state law are permitted).

223 *Howlett v. Rose*, 496 U.S. 356, 372 (1990) (“States may apply their own neutral procedural rules to federal claims, unless those rules are preempted by federal law.”).

provision is not based on a concern over the competence of state courts to adjudicate contracts or other business disputes with an international component. Instead, the provision is intended to use subject matter jurisdiction to avoid the express preemption of state personal jurisdictional rules under COCCA. As *Haywood* instructs, although “States retain substantial leeway to establish the contours of their judicial systems, they lack authority to nullify a federal right or cause of action they believe is inconsistent with their local policies.”²²⁴ Consequently, where Congress and the President have expressed the policy that international forum selection clauses are to be enforced regardless of a geographic nexus to the United States, local state public policy preferences must yield under the Supremacy Clause, notwithstanding the existence of conflicting state procedural rules.²²⁵

Part IV: Towards a Comprehensive Federal Scheme: Codifying *Bremen* in a FSIA Framework

It is one thing to argue for a federal implementation scheme, but quite another to suggest what it should look like. Drafting decisions in this difficult area require intense attention to detail without losing sight of COCCA’s overall goals. As set forth in this section, a broader federal scheme would bring greater clarity to COCCA implementation in the long-term, even though a narrow drafting of COCCA’s provisions would be simpler and less costly politically. Towards that end, this article aims to open debate on two key issues. First, whether COCCA’s implementing statute should codify the existing standard, as set forth in *Bremen*, on the enforceability of forum selection clauses in international contracts.²²⁶

²²⁴ *Haywood*, 129 S. Ct. at 2116.

²²⁵ See *Testa v. Katt*, 330 U.S. 386, 392 (1947) (“[T]he policy of the federal Act is the prevailing policy in every state.”); see also *Mondou v. N.Y., N.H. & H.R. Co.*, 223 U.S. 1, 57 (1912).

“The suggestion that the act of Congress is not in harmony with the policy of the State, and therefore that the courts of the state are free to decline jurisdiction, is quite inadmissible, because it presupposes what in legal contemplation does not exist. When Congress, in the exertion of the power confided to it by the Constitution, adopted that act, it spoke for all the people and all the states, and thereby established a policy for all. That policy is as much the policy of Connecticut as if the act had emanated from its own legislature, and should be respected accordingly in the courts of the state.” *Mondou*, 223 U.S. at 57.

²²⁶ *M/S Bremen v. Zapata Offshore Co.*, 407 U.S. 1, 10 (1972) (holding that the forum selection clause is prima facie valid and is to be honored by the parties and enforced by the

Second, whether the FSIA can serve as a model for the structure and comprehensiveness of a COCCA statute.²²⁷ By combining *Bremen* and the FSIA, COCCA implementation can eliminate the disparities between federal procedural and state substantive law that have encouraged the use of litigation strategy to determine case outcomes.²²⁸

1. Adopting a Substantive Federal Rule of Decision Based on Bremen

For almost forty years, the *Bremen* rule favoring the enforcement of forum selection agreements in international business contracts has guided federal and state courts deciding the enforceability of domestic forum selection clauses in the international commercial context.²²⁹ *Bremen's* policy favoring the enforcement of international forum selection agreements is more consistent with COCCA's goals than the ULC approach, which, as discussed in Part III, allows states to avoid COCCA's obligations through jurisdiction-stripping provisions.²³⁰ Therefore, codifying the *Bremen* rule as part of the implementation of COCCA is logical. Under a federal substantive rule based on *Bremen*, choice of court agreements subject to

courts in the absence of some compelling and countervailing reason making enforcement unreasonable).

227 Foreign Sovereign Immunities Act of 1976, 28 U.S.C. §§ 1602-11 (2006).

228 See Holt, *supra* note 16, at 1926-27 (noting that depending on the type of procedural motion made, the outcome can vary based on the confused application of federal and state law to forum selection clauses).

229 See *supra* Part II; see, e.g., Prof'l Ins. Corp. v. Sutherland, 700 So. 2d 347, 350 (Ala. 1997) (finding that *Bremen* does not mandate that state courts enforce forum selection provisions outside of an admiralty context). The Court opined:

“declaring Alabama’s law of contracts, this Court is free to independently assess the public policy of this state, subject only to the requirements of federal law. However, we, as have the courts of almost all other jurisdictions, do now find the Supreme Court's reasoning in *M/S Bremen* on this issue to be persuasive. Thus, we determine that ‘outbound’ forum selection clauses such as those in this case are not void per se as against the public policy of Alabama.” *Sutherland*, 700 So. 2d at 350.

See also *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 631 (1985) (discussing the factors in *Bremen* and finding *Bremen* establishes a strong presumption in favor of enforcement of freely negotiated contractual choice-of-forum provisions).

230 See *supra* Part III for discussion of COCCA.

COCCA would be enforced unless the opposing party clearly shows either: (1) the agreement is unreasonable or unjust; or (2) the forum selection clause was the result of fraud or coercion.²³¹

Assuming the United States does not opt to issue an Article 19 declaration, a substantive rule of decision based on *Bremen* that incorporates COCCA's provisions should also specifically address a lack of geographic connection to the chosen court and any limitations this places on the determination of the reasonableness of a choice of court agreement. Borrowing again from *Bremen*, a clarifying rule or comment could state that an agreement subject to COCCA should not be deemed unreasonable on the grounds of inconvenience to the parties unless the opposing party establishes that enforcement of the agreement in the chosen court will deprive that party of a fair trial.²³² This standard would further *Bremen*'s goal of approving the parties' choice of forum when the parties choose a neutral forum respected for its competence in a particular area.²³³

231 See *supra* note 56. However, *Bremen* also speaks to the strong public policy of the chosen forum as a basis for invalidating a forum selection clause. See *supra* note 62. Because *Bremen* was dealing with the obligation of non-chosen courts to evaluate outbound forum selection clauses, the public policy of the receiving State had to be considered. See generally *supra* Part II.1. In implementing obligations of a chosen court under COCCA, the adoption of the *Bremen* standard favoring the enforcement of forum selection clauses would obviate the need for a public policy exception for chosen courts considering the validity of the agreement. See generally *supra* Part I & Part II.1. Indeed, the point of the substantive rule in the implementing law is to reflect the public policy of the United States with respect to the enforceability of choice of court agreements subject to COCCA.

232 See *supra* text accompanying note 56.

233 See *supra* notes 56-62. While this standard is consistent with the decision not to issue an Article 19 declaration, it should be noted that requiring some connection to the United States as a mechanism to limit access to American courts for purely foreign disputes is a central component of the FSIA. In *Verlinden*, the Supreme Court noted in evaluating the FSIA's jurisdictional provisions that:

“the legislative history reveals an intent not to limit jurisdiction under the Act to actions brought by American citizens. [but] Congress was aware of concern that our courts [might be] turned into small ‘international courts of claims[,]’ . . . open . . . to all comers to litigate any dispute which any private party may have with a foreign state anywhere in the world . . . by enacting substantive provisions requiring some form of substantial contact with the United States.” *Verlinden B.V. v. Cent. Bank of Nigeria*, 461 U.S. 480, 490 (1983) (citations omitted).

Codifying the *Bremen* standard and incorporating language acknowledging the circumstances under which remoteness or inconvenience may render a choice of court agreement unreasonable should make the elimination of the *forum non conveniens* defense, as required under COCCA Article 5,²³⁴ more palatable to state and federal courts. As discussed in Part II of this article, *Bremen* allows judges to consider the public interest factors at stake in enforcing a forum selection clause to ensure a fair trial.²³⁵ This standard, therefore, satisfies two competing considerations in adapting COCCA to the realities of litigation in the United States. First, it preserves the inherent authority of judges to consider the equities and reasonableness of the agreement. Second, it minimizes consideration of the personal convenience of the parties as required under COCCA's procedural provisions regarding *forum non conveniens*.²³⁶

Finally, a federal substantive rule on the validity of forum selection clauses subject to COCCA makes sense in the international context in which COCCA cases will be litigated. A federal substantive rule will promote simpler and more consistent decisions in foreign non-chosen courts, which benefits parties and the courts alike. Indeed, without a clear federal rule on the validity of forum selection clauses, the overall enforceability of such agreements continues to be limited by state public policy choices and by various procedural rules used at the federal and state level.²³⁷ From an international perspective, therefore, a uniform substantive standard may have a significant effect on the decisions of non-chosen courts outside the United States that "shall suspend or dismiss proceedings to which an

234 See *supra* Part I for a discussion of COCCA's Article 5 provisions.

235 See *supra* Part II.

236 Cf. David Marcus, *The Perils Of Contract Procedure: A Revised History of Forum Selection Clauses in the Federal Courts*, 82 TUL. L. REV. 973, 1048 (2008) (discussing the evolution of the *Bremen* contractual approach to enforcement of forum selection clauses to tests based on extra-individual concerns, as well as party-centered interests, suggesting that the replacement of standard procedural doctrine with private contracts is inherently limited because the parties' consent can only go so far toward legitimating the exercise of governmental power through adjudication).

237 See *supra* Part II for discussion about the confusion between substantive and procedural law in forum selection clause enforcement, and the role of state statutory law in limiting enforceability.

exclusive choice of court agreement applies,” unless the choice of court agreement is null and void under the law of the chosen court.²³⁸

2. Developing a Comprehensive Federal Procedural and Jurisdictional Scheme for COCCA

Codifying a substantive rule based on *Bremen* alone will not resolve the disparity among federal and state courts concerning what procedural law applies to the enforceability of forum selection clauses in international commercial cases.²³⁹ In particular, a federal substantive rule will not resolve the unpredictability of forum selection clause enforcement resulting from the Supreme Court’s ruling in *Ricoh* that allows federal chosen courts to transfer a case to a non-chosen federal court under § 1404(a) notwithstanding the choice of the parties.²⁴⁰ This procedural issue will likely continue to be litigated if a federal rule of decision based on *Bremen* is adopted in the absence of specific federal procedural rules relating to subject matter and personal jurisdiction, service of process, venue, and removal in COCCA cases. Drawing upon analogous provisions of the FSIA provides an excellent framework to meet this challenge.

A. Subject Matter Jurisdiction and Removal.

COCCA requires no change to existing rules on the subject matter jurisdiction of domestic courts.²⁴¹ When implementing COCCA, however, serious consideration should be given to adopting language that specifically creates federal question jurisdiction in the federal courts as permitted under Article III of the Constitution.²⁴² Establishing federal subject matter

238 See COCCA, *supra* note 3, art. 6(a).

239 See *supra* Part II for discussion about the problem relating to the application of procedural law.

240 See *supra* Part II.1 for discussion of *Ricoh*.

241 COCCA, *supra* note 3, art. 5(3)(a).

242 See U.S. CONST. art. III, § 2, cl. 1. Federal court subject matter jurisdiction is derived from the provisions of Article III of the United States Constitution, which created only one Supreme Court of limited jurisdiction, and such lower federal courts as Congress would deem to create. *Id.* Under Article III, federal courts may only be empowered to hear cases: (1) involving disputes between citizens of different states (the diversity clause); (2) controversies between “a State, or the Citizens thereof, and foreign States, Citizens or Subjects” (the foreign diversity clause); and (3) cases “arising under this Constitution, the Laws of the United States, and Treaties made, or which shall be made, under their

jurisdiction for COCCA cases would have a number of beneficial effects for the efficient enforcement of choice of court agreements subject to the Convention. Among other things, it would open the door for the promulgation of rules of personal jurisdiction consistent with COCCA that can supplant conflicting state long-arm provisions. Federal question jurisdiction would also resolve any potential future debate about whether a federal *Bremen* standard applies in COCCA cases filed in federal or state court. Furthermore, because diversity jurisdiction in federal courts does not exist for cases brought by foreign plaintiffs against foreign defendants, federal question jurisdiction would pave the way for removal in purely foreign COCCA disputes in accordance with FSIA.²⁴³ Finally, express federal question jurisdiction would also make COCCA consistent with the implementation of the New York Convention, which COCCA is intended to complement.²⁴⁴

Adopting a comprehensive federal legislative scheme that includes a substantive rule of decision using the *Bremen* standard and the procedural aspects of COCCA on personal jurisdiction, venue and *forum non conveniens* would also allow for the creation of federal question jurisdiction for COCCA cases. Actions subject to COCCA would “arise under” federal law for purposes of establishing federal question subject matter jurisdiction under the analysis used by the Supreme Court in *Verlinden B.V. v. Central Bank of Nigeria*.²⁴⁵ In *Verlinden*, the Supreme Court specifically considered whether Congress exceeded the scope of its Article III powers by granting federal courts subject matter jurisdiction over claims subject to the FSIA, even though the ultimate liability issues would be resolved according to

Authority” (the federal question clause). *Id.* See also 28 U.S.C. §§ 1331-32 (outlining federal courts subject matter jurisdiction).

243 *Cf.* *Ruhrgas AG v. Marathon Oil Co.*, 526 U.S. 574, 584 (1999) (explaining that complete diversity is destroyed if there is a foreign plaintiff and a foreign defendant named as parties, even if they are from different countries).

244 See *Glencore Grain Rotterdam B.V. v. Shivnath Rai Harnarain Co.*, 284 F.3d 1114, 1119-20 (9th Cir. 2002). The Court opined:

“In 1970 Congress ratified the [New York] Convention. . . Congress implemented the Convention by passing Chapter II of the Federal Arbitration Act (“FAA”). . . which provides that an ‘action falling under the Convention shall be deemed to arise under the laws and treaties of the United States. The district courts of the United States ... shall have original jurisdiction over such an action or proceeding, regardless of the amount in controversy.’” *Id.*

245 461 U.S. 480 (1983).

state law.²⁴⁶ As in COCCA cases involving disputes between foreign parties litigated in the United States, FSIA raises the possibility of U.S. litigation involving foreign plaintiffs and a foreign state which would not support diversity jurisdiction in the federal courts.²⁴⁷

In deciding whether FSIA supports federal question jurisdiction for foreign plaintiffs, the Supreme Court followed the framework for federal question jurisdiction presented in Chief Justice Marshall's famous opinion in *Osborn v. Bank of the United States*.²⁴⁸ This opinion laid down the "broad conception of 'arising under' jurisdiction."²⁴⁹ Under *Osborn*, federal question jurisdiction exists where the "right set up by the party may be defeated by one construction of the constitution or law[s] of the United States and sustained by the opposite construction."²⁵⁰ The Court in *Verlinden* concluded that because a plaintiff's claim could be defeated by the threshold application of the FSIA's immunity provisions, an action against a foreign sovereign arises under federal law for the purposes of Article III jurisdiction.²⁵¹ The Supreme Court further noted that the FSIA was more than a mere jurisdictional statute, but instead set forth "comprehensive rules governing sovereign immunity" and prescribed procedures for commencing lawsuits against foreign states in federal and state courts.²⁵²

Based upon *Verlinden*, Congress has the authority to create federal question jurisdiction for claims under COCCA that incorporate governing substantive and procedural standards to be applied in federal and state courts. A plaintiff's action subject to COCCA would require a court to

246 *Id.* at 491.

247 *Id.* at 492 (stating, with respect to actions between foreign citizens, "[s]ince Article III requires only 'minimal diversity,' . . . diversity jurisdiction would be a sufficient basis for jurisdiction where at least one of the plaintiffs is a citizen of a State). FSIA does require a connection to the United States for access to U.S. courts. *Supra* text accompanying note 233.

248 22 U.S. 738 (1824).

249 *Verlinden*, 461 U.S. at 492 (quoting *Osborn v. Bank of the United States*, 22 U.S. 738, 822 (1824)).

250 *Id.*

251 *Id.* at 494.

252 *Id.* at 495 n.22.

determine if COCCA applies to the dispute or if the choice of court agreement was valid. Courts applying COCCA would also have to determine whether personal jurisdiction was proper under the COCCA standard, rather than the conflicting state long-arm statute, and whether *forum non conveniens* could be applied. In these circumstances, given the “broad conception” of arising under jurisdiction recognized since *Osborn*, federal question jurisdiction would exist for all claims under a comprehensive COCCA scheme.

Federal subject matter jurisdiction also raises the question of removal of claims subject to COCCA from state courts to federal courts. As noted above, because of Article III’s diversity limitation, COCCA cases between only foreign parties normally would not be amenable to suit in federal courts. By enacting federal legislation that provides for federal question jurisdiction, Congress can allow for removal, as it did under the FSIA, which provides foreign states with the right to remove any civil action from a state court to a federal court.²⁵³ In determining whether to include removal provisions in any COCCA implementing law, however, Congress must also consider circumstances where the parties have negotiated a contract that calls only for submission to the jurisdiction of a particular state court, to the exclusion of federal courts in the same state. As a result, Congress may wish to consider a rule of interpretation as to when a choice of court agreement will be deemed to apply only to state courts.

Because COCCA does not contemplate removal, Congress must make a policy choice whether to include a removal provision in the COCCA implementing scheme. Under existing law, some courts consider an exclusive forum selection clause designating only state courts for dispute resolution as a waiver of the right to remove. For example, in *Snapper, Inc. v. Redan*,²⁵⁴ the Eleventh Circuit affirmed a decision construing a forum selection clause that allowed litigation to be brought in state or federal court in Georgia “as the Creditor may elect” to be considered a waiver by the guarantor of the right to remove an action filed by the creditor in Georgia state court.²⁵⁵ Other courts require waiver of the right to remove to be clear

²⁵³ See 28 U.S.C. § 1441(d) (2006).

²⁵⁴ 171 F.3d 1249 (11th Cir. 1999).

²⁵⁵ *Id.* at 1260 (11th Cir. 1999); see *Ocwen Orlando Holdings Corp. v. Harvard Prop. Trust, LLC*, 526 F.3d 1379, 1381 (11th Cir. 2008) (holding that language in the clause agreeing to “waive any right to transfer any such action filed in any court to any other court” effected a waiver of right to remove in addition to a right to transfer for the convenience of the parties and witnesses); *Dominium Austin Partners, L.L.C. v. Emerson*,

and unequivocal.²⁵⁶ If Congress does adopt a comprehensive federal scheme implementing COCCA, policy choices need to be made about whether to allow removal in violation of a choice of court agreement.²⁵⁷

B. Personal Jurisdiction and Service of Process.

Federal personal jurisdiction is particularly important in the COCCA context because of potential conflicts with state long-arm statutes that are more restrictive than the due process test of *International Shoe*. As discussed in Part II, current Supreme Court precedent holds that a valid choice of law agreement amounts to consent to jurisdiction and raises no due process concerns. If COCCA cases are deemed federal question cases and federal personal jurisdiction rules are prescribed, then COCCA's requirements can be fully satisfied without any constitutional due process infirmities. Adopting a federal rule for personal jurisdiction in chosen courts would also help clarify existing rules on personal jurisdiction for enforcement proceedings that are subject to COCCA.²⁵⁸

Personal jurisdiction under COCCA could mirror the FSIA's personal jurisdiction provisions. The FSIA's personal jurisdiction provisions provide in Section 2: "Personal jurisdiction over a foreign State shall exist as to every claim for relief over which the district courts have

248 F.3d 720, 727 (8th Cir. 2001) (holding that "a forum selection clause may be viewed as a waiver of a defendant's right to object to venue").

256 *See, e.g.*, *City of New Orleans v. Mun. Admin. Servs., Inc.*, 376 F.3d 501, 505-06 (5th Cir.2004) (affirming denial of a remand motion where the forum selection clause was not a "clear and unambiguous waiver of removal" because the clause read, "The undersigned Contractor does further hereby consent and yield to the jurisdiction of the State Civil Courts of the Parish of Orleans and does hereby formally waive any pleas of jurisdiction on account of the residence elsewhere of the undersigned Contractor."); *Cadle Co. v. Reiner, Reiner & Bendett, P.C.*, 307 F.App'x. 884, 888 (6th Cir. 2009) (holding that to waive the right to remove, a forum selection clause must mention removal and set forth an explicit waiver of that right).

257 Congress could opt to add a provision to the list of "non-removable actions" in 28 U.S.C. § 1445 to include certain agreements subject to COCCA designating only the courts of a state. *See* 28 U.S.C. § 1445 (2006).

258 *Cf.* Caroline Edsall, *Implementing The Hague Convention on Choice of Court Agreements In The United States: An Opportunity to Clarify Recognition and Enforcement Practice*, 120 Yale L.J. 397, 405 (2010) (arguing that in implementing legislation for the Hague Convention, "Congress should not hesitate to set forth explicitly what would satisfy personal jurisdiction in the context of recognition and enforcement" to "codify a single approach, and thereby provide predictability for litigants under the Convention.").

jurisdiction under subsection (a) where service has been made under . . . this title.”²⁵⁹ Implementing legislation for COCCA could provide similar language for service of process provisions or otherwise cross-reference the worldwide service of process provisions of the Hague Service Convention.²⁶⁰

C. Venue

Nothing in COCCA replaces existing rules on proper venue, although if transfer of venue is discretionary, courts are directed to give “due consideration” to the choice of the parties.²⁶¹ Strict implementation of this provision would uphold the existing standard announced in *Ricoh* that, notwithstanding the parties’ choice of forum in a valid forum selection clause, a court could exercise its discretion to transfer venue to a more appropriate forum under 28 U.S.C. § 1404(a).²⁶² At least one commentator has suggested removing discretion under § 1404(a) in the enforcement of forum selection clauses and instead applying the *Bremen* standard to resolve all issues relating to enforceability in a single procedural framework.²⁶³ At a minimum, when Congress implements COCCA, it should clarify whether it intends to retain the *Ricoh* ruling regarding the scope of § 1404(a) once a treaty on the issue is in place.²⁶⁴

259 See Foreign Sovereign Immunities Act of 1976 § 2 (codified as amended at 28 U.S.C. § 1330(b) (2006)).

260 See Fed. R. Civ. P. 4(f) cmt. C4-24 (noting that in *Volkswagenwerk Aktiengesellschaft v. Schlunk*, 486 U.S. 694, 699 (1988), the Supreme Court held that the Hague Convention on Service of Process preempted contrary state methods of service of process in cases subject to its provisions).

261 See COCCA, *supra* note 3, art. 5(3)(b).

262 See *Stewart Org., Inc. v. Ricoh*, 487 U.S. 22, 29 (1988); see also *supra* text accompanying notes 93-100.

263 See Holt, *supra* note 16, at 1945 (arguing for the creation of a single federal rule that would be the only available means to enforce forum selection clauses in federal court and would include language instructing courts to apply the standard from *Bremen* and ensure that defendants cease attempts to invoke the federal transfer statute by amending 28 U.S.C. § 1404(a) to indicate that courts must not consider the presence of a forum selection clause in their transfer analysis).

264 *Ricoh*, 487 U.S. at 30 (referring to 28 U.S.C. § 1404(a), which directs a district court to take account of factors other than those that bear solely on the parties’ private ordering of their affairs).

D. A Comprehensive Federal Scheme is Both Necessary and Practical.

As these procedural issues indicate, when Congress determines the circumstances under which foreign parties can litigate their claims in United States courts under COCCA, Congress must do more than simply legislate the terms of the Convention. The complexities of federal and state court relations, the limited jurisdiction of the federal courts, the prospects of removal, and the variety of procedural standards to determine personal jurisdiction, service of process and venue make implementation far from a matter of rote transcription. Looking to the FSIA's provisions on how and when American courts will allow litigation by foreign sovereigns provides a useful baseline on crafting federal law that dictates some, but not all, of the applicable legal standards.

Conclusion

Implementation of international obligations in the United States is a complex issue. This is especially true when international obligations implicate state court procedures or judicial authority.²⁶⁵ While there are strong arguments in favor of a state-by-state approach to implementation of Article 5 in the American federal system, the interests that COCCA and the United States, as a signatory, seek to promote are better served through a comprehensive federal legal framework applicable in federal and state courts. By creating a uniform federal approach rather than a uniform state law approach, the United States can achieve legal uniformity that not only fulfills the requirements of COCCA, but also enhances the ability of American corporations to access foreign courts for the enforcement of commercial judgments and, thereby, better compete in the global market place. In this way, federal law implementing COCCA can bring a modicum of certainty to an otherwise uncertain legal landscape by untangling international choice of court agreements from *Erie's* murky waters.

In implementing COCCA, Congress must also engage in a balancing act not simply between international and domestic law, but between federal

²⁶⁵ Cf. *Medellin*, *supra* note 153, at 517. The Court opined:

“Given that ICJ judgments may interfere with state procedural rules, one would expect the ratifying parties to the relevant treaties to have clearly stated their intent to give those judgments domestic effect, if they had so intended. Here there is no statement in the Optional Protocol, the U.N. Charter, or the ICJ Statute that supports the notion that ICJ judgments displace state procedural rules.” *Id.*

and state power and the authority of the three co-equal branches of the federal government. As Chief Justice Roberts wrote, “Congress is up to the task of implementing non-self-executing treaties, even those involving complex commercial disputes.”²⁶⁶ This task will include drafting provisions preempting state law on personal jurisdiction and *forum non conveniens*, while simultaneously preventing state attempts to evade COCCA’s goals through application of substantive standards that undermine the procedural rules necessary to realize the ultimate goal of enhanced recognition and enforcement of commercial judgments. By using *Bremen* and the FSIA as models, Congress can draw upon standards widely accepted in federal and state courts alike.

Finally, Congress must recognize the fact that choice of court agreements are not “alternate dispute resolution” procedures that can be dictated entirely by private parties considering private interests. When parties choose to have their disputes resolved in formal court systems rather than through private means, they must accept the risk and responsibility of participating in the public sphere. Private parties and Congress alike must acknowledge that courts have a fundamental institutional obligation to ensure that proceedings before them are fair, and that the interests of justice are satisfied, regardless of what private arrangements the parties have made. An implementation scheme for COCCA that does not allow American courts to consider the overall fairness of litigating in their forum would run contrary to the demands of an open and democratic society that depends on competent and impartial courts of justice. *Bremen* resolved this problem by incorporating public considerations into the determination of the reasonableness, and, thus, the enforceability, of forum selection clauses in international admiralty disputes. Congress too can solve this problem through a comprehensive set of legal standards that enforce choice of court agreements in international commercial transactions under COCCA while preserving the inherent authority of judges to ensure that the public interest in ensuring fair trials is maintained.

²⁶⁶ *Id.* at 521.

Factors to Consider Before Arbitrating in the Arab Middle East: Religious and Legislative Constraints

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Abstract

This article discusses two significant factors affecting arbitration in the Arab Middle East: the effect of religion on arbitration and the effect of legislative constraints on arbitration. By presenting foreign investors and practitioners with an overview of some of the unique social, legal and religious issues distinctive to arbitration in the Arab Middle East, this article will provide foreign investors and practitioners with examples of factors to consider that can affect arbitration decisions in the Middle East.

Introduction

The Arab Middle East's distinctive geographical position, the region's availability of natural resources, and the recent population increases and corresponding burgeoning demand for Western products¹ has primed Middle Eastern countries to be some of the largest participants in the global market. The Middle East is home to many dynamic trade and investment opportunities. For example, Saudi Arabia experienced an increase in foreign direct investment of \$27 billion from 2005 to 2008.² The Industrial & Commercial Bank of China Ltd., the largest Chinese commercial bank, is expanding widely in the Middle East and is considering acquisitions there to take advantage of China's booming

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1 See, e.g., John H. Donboli & Farnaz Kashefi, *Doing Business in the Middle East: A Primer for U.S. Companies*, 38 CORNELL INT'L L.J. 413, 414, 415 (2005).

2 The World Bank, World Development Indicators (2008), <http://data.worldbank.org/indicator/BX.KLT.DINV.CD.WD> (last visited June 19, 2011) (indicating an increase in foreign direct investment (net inflows) from \$12,106,749,694 in 2005 to \$39,455,863,929 in 2008, amounts in "current U.S. dollars").

investment in the region.³ In 2007, Egypt was poised for the expansion of approximately 40 international franchises, including 25 fast food franchises such as KFC, McDonald's and Pizza Hut.⁴ Finally, the Middle East countries possess the lion's share of the planet's crude oil resources, with Saudi Arabia, the largest exporter of petroleum, owning about twenty percent of world's proved oil reserves.⁵ In fact, analysts predict that nine of the world's ten largest oil refinery crackers will be located in the Middle East by 2012.⁶

Due to these unique trade and investment opportunities, potential methods to settle contract disputes in the Arab Middle East must be considered. Arbitration is an increasingly accepted form of alternative dispute resolution. Indeed, commercial contracts increasingly include arbitration clauses. Arbitration is often more efficient than other judicial remedies and has many attractions including: expediency, professionalism, specialized decision makers, confidentiality, and freedom of choice of substantive and procedural laws and place of arbitration. However, arbitration is most efficient when the parties involved understand the different legal, social, religious, cultural and other factors that may affect the arbitration and the enforceability of the arbitration award.

These factors differ between legal systems, especially in the Arab Middle East. In some Islamic nations, the courts decline to enforce foreign arbitral awards on domestic public policy grounds, including precepts of Islamic law.⁷ For instance, in Saudi Arabia and the United Arab Emirates, public order is constituted by the *Shari'a*, the body of rules derived from the main sources of Islamic law. Accordingly any foreign arbitral award that is

3 See Press Release, Industrial and Commercial Bank of China, ICBC Opens its Subsidiary in the Middle East (Oct. 10, 2008), http://www.icbc-ltd.com/icbcltd/about_us/news/icbc_opens_its_subsiary_in_the_middle_east.htm (last visited July 6, 2011).

4 See Kendal Tyre, *Franchising Sector in Egypt Receives Financial Boost* (June 29, 2009), http://www.nixonpeabody.com/linked_media/publications/Franchise_Alert_06_29_09.pdf (last visited March 2, 2011).

5 Saudi Arabia possesses 19.9% of the world's proved oil reserves and the Middle East possesses 55.6%. U.S. ENERGY INFORMATION ADMINISTRATION, WORLD PROVED RESERVES OF OIL AND NATURAL GAS, MOST RECENT ESTIMATES (March 3, 2009), <http://www.eia.gov/emeu/international/reserves.html>.

6 Robert Westervelt, *Mideast Advance*, 171 Chemical Week 3 (2009).

7 See Faisal Kutty, *The Shari'a Factor in International Commercial Arbitration*, 28 LOY. L.A. INT'L & COMP. L. REV. 565, 602-03 (2006).

inconsistent with *Shari'a* rules is set aside.⁸ A common example of this is setting aside foreign arbitral awards concerning contracts involving *riba* (interest).⁹ Because arbitration with an unenforceable award is pointless, foreign investors and practitioners must be aware of the issues affecting the enforceability of an arbitration award before they agree to an arbitration clause or include one in a contract.

Part I of this article will discuss religion as one of the factors affecting arbitration, particularly in the context of contracts. This section will demonstrate why religious influence on the legal system of a country must be considered before arbitrating in countries where the legal system is influenced by religious rules. Arbitration in Saudi Arabia provides a useful example of this process in a Middle Eastern country with a legal system based on Islamic Law (*Shari'a*). Part II of this article will discuss legislative constraints that warrant consideration before arbitrating to guarantee the enforceability of the arbitration awards, especially for technology licensing agreements. Egyptian law is analyzed as an example of a Middle Eastern country with exacting arbitration rules concerning technology licensing agreements.

I. *Shari'a* and Its Influence on Arbitration Laws in the Arab Middle East

In order to understand the influence of *Shari'a* on Middle Eastern arbitration, it is essential to understand the fundamentals of *Shari'a* law and its impact on national law and arbitration in the region. An example of *Shari'a* influence in Saudi Arabia illustrates the importance of considering religious issues for foreign investors working with the Arab Middle East.

A. *Shari'a* in Brief

Islamic rules and principles are provided by the Muslims' holy book, the *Qur'an*.¹⁰ In the Islamic faith the *Qur'an* was dictated word for word by *Allah*¹¹ to his Prophet Muhammad.¹²

⁸ See ABDUL HAMID EL-AHDAB, ARBITRATION WITH THE ARAB COUNTRIES 608-09 (1999).

⁹ See *id.* at 609. *Riba* is an Arabic word which means usury. *Glossary of Islamic Legal Terms*, 1 J. ISLAMIC L. 89, 99 (1996).

¹⁰ The *Qur'an* is the Islamic holy book revealed to Prophet *Muhammad* (PBUH). *Glossary of Islamic Legal Terms*, *supra* note 9, at 99; see generally, Irshad Abdal-Haqq, *Islamic Law An Overview of Its Origin and Elements*, 7 J. ISLAMIC L. & CULTURE 27, (2002) (defining

Shari'a refers to the body of rules derived from the main sources of Islamic law. *Shari'a* is the body of law and *Fiqh* is the process of applying the rules of *Shari'a* to real or hypothetical situations.¹³ *Shari'a* is divided into primary sources and secondary sources.¹⁴ Primary sources include the rules set forth in the *Qur'an* and the *Sunna*.¹⁵ Secondary sources include *Ijma'* and the *Qiyas*. *Ijma'* is an Arabic word that literally means the

the Islamic law, explaining the main elements of the *Shari'a*, and discussing the methodologies and schools of the Islamic jurisprudence).

11 *Glossary of Islamic Legal Terms*, *supra* note 10, at 90 (“Islamic name for the creator, the one and only deity; God.”); *see also* THE HOLY QURAN ENGLISH TRANSLATION OF THE MEANINGS AND COMMENTARY, 1536 (The Presidency of Islamic Researchers, Ifta, Call and Guidance ed., 1994) [hereinafter THE QURAN]; *Id.* at 2028 (“Then we put thee on the right Way of Religion: so follow though that Way and follow not the desires of those who know not”); *and id.* at 2028 (“Say: He is Allah, the One; Allah, the Eternal, Absolute, He Begetteth not, nor is He begotten; And there is none like unto Him”) (quoting the meaning of the *Qur'an* 112).

12 Prophet *Muhammad* (PBUH) is the Prophet of Islam. When the name of Prophet *Muhammad* (PBUH) is mentioned, it is followed by the sentence Peace Be Upon Him (“PBUH”) as a mark of respect and veneration. Abdal-Haqq, *supra* note 10, at n. 58. According to Abdal-Haqq, *supra* note 10, at 40:

Muhammad had a very difficult time establishing Islam among the Arabs of his day. Ultimately he succeeded. Though born an orphan and unable to read or write, he was able to combine religious with the secular in one of the most backward corners of the earth, to establish a civilization that ushered in the Renaissance in Europe, among other things. For his accomplishment, he has been called *the most influential person* in the history of the world by a non-Muslim historian [Michael H. Hart].

13 *Fiqh* is an Arabic word which refers to the Islamic Jurisprudence and sometimes to the collection of decisions reached by specific individual or institution. *Glossary of Islamic Legal Terms*, *supra* note 9, at 92. According to Abdal-Haqq, some authors use the words Islamic law, the *Shari'a* and *Fiqh* as simultaneous words which may confuse readers. Abdal-Haqq, *supra* note 10, at 32.

14 *See generally* M. Cherif Bassiouni & Gamal M. Badr, *The Shari'ah: Sources, Interpretation, and Rule-Making*, 1 UCLA J. ISLAMIC & NEAR E. L. 135 (2002) (defining the *Shari'ah* and introducing its sources and methods of interpretation and discussing the possibility of formulating new rules of law to meet the situations that were unknown during previous centuries and currently need to be both Islamic and modern).

15 The word *Sunna* is an Arabic word that refers to the sayings and deeds of Prophet *Muhammad* (PBUH) and it is referred to sometimes as *Hadit*. Abdal-Haqq, *supra* note 10, at 33.

unanimous agreement or consensus of opinion and refers to the consensus of opinion of the learned Muslim scholars. *Qiyas* is an Arabic word that literally means analogy and refers to the process of deducing legal decision on the basis of analogy by reference to the *Qur'an* and the *Sunna*.¹⁶

The *Qur'an* is the main source of the *Shari'a* and is a spiritual book and a guide for everyday behavior.¹⁷ The *Qur'an* consists of *Suras*¹⁸ (chapters) which are then divided into verses.¹⁹ Since the *Qur'an* is considered to be the highest source of *Shari'a*, its rules are not subject to challenge and cannot be modified by rules derived from any of the other sources of *Shari'a*.²⁰

The *Sunna* refers to the practices of Prophet Muhammad, which includes: "(1) Muhammad's own words; (2) Muhammad's actions (such as descriptions of how he prayed, conducted war, treated the poor, etc.); (3) Muhammad's tacit approval of actions performed in his presence, i.e. his silence on a matter was interpreted as consent; and (4) descriptions of his physical attributes, personality, demeanor, and disposition."²¹

Through the *Sunna*, Prophet Muhammad explained and completed principles stated in the *Qur'an*. The *Sunna* cannot contradict the *Qur'an*.²² An authentic *Sunna* that complies with the *Qur'an* is usually narrated and recorded in one of the *Sahih*, the best known and most trusted compilations of *Sunna*. These books are the *Sahih Al-Bukhari*, *Sahih Muslim*, *Sunan An-*

16 See *Glossary of Islamic Legal Terms*, *supra* note 9, at 94 (providing literal meanings); See also Bassiouni & Badr, *supra* note 14, at 152-57 (2002) (providing connotation of terms).

17 Bassiouni & Badr, *supra* note 14, at 148.

18 *Sura* is an Arabic word meaning chapter of the *Qur'an* and literally meaning a series of things. *Glossary of Islamic Legal Terms*, *supra* note 9, at 101.

19 Bassiouni & Badr, *supra* note 14, at 148-49.

20 Bassiouni & Badr, *supra* note 14, at 149; See also Bernard K. Freamon, *Slavery, Freedom, and the Doctrine of Consensus in Islamic Jurisprudence*, 11 HARV. HUM. RTS. J. 1, 3, 15 (1998) (discussing the Islamic law of slavery and the solutions provided thereof after giving a brief introduction about the current situation of Islam and the different sources of the *Shari'a*).

21 Abdal-Haqq, *supra* note 11, at 47.

22 See Bassiouni & Badr, *supra* note 14, at 152.

Nasa'I, *Sunan Abi Dawud*, *Sunan At-Tirmidhi*, and *Sunan Ibn Majah*.²³ If there is no guidance on an issue in the *Qur'an* or the *Sunna*, the secondary *Shari'a* sources (*Ijma'* and the *Qiyas*) apply.²⁴

B. *Shari'a* as a Source of National Laws in Muslim Countries

Different countries treat *Shari'a* differently as a source of national law. Islamic countries can be divided into three categories based on the degree of influence of *Shari'a* on their legal system.²⁵

The first category includes countries like Lebanon and Turkey that do not consider *Shari'a* to be a source of their national law.²⁶ In these countries, the influence of *Shari'a* on the actual practice of law and on legal decisions is limited or not formally clear. For instance, the Turkish Constitution provides that:

The Republic of Turkey is a democratic, secular and social state governed by the rule of law; bearing in mind the concepts of public peace, national solidarity and justice; respecting human rights; loyal to the nationalism of Atatürk, and based on the fundamental tenets set forth in the Preamble.²⁷

The second category includes countries like Algeria, Tunisia, Egypt, and Jordan.²⁸ The effect of *Shari'a* on the legal systems of the countries in

23 See Abdal-Haqq, *supra* note 10, at 46-49.

24 See Abdal-Haqq, *supra* note 10, at 54, 56-57.

25 NISRINE ABIAD, SHARIA, MUSLIM STATES AND INTERNATIONAL HUMAN RIGHTS TREATY OBLIGATIONS: A COMPARATIVE STUDY, 43-46 BRIT. Inst. of Int'l & COMP. L. 2008. Abiad places the countries into "a large and diverse spectrum" *Id.* at 43. On one end of the spectrum are secular countries like Turkey, and on the other end are countries such as Iran wherein Sharia is "the only source of legislation." *Id.* at 44. "Between these two extremes are...[various countries]... "which accord Sharia different degrees of status as a normative source of the law." *Id.* at 46.

26 See *id.* at 35-36, 44 (using Lebanon and Turkey as examples of countries in which Islam is not constitutionally assigned a privileged status).

27 TURKEY [Constitution] art. 2.

28 See ABIAD, *supra* note 25, at 37-38, 46-51.

this category differs from one country to the next.²⁹ The Algerian, Tunisian, and Jordanian Constitutions only provide that Islam as the formal religion of the country without providing for *Shari'a* as the primary source of law.³⁰ Conversely, Article 2 of the Egyptian Constitution declares Islam as the religion of the State and the “principal” source its law.³¹ Therefore, according to the Egyptian Supreme Constitutional Court,

The principles of the Islamic *shari'a* are the major source of legislation (*tashri*). This imposes a limitation curtailing both the legislative and executive power, through which they are obliged, in whatever laws or decrees they enact, to avoid provisions that may contradict the provisions of Islamic law which are definite in terms of their immutability and their meaning...Whatever legislative enactment contravenes them must be declared null and void.³²

The third category of Islamic countries are countries like Iran, Qatar, the United Arab Emirates and Saudi Arabia which recognize *Shari'a* as the main source of their national laws to the extent that they consider the *Qur'an* to be the constitution of their countries.³³ Article 1 of the Basic Law of 1992 of Saudi Arabia provides that: “Saudi Arabia is an Arab Islamic country with full sovereignty whose religion is Islam and its Constitution, the Book of Allah and the *Sunna* of His Prophet, peace be upon him ”³⁴ Article 1 of the Qatari Constitution provides that “Qatar is an

²⁹ See *id.* at 47.

³⁰ See *id.* at 37-38, 51.

³¹ CONSTITUTION OF THE ARAB REPUBLIC OF EGYPT, art. 2, available at <http://www.egypt.gov.eg/english/laws/Constitution> (last visited Oct. 4, 2010) (“the principal source of legislation is Islamic Jurisprudence (Sharia)”).

³² Case No. 5257/43/Dec. 28, 1997/Constitutional Court (Egypt), quoted in Kilian Bälz, Human rights, the rule of law, and the construction of tradition The Egyptian Supreme Administrative Court and Female Circumcision (appeal no. 5257/43, 28 Dec. 1997), 34 *Première série, Droits d'Égypte: histoire et sociologie* 141, available at <http://ema.revues.org/index1511.html>.

³³ ABIAD, *supra* note 25, at 39-46 (placing Iran, Pakistan, and Saudi Arabia at “one end of the spectrum” because they hold the Qur'an as their constitution/source of law).

³⁴ THE BASIC LAW OF GOVERNANCE, art. 1 (Saudi Arabia), available at Kingdom of Saudi Arabia Ministry of Foreign Affairs, *The Basic Law of Government*, <http://www.mofa.gov.sa/sites/mofaen/> (point to “About Kingdom”; then “Saudi Government” hyperlink) (last visited June 19, 2011).

independent Arab state. Islam is the State's religion and the Islamic Shariah is the main source of its legislations."³⁵ The same rule is provided by the Constitution of the United Arab Emirates: "Islam is the official religion of the Union. The Islamic Shari'ah shall be a main source of legislation in the Union."³⁶ Likewise, Pakistan established the Islamic Council to confirm that the bills are in conformity with the *Shari'a* before issuance, and established the Federal *Shari'a* Court to examine the conformity of the application of the national laws with the *Shari'a*.³⁷

C. Arbitration in *Shari'a*

Arbitration, or *tahkim*,³⁸ is well known in *Shari'a* through its different sources. The *Quran* refers loosely to arbitration in several of its verses. For instance, the theory of arbitration is presented in the *Quran* through the concept "...when ye judge between people that ye judge with justice..."³⁹ Jurists argue that this verse allows judgment and accordingly it allows arbitration to settle disputes as a general rule.⁴⁰ The *Qur'an* further provides for arbitration in the matrimonial context, "If ye fear a breach between them twain [i.e., husband and wife], [then] appoint (two) arbiters, one from his family and the other from hers..."⁴¹

The *Sunna* also confirms arbitration. The Prophet Muhammad reportedly appointed an arbitrator and adhered to his decisions.⁴² He also reportedly counseled a tribe to have a dispute arbitrated.⁴³ In addition, Arab arbitration expert Dr. Abdul Hamid El-Ahdab states, "The Idjma

35 QATAR [Constitution], art. 1, available at Embassy of the State of Qatar in Washington DC, *Constitution of Qatar*, <http://www.qatarembassy.net/constitution.asp> (last visited June 19, 2011).

36 UNITED ARAB EMIRATES [Constitution], art. 7, available at <http://www.unhcr.org/refworld/docid/48eca8132.html> (last visited June 28, 2011).

37 ABIAD, *supra* note 25, at 45-46.

38 *Glossary of Islamic Legal Terms*, *supra* note 9, at 101.

39 The *Qur'an* 4:58.

40 See EL-AHDAB, *supra* note 9, at 14-15.

41 The *Qur'an* 4:35.

42 EL-AHDAB, *supra* note 9, at 15.

43 *Id.*

(consensus) which is the third source of Moslem law, was even more explicit with respect to the definition and determination of the field of arbitration. Consequently, the validity of arbitration never was, and never could be, discussed in Islam.”⁴⁴

While arbitration as a dispute resolution tool may not be questioned, Abdul Hamid El-Ahdab points out that a discussion took place among Islamic scholars with regard to the exact meaning of arbitration in Islam and its scope.⁴⁵ The question is whether Islam understands arbitration as a mere attempt to conciliate, similar to the Islam concept of amiable composition or if Islam has an understanding of arbitration in line with the Western conception of arbitration, wherein arbitrators are empowered to decide upon disputes.⁴⁶ Abdel Hamid El-Ahdab concludes that:

The answers given by Moslem Law to the problems raised by arbitration have been given before the commercial and economic evolution had reached today's stage. However, they are not unalterable and do not constitute an exception to the universal rule that 'the laws must change over the times'. Indeed, Shari'a is not static and rigid and it is only bound by the Koran, the Sunna, the Idjma' and the Qiyas (analogy).⁴⁷

D. The Influence of *Shari'a* on Arbitration in Saudi Arabia

In practice, important developments in arbitration in the Arab Middle East began with the enactment of modern legislation regarding international arbitration.⁴⁸ In Bahrain, Jordan, Oman, and Tunisia, arbitration laws are drafted in accordance with the United Nations Commission on International Trade Law Model Law of 1985 (“Model

44 *Id.*

45 *Id.*

46 *Id.* at 13-18.

47 EL-AHDAB, *supra* note 940, at 19.

48. *See generally*, George Anthony Smith, Matthew A. Marrone. *Recent Developments in Arbitration Law in the Middle East*, WEINBERG WHEELER HUDGINS GUNN & DIAL (Sept. 15, 2010), <http://www.wwhgd.com/news-article-71.html>.

Law”).⁴⁹ In Lebanon and Qatar, arbitration legislation is drafted based on European law.⁵⁰

However, *Shari'a* still has a clear effect on arbitration in the Middle East. Saudi Arabia is a good example of the influence of *Shari'a* on arbitration in the Middle East because Saudi Arabian law is an excellent model of the application of classic Islamic law.⁵¹ Saudi Arabia considers the *Qur'an* to be its Constitution.⁵² Furthermore, Saudi Arabia is significant because it is one of the major emerging markets in the Middle East with a promising future in global investment and trade. Saudi Arabia has the largest economy in the Gulf region,⁵³ so the influence of *Shari'a* law on arbitration holds important implications for future trade and investment.

The Saudi legal system has a dual nature, with both religious principles that conform to *Shari'a* and a legal system that helps solve disputes and deal with different legal issues.⁵⁴ In this context, the *Arabia v. Arab Am Oil Co.* (ARAMCO) case represents a turning point in Saudi arbitration.

In the 1958 case, the ARAMCO Company and the Saudi government entered into a petroleum concession contract to research, exploit, and market petroleum and provided for arbitration to resolve disputes.⁵⁵ Later, Saudi Arabia effectuated the establishment of a private company, Saudi Arabia Maritime Tankers Company (“Tankers Company”) and gave it preferential rights to transfer petroleum from and to the Saudi

49 See William K. Slate, *UNCITRAL (United Nations Commission on International Trade Law): Its Workings in International Arbitration and a New Model Conciliation Law*, 6 CARDOZO J. CONFLICT RESOL. 73, n. 59 (2004).

50 Charles N. Brower, Jeremy K. Sharpe, Notes and Comments, *International Arbitration and the Islamic World: The Third Phase*, 97 AM. J. INT'L L. 643, 650 (1993).

51 Charles P. Trumbull, *Islamic Arbitration: A New Path for Interpreting Islamic Legal Contracts*, 59 VAND. L. REV. 609, 628 (2006) (discussing arbitration in contracts of Islamic nature).

52 EL-AHDAB, *supra* note 9, at 537.

53 S. Breckenridge Thomas, *International Arbitration: A Historical Perspective and Practice Guide Connecting Four Emerging World Cultures: China, Mexico, Nigeria, and Saudi Arabia*, 17 AM. REV. INT'L ARB. 183, 187-89.

54 Trumbull, *supra* note 51, at. 609, 629.

55 Thomas, *supra* note 53, at 233; EL-AHDAB, *supra* note 9, at 558-560.

terminals. ARAMCO argued that its concession contract allowed it to choose its own method to transfer petroleum, and refused to accept the Tankers Company's priority rights. The Saudi government brought the dispute to arbitration.⁵⁶

The arbitral tribunal ruled in favor of ARAMCO. The tribunal determined that ARAMCO's concession contract was subject to the Saudi legal system, whose main source of law is *Shari'a*. However, the tribunal also considered standard practices in the oil industry, international jurisprudence, and legal precedents. Ultimately, the tribunal found that Saudi law was not comprehensive enough and did not conform to standard industry practice.⁵⁷ ARAMCO's concession contract rights were upheld because "the (Saudi) government cannot abolish acquired rights in a concession contract by granting them, all or in part, to another person in a new concession contract."⁵⁸

Although the Saudi Council of Ministers initially forbade government agencies from arbitration following the case, Saudi Arabia's economic prominence and interaction with the West gradually made it more open to international arbitration,⁵⁹ as shown by its adoption of the Arbitration Law of 1983 ("Saudi Arbitration Act").⁶⁰ However, like the rest of Saudi law, the Saudi Arbitration Act is subject to *Shari'a*. This means that Western and Asian practitioners must have a basic understanding of Islam and the application of *Shari'a* if they wish to interact with Islamic countries like Saudi Arabia in the global market.⁶¹

Shari'a has multiple effects on the Saudi Arbitration Act. For instance, arbitration is not allowed in areas of law where conciliation is not allowed, such as criminal offenses, public order and other legal areas

56 EL-AHDAB, *supra* note 9, at 558-61 (quoting the arbitration tribunal).

57 See Thomas, *supra* note 68, at 233.

58 EL-AHDAB, *supra* note 9, at 561.

59 See Thomas, *supra* Note 53, at 233.

60 *Id.*; Arbitration Law, Royal Decree No. M.46, 12 *Rajab* 1403, A.H. (April 25, 1983) [hereinafter Saudi Arbitration Act], reprinted in EL-AHDAB, *supra* note 9, at 909-12.

61 See Charles P. Trumbull, Islamic Arbitration: A New Path for Interpreting Islamic Legal Contracts, 59 VAND. L. REV. 609 (2006).

reserved to the state.⁶² Moreover, Article 3 of the Saudi Arabian Implementation Rules states that:

The arbitrator must be a Saudi national or a moslem foreigner chosen amongst the members of the liberal professions or other persons. He may also be chosen amongst state officials after agreement of the authority on which he depends. Should there be several arbitrators, the Chairman must know the Sharia, commercial law and the customs in force in the Kingdom.⁶³

Finally, when the Saudi Arbitration Act is silent on certain issues, like whether foreign lawyers are allowed to appear in arbitration, the matter is referred to *Shari'a* rules as the source of Saudi laws and regulations.⁶⁴

Furthermore, Saudi Arabia's accession to the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards ("the New York Convention") and the International Convention for the Settlement of Investment Disputes ("ICSID") does not affect the fact that Saudi courts review arbitral decisions to ensure that they are consistent with Saudi Arabia's public policy and *Shari'a*.⁶⁵ As a result, arbitration awards against a Saudi Company in favor of a foreign company are almost never enforced for "public policy" reasons. Contracts which provide for the application of foreign law are also often accused of violating the Saudi public order and *Shari'a* ipso facto, and thus considered void.⁶⁶

Examples of contracts that might violate *Shari'a* in Saudi Arabia include contracts for commercial transactions that include profit via interest

62 Thomas, *supra* Note 53, at 233; *see also* Implementation Rules for the Arbitration Act, Royal Decree No. 71 2021/11, 09/08/1405 H May 27, 1985 [hereinafter Implementation Rules], Art. 3, reprinted in El-Ahdab, *supra* 9, at 909-12; Kutty, *supra* Note 7, at 599; El-Ahdab, *supra* 9, at 573-74.

63 Implementation Rules, *supra* 62, art. 3; *see also* Kutty, *supra* note 7, at 606.

64 *See* Thomas, *supra* note 53, at 235. With regard to the issue of whether foreign lawyers are allowed to appear in arbitration, the *Qur'an* and the *Sunna* have construed this silence as not prohibiting foreign representation according to the implementation of a principle of the *Shari'a*, which authorizes anything not expressly forbidden. *Id.*

65 *See* Kutty, *supra* note 7, at 600-02, 618.

66 *See* EL-AHDAB, *supra* note 9, at 601.

or contracts that involve gambling.⁶⁷ Any contract containing risky or hazardous dealings, where details concerning the transaction are unknown or uncertain such as transaction insurance contracts, would be subject to this rule. A contract's validity under *Shari'a* depends on the clauses of the contract, and foreign investors should be aware of potential complications in arbitration based on this.⁶⁸

II. Legislative Constraints on Arbitration in Technology Licensing Agreements in the Arab Middle East

In addition to contemplating the religious impact of *Shari'a* on arbitration in the Arab Middle East, investors and practitioners need to consider the legislative constraints on arbitration, particularly when resolving disputes over technology licensing agreements. A brief overview of the complications related to technology licensing agreements and the important role of arbitration to resolve these disputes is followed by an example of legislative restraints on arbitration in Egypt.

A. Technology Licensing Agreements and Arbitration

One way to exploit technology owned by others is through a licensing agreement with the other.⁶⁹ Licenses to use technology usually result in serious responsibilities for licensees. For instance, licensees are typically responsible for any manufacturing defects or inadequate quality control.⁷⁰ Moreover, sometimes if the license is exclusive there is an overall obligation on the licensee to use all reasonable efforts to achieve the objectives of the license agreement.⁷¹

As a result, huge and complicated disputes arise in connection with technology licensing agreements. These disputes occur in the following contexts: cross-licensing arrangements; international trademark or patent infringements; rights and obligations arising under joint research and

⁶⁷ Kutty, *supra* note 7, at 605-06; Thomas, *supra* note 53, at 227.

⁶⁸ See Kutty, *supra* note 7, at 605-06.

⁶⁹ See generally, Exchanging Value Negotiating Technology Licensing Agreements (A Training Manual), 16 The World Intellectual Prop. Org. & Int'l Trade Ctr., Exchanging Value Negotiating Technology Licensing Agreements (A Training Manual) (2005).

⁷⁰ See *Id.* at 67.

⁷¹ *Id.* at 71.

development initiatives; agreements to settle prior litigation in several jurisdictions; copyrights; domain name issues; and generic commercial disputes like construction and business acquisitions.⁷²

Arbitration is an attractive method of solving disputes arising out of technology licensing agreements, particularly because it guarantees confidentiality to the parties and supports the special needs of commercial reputations and trade secrets related to technology licensing agreements. Arbitration also ensures expediency in resolving disputes and allows more flexibility to choose the place and language of proceedings. Finally, arbitration utilizes decision makers who understand the complex issues involved in these types of conflict.⁷³

In the Middle East, arbitration in technology licensing agreements is extremely important because:

Middle Eastern countries are generally characterized by weak judiciaries which are not independent from the executive branches of government. The Judges in the region are often government employees working under the executive through the minister of justice. This gives the executive branch the power to interfere in the judicial process. Egypt and Lebanon, for example, have highly developed judiciaries but are often under pressure from the executive branches of their governments. Further, the judiciary in Middle East countries is often characterized by a lack of binding precedent, lack of procedural transparency, sparsely developed doctrines, unavailability of remedies such as injunctive relief and lack of publicly available administrative or judicial decisions.⁷⁴

As a result, arbitration in the Middle East may be the most effective solution when there is conflict resulting from a complicated agreement like

72 Sophie Lamb & Alejandro Garcia, *Arbitration of Technology & Intellectual Property Disputes*, Global Arbitration Review: The European & Middle Eastern Arbitration Review 2008, Int'l J. of Public and Priv. Arb. 1, at 49-50.

73 See WORLD INTELLECTUAL PROP. ORG. & INT'L TRADE CTR., *supra* note 69, at 75.

74 MICHAEL K. LINDSEY, INTRODUCTION TO FRANCHISING IN THE MIDDLE EAST: NAVIGATING THE RISKS AND REWARDS OF THE WORLD'S MOST INTERESTED MARKET 13 (The American Bar Association ABA Forum on Franchising and the ABA Center for Continuing Legal Education 2010).

a technology licensing agreement.⁷⁵ However, although arbitration is a good choice as opposed to the traditional judicial systems of the Middle East, investors must take into account the constraints on arbitration in the Middle East and make sure they are completely aware of what they are signing up for.

B. Legislative Constraints on Arbitration in Egypt

The legislative constraints on arbitration in technology licensing agreements can be demonstrated through the situation in Egypt. In the late nineteenth century, Egypt became the first Arab country to adopt a Western influenced legal system.⁷⁶ Egyptian law is influenced by European legal models, particularly the French “Code Civil” and “Code de Commerce.”⁷⁷ Arbitration in Egypt is governed by Law No. 27 of 1994, known as the “Egyptian Arbitration Act,”⁷⁸ which is modeled on the United Nations Commission on International Trade Law (“UNCITRAL”) Model Law.⁷⁹

The Egyptian Arbitration Act has three primary functions. First, it distinguishes between national and international arbitration by providing in Article 1 that “the provisions of the present Law shall apply to all arbitration...when such arbitrations are conducted in Egypt or when the parties to an international commercial arbitration conducted abroad agree to subject it to the provisions of this Law.”⁸⁰ Second, the Egyptian Arbitration Act gives the parties to an arbitration absolute freedom to choose procedural

⁷⁵ See *id.*

⁷⁶ SAMIR SALEH, COMMERCIAL ARBITRATION IN THE ARAB MIDDLE EAST, SHARI'A, LEBANON, SYRIA, AND EGYPT, 335 Hart Publishing 2006; see also Herbert J. Liebesny, *A Symposium on Muslim Law (Part II): Impact of Western Law in the Countries of the Near East*, 22 GEO. WASH. L. REV. 127 (1953).

⁷⁷ ARBITRATION AND MEDIATION IN THE SOUTHERN MEDITERRANEAN COUNTRIES (Giuseppe De Palo & Mary B. Trevor eds., 2007).

⁷⁸ Law No. 27 of April 18, 1994 Promulgating the Law Concerning Arbitration in Civil and Commercial Matters, *translated in* El-AHDAB, *supra* note 9, at 156, 820-35 [hereinafter Egyptian Arbitration Act].

⁷⁹ El-AHDAB, *supra* note 9, at 155-56. UNCITRAL is the principal legal entity in the United Nations established to modernize and harmonize international commerce laws. UNCITRAL drafts model laws, legislative guides, and legal recommendations. About UNCITRAL, http://www.uncitral.org/uncitral/en/about_us.html (last visited June 1, 2011).

⁸⁰ Egyptian Arbitration Act, *supra* note 78, art. 1.

and substantive law applicable to the Arbitration.⁸¹ Finally, the Egyptian Arbitration Act applies to domestic and international arbitration, so it does not take a rigid position with regard to the place of arbitration; parties are free to agree to hold the arbitration in Egypt or abroad.⁸²

Technology licensing agreements in Egypt are governed by Law No. 17 of 1999, known as the “Commercial Code,” particularly articles 72-87 of the Code, referred to here as the “Technology Transfer Provisions.”⁸³ In particular, the Technology Transfer Provisions concern agreements whose subject matter is the transfer of technology to be used in Egypt.⁸⁴ The Provisions are very protective of the licensees. For example, Article 75 gives the licensee the permission to invalidate any clause in the agreement that restricts his rights in using, developing, producing or advertising the transferred technology.⁸⁵ Some believe that the reason behind this cautious and protective approach to licensees in Egypt stems from the idea that licensees, as receivers of technology in developing countries, are often in a weak position compared to licensors.⁸⁶ The outcome of this conservative

81 See SALEH, *supra* note 76, at 386. See Egyptian Arbitration Act, *supra* note 78, art. 25, which provides that “[t]he parties to the arbitration have the right to agree on the procedures to be followed by the arbitral tribunal, including the right to subject such procedures to the provisions in force in any arbitral organization or centre in Egypt or abroad...” Moreover, Article 39 provides that “The Arbitral Tribunal shall apply the rules agreed by the parties to the subject matter of the dispute...”

82 SALEH, *supra* note 76, at 388; see also Egyptian Arbitration Act, *supra* note 78, art. 28, which provides that “[t]he parties to arbitration may agree on a place of arbitration in Egypt or abroad...”

83 Law No. 17 of 1999, Promulgating the New Commercial Code, arts. 72-87, *translated in* Egypt: Technology Transfer Provisions in Law No. 17 of 1999, 15 Arab L. Q. 418 (2000) [hereinafter Egyptian Commercial Code No. 17 of 1999].

84 Egyptian Commercial Code No. 17 of 1999, *supra* note 83, art. 72. Article 72 states:

The provisions of this Chapter shall apply to each contract for the transfer of technology to be used in the Arab Republic of Egypt, whether such transfer is international lying across the regional borders of Egypt, or inland, without taking into consideration in both cases the nationality of the parties to the agreement or their places of residence.”

85 Egyptian Commercial Code No. 17 of 1999, *supra* note 83, art. 75 (“Any condition prescribed in the technology transfer contract, which restricts the freedom of the importer in its use, development, acquaintance of the product or its advertisement, may be invalidated”).

86 Sameha El-Kalouby, <Transliterated Arabic Title> [The Explanation of the Egyptian Commercial Code Part Two], 105 Dar-Alnahda Al-arabeya 2005 (available in Arabic).

attitude is protective arbitration rules regarding technology licensing agreements that differ from the general, more flexible rules governing the Egyptian Arbitration Act.

One example of the difference between arbitration law under the Egyptian Arbitration Act and the Technology Transfer Provisions involves choice of law and location in arbitrations. Unlike Article 25 of the Egyptian Arbitration Act, which gives parties to an arbitration freedom to choose the procedural and substantive law applicable to the arbitration, Article 87 of the Technology Transfer Provisions provides that if parties to a technology transfer agreement choose to arbitrate, the arbitration will be subject to Egyptian substantive and procedural law. Any agreement to arbitrate under a different foreign law is null and void.⁸⁷ As a corollary, while the Egyptian Arbitration Act Article 28 gives the arbitrating parties absolute freedom to choose the place of arbitration, Article 87 of the Technology Transfer Provisions provides that technology transfer agreement arbitrations must take place inside Egypt.⁸⁸ Lastly, Article 72 of the Technology Transfer Provisions applies to all contracts for the transfer of technology to be used in Egypt, regardless of locality, whereas the Egyptian Arbitration Act Article 1 applies to international commercial arbitration conducted abroad only if the parties have agreed to be subject to the Arbitration Law.⁸⁹

Resultantly, any foreign investor arbitrating a technology transfer agreement in Egypt is obliged to conduct the arbitration in Egypt and abide by Egyptian substantive and procedural law. Some critics argue that these protective technology transfer rules discourage foreign investors from transferring technology to Egypt.⁹⁰ Licensors arbitrating technology

87 See Egyptian Commercial Code No. 17 of 1999, *supra* note 83, art. 87 (“In all cases, decided on the subject of the dispute shall be according to the provisions of the Egyptian law, and any agreement to the contrary shall be null and void.”).

88 See *id.* (“The Egyptian courts shall have jurisdiction to decide on disputes... Agreement may be reached on settling the dispute amicably or via arbitration to be held in Egypt according to the provisions of Egyptian law”); Egyptian Arbitration Act, *supra* note 80, art. 28 (“The parties to arbitration may agree on a place of arbitration in Egypt or abroad”).

89 Egyptian Commercial Code No. 17 of 1999, art. 1, *supra*, note 84; Egyptian Arbitration Act, *supra* note 78, art. 1 (“the provisions of the present Law shall apply... when such arbitrations are conducted in Egypt or when the parties to an international commercial arbitration conducted abroad agree to subject it to the provisions of this law”).

90 Sameha El-Kalouby, <Transliterated Arabic Title> [The Explanation of the Egyptian Commercial Code Part Two], 105 Dar-Alnahda Al-arabeya 2005 (available in Arabic).

transfer agreements in Egypt must be aware of legislative constraints they face when arbitrating a technology licensing agreement in Egypt.

Conclusion

Foreign investors in the Middle East must be aware of the constraints and legal frameworks that affect arbitration in the region before deciding to arbitrate their disputes in the Arab Middle East and avoid unenforceable arbitration awards. The importance of considering different legal, religious, social, and cultural issues that may affect arbitration is an essential part of doing business in the Middle East.

Though Middle Eastern arbitration laws are often based on Western arbitration law, *Shari'a* special rules and legislative constraints put into place to protect national interests have a significant influence on arbitration law in the Middle East.⁹¹ Arbitration in the Middle East is unique, and lack of a proper understanding of the situation can be costly. Foreign investors and practitioners who are looking at arbitrating in the Middle East must invest the time to become familiar with the special legal and religious context of the country in which they want to arbitrate. An understanding of different concerns and backgrounds and how they affect arbitration is essential for investors and practitioners before deciding to arbitrate in the Arab Middle East.

⁹¹ See, e.g., Saudi Arbitration Act, *supra* note 60, art. 3.

**Improper Seizures by Sovereigns at Customs:
Limiting EC 1383/2003 through the Effects Principle**

Soji John*

Introduction

On several recent occasions, European Union (“EU”) (formerly the European Community (“EC”))¹ customs officials seized generic pharmaceuticals at Union ports that non-EU manufacturers sought to transship to non-EU markets.² In order to secure the release of these drugs, the manufacturers have had to recall the shipments rather than sending them forward to the destination countries.³ These European nations seem to be within their rights to hinder the free passage of these goods. After all, vessels entering a port are typically subject to the jurisdiction of the sovereign state.⁴ However, by detaining legitimate goods, these nations are applying their domestic patent laws in a manner that is *effectively* extraterritorial. Although their actions are territorial, by using their customs facilities and ports in a manner that may be contrary to international norms and agreements, these European nations are essentially expanding their

* The author thanks Professor Anthony Colangelo of The Southern Methodist University Dedman School of Law for his help with this article. His comments and guidance were invaluable in its preparation. Any errors are attributable solely to the author.

1 Coming into force on December 1, 2009, the Treaty of Lisbon resulted in amendment of the Treaty on European Union. Treaty of Lisbon Amending the Treaty on European Union and the Treaty Establishing the European Community, Dec. 13, 2007, 2007 O.J. (C306) 1. This caused the European Union (“EU”) to “replace and succeed” the European Community (“EC”). *Id.* art. 1(2)(b).

2 Martin Khor, *Row over Seizure of Low-Cost Drugs*, STAR ONLINE (Aug. 10, 2009) (citing John W. Miller and Geeta Anand, *Corporate News: India to Fight EU Drug Delays in WTO Complaint*, WALL ST. J., Aug. 6, 2009, at B4), <http://thestar.com.my/columnists/story.asp?file=/2009/8/10/columnists/globaltrends/4487956&sec=Global%20Trends> (last visited Oct. 16, 2011). These generic medicines, although patented in these European nations, are unprotected both where they are manufactured and in the markets to which they are destined. *See id.*

3 *See id.* (reporting that a shipment of Losartan was returned to India after being held by Dutch customs).

4 RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW OF THE UNITED STATES § 512 n.5 (1987).

patent laws, which are understood to be bounded nationally, to have significant extraterritorial effects.

Jurisdictional issues implicate limits on the rights of sovereigns to exert influence over other states, in particular the ability to affect legal interests. Although municipal law is the *primary* means of regulation within national boundaries, international law restricts a nation's jurisdiction in applying its municipal law extraterritorially.⁵ Therefore, while municipal laws dominate national conduct, they are correspondingly limited internationally.⁶

The modern view is that states must give an appropriate basis for exercising extraterritorial jurisdiction.⁷ For example, the Third Restatement of Foreign Relations Law supports jurisdiction over foreign conduct that is "directed against . . . a limited class" of national interests.⁸ At the same time, the Third Restatement limits this power, utilizing a reasonableness test to analyze the validity of the exercise of extraterritorial jurisdiction.⁹ Thus, while local law restricts jurisdiction nationally, additional international principles generally limit extraterritorial jurisdiction. As a result, nations need affirmatively to justify this extraterritorial exercise of power.

This paper considers the limits on the application of domestic customs law to transshipped goods at local ports. It proposes that the exercise of local customs laws to seize goods in transshipment should be restricted to those cases where there is an appropriate nexus between the supposed violations of domestic law and the interests of the port nation, even though it is internationally accepted that port states have jurisdiction over vessels that enter their port. In particular this paper contends that the broad application of EC Regulation No. 1383/2003¹⁰ ("EC 1383") by

5 LORI F. DAMROSCH ET AL., INTERNATIONAL LAW CASES AND MATERIALS 757-58 (5th ed. 2009).

6 *Id.*

7 *See id.* at 758.

8 RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW OF THE UNITED STATES § 402 (1987).

9 *Id.* § 403.

10 Council Regulation 1383/2003, Concerning Customs Action Against Goods Suspected of Infringing Certain Intellectual Property Rights and the Measures to be Taken Against

European nations' customs officials to seize generic pharmaceuticals transshipped from India to Latin American nations improperly extends the reach of local patent laws extraterritorially and hinders trade. Further it asserts that in order to determine when applying domestic law to transshipped goods is appropriate, the EU should promote the use of the effects principle.

Part I of this paper explains that the seizure of goods purely in transit, such as generic pharmaceuticals, is controversial, even within the EU. Part II addresses the evolution of extraterritorial application of domestic customs regulations, including the use of the effects principle. Part III posits that the EU's pharmaceutical transshipment intervention is illegitimate under the effects principle and international law. Finally, part IV advocates for using the effects principle to guide extraterritorial application of EC 1383 customs regulations.

I. EU and International Customs Regulations of Transshipped Goods

The seizure of goods that are solely transiting through a port state by customs officials is a highly controversial issue. International treaties have attempted to balance the competing interests of efficient trade and intellectual property ("IP") protection by focusing on facilitating trade to the greatest extent possible within the parameters of minimum requirements of participating states to protect patent rights. Nonetheless, the conflict between safeguarding patent rights and promoting the free flow of goods remains apparent with the seizure of transshipped goods such as pharmaceuticals, even within the EU. For example, the United Kingdom ("U.K.") has limited the application of EC 1383 to seize only goods that could enter and affect its markets, while Netherlands officials promote a broader reading of the statute, allowing seizure of goods without regard to direct effects on its market.¹¹ This section will analyze the controversy surrounding the confiscation of pharmaceuticals transiting through the EU, within the context of international law.

Goods Found to Have Infringed Such Rights, art. 5, 2003 O.J. (L 196) 7, 9-10 (EC) [hereinafter EC 1383].

11 See Rb. Gravenhage 18 juli 2008, rolnr. 311378 / KG ZA 08-617 (Sosecal Industria e Comercio Ltda/Societa Italiana Lo Syiluppo Dell' Elettronica) (Neth.), available at http://www.eplawpatentblog.com/PDF_December09/The%20Hague%20DC%20Sisvel%20v%20Sosecal%20EN.pdf; Nokia Corp. v. Her Majesty's Comm'r of Revenue & Customs, [2009] EWHC (Ch) 1903, [79]-[80].

A. EU Customs Officials' Controversial Seizures of Generic Pharmaceuticals in Transshipment

During the past two years, EU member nations have intercepted and prevented the onward shipment of generic medicines en route to developing Latin American countries for IP violations.¹² Largely at the behest of multinational pharmaceutical corporations ("MNCs"), EU member nations seized these goods despite the absence of patent protection or trademark infringement in the manufacturing or destination country.¹³ World organizations monitoring access to drugs are concerned that these seizures are not incidental, but rather a tactic of MNCs to increase the market for their patented, brand-name drugs by persuading intermediary port nations to disrupt the legitimate global trade in generics.¹⁴

For example, developing nations which were denied transshipments of these pharmaceuticals were especially critical of a December 2008 seizure of Losartan, a generic version of the brand name drug, Cozarr.¹⁵ Customs officials in Rotterdam, Netherlands seized this shipment en route to Brazil at the prompting of Merck Inc., which holds the Dutch patents on Cozarr.¹⁶ These officials relied on their *national* interpretation of EC 1383, designed to restrict goods violating IP rights, and confiscated these drugs

12 Khor, *supra* note 2. Germany and the Netherlands have intercepted the following medicines: Clopidogrel, a blood thinner; Rivastigmine for Alzheimer's disease; Olanzapine, an anti-psychotic; and Losartan, for high blood pressure. *Id.*

13 *Id.* Compulsory licensing enables a government to allow the production of medicine without the patent owner's permission. *Compulsory Licensing of Pharmaceuticals and TRIPS*, WORLD TRADE ORG. (Sept. 2006), http://www.wto.org/english/tratop_e/trips_e/public_health_faq_e.htm (last visited Oct. 16, 2011).

14 See Peter Maybarduk, *Stop Fakes, Not Generics*, ACCESS TO MED. PROJECT (May 13, 2009), <http://www.essentialaction.org/access/index.php?/archives/181-Stop-Fakes,-Not-Generics.html#extended> (stating that pharmaceutical companies deliberately confuse patent rights and trademark counterfeiting issues and exploit public safety concerns to protect their monopolies).

15 See Goran Danilovic, *Recent Dutch Seizures of Generic Drugs Add Fire to the WTO Dispute Regarding Seizure of Goods in Transit*, LEXOLOGY (March 23, 2009), <http://www.lexology.com/library/detail.aspx?g=06012359-6993-4ee8-a8e5-e3a93ef4c245>.

16 See *id.*

ostensibly for patent violations and to prevent the proliferation of substandard medications.¹⁷

The quality of medicines can be a genuine concern since counterfeit medicines have caused health issues throughout the world. Because counterfeiting occurs for generics as well as brand-name medicines, there is a legitimate concern over the authenticity of generic drugs, in this case, Losartan, entering Latin America.¹⁸ However, the goods that the Rotterdam customs officials seized were *not* counterfeit versions of Cozarr or Losartan, and no evidence indicates there was any suggestion to that effect.¹⁹ Rather, the manufacturers accurately designated these medicines as the generic drug Losartan.²⁰

Moreover, even if there are legitimate concerns as to the *authenticity* of the *generic drug*,²¹ these apprehensions do not trigger the trademark rights of manufacturers of *brand name* drugs or the anti-counterfeit laws of

17 See *Seizure of Medicines a Blow to Developing States*, ECON. JUST. NETWORK (Aug. 18, 2009), <http://www.ejn.org.za/index.php/ejn-on-the-move/ejn-on-the-move-news/211-seizure-of-medicines-a-blow-to-developing-states>. Reasons given for the seizure “include cracking down of counterfeit drugs and substandard potentially hazardous products, and preventing patent violation.” *Id.* Nonetheless, the generic was manufactured in a country where Dutch patents do not apply and was en route to a country where Dutch patents do not apply. Thus, the seizure appears to be a power play to sell more brand-name drugs. See *id.*

18 See INT’L MED. PRODS. ANTI-COUNTERFEITING TASKFORCE, WORLD HEALTH ORG., COUNTERFEIT DRUGS KILL! 2 (2008), available at <http://www.who.int/impact/FinalBrochureWHA2008a.pdf>; WYATT YANKUS PHARMACY NEAR YOU 1-2 (Am. Council on Sci. & Health ed., 2009), available at http://www.acsh.org/docLib/20090202_counterfeitdrug09.pdf. The World Health Organization (“WHO”) has defined counterfeit drugs as medicines that are “deliberately and fraudulently mislabeled with respect to identity, composition, and/or source.” Yankus, *supra*, at 1, annotation estimated that about ten percent of the world’s drug supply is counterfeit. Yankus, *supra*, at 1, 3 n.4. The WHO has estimated that the amount of counterfeit drugs in less developed countries reaches up to twenty-five percent. JULIAN MORRIS & PHILIP STEVENS, COUNTERFEIT MEDICINES IN LESS DEVELOPED COUNTRIES: PROBLEMS AND SOLUTIONS 3 (Int’l Policy Network ed., 2006), available at http://www.policynetwork.net/sites/default/files/IPN_Counterfeits.pdf.

19 Danilovic, *supra* note 15; Khor, *supra* note 2.

20 Khor, *supra* note 2.

21 INT’L MED. PRODS. ANTI-COUNTERFEITING TASKFORCE, *supra* note 18, at 4; Morris & Stevens, *supra* note 18, at 3.

European countries through which these generics merely transit. These drugs, properly manufactured and labeled, were not made for EU national markets, but for Latin American countries. As a result, this effectively extraterritorial application of IP laws does not comply with the Agreement on the Trade Related Aspects of Intellectual Property Rights ("TRIPS").²² By applying EC 1383 broadly under the guise of IP violations to goods that are *not* to be imported and do not have any credible way of entering the EU marketplace these customs officials are inadvertently encumbering the free trade of legitimate pharmaceuticals. This consequently affects the health and economy of Latin American nations and essentially applies local patent laws internationally.

B. International Agreements Governing Shipment in Trade

Despite these situations of EU nations extending the extraterritorial reach of domestic patent regulations, these countries are subject to international law, including their obligations to international organizations such as the World Trade Organization ("WTO"). Shortly following World War II, nations set up a charter for an International Trade Organization ("ITO") to "apply uniform principles of fair dealing with regards to trade."²³ The ITO eventually failed to come into force but led to the development²⁴ of the General Agreement on Trade and Tariff ("GATT") protocol.²⁵ After several rounds of negotiations and modifications, the "WTO" was formed in 1994 as a permanent trade body under the GATT.²⁶

22 Agreement on Trade-Related Aspects of Intellectual Property Rights, Marrakesh Agreement Establishing the World Trade Organization, Annex IC, Apr. 15, 1994, 108 Stat. 4809, 1869 U.N.T.S. 299 [hereinafter TRIPS Agreement]; see Jennifer Giordano-Coltart, Comment, *Walking the Line: Why the Presumption Against Extraterritorial Application of U.S. Patent Law Should Limit the Reach of 35 U.S.C. § 271(F)*, 2007 DUKE L. & TECH. REV. 4, ¶ 24.

23 LORI F. DAMROSCH, ET AL., INTERNATIONAL LAW CASES AND MATERIALS 1575-76 (4th ed. 2001).

24 *Id.* at 1576.

25 General Agreement on Tariffs and Trade, Oct. 30, 1947, 61 Stat. pt. 5, 55 U.N.T.S. 194 [hereinafter GATT].

26 DAMROSCH, *supra* note 23 at 1577.

Most nations are now part of this multilateral organization created to reduce trade barriers and promote tariff-free trade.²⁷

As part of the WTO, members are obliged to follow GATT protocols.²⁸ In particular, GATT Article V discusses the agreement between nations concerning the *transit* of goods.²⁹ GATT dictates that goods, and vessels transporting these goods, are in transit through a WTO member's territory when "the passage across such territory, with or without trans-shipment, warehousing, breaking bulk, or change in the mode of transport, is only a portion of a complete journey beginning and terminating beyond the frontier" of the member's territory.³⁰ GATT requires that member nations allow goods to move "via the routes most convenient for international transit."³¹ Nations may require goods to enter into customs houses for routing and traffic control but should not otherwise unnecessarily delay or restrict the transshipment of goods through their port.³²

In addition to GATT, EU nations are also subject to other international obligations on their ports and customs. For example, EU member states have agreed to the United Nations Convention on the Law of the Sea ("UNCLOS"), a generally accepted body of principles ratified by many nations.³³ In fact, "nearly all of the substantive provisions in the Convention reflect existing customary international law, which is binding

27 WORLD TRADE ORG., THE WORLD TRADE ORGANIZATION (2009), *available at* http://www.wto.org/english/res_e/doload_e/inbr_e.pdf.

28 *Id.*

29 GATT, *supra* note 25, art. V.

30 *Id.* ¶ 1.

31 *Id.* ¶ 2.

32 *Id.* ¶ 3.

33 United Nations Convention on the Law of the Sea art. 192, Dec. 10, 1982, 1833 U.N.T.S. 397 [hereinafter UNCLOS]. One major exception is the United States, which has not agreed to be bound by its terms. *Chronological Lists of Ratifications of, Accessions and Successions to the Convention and the Related Agreements as at 03 June 2011*, UNITED NATIONS, http://www.un.org/Depts/los/reference_files/chronological_lists_of_ratifications.htm (last updated June 3, 2011) (indicating that the United States has not agreed to be bound by UNCLOS).

even on those states that do not become members to the Convention.”³⁴ Thus, UNCLOS, serving as a body of international law to which all nations should adhere, applies to the transit of goods.

UNCLOS requires port nations to open their ports to facilitate trade with landlocked states.³⁵ In particular, port states must take all measures “to avoid delays or other difficulties of a technical nature in traffic and in transit.”³⁶ Therefore, while it is true that ports and customs are under the sovereignty of the territorial authority, this local authority must also take into account international obligations that limit how they apply national laws.

C. TRIPS and the Territoriality of Patent Rights

In addition to international obligations such as GATT and UNCLOS, the WTO set up the TRIPS Agreement in April 1994 to establish the *minimum standard* that WTO member nations must meet for the protection of intellectual property.³⁷ This modern agreement is successful and almost universally accepted. Its principles are based upon the Paris Convention of 1884, which historians characterize as the first true international legislation of patent law.³⁸ Prior to the Paris Convention, nations held patents as “dependant,” so if an inventor obtained patents in two nations and let the patent lapse in one, the second nation could hold the patent lapsed as well.³⁹ In this way, the application of the patent law in one

34 Richard J. McLaughlin, *UNCLOS and the Demise of the United States' Use of Trade Sanctions to Protect Dolphins, Sea Turtles, Whales, and Other International Marine Living Resources*, 21 *ECOLOGY L.Q.* 1, 4 (1994).

35 UNCLOS, *supra* note 33, art. 124.

36 *Id.* art. 130.

37 See *A Summary of the Final Act of the Uruguay Round*, WORLD TRADE ORG., http://www.wto.org/english/docs_e/legal_e/ursum_e.htm (last visited Oct. 6, 2011).

38 ROBERT P. MERGES, ET AL., *INTELLECTUAL PROPERTY IN THE NEW TECHNOLOGY AGE* 331-32 (4th ed. 2007) (“The Paris Convention was . . . a product of the first true “internationalization” wave in the field of patent law.”).

39 Jacob A. Schroeder, *So Long As You Live Under My Roof, You'll Live By . . . Whose Rules?: Ending The Extraterritorial Application of Patent Law*, 18 *TEX. INTELL. PROP. L.J.* 55, 64 (2010).

country was linked to the validity of the patent in another.⁴⁰ Therefore, local application of patent laws had extraterritorial implications prior to the Paris Convention.

Conversely, the Paris Convention explicitly promoted the principle of *independence*.⁴¹ Independence originated with the notion of state sovereignty and the view that national patents are property rights granted by the sovereign.⁴² Although independence limited the extraterritorial application of local patent law, other problems remained. Because states implemented patent protections independently, there were huge disparities in the protections available in different nations.⁴³ Though some technologies could be patented in one nation, they were not afforded protections in another because of variations in the law.⁴⁴ For example, in India, protections for pharmaceuticals were not present until 2005, allowing a large generics industry to develop that capitalized on copying drugs that were invented in countries with patent protection.⁴⁵ In addition to inequality resulting from protection for some technologies, nations also gave stronger protection to nationals than to citizens of foreign countries.⁴⁶ As a result, when patents became national in scope and states acted independently, trade barriers resulted from these global inconsistencies in protection.⁴⁷

To reduce these disparities, developed nations promoted TRIPS as a WTO obligation, setting a minimum level of protection for inventions and encouraging national implementation of IP laws by all WTO member

40 *Id.*

41 Paris Convention for the Protection of Industrial Property art. 4bis(1), July 14, 1967, 21 U.S.T. 1583, 828 U.N.T.S. 305.

42 See Schroeder, *supra* note 39, at 65.

43 See *id.*

44 *Id.*

45 Amy Kapczynski, *Harmonization and its Discontent: A Case Study of TRIPS Implementation in India's Pharmaceutical Sector*, 97 CAL. L. REV. 1571, 1576-80 (2009).

46 Schroeder, *supra* note 40, at 65.

47 See *id.* at 65-66.

states.⁴⁸ While TRIPS seeks to establish a uniform level of protection, it maintains the independence of national patent systems.⁴⁹ Furthermore, since TRIPS is a non-self executing agreement, each member nation must implement its requirements within their own patent system.⁵⁰ Accordingly, when nations offer greater protections than the minimum required by TRIPS,⁵¹ variations between IP laws inevitably result. Consequently, signatories of TRIPS, like EU nations, are required to recognize the sovereignty of other states and apply their patent laws only territorially.

A fundamental basis for jurisdiction is territoriality: the sovereign has supreme authority over its land.⁵² Nations can voluntarily limit these territorial rights when they enter into international treaties such as GATT and UNCLOS or join international organizations such as the WTO. At the same time, there is a presumption that the laws of the sovereign are confined to his territory.⁵³ Thus, from a strictly territorial view, “every state enjoy[s] broad exclusive jurisdiction over person[s] and activities within its territory, but no state [can] assert its jurisdiction extraterritorially.”⁵⁴ This applies to patent law, based on the independence doctrine under TRIPS, such that each nation is limited to applying its patent system nationally.

II. Flag State v. Port State Jurisdiction: Rights of the Sovereign at Port

As discussed above, both GATT and TRIPS recognize the importance of limiting the jurisdiction of sovereigns for efficient trade. Also to promote trade, international law “presumes that ports of every state

48 Kapczynski, *supra* note 45, at 1579; Schroeder, *supra* note 39, at 65-66.

49 TRIPS Agreement, *supra* note 22, art. 2.

50 Schroeder, *supra* note 39, at 66.

51 *Id.* at 66.

52 DAMROSCH, *supra* note 5, at 768.

53 Gary B. Born, *A Reappraisal of the Extraterritorial Reach of U.S. Law*, 24 L. & POL'Y INT'L BUS. 1, 8 (1992).

54 *Id.* at 8 n.28.

should be open to all commercial vessels.”⁵⁵ These commercial vessels are treated as having the nationality of the flags they fly, known as flag-state jurisdiction, as long as there is a “genuine link” between the vessel and the nation whose flag is flown.⁵⁶ In international waters, the jurisdiction of the flag state traditionally dominates.⁵⁷ Generally it is only when a flag-state vessel enters port voluntarily that the vessel is subject to the jurisdiction of the port state.⁵⁸ In some instances, though, it is possible for port states to exercise authority over actions that take place in international waters or in ports where international agreements generally limit sovereign authority. This extension of jurisdiction is based upon the effects principle, under which extraterritorial conduct having domestic consequences can be regulated by the impacted state.⁵⁹

A. Port States and Transshipments

Although the extraterritorial expansion of sovereign jurisdiction under the effects principle has important implications for transshipment, international agreements have, at the same time, circumscribed some of the jurisdiction that port states typically wield in their own territory. This section considers the evolution of the jurisdiction and actions of port states concerning the transshipment of cargo. First, an early twentieth century case regarding alcohol transshipment through United States ports during Prohibition is examined. Second, a more recent case of Chilean transshipment of swordfish caught by European fishermen is considered. In

55 John T. Oliver, *Legal and Policy Factors Governing the Imposition of Conditions on Access to and Jurisdiction over Foreign-Flag Vessels in U.S. Ports*, 5 S.C. J. INT'L L. & BUS. 209, 210 (2009).

56 UNCLOS, *supra* note 33, art. 91, para. 1; DAMROSCH, *supra* note 23, at 1466-67. Aircraft are treated as having the nationality of the state in which they are registered. Convention on International Civil Aviation art. 17, Dec. 7, 1944, 61 Stat. 1180, 15 U.N.T.S. 295.

57 See Suzanne Bostrom, Comment, *Halting the Hitchhikers: Challenges and Opportunities for Controlling Ballast Water Discharges and Aquatic Invasive Species*, 29 ENVTL. L. 867, 890 (2009) (“As exemplified by the International Convention for the Prevention of Pollution from Ships (MARPOL) and UNCLOS, international law tends to favor flag state enforcement over port state powers.”).

58 RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW OF THE UNITED STATES § 512, reporters' nn.5-6 (1987).

59 See *United States v. Aluminum Co. of Am.*, 148 F.2d 416, 443 (2d Cir. 1945).

both cases, the transshipment had sufficient effect on the port state that it justified the expansion of sovereign jurisdiction hindering international norms set up to facilitate trade.

i. Transshipments of Liquor at United States Ports under the Volstead Act

This case study examines United States port jurisdiction over the transshipment of liquor. The United States adopted a national prohibition of alcohol with the passage of the Eighteenth Amendment.⁶⁰ In particular, the Eighteenth Amendment provided that “the manufacture, sale, or transportation of intoxicating liquors within, the importation thereof into, or the exportation thereof from the United States and all territory subject to the jurisdiction thereof for beverage purpose is hereby prohibited.”⁶¹ The Volstead Act enforced the Eighteenth Amendment, stating that “no persons shall . . . manufacture, sell, barter, *transport*, import, export, deliver, furnish, or possess any intoxicating liquor” unless explicitly exempted by the act.⁶² This act, like most United States statutes, should be strictly territorial and should apply only domestically.⁶³

However, United States customs officials applied the Volstead Act to have extraterritorial effect by restricting the transport of liquors between foreign nations through United States ports. In one case in the Eastern District of Michigan, the United States collector of customs and other officials attempted to prevent the shipments of liquor to foreign countries through the United States.⁶⁴ However, the district court issued an

60 Thomas H. Walters, *Michigan's New Brewpub License: Regulation of Zymurgy for the Twenty-First Century*, 71 U. DET. MERCY L. REV. 621, 635 (1994). The national prohibition bill passed through Congress and was sent to the states in 1917 and ratified in 1919. *Id.*

61 U.S. CONST. amend. XVII, *repealed* by U.S. CONST. amend. XXI.

62 National Prohibition (Volstead) Act, ch. 85, 41 Stat. 305 (1919) *invalidated* by U.S. CONST. amend. XXI (emphasis added).

63 *Grogan v. Hiram Walker & Sons, Ltd.*, 259 U.S. 80, 93 (1922) (McKenna, J., dissenting) (“It is certainly the first sense of every law that its field of operation is the country of its enactment.”); *see also* *Am. Banana Co. v. United Fruit Co.*, 213 U.S. 347, 357 (1909) (stating that “a construction of any statute [is] intended to be confined in its operation and effect to the territorial limits over which the lawmaker has general and legitimate power”).

64 *Hiram Walker & Sons, Ltd. v. Lawson*, 275 F. 373, 373 (E.D. Mich. 1921).

injunction to prohibit the United States officers from interfering with the transshipment of the liquors.⁶⁵ In contrast, a second case in the Southern District of New York denied the plaintiff's motion to enjoin officials from stopping transshipments of liquor to foreign countries on the basis that transshipment violated the Volstead Act.⁶⁶

The Supreme Court joined and decided both cases.⁶⁷ The Court analyzed a treaty with England that allowed passage through United States ports when items were brought to port strictly for transshipment to British territories.⁶⁸ The transshipment companies argued that this treaty and a strict reading of the Volstead Act permitted transshipment because the liquor was not intended for consumption in the United States.⁶⁹ The Volstead Act was concerned with domestic consumption and did not explicitly restrict transshipment at United States ports.⁷⁰ The majority, however, found that although Congress had not strictly prohibited transshipment, such was its intent because it had explicitly forbidden all *other* customs actions while expressly allowing transshipments through the Panama Canal.⁷¹ In considering whether the Act covered transshipments, the majority also explained that the Volstead Act took into consideration that liquor *could* be diverted for local use.⁷² Since it was possible for a quantity of the liquor entering for transshipment to be diverted to the domestic marketplace,⁷³ the alcohol was indeed entering the United States

⁶⁵ *Id.* at 379.

⁶⁶ *Anchor Line (Henderson Bros.) v. Aldridge*, 280 F. 870, 871-72, 876 (S.D.N.Y. 1921).

⁶⁷ *Grogan*, 259 U.S. at 87.

⁶⁸ *Id.* Also, note that this case was decided in 1922, prior to GATT.

⁶⁹ *Id.* at 89.

⁷⁰ *Id.*

⁷¹ *Id.* at 90.

⁷² *Id.* at 89-90.

⁷³ *Id.* at 89. In fact, liquor was known to be stolen from the Port of New York. In 1921, it was documented that approximately 100,000 bottles of liquor were stolen from docks, lighters, and trucks in two years. *Bars Foreign Rum from U.S. Ports – Court Decides Law Prohibits Transshipment of Liquors Through this Country*, N.Y. TIMES, Oct. 21, 1921 (reporting the decision of *Anchor Line (Henderson Bros.) v. Aldridge*, 280 F. 870 (S.D.N.Y. 1921)).

“for beverage purposes.”⁷⁴ Thus, the transshipment directly resulted in a violation of the Volstead Act.⁷⁵

However, the dissent argued that the Volstead Act only prohibited the type of transportation that was “within . . . the United States and ‘for beverage purposes.’”⁷⁶ The dissent contended that the transshipped liquor did not fall under the ambit of the Volstead Act and, therefore, should be transshipped per the treaty with England.⁷⁷ The dissent also argued that the majority’s application of national law resulted in “direct[ing] the practices of the world” by essentially applying the local law extraterritorially.⁷⁸ That is, by setting up barriers to free trade in liquor, the United States was indirectly hindering the extraterritorial consumption of alcohol.⁷⁹ Moreover, the dissent noted that even if there is some diversion of the liquor into domestic markets, the quantity must be significant before that diversion justified the prevention of transshipment per the Volstead Act.⁸⁰

Unfortunately, rather than resorting to an analysis akin to the effects principle, the majority relied primarily upon the notion of sovereignty and its interpretation of Congressional intent authorizing the customs actions, showing little concern for international duty.⁸¹ Although the majority did attempt to bolster its analysis with some inquiry into the effect of the transshipped liquor, it was primarily the dissent that considered whether there could be a significant impact on domestic markets that justified limiting transshipments. Today, United States courts make greater efforts to associate the exercise of jurisdiction with the prevention of domestic

74 *Grogan*, 259 U.S. at 88-89.

75 *Id.* at 90.

76 *Id.* at 94 (McKenna, J., dissenting) (emphasis added).

77 *Id.*

78 *Id.* at 95.

79 *See id.* at 89 (majority opinion).

80 *Id.* at 96-97 (McKenna, J., dissenting).

81 Comment, *Does the Eighteenth Amendment Violate International Law?*, 33 YALE L.J. 72, 77-78 (1923) (“[I]t must be conceded, perhaps, that the United States is under an international duty not to prevent the enjoyment of [a state’s privilege to transport liquor on the seas] under international law by any act proximately causing the inhibition.”).

harm through the effects principle due to greater international obligations and the potential for subsequent international response.⁸²

ii. The Chilean Swordfish Dispute: Modern View on Extraterritorial Application

The shift in modern extraterritorial application is further illustrated through the modern case study of Chile's refusal to permit transshipment of Chilean fish. Chile restricted access to its ports by Spanish deep-sea fishers carrying swordfish destined for the United States. In doing so, Chile applied its local Fisheries Law, which has been described as preventing "any vessels from transshipping or landing vessels in Chilean ports when its catches do not comply with Chilean law."⁸³ Chile found that swordfish were an over-exploited species and contended that the Spanish fishing just outside of Chile's 200-mile exclusive economic zone ("EEZ") resulted in depletion that had devastating effects upon Chile's own industries.⁸⁴ As a result of Chile's action, ANAPA, the Spanish National Association of deep-sea long liners, brought a complaint in the EC that Chile was creating unnecessary obstacles to trade.⁸⁵ According to ANAPA, the Chilean practices prevented "[c]ommunity vessels . . . [from expanding] their fishing capacity within the South Pacific fishing area . . . [so as to make] it unprofitable to invest in the exploitation of the fishing resources in this area."⁸⁶

Based upon these complaints, the EC conducted an examination and brought action against Chile in the WTO.⁸⁷ The EC based its action upon Article V of the GATT, which requires "freedom of transit for goods

82 See Born, *supra* note 53, at 22, 26, 30-32; Austen Parrish, *The Effects Test: Extraterritoriality's Fifth Business*, 61 VAND. L. REV. 1455, 1471-72 (2008).

83 John Shamsey, *ITLOS vs. Goliath: The International Tribunal for the Law of the Sea Stands Tall with the Appellate Body in the Chilean-EU Swordfish Dispute*, 12 TRANSNAT'L L. & CONTEMP. PROBS. 513, 518 (2002).

84 *Id.* at 519.

85 Notice of Initiation of an Examination Procedure Concerning an Obstacle to Trade, Within the Meaning of Council Regulation (EC) No 3286/94, Consisting of Trade Practices Maintained by Chile in Relation to the Transit and Transshipment of Swordfish in Chilean Ports, §§ 1, 3, 1998 O.J. (C 215) 2.

86 *Id.*

87 *Id.*; Shamsey, *supra* note 83, at 520.

through the territory of each contracting party.”⁸⁸ In defense, Chile claimed that its actions were neither discriminatory nor a “disguised restriction on international trade,” but were “necessary to protect human, animal, or plant life or health” as allowed per Article XX(b) of the GATT.⁸⁹

In response to the WTO action, Chile brought a claim against the EC in the International Tribunal for the Law of the Sea (“ITLOS”).⁹⁰ Chile explained the steps it took to establish restrictions and controls for its own fishing vessels within its EEZ⁹¹ and stated that the Spanish vessels had not provided the necessary documentation to show their compliance with these requirements.⁹² Moreover, Chile stated that because these fish are a migratory species, unrestricted fishing directly outside of its EEZ has a direct impact upon Chile’s economic interests.⁹³ Chile contended that its “good-faith non discriminatory, domestic environmental regulations that reach[ed] activities beyond its sovereign jurisdiction can stand up to international free trade concerns.”⁹⁴

In the end, the EC and Chile came to an agreement allowing a limited number of EC ships to call at Chile’s ports.⁹⁵ However, Chile made a strong case by linking its extraterritorial activity to a direct domestic detriment. In this way, the effects principle played a significant role in justifying Chile’s effectively extraterritorial action.

88 Shamsey, *supra* note 83, at 520-21 (quoting GATT, *supra* note 25, art. V, ¶ 2).

89 *Id.* at 521-22 (quoting GATT, *supra* note 25, art. XX(b)).

90 *Id.* at 523.

91 *Id.* at 523-24.

92 *Id.* at 524.

93 *See id.* at 525 (detailing Chile’s assertion that “a state's support of its nationals' right to fish should end when those fishing practices contravene Articles 63, paragraph 2, and 64-67, which provide that states shall work to protect highly migratory species occurring within and *outside* of the coastal state's EEZ”).

94 *Id.* at 526.

95 *Id.* at 538. In a prior WTO dispute, Tuna/Dolphin I, the WTO panel held that a state could not undertake an environmental measure that has “the effect of regulating cargo caught *outside of* a nation’s jurisdiction.” *Id.* at 531. However, ITLOS may have allowed broader protection for the environment at the detriment of trade. *Id.* at 536.

B. The Effects Principle

Given the trend in justifying extraterritorial jurisdiction based on negative domestic impact, it is essential to outline the emergence and limitations of the effects principle. Jurisdiction in a port is typically based upon the territoriality principle: when a ship enters a port it submits to the jurisdiction of that sovereign.⁹⁶ Thus, the port state would have jurisdiction over violations of domestic law committed by the foreign-flag vessel at port.⁹⁷ Violations committed out of the territory of the sovereign, however, would not be subject to its jurisdiction.⁹⁸ In addition, when considering the application of domestic law extraterritorially, courts often consider whether the legislature *intended* the domestic law to apply extraterritorially and whether such application would comply with international law.⁹⁹ Under this analysis, application of domestic law to conduct outside sovereign ports is possible only if it has been authorized and the application complies with international law.

In this context, several courts began to hold that the effects principle permitted the regulation of extraterritorial conduct that impacted the state. For instance, the Permanent Court of Justice recognized the effects principle in the *S.S. Lotus* case.¹⁰⁰ Under the effects principle, a violation of a state's law need not occur in the state's territory for the state to have jurisdiction; it is enough that the violation leads to effects in the state.¹⁰¹ Furthermore, the effects principle was acknowledged in the *United States v. Aluminum Company of America*¹⁰² case, where the Second Circuit stated, "it is settled

⁹⁶ Oliver, *supra* note 55, at 219.

⁹⁷ *Id.* at 231.

⁹⁸ *Id.* at 233.

⁹⁹ *Id.* at 233-34.

¹⁰⁰ Julie L. Henn, Note, *Targeting Transnational Internet Content Regulation*, 21 B.U. INT'L L.J. 157, 161 (2003) (citing Case of the *S.S. Lotus* (Fr. v. Turk.), Judgment, 1927 P.C.I.J. (ser. A) No. 10 (Sept. 7)) ("In the *S.S. Lotus* case, the Court [in 1927] found that Turkey had jurisdiction to prosecute French citizens for injuries sustained by Turkish citizens after a collision [on the high sea] between a French steamer and a Turkish boat.").

¹⁰¹ David J. Gerber, *Prescriptive Authority: Global Markets as a Challenge to National Regulatory Systems*, 26 HOUS. J. INT'L L. 287, 294 (2004).

¹⁰² 148 F.2d 416 (2d Cir. 1945).

law . . . that any state may impose liabilities, even upon persons not within its allegiance, for conduct outside its borders that has *consequence within* its borders which the state reprehends.”¹⁰³

Indeed, with the increase in international trade and cooperation resulting from lowered barriers to human and capital mobility and to information exchange, the effects principle provides a method to regulate extraterritorial conduct.¹⁰⁴ At the same time, the effects test has flaws. For example, the test is difficult to apply in determining what an “effect” is and when an effect is sufficient to warrant action.¹⁰⁵ Nonetheless, even though scrutiny is less mechanical than with the territorial jurisdiction principle, the effects principle provides a straightforward analysis in many instances.¹⁰⁶ For example, economic effects are relatively easy to recognize, as evidenced through the acceptance of the extraterritorial application of federal securities law and anti-trust actions.¹⁰⁷ Thus, when applying the effects test, the primary issue is determining whether the effect is sufficient to warrant action.

When read broadly, the effects principle could result in universal application of domestic law since any act could have *some* effect, however tenuous, upon the interests of a state. Therefore, most jurisdictions recognize some limitations of the principle. For instance, the United States applies a “‘reasonableness’ requirement as a threshold for applying national law to extraterritorial activities.”¹⁰⁸

As another constraint in administering the effects principle in the United States, extraterritorial application is only available when the

103 *Id.* at 443 (emphasis added); Gerber, *supra* note 101, at 294.

104 *See* Parrish, *supra* note 82, at 1456-60.

105 *Id.* at 1480-82.

106 *See* Born, *supra* note 53, at 29.

107 *Id.* at 33-34, 45-48.

108 Yulia A. Timofeeva, *Worldwide Prescriptive Jurisdiction in Internet Content Controversies: A Comparative Analysis*, 20 CONN. J. INT'L L. 199, 205 (2005) (citing RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW OF THE UNITED STATES § 403(1) (1987)).

domestic effects are “direct, substantial, and reasonably foreseeable.”¹⁰⁹ For example, the Foreign Trade Antitrust Improvements Act of 1982 (“FTAIA”) limits the Sherman Act to domestic application except where foreign conduct “significantly harms imports, domestic commerce, or American exporters.”¹¹⁰ In particular, the FTAIA states that the effect must be “direct, substantial, and reasonably foreseeable,”¹¹¹ codifying common law limitations on the effects test.

The FTAIA limits on the effects principle are clearly illustrated in the *F. Hoffman – La Roche Ltd. v. Empagran S.A.*¹¹² case. In *Empagran*, the Court considered price fixing by vitamin manufacturers outside the United States and concluded that the FTAIA can only apply to significant adverse effects within United States territory from a foreign action and not to foreign adverse effects independent of any adverse domestic effect.¹¹³ The Court imposed a territorial limit to the effects of harmful foreign action when applying the Sherman Act although it ultimately found the domestic economic effects to be significant enough to bring a claim.¹¹⁴ Generalizing this notion, the effects principle must be limited to direct, substantial, and reasonably foreseeable actions that have domestic impact. When applied to economic effects, the principle serves as a viable method to determine whether the application of domestic laws resulting in significant extraterritorial effects is warranted.

C. UNCLoS and Environmental Harm from Actions in International Waters

Similar to jurisdictional limitations in the United States extraterritorial application of domestic anti-trust law, the effects principle also plays a significant role in the application of port state jurisdiction to

109 Foreign Trade Antitrust Improvements Act of 1982, 15 U.S.C. § 6a (2006); Gerber, *supra* note 101, at 295 (describing the 15 U.S.C. § 6a rule in the context of extraterritorial application of the Sherman Act).

110 *F. Hoffman –La Roche Ltd. v. Empagran S.A.*, 542 U.S. 155, 158 (2004).

111 15 U.S.C. § 6a (2006).

112 *Empagran*, 542 U.S. 155 (2004).

113 *Id.* at 164.

114 *Id.* at 173.

international issues, such as environmental pollution. Environmental harms are the result of the tragedy of the commons, where the producer of a harm is not naturally subject to its cost and, therefore, does not have sufficient incentive to desist from acting in a destructive manner.¹¹⁵ In the context of maritime law and commercial shipping, this may occur from substandard vessels that pollute the environment or from poor shipping practices, like high speeds or improper routes that harm ocean life.¹¹⁶ Because these harms affect port nations, potentially damaging the nation's tourism industry or polluting the nation's hydrological resources, customary laws and treaties have extended port state jurisdiction to vessels in international waters.¹¹⁷

For example, UNCLOS was designed to control several laws-of-the-sea issues, including pollution, and it has largely been accepted as customary international law.¹¹⁸ General obligations under Article 192 of Part XII of UNCLOS mandate that "[s]tates have the obligation to protect and preserve the marine environment."¹¹⁹ This limits the state's right to dispose of resources freely, recognized by Article 193, based upon the impact to the environment.¹²⁰ In addition, Article 194(2) requires states to

115 Barton H. Thomson, *What Good is Economics?*, 37 U.C. DAVIS L. REV. 175, 187 (2003).

116 Vincent J. Foley & Christopher R. Nolan, *The Erika Judgment – Environmental Liability and Places of Refuge: A Sea Change in Civil and Criminal Responsibility that the Maritime Community Must Heed*, 33 TUL. MAR. L.J. 41, 58 (2008).

117 ØYSTEIN JENSEN, COASTAL STATE JURISDICTION AND VESSEL SOURCE POLLUTION, THE INTERNATIONAL LAW OF THE SEA FRAMEWORK FOR NORWEGIAN LEGISLATION 5-6 (The Fridtjof Nansen Inst. ed., 2006).

118 See generally Nicholas H. Berg, *Bringing It All Back Home: The Fifth and Second Circuits Allow Domestic Prosecutions for Oil Record Book Violations on Foreign-Flagged Vessels*, 34 TUL. MAR. L.J. 253, 258 (2009) (explaining that "UNCLOS created an international legal regime to govern the use of the high seas" and was signed by 159 nations); Foley & Nolan, *supra* note 116, at 58 ("UNCLOS is considered customary international law to which the United States adheres."); John T. Oliver, *Legal and Policy Factors Governing the Imposition of Conditions on Access to and Jurisdiction Over Foreign-Flag Vessels in U.S. Ports*, 5 S.C.J. INT'L L. & BUS. 209, 213 (2009) (stating that although the U.S. is a signatory to UNCLOS, the U.S. Senate has not yet ratified the convention).

119 UNCLOS, *supra* note 33, art. 192.

120 See *id.* art. 193.

take necessary measures to control their pollution so it does not damage “other [s]tates and their environment.”¹²¹ These articles set customary environmental requirements for vessels operating on the open seas.

In addition, Article 218 of UNCLOS goes beyond traditional port state jurisdiction, which only allows port states to exercise authority over foreign flag vessels for actions in their territorial waters or ports. Article 218 allows states to exercise enforcement jurisdiction over vessels in their territory for acts that have occurred in either international waters or the waters of another state at the request of that state.¹²² Thus, Article 218 of UNCLOS provides a mechanism to restrict harmful actions outside of a state’s normal jurisdiction. The purpose of this regulation is to prevent one state’s ships from using the most expedient course of travel when it harms unassociated states.

As shown above, UNCLOS extends port state jurisdiction, however, there must be a relationship similar to the effects principle, between the harm suffered and the state exercising jurisdiction. The port state must show that it has suffered a cognizable harm. “[T]he port state may institute legal proceedings against offenders” if a violation occurred in another state’s maritime zone and “the violation has caused or is likely to cause pollution” in its own maritime zones.¹²³ Thus, “the powers enjoyed by the port state authority under Article 218(2) are in essence those under the ‘effects’ principle,” where the action must have a recognizable effect on the state.¹²⁴

D. Weapons of Mass Destruction and Port States

Combating terrorism is another instance in which port states may extend their traditional jurisdiction through the effects principle to restrict vessels of another flag. Following the attacks on September 11, 2001, the

¹²¹ *Id.* art. 194(2).

¹²² Ho-Sam Bang, *Port State Jurisdiction and Article 218 of the UN Convention on the Law of the Sea*, 40 J. MAR. L. & COM. 291, 296 (2009). Note, however, that by taking action themselves, flag-states may preempt such action by a foreign state for unlawful discharges or other environmental harm. *Id.*

¹²³ UNCLOS, *supra* note 33, art. 218; Bang, *supra* note 122, at 297.

¹²⁴ Bang, *supra* note 122, at 297 (emphasis added).

United States government extended efforts to contain weapons of mass destruction (“WMDs”).¹²⁵ The United States strengthened diplomatic efforts such as the Treaty on the Non-Proliferation of Nuclear Weapons and the Chemical and Biological Weapons Conventions.¹²⁶ In addition, the United States undertook new initiatives like the Proliferation Security Initiative (“PSI”), in which a loose alliance of countries focuses on restricting the movement of WMDs through shipping routes.¹²⁷ The PSI has been especially contentious because it envisions using combined intelligence from member nations to hinder ships on the open seas, extending beyond the traditional jurisdiction allowed by customary international law or UNCLOS.¹²⁸

This controversy stems from the widely accepted international norm of the right of innocent passage. UNCLOS Article 19 requires states to permit the passage of ships unless the passage is “prejudicial to the peace, good order, or security of the coastal state.”¹²⁹ For a state to have jurisdiction to hinder a vessel under UNCLOS, it would have to show that the transport of WMDs results in a threat by force that endangers its “sovereignty, territorial integrity, or political independence”¹³⁰ or that violates some other principle of international law *contemporaneously* with

125 Daniel H. Joyner, *Jus Ad Bellum in the Age of WMD Proliferation*, 40 GEO. WASH. INT'L L. REV. 233, 236 (2008).

126 Samuel E. Logan, *The Proliferation Security Initiative: Navigating the Legal Challenges*, 14 J. TRANSNAT'L L & POL'Y 253, 254 (2005).

127 *Id.* at 255. The United States has also made advances to restrict the transshipment of illegal WMDs. See *Global Transshipment Control Enforcement Conference: Statement of Principles*, BUREAU OF INDUS. AND SEC., U.S. DEP'T OF COMMERCE, (July 2003), http://web.archive.org/web/20080819190211/http://www.bis.doc.gov/complianceand enforcement/tecisydney7_03principles.htm (accessed by searching for http://www.bis.doc.gov/complianceand enforcement/tecisydney7_03principles.htm in the Internet Archive index) (last visited Oct. 16, 2011).

128 Michael A. Becker, *The Shifting Public Order of the Oceans: Freedom of Navigation and the Interdiction of Ships at Sea*, 46 HARV. INT'L L.J. 131, 134 (2005).

129 UNCLOS, *supra* note 33, art. 19, ¶ 1.

130 *Id.* art. 19, ¶ 2(a).

the transshipment.¹³¹ Thus, it is the transport of the WMD that must pose a threat and not the possible future use of the WMD.¹³²

Under Article 25 of UNCLOS, a nondiscriminatory stoppage of all vessels is allowed for conducting routine searches for *temporary* bans within 12 nautical miles of the state's coastal territory.¹³³ Beyond these routine searches, there must be credible evidence that the passage is not innocent.¹³⁴ Thus, for states to circumscribe a traditional international norm there should be a *significant nexus between the harm and the territory in question*, a direct application of the effects principle.¹³⁵

As the above examples clearly illustrate, a state must justify the application of its national laws extraterritorially to transport vessels or to transshipped goods based on substantial domestic effect.¹³⁶ In the older case of liquor transshipment, the direct harm from the potential illegal entry of a regulated substance into the domestic market met the effects test.¹³⁷ More recently, the transshipment of Chilean swordfish demonstrated that significant, direct depletion of natural resources upon which a state relies economically may be sufficient to grant authority to restrict transshipments

131 See Logan, *supra* note 126, at 259.

132 *Id.* at 259.

133 *Id.* at 261. Regarding the 12 nautical miles, the suspension of right of innocent passage must, among other requirements, "only cover specified areas of the territorial sea," wherein "territorial sea" is a limit not exceeding 12 nautical miles. UNCLOS, *supra* note 33, arts. 3, 25.

134 Logan, *supra* note 126, at 261-62. However, it is likely that the world may accept some collateral damage in the hindrance of innocent passage to accomplish such an important goal. *Id.*

135 However, in the internal water of a State and at its ports, that State has more freedom; subject to the international principles discussed earlier, it will have the freedom to inspect the contents of a foreign vessel at its port and seize its illegal cargo. *Id.* at 265.

136 However, some United States Courts hold that these actions may be justified by the protective principle, recognized under international law to apply in a strict sense to dangers of security. Oliver, *supra* note 55, at 234-35, 239-40. On the other hand, federal courts have required what has been described as an "adequate nexus between the prohibited activity and the United States," demonstrating a limitation of the protective principle by some requisite effect. *Id.* (citing *United States v. Perlaza*, 439 F.3d 1149, 1162 (9th Cir. 2006)).

137 See *Grogan v. Hiram Walker & Sons*, 259 U.S. 80, 90 (1922).

and apply domestic laws having extraterritorial effects.¹³⁸ In addition, regulation of environmental pollution issues resulting from substandard vessels establishes that direct harm to a state's resources may justify extraterritorial jurisdiction.¹³⁹ Finally, a direct threat resulting from the actual transshipment of WMDs may represent sufficient harmful effect to warrant extraterritorial jurisdiction.¹⁴⁰

III. Generic Pharmaceuticals as Legitimate Goods in International Trade

Similar to the diverse transshipment and foreign vessel issues governed by the effects principle above, EU nations must also show a direct, substantial, and reasonably foreseeable effect upon their states by the transshipment of drugs through their ports in order to seize legitimate pharmaceuticals. In this sense, considerations beyond the protection of MNCs and their patented brand name drugs must be taken into account. Latin American countries, for example, converted their healthcare from public institutions to privately managed companies, resulting in significant health crises throughout Latin America due to dwindling healthcare access for the poor.¹⁴¹ International organizations encouraged and assisted less developed countries in increasing access to life preserving medicines, in particular by using TRIPS flexibilities.¹⁴² This enabled Latin American

138 See *supra* Part II.A.ii.; see also Notice of Initiation of an Examination Procedure Concerning an Obstacle to Trade, Within the Meaning of Council Regulation (EC) No 3286/94, Consisting of Trade Practices Maintained by Chile in Relation to the Transit and Transshipment of Swordfish in Chilean Ports, 1998 O.J. (C 215) 3.

139 See Bang, *supra* note 122, at 291.

140 See Logan, *supra* note 126, at 269-70.

141 Celia Iriart et al., *HMOs Abroad: Managed Care in Latin America*, in *SICKNESS AND WEALTH* 69-71, 73-76 (Meredith P. Fort et al. eds., 2004).

142 See SERVAAS VAN THIEL, PUBLIC HEALTH VERSUS INTELLECTUAL PROPERTY: OR HOW MEMBERS OF THE WORLD TRADE ORGANIZATION (WTO) WITHOUT PHARMACEUTICAL PRODUCTION CAPACITY COULD HAVE ACCESS TO AFFORDABLE MEDICINES IN PUBLIC HEALTH EMERGENCIES BY USING COMPULSORY LICENSES 5-8 (Center for Int'l Dev. ed., 2003), <http://www.cid.harvard.edu/cidtrade/Papers/vanthiel.pdf> (reporting the assistance of the World Intellectual Property Organisation and WTO in implementing the TRIPS Agreement on intellectual property); Press Release, Doctors Without Borders, MSF Calls Upon Latin American Governments to Guarantee Access to Medicines (Nov. 13, 2003), <http://doctorswithoutborders.org/press/release.cfm?id=491&cat=press-release&ref=tag-index> (last visited Oct. 16, 2011) (reporting that "MSF urges countries in the Americas to

countries, whose poverty rates are generally between twenty to sixty percent,¹⁴³ to more easily obtain generic medicines. Such assistance is necessary because economic development and output are intimately tied to a healthy population.¹⁴⁴ Thus if EU nations are to infringe upon Latin American countries' need for generic medicines, they must present a justifiable effect upon their interests.

The present controversy involves generic pharmaceuticals that Indian companies have manufactured and shipped to Latin America. The WTO TRIPS Preamble requires that members should "ensure that measures and procedures [they undertake] to enforce intellectual property rights do not themselves become barriers to *legitimate* trade."¹⁴⁵ Therefore, the legitimate generic drugs that Rotterdam customs officials seized and sent back to India are entitled to be shipped under the provisions of TRIPS, as well as GATT and UNCLOS. Thus, intervening actions by EU nations require justification based on substantial and foreseeable harm under the effects principle to warrant pharmaceutical seizures in contravention of international law.

make full use of the flexibilities in the TRIPS agreement, . . . particularly those that refer to the production or importation of generic medicines . . .").

143 See generally U.N. Econ. Comm'n for Latin Am. and the Caribbean, *The Reactions of Latin American and Caribbean Governments to the International Crisis: an Overview of Policy Measures up to 30 January 2009*, 37-69, U.N. Doc. LC/L 3000 (Jan. 30, 2009) (reporting poverty rates of Latin American countries, such as 21% for Argentina in 2006, 54% for Bolivia in 2007, and 30% for Brazil in 2007). Analysts expect the 2007 values to worsen with the global recession as Latin American countries have been hurt by the global economic recession of 2008 and 2009. See *id.* at 3. The availability of flexibilities, such as compulsory licensing under the TRIPS Agreement, is based upon the country's stage of development and its manufacturing capabilities. See generally World Trade Organization, Ministerial Declaration on the TRIPS Agreement and Public Health, WT/MIN(01)/DEC/2 (2001), available at http://www.wto.org/english/thewto_e/minist_e/min01_e/mindecl_trips_e.pdf.

144 C. JAMES ATTRIDGE & ALEXANDER S. PREKER, IMPROVING ACCESS TO MEDICINES IN DEVELOPING COUNTRIES: APPLICATION OF NEW INSTITUTIONAL ECONOMICS TO THE ANALYSIS OF MANUFACTURING AND DISTRIBUTION ISSUES 1 (The World Bank, Health Nutrition, and Population Discussion Paper, 2005), available at <http://siteresources.worldbank.org/HEALTHNUTRITIONANDPOPULATION/Resources/281627-1095698140167/AttridgeImprovingAccessFinal.pdf>.

145 TRIPS Agreement, *supra* note 22, Preamble (emphasis added).

A. TRIPS and Latin American Importation of Generics

In this context, it is important to examine international provisions that support the transshipment of generic drugs through EU nations. In particular, TRIPS allows Latin American governments to use compulsory licenses to acquire medicine.¹⁴⁶ Although TRIPS establishes a modern framework for IP protection “grounded” in the principles of national and most favored nation treatment,¹⁴⁷ it also incorporates limitations on patents for national emergency and *public health*, allowing compulsory licenses to force a patent holder to license its technology at a fair rate.¹⁴⁸ TRIPS also enables least developed countries (“LDCs”) to forgo patent protection for pharmaceuticals until 2016.¹⁴⁹ In this way, TRIPS supports patent protections while balancing the potentially detrimental impact of IP protection on access to medicine in developing nations by promoting the use of generics to meet pharmaceutical needs.¹⁵⁰

However, until the 2003 TRIPS Council Agreement following the 2001 Doha Declaration, compulsory licensing limited generic medicines to *domestic* use.¹⁵¹ While the Doha Declaration explicitly recognized a government’s power to issue compulsory licenses, the Council Agreement waives the provisions of Article 31(f) that prohibit exporting compulsory

146 Laurinda L. Hicks & James R. Holbein, *Convergence of National Intellectual Property Norms in International Trading Agreements*, 12 AM. U. J. INT’L & POL’Y 769, 788 (1997).

147 *Id.* at 784.

148 *Id.* at 788. TRIPS effectively allows compulsory licenses to make the patent protected material without the authorization of the rights holder under limited circumstances. Subhasis Saha, *Patent Law and TRIPS: Compulsory Licensing of Patents and Pharmaceuticals*, 91 J. PAT. & TRADEMARK OFF. SOC’Y 364, 366-67 (2009).

149 *Medicines: WTO and the TRIPS Agreement*, WORLD HEALTH ORG., http://www.who.int/medicines/areas/policy/wto_trips/en/index.html (last visited Apr. 3, 2010) (discussing the impact of the implementation of TRIPS).

150 *Id.*

151 Jessica J. Fayerman, *The Spirit of TRIPS and the Importation of Medicines Made Under Compulsory License After the August 2003 TRIPS Council Agreement*, 25 NW. J. INT’L L. & BUS. 257, 262-63 (2004). Article 31, which “implicitly provides for compulsory licensing,” and Article 27(2), which recognizes the conflict of public health and IP protection, were used by South Africa to support compulsory licensing. *See id.* at 260.

licensed products.¹⁵² Using the Council Agreement's waiver, a country in need of a drug may ask the government of another country "that produces a generic version of the drug to authorize one of its manufacturers to export it, without the consent of the patent holder."¹⁵³ Therefore, Latin American nations that provide generic medicines to combat national health crises are TRIPS compliant when using compulsory licensing, the waiver of Article 31(f)'s limitations in exporting, or the waiver for patent requirements for LDCs. As a result, TRIPS supports transshipment of generic pharmaceuticals through EU nations.

B. International Organizations' Support of Latin American Use of Generics

Importantly, the use of TRIPS' compulsory licensing to obtain necessary medicines in Latin American is strongly encouraged. For example, non-governmental organizations ("NGOs") have encouraged Latin American countries to retain as much flexibility as possible under TRIPS¹⁵⁴ to maximize access to generic drugs for developmental and humanitarian reasons.¹⁵⁵ Furthermore, multilateral trade agreements such as the South-South Cooperation ("SSC") agreement support Latin American access to generics.¹⁵⁶ The United Nations recognizes the SSC as a useful tool to encourage "a better quality of life for the world's poor" by improving

152 *Id.* at 260-64 (proposing a waiver to allow export of items created under compulsory license by article 31(f) of the TRIPS Agreement); Roberta Parrish, *Does Waiver of Patent Restriction Clear Way for Generics in Poor Countries*, 16 HEALTH LAW. 12, 14 (2004) (requiring that exporters differentiate the goods to avoid confusion in the marketplace and avoid re-exportation).

153 Parrish, *supra* note 153, at 15 ("The requests have to be made in good faith and for no commercial gain.").

154 *See* Doctors Without Borders, *supra* note 142.

155 ESPICOM, THE LATIN AMERICAN MARKET FOR GENERIC DRUGS – A COMPARATIVE STUDY OF 7 KEY MARKETS (2006) (documenting an increase between 2004 and 2005 in the generic sector in Latin America, which increased by 26.9% from \$1.3 to \$1.7 billion (USD)).

156 Gary Corbin, *South-South Cooperation Defies the North*, MERCYCORPS (Dec. 6, 2006), <http://www.globalenvision.org/library/3/1371> (last visited Oct. 16, 2011).

health,¹⁵⁷ and Brazil, India, and South Africa are concentrating on the pharmaceutical sector as an area to increase SSC activities.¹⁵⁸

Although compulsory licensing, waivers for patent requirements and for export limitations, and multilateral trade agreements promoting access to generic pharmaceuticals may result in revenue pressures for MNCs,¹⁵⁹ these tools fully comply with international agreements. Thus, the importation of generic medicines by Latin American countries is *legitimate trade* protected by TRIPS and championed by international organizations.

IV. EU Member Nations' Seizure of Generic Pharmaceuticals as Goods in Transit: Use of the Effects Principle

MNCs are increasing the cost of generic drugs shipped to Latin American countries by improperly advocating for the use of EU regulations to hinder the transfer of goods from manufacturers to purchasers.¹⁶⁰ By using EC 1383 to impound medicines intended for developing Latin American countries, some EU member nations are improperly administering national IP protections extraterritorially.¹⁶¹ Such an application of EC 1383, using the manufacturing fiction doctrine discussed below, oversteps TRIPS IP protections available to WTO member

157 Anwarul K. Chowdhury, U.N. Under-Secretary-General and High Representative for the Least Developed Countries, Landlocked Developing Countries and Small Island Developing States, *Celebrating the Global South: Diversity and Creativity*, Statement (Dec. 19, 2005), available at <http://www.un.org/special-rep/ohrls/Statements/19%20Dec%2005%20-%20South-South%20Cooperation.pdf>.

158 Indranil Banerjee, *Development: Turning South-South Rhetoric into Action*, INTERPRESS SERV. NEWS AGENCY (Oct. 15, 2008), available at <http://ipsnews.net/news.asp?idnews=44265>; Ranja Sengupta, *Free Trade Between Mercosur and India*, GLOBAL POLICY FORUM (July 18, 2003), <http://www.globalpolicy.org/component/content/article/162/27877.html> (last visited Oct. 16, 2011).

159 P.B. Jayakumar, *MNC Drug Makers Eye Generics in India, Other Emerging Countries*, BUS. STANDARD (Apr. 3, 2009), available at <http://www.business-standard.com/india/news/mnc-drug-makers-eye-generics-in-india-other-emerging-countries/353814>.

160 See Martin Khor, *supra* note 2.

161 See Jennifer Giordano-Coltart, *Walking the Line: Why the Presumption Against Extraterritorial Application of U.S. Patent Law Should Limit the Reach of 35 U.S.C. § 271(F)*, 2007 DUKE L. & TECH. REV. 4, 24 (“[T]he territorial nature of intellectual property law is implicit in the principles of comity and national treatment.”).

nations.¹⁶² Moreover, it is inconsistent with international agreements such as GATT and UNCLOS. Rather than using the manufacturing fiction doctrine to support the seizure of legitimate goods, EU nations should apply EC 1383 under the effects principle.

A. Need to Regulate Counterfeit Pharmaceuticals

There is a clear need to balance the importance of IP protection with the danger of counterfeit drugs. Counterfeit medicines that are deliberately and fraudulently labeled to mislead the consumer or that have improper active ingredients are an issue for both the brand name and generic medicine marketplace.¹⁶³ They pose a health risk, causing drug resistance, therapeutic failure, and possibly even death.¹⁶⁴ This is a problem for both developed and developing nations, but counterfeiting is especially serious in developing countries, where “supply shortages, lax regulations and oversight, and corruption allow the trade to thrive.”¹⁶⁵

Recognizing problems created by counterfeits, TRIPS obligated member states to implement national laws to prevent goods with counterfeit trademarks and pirated copyrights from entering their markets.¹⁶⁶ In particular, rights holders having “valid grounds” may file an application with the government to have customs authorities detain suspect goods.¹⁶⁷ At the same time, TRIPS requirements and GATT provisions requiring members to prevent hindrances of trade, as discussed above, limit how states can apply their anti-counterfeit laws to prevent the entry of illegal

162 Shashank P. Kumar, *Border Enforcement of IP Rights Against in Transit Generic Pharmaceuticals: An Analysis of Character and Consistency*, EUR. INTELL. PROP. REV., (forthcoming 2010), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1383067 (last visited on Oct. 16, 2011).

163 INT'L MED. PRODS. ANTI-COUNTERFEITING TASKFORCE, *supra* note 18, at 2.

164 *Id.*

165 Yankus, *supra* note 18, at 2.

166 TRIPS Agreement, *supra* note 22, art. 51.

167 *Id.*

goods into their markets.¹⁶⁸ Aware of these limitations, EU nations modified their border protections and implemented EC 1383.

B. Improperly Broad Application of EC 1383 to Seize Transshipped Goods

In order to understand the application of EC 1383 to the seizure of legitimate pharmaceuticals in transshipment, a brief overview of EU efforts to protect IP is essential. EC nations implemented EC 1383 as the latest in a series of measures undertaken to limit IP infringement within their member states. First, in 1986, the EC enacted Council Regulation EEC No. 3842/86, prohibiting the circulation of goods that infringed trademark rights.¹⁶⁹ Then, in 1994, the EC expanded protection through EC Regulation No. 3295/94 (“EC 3295/94”) to prohibit the circulation, exportation, and importation of counterfeit goods and goods violating copyright protection.¹⁷⁰ The EC added enforcement for patent violations in 1999.¹⁷¹ Finally, the latest regulation, EC 1383, expanded the power of customs officials and made it easier for rights holders to request action to impound goods violating IP rights.¹⁷²

EC 1383 grants member nations’ customs authorities the right to take action against goods suspected of infringing an intellectual property right, stating in particular that

[i]n cases where . . . goods infringing an *intellectual property right* originate in or come from *third countries*, their introduction into the Community customs territory, including their *transshipment*, . . . should be prohibited and a procedure set up to enable the customs authorities to enforce this prohibition as effectively as possible.¹⁷³

168 *Id.* (clarifying that members have no obligation to apply such seizures to transshipped goods).

169 Council Regulation 3842/86, 1986 O.J. (L 357) 1 (EEC).

170 Council Regulation 3295/94, 1994 O.J. (L 341) 8 (EC).

171 Council Regulation 241/1999, 1999 O.J. (L 027) 1 (EC).

172 *See* EC 1383, art. 5, 2003 O.J. (L 196) 9-10.

173 *Id.* ¶ 3, at 7.

Therefore, EC 1383 *could* provide for the seizure of both infringing imported goods and infringing goods that are *not destined* for countries within the EU but are merely being transshipped.¹⁷⁴ In fact, this particular issue has been considered by the Dutch Group AIPPI, an NGO that formulates local IP policy.¹⁷⁵ Supporting the seizures by customs officials, they have stated that Article 16 of EC 1383 *prohibits any further trade* in goods that “infringe an IP right,” including goods in transit that have entered the EU customs territory.¹⁷⁶ The important element, however, is that the goods must infringe an intellectual property right, even if they are only being transshipped through the EU.

For this reason, Dutch courts permitting seizures of transshipped goods employ the manufacturing fiction doctrine under which courts treat goods in transit as manufactured in the state where the customs action is brought.¹⁷⁷ Application of this doctrine causes goods in transit to infringe an exclusive right of the patent holder to “make, use, put on the market or resell, hire out or deliver the patented invention, or otherwise deal in it commercially, or to offer, import or stock it for any of those purposes,” because the goods are assumed to be made in the EU nation where such manufacture would be illegal.¹⁷⁸

174 *See id.*

175 *See* GERTJAN KUIPERS ET AL., BORDER MEASURES AND OTHER MEANS OF CUSTOM INTERVENTION AGAINST INFRINGERS 16 (AIPPI ed., 2009), *available at* <http://www.aippi.nl/uploads///Q208%20NL%201.PDF> (Neth.).

176 *Id.* at 12.

177 Paul Maeyaert, *Grey and Counterfeit Goods in Transit: Trademark Law in No-man's Land*, IAM MAGAZINE, June 8, 2009, at 12, 14, *available at* <http://www.iammagazine.com/issues/Article.ashx?g=e5225bb7-e7ac-4231-853e-6415dae67879>; *see also* Kuipers, *supra* note 175, at 12 (explaining that the manufacturing doctrine that the Netherlands employs is based on language in EC 1383 that has been removed).

178 LUCIE GUIBAULT & O. VAN DAALEN, UNRAVELLING THE MYTH AROUND OPEN SOURCE LICENSES 91 (TMC Asser Press, 2005). The European Patent Convention (“EPC”) which grants patents is entirely separate from the European Community; however, these patents form a “‘bundle’ of national patents which have to be validated, maintained and litigated separately in each Member State.” *Id.* In the Netherlands, an inventor may choose to obtain a strictly national patent per the Dutch Patent Act or an EPC Patent with a Netherlands designation. *Id.* at 92. Pharmaceutical MNCs almost universally choose the latter.

The manufacturing fiction doctrine was applied under EC 3295/94 in the European Court of Justice (“ECJ”) case *Polo Lauren v. Dwidua*.¹⁷⁹ In this case, a United States trademark owner brought an action against an Indonesian consignee shipping goods through Austrian customs.¹⁸⁰ The ECJ held that because the goods would have been illegal *if manufactured in Austria*, the trademark owners could prohibit their transit.¹⁸¹ In fact, the Netherlands has applied the manufacturing fiction doctrine to patent infringement since 2004, when its Supreme Court held that a consignment of CD-R disks from Taiwan violated Philips, Inc.’s patent rights without requiring the rights holder to show that the goods would enter the European market.¹⁸² Thus, the Netherlands customs authorities’ seizure of Losartan is consistent with their previous application of domestic law to prevent the transshipment of goods that violate local patents using the manufacturing fiction doctrine.

However, recent ECJ decisions bring the application of this doctrine to EC 1383 into question.¹⁸³ For example, in *Class International BV v. Colgate-Palmolive Company*¹⁸⁴ the ECJ held that trademark owners attempting to prevent infringement under the Trademark Directive 89/104 (“89/104”)¹⁸⁵ must show that items *will* be released into the member nation’s market before obstructing the movement of goods in transit.¹⁸⁶ The

179 Case C-383/98, *Polo/Lauren Co., L.P. v. PT. Dwidua Langgeng Pratama Int’l Freight Forwarders*, 2000 E.C.R. I-2531, ¶ 29, at I-2544, ¶ 34, at I-2545.

180 *Id.* ¶ 2, at I-2534.

181 *Id.* ¶ 1, at I-2546; *see also* Jens van den Brink, *Comeback for the Legal Fiction of the Anti Piracy Regulation?*, KENNEDY VAN DER LANN NEWSL. (Aug. 2008), http://www.kennedyvanderlaan.nl/KVdL/en-GB/_main/News/Newsletter/Newsletter+August+2008/Anti+Piracy+Regulation_IP/default.htm (last visited Oct. 16, 2011).

182 HR 19 maart 2004, NJ 2004, 110 m.nt. JMH (Koninklijke Philips Electronics N.V./Postech Corp.)(Neth.); *see also* Geert Theuws, *ECJ to Decide on Manufacturing Fiction*, EPLAW PATENT BLOG (Dec. 20, 2009), <http://www.eplawpatentblog.com/eplaw/sisvel>.

183 *See* Theuws, *supra* note 182.

184 Case C-405/03, *Class Int’l BV v. Colgate-Palmolive Co.*, 2005 E.C.R. I-8735.

185 First Council Directive 89/104/EEC, 1989 O.J. (L 040) 1 (EC).

186 *Class Int’l*, 2005 E.C.R. ¶ 34, at I-8775, ¶ 48, at I-8779.

court further limited importation to mean goods *to be placed* in the EU market, not simply entering the member nation for external transit or transshipment.¹⁸⁷

Furthermore, in *Montex Holdings Ltd. v. Diesel SpA*,¹⁸⁸ the ECJ analyzed whether 89/104 allowed a trademark owner the right to prohibit transit of goods. The court followed its previous *Class International* decision that allowed unencumbered external transit of fake Diesel jeans to countries that did not protect the trademark.¹⁸⁹ The ECJ also held that infringement must be determined by the legal status of the mark in the *destination* country.¹⁹⁰ Finally, the court found that the trademark owner must establish, “either the existence of a release for free circulation of the non-Community goods bearing his mark in a Member State in which the mark is protected, or of another act necessarily entailing their being put on the market in such a Member state” to prohibit transit.¹⁹¹

Nevertheless, the *Montex* decision fueled debate about whether the manufacturing fiction doctrine applies to EC 1383 in general, and to patents in particular. Opponents of the doctrine hold that *Montex* essentially did away with the doctrine while proponents argue that *Montex* was not analyzing EC 1383 but rather 89/104, so the court did not speak to the viability of the doctrine applying to EC 1383.¹⁹² In the 2008 *Sosecal v. Sisvel*¹⁹³ case, the District Court for The Hague, which decides Dutch patent cases, held that the latter interpretation of *Montex* was correct and that the manufacturing fiction is applicable in its jurisdiction.¹⁹⁴

187 *Id.* ¶ 34, at I-8775, ¶ 2, at I-8788.

188 Case C-281/05, *Montex Holdings Ltd. v. Diesel SpA*, 2006 E.C.R. I-10897.

189 *Id.* ¶¶ 20-23, at I-10907 to -10908, ¶ 27, at I-10909, ¶ 1, at I-10913.

190 *Id.* ¶ 1, at I-10913.

191 *Id.* ¶ 26, at I-10909.

192 Theuws, *supra* note 182.

193 Rb. Gravenhage The Hague 18 juli 2008, rolnr. 311378 KG ZA 08-617 (*Sosecal Industria e Comercio Ltda/Societa Italiana Lo Syiluppo Dell' Elettronica*) (Neth.), available at http://www.eplawpatentblog.com/PDF_December09/The%20Hague%20DC%20Sisvel%20v%20Sosecal%20EN.pdf.

194 *Id.* ¶ 4.14.

The ECJ still has to speak on the issue. By interpreting EC 1383 to apply to goods *purely* in transit, the legality of shipped pharmaceuticals is dependent on the IP rights in the EU port where it makes an incidental stop.¹⁹⁵ As a result, although the ECJ prohibited seizing goods that will not enter the member nation's protected market, the practice continues in some EU member nations like the Netherlands, where customs officials seized Losartan.¹⁹⁶

C. Need for EU Member Nations to Comply with EU Laws and International Trade Agreements in Applying EC 1383

When determining how to apply EC 1383 to the transshipment of generic pharmaceuticals, EU nations should consider both EU law and international agreements. EU member nations generally have an obligation to interpret national laws to comply with EU regulations.¹⁹⁷ Following this principle, the United Kingdom's High Court of Justice's Chancery Division used *Montex* to support Her Majesty's Commissioners of Revenue and Customs' refusal to detain fake cell phones in transit through the EU under EC 1383.¹⁹⁸ Nokia, Inc., sought the seizure of cell phones manufactured in Asia and transported to third nations through the U.K.¹⁹⁹ The Court held that these items were not counterfeit because *as goods in transit*, they were *never to be placed on the U.K. market* to infringe the trademark.²⁰⁰ The Court also refused to espouse the manufacturing fiction doctrine, stating

195 EC 1383, art. 2, 2003 O.J. (L 196) 7 (defining infringing items based on the law of the Community port, such as "goods which, in the Member State in which the application for customs action is made, infringe . . . a patent *under that Member State's law*") (emphasis added). The ECJ found in *Rolex* that EC 3295/94 enumerated measures regarding the entry, export, and re-export in and out of the Community of goods that infringe certain intellectual property rights, and, therefore, EC 1383 applies to goods in transit *between two non-member nations*. Case C-60/02, Criminal Proceedings Against X, 2004 E.C.R. I-665, ¶ 1, at I-688 (emphasis added).

196 *See supra*, Part I.A.

197 Case C-12/08, *Mono Car Styling SA v. Odemis*, 2009 E.C.R. I-06653, ¶ 61.

198 *Nokia Corp. v. Her Majesty's Comm'r of Revenue & Customs*, [2009] EWHC (Ch) 1903, [79]-[80].

199 *Id.* [3]-[13], at 1094-95.

200 *Id.* [49], at 1107.

that it was contrary to *Montex*.²⁰¹ Most importantly, the Court specified that it is unlikely that EC 1383 authorizes “goods *lawfully made in one territory* and intended for *lawful use in another* but transshipped through a Member State in which the mark is registered . . . [to] be . . . seiz[ed].”²⁰² Unfortunately, this is exactly what occurs when member nations like the Netherlands, who are under the same obligation as the United Kingdom to apply ECJ holdings, seize generic pharmaceuticals in transit to Latin America. Rather than relying upon the manufacturing fiction doctrine, EU nations who wish to seize drugs in transit should link the effects of the transport of these drugs through their ports to a significant effect on their market under the effects principle.

In addition to applying EU law, EU nations that are members of the WTO are obligated to implement TRIPS.²⁰³ TRIPS requires member countries to establish IP laws that enforce IP rights only “in such a manner [so] as to avoid the creation of barriers to *legitimate trade*.”²⁰⁴ The agreement defines legitimate trade as being “justifiable . . . by relevant public policies,”²⁰⁵ which take into account public interest.²⁰⁶ As shown above, the international community recognizes generic pharmaceuticals as legitimate goods in which there is a strong public health interest.²⁰⁷ Although TRIPS only sets minimum requirements to allow member nations to expand IP protections, TRIPS also sets mandates on the application of IP law to goods in transit by requiring that the rights in the *country of importation* should determine the infringement status of goods.²⁰⁸ TRIPS

201 *Id.* [76], at 1112.

202 *Id.* (emphasis added).

203 See TRIPS Agreement, *supra* note 22, art. 8.

204 *Id.* art. 41 (emphasis added).

205 *Id.*

206 Xavier Seuba, Border Measures Concerning Goods Allegedly Infringing Intellectual Property Rights: The Seizures of Generic Medicines in Transit (June 2009) (unpublished Working Paper, on file with the International Center for Trade and Sustainable Development), http://ictsd.net/downloads/2009/08/border-measures-concerning-goods-allegedly-infringing-intellectual-property-rights_the-seizures-of-generic-medicines-in-transit.pdf (last visited Oct. 16, 2011).

207 See *TRIPS: Negotiation, Implementation, and TRIPS Council Work*, WORLD TRADE ORG., http://www.wto.org/english/thewto_e/minist_e/min99_e/english/about_e/10trips_e.htm (last visited Oct. 16, 2011); see also *supra* Part III.

208 TRIPS Agreement, *supra* note 22, art. 52.

requires that EU member nations evaluate goods in transit according to the IP laws in the goods' *destination* countries.²⁰⁹ Therefore, while Dutch officials interpret EC 1383 through the manufacturing fiction doctrine to justify seizing legal pharmaceuticals,²¹⁰ ECJ holdings, other EU nations' execution of EC 1383, and TRIPS requirements indicate that EC 1383 may not support the seizure of legitimate pharmaceuticals in transit under the manufacturing fiction doctrine.

D. The Effects Principle Applied to Analyze Seizures under EC 1383

In applying EC 1383 to goods in transit, the ECJ should explicitly endorse the effects principle. As shown above, the United States and other nations have used the effects principle to justify the regulation of foreign conduct. For example, in the United States anti-trust context, enforcement mechanisms for businesses or persons in foreign countries that violate United States domestic law are typically applied through multinational agreements with the local governments of the violating entity.²¹¹ In this instance, application of a nation's laws abroad would be *directly* extraterritorial in nature and must be justified by substantial negative domestic effects.

Also, EU officials acting in their homeport should use the effects test to justify territorial actions that have *indirect* extraterritorial consequences, such as seizures of transshipped goods. It is important to justify these seizures because EU nations have entered into international agreements that constrain their actions at their ports and the resultant extraterritorial expansion of their national patent laws. This is a balancing test, considering whether the national effects from continued transshipment of the pharmaceuticals outweighs the international effects from seizure. In order for EU nations to seize and prevent the onward transport of these drugs, the transshipment through their ports must have a direct, substantial, and reasonably foreseeable effect on their domestic market that significantly outweighs foreign detriment from restrictions in transshipment.

209 *Id.* art. 51.

210 *See, e.g.,* Kuipers, *supra* note 175.

211 *See* Jordan A. Dresnick et al., *The United States as Global Cop: Defining the Substantial Effects Test in U.S. Anti-trust Enforcement in the Americas and Abroad*, 40 U. MIAMI INTER-AM. L. REV. 453, 489-90 (2009).

Detractors of the effects principle claim the principle gives too much discretion to the judiciary, which could lead to universal application of domestic laws.²¹² However, this is not the case when only direct, substantial, and reasonably foreseeable effects compel seizures. This effects test only applies in pure transshipment cases where goods could credibly find their way into EU markets. If domestic leakage is substantial enough to have a reasonably foreseeable effect on the market, the state would then have a legitimate right to enforce its local patent laws to transshipped goods. The goods in transshipment could be confiscated and seized on the basis that they were contributing to this leakage. Thus, when the measure of effect is economic harm, as in the anti-trust and securities context,²¹³ the result of damage from leaked goods into the market should be evident from the use of the pharmaceuticals in the market and the subsequent financial losses to the brand name drug manufacturers.

As in the case of environmental law under UNCLOS, if the acts that are outside of a state's borders, such as the manufacture and sale of "infringing" goods involving only non-EU nations, would lead to a cognizable harm to the state itself, the state should have a right to seize these goods. Such enforcement has already occurred through the application of the Volstead Act,²¹⁴ and it has been further debated in the Chilean swordfish dispute, where extraterritorial action significantly, directly, and reasonably foreseeably affected national interests.²¹⁵ However, unlike the transshipment of liquor under the Volstead Act, a modern view should be espoused that attempts to appropriately justify the seizure of goods that pose a substantial economic threat to domestic markets. In the case of the seizure of Losartan by Dutch authorities, justification of the seizure to divert the goods back to the source country would require credible evidence of both a leakage into protected markets and a significant economic effect of that leakage on domestic markets.

In addition to substantial justification underlying the seizure of Losartan by the Netherlands, other economic factors should be considered

212 Parrish, *supra* note 82, at 1478-82.

213 Born, *supra* note 53, at 45-48.

214 *See id.* at 33-34, 45-48.

215 *See* Notice of Initiation of an Examination Procedure Concerning an Obstacle to Trade, Within the Meaning of Council Regulation (EC) No 3286/94, Consisting of Trade Practices Maintained by Chile in Relation to the Transit and Transshipment of Swordfish in Chilean Ports, 1998 O.J. (C 215) 2.

when applying the effects principle to extraterritorial actions. The EU should consider the increasingly interconnected nature of trade and the possible retaliatory action resulting from unjustifiably restricting the trade of legitimate goods. Although EU customs officials' actions are in the strictest sense territorial, they have significant extraterritorial effects, and EU customs officials must justify their conduct in an international context using the effects principle.

Conclusion

EU customs officials have applied EC 1383 to seize transshipped generic pharmaceuticals under the manufacturing fiction theory that local intellectual property laws apply to pharmaceuticals manufactured in and destined for foreign nations. These actions result in raising barriers to legitimate trade and are contrary to EU nations' international obligations. These actions also result in local patent laws, which are territorially restricted, having extraterritorial implications. Rather than rely upon a legal fiction, these EU states should use an effects principle analysis to determine whether the impact of these goods upon local markets justifies restricting their transshipment through seizures. This impact is objectively measurable, and the effects principle can be adequately constrained to provide a reasonable basis to analyze the appropriateness of these seizures.

Combating Fraud in the Caribbean Region: Lessons from Recent Events

John H. Walsh*

On November 26, 2010, I had the opportunity to meet with the Caribbean Group of Securities Regulators (“CGSR”) during its 7th Annual Conference¹ and speak about combating fraud and lessons learned from recent events. Following the meeting, representatives of the host, Financial Services Commission of Jamaica, requested a written version of my remarks in a format suitable for wider distribution. I would like to express my sincere appreciation to the CGSR and the Financial Services Commission of Jamaica for the opportunity to meet and speak with them about important matters of mutual interest.

Introduction

Nothing is more damaging to a healthy financial sector or more opposed to economic growth and prosperity than fraud. All securities regulators must focus on fraud. Fraud is the enemy of every investor, market, and securities regulator.

Fraud is not new. It is a long-standing problem that requires constant vigilance. While fraud is not new, recent frauds have dramatically

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1 The CGSR is composed of: Barbados Securities Commission; The Bermuda Monetary Authority; Central Bank of Belize; British Virgin Islands Financial Services Commission; Cayman Islands Monetary Authority; Eastern Caribbean Securities Regulatory Commission; Financial Services Commission of Jamaica; Guyana Securities Council; The Securities Commission of the Bahamas; Trinidad and Tobago Securities and Exchange Commission; and Turks and Caicos Islands Financial Services Commission. *See What is the CGSR*, CARIBBEAN GROUP OF SEC. REGULATORS, www.caribsec.org (last visited Sept. 11, 2011).

raised the stakes for securities regulators. Over the last few years financial frauds of extraordinary scale have been alleged, including several that involve the Caribbean Region. This article will focus on the lessons taught by recent events. Part I of this article will outline historical background and types of fraud to provide context to contemporary fraud activities. Part II will address ongoing fraud cases and their impact on securities regulators. Part III posits that securities regulators must be ready to change significantly to enhance their anti-fraud programs and identifies ten lessons that have been taught by recent events.

I. Regulators Must Never Relax Their Vigilance Against Fraud

Fraud is a centuries old issue. In fact, the first Encyclopedia Britannica, published in 1771, provides an excellent working definition of fraud. "Fraud, in law, signifies deceit in grants, or conveyances of lands, [etc.] or in bargains and sales of goods, [etc.] to the damage of another person."²

Moreover, efforts to combat fraud have a long history. Organized government has battled against fraud for thousands of years. For example, 3,700 years ago, at the dawn of human civilization King Hammurabi of Babylon set forth a code of laws³ that included a law about fraud. Law 265 stated that if someone to whom property has been entrusted engages in fraud and makes false returns, then he shall be convicted and pay the victim ten-times the loss.⁴

Despite being an age-old problem, fraud is highly adaptable to new conditions. For example, the Internet recently revolutionized

2 ENCYCLOPÆDIA BRITANNICA 631 (William Smellie ed., 1st ed. 1771), *available at* http://books.google.com/ebooks?id=xnW408_9_SMC&num=10.

3 Hammurabi's Code is dated to approximately 1,755 BCE. *See generally* DOMINIQUE CHARPIN, *WRITING, LAW, AND KINGSHIP IN OLD BABYLONIAN MESOPOTAMIA*, 71-82 (2010) (noting that while Hammurabi drew on earlier collections, his code seems to have enjoyed a special status in Babylonian culture, both because of its diffusion through monumental stelas (slabs), and also because it seems to have acquired the status of a cultural classic even though we do not possess any quotations from the Code in ancient legal documents).

4 Law 265 reads, "If a herdsman, to whose care cattle or sheep have been entrusted, be guilty of fraud and make false returns of the natural increase, or sell them for money, then shall he be convicted and pay the owner ten times the loss." *EAWC Anthology: Hammurabi's Code of Laws*, U. EVANSVILLE, <http://eawc.evansville.edu/anthology/hammurabi.htm> (last visited Sept. 25, 2011).

communications, but as people began to use the Internet, so did fraudsters.⁵ Remarkably, although the technology was novel, the frauds were not, leading commentators to note that Internet fraud was an “old trick” in a “new medium.”⁶

Today, society is going through yet another transformation in its communication technologies. Social media like Facebook and Twitter have taken a prominent place in the social dialogue. Just as with the Internet, the fraudsters have taken advantage of new opportunities. The U.S. Securities and Exchange Commission (“SEC”) is starting to bring fraud cases involving social media, such as the Carol McKeon case below.

While frauds perpetrated on new social media can be the same old tricks, these cases can also present novel elements. For instance, in June 2010 the SEC brought an emergency enforcement action against Carol McKeon and various related entities and individuals.⁷ The SEC alleged that the defendants had touted various stocks through Facebook, Twitter, email, text messages, and on a web site. The defendants did not disclose that at the same time they were actively selling these stocks.⁸ This is the old-fashioned fraud known as “scalping,” where fraudsters profit from the upward movement in price created by their own promotions.⁹ However, two elements in this case were novel. First, the fraudsters used state-of-the-art social media to communicate with their victims. Second, the SEC and securities regulators in Quebec worked together across international

5 For example, the Better Business Bureau has reported that there are approximately 23,000 videos on YouTube, a popular Internet site, that appear to be fraudulent schemes. *BBB Warns Cash Gifting Pyramid Schemes Flourishing Online*, BETTER BUS. BUREAU (May 17, 2010), www.bbb.org/us/article/bbb-warns-cash-gifting-pyramid-schemes-flourishing-online-9865.

6 Brendon Fowler, Cara Franklin & Robert Hyde, *Cybercrime: Internet Securities Fraud: Old Trick, New Medium*, 2001 DUKE L. & TECH. REV. 0006, available at <http://www.law.duke.edu/journals/dltr/articles/2001dltr0006.html>.

7 SEC v. McKeown, Litigation Release No. 21580, 2010 WL 2589811 (June 23, 2010), available at <http://www.sec.gov/litigation/litreleases/2010/lr21580.htm>.

8 *Id.*

9 For a discussion of scalping, see SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963).

boundaries to investigate and prosecute the case.¹⁰

The facts and circumstances differ from fraud to fraud across time, but certain underlying themes appear again and again. As a result, it is useful to review some of the types of frauds that regularly appear and require regulators' constant vigilance.

First, fraudsters often try to act as if they are legitimate, regulated businesses.¹¹ For example, in the Caribbean Region, at least one questionable operation has used a formal business location, as well as facilities and structures similar to those in the formal financial sector.¹² Alternatively, in the U.S. securities market, there has been a problem with fraudsters selling "Prime Bank Notes."¹³ Investors are told these notes are available only to major financial institutions and they pay tremendous rates of return with no risk.¹⁴ In the recent SEC case against Elite Resources LLC, victims were told that if they paid a fee of more than \$200,000, they would be allowed to participate in a "Top 25 Bank" guarantee program that would give them access to \$100 million in credit that they would not have to repay.¹⁵ Unfortunately, as the SEC noted, such investments do not exist.¹⁶

10 Litigation Release No. 21580, *supra* note 7. Hopefully, this type of international cooperation will be as widespread in the future as new communication technologies. *See infra* pp. 22-23.

11 For examples of the steps fraudsters may take to try to give authenticity to their lies, see *Fake Seals and Phony Numbers: How Fraudsters Try to Look Legit*, U.S. SEC. & EXCH. COMM'N (Dec. 2, 2009), www.sec.gov/investor/pubs/fake-seals.htm (last visited Oct. 16, 2011).

12 This problem is discussed in Claremont Kirton, *Informal Financial Activity in Jamaica: A Preliminary Analysis of the Recent Experiences with Pyramid Schemes*, in *THE CARIBBEAN ECONOMY: A READER* 464, 470 (Dennis Pantin, ed., 2005).

13 *See How Prime Bank Frauds Work*, U.S. SEC. & EXCH. COMM'N (Jun. 12, 2009), www.sec.gov/divisions/enforce/primebank/howtheywork.shtml (last visited Oct. 16, 2011).

14 *Id.*

15 Complaint For Injunctive Relief at 2, 6, SEC v. Elite Resources, LLC, No. 1:10-cv-3522-CAP (N.D. Ga. Oct. 29, 2010), *available at* <http://www.sec.gov/litigation/complaints/2010/comp21713.pdf>.

16 *Id.* at 2.

Second, pyramid scheme fraud is a constant menace. The hallmark of a pyramid scheme is “the promise of sky-high returns in a short period of time for doing nothing other than handing over your money and getting others to do the same.”¹⁷ In the Caribbean Region, several recent pyramid schemes have exploited a traditional form of mutual self-help known as “partnering.”¹⁸ U.S. securities markets confront similar problems. In a recent SEC case, respondent James H. Park claimed to be operating a multi-level marketing company selling English and Spanish language tutorial DVDs through a network of associates around the world,¹⁹ that particularly preyed on communities in Puerto Rico and Florida.²⁰ New sales associates would make an investment in the DVDs and then recruit other sales associates to do the same thing, thereby profiting from recruiting new associates. Indeed, Park claimed that once they made an investment, associates would receive a lifetime of passive income with no further effort on their part. Unfortunately, as noted in the SEC’s complaint, pyramid schemes are destined to collapse.²¹

Third, regulators must be vigilant for Ponzi schemes. These schemes are named after Charles Ponzi, a fraudster of the early Twentieth Century.²² In a Ponzi scheme, new investor’s money is used to make payments to earlier investors.²³ The Association of Certified Fraud Examiners has effectively described this fraud: “A simple investment scam rakes in as much money as possible and then disappears. A Ponzi stays in

17 *Pyramid Schemes*, U.S. SEC. & EXCH. COMM’N (Feb. 25, 2009), www.sec.gov/answers/pyramid.htm (last visited Oct. 16, 2011).

18 See Kirton, *supra* note 12, at 467-68.

19 Park, Securities Exchange Act Release No. 61816, 98 SEC Docket 397 (Mar. 31, 2010).

20 See also SEC v. Lane, Litigation Release No. 20393, 2007 WL 4320753 (Dec. 11, 2007), available at <http://www.sec.gov/litigation/litreleases/2007/lr20393.htm> (further describing the scheme).

21 Complaint for Injunctive and Other Relief at 1-4, SEC v. Park, No. 6:09-cv-01137-PCF-GJ (M.D. Fla. July 1, 2009), available at <http://sec.gov/litigation/complaints/2009/comp21115.pdf>.

22 See “*Ponzi Shemes*”: *How Did Ponzi Schemes Get Their Name?*, U.S. SEC. & EXCH. COMM’N, <http://www.sec.gov/answers/ponzi.htm#PonziName> (last visited Sept. 25, 2011).

23 See “*Ponzi Shemes*”: *What is a Ponzi Scheme?*, U.S. SEC. & EXCH. COMM’N, <http://www.sec.gov/answers/ponzi.htm#PonziWhatIs> (last visited Sept. 25, 2011).

business by turning some of the money back into the game.”²⁴ Through this practice, some Ponzi schemes have been able to stay in business for years.²⁵

The variety of possible Ponzi schemes is limited only by the human imagination. The Caribbean Region, as discussed in the next section of this article, has witnessed several alleged Ponzi Schemes. Similarly, in recent months the SEC has brought cases against Ponzi schemes in which investors allegedly thought they were participating in a program for trading diamonds,²⁶ investing in real estate construction²⁷ and oil ventures,²⁸ loans to doctors,²⁹ or a day trading system,³⁰ to name a few.

Finally, offering frauds are another continuing threat. Offering frauds depend on spreading false information about the financial product being sold.³¹ For example, the Pension Fund of America, an enterprise including both U.S. and Cayman Islands entities, used a network of agents to sell millions of dollars worth of “retirement trust plans” to thousands of investors in Central and South America.³² The Pension Fund assured prospective clients that their investment would be safe because large and well-established U.S. banks would serve as “trustees.” Unfortunately, in reality up to 90% of the invested funds were used to pay exorbitant

24 ASS’N OF CERTIFIED FRAUD EXAMINERS, FRAUD EXAMINERS MANUAL 1.1730 (2010).

25 *Id.*

26 SEC v. Dalton, Litigation Release No. 21747, 2010 WL 4648478 (Nov. 17, 2010), available at <http://sec.gov/litigation/litreleases/2010/lr21747.htm>.

27 SEC v. Anderson, Litigation Release No. 21688, 2010 WL 3939799 (Oct. 7, 2010), available at <http://sec.gov/litigation/litreleases/2010/lr21688.htm>.

28 SEC v. Zada, Litigation Release No. 21737, 2010 WL 4493476 (Nov.10, 2010), available at <http://sec.gov/litigation/litreleases/2010/lr21737.htm>.

29 Systematic Fin. Assocs., Inc., Investment Advisers Act Release No. 3093, 2010 WL 3791953 (Sept. 29, 2010), available at <http://sec.gov/litigation/admin/2010/ia-3093.pdf>.

30 SEC v. CJ’s Fin., Litigation Release No. 21619, 2010 WL 3071384 (Aug. 6, 2010), available at <http://sec.gov/litigation/litreleases/2010/lr21619.htm>.

31 For a discussion of some of the techniques used to spread false information about an offering, see *Microcap Stock: A Guide for Investors, What’s So Important About Public Information*, U.S. SEC. & EXCH. COMM’N (Jun. 27, 2011), www.sec.gov/investor/pubs/microcapstock.htm (last visited Oct. 16, 2011).

32 SEC v. Pension Fund of Am., Litigation Release No. 19161, 2005 WL 724635 (Mar. 30, 2005), available at <http://sec.gov/litigation/litreleases/lr19161.htm>.

commissions, an “administrative fee,” and other costs. In addition, insiders at the firm misappropriated millions of dollars for themselves.³³

Importantly, the *Pension Fund* case also illustrates another important point about fraud: the risk of collateral damage to otherwise legitimate financial institutions. In this case, the Pension Fund’s offering fraud ended up ensnaring a global financial services firm. The SEC sanctioned HSBC USA because it had served as trustee.³⁴ The SEC stated that HSBC had allowed the Pension Fund to: (1) use HSBC’s name and logo in the offering materials; (2) use marketing materials that falsely suggested that the trust plans had been co-developed by HSBC; and (3) claim that investors’ money would be “totally safe” because it would be deposited into a trust account at HSBC, when the funds were actually deposited into an ordinary checking account for the Pension Fund.³⁵ The SEC also noted that HSBC had received warning of problems with the Pension Fund.³⁶

In the face of these ongoing frauds, a regulator could wonder what the purpose of combating fraud and remaining vigilant might be. If fraud will always be present, with a constant stream of fake products, pyramid schemes, Ponzi schemes, and offering frauds, what is the value of regulators’ vigilance? The answer is not simply moral, although the moral harm done to markets by fraud is receiving new attention.³⁷ Rather, the answer also implicates pragmatic economic policy. Having a vigorous enforcement program is a critical element in lowering the cost of capital. Academic research has demonstrated that there is a correlation between markets with active enforcement programs and markets with lower costs of capital.³⁸

33 *Id.*

34 HSBC Bank USA, N.A., Securities Act Release No. 8844, 91 SEC Docket 1522 (Sept. 19, 2007), available at <http://sec.gov/litigation/admin/2007/33-8844.pdf>.

35 *Id.*

36 *Id.* at ¶ 20.

37 For an excellent synopsis of the new focus on “moral markets,” see e.g., Ronald J. Colombo, *Exposing the Myth of Homo Economicus*, 32 HARV. J.L. & PUB. POL’Y 737 (2009).

38 Perhaps the best-known expression of this work is found in John Coffee, *Law and the Market: The Impact of Enforcement*, 156 U. PA. L. REV. 229 (2007). See also Ziven Scott Birdwell, *The Key Elements for Developing a Securities Market to Drive Economic*

No one can promise a fraud-free market. However, by being vigilant for fraud and punishing it severely when it is found, regulators help keep fraud in check, giving investors more confidence. The more regulators enforce, the more confidence investors have and the lower the price they will demand to invest. Working to lower the cost of capital and to support our respective economies' growth and prosperity is an important mission for all securities regulators, especially in light of recent events.

II. Recent Events Have Raised the Stakes

Fraud will always be present; thus, regulators must always be vigilant. However, in recent years the growth in fraud's scale is a new development of great consequence. In particular, three frauds of extraordinary scale have been alleged that warrant note.

The first of these frauds is the Bernard Madoff scandal. In December 2008, the SEC sued Madoff for securities fraud, alleging he had conducted a Ponzi scheme into which billions of dollars had been deposited over many years.³⁹ The SEC's complaint against one of Madoff's associates described the scheme:

For decades, Madoff and others orchestrated a massive Ponzi scheme . . . [in which] Madoff solicited funds from direct investors and feeder funds by promising to invest those funds in equity securities and hedge the related downside risk, and thereby make certain rates of return. . . . In fact, however . . . Madoff [did not invest] . . . these funds in the manner described. Instead, Madoff directed that investor funds be kept in highly liquid form, including cash, certificates of deposit, and treasury bills. A large portion of these funds were used to pay investor redemption requests and to line Madoff's pockets and the pockets of those around him.⁴⁰

Madoff was also charged with federal criminal violations arising from his scheme. In March 2009, he pled guilty and was sentenced to 150

Growth: A Roadmap for Emerging Markets, 39 GA. J. INT'L & COMP. L. (2011) (providing an excellent discussion of this work in the context of market development).

³⁹ Complaint at 4-5, SEC v. Bonventre, No. 10-cv-1576 (S.D.N.Y. Feb. 25, 2010), available at <http://www.sec.gov/litigation/complaints/2010/comp21424.pdf>.

⁴⁰ *Id.* at 6.

years in prison. Related proceedings continue.⁴¹ As recently as November 18, 2010, the SEC sued more of his associates.⁴²

The second recent mass-scale alleged fraud is the Robert Allen Stanford scandal. The SEC filed a complaint against Stanford and Stanford International Bank (“SIB”) alleging a large-scale Ponzi scheme from the sale of SIB Certificates of Deposit (“CDs”) totaling over \$7.2 billion by the end of 2008.⁴³ SIB promoted its safety, security, and high rates of return on investments and CDs that surpassed U.S. commercial bank rates. Stanford allegedly misappropriated billions of investor dollars and invested in speculative businesses controlled by Stanford. Stanford allegedly lied to investors and invented the investment portfolio’s performance to hide its fraudulent activities. The SEC alleged that Stanford made principal redemption and interest payments from these CD sales instead of earnings.⁴⁴

In June 2009, federal criminal authorities indicted Stanford and certain SIB employees, and he was ordered detained in jail pending his criminal trial.⁴⁵ The proceedings against Stanford continue.

In addition to the allegations against Stanford and SIB, the SEC has alleged that Stanford bribed regulatory officials to sustain the Ponzi scheme. The SEC alleges that Stanford:

bought Leroy King, the CEO of Antigua's Financial Services Regulatory Commission [“FSRC”], who accepted thousands of dollars of Stanford bribes per month to ignore

41 *Id.* at 4-5.

42 Press Release, U.S. Sec. and Exch. Comm’n, SEC Charges Two Longtime Madoff Employees with Fraud (Nov. 18, 2010), <http://www.sec.gov/news/press/2010/2010-225.htm> (last visited Oct. 16, 2011).

43 *Oversight of the SEC Inspector General’s Report on the “Investigation of the SEC’s Response to Concerns Regarding Robert Allen Stanford’s Alleged Ponzi Scheme” and Improving SEC Performance Before the S. Comm. on Banking, Housing, & Urban Affairs*, 111th Cong. (2010) (statement of Robert Khuzami, Director, SEC Division of Enforcement, & Carlo di Florio, Director, U.S. Sec. and Exch. Comm’n Office of Compliance Inspections and Examinations), *available at* <http://www.sec.gov/news/testimony/2010/ts092210rk-cd.htm>.

44 *Id.*

45 *Id.*

Stanford's Ponzi scheme. Accordingly to [the SEC's] complaint, King showed Stanford the SEC letters to the FSRC seeking information about Stanford's operations. He even permitted Stanford and his lawyers to draft the FSRC's responses back to the SEC containing false assurances that Stanford's Antiguan operations were in compliance with the law.⁴⁶

The Director of the SEC's Division of Enforcement, an experienced prosecutor, said that this was "one of the more disturbing aspects of any case" he has ever seen.⁴⁷

The third example of recent high-stakes fraud is David Smith's currency trading scandal. On August 18, 2010, federal criminal authorities charged Smith for fraudulent activity related to the Overseas Lockett International Corporation.⁴⁸ Smith promised to use investors' funds to engage in foreign currency trading and claimed investors could expect a high rate of return with only 20% of their investment at risk.⁴⁹ However, instead of engaging in the trading, he reportedly misappropriated clients' funds, transferring the funds to his private bank accounts and using them to furnish a lavish and expensive life style.⁵⁰ Moreover, the criminal charges allege that Smith employed numerous employees and created client account statements showing large and false monthly returns.⁵¹ Smith raised over \$220 million from thousands of investors in Florida, Jamaica, and the Turks and Caicos Islands.⁵² Smith has pled guilty and been sentenced to prison in

46 Robert Khuzami, Director, Div. of Enforcement, U.S. Sec. and Exch. Comm'n, Remarks before the New York City Bar: My First 100 Days as Director of Enforcement (Aug. 5, 2009), <http://www.sec.gov/news/speech/2009/spch080509rk.htm> (last visited Oct. 16, 2011).

47 *Id.*

48 Information at 1-7, United States v. Smith, No. 6:10-cr-00232-MSS-DAB (M.D. Fla. Aug. 18, 2010).

49 *Id.* at 4.

50 *Id.* at 6.

51 *Id.* at 7.

52 *Update: International Forex Ponzi Swindler David A. Smith Sentenced To 30 Years In U.S. Jail*, PATRICKPRETTY.COM (Aug. 15, 2011, 7:27 PM), <http://www.patrickpretty.com/2011/08/15/update-international-forex-ponzi-swindler-david-a-smith-senenced>.

the U.S. and Turks and Caicos Islands.⁵³

Several important points arise from the expansive nature and consequences of these on-going proceedings. First, the scale of these allegations is quite extraordinary considering the amounts raised, the number of investors, and the operations' duration. These allegations are measured in millions or even billions of U.S. dollars, thousands of investors, and time spans possibly of decades.⁵⁴

Second, these cases have received intense scrutiny. In particular, questions arose about how the frauds continued for as long as they did and grew to the size they did. In the United States, there have been a number of forensic reviews of regulators' performance, including by Congressional committees and by internal investigations of the SEC's Inspector General.⁵⁵

Third, long-term ramifications from these immense frauds should be anticipated. To gauge an event's long-term impact, it is often useful to see how the matter has been discussed in the academic community, which is usually more detached from the heat of the moment. Nonetheless, recent academic literature suggests there will be significant consequences. One recent article, for example, describes how Madoff has spawned a new social narrative, shaped by his victims, in which financial fraud is viewed as singularly evil.⁵⁶ As a result, white-collar crime is now viewed as more dangerous to society than violent crime and deserving of harsher sanctions

⁵³ *Id.*

⁵⁴ Information at 3, *United States v. Smith*, No. 6:10-cr-00232-MSS-DAB (M.D. Fla. Aug. 18, 2010); *Oversight of the SEC Inspector General's Report*, *supra* note 43; Khuzami, *supra* note 46.

⁵⁵ See, e.g., U.S. SEC. & EXCH. COMM'N, INVESTIGATION OF FAILURE OF THE SEC TO UNCOVER BERNARD MADOFF'S PONZI SCHEME, REP. NO. OIG-509 (2009), available at www.sec.gov/news/studies/2009/oig-509.pdf; U.S. SEC. & EXCH. COMM'N, REVIEW OF THE COMMISSION'S PROCESSES FOR SELECTING INVESTMENT ADVISERS AND INVESTMENT COMPANIES FOR EXAMINATION, REP. NO. 470 (2009), available at <http://www.sec-oig.gov/Reports/AuditsInspections/2009/470.pdf>; *Testimony Concerning the SEC's Failure to Identify the Bernard L. Madoff Ponzi Scheme and How to Improve SEC Performance, Before S. Comm. on Banking, Housing, & Urban Affairs 111th Cong.* (2009), available at <http://www.sec.gov/news/testimony/2009/ts091009rk-jw.htm> (statements of Robert Khuzami, Director, SEC Div. of Enforcement, & John Walsh, Acting Director, Office of Compliance Inspections and Examinations).

⁵⁶ Christine Hurt, *Evil Has a New Name (And a New Narrative): Bernard Madoff*, 2009 MICH. ST. L. REV. 947, 951 (2009).

when detected.⁵⁷

Finally, the Caribbean Region has figured prominently in several of these allegations. At least one academic has argued that in light of the role offshore financial centers played in these allegations, a serious reconsideration of the onshore-offshore relationship is in order.⁵⁸ Moreover, the problems were not isolated to the offshore sector. Many residents of the Caribbean Region were victims.⁵⁹ As societies respond to the scale, the scrutiny, and the long-term impact of these events, the Caribbean Region is likely to play a prominent role in the dialogue.

In sum, recent events have dramatically raised the stakes of the fight against fraud and several significant lessons must be considered.

III. Regulators Must Be Ready to Change Significantly to Enhance Their Anti-Fraud Programs

In the summer of 2009, in the midst of the crisis following revelation of the Madoff fraud, I served as Acting Director of the SEC's examination program. Through that experience I had the opportunity to learn first hand how regulators could respond to recent events, and formulated those experiences into ten lessons.

Lesson Number 1: Regulators Must Recognize that There Are Important Lessons to Learn, and that Addressing Them Will Involve Significant Change.

Often the most difficult lesson of all is recognizing that change is needed. The SEC had the benefit of multiple forensic reviews and the recommendations that emerged from that process. For example, the SEC's Inspector General made a significant number of specific recommendations for the examination program to address the problems and challenges he identified in his investigation of the agency's handling of the allegations against Madoff. The recommendations covered a wide range of topics, including the conduct of risk assessments, the preparation of scope memoranda, tracking examinations, and training. The SEC made it a

⁵⁷ *Id.* at 984-86.

⁵⁸ See Nick S. Dhesei, *The Conman and the Sheriff: SEC Jurisdiction and the Role of Offshore Financial Centers in Modern Securities Fraud*, 88 TEX. L. REV. 1345 (2010).

⁵⁹ See *id.* at 1350-51.

priority to ensure that the agency took all necessary actions in response to the lessons learned from its handling of the Madoff fraud.⁶⁰ All of the Inspector General's recommendations for the examination program have been successfully implemented.⁶¹

The challenge for regulators is to recognize the need for change, engage in thoughtful analysis to address the issue, and implement the needed changes. It is essential for regulators to make sure they are learning the lessons from these frauds.

Lesson Number 2: Regulators Must Understand Fraud

A serious weakness of many investors and regulators is their unfounded belief that they will recognize fraud when they see it. Unfortunately, this may not be the case. For many people, it is difficult to believe just how convincing and appealing a fraudster can be.

To address this concern, the SEC's examination program decided to give its staff more professional training in fraud detection through massive participation in a program offered by the Association of Certified Fraud Examiners. Over one third of the more than 900 SEC examiners became Certified Fraud Examiners.⁶² The staff also held training sessions establishing third-party verification of customer assets.⁶³ Finally, examiners worked with other interested regulators at the federal, state, and self-regulatory levels to share anti-fraud techniques and experiences.⁶⁴

60 *Testimony Concerning Oversight of the U.S. Securities and Exchange Commission: Evaluating Present Reforms and Future Challenges, Before H. Comm. on Financial Servs. Subcomm. on Capital Markets, Insurance, & Government-Sponsored Enterprises*, 111th Cong. (2010) (statement of Mary L. Schapiro, Chairman, U.S. Sec. and Exch. Comm'n).

61 See U.S. SEC. & EXCH. COMM'N, SEMI-ANNUAL REPORT TO CONGRESS: APRIL 1, 2010 – SEPTEMBER 30, 2010 91 (2010), available at <http://www.sec-oig.gov/Reports/Semiannual/2010/semifall10.pdf> (listing no remaining open recommendations from the Madoff reports in Table 3).

62 *Testimony Concerning the SEC's Failure to Identify the Bernard L. Madoff Ponzi Scheme, supra* note 55. As a member of the SEC staff at the time of the speech to the CGSR, the author did not recommend or endorse any private organization, including the ACFE.

63 *Id.*

64 *Id.*

Regulators can no longer rely on the belief that they will know fraud when they see it. A more professional approach is essential.

Lesson Number 3: Regulators Must Apply Effective Anti-Fraud Techniques

To catch a fraudster, regulators must often ask embarrassing questions that reveal that they do not necessarily believe what they are being told. This can be awkward, particularly in a highly professional setting. Of course, the fraudsters are quite ready to use those settings to hide their operations. Therefore, there are three types of questions that are particularly useful.

First, questions addressed to third parties that verify the information the regulator possesses are essential. This is called "Third Party Verification." SEC examiners now regularly reach out to third parties to verify information provided by registered firms. The two general approaches are verifying "up" and verifying "down." When a regulator verifies "up," he approaches custodians, depositories, counter-parties, and other institutions. For example, the regulator may ask a custodian to verify that the firm under review actually has the assets it claims. When a regulator verifies "down" it approaches customers. Generally, the purpose of this review is to confirm that the assets visible at the firm and custodian level are consistent with the customers' understanding.⁶⁵ Regulators should always approach customers with care, to avoid setting off any unnecessary panic.

Questions focused on computer forensics are also critical. The SEC's examination program recently created a new position for a computer security specialist, who is supporting information security reviews and other examinations. The specialist has been asking questions about the production of information in examinations, such as whether the information is true and complete or if items were deleted prior to production. Testing the accuracy of a production through review of the computer of origin can be very revealing.

Finally, perhaps the most uncomfortable question to address is associated with testing the misuse of original documents. Many firms now scan originals into an electronic system, and fraudsters may try to use those

⁶⁵ John H. Walsh, Acting Director, Office of Compliance Inspections and Examinations, U.S. Sec. and Exch. Comm'n, Remarks at the 2009 NSCP National Meeting (Oct. 5, 2009), <http://www.sec.gov/news/speech/2009/spch100509jhw.htm> (last visited Oct. 16, 2011).

systems to mask forgery. One of the best ways to test a system is to select documents that were recently scanned into the system and compare the electronic version to the original. Documents can look perfect on the electronic system, but when compared to the original, often taken from the shred bin, one can readily see when someone used white-out to redirect a previously authorized wire transfer or scissors and glue to attach a client's signature to a new document. Firms do not like when the contents of their shred bin are examined, but this can help catch fraud.

Lesson Number 4: Regulators Must Deploy Robust and Multi-Faceted Approaches to the Problem

Fighting fraud cannot be done by one program alone, however good that program may be. Fraud is so elusive that an effective anti-fraud program requires multiple levels of response.

Criminal and civil enforcement are necessary. There are some fraudsters who will be deterred only by the threat of criminal sanctions. But enforcement cannot be limited to jail time; greater depth is needed. Civil enforcement is also necessary. A strong cadre of civil sanctions is very useful, such as penalties, bars from working in the regulated business, and paying back the illegal profits (disgorgement).

Anti-fraud programs also need improved examination and reporting to promote enforcement. On-site examinations can be invaluable, as examiners are often the first to arrive on the scene of a fraud. Investor education is another necessity. Investors can help fight fraud by asking questions before they invest and by contacting regulators before too much damage is done. Finally, private sector compliance and self-regulation also have positive roles to play.

Moreover, in a robust anti-fraud program, all of these tools are fully deployed and coordinated. At the SEC, bringing together different programs to enhance effective coordination has been a key initiative of Chairman Schapiro. She has described this as establishing a "culture of collaboration, information exchange, and idea sharing" that includes interdisciplinary teams and other integration initiatives.⁶⁶ Over the last two years the staff of the SEC has been focused on ensuring that all these different functions are working together. Every regulator should consider

⁶⁶ *Testimony Concerning Oversight of the U.S. Securities and Exchange Commission*, *supra* note 60.

how it can add depth and enhanced coordination to its anti-fraud defenses.

Lesson Number 5: Regulators Must Obtain the Intelligence They Need, and Make Use of It Once They Have It

One of the more challenging aspects of fighting fraud is obtaining useful information while the fraud is in progress. Few victims complain while they think they are making money. But regulators do not want to wait until a scheme crashes before they get involved. To get ahead of the curve, regulators must respond properly to early warnings of fraud referred to as Tips, Complaints, and Referrals (“TCRs”).

Improving the SEC’s handling of TCRs has been a major initiative for the agency.⁶⁷ As part of this initiative, the Division of Enforcement has established an Office of Market Intelligence (“OMI”) and staffed it with market surveillance specialists, accountants, and attorneys. OMI’s mission is to ensure that the agency collects all TCRs in one place, combines them with other public and confidential information, and then dedicates investigative resources to those TCRs presenting the greatest threat of investor harm. In April 2010, OMI implemented an interim central system for collecting TCRs. Going forward, OMI also will strategically mine the TCR databases to identify emerging techniques and trends in securities fraud.⁶⁸ This strategic function should help identify misconduct as early as possible in the life-cycle of a fraud.

Regulators understand that it is not enough to handle a single complaint appropriately. The real challenge is to identify the crucial information in the masses of data that are constantly inundating regulatory agencies. Focusing on TCRs is a critical step towards achieving that effort.

Lesson Number 6: Regulators Need the Right Expertise

To fight fraud effectively, regulators must have expertise in the business practices it seeks to exploit. To address this need at the SEC, the examination program created a new position, the Senior Specialized Examiner (“SSE”). These positions are staffed with individuals who bring

⁶⁷ *Testimony Concerning Investigating and Prosecuting Fraud after the Fraud Enforcement and Recovery Act, Before S. Comm. on the Judiciary, 111th Cong.* (2010) (statement made by Robert Khuzami, Director, U.S. Sec. and Exch. Comm’n Division of Enforcement), available at <http://www.sec.gov/news/testimony/2010/ts092210rk.htm>.

⁶⁸ *Id.*

new and special expertise to the program. The examination program has recruited a variety of skills to both SSE and regular staff positions, including risk management, trading, operations, portfolio management, options, compliance, valuation, new instruments and portfolio strategies, forensic accounting, information security, derivatives, structured products, and hedge fund activities.⁶⁹

This program began in 2009, but the new expertise has already helped the SEC in a number of ways to understand the businesses it regulates.

Lesson Number 7: Regulators Need the Right Technology

Technology is both a blessing and a curse to regulators. It is a blessing because it is such a powerful tool. Today, one examiner with a laptop and standard off-the-shelf applications can screen and review a large portfolio in ways that would have been impossible before, even to large teams of examiners. Unfortunately, technology is also a curse because it is expensive and constantly evolving. Generally, government agencies do not have a lot of money to throw at new technology. Regulators constantly struggle with how to spend their limited technology budgets, but it is critical that they keep up with advances.⁷⁰

Lesson Number 8: Regulators Must Cooperate Across International Borders

Today fighting fraud is an international imperative. Fraudsters can easily move from jurisdiction to jurisdiction. If regulators are to fight them, they cannot stop pursuing fraud at their borders. International cooperation is essential.

The SEC is committed to enhancing international cooperation through targeted coordination and ongoing dialogue to establish a “collaborative, efficient, international regulatory structure that protects

⁶⁹ Walsh, *supra* note 65

⁷⁰ See Mary Schapiro, Chairman, U.S. Sec. and Exch. Comm'n, Brodsky Family Lecture at Northwestern University School of Law (Nov. 9, 2010) (“[T]hough we are making progress on technology, we still have far to go to keep up with our markets.”), <http://www.sec.gov/news/speech/2010/spch110910mls.htm> (last visited Oct. 16, 2011).

investors across borders and promotes stable economic growth.”⁷¹ In the examination program, for example, the staff works with foreign regulators in a variety of ways, including providing technical assistance, sharing information, and conducting coordinated examinations.⁷² The possibility of conducting more coordinated examinations is particularly exciting. If a pattern of conduct arises that appears to encompass both the U.S. and other jurisdictions, such as suspicious sales in a jurisdiction other than the U.S. where the records are all located in the U.S., the SEC’s Office of International Affairs should be contacted about the possibility of conducting coordinated examinations.⁷³

International cooperation is a powerful regulatory tool. It also sends a sharp message to those who might try and arbitrage their frauds across international borders.

Lesson Number 9: International Cooperation Must Be Timely and Effective

Even with international cooperation, the fraudsters will succeed if they can move faster than the regulators. For example, it can take weeks or months of processing for one regulator to obtain information from the other, while the fraudster can move money from one jurisdiction to the other in a matter of minutes. The time has come for faster cooperation and information sharing. Many jurisdictions have established financial intelligence units to conduct real-time information gathering and sharing, and, in some cases, to assist in restraining the proceeds of fraud.⁷⁴ Commentators have observed that securities regulators and financial intelligence units must continue to develop their capacities to work

71 Elisse B. Walter, Comm’r, U.S. Sec. and Exch. Comm’n, Keynote Address at the Eurofi Financial Forum 2010 (Sept. 29, 2010), <http://www.sec.gov/news/speech/2010/spch092910ebw.htm> (last visited Oct. 16, 2011).

72 See PRACTICING L. INST., THE SEC SPEAKS IN 2009 1053-54 (Linda Chatman Thomsen & Andrew J. Donohue eds., 2009).

73 See *Office of International Affairs, SEC International Initiatives*, U.S. SEC. & EXCH. COMM’N (Aug. 29, 2011, 9:07 PM), http://www.sec.gov/about/offices/oia/oia_initiatives.shtml#bilateralregcoop. For contact information for the SEC’s Office of International Affairs, see *Contact the SEC*, U.S. SEC. & EXCH. COMM’N, http://www.sec.gov/about/offices/oia/oia_contact.shtml (last visited on Oct. 16, 2011).

74 Birdwell, *supra* note 38, at 151-55.

together.⁷⁵ Regardless of the method used, regulators must start moving as quickly as fraudsters to effectively deter fraud.

Lesson Number 10: Regulators Must Restore Confidence in the Markets and Themselves

As a final recommendation, regulators must restore confidence in the system. One area requiring immediate attention is due diligence. As Ben Bernanke, Chairman of the Board of Governors of the U.S. Federal Reserve said, “the origins of most financial crises...can be traced to failures of due diligence or market discipline.”⁷⁶ In recent months, the SEC has brought several enforcement cases in this area. One case alleged that Hennessee Group LLC promised to follow certain due diligence procedures before making recommendations and then failed to do so.⁷⁷ Another case alleged that Banc of America Investment Services claimed it would treat affiliates and third-parties the same in its due diligence process, and then secretly favored affiliates.⁷⁸ In the case against Spencer International Advisors, the firm claimed it would conduct due diligence, collected a due diligence fee, and then simply relied on whether an issuer had obtained bank credit.⁷⁹ These cases highlight the importance of restoring confidence in those who promote due diligence in our markets.

Regulators must also restore confidence in themselves. They must move actively and visibly to assess themselves and correct their flaws. They must recognize why they may be viewed unfavorably and why the regulatory practices of the past may no longer suffice. In sum, they must change and learn the lessons of recent events.

⁷⁵ *Id.*

⁷⁶ See DAVID WESSEL, IN FED WE TRUST 180 (2009). Bernanke also added, “excluding, perhaps, those attributable to natural disasters, war and other nonfinancial events.” *Id.*

⁷⁷ Hennessee Group LLC, Investment Advisers Act Release No. 2871, 95 SEC Docket 2049 (Apr. 22, 2009), available at <http://www.sec.gov/litigation/admin/2009/ia-2871.pdf>.

⁷⁸ Banc of Am. Inv. Servs., Inc., Securities Act Release No. 8913, 93 SEC Docket 230 (May 1, 2008), available at <http://www.sec.gov/litigation/admin/2008/33-8913.pdf>.

⁷⁹ Spencer Int'l Advisers, Inc., Investment Advisers Act Release No. 3059, 98 SEC Docket 3500 (July 27, 2010), available at <http://www.sec.gov/litigation/admin/2010/ia-3059.pdf>.

Conclusion

Fraud will always be present, but fighting it provides real benefits to financial markets. Recently, extraordinary allegations have dramatically raised the stakes for investors, markets, and regulators to combat fraud. Regulators must be ready to change significantly and publicly based on the ten lessons above to address today's fraud challenges.

Dodd-Frank: Regulating Systemic Risk in the Offshore Shadow Banking Industry

Alexander Goodenough*

Introduction

The shadow banking industry consists of entities that are not traditional banks, but yet perform bank-like functions.¹ Shadow banks include some hedge funds, private equity funds, and a variety of nontraditional financial vehicles.² Estimates vary concerning the exact size of the global shadow banking sector,³ but there is some agreement that problems in shadow banking can quickly translate into systemic problems in the traditional banking sector.⁴

In a politically-stated attempt to counter the threat of future crashes caused or exacerbated by systemic risks to the financial system, the United States recently enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”).⁵ This act expands the reporting requirements for investment advisers, defined to include those who manage

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1 FINANCIAL SERVICES AUTHORITY [FSA], THE TURNER REVIEW A REGULATORY RESPONSE TO THE GLOBAL BANKING CRISIS, 21 (2009), *available at* http://www.fsa.gov.uk/pubs/other/turner_review.pdf [hereinafter THE TURNER REVIEW].

2 Kenneth W. Dam, *The Subprime Crisis and Financial Regulation: International and Comparative Perspectives*, 10 CHI. J. INT'L L. 581, 605-06 (2010).

3 Manmohan Singh & James Aitken, *The (sizable) Role of Rehypothecation in the Shadow Banking System* (Int'l Monetary Fund [IMF] Working Paper No. 10/172, July 2010), *available at* <http://www.imf.org/external/pubs/cat/longres.cfm?sk=24075.0>.

4 FSA, ASSESSING POSSIBLE SOURCES OF SYSTEMIC RISK FROM HEDGE FUNDS, at 3 (2010), *available at* http://www.fsa.gov.uk/pubs/other/hedge_funds.pdf [hereinafter ASSESSING POSSIBLE SOURCES OF SYSTEMIC RISK FROM HEDGE FUNDS].

5 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

shadow banks.⁶ The Dodd-Frank Act in Title IV expands the reporting requirements by amending the Investment Advisers Act of 1940 to eliminate the private adviser exception and replace it with the foreign private adviser exemption.⁷ The extremely narrow nature of the new foreign private adviser exception means that many foreign investment advisers with little professional contact with the United States will be caught within the reporting requirements of the act.⁸

This article begins with a background consideration of the origins of the 2007 financial crisis and its impact on financial markets around the globe. Part I(a) introduces shadow banks and discusses their possible benefits to the financial system along with their demonstrated weaknesses. Part I(b) considers the role offshore financial centers play in the world financial system. Part I(c) discusses the problem of systemic risk and considers its sources. Part II(a) discusses past regulation and attempts at regulation of shadow banks in the United States. Part II(b) introduces the new reporting requirements of the Dodd-Frank Act and considers whether they have extra-territorial scope. Part II(c) analyzes the meanings ascribed by the SEC to certain key phrases in the Dodd-Frank Act in order to determine the scope of the Act's reporting requirements. Part III(a) discusses reasons why international cooperation will be necessary to control systemic risk. Part III(b) analyzes current and past international cooperation and information sharing agreements. Part IV considers the contemporaneous development of systemic risk regulation in the European Union and compares it with that of the Dodd-Frank Act. Finally, Part V discusses the nature of international cooperation necessary to enable systemic risk regulation of the shadow banking sector.

Background: Origins and Consequences of 2007 Financial Crisis

There are many factors that set the stage for the 2007 financial crisis: macro-economic imbalances, financial innovation, rapid growth, increasing leverage, over-reliance on complex financial models, and hard-wired procyclicality in the financial system.⁹ While these set the stage, the

6 § 404, 124 Stat. at 1571-72.

7 § 403, 124 Stat. at 1571.

8 See § 402(a), 124 Stat. 1570.

9 See THE TURNER REVIEW, *supra* note 1, at 11-25. Procyclicality refers to the tendency to exacerbate rather than retard the effects of the business cycle.

triggering event of the crisis was a collapse of confidence in the asset backed security (“ABS”) market caused by doubts about the quality of the packages of mortgages that were the underlying assets.¹⁰ This resulted in a sudden freezing of a previously liquid market.¹¹ Traditional banks found themselves unable to sell the assets they had been securitizing and therefore were left with these assets on their balance sheets.¹² Confidence in the wider commercial paper market rapidly deteriorated making it impossible for certain institutions to re-finance their debt.¹³ These factors combined meant that both traditional and shadow banks could neither continue to finance their balance sheets nor reduce them by selling assets.

In the United States this lack of liquidity combined with falling asset prices claimed two of Bear Stearns’ hedge funds and then necessitated a rescue of the entire bank itself.¹⁴ The process snowballed with the Lehman Brothers bankruptcy and a government bailout of American International Group.¹⁵ The panic filtered down to the level of retail depositors, resulting in runs and causing the failures of Washington Mutual and IndyMac even though those banks were not dependent on the credit markets for funding.¹⁶

In the United Kingdom the disappearance of the market for securitized assets along with a lack of liquidity in the commercial paper market claimed Northern Rock, Bradford & Bingley, and HBOS, thus requiring government intervention.¹⁷ Retail withdrawals in the United

10 See, e.g., THE TURNER REVIEW, *supra* note 1, at 25; Gertrude Tumpel-Gugerell, Member of Exec. Bd. of the European Cent. Bank, Introductory remarks at the European Central Bank workshop on recent advances in modeling systemic risk using network analysis (Oct. 5, 2009), available at http://www.ecb.int/press/key/date/2009/html/sp091005_1.en.html; Dam, *supra* note 2, at 605-06.

11 See THE TURNER REVIEW, *supra* note 1, at 27.

12 THE TURNER REVIEW, *supra* note 1, at 35.

13 See THE TURNER REVIEW, *supra* note 1, at 27.

14 THE TURNER REVIEW, *supra* note 1, at 27; Mark Pittman, *Bear Stearns Fund Collapse Sends Shock Through CDOs*, BLOOMBERG, June 21, 2007, available at <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ahWfhEJ7dra4>.

15 See THE TURNER REVIEW, *supra* note 1, at 27.

16 See *id.* at 95.

17 See *id.* at 27.

Kingdom claimed Icelandic bank Landsbanki, forcing international cooperation to ensure that deposit insurance obligations were met.¹⁸ Traditional banks in many other countries also suffered significant losses because of their purchase of securitized instruments.¹⁹

Worldwide, mandatory capital requirements at traditional banks forced those institutions to hoard cash as falling asset prices threatened their balance sheets.²⁰ The resulting lack of commercial lending then transmitted the crisis from the financial to the nonfinancial economy, as businesses found it difficult to raise financing or had their existing credit lines withdrawn or reduced.

Part I(a): The Nature of Shadow Banks

The phrase “shadow banking” is perhaps an unfortunate one as it suggests an industry involved in shady dealings. However, shadow banking merely refers to the fact that this industry performs many of the same functions of the traditional banking industry, such as maturity and liquidity transformation, but differs in that shadow banks do not accept deposits.²¹ Instead, shadow banks rely on the credit markets for funding. For instance, the now notorious structured investment vehicles (“SIVs”) enabled maturity transformation similar to that of banks borrowing short and lending long.²² SIVs did this by using very short term borrowing to facilitate the purchase of longer maturity assets.²³

However, SIVs enabled traditional banking institutions to conceal off balance sheet the risks they were taking.²⁴ Those risks arose because, while a traditional bank that created an SIV might have sold the equity in the SIV, the equity holders may have retained a right effectively to return

18 *See id.* at 38.

19 *See id.* at 36.

20 *Id.* at 59.

21 *Id.* at 21.

22 *Id.* at 21.

23 *Id.* at 21.

24 *Id.* at 20.

the assets of the SIV to the bank if things went wrong.²⁵ Thus, SIVs earned their notoriety when they suffered enormous losses during the crisis, and traditional banks were forced to move those liabilities back onto their balance sheets.²⁶

Therefore, some shadow banks were effectively branches of traditional banking entities, which were already subject to extensive regulation,²⁷ but poor regulatory oversight enabled traditional banks to use shadow banking entities to conceal off balance sheet the risks they were taking.²⁸ Also, the complicated nature of the securitized assets held by these shadow banks made it particularly difficult to assess their risk.²⁹ This process hindered the ability of investors and regulators to judge the risks to which traditional banks were exposed.³⁰ The Dodd-Frank Act addresses in the Volcker Rule the problems caused by the use of shadow banks by traditional banks.³¹ This rule forbids traditional banks from having certain proprietary trading operations such as those often conducted through shadow banks.³² Thus, the rule may have closed an important channel for systemic risk transfer between the traditional and shadow banking sectors.

Notably, certain hedge funds can fall within the definition of shadow banks. Good examples of how hedge funds can operate as shadow banks are the two Bear Stearns funds that failed at the beginning of the 2007 crisis. Those funds were invested in collateralized debt obligations (“CDOs”), which were packages of securitized mortgages.³³ That investment was financed by loans and credit lines from other banking

²⁵ See *id.* at 20.

²⁶ See *id.* at 20.

²⁷ See Dam, *supra* note 2, at 612-17.

²⁸ THE TURNER REVIEW, *supra* note 1, at 43.

²⁹ Dam, *supra* note 2, at 615-16.

³⁰ THE TURNER REVIEW, *supra* note 1, at 43.

³¹ See İnci Ötoker-Robe and Ceyla Pazarbasiogluat, *Impact of Regulatory Reforms on Large Complex Financial Institutions* 24 (IMF Staff Position Note No. 10/16, 2010).

³² See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 619, 124 Stat. 1376, 1620-31 (2010).

³³ See Pittman, *supra* note 14.

institutions, including Merrill Lynch, Goldman Sachs, JPMorgan Chase, and Bank of America.³⁴ The hedge funds failed when declining prices in the CDO market caused those funds' creditors to call in their loans.³⁵ While many hedge funds do not fall within the definition of shadow banks because they do not perform large scale liquidity transformation,³⁶ the Volker rule might have the effect of increasing the number of hedge funds that do operate as shadow banks.³⁷ The exclusion of traditional banks from this market will provide an opportunity for hedge funds to expand in this area.³⁸

Part I(b): Offshore Financial Centers and Shadow Banks

Offshore Financial Centers ("OFCs") are generally geographically small jurisdictions characterized as having economies with disproportionately large financial sectors, which are geared to handling transactions for nonresidents.³⁹ Together, a few OFCs are home to a significant portion of the world's shadow banking industry. For instance, the Cayman Islands alone are the domicile of almost 40% of the world's hedge funds.⁴⁰ Thus, despite their geographically small size, OFCs are very important to the world's financial system.

There are two primary reasons shadow banking entities may choose to incorporate offshore: taxation and regulation.⁴¹ OFCs tend to have much

34 Pittman, *supra* note 14.

35 Pittman, *supra* note 14.

36 THE TURNER REVIEW, *supra* note 1, at 72.

37 See generally Ötoker-Robe & Pazarbasiogluat, *supra* note 31, at 26.

38 *Id.*

39 See U.S. GOV'T ACCOUNTABILITY OFFICE [GAO], GAO-08-778, CAYMAN ISLANDS 6-7 (2008) [hereinafter GAO, CAYMAN ISLANDS]. See also IMF, Monetary and Exch. Affairs Dep't, *Background Paper: Offshore Financial Centers*, at 9, (2000), available at <http://www.imf.org/external/np/mae/oshore/2000/eng/back.htm#I>.

40 CHARLES RIVER ASSOCIATES, IMPACT OF THE PROPOSED AIFM DIRECTIVE ACROSS EUROPE 19 (2009), available at http://www.fsa.gov.uk/pubs/other/Impact_of_AIFM_Directive.pdf [hereinafter IMPACT OF THE PROPOSED AIFM DIRECTIVE ACROSS EUROPE].

41 Financial Stability Forum [FSF], *Report of the Working Group on Offshore Financial Centers*, at 9 (2000), available at http://www.financialstabilityboard.org/publications/r_0004b.pdf. See also GAO, CAYMAN ISLANDS, *supra* note 39, at 6.

lower levels of taxation on investment income than traditional onshore centers.⁴² Historically, regulation has not been a major reason for shadow banks to incorporate offshore, since domestic regulation was minimal or non-existent. This may change with the stricter reporting requirements of the Dodd-Frank Act.

Shadow banks are valuable to the modern economy because they provide an alternative to maturity and liquidity transformation by traditional banks.⁴³ These entities can play an important role in securitization.⁴⁴ Securitization can be beneficial by diversifying the holding of credit risk from traditional banks to a larger set of investors who should in theory be better able to absorb losses.⁴⁵ Unfortunately this result was not achieved in the years running up to the 2007 crisis.⁴⁶ However, there is no reason why this desirable end cannot be achieved.⁴⁷ Indeed this end might have been achieved already but for two factors: the over-leverage used by shadow banks, which forced them to liquidate assets at disadvantageous prices; and the fact that the traditional banks that originated the securitized assets held by the shadow bank retained risk in the event those assets declined in value.⁴⁸

Shadow banks domiciled in OFCs allow advisers in the United States both to compete for funds to manage and to invest globally.⁴⁹ Shadow banks' organization in OFCs enhances competitiveness by

42 GAO, CAYMAN ISLANDS, *supra* note 39, at 9.

43 THE TURNER REVIEW, *supra* note 1, at 21, 52.

44 SARAI CRIADO & ADRIAN VAN RIXTEL, STRUCTURED FINANCE AND THE FINANCIAL TURMOIL OF 2007-2008: AN INTRODUCTORY OVERVIEW 18 (Banco De Espana Documentos Ocasional No. 0808, 2008), *available at* <http://www.bde.es/informes/be/ocasional/do0808e.pdf>; GAO, CAYMAN ISLANDS, *supra* note 39, at 21. *See* Dam, *supra* note 1, at 622-23.

45 THE TURNER REVIEW, *supra* note 1, at 42.

46 THE TURNER REVIEW, *supra* note 1, at 42.

47 *See* IMF, *Global Financial Stability Report* (2006), *available at* <https://www.imf.org/external/pubs/ft/GFSR/2006/01/index.htm>; Dam, *supra* note 2, at 623-26.

48 *See* Dam, *supra* note 2, at 625-30.

49 GAO, CAYMAN ISLANDS, *supra* note 39, at 16.

reducing double taxation of investment returns.⁵⁰ Shadow banks such as hedge funds and private equity funds are considered important alternatives to investors because they provide a means of increasing investment portfolio returns by providing diversification with reduced correlation to other asset classes.⁵¹ Indeed, they also played an important role in resolving the 2007 financial crisis by purchasing distressed assets, thereby providing much needed liquidity to the credit markets.⁵² Shadow banks based in OFCs provide an important channel for foreign investment in the United States.⁵³ Because of the perceived litigation risk, some foreign investors hesitate to invest in the United States directly.⁵⁴

Part I(c): Systemic Risk

Systemic risk is a by-product of the inter-connectedness of the global financial system.⁵⁵ Systemic risk may be regarded as being similar to pollution in that it is a negative externality.⁵⁶ This externality occurs because investors transacting in the financial markets consider only the risks their transactions pose to them rather than the risks the transactions pose to their creditors, counter-parties, or other third parties. Therefore, systemic stability seems to be a public good to the extent that everyone benefits from it, but no one individually has the incentive to provide it.⁵⁷ While there may not be an incentive deliberately to minimize systemic risk individually, protection may be provided as a mere by-product of individuals' desire to avoid losses. As individuals minimize their individual

50 GAO, CAYMAN ISLANDS, *supra* note 39, at 30.

51 IMPACT OF THE PROPOSED AIFM DIRECTIVE ACROSS EUROPE, *supra* note 40, at 53-56.

52 See Bei Hu, *Hedge Funds Lower Fees, Lengthen Lockups on New Funds*, BLOOMBERG, Dec. 3, 2010, available at <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=asQ4d66xij2o>.

53 GAO, CAYMAN ISLANDS, *supra* note 39, at 19.

54 GAO, CAYMAN ISLANDS, *supra* note 39, at 16.

55 European Central Bank, *Recent Advances in Modelling Systemic Risk Using Network Analysis*, at 6 (2010), available at <http://www.ecb.int/pub/pdf/other/modellingsystemicrisk012010en.pdf>.

56 *Id.* at 5.

57 *Id.* at 6.

risk exposure, they simultaneously provide incentives that minimize systemic risk.⁵⁸

There are two general ways in which systemic risk can spread. The market channel conveys systemic risk when forced asset sales by one or more entities cause market prices for those assets to decline.⁵⁹ These declining market prices then trigger further forced sales and cause prices to cascade downward. This process stems from a failure by investors to judge correctly the downside risk of their investment or to hedge this risk correctly. The market channel is particularly dangerous when many investors in a market are using high levels of leverage, because then losses lead quickly to forced sales. The credit channel conveys systemic risk when the failure of an entity causes losses to that entity's creditors that in turn threaten the creditors' financial stability.⁶⁰ Credit risk stems from a failure of creditors to judge risk accurately, require adequate security for their loans, and/or to diversify across risks. Credit risk is also more prevalent when high levels of leverage are used because then losses lead more quickly to failures.

As its name suggests, the boundary of systemic risk is determined by the boundaries of the system of which those risks are a part.⁶¹ As the 2007 crisis illustrated, the interconnectivity of the financial system can quickly cause international contagion of financial disturbances.⁶² The extent of the risk posed by an individual entity to the international financial system may be judged by the size of the entity and how inter-connected it is with the rest of the financial system, that is, by network analysis.⁶³ The

58 See generally DAVID MAYES, A MORE MARKET BASED APPROACH TO MAINTAINING SYSTEMIC STABILITY (FSA Occasional Paper Series, 2000), available at <http://www.fsa.gov.uk/pubs/occpapers/op10.pdf> (arguing that greater transparency and the possibility of failure would reduce risk taking and strengthen the traditional banking system).

59 ASSESSING POSSIBLE SOURCES OF SYSTEMIC RISK FROM HEDGE FUNDS, *supra* note 4, at 3; IMPACT OF THE PROPOSED AIFM DIRECTIVE ACROSS EUROPE, *supra* note 40, at 79-80.

60 ASSESSING POSSIBLE SOURCES OF SYSTEMIC RISK FROM HEDGE FUNDS, *supra* note 4, at 78-79.

61 See IMF, *Global Financial Stability Report*, at 113 (2009), available at <http://www.imf.org/external/pubs/ft/gfsr/2009/01/pdf/text.pdf>.

62 See THE TURNER REVIEW, *supra* note 1, at 27.

63 European Central Bank, *Recent Advances in Modelling Systemic Risk Using Network Analysis*, at 6, (Jan. 2010), available at

systemic importance of an entity, whether it is a traditional or a shadow bank, may also be judged by looking at its balance sheet.⁶⁴ The asset side of the balance sheet will provide information relating to the systemic risk the entity poses through the market channel, while the liabilities side will show which other entities are exposed to risk via the credit channel and the extent of that risk.

Systemic risk is not limited to any particular type of financial institution; both traditional banks⁶⁵ and shadow banks can pose systemic risks.⁶⁶ The problem in the 2007 financial crisis was that traditional banks did not publicly disclose the risks that they were taking, since those risks were often concealed in off balance sheet shadow banking entities.⁶⁷ While some issues can be addressed by regulation of the traditional banking sector, problems remain because many shadow banks do not publicly disclose the information necessary for market participants to judge the systemic risk posed by those shadow banks.⁶⁸

While the shadow banking sector did not itself cause the financial crisis in 2007, it did exacerbate the crisis.⁶⁹ Shadow banking institutions had to react very quickly to changes in asset prices and the availability of credit due to the short-term nature of their funding and high levels of leverage.⁷⁰ De-leveraging in the shadow banking sector due to the liquidity

<http://www.ecb.int/pub/pdf/other/modellingsystemicrisk012010en.pdf>; *Global Financial Stability Report*, *supra* at note 61 at 113.

64 See Jorge A. Chan-Lau, *Balance Sheet Network Analysis of Too-Connected-to-Fail Risk in Global and Domestic Banking Systems*, (IMF Working Paper WP/10/107, 2010), available at <http://www.imf.org/external/pubs/ft/wp/2010/wp10107.pdf>.

65 See THE TURNER REVIEW, *supra* note 1, at 27.

66 See REPORT OF THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG TERM CAPITAL MANAGEMENT, Treas. Rep. No. 3097, at 17-18 (1999), available at <https://ustreas.gov/press/releases/reports/hedgfund.pdf>.

67 See THE TURNER REVIEW, *supra* note 1, at 21.

68 See Thomas C. Pearson & Julia Lin Pearson, *Protecting Global Financial Market Stability and Integrity: Strengthening SEC Regulation of Hedge Funds*, 33 N.C. J. INT'L L. & COM. REG. 1, 25-31 (2007).

69 See THE TURNER REVIEW, *supra* note 1, at 11-25, 27.

70 *Id.* at 21.

crunch led to asset depreciation caused by forced asset sales.⁷¹ Those sales spread risk via the market channel by causing further declining asset prices.⁷² Many shadow banks could neither continue to finance their balance sheets because of the credit crunch, nor reduce their balance sheets by asset sales, because asset prices were either very depressed or the market for such assets had ceased to function altogether. Creditors of shadow banks were then faced with losses that threatened their own stability.⁷³ Uncertainty generated by this sequence of events then caused disruption to the broader commercial paper market.

Part II(a): Past Reporting Requirements in the United States

The Investment Advisers Act of 1940 required that investment advisers register and make their records available to the SEC.⁷⁴ However, the reporting requirements contained exemptions that enabled many advisers to avoid having to register or provide information.⁷⁵ Most importantly, these exceptions included the private adviser exception.⁷⁶ This exemption allowed advisers with fewer than 15 clients to avoid having to report to the SEC at all.⁷⁷ The term client referred only to the number of funds managed by the private adviser, rather than counting the individual investors in them.⁷⁸ Many important advisers had fewer than 15 separate

⁷¹ *Id.* at 22.

⁷² See IMPACT OF THE PROPOSED AIFM DIRECTIVE ACROSS EUROPE, *supra* note 40, at 79-80.

⁷³ See *id.* at 78-79.

⁷⁴ Investment Advisers Act, 15 U.S.C. § 80b-4 (2006).

⁷⁵ 15 U.S.C. § 80b-3.

⁷⁶ Amy L. Goodman, *Financial Reform: 2010, Working Summary No. 1, Washington Report on Financial Institutions*, at 297 (PLI Corp. Law & Practice, Course Handbook Ser. No. 1822, 2010).

⁷⁷ Investment Advisers Act, 15 U.S.C. § 80b-3(b)(3) (2006) (“The provisions of subsection (a) of this section shall not apply to any investment adviser who... has had fewer than fifteen clients...”).

⁷⁸ Pearson & Pearson, *supra* note 68, at 51-56; *Goldstein v. SEC*, 451 F.3d 873, 876 (D.C. Cir. 2006). See also Definition of "Client" in Investment Adviser for Certain Purposes Relating to Limited Partnerships, 50 *Fed. Reg.* 8,740 (1985).

funds and, therefore, were exempt from registration under the act.⁷⁹ The SEC attempted to close this loophole by broadening the definition of “clients” in its Hedge Fund Rule.⁸⁰

In 2004 the SEC attempted to narrow the private adviser exception by producing new regulations that redefined “clients” to include “shareholders, limited partners, members or beneficiaries.”⁸¹ Thus, every adviser managing funds with more than 15 investors had to register,⁸² and after registering, advisers could be required to provide records to the SEC.⁸³

The hedge fund rule was challenged in *Goldstein v. SEC* and vacated by the D.C. Circuit.⁸⁴ Although the Court acknowledged that the SEC’s reading was not foreclosed by the wording of the Advisers Act, the Court held that the SEC’s reading of clients was arbitrary and too broad.⁸⁵ The D.C. Circuit found that the relationship between advisers and the investors in the funds advised was not sufficiently close to justify treating the investors as clients of the advisers, because investors were not given individualized advice by the adviser.⁸⁶ Rather, the court held the adviser had only a uniform fiduciary duty to the fund.⁸⁷

Following *Goldstein*, the SEC tightened regulation of hedge funds concerning only misleading statements to investors.⁸⁸ Thus, prior to the

⁷⁹ *Goldstein*, 451 F.3d at 876.

⁸⁰ Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054 (2004).

⁸¹ See *Goldstein*, 451 F.3d at 877 (quoting 17 C.F.R. § 275.203(b)(3)-2(a)).

⁸² See *id.* at 874.

⁸³ See Investment Advisers Act 15 U.S.C. § 80b-4 (2006).

⁸⁴ *Goldstein*, 451 F.3d at 884.

⁸⁵ *Id.*

⁸⁶ *Id.* at 882-83.

⁸⁷ *Id.* at 883.

⁸⁸ Pearson & Pearson, *supra* note 68, at 59 (citing Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, Securities Act Release No. 8766, Investment Advisers Act Release No. 2576, Fed. Sec. L. Rep. (CCH) ¶¶ 84042-43 (Dec. 27, 2006)).

Dodd-Frank Act, many investment advisers to shadow banks were not subject to reporting requirements in the United States.⁸⁹

The United States had previously exempted from regulation shadow banks that only accepted investments from “accredited investors.”⁹⁰ Accredited investors have been defined by the SEC to include high-net-worth individuals, worth in excess of \$1,000,000, and certain entities with assets exceeding \$5,000,000.⁹¹ The rationale behind allowing those investors to invest in less regulated shadow banking entities was that, due to their assumed level of sophistication, such investors do not require the protection of the SEC.⁹² Sophisticated investors are thought capable of protecting themselves from investing losses and frauds. If this is true, then sophisticated investors should, as a by-product, protect others from systemic risk. This is because if these investors are capable of ensuring that the entities they invest in do not fail, then systemic risk contagion via the credit channel is eliminated. Systemic risk via the market channel is also reduced because these investors will ensure the entities they invest in are appropriately leveraged and not subject to forced sales due to margin calls. Sophisticated investors will seek to avoid margin calls because they force the liquidation of assets, usually at times when the prices of those assets are depressed. Thus, limiting the ability of non-sophisticated investor to invest in shadow banking entities should have tended to increase the effectiveness of market forces in ensuring these entities did not fail, thereby reducing systemic risk.

This theory obviously did not work with shadow banks for Long Term Capital Management (“LTCM”) in 1998 or SIVs during the 2007 crisis. Those entities lost their sophisticated investors very large sums of money. However, the market seems to have partially resolved these problems itself. SIVs are now an extinct species.⁹³ Hedge funds no longer

89 See Pearson & Pearson, *supra* note 68, at 49-51.

90 Investment Advisers Act, 15 U.S.C. § 80a-6 (This section has been amended by the Dodd-Frank Act). Strictly speaking non-accredited investors are not excluded from investing in such asset classes but marketing to non-accredited investors triggers registration requirements. Given that such funds wished to avoid those requirements the effect was the same as an outright exclusion.

91 Accredited Investor, 17 C.F.R. § 230.215 (1982).

92 Cf. Howard M. Friedman, *On being Rich, Accredited, and Undiversified: The Lacunae in Contemporary Securities Regulation*, 47 OKLA. L. REV. 291, 299 (1994) (arguing that the rich are not in fact as sophisticated in their investment as has been assumed).

93 See, e.g., Paul J. Davies, Anousha Sakoui and Gillian Tett, *Sigma collapse ends shadow*

operate at the same level of leverage as was used at LTCM, and counterparties to hedge funds are now more careful to monitor exposure and require more information about risk-taking by the funds.⁹⁴ Thus, investors appear to have altered their behavior to take into account new information regarding the levels of risk posed by certain investing activities, particularly in shadow banking entities.

Part II(b): The Dodd-Frank Act

The Dodd-Frank Act amends the Investment Advisers Act of 1940 by, among other things, eliminating the private adviser exception,⁹⁵ and creating the foreign private adviser exception.⁹⁶ The Bill also sets up a Financial Stability Oversight Council (“FSOC”).⁹⁷ Advisers must register with the SEC and may be required to provide systemic risk data to it and the FSOC.⁹⁸

The Supreme Court found in *Morrison v. National Australia Bank Ltd.* that, unless there is specific Congressional indication to the contrary, federal law is interpreted not to have effect outside the United States.⁹⁹ In *Morrison* the Supreme Court found that Congress did not intend section 10(b) of the Securities and Exchange Act of 1934 to have extra-territorial application.¹⁰⁰ A similar question may be raised as to whether Congress intended Title IV of the Dodd-Frank Act to have extra-territorial application.

There are two levels at which a statute can be found to have extra-territorial application according to the Supreme Court in *Morrison*: at the

bank project, FINANCIAL TIMES, Oct. 1, 2010, available at http://www.ft.com/cms/s/0/19db6e24-8fff-11dd-9890-0000779fd18c.html?nclick_check=1.

94 IMPACT OF THE PROPOSED AIFM DIRECTIVE ACROSS EUROPE, *supra* note 40, at 77-78.

95 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 403, 124 Stat. 1376, 1571 (2010).

96 §§ 402-03, 124 Stat. at 1570-71.

97 § 111, 124 Stat. at 1392-93.

98 § 404, 124 Stat. at 1572.

99 *Morrison v. Nat'l Austl. Bank Ltd.*, 130 S. Ct. 2869, 2878 (2010).

100 *Id.*

section level,¹⁰¹ or at the statutory level.¹⁰² Accordingly, the Dodd-Frank Act must be analyzed at both levels to determine whether the act contains an affirmative indication of Congressional intent for extra-territorial application.¹⁰³

Section 10(b) of the Securities and Exchange Act of 1934 governs fraud “in connection with the purchase or sale of any security...”¹⁰⁴ The focus of section 10(b) is on the transaction rather than the parties to it.¹⁰⁵ Section 402 of the Dodd-Frank Act defines the new foreign private adviser exception.¹⁰⁶ The focus of this exception is the person advised rather than any transactions performed or services rendered.¹⁰⁷ The reporting requirement is triggered if the adviser has clients or investors in the United States. Therefore, it seems the term ‘foreign private adviser’ is intended to have territorial scope as far as the clients or investors being advised are concerned, but, as its name suggests, extra-territorial scope as far as advisers are concerned.

Section 403 of the Dodd-Frank Act amends section 203 of the Investment Advisers Act of 1940 to eliminate the private adviser exception and to replace it with the foreign private adviser exception.¹⁰⁸ So amended, the phrase “investment adviser” will have extra-territorial reach to all foreign advisers who do not fall within the foreign private adviser exception.¹⁰⁹ Unlike section 10(b),¹¹⁰ section 203(b) will not reach only to

101 *See id.* at 2883 (discussing the clear statement of extra-territoriality in subsection 30(a)).

102 *See id.* at 2882 (discussing how the definition of interstate commerce does not defeat the presumption against extra-territoriality).

103 *See id.* at 2882-83.

104 Securities and Exchange Act of 1934, 15 U.S.C. § 78j(2)(b) (2000).

105 *Morrison*, 130 S. Ct. at 2884.

106 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 402, 124 Stat. 1376, 1570 (2010).

107 *Compare* § 402, 124 Stat. at 1570, *with* Securities and Exchange Act of 1934, 15 U.S.C. § 78j (2000).

108 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 403, 124 Stat. 1376, 1571 (2010).

109 *Id.* (there are other exceptions to the registration requirements but those relate to

transactions in the United States, but will follow the funds of United States clients or investors anywhere in the world.¹¹¹ Therefore, amended section 203 has broad international scope by virtue of the narrowness of the foreign private adviser exception.¹¹²

Section 404 of the Dodd-Frank Act requires investment advisers to provide systemic risk information to the SEC.¹¹³ Other than the extra-territorial reach conveyed to it by its use of the phrase “investment adviser,” section 404 does not make reference to the collection of data outside the United States.¹¹⁴ Thus, the only indication that section 404 was intended to have extra-territorial application is the scope of the exception to it. Whether this would be an affirmative indication of Congressional intent for extra-territoriality is doubtful in light of the narrow statutory reading in *Morrison*. Therefore, it is necessary to consider other sections of the Dodd-Frank Act to determine whether Congress indeed intended the collection of systemic risk data from outside the United States.¹¹⁵

Congress certainly anticipated the necessity of gathering information from foreign nonbank financial companies outside the United States in the Dodd-Frank Act.¹¹⁶ For instance, in order to mitigate the burden of reporting, section 112 provides that the FSOC, whenever possible, will make use of information already collected by foreign regulators.¹¹⁷ Section

activities within the United States).

110 *Morrison*, 130 S. Ct. at 2884.

111 See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 403, 124 Stat. 1376, 1571 (2010).

112 See *id.*

113 § 404, 124 Stat. at 1571-72.

114 *Id.*

115 See *Morrison*, 130 S. Ct. at 2884-85.

116 See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 102, 124 Stat. 1376, 1391 (2010) (defining a foreign nonbank financial company as a company incorporated or organized in a country other than the United States that is predominantly engaged in financial activities); § 112, 124 Stat. at 1394-95 (the function of the council is to monitor such companies for systemic risks).

117 §§ 112(d)(3)(C), 116(b)(1)(A), 124 Stat. at 1395, 1406.

113 grants the Board of Governors of the Federal Reserve (“the Board of Governors”) the authority to determine which foreign nonbank financial companies it should supervise because of the systemic threat posed by those companies to the United States.¹¹⁸ The Board of Governors is authorized to consider, when making that determination, the regulation these companies are already subject to by foreign supervisory authorities,¹¹⁹ and to consult with those regulators.¹²⁰ Once the Board of Governors has determined it should supervise a company, it is authorized to regulate that company’s behavior.¹²¹ All that appears to be necessary is a determination that the company poses a threat to the financial stability of the United States.¹²²

Section 175 of the Dodd-Frank Act provides for the cooperation of the FSOC and the Board of Governors with foreign counterparts and governments, international organizations, and multilateral organizations.¹²³ Sections 929K and 981 facilitate this international coordination by allowing the sharing of privileged regulatory information with foreign supervisory authorities.¹²⁴ Section 929J is the sharper end of the stick, in that it requires foreign accounting firms to produce the documents at the request of the SEC or Board of Governors.¹²⁵

Thus, several other sections of the Dodd-Frank Act explicitly provide for the regulation of, and data collection from, foreign entities because of the systemic risk they might pose to the financial system of the United States.¹²⁶ Although the aim of the Securities and Exchange Act of 1934 was at least in part to control systemic risk,¹²⁷ it seeks to achieve this

118 § 113(b)(1), 124 Stat. at 1398-99.

119 §§ 113(b)(2)(H), 115(b)(2), 124 Stat. at 1399, 1403.

120 § 113(f)(3), -(i), 124 Stat. 1376, 1402.

121 § 121(d), 124 Stat. at 1411.

122 *See* § 113(b), 124 Stat. at 1398-99.

123 § 175, 124 Stat. 1376, 1442 (2010).

124 §§ 929K, 981, 124 Stat. at 1860-61, 1926-27.

125 § 929J, 124 Stat. at 1859-60.

126 *See, e.g.*, § 113(b), 124 Stat. at 1398-99.

127 *See* Securities and Exchange Act of 1934, 15 U.S.C. § 78b(3)-(4) (1975).

through regulation of domestic securities transactions.¹²⁸ The Dodd-Frank Act knows no such bounds. Instead the criterion that the Dodd-Frank Act uses to determine its reach is the extent of systemic risk to the United States.¹²⁹ Therefore, the SEC is justified in reading Title IV of the Dodd-Frank Act to have extra-territorial scope in its rules.¹³⁰

Part II(c): Foreign Private Adviser Exception

The definition of a “foreign private adviser” requires a foreign based investment adviser with only minimal contacts with the United States to register with the SEC.¹³¹ A foreign private adviser is defined as:

any investment adviser who--

- (A) has no place of business in the United States;
- (B) has, in total, fewer than 15 clients and investors in the United States in private funds advised by the investment adviser;
- (C) has aggregate assets under management attributable to clients in the United States and investors in the United States in private funds advised by the investment adviser of less than \$25,000,000, or such higher amount as the Commission may, by rule, deem appropriate in accordance with the purposes of this title; and
- (D) neither--

128 See Securities and Exchange Act of 1934, 15 U.S.C. § 78b(1)-(2) (1975); *Morrison v. Nat'l Australia Bank Ltd.*, 130 S. Ct. 2869, 2884-85 (2010) (“Those purchase-and-sale transactions are the objects of the statute’s solicitude. It is those transactions that the statute seeks to regulate.”).

129 See, e.g., Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 112(a)(1), 113(a)-(c), 121(a), 175, 404, 124 Stat. 1376, 1394-95, 1398-1401, 1410, 1442, 1571-72 (2010).

130 See Foreign private advisers, 17 C.F.R. § 275.202(a)(30)-1 (effective July 21, 2011). See also Exemption for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than \$ 150 Million in Assets Under Management, and Foreign Private Advisers, 75 Fed. Reg. 77190 (proposed Dec. 10, 2010) (codified at 17 C.F.R. pt. 275) [hereinafter Exemption for Advisers].

131 See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 402, 124 Stat. 1376, 1570 (2010). See also Foreign private advisers, 17 C.F.R. § 275.202(a)(30)-1 (effective July 21, 2011). But see Chris Brummer, *Post-American Securities Regulation*, 98 CAL. L. REV. 327, 335-36 (2010) (discussing the restraint traditionally shown by the SEC in extra-territorial matters).

- (i) holds itself out generally to the public in the United States as an investment adviser; nor
- (ii) acts as--
- (I) an investment adviser to any investment company registered under the Investment Company Act of 1940;
- or
- (II) a company that has elected to be a business development company pursuant to section 54 of the Investment Company Act of 1940 (*15 U.S.C. 80a-53*), and has not withdrawn its election.¹³²

The words “in private funds” do not appear in the original private adviser exception.¹³³ The inclusion of this phrase now indicates that Congress intends the phrase “clients and investors” in this instance to have the meaning the SEC attributed to clients in the Hedge Fund Rule, which was rejected in *Goldstein*. This results in the new foreign private adviser exception being much narrower in scope than the old private adviser exception. The narrowness of the new exception widens the scope of the registration requirements.¹³⁴

There are a number of phrases in the foreign private adviser exception that are not defined in the Dodd-Frank Act. Indeed, the Congressional record is oddly devoid of discussion of the foreign private adviser exemption.¹³⁵ Therefore, the SEC has had to promulgate regulations defining those phrases used in the exception with little legislative guidance. This section will consider the definitions the SEC has published in its updated rules for the Investment Advisers Act of 1940 in response to the Dodd-Frank Act,¹³⁶ and how those definitions affect the scope of the act.

132 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 402, 124 Stat. 1376, 1570 (2010).

133 Investment Advisers Act, 15 U.S.C. § 80b-3(b)(3) (2006).

134 See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 403, 124 Stat. 1376, 1571 (2010).

135 See, e.g., H.R. Rep. No. 111-517, at 866-67. See also Michael I. Overmyer, *Note: The “Foreign Private Adviser” Exemption: A Potential Gap in the New Systemic Risk Regulatory Architecture*, 110 COLUM. L. REV. 2185, 2280 n.164 (2010).

136 Rules and Regulations, Investment Advisers Act of 1940, 17 C.F.R. § 275.

In rule 202(a)(30)-1 the SEC defines as a single “client” a natural person, that person’s minor children, relatives or spouse with the same address, and all accounts and trusts of which the first two categories are the sole beneficiaries.¹³⁷ Fictional persons such as corporations, partnerships, LLCs, and trusts are also a single client provided that the adviser provides advice only on the basis of the organization’s investment objectives.¹³⁸ Multiple fictional persons can count as a single client provided those organizations have identical shareholders, partners, limited partners, members or beneficiaries.¹³⁹ Double counting is avoided since an organization or private fund is not counted as a client if any investor in it has been already counted.¹⁴⁰ The definition is not entirely clear because of the uncertainty introduced by the question of whether the advice given is solely for the objectives of an organization. The SEC states that whether or not an advisory relationship should be characterized as with a single client must be determined on a case by case basis.¹⁴¹ This introduces uncertainty as to whether an adviser can count an organization as a single client or must look-through and count the investors in that entity.

Also in rule 202(a)(30)-1 the SEC defines investor as:

Any person who would be included in determining the number of beneficial owners of the outstanding securities of a private fund under section 3(c)(1) of the Investment Company Act (15 U.S.C. 80a-3(c)(1)), or whether the outstanding securities of a private fund are owned exclusively by qualified purchasers under section 3(c)(7) of that Act (15 U.S.C. 80a(c)(7)); and Any beneficial owner of any outstanding short-term paper, as defined in section 2(a)(38) of the Investment Company Act of 1940 (15 U.S.C. 80(a)(38)), issued by the private fund.¹⁴²

137 Foreign private advisers, 17 C.F.R. § 275.202(a)(30)-1 (a)(1) (effective July 21, 2011).

138 17 C.F.R. § 275.202(a)(30)-1 (a)(2)(i).

139 17 C.F.R. § 275.202(a)(30)-1 (a)(2)(ii).

140 17 C.F.R. § 275.202(a)(30)-1 (b)(5).

141 Exemption for Advisers, *supra* note 130, at 77211 n.231.

142 Foreign private advisers, 17 C.F.R. § 275.202(a)(30)-1 (c)(2) (effective July 21, 2011).

Thus, persons who hold either equity or debt in the private fund would be counted as an investor.¹⁴³ The definition of investors looks-through to find the “underlying holders” of private fund issued securities.¹⁴⁴ Therefore, use of nominee or intermediate accounts will not avail an adviser in avoiding the reporting requirements as such structures will be looked through to count individual investors.¹⁴⁵ Similarly, a look-through will be employed to count investors in any entity formed for the specific purpose of investing in a private fund, as investors in that fund.¹⁴⁶ An adviser to a master fund must count as investors the holders of securities in any feeder fund.¹⁴⁷ Also, the holders of certain derivatives based upon the private fund, such as a total return swap, and the holders of short-term paper, less than nine months in duration, fall within the definition of investors.¹⁴⁸ The status of entities that provide margin facilities is not mentioned, but, if so, they would be in a similar position as the holders of short term debt and, therefore, might also be counted as investors. Thus, reaching the \$25,000,000 limit for the foreign private adviser exemption is possible without any direct investor in the funds being a U.S. person.

The phrase “in the United States” is defined to conform with the meaning of “U.S. person” under Regulation S.¹⁴⁹ The operative time for determining a person’s status is when that person becomes a client or investor.¹⁵⁰ This means that advisers are not required to keep track of the movements of their clients and investors in order to determine whether they have to register. Under Regulation S, a U.S. person includes: any resident of the United States, any corporation or partnership formed under the laws of the United States, any estate of which any executor or administrator is a U.S. person, any trust of which any trustee is a U.S. person, any agency or

143 *Id.*

144 Exemption for Advisers, *supra* note 130, at 77212 n.241.

145 *Id.*

146 *Id.* at 77212 n.244.

147 *Id.*

148 *Id.* at 77212.

149 Foreign private advisers, 17 C.F.R. § 275.202(a)(30)-1 (c)(3)(i) (effective July 21, 2011).

150 § 275.202(a)(30)-1 note to paragraph(c)(3)(i).

branch of a foreign entity located in the United States, and partnerships or corporations formed by natural U.S. persons in foreign jurisdictions for the purpose of investing in unregulated securities.¹⁵¹ Discretionary accounts owned by U.S. persons are also treated as U.S. persons.¹⁵² So far the foreign subsidiaries of US corporations that qualify as accredited investors are not designated as U.S. persons.¹⁵³ As it will be difficult to categorically distinguish foreign subsidiaries set up to avoid the reporting requirements from those set up for normal business purposes, the SEC will probably designate foreign subsidiaries as U.S. persons on a case by case basis to prevent the use of foreign subsidiaries to avoid the reporting requirements.

A place of business is defined to be any office where the investment adviser regularly provides advisory services, solicits, meets with, or otherwise communicates with clients, and any location held out to the public as a place where the adviser conducts any such activities.¹⁵⁴ Thus, merely having a trading office in the United States is not enough to qualify as having a place of business in the United States. This narrow definition of a place of business will help reduce the potential negative effect the reporting requirements could have of reducing the participation of foreign investment advisers in the United States' capital markets by enabling such advisers to continue to have offices in the United States for trading or other management purposes.

The SEC has defined "assets under management" by reference to regulatory assets under management as calculated for Item 5 of Form ADV.¹⁵⁵ Item 5 of Form ADV requires that an adviser include in the value of assets under management the full value of any portfolio, including securities purchased on margin, that is greater than 50% invested in securities.¹⁵⁶ Securities are defined to include cash and cash equivalents.¹⁵⁷

151 Regulation S -- Rules Governing Offers and Sales Made Outside the United States Without Registration Under the Securities Act of 1933, 17 C.F.R. § 230.902(k) (2005).

152 17 C.F.R. § 230.902(k)(vii).

153 17 C.F.R. § 230.902(k)(viii).

154 Foreign private advisers, 17 C.F.R. § 275.202(a)(30)-1 (c)(3)(ii) (effective July 21, 2011) (citing 17 C.F.R. § 275.222-1(a)).

155 17 C.F.R. § 275-203A-3(d).

156 17 C.F.R. § 279.1.

157 SEC, Form ADV: General Instructions, at 17, *available at*

Non-securities include collectables, commodities and real estate.¹⁵⁸ Thus, some advisers may be able to avoid reporting by altering the proportion of asset classes held by the funds they manage.

The SEC interprets the term advisers to include subadvisers; therefore, the exemptions to the registration requirements are available to subadvisers who meet all the criteria for the exemption.¹⁵⁹ Mere existence as separate legal entities is not sufficient; rather, the two entities must be operated independently.¹⁶⁰ This will have to be determined on a case by case basis.

The SEC seems to have closed the most obvious methods of structuring investments to avoid reporting requirements, particularly with its inclusion of extensive look-through provisions in its definition of investor.¹⁶¹ But from the point of view of regulating systemic risk, a few points of concern remain. The first point of concern regards the foreign subsidiaries of U.S. non-natural persons, which qualify as accredited investors. Such foreign subsidiaries are not considered to be U.S. persons themselves. Not only does it open a potential avenue for circumvention of the reporting requirements, but it also leaves open an important avenue of systemic risk as the losses of a foreign subsidiary could threaten the stability of the U.S. parent. Second is the fact that holders of debt of maturity longer than nine months are not counted as investors. From the systemic risk point of view, long-term debt holders are not obviously in a better position than short-term debt holders should the debtor default; both are at risk of contagion of systemic risk through the credit channel. Perhaps it is unusual for debt with duration of more than nine months to be unsecured. Whatever the reason for the distinction, this avenue for systemic risk contagion remains outside the reporting requirements. Third, and most importantly, Title IV of the Dodd-Frank Act does not address an important aspect of international systemic risk via the market channel. This is

<http://www.sec.gov/about/forms/formadv-instructions.pdf>.

¹⁵⁸ *Id.* at 19.

¹⁵⁹ See Exemption for Advisers, *supra* note 130, at 77214.

¹⁶⁰ *Id.*

¹⁶¹ The author readily admits that he is not an expert in finding loopholes in securities regulation and has no doubt that legal advisers much more ingenious than himself will be able to devise other clever ways to enable their clients to take advantage of the foreign private adviser exception.

basically a result of the foreign private adviser exception. By virtue of the exception, the Dodd-Frank Act does not require that every shadow bank that invests in the United States register and make systemic risk information available to the SEC, let alone every shadow bank in the world.¹⁶² Nonetheless these entities pose a systemic risk to other participants in the United States' markets. Forcing every shadow bank that invests money in the United States to register with the SEC would raise the costs of investing in the United States, thereby tending to deter foreign investment. This is undesirable for numerous policy reasons.¹⁶³ As for requiring every investment adviser in the world to register with the SEC, this is a ridiculous proposition. The United States simply does not have lawful jurisdiction to enforce any such requirement and it would be contrary to accepted standards of international comity.¹⁶⁴

Part III(a): International Regulatory Cooperation Necessary

International regulatory cooperation is necessary in connection with the Dodd-Frank Act for two reasons. First, regulatory cooperation will be necessary for the SEC to be able to verify that the information disclosed to it by advisers to foreign entities is accurate and in accordance with the Dodd-Frank Act. In the event that the SEC believes that such information might be false, the SEC will have to be able to obtain sufficient information from the foreign entity to verify the accuracy of the disclosures made by its adviser. Second, regulatory cooperation will be necessary for effective use of the information obtained under the Dodd-Frank Act for systemic risk regulation. There may arise situations in which the systemic risk information provided in accordance with the Act will indicate that a foreign entity could pose a threat to the financial stability of the United States. A foreign entity that is not required to provide systemic risk information under the act could be judged to pose a threat to the financial system of the United States if: (1) a significant number of reporting advisers indicated that they

162 See generally Michael I. Overmyer, *Note: The "Foreign Private Adviser" Exemption: A Potential Gap in the New Systemic Risk Regulatory Architecture*, 110 COLUM. L. REV. 2185 (proposing that the foreign private adviser exemption should be eliminated because it constitutes a chink in the SEC's ability to regulate systemic risk).

163 As the United States currently runs a rather large current account deficit, it is reliant on the willingness of foreigners to invest money in it in order to maintain the value of its currency. Therefore it seems dangerous to deter such foreign investment.

164 See generally Richard K. Gordon, *On the Use and Abuse of Standards for Law: Global Governance and Offshore Financial Centers*, 88 N.C. L. Rev. 501 (2010) (discussing past transgressions on national sovereignty).

had exposure to that entity; (2) a few advisers to large, systemically important entities indicated that they had significant exposure to the non-reporting entity; or (3) many reporting advisers had exposure to a market to which that entity could pose a systemic risk. In such a situation United States regulators may wish to obtain information relating to the stability of the non-reporting entity. Alternatively, the necessity of making a request may be avoided if United States regulators are satisfied that the non-reporting entity is subject to adequate foreign regulation.

Part III(b): Current International Cooperation and Information Sharing Agreements

This section will consider past efforts to obtain international information sharing agreements and to achieve international harmonization of law. This will indicate whether current information sharing agreements are adequate for United States regulators to obtain the information necessary to regulate systemic risk in accordance with the Dodd-Frank Act, or, if not, how easily such agreements could be obtained and whether significant harmonization of regulation is likely to be achieved in the realm of systemic risk regulation.

Organization for Economic Cooperation and Development

The Organization for Economic Cooperation and Development (“OECD”) has shown great interest in combating what it refers to as harmful tax competition. The OECD apparently believes that a “level playing field” in taxation is necessary to ensure continued global economic growth.¹⁶⁵ The OECD’s initial plan to counter this problem, the 1998 Report, was ambitious and involved a broad attempt to harmonize international tax codes.¹⁶⁶ This plan included promulgating model bilateral information sharing agreements on tax matters.¹⁶⁷

165 Org. for Econ. Cooperation and Dev. [OECD], *Harmful Tax Competition, An Emerging Global Issue*, OECD Taxation Vol. 1998, No. 4, pp. 1-82 (1998), available at <http://www.oecd.org/dataoecd/33/0/1904176.pdf> [hereinafter *Harmful Tax Competition*].

166 *Id.* at 37-40.

167 OECD, *Agreement on Exchange of Information on Tax Matters* (2002), available at http://www.oecd-ilibrary.org/taxation/implementing-the-tax-transparency-standards/the-2002-model-agreement-on-exchange-of-information-on-tax-matters-and-its-commentary_9789264088016-7-en;jsessionid=10hqycy1e9to8.delta.

The recommendations of the OECD's 1998 Report included the adoption of certain domestic legislation to eliminate what it characterized as harmful tax practices, the adoption of tax treaties, and an agreement that countries take collective action against jurisdictions that did not implement the agreed tax standards.¹⁶⁸ An important shift in focus began in the 2000 Progress Report. Rather than focusing on eliminating tax competition altogether and leveling the playing field, the OECD in 2000 shifted its focus to obtaining the cooperation of non-members with member countries on tax matters.¹⁶⁹ The OECD developed an internationally agreed tax standard, which provides that domestic law will not prevent countries from exchanging information on tax matters.¹⁷⁰

In its 2004 Progress Report the OECD catalogued its success in getting member countries to abolish their allegedly harmful tax practices.¹⁷¹ The OECD was also successful in obtaining commitments from non-members to cooperate in the exchange of tax information.¹⁷² However, progress toward the level playing field of the 1998 Report had not moved beyond a general agreement that this ideal was about fairness.¹⁷³

The 1998 Report identified a tax haven as a country with zero or only nominal taxation, a lack of effective exchange of information, a lack of transparency, and a lack of a substantial activities requirement.¹⁷⁴ Yet now it seems the only requirement for a country to be substantially compliant with the internationally agreed tax standard is effective exchange of

168 *Harmful Tax Competition*, *supra* note 165, at 39-40.

169 OECD, *Report to the 2000 Ministerial Council meeting and Recommendations by the Committee on Fiscal Affairs*, at 18 (2000), available at <http://www.oecd.org/dataoecd/25/27/44430257.pdf>.

170 OECD, *A progress Report on the Jurisdictions Surveyed by the OECD Global Forum in Implementing the Internationally Agreed Tax Standard*, at n.1 (2011), available at <http://www.oecd.org/dataoecd/50/0/43606256.pdf>.

171 OECD, *The OECD's Project on Harmful Tax Practices: The 2004 Progress Report*, at 5-11(2004), available at http://www.irdcec.it/system/files/imce/aree-tematiche/pac/FINT_harmful%20tax%20competition%202004.pdf.

172 *See id.* at 13-14.

173 *See id.* at 12.

174 *Harmful Tax Competition*, *supra* note 165, at 39-40.

information.¹⁷⁵ Gone are mentions of “leveling the playing field.”¹⁷⁶ It seems the OECD has had, for the time being, to give up its ambitious plans to harmonize tax systems and to settle for international information exchange agreements.¹⁷⁷ Even these information exchange agreements are very narrowly drawn.¹⁷⁸ Thus, despite the importance of taxation to its members, the OECD was only able to obtain limited information exchange agreements from non-members.

Bank for International Settlements

The Bank for International Settlements (“BIS”) “is an international organization which fosters international monetary and financial cooperation and serves as a bank for central banks.”¹⁷⁹ BIS has spawned a series of subcommittees, several of which are concerned with ensuring global financial stability.¹⁸⁰

The most famous of these is the Basel Committee on Banking Supervision (“BCBS”), which issues the Core Principles for Effective Banking Supervision and the Concordat on Cross-Border Banking Supervision, otherwise known as the Basel Accord.¹⁸¹ Basel I set minimum capital requirements for the traditional banks of member countries.¹⁸²

175 OECD, *A progress Report on the Jurisdictions Surveyed by the OECD Global Forum in Implementing the Internationally Agreed Tax Standard*, at n.1 (2011), available at <http://www.oecd.org/dataoecd/50/0/43606256.pdf>.

176 See *Harmful Tax Competition*, *supra* note 165, at 9, 56, 70.

177 See generally Gordon, *supra* note 164, at 526-638.

178 See, e.g., Agreement between the Governments of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland, Including the Government of the Cayman Islands, for the Exchange of Information Relating to Taxes, U.S.-U.K., Nov. 27, 2001, T.I.A.S. No. 13175.

179 Bank for International Settlements [BIS], About BIS, <http://www.bis.org/about/index.htm> (last visited Jan. 12, 2011).

180 See BIS, Monetary & Financial Stability – Overview, <http://www.bis.org/stability.htm> (last visited Jan. 12, 2011).

181 BIS, About the Basel Committee, <http://www.bis.org/bcbs/index.htm> (last visited Jan. 12, 2011).

182 Basel Committee on Banking Supervision [BCBS], *International Convergence of Capital Measurement and Capital Standards*, at 3-8 (1988), available at <http://www.bis.org/publ/bcbssc111.pdf>.

These capital requirements were calculated on the bases of a bank's capital structure¹⁸³ and the risk categories into which a bank's assets fell.¹⁸⁴ Basel I did succeed in raising the average capital ratios of member's banking systems.¹⁸⁵ However, Basel I faced enforcement problems because regulators were under pressure to interpret loosely the requirements of the accord to favor domestic banks.¹⁸⁶

In 2004 Basel II was adopted in response to criticism that Basel I failed to level the regulatory playing field because its provisions were subject to diverse interpretation and failed to weigh capital and asset risks realistically.¹⁸⁷ Basel II allowed regulators to permit supervised banks to conduct their own internal risk management assessments.¹⁸⁸ Despite its formidable size,¹⁸⁹ Basel II failed to achieve consistent international application.¹⁹⁰

BCBS recently made public the Basel III agreement. Basel III increases bank reserve requirements and creates a fluctuating conservation buffer.¹⁹¹ Basel III builds on the foundations set by Basel II and is estimated to increase market risk capital requirements by three to four

183 *Id.*

184 *Id.* at 8-13.

185 See ETHAN B. KAPSTEIN, *GOVERNING THE GLOBAL ECONOMY: INTERNATIONAL FINANCE AND THE STATE* 120-22 (1994); TONY PORTER, *STATES, MARKETS AND REGIMES IN GLOBAL FINANCE* 76-78 (1993).

186 See Pierre-Hugues Verdier, *Transnational Regulatory Networks and Their Limits*, 34 *YALE J. INT'L L.* 113, 137-39 (2009).

187 See *id.* at 139-40.

188 See *id.* at 140.

189 See BCBS, *Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework – Comprehensive Version* (2006), available at <http://www.bis.org/publ/bcbs107.htm> (The compilation of all the relevant accords, amendments and papers is 347 pages in length).

190 See Verdier, *supra* note 186, at 142.

191 Press Release, BCBS, Group of Governors and Heads of Supervision Announces Higher Global Minimum Capital Standards (Sept. 12, 2010), available at <http://www.bis.org/press/p100912.htm>.

times.¹⁹² Only time will tell whether Basel III will be more uniformly applied than Basel I and II and will succeed in achieving a more stable international banking system.

The International Organization of Securities Commissions

The International Organization of Securities Commissions (“IOSCO”) has succeeded in getting 71 countries to sign its Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information (“MMOU”).¹⁹³ This was achieved comparatively easily because of homogeneity of interests.¹⁹⁴ All countries share an interest in having a reputation for sound, non-fraudulent financial markets to attract foreign investment.

The MMOU states that securities regulators of signatories will provide broad assistance to requesting regulators about financial transactions and that the transfer of information will not be hampered by secrecy laws.¹⁹⁵ The MMOU states: “The Authorities will, within the framework of this Memorandum of Understanding, provide each other with the fullest assistance permissible to secure compliance with the respective Laws and Regulations of the Authorities.”¹⁹⁶ This assistance includes not only providing the requesting authorities with all relevant documents held in the files of the responding regulatory agency, but also obtaining further information.¹⁹⁷ This information may include:

192 See Press Release, BCBS, Adjustments to the Basel II market risk framework announced by the Basel Committee (18 June 2010), available at <http://www.bis.org/press/p100618.htm>.

193 See Int'l Org. of Securities Commissions [IOSCO], List of Signatories to the IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information, http://www.iosco.org/library/index.cfm?section=mou_siglist (last visited Jan. 12, 2011).

194 See Verdier, *supra* note 186, at 143.

195 IOSCO, *Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information* (2002), <http://www.iosco.org/library/index.cfm?section=pubdocs&year=2002&publicDocID=126> (last visited Jan. 12, 2011).

196 *Id.* at 4.

197 *Id.*

contemporaneous records sufficient to reconstruct all securities and derivatives transactions, including records of all funds and assets transferred into and out of bank and brokerage accounts relating to these transactions; records that identify: the beneficial owner and controller, and for each transaction, the account holder; the amount purchased or sold; the time of the transaction; the price of the transaction; and the individual and the bank or broker and brokerage house that handled the transaction; and information identifying persons who beneficially own or control non-natural Persons organized in the jurisdiction of the Requested Authority.¹⁹⁸

Assistance under the MMOUs cannot be denied merely because “the type of conduct under investigation would not be a violation of the Laws and Regulations of the Requested Authority.”¹⁹⁹ Requests for assistance under the MMOUs are to be made in writing and include the nature of “the laws or regulations that may have been violated and that relate to the subject matter of the request.”²⁰⁰ The information obtained through the use of the MMOUs can be used only for the purposes stated in the request for assistance, and must be kept confidential.²⁰¹ The MMOU does require all authorities to provide to other authorities, without request, any information which is likely to be of assistance to those other authorities.²⁰² Any authority can terminate its agreement to the MMOU upon 30 days notice.²⁰³ Importantly the MMOU requests do not require that regulatory authorities take steps to prevent, or mitigate the consequences of, the activity that is the subject of a request for assistance under an MMOU.²⁰⁴ Foreign judgments

198 *Id.* at 4-5.

199 *Id.* at 5.

200 IOSCO, *Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information*, at 5 (2002), <http://www.iosco.org/library/index.cfm?section=pubdocs&year=2002&publicDocID=126> (last visited Jan. 12, 2011).

201 *Id.* at 6-8.

202 *Id.* at 8.

203 *Id.* at 9.

204 *See id.* at 9.

resulting from the information obtained cannot be enforced by virtue of the MMOU.²⁰⁵ Therefore, under the MMOU the regulators of one country could not request that regulators of a second country prevent an entity in that country from entering into transactions that create or increase systemic risk.

The MMOU has done nothing to harmonize countries' securities laws.²⁰⁶ The MMOU provides for specific instances of cooperation rather than broad or continuing cooperation. However, the MMOU does enable United States regulators to request information from entities in other countries if the United States regulators have reason to believe that false disclosures have been made. But, crucially, the MMOU does not facilitate international information exchange for systemic risk purposes, absent an allegation of a breach of securities law.

Financial Action Task Force

The Financial Action Task Force ("FATF") is an inter-governmental policy making body that promotes and coordinates the harmonization of national laws to combat money laundering and terrorist financing.²⁰⁷ The FATF has promulgated a number of recommendations to countries regarding how they should implement effective anti-money laundering ("AML") and counter-terrorist financing ("CTF") laws.²⁰⁸ FATF recommends the adoption of laws requiring financial institutions to conduct customer due diligence, commonly known as "know your customer rules," and to keep appropriate records.²⁰⁹ Additionally, FATF recommends the passage of laws requiring financial institutions to report suspicious behavior,²¹⁰ and that countries set up regulatory bodies for the purpose of

205 See Verdier, *supra* note 186, at 147 (citing William S. Dodge, *Breaking the Public Law Taboo*, 43 HARV. INT'L L.J. 161, 187-89 (2002)).

206 *Id.*

207 Financial Action Task Force [FATF], *An introduction to the FATF and its work*, at 2 (2010), available at <http://www.fatf-gafi.org/dataoecd/48/11/45139480.pdf>.

208 See FATF, *Methodology for Assessing Compliance with the FATF 40 Recommendations and the FATF 9 Special Recommendations* (2004), available at <http://www.fatf-gafi.org/dataoecd/16/54/40339628.pdf>.

209 *Id.* at 15-23.

210 *Id.* at 25.

enforcing compliance and analyzing information collected.²¹¹ FATF encourages countries to sign treaties and to ensure that domestic law facilitates international cooperation on AML and CTF actions.²¹² This cooperation not only extends to supplying information, but also to seizing assets and evidence.²¹³ FATF urges that the greatest assistance possible should be provided even if the activity deemed suspicious is not a breach of domestic law.²¹⁴

The FATF seeks to encourage compliance with its recommendations by conducting mutual evaluations of countries.²¹⁵ Lists of countries that deemed non-cooperative due to lack of AML and CFT enforcement systems have been published by FATF.²¹⁶ The FATF then recommends and coordinates preventative measures against such countries.²¹⁷ These preventative measures include enhanced scrutiny of transactions involving those jurisdictions:²¹⁸ “In addition to enhanced scrutiny, the FATF will, if necessary, ultimately call for the application of appropriate counter-measures in order to protect the financial system.”²¹⁹

As demonstrated above, FATF begins the process of obtaining compliance softly, by merely making recommendations, but if these

211 *Id.* at 34-37.

212 *Id.* at 42, 45.

213 FATF, *Methodology for Assessing Compliance with the FATF 40 Recommendations and the FATF 9 Special Recommendations*, at 42-45, available at <http://www.fatf-gafi.org/dataoecd/16/54/40339628.pdf>.

214 *Id.* at 43-44 (“Technical differences between the laws in the requesting and requested states, such as differences in the manner in which each country categorizes or denominates the offence should not pose an impediment to the provision of mutual legal assistance.”).

215 *Id.* at 2-3. See also FATF, *Key Principles for Mutual Evaluations and Assessments*, available at http://www.fatf-gafi.org/document/34/0,3343,en_32250379_32236963_45572898_1_1_1_1,00.html.

216 See FATF, *High-risk and Non-cooperative Jurisdictions*, http://www.fatf-gafi.org/pages/0,3417,en_32250379_32236992_1_1_1_1_1,00.html (last visited Jan. 12, 2011).

217 See *id.*

218 *Id.*

219 *Id.*

“recommendations” are not followed then harder enforcement follows. Increased scrutiny of transactions with a non-cooperative country appears likely to encourage compliance by increasing the difficulty of doing business with that country, thereby reducing its trade and/or attractiveness as a destination for investment.

Financial Stability Board

The Financial Stability Board (“FSB”) has a mandate from its members to monitor risks to global financial stability and make recommendations.²²⁰ The FSB serves as an overseer of international coordination across a broad range of financial regulation.²²¹ It has as members not only countries,²²² but also international organizations such as the BIS, OECD, IOSCO, IMF, and the World Bank.²²³ The G20 established the FSB as the successor to the Financial Stability Forum (“FSF”) in 2009.²²⁴

The FSF was founded in 1999 to promote cooperation between the already existing national and international supervisory bodies.²²⁵ The FSF has compiled a list of 12 standards that it has deemed to be “key for sound financial systems and deserving of priority implementation depending on country circumstances.”²²⁶ The standards were not produced by the FSF, but rather represent the collective wisdom of other international

220 Financial Stability Board [FSB], Mandate, <http://www.financialstabilityboard.org/about/mandate.htm> (last visited Jan. 12, 2011).

221 FSB, Overview, <http://www.financialstabilityboard.org/about/overview.htm> (last visited Jan. 12, 2011).

222 See FSB, Links to FSB Members, <http://www.financialstabilityboard.org/members/links.htm> (last visited Jan. 12, 2011). Current member countries of the FSB include all G20 members plus Hong Kong, The Netherlands, Singapore, Spain and Switzerland. *Id.*

223 *Id.*

224 FSB, History, <http://www.financialstabilityboard.org/about/history.htm> (last visited Jan. 12, 2011).

225 *Id.*

226 FSB, 12 Keys Standards for Sound Financial Systems, http://www.financialstabilityboard.org/cos/key_standards.htm (last visited Jan. 12, 2011).

organizations such as the OECD, FATF, BCBS, and IOSCO.²²⁷ These standards include FATF's Forty Recommendations,²²⁸ BCBS's Core Principles for Effective Banking Supervision,²²⁹ and IOSCO's Objectives and Principles of Securities Regulation.²³⁰

The FSB does not possess any power to enforce its recommendations.²³¹ Rather it coordinates the adoption of standards to promote financial stability and reports on the progress of that adoption.²³² Also, the FSB conducts reviews of individual member countries' progress in implementing its standards.²³³ Overall the FSB aims to convince countries that adopting certain standards of financial regulation is not only individually beneficial for countries, but is mutually beneficial to all the members of the international financial community.

Overview of International Cooperation

International information sharing is limited to an exchange of the information requested. Countries do not share all of their tax or regulatory information in the absence of a specific request since this information is both voluminous and subject to misuse. In neither area has significant global harmonization been achieved.

227*Id.*

228 FATF, *FATF 40 Recommendations* (2003), available at http://www.fatf-gafi.org/document/28/0,3343,en_32250379_32236920_33658140_1_1_1_1,00.html.

229 BCBS, *Core Principles for Effective Banking Supervision* (2006), available at <http://www.bis.org/publ/bcbs129.pdf>.

230 IOSCO, *Objectives and Principles of Securities Regulation*, (2003), available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD154.pdf>.

231 FSB, Mandate, <http://www.financialstabilityboard.org/about/mandate.htm> (last visited Jan. 12, 2011).

232 See, e.g., FSB, *Overview of Progress in the Implementation of the G20 Recommendations for Strengthening Financial Stability*, (2010), available at http://www.financialstabilityboard.org/publications/r_100627c.pdf; FSB, *Ongoing and Recent Work Relevant to Sound Financial Systems*, (2010), available at http://www.financialstabilityboard.org/publications/on_1006.pdf.

233 See, e.g., FSB, *Country Review of Mexico*, (2010), available at http://www.financialstabilityboard.org/publications/r_100927.pdf.

Although there were attempts by the OECD to harmonize global tax laws,²³⁴ the OECD has backed away from this goal and settled for narrow information exchange agreements.²³⁵ The fact that such a desirable outcome for many powerful countries could not be achieved by an organization as influential as the OECD is an indication of just how difficult it is to achieve harmonization of national laws.

Certain organizations, however, have been quite successful in obtaining international harmonization. The Basel Committee, despite some bending of its rules by regulators, has been successful in obtaining a general increase in the reserve requirements of banking systems around the world. Also, the FATF has obtained nearly universal cooperation in the anti-money-laundering and counter terrorist financing areas, along with a great degree of harmonization of national laws in these areas. The explanation of these successes probably lies with a greater alignment of interests and backing by a more powerful global political will.

As far as securities regulation is concerned, IOSCO has obtained broad cooperation in the realm of information sharing. However, information sharing is the only form of cooperation agreed to. There must have been a suspected breach of law or regulation for information to be shared, and no harmonization of securities regulation has been achieved. These attempts at international cooperation in the regulation of banking, taxation, and AML/CTF show that harmonization of national law is unlikely, absent an alignment of national interests and/or strong global political will, but that limited agreements to cooperate can be achieved with comparative ease.²³⁶

The MMOU allows countries to gain specific information relating to violations of securities regulations. Thus, United States regulators could obtain information if they believed that systemic risk information provided in accordance with the Dodd-Frank Act was false. However, and most importantly, present agreements do not allow for information exchange absent an allegation of a breach of securities regulations. This condition

234 See *Harmful Tax Competition*, *supra* note 165, at 39-40; OECD, *Report to the 2000 Ministerial Council meeting and Recommendations by the Committee on Fiscal Affairs*, at 12-14 (2000), available at <http://www.oecd.org/dataoecd/25/27/44430257.pdf>.

235 OECD, *The Global Forum on Transparency and Exchange of Information for Tax Purposes, Statement of Outcomes* (2010), available at <http://www.oecd.org/dataoecd/1/49/46107244.pdf>.

236 See Verdier, *supra* note 187, at 148.

hampers the ability of United States regulators to judge the risks posed to the United States' financial system by entities not required to report under the act. Also, cooperation in securities enforcement is limited to information exchange; therefore, the SEC could not necessarily get its decisions enforced by foreign regulators.

Past attempts to harmonize national laws, like the OECD's tax initiatives, have met with limited success. Such attempts have only succeeded where there was an incentive for countries to implement those laws. Therefore, it will be important for regulators to emphasize the mutual benefits that will be achieved by reductions in systemic risk caused by the adoption of harmonious standards of regulation. Systemic stability is a public good that spans the global financial system, and every country stands to gain if systemic risk in the international financial system is reduced. Also, harmonization of systemic risk regulation would probably mean that international financial companies will not be subjected to duplicative or redundant regulation.

Information sharing for purposes of systemic risk regulation is of greater value to OFCs than agreements for the sharing of tax information. Whereas it is primarily large onshore jurisdictions that benefit from the information sharing provisions of tax treaties, information sharing for systemic risk regulation has the potential to yield mutual benefits. Therefore, in light of the OECD's success in obtaining information sharing agreements for taxation, it is reasonable to believe that it will be possible to obtain information sharing agreements for systemic risk regulation.

This system of regulation will look much more like banking supervision overseen by BCBS than traditional securities regulation. Traditional securities regulation was aimed primarily at protecting investors from specific fraud, market manipulation, and insider trading. The focus of new regulations, such as those provided for in the Dodd-Frank Act, is to protect investors from the general contagion of individual financial failures. This function more closely resembles the protection of individual depositors by maintaining the soundness of the banking system than it does traditional securities regulation. Given the divergent standards adopted in the United States and in the European Union, harmonization like that achieved by BCBS appears unlikely in the area of systemic risk regulation.

Part IV: Alternative Investment Fund Managers Directive

Although there has so far been comparatively little regulation of shadow banking entities, the United States was not the only jurisdiction

which the recent financial crisis spurred to legislate in this area. The European Union (“EU”) has passed the Alternative Investment Fund Managers (“AIFM”) Directive (“AIFM Directive”).²³⁷ It will regulate European shadow banks exempt from the UCITS Directive, which regulates mutual funds.²³⁸ It is interesting to compare the AIFM Directive with the Dodd-Frank Act because both pieces of legislation represent a move into relatively uncharted regulatory territory.²³⁹

Importantly, unlike the Dodd-Frank Act, the AIFM Directive has the effect of preventing AIFM based in a country outside the EU from marketing their funds in the EU unless that country has appropriate information exchange agreements with an EU Member State.²⁴⁰ Similar rules apply even if AIFM are based in the EU and only the funds they manage are outside the EU.²⁴¹ These prohibitions differ from the foreign private adviser exception of the Dodd-Frank Act because they bar outright foreign advisers from marketing their funds in the EU unless those funds are based in countries that allow information exchange. Dodd-Frank allows advisers to market their funds in the United States provided that they register and provide systemic risk information as requested. However, Dodd-Frank does not provide a mechanism to ensure that this information can be verified.

237 Council Directive 2011/61, of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010, 2011 O.J. (L 174) 1 (EU), available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:174:0001:0073:EN:PDF> [hereinafter AIFM Directive].

238 *Id.* at 1.

239 The author would like to caveat his discussion of the AIFM Directive by stating that because of space constraints the discussion of the directive’s provisions here will be brief and simplistic.

240 See AIFM Directive, *supra* note 237, art. 40(2)(a). This is actually a great simplification. The AIFM Directive contains several different articles setting forth the rules for AIFM depending on their location and the location of the funds they manage. Article 40 sets forth the rules for an AIFM based outside the EU to market a fund also based outside the EU within the EU by use of the “passport” provision. A “passport” basically enables an AIFM to market its funds in the EU provided it is authorized by a member state in accordance with the AIFM directive. See AIFM Directive, *supra* note 237, art. 32.

241 AIFM Directive, *supra* note 237, arts. 35 and 36.

Apart from its scope, the AIFM Directive differs in that it asserts control over the actions of advisers to shadow banks. The AIFM Directive provides that AIFM must make annual reports for the funds they manage available upon request.²⁴² Also AIFM are required to make certain other disclosures to investors including a description of the investment strategy of the fund, the techniques they may employ, the liquidity of their investments and the leverage they use.²⁴³ The AIFM Directive also governs the remuneration of AIFM and allows a member state to regulate conflicts of interest between AIFM and the funds they manage.²⁴⁴ The directive requires AIFM to review and maintain risk management systems and conduct stress tests to assess the liquidity risk of the funds they manage.²⁴⁵

The exact extent of the information required under the Dodd-Frank Act can vary because the FSOC and the SEC are allowed to require such further information as they deem necessary,²⁴⁶ but there is a general difference in the information collected by the Dodd-Frank Act and the AIFM Directive. Whereas the Dodd-Frank Act aims to collect raw data from the adviser for the benefit of regulators, the AIFM Directive appears to be concerned both with regulating AIFM's methodology and requiring public disclosures so that investors in funds managed by AIFM can make informed investing decisions.²⁴⁷ The AIFM Directive tries to regulate AIFM behavior to lower risks of systemic problems *ex ante* whereas the Dodd-Frank Act seeks to provide regulators with the information necessary to take action to avert a developing systemic crisis.

So from the start, global regulation of shadow banking entities will not be harmonious. Therefore, shadow banks will potentially have to deal with distinct, but largely repetitive, regimes of systemic risk regulation. The AIFM Directive anticipates such problems by exempting AIFM from

242 *Id.* art. 22.

243 *Id.* art. 23.

244 *Id.* arts. 13 and 14.

245 *Id.* arts. 15 and 16.

246 *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 404, 124 Stat. 1376, 1571-72 (2010).

247 *Compare* § 404(2), 124 Stat. at 1571-72, *with* AIFM Directive, *supra* note 237, arts 12-24.

compliance with its provisions provided they are already in compliance with incompatible rules or regulations that provide investors with an equivalent level of protection.²⁴⁸ Indeed, it will be interesting to see whether EU regulators will hold that the Dodd-Frank Act “provides for an equivalent rule (as the AIFM Directive) having the same regulatory purpose and offering the same level of protection to... investors...”²⁴⁹

Despite the differences between the Dodd-Frank Act and the AIFM Directive, both sets of regulation do take into account the fact that entities might already be subject to foreign regulation.²⁵⁰ Proposals have been made in the United States that securities regulators should take greater account of compliance with foreign securities regulations when determining whether full SEC regulatory oversight is necessary.²⁵¹ Therefore, even if regulatory regimes differ in important ways, it is possible that the necessity of international information sharing and the burden of complying with redundant layers of regulation will be reduced if governments accept that entities are already adequately regulated by foreign countries.

Part V: New agreements needed to allow exchange of systemic risk information.

The efforts of the OECD and IOSCO show that it is very difficult to convince countries to harmonize their laws. Even if such harmonization of national laws could be achieved, BCBS's experience with national regulators bending its rules to favor domestic entities indicates that such regulation is unlikely to be uniformly applied. Therefore, it is unlikely that

248 AIFM Directive, *supra* note 237, art. 37.

249 *Id.* art. 37(2)(b).

250 *See, e.g., id.* art. 37; Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 113(b)(2)(H), 115(b)(2), 124 Stat. 1376, 1399, 1403 (2010).

251 *See* Ethiopis Tafara & Robert J. Peterson, *A Blueprint for Cross-Border Access to U.S. Investors: A New International Framework*, 48 HARV. INT'L L.J. 31 (2007).

“Instead of being subject to direct SEC supervision and U.S. federal securities regulations and rules, foreign stock exchanges and broker-dealers would apply for an exemption from SEC registration based on their compliance with substantively comparable foreign securities regulations and laws and supervision by a foreign securities regulator with oversight powers and a regulatory and enforcement philosophy substantively similar to the SEC's.” *Id.* at 32.

See also International Disclosure Standards, 64 F.R. 6261 (proposed Feb. 9, 1999) (codified at 17 C.F.R. 210, 228, 229, 230, 239, 240, 249, 260).

true harmonization of systemic risk regulation will be achieved.²⁵² Differences between the AIFM Directive of the EU and the Dodd-Frank Act in the United States show that even onshore jurisdictions differ in how they believe shadow banks should be regulated. But harmonization may not be necessary provided countries share systemic information. Indeed the Dodd-Frank Act and the AIFM Directive anticipate such international cooperation.²⁵³

IOSCO's MMOU should be modified specifically to allow for cooperation in systemic risk regulation. Although the SEC has more rigorous cooperation agreements with certain foreign jurisdictions,²⁵⁴ it is desirable that there be broadly-based international agreements, as systemic risk can originate in and threaten multiple jurisdictions at once. Given the past successes of international organizations in obtaining information sharing agreements, systemic risk information exchange agreements can probably be readily obtained. This is because all jurisdictions, both on and off shore, have strong interests in preventing the international contagion of financial failures.

The OECD's model tax treaties and IOSCO's MMOU show that in order for them to be widely accepted, international cooperation agreements must have strict prerequisites for information exchange and controls on how the information obtained may be used.²⁵⁵ Systemic risk information exchange agreements will probably require that the requesting regulator

252 *But see* IOSCO, *Hedge Funds Oversight* (2009), available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD293.pdf>. This document sets forth guidelines for internationally consistent regulation of the hedge fund industry.

253 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 175, 929K, 981, 124 Stat. 1376, 1442, 1860-61, 1926-27 (2010); AIFM Directive, ¶¶ 63, 69 and 84.

254 *See, e.g.*, Memorandum of Understanding between the Securities and Exchange Commission of the United States and the Financial Services Authority of the United Kingdom, (Sept. 25, 1991), available at www.sec.gov/about/offices/oia/oia_multilateral/ukfsa_mou.pdf.

255 *See, e.g.*, Agreement between the Governments of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland, Including the Government of the Cayman Islands, for the Exchange of Information Relating to Taxes, U.S.-U.K., Nov. 27, 2001, T.I.A.S. No. 13175; IOSCO, *Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information* (2002), available at <http://www.iosco.org/library/index.cfm?section=pubdocs&year=2002&publicDocID=126>.

specify the reasons why a given shadow bank is thought to pose a threat to the financial system of the requesting country, and the request will have to state the nature of the information desired. Further, the agreement should contain provisions restricting the purposes for which the information obtained may be used so as to prevent fishing expeditions for tax information under the auspices of systemic risk regulation.²⁵⁶ The agreements will have to provide that information will not be released publicly, both to prevent proprietary strategies of shadow banks from being revealed, and to ensure that the mere fact of the request does not have adverse effects on any particular shadow bank.²⁵⁷

If some jurisdictions do not accede to sign information-sharing agreements, then other jurisdictions can follow the familiar steps to obtain these agreements. First, organizations like the FSB could perhaps persuade noncompliant jurisdictions that adopting information sharing agreements is really in their own self interest. Second, jurisdictions that do not share information could be named and shamed in the same way as the OECD and FATF named and shamed jurisdictions that did not adopt their recommendations. If this is not sufficient, then domestic entities transacting with noncompliant jurisdictions could be subjected to a heightened level of systemic risk scrutiny. This would raise the cost of doing business with these jurisdictions and provide them with a strong incentive to enter into information sharing agreements.

As shadow banks in OFCs cater to nonresidents, these shadow banks will experience high costs if they have to comply with multiple foreign regulatory standards in order to be able to market their services in onshore jurisdictions. These costs will encourage OFCs to adopt levels of regulation that onshore regulators will accept as sufficient to make additional onshore regulation unnecessary. This does not necessarily require that the OFC adopt identical systemic risk regulation. OFCs probably will attempt to adopt lighter, perhaps more efficient regulations that would nonetheless be found to be substantially similar in their effects to those of onshore jurisdictions.

²⁵⁶ See, e.g., AIFM Directive, *supra* note 237, art. 52 (permitting the transfer of information to third countries to the extent necessary to further the purposes of the AIFM Directive).

²⁵⁷ For instance, investors, upon learning that there had been a request for information, might attempt to withdraw their investment from the shadow bank fearing that regulators know something the investors did not. The Dodd-Frank Act anticipates such problems and in section 112 exempts the Financial Stability Oversight Committee from certain Freedom of Information Act requirements.

Conclusion

The aim of global systemic risk regulation should be to fill risk-information gaps. Individual shadow banks have an incentive to maintain the secrecy of their operations to preserve the value of their proprietary trading strategies. This impedes the ability of participants in the market for asset management to deter excessive risk taking with investors' funds. Regulators should ensure that investors obtain the maximum amount of information that is compatible with preservation of proprietary strategies, thus allowing risk-averse individual investors to minimize systemic risk as far as possible. Regulators should then focus on collecting confidential information nationally and internationally that will enable them to monitor systemic risk through network analysis and examination of systemically important shadow banks' balance sheets.

Although international harmonization of systemic risk regulation is desirable to minimize compliance costs for shadow banks and ease the burdens of information sharing on national regulators, both past experience of attempts at such harmonization and the significant differences between the American and European approaches to systemic risk regulation indicate that such harmonization is unlikely. A mixture of international information sharing agreements to allow the exchange of systemic risk regulation, combined with acceptance in appropriate instances that foreign entities are already subject to adequate regulation, is the most efficient and feasible course. The fact that many countries have already signed agreements to share information relating to securities regulation indicates that agreements for systemic risk information sharing should be obtainable.

“Direct Effect in the United States” under the Foreign Sovereign Immunities Act after *Cruise Connections v. Attorney General of Canada*

Y. David Huang*

Introduction

In the global marketplace, private parties often transact with foreign nations or their instrumentalities. When disputes arise, under what circumstances can a private party sue a foreign nation in U.S. court for the breach of a contract relating to commercial activity occurring outside U.S. territory? How much connection between the foreign commercial activity and the U.S. is necessary for jurisdiction?

The Foreign Sovereign Immunities Act¹ (FSIA) of 1976 was intended to address these questions. The FSIA is the codification of the “restrictive” view of sovereign immunity that aims to balance traditional absolute foreign sovereign immunity with practical interests of private domestic parties dealing with foreign nations.² By default, the FSIA provides immunity by denying jurisdiction over a foreign sovereign in U.S. federal or state court.³ However, the statute also provides exceptions that form the sole mechanisms for obtaining jurisdiction over a foreign sovereign.⁴ One set of exceptions is known as the “commercial activity exception,”⁵ codified at § 1605(a)(2). Under § 1605(a)(2), if the action is

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1 28 U.S.C. §§ 1330, 1332, 1391(f), 1441(d), 1602-11 (2006).

2 *Weltover, Inc. v. Republic of Argentina*, 941 F.2d 145, 148 (2d Cir. 1991), *aff'd*, 504 U.S. 607 (1992).

3 28 U.S.C. § 1604 (“Subject to existing international agreements . . . a foreign state shall be immune from the jurisdiction of the courts of the United States and of the States except as provided in sections 1605 to 1607 of this chapter”).

4 *Republic of Argentina v. Weltover, Inc.*, 504 U.S. 607, 610-11 (1992); *Argentine Republic v. Amerada Hess Shipping Corp.*, 488 U.S. 428 (1989).

5 *See, e.g.*, 1 VED P. NANDA & DAVID K. PANSIUS, LITIGATION OF INTERNATIONAL DISPUTES IN U.S. COURTS § 3:12 (2d ed. 2011).

based upon an act outside the territory of the United States in connection with commercial activity of the foreign sovereign, jurisdiction over the foreign sovereign can be obtained if the act “causes a direct effect in the United States.” But what constitutes a “direct effect in the United States”? With little statutory or legislative guidance,⁶ courts have struggled to interpret the meaning of “direct effect,” a seemingly simple phrase that has proven to be very troublesome in legal analysis.

The Supreme Court’s 1992 *Republic of Argentina v. Weltover, Inc.*⁷ decision only added additional problems to “direct effect” jurisprudence. The Court rejected foreseeability and substantiality of the alleged effect as requirements and, instead, stated that an effect is “direct” if it follows as “immediate consequence” of the foreign sovereign’s actions.⁸ Stripped of the useful guideposts of foreseeability and substantiality, courts have had much trouble using the immediacy standard, which did very little to clarify the term “direct.” For breach of contract cases, modern “direct effect” jurisprudence contains at least two major issues, neither of which is straightforward. One issue, a subject of circuit splits, relates to how a foreign government’s scope of contractual obligation should play a role in determining the types of “effects” that may qualify. Another issue is the application of the “immediate consequence” rule in determining whether an effect was “direct,” a term that can be overly abstract, as the case of this note illustrates.

The 2010 D.C. Circuit case *Cruise Connections Charter Management I, LP v. Attorney General of Canada*⁹ creates additional ambiguity in “direct effect” jurisprudence. In *Cruise Connections*, the Royal Canadian Mounted Police’s alleged breach of a contract was found to have had a direct effect because it resulted in the “loss of revenue” under the plaintiff party’s third-party agreements, even though the Royal Canadian Mounted Police contracted with the plaintiff only and had no performance obligations in the United States.¹⁰ This holding departs from traditional case

⁶ NANDA & PANSIUS, *supra* note 5, § 3:12.

⁷ *Republic of Argentina v. Weltover, Inc.*, 504 U.S. 607 (1992).

⁸ *Id.*

⁹ 600 F.3d 661 (D.C. Cir. 2010), *en banc reh’g denied*, 2010 U.S. App. LEXIS 16743 (D.C. Cir., June 21, 2010).

¹⁰ *Id.* Judge Tatel wrote the opinion for a unanimous panel including Judge Silberman and Judge Williams.

law in the circuit, which found direct effect in breach of contract cases only when the foreign government had agreed to render payment at a U.S. location. Furthermore, although established principles require a direct effect to have no intervening cause, the court found the third-party agreement losses to be “immediate consequences” of the alleged breach, even though such losses were one or more steps removed from the alleged breach, as they were tied to third-party obligations.

This note will argue that the D.C. Circuit’s departure from earlier case law is based on flawed reasoning, and that as a result, direct effect jurisprudence has been made even more ambiguous. Part I provides an overview of sovereign immunity, the 1976 Foreign Sovereign Immunities Act, and subsequent case law. Part II provides an overview and summary of *Cruise Connections*. Part III analyzes the D.C. Circuit’s reasoning, concluding that its finding of direct effect in third-party agreement losses is illogical, inconsistent with earlier case law, and based on flawed legal reasoning. Part IV discusses the implications of the case, including a broadening of a court’s discretion in finding direct effect, and possible future emphasis on generalized economic effect in the U.S. and disappointed expectation of economic gain as factors for finding direct effect. Part IV also provides possible approaches toward more uniformity and clarity in view of the ambiguities resulting from this decision.

I. Background

This section begins with a description of the restrictive theory of sovereign immunity which formed the basis of the FSIA. The section then describes the ambiguity of the “direct effect” element, and proceeds by highlighting case law interpretations of this element.

A. The FSIA’s Codification of the Restrictive Theory of Sovereign Immunity

In common law courts, the plea of sovereign immunity was originally recognized as an absolute bar to any lawsuit, based on the theory of implied consent among sovereigns to withhold jurisdiction.¹¹ The drawback of absolute sovereign immunity is the outright denial of recovery against foreign governments in U.S. courts. Over time, increase in trade activity gradually eroded absolute immunity in favor of a more practical,

11 HAZEL FOX, *THE LAW OF STATE IMMUNITY* 35 (2d ed., Oxford Univ. Press 2008); see also NANDA & PANSIUS, *supra* note 5, § 3:12.

balanced approach known as the “restrictive theory of sovereign immunity.”¹² This later theory is based on a dichotomy that a foreign sovereign should be immune for its public acts, but not immune for its private acts.¹³ Private acts include those of commercial or private law nature, while public acts are those performed in the exercise of sovereign power, such as military deployment.¹⁴ Justice Marshall laid out this public-private dichotomy in the seminal 1812 case *Schooner Exchange v. McFaddon*,¹⁵ which inaugurated foreign sovereign immunity jurisprudence in the United States.¹⁶

The restrictive theory developed on a case-by-case basis until the need for a more definite and reliable doctrine led to codification under the Foreign Sovereign Immunities Act (FSIA) of 1976.¹⁷ The major portion of the FSIA was codified at 28 U.S.C. §§ 1602-11, which forms chapter 97 of the title.¹⁸ One court wrote, “The statute seeks a balance between the provision of a convenient forum for claimants aggrieved in commercial dealings with foreign states and the promotion of comity and harmony between the United States and other nations.”¹⁹

Section 1604 provides that subject to preexisting international agreements, “a foreign state shall be immune from the jurisdiction of the

12 FOX, *supra* note 11, at 35.

13 *Id.*

14 *Id.*; NANDA & PANSIUS, *supra* note 5, § 3:12 (citing Republic of Austria v. Altmann, 541 U.S. 677, (2004)) (explaining that the restrictive theory still protects “the sovereign’s right to act in a governmental manner free from suit.”); The Schooner Exch. v. McFaddon, 11 U.S. 116 (1812) (“[t]here is a manifest distinction between the private property of a person who happens to be a prince and that military force which supports the sovereign power, and maintains the dignity and the independence of a nation”).

15 The Schooner Exch. v. McFaddon, 11 U.S. 116, 137 (1812) (laying out the public-private dichotomy in dicta).

16 NANDA & PANSIUS, *supra* note 5, § 3:12 (citing Republic of Austria v. Altmann, 541 U.S. 677, (2004)).

17 *Id.*

18 Foreign Sovereign Immunities Act of 1976, Pub.L. No. 94-583, 90 Stat. 2891 (1976) (codified at 28 U.S.C. §§ 1330, 1332(a)(2), (3), (4), 1391(f), 1441(d), 1602-1611).

19 Colonial Bank v. Compagnie Generale Maritime et Financiere, 645 F. Supp. 1457, 1465 (S.D.N.Y. 1986).

courts of the United States and of the States,” unless an exception given in §§ 1605-07 applies. Procedurally, sovereign immunity is an affirmative defense which must be pled in the defendant’s answer.²⁰

However, the statute provides exceptions that destroy immunity. Section 1605(a)(2), known as the commercial activity exception, provides jurisdiction if the action is “based upon”²¹ (1) the foreign state’s commercial activity carried on in the United States; (2) “an act performed in the United States in connection with a commercial activity of the foreign state elsewhere”; or (3) “an act outside the territory of the United States in connection with a commercial activity of the foreign state elsewhere and that act causes a direct effect in the United States.” Thus, for commercial activity outside the United States, the third prong must be used to gain jurisdiction over the foreign sovereign. Of course, if the foreign sovereign conducted activity inside the United States, the “direct effect” element is absent in the corresponding first and second prongs. The statute provides definitions for “foreign states” (which includes the foreign state’s “agency or instrumentality”), the geographical meaning of “United States,” and the term “commercial activity,” but it contains no definition of “direct effect.”

B. Interpreting “Direct Effect:” *Weltover*’s Rejection of Foreseeability in Favor of an “Immediate Consequence” Standard, and Emphasis on Payment location

The lack of statutory definition meant that courts had to supply their own definition of “direct effect.” One approach was to interpret “direct effect” as “one that is substantial and foreseeable,”²² a view shared by many courts at the time.²³ This view had some asserted basis in legislative history, but later authority rejected this view and deemed legislative history to be

²⁰ FOX, *supra* note 11, at 319.

²¹ See *Saudi Arabia v. Nelson*, 507 U.S. 349, 357 (1993) (“‘based upon’ . . . is read most naturally to mean those elements of a claim that, if proven, would entitle a plaintiff to relief under his theory of the case”).

²² *Zedan v. Kingdom of Saudi Arabia*, 849 F.2d 1511 (D.C. Cir. 1988); *Transamerican S.S. v. Somali Democratic Republic*, 247 U.S. App. D.C. 208, 767 F.2d 998, 1004 (D.C. Cir. 1985).

²³ Heidi L. Frostestad, Note, *Voest-Alpine Trading v. Bank of China: Can a Uniform Interpretation of a “Direct Effect” be Attained Under the Foreign Sovereign Immunities Act of 1976?*, 34 VAL U.L. REV 515, 527 (2000) (“After the 1976 enactment of the FSIA, most Circuit Courts adopted a ‘substantial and foreseeable’ test”).

inconclusive as to the meaning of “direct effect.”²⁴ However, the Supreme Court expressly rejected both the “substantial” and “foreseeable” criteria in *Weltover, Inc. v. Republic of Argentina*.²⁵ In *Weltover*, two Panamanian corporations and a Swiss bank brought a breach of contract suit against Argentina in New York federal court, alleging that Argentina unilaterally rescheduled the maturity dates for certain bonds.²⁶ The contract allowed the plaintiffs to choose the location of payment, and before the breach occurred, the plaintiffs chose a New York bank.²⁷ The court rejected the contention that § 1605(a)(2) “contains any unexpressed requirement of substantiality or foreseeability.” It instead held that an effect is “direct” if it follows “as an immediate consequence of the defendant’s . . . activity.”²⁸ Note that, although “immediate” commonly refers to nearness in time, federal courts have interpreted “immediate” in the direct effect context to mean the lack of an *intermediate* event or the lack of intervention,²⁹ which is the other definition of “immediate.”

In *Weltover*, the Court found direct effect, reasoning that because Argentina was contractually obligated to pay the plaintiffs in a New York bank, “[m]oney that was supposed to have been delivered to a New York bank for deposit was not forthcoming.”³⁰ Thus, besides the endorsement of

24 NANDA & PANSIUS, *supra* note 5, § 3:12. The House Report reference stated that “direct effect” should be consistent with section 18 of the Restatement (Second) of Foreign Relations Law, which uses the terms “foreseeable” and “substantial.” *Id.* However, this restatement section was later deemed to be irrelevant to direct effect. *See, e.g., Texas Trading & Mill. Corp. v. Federal Republic of Nigeria*, 647 F.2d 300, 311 (2d Cir. 1981) (“[Section]18 concerns the extent to which substantive American law may be applied to conduct overseas, not the proper extraterritorial jurisdictional reach of American courts . . .”). Regardless, the Supreme Court later rejected the criteria of foreseeability and substantiality in *Republic of Argentina v. Weltover, Inc.*, 504 U.S. 607 (1992). The ultimate result is that legislative history of the FSIA contains no conclusive explicit or inferable definition of this phrase

25 *Republic of Argentina v. Weltover, Inc.*, 504 U.S. 607 (1992).

26 *Id.* at 617.

27 *Id.*

28 *Id.* at 618 (internal quotations omitted).

29 *Lyon v. Augusta S.P.A.*, 252 F.3d 1078, 1083 (9th Cir. 2001) (“While one meaning of immediate is ‘occurring, acting, or accomplished without loss of time,’ the more relevant meaning in this context is ‘acting or being without the intervention of another object, cause, or agency’”).

30 *Weltover*, 504 U.S. at 617-19 (1992) (the contract allowed the plaintiffs to choose the

the “immediate consequence” test and the rejection of foreseeability and substantiality, *Weltover*’s analysis of the specific facts had the effect of fixating subsequent cases on a payment location test.

C. Cases after *Weltover*: “Legally Significant Acts” and the Focus on Payment Location Obligations

Weltover’s “immediate consequence” test was not met well. The Tenth Circuit remarked that *Weltover*’s rejection of foreseeability and substantiality eliminated useful “guideposts” to a statutory phrase that was already “hopelessly ambiguous when applied to any particular transaction.”³¹

The rejection of foreseeability and substantiality was seen as allowing immunity to be destroyed too easily.³² One commentator humorously summarized the development of sovereign immunity jurisprudence through *Weltover* as moving from “the king can do no wrong” to “your king can be sued here.”³³ In light of this potential problem, one circuit split in “direct effect” jurisprudence revolves around an additional, judicially created requirement for direct effect. In adding more substance to *Weltover*’s immediacy test while also preserving the decisiveness of the U.S. place of payment in *Weltover*,³⁴ the Second, Eighth, and Ninth Circuits³⁵ have imposed a judicially created requirement that a foreign

location of payment, and before the breach, the plaintiffs chose a New York bank).

31 *United World Trade v. Mangyshlakneft Oil Prod. Ass’n*, 33 F.3d 1232, 1237 (10th Cir. 1994).

32 *See, e.g.*, David E. Gohlke, Comment, *Clearing the Air or Muddying the Waters? Defining “A Direct Effect in the United States” Under the Foreign Sovereign Immunities Act After Republic of Argentina v. Weltover*, 18 Hous. J. Int’l L. 261, 296 (1995) (in addressing an argument that *Weltover* simplified direct effect analysis, the comment responded, “[M]atters are simplified only because the standard against which to judge the directness of an “effect in the United States” has been set so low that virtually any determination will not be a manifest abuse of discretion.”).

33 *Id.* at 264.

34 *NANDA & PANSIUS*, *supra* note 5, § 3:12.

35 *Adler v. Federal Republic of Nigeria*, 107 F.3d 720, 727 (9th Cir. 1997) (in adopting the legally significant act test, the Ninth Circuit noted that the Second, Eighth and Tenth Circuits also apply this test). The Tenth Circuit later expressly rejected this test. *Orient Mineral Co. v. Bank of China*, 506 F.3d 980, 998 (10th Cir. 2007) (expressly rejecting the legally significant act test in the Tenth Circuit).

sovereign's act or omission having a direct effect in the United States must be legally significant (a formulation known as the "legally significant act" rule).³⁶ In the breach of contract context, a legally significant act is the failure to render performance (such as making payment) contractually obligated to be performed in the United States (such as payment at a U.S. bank).³⁷ Under this rule, if the foreign sovereign had a contractual obligation to make payment to a U.S. party, but the payment location is either never specified or is specified at a foreign location, there can be no direct effect following a breach. Thus, for breach of payment cases, while a U.S. payment location is a *sufficient* condition to find direct effect under

36 *Guirlando v. T.C. Ziraat Bankasi A.S.*, 602 F.3d 69, 76 (2d Cir. 2010) (equating acts with omissions); *Filetech S.A. v. Fr. Telecom S.A.*, 157 F.3d 922, 931 (2d Cir. 1998) ("This test requires that the conduct having a direct effect in the United States be legally significant conduct").

37 *Adler*, 107 F.3d at 727 (the Ninth Circuit stating that because Nigeria was obligated to make payment in New York, "failure to satisfy that obligation necessarily had a direct effect in the United States"); *United World Trade v. Mangyshlakneft Oil Prod. Ass'n*, 33 F.3d 1232, 1237 (10th Cir. 1994) (finding no legally significant act when "no part of the contract in this case was to be performed in the United States").

There has been some confusion regarding whether the "legally significant act" has to occur in the U.S. under the "legally significant act" test. The Second Circuit once used the phrase "legally significant conduct in the United States." *Antares Aircraft, L.P. v. Federal Republic of Nigeria*, 999 F.2d 33, 34 (2d Cir. 1993). Such formulation has led some authorities and commentators to recognize the test, at least in one variation, to require that the foreign sovereign must actually perform some activity in the United States. *See Orient Mineral Co. v. Bank of China*, 506 F.3d 980, 998 (10th Cir. 2007); Matthew Bensen, Comment, *The All New (International) "People's Court": The Future of the Direct Effect Clause After Voest-Alpine Trading USA Corp. v. Bank of China*, 83 MINN L. REV. 997 (1999) ("an act has 'legal significance' only if . . . the foreign government engaged in some activity in the United States"). This formulation naturally leads to confusion in breach of contract situations, because the actual breach of a contract is not itself a physical act tied to a location. In light of this, the Second Circuit has recently provided explicit clarification that in its version of the "legally significant acts" test, only the "direct effect" needs to be in the United States. *Guirlando v. T.C. Ziraat Bankasi A.S.*, 602 F.3d 69, 75-77 (2d Cir. 2010).

In the breach of contract context, *Guirlando* stated that the foreign sovereign's decision to breach occurs abroad, but the direct effect, if any, would be in the United States. *Id.* at 77. *Guirlando* did not expressly address whether a U.S. payment location is required to satisfy the "legally significant act" test. However, *Guirlando* suggests that a U.S. payment location is still required because (1) it recounts that a direct effect occurred in *Weltover* because "a foreign state's failure to make payment in the United States as required by contract," *id.* at 75; (2) it recounts *Antares*, 999 F.2d 33, in which the circuit found no direct effect because the contract had no provisions for obligations in the United States, *id.* at 77; and (3) it restates the rule that mere injury to a U.S. citizen is insufficient to find a direct effect, *id.*

Weltover, the legally significant act rule makes it also a *necessary* condition.

The Fifth, Sixth, and Tenth Circuits expressly reject this test.³⁸ For example, in *Voest-Alpine Trading USA Corp. v. Bank of China*³⁹ the Tenth Circuit found direct effect in a banking transaction, even though the Bank of China was not obligated to pay the plaintiff in the United States.⁴⁰ *Voest-Alpine* broadly and expressly held that “financial loss incurred in the United States by an American plaintiff, if it is an immediate consequence of the defendant's activity, constitutes a direct effect.”⁴¹ Circuits requiring a legally significant act can connect contractual obligations with the geographical United States to find direct effect, while in circuits adopting *Voest-Alpine*'s view, the analysis becomes more open-ended and unpredictable, as there are no guidelines other than “direct.”⁴² However, commentators have also argued that the legally significant act requirement is not ideal because contractual clauses specifying performance in the United States by the foreign sovereign essentially become waivers of immunity.⁴³ Because neither side in this circuit split has an ideal method for finding direct effect, commentators have criticized the *Weltover* decision for causing the split and eliminating useful guideposts for evaluating a foreign sovereign's degree of involvement with parties in the U.S.⁴⁴

38 *Orient Mineral Co. v. Bank of China*, 506 F.3d 980, 998 (10th Cir. 2007); *Am. Telecom Co., LLC v. Republic of Lebanon*, 501 F.3d 534, 540 (6th Cir. 2007) (“the Fifth and Sixth Circuits have renounced any legally-significant-act test”); *Voest-Alpine Trading USA Corp. v. Bank of China*, 142 F.3d 887 (5th Cir. 1998).

39 142 F.3d 887 (5th Cir. 1998).

40 *Id.* at 893.

41 *Id.* at 893, 897.

42 See *NANDA & PANSIUS*, *supra* note 5, § 3:12 (stating that due to *Weltover*'s rejection of foreseeability, either ‘immediate’ effect is interpreted as providing jurisdiction in almost every instance where a U.S. person is injured; or “immediate” is interpreted as engrafting requirements of conduct or performance that is or was to be performed in the United States”).

43 *Id.*

44 See generally *id.*; David E. Gohlke, Comment, *Clearing the Air or Muddying the Waters? Defining “A Direct Effect in the United States” Under the Foreign Sovereign Immunities Act After Republic of Argentina v. Weltover*, 18 HOUS. J. INT'L L. 261 (1995).

The D.C. Circuit has not explicitly adopted the legally significant act test. However, it has required something similar,⁴⁵ at least prior to *Cruise Connections*. For payment situations, the traditional D.C. Circuit rule is that “there is no direct effect unless payment was ‘supposed’ to have been made in the United States.”⁴⁶ This rule is based on the D.C. Circuit’s emphasis of the payment obligation in *Weltover*,⁴⁷ which used the term “money supposed to have been delivered.”⁴⁸ This rule has also been formulated to require either an express agreement of a U.S. payment location or an implied agreement of the same based on customary practice between the parties.⁴⁹ Thus, within the payment context, this requirement is similar to what a legally significant act test would require, except that the U.S. payment location agreement may be customary rather than express.⁵⁰

45 *Global Index, Inc. v. Mkapa*, 290 F. Supp. 2d 108, 113 (D.D.C. 2003) (“While other circuits have expressly adopted or rejected the ‘legally significant act’ test, the D.C. Circuit follows the . . . more general approach set forth in *Weltover*”).

Interestingly, the D.C. Circuit used the “legally significant act” analysis in *Zedan v. Kingdom of Saudi Arabia*, 849 F.2d 1511, 1515 (D.C. Cir. 1988) (noting that in cases where courts have found direct effect “something legally significant actually happened in the United States”). However, this analysis was interwoven with the concept of foreseeability. *Id.* After *Weltover*, the D.C. Circuit has not mentioned a legally significant act test.

46 *Global Index*, 290 F. Supp. 2d at 113; *See also* *Goodman Holdings v. Rafidain Bank*, 26 F.3d 1143 (D.C. Cir. 1994) (finding no direct effect where “neither New York nor any other United States location was designated as the ‘place of performance’ where money was ‘supposed’ to have been paid” to the plaintiffs).

47 *See Agrocomplect AD v. Republic of Iraq*, 304 Fed. Appx. 872, 873 (D.C. Cir. 2008) (no direct effect where plaintiff failed to show that “payments under its contract with Iraq were supposed to pass through an American bank, as *Weltover* requires”); *Global Index*, 290 F. Supp. 2d at 113 (“the D.C. Circuit follows the same, more general approach set forth in *Weltover*”)

48 *Republic of Argentina v. Weltover, Inc.*, 504 U.S. 607, 619 (1992) (“Money that was supposed to have been delivered to a New York bank for deposit was not forthcoming”).

49 *Cruise Connections Charter Mgmt. 1, LP v. Attorney Gen. of Can.*, 634 F. Supp. 2d 86, 88-89 (D.D.C. 2010) (“In short, before the breach occurs, the parties must have agreed – either expressly or impliedly – that payment would occur in the United States”), *rev’d*, 600 F.3d 661 (D.C. Cir. 2010).

50 Regarding the technical differences between the two standards, the D.C. District Court has stated that “the Second Circuit’s ‘legally significant act’ test requires express provision of payment in the U.S.,” while the “D.C. Circuit follows the same, more general approach set forth in *Weltover*” where “[t]here is no direct effect unless payment was ‘supposed’ to have been made in the United States.” *Global Index, Inc. v. Mkapa*, 290 F. Supp. 2d 108, 112 (D.D.C. 2003). As mentioned, “supposed” has been interpreted to require either an implied or express agreement. Whether an implied agreement in this sense is actually broader than the type of obligations required by the “legally significant act” test is not

However, as will be discussed, the D.C. Circuit found direct effect in *Cruise Connections* even though there was no agreement for the defendant to render payment in the United States and the payment (at a bank not necessarily in the U.S.) was the defendant's only obligation to the plaintiff.

D. Intervening Act Analysis

Courts have also used alternative definitions of direct effect consistent with *Weltover's* immediacy definition. The D.C. Circuit has stated that a direct effect is "one which has no intervening element, but, rather, flows in a straight line without deviation or interruption," a definition recited in *Cruise Connections*.⁵¹ Some courts in other circuits have recited this same definition in whole,⁵² while others do so while omitting "straight line without deviation."⁵³ *Zedan v. Kingdom of Saudi Arabia*⁵⁴ provides one example of an intervening act analysis.

dispositive to *Cruise Connections*, and is beyond the scope of this note.

Although the holding in *Voest-Alpine*, described earlier, was rather sweeping in adopting a bare-minimum immediacy test, the D.C. Circuit probably would have arrived at the same result given the particular facts in *Voest-Alpine* because of the D.C. Circuit's recognition of customary agreements. The *Voest-Alpine* court found direct effect because the Chinese bank customarily sent payment to a payment location requested by the U.S. party, and the U.S. party requested the payment to be sent to be a bank in the United States. *Voest-Alpine Trading USA Corp. v. Bank of China*, 142 F.3d 887, 896 (5th Cir. 1998).

51 *Cruise Connections Charter Mgmt. 1, LP v. Attorney Gen. of Can.*, 600 F.3d 661, 664 (D.C. Cir. 2010) (quoting *Princz v. Federal Republic of Germany*, 26 F.3d 1166, 1172 (D.C. Cir. 1994)).

52 *Guirlando v. T.C. Ziraat Bankasi A.S.*, 602 F.3d 69, 74 (2d Cir. 2010) (citing *Martin v. Republic of South Africa*, 836 F.2d 91, 95 (2d Cir. 1987) which recited this same definition).

53 *Morris v. People's Republic of China*, 478 F. Supp. 2d 561, 568 (S.D.N.Y. 2007) (noting that "A line of cases interpreting "direct effect" in the context of tort liability has found that an intervening act, or an extended causal chain, can keep an effect from being characterized as direct," citing *Virtual Countries, Inc. v. Republic of South Africa*, 300 F.3d 230, 237 (2d Cir. 2002); *Lyon v. Agusta S.P.A.*, 252 F.3d 1078, 1084, n. 3 (9th Cir. 2001) (using an intervening act analysis for a tort case, but not expressly adopting the "flows in a straight line" definition)); see also *United World Trade, Inc. v. Mangyshlakneft Oil Prod. Ass'n*, 33 F.3d 1232, 1238 (10th Cir. 1994) ("We agree with the district court that UWT's efforts to provide a guarantee to ISAB were dependent on an intervening factor").

54 849 F.2d 1511 (D.C. Cir. 1988).

In *Zedan*, a U.S. citizen entered into a contract with Saudi Arabia whereby he would perform construction services in Saudi Arabia.⁵⁵ Saudi Arabia breached the contract, but because the plaintiff was in Saudi Arabia at the time, an intervening act—the plaintiff's return to the United States—stood between the breach and a “direct effect in the United States.”⁵⁶

Thus, the question is not whether the intermediate step was foreseeable (as it was arguably quite foreseeable that the plaintiff would eventually return to the U.S.), but whether there was an intervening act at all. In *Upton v. Empire of Iran*,⁵⁷ the roof of an Iranian airport collapsed, causing injury to American citizens.⁵⁸ The survivors charged that Iran's acts “caused the deaths and injuries to Americans *which caused* direct effects in the United States” (emphasis added).⁵⁹ However, the court found no direct effect, stating that the very way the events are phrased “attenuates the connection between the act and the effect.”⁶⁰

Causation in direct effect analysis differs from the concept of proximate cause. In proximate causation, a reasonably foreseeable intervening act does not break the chain of causation.⁶¹ In contrast, foreseeable is not a requirement or a part of the formal analysis after *Waltover*. Cases like *Zedan* suggest that even a very foreseeable intervening cause would still violate the “no intervening element” definition of “direct effect.” After all, the definition of “direct effect” is “no intervening element,” not “no *unforeseen* intervening element.” The district court in *Cruise Connections* implied that foreseeability has no role in direct effect analysis, stating that the plaintiff's arguments in favor of finding direct effect were flawed because “there was an intervening element between the defendants' actions and [plaintiff's] losses, not that those losses were

55 *Id.* at 1512.

56 *Id.*

57 459 F. Supp. 264 (D.D.C. 1978), *aff'd mem.*, 607 F.2d 494 (D.C. Cir. 1979).

58 *Id.* at 265.

59 *Id.* at 266.

60 *Id.*

61 *See, e.g., Cleveland v. Piper Aircraft Corp.*, 890 F.2d 1540, 1555 (10th Cir. 1989) (“If an intervening act or cause is one which is reasonably foreseeable, the intervening act does not break the chain of causation”).

unforeseeable to the defendant.”⁶² On reversal, the D.C. Circuit did not explicitly apply the concept of foreseeability to the facts, but its analysis of intervening acts suggests that foreseeability might have played some role in qualifying what constitutes an intervening act. The issue of foreseeability is explored in depth in Part III.E.

II. Statement of the Case

In most “direct effect” cases, the presence or absence of a designated payment location is decisive.⁶³ Unlike these typical cases, *Cruise Connections* was decided on how the foreign sovereign’s actions affected the plaintiff’s third-party contracts.⁶⁴

A. The Facts

The adverse parties were Cruise Connections Charter Management 1 (“Cruise Connections”), a U.S. corporation, and the Royal Canadian Mounted Police (RCMP), a Canadian national police service.⁶⁵ In July of 2008, the two parties contracted for Cruise Connections to provide cruise ships to house RCMP personnel on ships berthed in Vancouver Harbor so that RCMP could coordinate security for the 2010 Winter Olympics.⁶⁶ The contract price was approximately \$54 million (CAD).⁶⁷ Cruise Connections had no ships of its own, so it was required to negotiate subcontracts, called

62 *Cruise Connections Charter Mgmt. 1, LP v. Attorney Gen. of Can.*, 634 F. Supp. 2d 86, 90 (D.D.C. 2010), *rev'd*, 600 F.3d 661 (D.C. Cir. 2010).

63 *Global Index, Inc. v. Mkapa*, 290 F. Supp. 2d 108, 113 (D.D.C. 2003) (“As a factual matter, however, in almost every case, in this circuit and others, involving the direct effect exception, the existence or absence of an expressly designated place of payment has been decisive.”).

64 *Cruise Connections Charter Mgmt. 1, LP v. Attorney Gen. of Can.*, 600 F.3d 661, 665 (D.C. Cir. 2010) (“In both instances, then, RCMP’s termination of the Cruise Connections contract led inexorably to the loss of revenues under the third-party agreements. This is sufficient.”).

65 Complaint at 3, *Cruise Connections Charter Mgmt. 1, LP v. Attorney Gen. of Can.*, 634 F. Supp. 2d 86 (D.D.C. 2010) (No. 08-2054).

66 *Cruise Connections Charter Mgmt. 1, LP v. Attorney Gen. of Can.*, 634 F. Supp. 2d 86, 87 (D.D.C. 2010), *rev'd*, 600 F.3d 661 (D.C. Cir. 2010).

67 *Id.* The contract price was initially set at approximately \$54 million (CAD) when the parties reached agreement in July, but was increased to approximately \$55 million (CAD) in August. Complaint, *supra* note 65, at 4.

charter party agreements, with two American cruise lines: Royal Caribbean International and Holland America Line.⁶⁸ Under the charter party agreements, the two cruise lines would supply three ships for approximately \$39 million (USD). The agreements also provided that Cruise Connections would guarantee the cruise lines a certain amount of onboard sales revenue, but if the sales revenue exceeded that amount, the excess proceeds, estimated at \$4.5 million (USD), would go to Cruise Connections.⁶⁹

As requested by the cruise lines, Cruise Connections asked RCMP to assure that RCMP would pay Canadian taxes incurred by the cruise lines.⁷⁰ RCMP initially complied, but just before the cruise lines were set to sign the charter party agreements with Cruise Connections, RCMP reversed its tax commitments and additionally required a 90% letter of credit.⁷¹ As a result, Cruise Connections was unable to secure financing to obtain the ships.⁷² RCMP then terminated the contract, citing Cruise Connections' failure to secure financing in a timely manner.⁷³ Before RCMP terminated the contract, Cruise Connections had also agreed to lease one of the ships to a U.S. travel agency for \$1.25 million (USD) during the ship's transit from San Diego to Vancouver.⁷⁴ The transactions thus consist of three components summarized as follows:

68 Cruise Connections Charter Mgmt. 1, LP v. Attorney Gen. of Can., 600 F.3d 661, 662 (D.C. Cir. 2010). ("The contract required Cruise Connections to subcontract with two U.S.-based cruise lines"). The contract also stated that "The contractor [Cruise Connections] shall provide 5037 berths, utilizing 4092 berths on two Carnival Cruise Line ships [later changed to Royal Caribbean] and 1248 berths on one "S" Class Holland America Cruise Line ship." Exhibit 5 at 3, Cruise Connections Charter Mgmt. 1, LP v. Attorney Gen. of Can., 634 F. Supp. 2d 86 (D.D.C. 2010) (No. 08-2054).

69 *Id.* at 663-64.

70 Cruise Connections Charter Mgmt. 1, LP v. Attorney Gen. of Can., 600 F.3d 661, 663-64 (D.C. Cir. 2010).

71 *Id.*

72 *Cruise Connections*, 634 F. Supp. 2d 86, 87 (D.D.C. 2010); *see also* Complaint, *supra* note 65, at 6.

73 Cruise Connections Charter Mgmt. 1, LP v. Attorney Gen. of Can., 600 F.3d 661, 663 (D.C. Cir. 2010).

74 *Id.* at 663-64.

1. The main contract between Cruise Connections and RCMP, allegedly breached by the latter, whereby RCMP would pay Cruise Connections approximately \$54 million (CAD);
2. The charter party agreements, thwarted by the cancellation of the main contract, whereby: (2a) Cruise Connections would pay \$39 million (USD) to the cruise lines for three ships, and (2b) earn an estimated \$4.5 million (USD) from onboard sales revenue;
3. The travel agency agreements, whereby Cruise Connections would receive \$1.25 million (USD) to lease a ship in transit to Vancouver, also thwarted by RCMP's termination of the main contract.

During litigation, RCMP claimed that the main contract entailed no performance taking place in the U.S.⁷⁵ Eventually, the D.C. Circuit found direct effect based on the charter party and travel agency agreements, even though they were third party in nature.

Cruise Connections filed suit in the United States District Court for the District of Columbia alleging breach of contract by RCMP, represented in name by the Attorney General of Canada.⁷⁶ RCMP moved to dismiss for the lack of subject matter jurisdiction, arguing that the alleged breach did not cause a "direct effect in the United States."⁷⁷ Since RCMP conceded that the action was based upon an alleged breach of contract in connection with Canadian commercial activity,⁷⁸ jurisdiction thus hinged on the "direct effect" element of § 1605(a)(2).

⁷⁵ *Id.* at 665 (citing Brief of Appellees at 23, *Cruise Connections Charter Mgmt. 1, LP v. Attorney Gen. of Can.*, 600 F.3d 661, 665 (D.C. Cir. 2010) (No. 08-2054)). This point was also advanced at the district court. Memorandum of Points and Authorities in Support of Defendants' Motion to Dismiss at 25, *Cruise Connections Charter Mgmt. 1, LP v. Attorney Gen. of Can.*, 634 F. Supp. 2d 86 (D.D.C. 2010) (No. 08-2054) ("Plaintiffs have not alleged a single aspect of the underlying transaction that was to take place in the United States").

⁷⁶ *Cruise Connections Charter Mgmt. 1, LP v. Attorney Gen. of Can.*, 600 F.3d 661, 663 (D.C. Cir. 2010).

⁷⁷ *Id.* at 663.

⁷⁸ *Cruise Connections Charter Mgmt. 1, LP v. Attorney Gen. of Can.*, 634 F. Supp. 2d 86, 88 (D.D.C. 2010), *rev'd*, 600 F.3d 661 (D.C. Cir. 2010).

B. The District Court's Finding of No Direct Effect

The district court first examined the loss of payment by RCMP due to its alleged breach of the main contract. Based on *Weltover* and D.C. Circuit precedent, the district court observed that to find direct effect, the parties must have agreed expressly (such as by a contractual provision) or implicitly (by longstanding custom between the parties) that payment would occur in the United States.⁷⁹ Although Cruise Connections alleged that RCMP agreed to make payment in the U.S., the district court disagreed and found no such agreement, express or implied.⁸⁰

Next, the district court found no direct effect in Cruise Connections' inability to perform the travel agency contract and its inability to secure the cruise line charter party agreements.⁸¹ The district court recited the "straight line" definition, quoting *Princz v. Federal Republic of Germany*,⁸² wherein the D.C. Circuit wrote, "A direct effect . . . has no intervening element, but, rather, flows in a straight line without deviation or interruption."⁸³ The district court reasoned that because the travel agency and cruise line charter party agreements were not part of the main contract, Cruise Connections' inability to perform contractual obligations to the travel agency and cruise lines constituted an "intervening element" between RCMP's actions and Cruise Connections' financial loss.⁸⁴

⁷⁹ *Id.* at 88-89. The district court observed that under *Republic of Argentina v. Weltover, Inc.*, 504 U.S. 607 (1992), and subsequent D.C. Circuit cases, a direct effect requires one of four situations occur before the breach, a list implied by the court to be exhaustive at least for payments scenarios: (1) the contract expressly designated an American payment location; (2) the contract allowed the payee to designate a payment location and the payee designates an American location (citing *Republic of Argentina v. Weltover, Inc.*, 504 U.S. 607 (1992)); (3) the contract is silent on payment location, but both parties subsequently agree to an American location (citing *I.T. Consultants, Inc. v. The Islamic Republic of Pakistan*, 351 F.3d 1184 (D.C. Cir. 2003); and (4) the contract is silent on payment location, the parties had a longstanding and consistent customary practice to use an American payment location (citing *Goodman Holdings v. Rafidain Bank*, 26 F.3d 1143 (D.C. Cir. 1994)).

⁸⁰ *Cruise Connections Charter Mgmt. 1, LP v. Attorney Gen. of Can.*, 634 F. Supp. 2d 86, 89-90 (D.D.C. 2010), *rev'd*, 600 F.3d 661 (D.C. Cir. 2010).

⁸¹ *Id.* at 90.

⁸² 26 F.3d 1166 (D.C. Cir. 1994).

⁸³ *Cruise Connections*, 634 F. Supp. 2d at 90 (quoting *Princz*, 26 F.3d at 1172).

⁸⁴ *Id.*

C. Reversal by the D.C. Circuit

In a unanimous panel decision by Judge Tatel, the D.C. Circuit reversed, finding direct effect because RCMP's termination led to loss of revenues under the third-party agreements.⁸⁵ First, the court acknowledged the dispute regarding an alleged U.S. payment location (designated in Part II.A, *supra*, as "item 1"), but it surprisingly declined to decide the case on this issue. To the court, it made "no difference where RCMP would have paid Cruise Connections," as there were links to the U.S. other than mere payment by RCMP sufficient for direct effect.⁸⁶ Importantly, by taking its direct effect analysis outside of payment location analysis, the court expanded the category of "effects" that could constitute direct effect.

Next, the court examined Cruise Connections' loss of potential onboard revenue (item 2b), the subsidiary component of the charter party agreement.⁸⁷ The court cited the same *Princz* rule cited by the district court.⁸⁸ It then acknowledged that because onboard revenue would have depended on specific choices of security personnel to purchase drinks or gifts, there might be "merit" to an argument that such dependence created an "intervening event" between RCMP's alleged breach and onboard revenue, according to the court. But the court also declined to rule on whether the onboard revenue was sufficient for direct effect.⁸⁹

However, because "RCMP's termination of the Cruise Connections contract led inexorably to the loss of revenue under the third-party agreements" (in addition to the loss of potential on-board revenue), the

85 Cruise Connections Charter Mgmt. 1, LP v. Attorney Gen. of Can., 600 F.3d 661, 665 (D.C. Cir. 2010), *en banc reh'g denied*, 2010 U.S. App. LEXIS 16743 (D.C. Cir., June 21, 2010).

86 *Id.* at 663-65.

87 *Id.* The court analyzed the charter party agreement as two separate components: the onboard revenue, and the general charter party agreement. In contrast, the district court analyzed the charter party agreements as a whole, rather than separating out the issue of the onboard revenues. *See* Cruise Connections Charter Mgmt. 1, LP v. Attorney Gen. of Can., 634 F. Supp. 2d 89-90 (D.D.C. 2010).

88 Cruise Connections Charter Mgmt. 1, LP v. Attorney Gen. of Can., 600 F.3d 661, 663 (D.C. Cir. 2010).

89 *Id.*

court found direct effect.⁹⁰ The “loss of revenue” under *either* the travel agency contract (item 3) *or* the main component of charter party agreements (item 2a) was sufficient.⁹¹ The court’s reasoning is as follows.

First, it reasoned that “no intervening event stood between RCMP’s termination of the contract and the lost revenues from the travel agency contract and the charter party agreements.” The travel agency agreement was a “done deal,” with nothing left to negotiate, and Cruise Connections would have received a flat fee but for RCMP’s termination.⁹² Thus, to the court, the loss of the travel agency agreement followed as “an immediate consequence” of RCMP’s termination of the main contract.⁹³ Likewise, although the charter party agreements were not formally complete between Cruise Connections and the cruise lines, they would have been completed if not for RCMP’s termination of the main contract with Cruise Connections.⁹⁴

The court then addressed the effect itself, apparently finding that generalized economic effect in the U.S. was sufficient. It pointed out that *Weltover* found direct effect because money supposed to have been delivered to a U.S. bank “was not forthcoming.”⁹⁵ In a questionable analogy, the court then reasoned that because of RCMP’s cancellation, “revenues that would otherwise have been generated in the United States were not forthcoming.”⁹⁶ The court then rejected RCMP’s contention that there can be no effect because Cruise Connections was not harmed by the termination.⁹⁷ It reasoned that only a “direct effect” is necessary, and

90 *Id.* at 664.

91 *See Id.* at 665. The sufficiency of either is suggested by the court’s use of the terms “likewise” and “in both instances” in comparing the charter party agreements and the travel agency agreements (“Likewise, all that remained for the Charter Party Agreements to be formally consummated” and “In both instances, then, RCMP’s termination of the Cruise Connections contract led inexorably to the loss of revenues under the third-party agreements. This is sufficient.”) (internal quotations and brackets omitted).

92 *Id.* at 644.

93 *Id.* at 664-65.

94 *Id.*

95 *Id.* at 665 (citing *Republic of Argentina v. Weltover, Inc.*, 504 U.S. 607, 619 (1992)).

96 *Id.*

97 *Id.*

“nothing in the FSIA requires that the direct effect in the United States harm the plaintiff.” Here, the thwarting of “revenues that would otherwise have been generated in the United States,” was sufficient to find direct effect.⁹⁸ “Revenue” here refers to revenue under the third-party agreements, not the loss of RCMP’s payment to the plaintiff Cruise Connections.

Finally, the court cited additional ties to the United States to justify its decision. Although acknowledging that mere harm to a U.S. party is insufficient for direct effect, it found more than mere citizenship: Cruise Connections’ efforts in negotiating the charter party agreements occurred in the United States; at least one of the ships would have moved through U.S. waters to Vancouver; RCMP’s contract termination “thwarted over \$40 million (U.S.) worth of cruise-related business in the United States”; and “the travel agency agreement was negotiated in and called for performance in the United States.”⁹⁹ To the court, these factors distinguished the situations from cases like *United World Trade* where all the work covered by the contract, including the plaintiff’s obligations, was to be done outside the United States.¹⁰⁰

RCMP also argued that it made no agreements effectuating the third party travel agency and charter party agreements, as its contract with Cruise Connections did not even contain provisions of performance outside of Canada. The court responded by stating that the effect only needs to be “direct, [and] not that the foreign sovereign agree that the effect would occur.”¹⁰¹ In responding to the argument that RCMP could not foresee the effects in the United States, the court also recited *Weltover*’s rejection of a foreseeability criterion.¹⁰² Thus, RCMP’s rebuttals were rejected.

III. Analysis of the D.C. Circuit’s Reasoning

In finding direct effect from the “loss of revenue under third-party agreements,” a ruling in tension with established case law, the court attempted to nominally adhere to established rules, but overruled or at least modified them implicitly, while setting forth few clear rules. As a result,

⁹⁸ *Id.* at 666 (internal quotations omitted).

⁹⁹ *Id.*

¹⁰⁰ *Id.*

¹⁰¹ *Id.*

¹⁰² *Id.*

Cruise Connections is best characterized not as a straightforward opinion but as a conglomerate of thoughts that lack consistency when closely scrutinized.

This part of the note first provides a useful frame of reference to examine the case by discussing the significance of the third parties. The analysis then proceeds to explain the flaws in the court's analysis of the two main facets of direct effect jurisprudence: (1) the contractual obligations of the foreign sovereign, based on the factual circumstances of *Weltover*; and (2) the "immediate consequence" test, the legal standard established by *Weltover*. The analysis then examines the remaining parts of the court's rationale.

A. The Significance of Third Parties in *Cruise Connections*

Because the finding of direct effect centered on the "loss of revenue under the third-party agreements,"¹⁰³ this analysis should begin by examining the legal consequence of the third parties. Two questions are particularly relevant: What if there were only two parties involved such that there could be no third party agreements? In this case, would the court still have found direct effect? For the reasons below, the answer appears to be no, at least not under the same reasoning. This observation, that direct effect was found *only* because of third party agreements, leads to a strange conclusion that the foreign sovereignty's immunity is compromised because it happened to be dealing with a U.S. entity that was in turn dealing with additional U.S. third parties.

Assume that *Cruise Connections* and the third parties were a single entity that entirely operated its own cruise ships, instead of having to subcontract for ships, and one that could sell its own cruise tickets for a transit trip from San Diego to Vancouver as the travel agency did.¹⁰⁴ Here, the scenario in *Cruise Connections* is reduced to a simple payment transaction and, as the district court recognized, D.C. Circuit case law required agreement of an American payment location for there to be direct effect.¹⁰⁵ The district court found no express or implied agreement between

103 *Id.*

104 In the actual case, *Cruise Connections* was to obtain ships from subcontracts (charter party agreements) with third party cruise lines, and had leased one of those ships to a third party travel agency during its transit from San Diego to Vancouver. *Cruise Connections*, 600 F.3d 661, 663-64 (D.C. Cir. 2010).

105 *Cruise Connections Charter Mgmt. 1, LP v. Attorney Gen. of Can.*, 634 F. Supp. 2d

Cruise Connections and RCMP for an American payment location, and this finding was not ruled on during appeal.¹⁰⁶ Assuming that the district court was correct, then there would have been no direct effect if Cruise Connections and the third parties were a single entity. This hypothetical scenario illustrates that RCMP lost immunity only because it was dealing with a group of entities connected by subcontracts rather than a single entity.

This leads to another question. What difference does it make between dealing with a single party and a middleman party that then subcontracts its obligations? The D.C. Circuit's opinion offers some starting points. Notably, RCMP alleged that the only connection between the plaintiff and the U.S. was citizenship.¹⁰⁷ (This argument is relevant to our single-entity hypothetical, wherein citizenship would probably be the only connection with the U.S.) In response to RCMP's argument, the court said that more than citizenship was involved: negotiation of the third party agreements occurred in the United States, one of the third party agreements was to be performed in the United States, the ships would have sailed through U.S. waters, and the thwarting of \$40 million (USD) of cruise-related business in the United States occurred.¹⁰⁸ These factors relate to dealings between Cruise Connections and the third parties. For example, the \$40 million figure is the amount that Cruise Connections would have paid the cruise lines. In our single-entity hypothetical, these factors concerning third party dealing would become irrelevant, as they become internal transactions within the single entity, and thus would not lend additional support to finding direct effect. Similarly, the "loss of revenue under the third-party agreements," considered sufficient to find direct effect in the actual case, would also be irrelevant as there are no third parties.

86, 88-89 (D.D.C. 2010), *rev'd*, 600 F.3d 661 (D.C. Cir. 2010); *See supra* note 79 (the district court's list of four situations required to find direct effect).

106 Cruise Connections Charter Mgmt. 1, LP v. Attorney Gen. of Can., 600 F.3d 661,663-65 (D.C. Cir. 2010) (acknowledging the finding by the district court, but declining to review, as it "made no difference where RCMP would have paid Cruise Connections); Cruise Connections Charter Mgmt. 1, LP v. Attorney Gen. of Can., 634 F. Supp. 2d 86, 89-90 (D.D.C. 2010), *rev'd*, 600 F.3d 661 (D.C. Cir. 2010).

107 Cruise Connections Charter Mgmt. 1, LP v. Attorney Gen. of Can., 600 F.3d 661, 665 (D.C. Cir. 2010).

108 *Id.* at 665 (D.C. Cir. 2010).

Thus, if Cruise Connections and the third parties had been a single entity, the court probably would not have found direct effect. This observation is underpinned by the court's statement that "[n]othing in the FSIA requires that the 'direct effect in the United States' harm the plaintiff."¹⁰⁹ This statement essentially endorses the finding of sufficient direct effect through third-party relationships. The sufficiency of third-party effects puts the result of the case in a strange light because RCMP's primary goal was obtaining ships, not dealing with a middleman that would compromise its sovereign immunity. But because RCMP did deal with a middleman rather than a cruise line that had ships of its own, it lost immunity in U.S. courts.

B. The Court's Standard of Revenue Generation "Not Forthcoming" is Based on an Unwarranted Analogy With *Weltover*

Having underlined the significance of the third parties in the case, this note examines the court's legal analysis. Here, the court questionably analogized *Weltover* to support a proposition that the thwarting of revenue generation in the United States is a "direct effect." It observed that, in *Weltover*, "money supposed to have been delivered to a New York bank for deposit was not forthcoming."¹¹⁰ It then reasoned that similarly, because RCMP terminated the contract, "revenues that would otherwise have been generated in the United States were not forthcoming."¹¹¹

As an initial matter, it is important to emphasize that "revenues" refer to payments among Cruise Connections and the third parties."¹¹² That is, part of RCMP's payment to Cruise Connection under the main contract would have then been passed onto the cruise lines, thereby generating "revenue" for the cruise lines. Cruise Connections would also obtain "revenue" from the travel agency agreement by using the ships leased from the cruise lines.

Turning to the analogy, several flaws are apparent. First, the court improperly compares payment with generation of revenue. In *Weltover*, the

¹⁰⁹ *Id.* at 666.

¹¹⁰ *Id.* (citing *Republic of Argentina v. Weltover, Inc.*, 504 U.S. 607, 619 (1992)).

¹¹¹ *Id.*

¹¹² The overall context here is "loss of *revenues* under third party agreements." *Id.* (emphasis added).

defendant was contractually obligated to make payment in a U.S. bank.¹¹³ Such payment can be described as a cash flow into the United States. If, *arguendo*, there are only two parties to a transaction, a cash flow necessarily results in revenue to one party. However, the revenue described here is not between the party sending and the party receiving payment, but is among the receiving party and third parties. Thus, “revenues that would otherwise have been generated in the United States” do not describe a cash flow from the foreign sovereign to the private party. Instead, they describe a local economic activity within the United States unrelated (or perhaps, not “directly” related) to the foreign sovereign.

Second, the analogy effectively deprives the scope of contractual obligation of legal consequence. In *Weltover*, the payment was part of the defendant’s obligation. In contrast, the described revenue generation in *Cruise Connections* contains no such obligations. RCMP may have had an obligation to pay Cruise Connections, but it had no obligations to any of the third parties.¹¹⁴ Like the circuits that have placed weight on *Weltover*’s emphasis on contractual obligation apparent from its facts (i.e., those expressly endorsing the legally significant act test),¹¹⁵ the D.C. Circuit has traditionally adhered to these same principles.¹¹⁶ As some circuits have done,¹¹⁷ the D.C. Circuit could have expressly abandoned this stance in favor of a broad reading of *Weltover*, where the facts regarding contractual obligation are ignored and only a bare “immediate” direct effect, in an unrestricted, abstract sense is required. However, the D.C. Circuit tried to remain faithful to its narrow, factual reading of *Weltover*, even though only a broad reading of *Weltover* could have reasonably supported its holding.

113 *Republic of Argentina v. Weltover, Inc.*, 504 U.S. 607, 617 (1992).

114 The D.C. Circuit’s opinion states that “the contract itself required the ships to come from Holland America and Royal Caribbean cruise lines,” *Cruise Connections*, 600 F.3d 661, 665 (D.C. Cir. 2010), and in its Brief, Cruise Connections emphasized that negotiating the charter party agreements was a “a substantial portion of Cruise Connections’ performance of the contract up to the point that the RCMP breached.” Plaintiffs’ Memorandum of Points and Authorities in Response to Defendants’ Motion to Dismiss at 5, *Cruise Connections Charter Mgmt. 1, LP v. Attorney Gen. of Can.*, 634 F. Supp. 2d 86 (D.D.C. 2010) (No. 08-2054). However, none of these statements refer to are obligations to be performed by RCMP.

115 *NANDA & PANSIUS*, *supra* note 5, § 3:12; *See supra* Part I.C.

116 *See supra* Part I.C.

117 *See, e.g.*, *Orient Mineral Co. v. Bank of China*, 506 F.3d 980, 998 (10th Cir. 2007); *Voest-Alpine Trading USA Corp. v. Bank of China*, 142 F.3d 887 (5th Cir. 1998).

The facts of the case cannot reasonably be compared to *Weltover* because the third party “revenues” were not payments from RCMP and were outside of RCMP’s contractual obligations.

Therefore, the holding of the case is built on flawed reasoning. Because the court endorses a factual comparison with *Weltover*, and yet performs a flawed and implausible comparison, the case only muddles the already confusing area of direct effect jurisprudence. A possible consequence of the court’s reasoning is that if direct effect in the D.C. Circuit still revolves around whether “payment was ‘supposed’ to have been made in the United States,”¹¹⁸ the “payment” need not be payment from the foreign sovereign and what qualifies as something “supposed to be made” is not limited to the foreign sovereign’s obligations from express or implied agreement.¹¹⁹ Due to the court’s focus on terms like “forthcoming” while generalizing the concept of “payment” to include general economic revenue, *Cruise Connections* may be read to stand for the proposition that a disappointed expectation of economic gain can qualify as an “effect” in the context of “direct effect.”

C. The D.C. Circuit Improperly Found that the Losses Under the Third-party Agreements were “Immediate Consequences” of RCMP’s Actions

Cruise Connections turned out to be a logically inconsistent opinion because the court unreasonably analogized the facts with *Weltover*’s facts. But the court did not have to even discuss *Weltover*’s facts in the first place. As mentioned earlier, some circuits broadly read *Weltover* as to merely require an immediate direct effect and nothing else regarding contractual obligations.¹²⁰ The D.C. Circuit could have expressly adopted such a stance and directly proceeded to the bare minimum immediacy analysis without analogizing *Weltover*’s facts at all. Regardless, its “immediacy” analysis was similarly flawed.

118 *Global Index, Inc. v. Mka*, 290 F. Supp. 2d 108, 113 (D.D.C. 2003); *See also* *Goodman Holdings v. Rafidain Bank*, 26 F.3d 1143 (D.C. Cir. 1994) (finding no direct effect “neither New York nor any other United States location was designated as the ‘place of performance’ where money was ‘supposed’ to have been paid” to the plaintiffs”).

119 *See supra* note 79 (the district court’s list of four situations required to find direct effect).

120 *See supra* Part I.C.

As mentioned, the rule in the D.C. Circuit, consistent with the meaning of “immediate,” is that a “direct effect . . . has no intervening element, but, rather, flows in a straight line without deviation or interruption.”¹²¹ To the district court, Cruise Connection’s inability to perform those obligations stood as an “intervening element” between RCMP’s conduct and the third party losses because the cruise line and travel agency agreements were not part of RCMP’s contract with Cruise Connections.¹²² In reversing, the D.C. Circuit instead focused on the “done deal” aspect of those agreements to find no intervening element.¹²³ Since either of the charter party agreements or the travel agency agreement was alone sufficient for direct effect,¹²⁴ each will be discussed in turn.

1. The Travel Agency Agreement

It is hard to justify the court’s finding that Cruise Connections’ loss from the travel agency agreement followed immediately from RCMP’s termination of the main contract. Even though the agreement was a “done deal” in the sense that Cruise Connections was set to receive the payment, it still could have received the payment even if RCMP terminated the contract. The lack of an immediate effect is illustrated by the multiple-steps from RCMP’s termination to Cruise Connections’ loss: (1) RCMP terminates the main contract; (2) Cruise Connections is unable to fulfill its intended agreement with the cruise lines; (3) the cruise lines withdraw from their nearly-complete agreement with Cruise Connections; (4) Cruise Connections is unable to supply the cruise ships to perform the travel agency agreement; and (5) Cruise Connections is unable to obtain the payment from the travel agency. Here, steps 2, 3, and 4 are intervening factors, i.e., factors standing in between steps 1 and 5. When there are intervening factors, the loss should not be deemed to follow as an immediate consequence.

121 Cruise Connections Charter Mgmt. 1, LP v. Attorney Gen. of Can., 600 F.3d 661, 664 (D.C. Cir. 2010) (quoting *Princz v. Federal Republic of Germany*, 26 F.3d 1166, 1172 (D.C. Cir. 1994)).

122 Cruise Connections Charter Mgmt. 1, LP v. Attorney Gen. of Can., 634 F. Supp. 2d 86, 90 (D.D.C. 2010), *rev’d*, 600 F.3d 661 (D.C. Cir. 2010).

123 Cruise Connections Charter Mgmt. 1, LP v. Attorney Gen. of Can., 600 F.3d 661, 66-65 (D.C. Cir. 2010).

124 *See supra* note 91.

Furthermore, the loss did not flow in a “straight line without deviation or interruption” from step 1 to step 5 because the events could have unfolded differently. For example, Cruise Connections could potentially have found a substitute deal with the cruise lines. Furthermore, even without a substitute deal, the cruise lines might not have actually pulled out, given that their decision to do so was based on their own independent assessment of the situation. More importantly, Cruise Connections could have found another way to supply a ship before performance was due.¹²⁵ The D.C. Circuit’s “done deal” argument only shows that Cruise Connections would have made revenue if RCMP *had not* breached. It does not necessarily mean that Cruise Connections would have lost revenue if RCMP *had* breached. Although this distinction might not be meaningful if causation is determined by foreseeability, it is significant in the context of intervening factor analysis in determining immediacy. Here, whether the travel agency agreement would have been fulfilled depended on Cruise Connections’ ability to perform, which stands as an intervening factor dependent on factors other than RCMP’s breach.

When faced with circumstances involving third-party agreements, including “done deal” agreements, federal courts have not been favorable to third-party losses in finding direct effect. In *Millicom International Cellular, S.A. v. Republic of Costa Rica*,¹²⁶ the defendants’ conduct allegedly caused the plaintiffs to default on a third party investment agreement.¹²⁷ Regarding losses under the third-party agreement, the D.C. District Court held that “any consequences of the defendants’ conduct affected only the plaintiffs’ obligations to third parties and therefore cannot . . . cause a ‘direct effect’ in the United States.”¹²⁸

Similarly, in *Corzo v. Banco Central de Reserva del Peru*,¹²⁹ the defendant’s conduct allegedly caused the plaintiff to breach contracts with

125 RCMP solicited bids in April 2008, and allegedly breached in September of that year, still well before the Olympics. Complaint, *supra* note 65, at 4-7.

126 *Millicom Int’l Cellular, S.A. v. Republic of Costa Rica*, 995 F. Supp. 14 (D.D.C. 1998).

127 *Id.* at 17.

128 *Id.* at 22. Likewise, repercussion felt by their shareholders and creditors also failed to establish direct effects because they were “derivative harm . . . too indirect to qualify as an ‘immediate consequence’ of the defendants’ conduct.”

129 *Corzo v. Banco Cent. De Reserva Del Peru*, 243 F.3d 519 (9th Cir. 2001).

computer companies in the United States.¹³⁰ However, the Ninth Circuit held that the losses from third party contracts did not follow as immediate consequences, but were rather, “at best secondary or incidental results” of the defendant’s actions.¹³¹ These cases illustrate a general principle that a resulting failure to fulfill third-party obligations, as in Cruise Connections’ inability to fulfill the travel agency agreement, is insufficient to constitute direct effect.

2. The Charter Party Agreements

It is similarly difficult to justify the court’s reasoning that the loss of the charter party agreements followed immediately from RCMP’s termination of the main contract. Here, we have a potential series of events as follows: (1) RCMP terminates the main contract; (2) Cruise Connections is unable to fulfill its intended agreement with the cruise lines; (3) the cruise lines withdraw from their nearly-complete agreement with Cruise Connections, thereby resulting in (4) the “loss of revenues.”¹³² The same analysis used for the travel agency agreement applies. Here, the chain involves the intervening step of Cruise Connections’ ability to fulfill a third-party obligation, and the intervening step of the cruise lines’ withdrawal from contract negotiations. Because of the intervening steps, the loss did not occur immediately.

Two additional factors support the lack of immediacy in the loss that effectively weakens the link from event 3 (withdrawal from the nearly-complete agreement) to event 4 (the “loss of revenues”). First, unlike the “done deal” travel agency agreement, the cruise lines never actually completed their contract with Cruise Connections.¹³³ Because there were no actual obligations, it is unreasonable to state that the cruise lines lost something when they did not have the revenue secured in the first place. The situation is perhaps better described as a loss of opportunity for revenue, rather than a direct loss of revenue. In a chain of events, actual loss of revenue is at least one step removed from a loss of opportunity for revenue.

¹³⁰ *Id.* at 522.

¹³¹ *Id.*

¹³² *Cruise Connections Charter Mgmt. 1, LP v. Attorney Gen. of Can.*, 600 F.3d 661, 665 (D.C. Cir. 2010).

¹³³ *Id.* at 663.

Secondly, the particular loss of potential revenue recognized by the court was suffered not by Cruise Connections but by the cruise lines, who would have received \$39 million (USD) from Cruise Connections for the lease of the ships.¹³⁴ RCMP was contracting only with Cruise Connections, not with the cruise lines. Tying RCMP's dealings with the cruise lines' losses requires a leap from one course of dealing to another course of dealing, as well as two leaps among parties—from defendant to plaintiff and from plaintiff to third party.

For all of the above reasons indicating intervening events before the losses in revenue, the court's finding of direct effect is therefore questionable.

D. Traveling Through U.S. Waters and the Place of Negotiations

A central principle among some circuits is that mere harm to a U.S. citizen is insufficient to find direct effect.¹³⁵ The D.C. Circuit acknowledged the validity of this principle¹³⁶ but then went on to list multiple factors showing that “Cruise Connections relies far more than its U.S. citizenship” because the contract encompassed work to be done in the United States: (1) Cruise Connections negotiated the charter party agreements in the United States; (2) “at least one of the ships would have moved through U.S. waters to Vancouver”; (3) “the termination of the contract thwarted over \$ 40 million (U.S.) worth of cruise-related business in the United States”; and (4) “the travel agency agreement was negotiated in and called for performance in the United States.”¹³⁷ The third factor (economic harm) and the performance portion of the fourth factor are probably the most important and the merits of which have already been discussed in detail. This leaves us with the factors of the ship's travelling through U.S. waters (factor 2) and negotiation of the third party agreements in the U.S (factor 1 and part of factor 3).

134 *Id.*

135 *See, e.g.,* Guirlando v. T.C. Ziraat Bankasi A.S., 602 F.3d 69, 78 (2d Cir. 2010) (“The mere fact that a foreign state's commercial activity outside of the United States caused physical or financial injury to a United States citizen is not itself sufficient to constitute a direct effect in the United States”).

136 *Cruise Connections*, 600 F.3d at 665 (“RCMP next argues that harm to a U.S. citizen, in and of itself, cannot satisfy the direct effect requirement. True enough . . .”).

137 *Id.*

Although these factors show that the contract implicated obligations (on the part of the Cruise Connections¹³⁸) that resulted in performance in the U.S., the court does not articulate their relevance to direct effect analysis. Indeed, there are problems with using these factors in direct effect analysis. It is unclear how the place of negotiation of the third party agreement is relevant, because it is not an effect resulting from any action of RCMP, but a precursor event. The factor of the ship's moving through U.S. waters is also unsatisfactory. In *Zedan v. Kingdom of Saudi Arabia*, a U.S. citizen was hired on the phone to perform road construction work for Saudi Arabia.¹³⁹ Therefore, the contract effectively required that he travel through U.S. territory to reach Saudi Arabia, but this traveling did not prevent the court from denying direct effect.¹⁴⁰ Although there's a factual difference between one person traveling by plane and an entire crew traveling on a boat, no clear legal distinction based on established rules is offered by the court.¹⁴¹

Nevertheless, the court distinguished *Zedan* on the basis that the work in *Zedan* was to be done "entirely" abroad.¹⁴² Although the court did not expressly state that Cruise Connection's contract with RCMP required work to be done in the U.S., the court implies that there is significance in how Cruise Connections was required to negotiate with the specific American cruise lines.¹⁴³ This resulted in negotiations actually occurring in

138 Cruise Connections emphasized that negotiating the charter party agreements was a "a substantial portion of Cruise Connections' performance of the contract up to the point that the RCMP breached." Plaintiffs' Memorandum of Points and Authorities in Response to Defendants' Motion to Dismiss at 5, *Cruise Connections Charter Mgmt. 1, LP v. Attorney Gen. of Can.*, 634 F. Supp. 2d 86 (D.D.C. 2010) (No. 08-2054).

139 *Zedan v. Kingdom of Saudi Arabia*, 849 F.2d 1511 (D.C. Cir. 1988).

140 *Id.*

141 Another flaw with the ship argument is that movement through U.S. water is due to the travel agency agreement, wherein the ship would move from San Diego to Vancouver. The D.C. Circuit's opinion noted that "the contract itself required the ships to come from Holland America and Royal Caribbean cruise lines," citing to Exhibit 6, *Cruise Connections Charter Mgmt. 1, LP v. Attorney Gen. of Can.*, 634 F. Supp. 2d 86 (D.D.C. 2010) (No. 08-2054), showing that the main contract identified and recognized the origin of the ships from the specific cruise lines. But if the travel agency agreement was not in place, the ships could have arrived from a foreign port without entering U.S. waters.

142 *Cruise Connections Charter Mgmt. 1, LP v. Attorney Gen. of Can.*, 600 F.3d 661, 665 (D.C. Cir. 2010).

143 *Id.* at 662 ("The contract required Cruise Connections to subcontract with two U.S.-based cruise lines").

the United States and the further involvement of American third parties. Yet, the court gives no express rule as to how to evaluate the plaintiff's fulfillment of its obligations, or even a clear statement that it's relevant. Confusingly, the court stated that the FSIA "requires only that [the] effect be 'direct,' not that the foreign sovereign agree that the effect would occur."¹⁴⁴ RCMP had argued that it never agreed to a "single aspect of the underlying transaction" to take place in the United States.¹⁴⁵ Perhaps the court is suggesting that as long as Cruise Connections did *something* in the United States to obtain the ships required by the contract, there would be direct effect even if the negotiations with the American cruise lines could have been held outside the U.S., and even if the ships could have sailed in from a foreign port without crossing U.S. waters.

If the court intended to make the plaintiff's performance in the United States (whether it was actually obligated by the contract or reasonably followed) a substantial factor in direct effect analysis, such a rule would also lack basis in established case law, which has focused on the foreign sovereign's obligations rather than the plaintiff's obligations. While some opinions have commented on the plaintiff's obligations generally, such opinions did not find them decisive.¹⁴⁶ The commercial activities exception, where it implicates direct effect analysis, deals with acts "in connection with a commercial activity of the foreign state."¹⁴⁷ Placing emphasis on plaintiff obligations entails the possibility of straying too far from the purpose of the statute. In the end, *Cruise Connections* offers no clear guidelines to analyze plaintiff obligations of a contract breached by the foreign state, if such obligations are relevant at all.

144 *Id.* at 665.

145 *See supra* note 75 and accompanying text.

146 *See, e.g.,* Am. Telecom Co., LLC v. Republic of Lebanon, 501 F.3d 534, 541 (6th Cir. 2007) (holding that its situation "where *both* parties' performance is to occur entirely in a foreign locale, does not, standing alone, produce an immediate consequence in the United States, and therefore, does not "cause a direct effect in the United States") (emphasis added); UNC Lear Servs., Inc. v. Kingdom of Saudi Arabia, 581 F.3d 210 (5th Cir. 2009) (holding that "[a]n effect of a contract is also direct when it is to be primarily performed in the United States" but the contract also specified a U.S. payment location, which the court acknowledged to be dispositive). Thus, in both of these cases, the plaintiff's obligations in the U.S. (or lack thereof) were not dispositive.

147 28 U.S.C. § 1605(2) (2010).

E. Did Foreseeability and Substantiality, Supported by Policy Considerations, Play a Role in the Decision?

Despite the numerous problems in the court's reasoning, the result itself is perhaps not unfair. After all, if the allegations are correct, RCMP did cause commercial disruption, even if the disruption was not properly immediate under the above analysis.¹⁴⁸ Furthermore, RCMP understood that it was dealing with a middleman and that the middleman (Cruise Connections) was dealing with American cruise lines. Cast in this light, it is not unreasonable to say that RCMP could have foreseen the consequences relating to the third party contracts. Was the court strained to find direct effect because the third party effects were foreseeable?

Some commentators have observed that even though *Weltover* rejected foreseeability as a required condition, certain opinions have used foreseeability as an implicit standard to finding direct effect (or lack thereof).¹⁴⁹ Regarding one Second Circuit case, *Antares Aircraft*,¹⁵⁰ which

148 And furthermore, foreign immunity is only a matter of jurisdiction, and even then, only one possible method of denying jurisdiction; nothing on the merits was decided in this case.

149 See NANDA & PANSIUS, *supra* note 5, § 3:12 (commenting that one could argue that the Supreme Court did not abandon foreseeability, as the facts in *Weltover* "probably satisfied a foreseeability test of direct effect"; and that in cases such as *Hanil Bank v. PT. Bank Negara Indonesia (Persero)*, 148 F.3d 127 (2d Cir. 1998), and *Antares Aircraft, L.P. v. Federal Republic of Nigeria*, 999 F.2d 33 (2d Cir. 1993) essentially employed a foreseeability standard).

Regarding Cruise Connections, Nanda and Pansius write that "Judge Tatel's opinion in Cruise Connections lends some support to a foreseeability analysis" and that in view of decisions such as this one, "foreseeability remains the easiest means to distinguish situations where a defendant knowingly invokes legally significant activity in the United States from those where the only real connection to the United States is that plaintiff is a U.S. person." *Id.*

The Second Circuit has recently stated that "To be a 'direct' effect within the meaning of the third clause of the commercial activity exception, the impact need not be either substantial or foreseeable." *Guirlando v. T.C. Ziraat Bankasi A.S.*, 602 F.3d 69, (2d Cir. 2010). The use of the terms "need not be" implies that foreseeability (and substantiality) may sometimes be a sufficient condition.

The Second Circuit has also propagated the rule that in *Weltover's* immediacy test, "the requisite immediacy" is lacking where the alleged effect "depend[s] crucially on variables independent of" the conduct of the foreign state." *Guirlando*, 602 F.3d at 75 (citing *Virtual Countries, Inc. v. Republic of South Africa*, 300 F.3d 230 (2d Cir. 2002), wherein the court denied direct effect for a suit alleging that South Africa's announcement of intentions to challenge the plaintiff's ownership "southafrica.com," impaired the

involved a tort injury to a particular individual, a commentator observed that it was fortuitous (i.e. unforeseeable) that the individual happened to be a U.S. citizen, and the court did not find direct effect.¹⁵¹ Contrast this with *Cruise Connections*, wherein RCMP knew its actions were affecting multiple American parties. Did the D.C. Circuit implicitly require intervening event analysis to be qualified such that only unforeseen intervening events are intervening, or that foreseeable events are not considered intervening? Note that the district court considered intervening events and foreseeability to be *unrelated* concepts in direct effect analysis: “Cruise Connections’ problem is that there was an intervening element between the defendants’ actions and its losses, not that those losses were unforeseeable to the defendant.”¹⁵²

The D.C. Circuit did not address the above statement made by the district court, and in the end provides no clear rules. The court only recites *Weltover*’s explicit rejection of foreseeability to support its statement that direct effect does not require that “the foreign sovereign agree that the effect would occur.”¹⁵³ If foreseeability is an appropriate standard, then what is it that must be foreseeable—the plaintiff’s harm, the third parties’ harm, or the substantiality of the harm? Regardless, no further discussion of foreseeability is provided, and no form of the word “foreseeability” or “foreseeable” appears anywhere else in the opinion. Thus, while the court appears to acknowledge that foreseeability is not a *required* condition, it declined to comment on whether foreseeability can be a *sufficient* condition. Thus, the role of foreseeability in direct effect jurisprudence remains enigmatic. However, one can also argue that the lack of discussion on foreseeability is not because the court does not consider foreseeability to be relevant, but that the court does not want to be *limited* by foreseeability.

plaintiff’s potential business alliance with a South African firm). Although not explicitly containing the term “foreseeability,” its flexible terms like “crucially” might make this rule more conducive to foreseeability analysis than D.C. Circuit’s usual definition which contains less flexible phrases such as “no intervening event” and “*straight line* without deviation.” Interestingly, this latter definition was cited along with the former definition in *Guirlando*, but no explanation as to how “intervening” and “depends crucially on . . . independent” are related is provided.

150 *Antares Aircraft, L.P. v. Federal Republic of Nigeria*, 999 F.2d 33 (2d Cir. 1993).

151 *NANDA & PANSIUS*, *supra* note 5, § 3:12.

152 *Cruise Connections Charter Mgmt. 1, LP v. Attorney Gen. of Can.*, 634 F. Supp. 2d 86, 90 (D.D.C. 2010), *rev’d*, 600 F.3d 661 (D.C. Cir. 2010).

153 *Id.* at 666.

Foreseeability is not often a clear-cut issue, and a court would probably prefer not to have to rely on foreseeability.

On the other hand, *Weltover*'s explicit rejection of substantiality was not cited, and for a good reason. There is a clear, reoccurring tone in the court's opinion, exemplified by statements such as "the alleged breach resulted in the direct loss of millions of dollars worth of business in the United States."¹⁵⁴ It appears that the court felt the need to protect the economic interest of domestic parties, which it probably felt was substantially impaired. But, again, there is no explicit endorsement of substantiality, and we are left to speculate the role it might play in future opinions.

IV. Direct Effect Jurisprudence After Cruise Connections

A. Implications of *Cruise Connections*

The following six points highlight the case's potential impact on direct effect jurisprudence. Notably, the common thread is the lack of certainty and definiteness in this area of the law. *Cruise Connections* offers very little in express rules. Its departure from D.C. Circuit precedent, when compounded with the lack of clear rules, probably only increases the ambiguity of direct effect jurisprudence.

1. **Even if the foreign sovereign's only obligation was to make a payment, an express or implied agreement for a U.S. payment location is no longer necessary to find "direct effect," even though it is sufficient to find "direct effect"**

Prior to *Cruise Connections*, a finding of direct effect based on an alleged failure to render payment required that the parties expressly or implicitly (i.e., by custom) agreed to a U.S. payment location.¹⁵⁵ In *Cruise Connections*, although the district court focused on whether a U.S. payment location was designated,¹⁵⁶ the D.C. Circuit declined to rule on this issue

¹⁵⁴ *Id.* at 666.

¹⁵⁵ *Cruise Connections Charter Mgmt. 1, LP v. Attorney Gen. of Can.*, 634 F. Supp. 2d 86, 88-89 (D.D.C. 2010). ("In short, before the breach occurs, the parties must have agreed – either expressly or impliedly – that payment would occur in the United States").

¹⁵⁶ *Id.* at 88-90.

altogether and instead decided the case on third party agreement losses.¹⁵⁷ *Cruise Connections* therefore establishes that a U.S. payment location is not required to find direct effect. The effect of the holding, read broadly, is that, although an express or implied agreement for a U.S. payment location is sufficient for direct effect, it is not required. Thus, when there is no such agreement, in the D.C. Circuit, it is now necessary to look beyond the geographical elements of the foreign sovereign's contractual obligations. The next point pertains to where we should actually look to find direct effect in such circumstances.

2. Harm to the plaintiff is not necessary (or sufficient) for "direct effect"

One of the few explicit rules in the case is that "[n]othing in the FSIA requires that the 'direct effect in the United States' harm the plaintiff."¹⁵⁸ This statement, combined with the court's acknowledgement that mere harm to a U.S. citizen is insufficient,¹⁵⁹ results in the rule that harm to the plaintiff party is neither necessary nor sufficient for direct effect. Of course, although this rule is explicit in language, it is anything but a useful guideline because it answers only what does *not* always constitute direct effect. If interpreted broadly, this statement may open the floodgates to pleading third-party effects as a way of defeating immunity or designing contracts with immunity-destroying third-party effects in mind.

3. "Direct effect" may be found where (1) the overall scope of the breached contract entails substantial commercial activity in the U.S. and (2) breach of the contract caused general economic disruption across an industry

Cruise Connections does emphasize two factors that may be important to find direct effect: (1) the fact that RCMP's contract with Cruise Connections necessarily or naturally entailed commercial activity, including commercial transactions, inside the United States; and (2) that the

157 *Cruise Connections Charter Mgmt. 1, LP v. Attorney Gen. of Can.*, 600 F.3d 661, 663-65 (D.C. Cir. 2010) (in deciding the case on other grounds, the court remarked, "It thus makes no difference where RCMP would have paid Cruise Connections.>").

158 *Id.* at 666.

159 *Id.* at 665.

breach of the contract caused generalized economic disruption of the cruise ship industry.

The first factor is based on the court's emphasis on a U.S. place of performance and place of negotiation of the third party.¹⁶⁰ Inquiry into this factor would focus not on RCMP's own contractual obligations, but the larger overall scope of activity related to the transaction, or perhaps foreseen or implied in the transaction. The court noted that the contract "required" the ships to come from American cruise lines.¹⁶¹ In this context, "require" does not refer to RCMP's contractual obligations, but the act necessary to fulfill (by non-defendant parties) in order to complete the contract. Of course, as suggested earlier, a contract between a U.S. and a foreign party could very easily require *some* activity in the United States, such as operational work in the U.S. party's American headquarters needed to carry out a contract, or for in the case of a single person, traveling through U.S. airspace to perform the contract abroad. Thus, it is difficult to draw a line as to what type of activity in the U.S. would be substantial enough to give rise to direct effect, or how closely tied the U.S. activity must be to the defendant's contract.

The second factor is based on the court's emphasis that RCMP's conduct caused revenue under the third-party agreements to be "not forthcoming."¹⁶² But because mere harm to a U.S. citizen is not sufficient for direct effect, the case also suggests that the key factor is the multitude of U.S. parties. Such a view is supported by the court's remark that RCMP's conduct "thwarted over \$40 million (U.S.) worth of cruise-related business in the United States,"¹⁶³ where the phrase "cruise-related business" implies interaction among parties, particularly of a related industry. Therefore, this second factor is very similar to the first factor (extent of activity in the United States) in that emphasis is placed on U.S. activity related to the defendant's contract. The case suggests that a knowing use of a third party in a deal raises the likelihood of direct effects. However, other than the facts of *Cruise Connections*, there are no standards to determining how many third parties, and how involved those third parties must be, to sustain

¹⁶⁰ See *supra* Part II.D.

¹⁶¹ *Cruise Connections Charter Mgmt. 1, LP v. Attorney Gen. of Can.*, 600 F.3d 661, 662 (D.C. Cir. 2010).

¹⁶² *Id.* at 665.

¹⁶³ *Id.*

industry-wide economic effect. In other words, it is not clear how much more is needed beyond mere harm to a U.S. business entity.

Because the factors suggested above are not accompanied by explicit rules, their implications will depend on whether *Cruise Connections* will be read broadly or be limited to its particular facts. It remains to be seen how federal courts, including those outside the D.C. Circuit, will use *Cruise Connections* in future cases.

4. *Weltover's* standard that an effect is "direct" if it follows as an "immediate consequence of the defendant's activity" remains devoid of substance and thus gives the court a large amount of discretion

The inefficacy of *Weltover's* immediacy is, of course, an old critique, but *Cruise Connections* highlights the problem once again. As discussed, the court's intervening act analysis (where the presence of an intervening act eliminates immediate consequence) contains numerous flaws. However, the D.C. Circuit was able to take advantage of the absence of a clear standard governing "intervening act" or "immediate consequences" to effectively rule that the intermediate steps in the causal chain leading to the third-party losses were not intervening. Part of the problem with intervening act analysis is that it is unclear as to what constitutes an "act." Since there is no precise standard, a court can easily collapse all the third-party mechanisms into a simplified timeline, something like: "RCMP breached the contract, thus causing lost revenue," as it did here (as opposed to a chain-of-events description like: RCMP breached the contract, causing the cruise lines to balk, causing Cruise Connections to be unable to obtain ships for the travel agency agreement, causing Cruise Connections to breach its agreement with the travel agency). Thus the case underlines the lack of substance in the "immediate consequence" standard in *Weltover*, the same concern that led to much criticism and additional judicial requirements such as the Second Circuit's legally significant acts test and the D.C. Circuit's apparent "express or implied agreement" standard (which *Cruise Connections* has qualified as not absolute). It is quite easy to see that either statutory or additional Supreme Court clarification is needed in this area. Until then, under the unduly vague "immediate consequence" standard, courts like the D.C. Circuit in *Cruise Connections* have utmost discretion in declaring what is considered a direct effect.

5. Substantiality, and possibly also foreseeability, may still be part of direct effect analysis to some informal

extent, even though they were rejected as requirements in *Weltover*

Although *Weltover* rejected foreseeability and substantiality as requirements, cases such as *Cruise Connections* show that they might still serve an informal role. It is not unreasonable to say that RCMP could have foreseen the third-party effects, given its knowledge of circumstances, and this consideration might have influenced the court's decision. But in the end, we have no clear guidelines as to how foreseeability affects "intervening" or "straight line" in the D.C. Circuit's definition of "direct effect,"¹⁶⁴ particularly when the Court expressly cited *Weltover*'s rejection of a foreseeability requirement. However, given that federal courts are currently endowed with vast discretion under *Weltover*'s immediacy standard, one can argue that they would prefer not to expressly bring foreseeability into play as it could restrain that discretion if it were to become a more formal part of the analysis.

While *Weltover*'s similarly rejected substantiality, the theme of substantiality permeates the *Cruise Connections* opinion, as seen by the court's emphasis on disruption of economic activity that could easily be described as substantial. Still, with no explicit endorsement of substantiality, which we can infer only by the tone of the opinion, the exact role of substantiality is ultimately left unclear. If substantiality is an implicit standard, we are left with no guidelines as to how substantial the effect must be. Would it make a difference if the amount in question is \$40,000 rather than \$40 million?

6. *Cruise Connections* may stand for the proposition that a breach of a contract between a foreign nation and a U.S. business entity will generally result in destruction of foreign sovereign immunity

The court's focus on terms like "forthcoming" while generalizing *Weltover*'s concept of "payment" to include general economic revenue suggests that any disappointed expectation of economic gain relating to a contract can qualify as an "effect" in "direct effect" analysis. Although "effect" might be potentially qualified by factors such as whether the scope of the contract entailed U.S. commercial activity, and whether a breach

164 "A direct effect has no intervening element, but, rather, flows in a straight line without deviation or interruption." *Cruise Connections Charter Mgmt. 1, LP v. Attorney Gen. of Can.*, 634 F. Supp. 2d 86, 90 (D.D.C. 2010) (quoting *Princz v. Federal Republic of Germany*, 26 F.3d 1166 (D.C. Cir. 1994)), *rev'd*, 600 F.3d 661 (D.C. Cir. 2010).

would cause disruption across an industry, these factors aren't clear standards or rules. If *Cruise Connections* is read broadly, these factors are not difficult barriers to finding direct effect, since a contract between a U.S. party, particularly a business entity, and a foreign nation could easily have at least some economic effect on U.S. commercial activity. The non-requirement of harm to the plaintiff further expands the potential "effects" that can destroy immunity.

As for whether an effect is "direct," this case has shown that the intervening act analysis is very malleable, at least in the D.C. Circuit, and it is not too difficult to find something that is "direct." These observations, when combined, leads to a reasonable conclusion that if *Cruise Connections* is read broadly, an alleged breach of a contract between a foreign nation and a U.S. business entity will usually result in destruction of foreign sovereign immunity. Stated another way, if the contract envisions significant U.S. commercial activity, direct effect is likely found, under a broad interpretation of *Cruise Connections*.

Accordingly, the sovereign immunity defense is weaker under this rule than under a rule that requires the agreement to include payment in the U.S. Of course, it remains to be seen how broadly the case will be read by later opinions.

B. Potential Solutions to Current Problems

Cruise Connections touches on two broad issues. The first issue is that given the purpose of the FSIA to balance the convenience of aggrieved private claimants with the "promotion of comity and harmony between the United States and other nations,"¹⁶⁵ has *Cruise Connections* upset the balance by making it too easy for immunity to be destroyed? Possibly, if not probably—but a precise inquiry into this question would require determination of the ideal amount of immunity, a question beyond the scope of this note.

The second issue is the lack of uniformity and consistency in direct effect jurisprudence, as illustrated by this case. A lack of uniformity and consistency can operate as a barrier to efficient commercial transaction between parties because it creates uncertainty. The challenge, of course, is finding a nexus to the United States between § 1602(a)(2)'s "commercial

165 *Colonial Bank v. Compagnie Generale Maritime et Financiere*, 645 F. Supp. 1457, 1465 (S.D.N.Y. 1986).

activity of the foreign state elsewhere” (i.e., *outside* the U.S.) and some harm or “effect” *inside* the United States. If the statutory language of “direct” is kept, it will be necessary for the Supreme Court to provide more clarification, particularly regarding intervening act analysis and place of performance provisions. Another possibility is to firmly insert foreseeability into the analysis. Foreseeability is advantageous in that it is commonly used in causation analysis.¹⁶⁶ On the other hand, if foreseeability becomes the main criterion (such as if “direct effect in the United States” is amended to something like “loss in the United States that the foreign state had reason to foresee as a probable result of its activity”), direct effect may be too easily found in breach of contract cases between sophisticated parties, wherein any breach would likely be foreseen to have an adverse effect on the other party. Congress would have to determine if such a relaxation of immunity is appropriate.

Yet another possibility, one that would offer a higher degree of immunity, is to examine the geographical scope of the contract to see if the foreign state bargained for the plaintiff to perform substantial act to take place in the United States. This approach would follow one possible reading of *Cruise Connections*, based on its emphasis of the negotiation of the third party agreements in the United States as pertinent to direct effect. However, further clarification would be needed as to what counts as sufficient acts to be performed by the plaintiff, and this approach would also alter the current framework (albeit a vague framework) by focusing on the contractual context of the breach rather than the effects of the breach and by treating contract cases as inherently different from tort cases.

Finally, further revision of direct effect jurisprudence should revisit the issue of third-party effects. A simple statutory amendment of “effect” to be “loss to the plaintiff” would resolve this particular ambiguity.

Conclusion

By finding that lost revenue under the plaintiff’s third party agreements constituted direct effect, under a rationale that lacks soundness in legal reasoning as well as basis in established case law, *Cruise Connections* has decreased the efficacy of immunity under the Foreign Sovereign Immunities Act. More importantly, the case’s departure from

¹⁶⁶ See, e.g., RESTATEMENT (SECOND) OF CONTRACTS § 351 (1981) (“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”).

established principles regarding intervening act analysis and contractual or customary payment at a U.S. payment location, while setting forth few clear standards, adds more uncertainty to an already disjointed area of the law that is very much in need of legislative or Supreme Court guidance.

**When Comprehensive Falls Short:
The Comprehensive Iran Sanctions, Accountability, and Divestment
Act of 2010**

Jennifer M. Kline*

Introduction

In mid-1995, Lloyds TSB Bank, plc (“Lloyds”) started manually removing and manipulating the names and addresses of its long-term Iranian banking clients to enable the processing of financial transactions in the United States.¹ Lloyds’ “Payment Services Aide Memoire” removes any mention of Iran in wire transfer payments to circumvent the additional time, cost, and difficulty of retrieving assets seized by the United States under the International Emergency Economic Powers Act (“IEEPA”).² Senior management at Lloyds defended this policy because United States sanctions subjected legitimate Iranian bank transactions to delays and uncertainties.³ Lloyds is not the only foreign financial institution to knowingly evade United States economic sanctions against Iran and promote its commercial interests.⁴ Today there is a constant tension between generating financial profits and promoting United States foreign policy goals to halt the funding of terrorism and the proliferation of weapons of mass destruction (“WMD”).

The latest addition to the United States’ arsenal of sanctions against Iran is the Comprehensive Iran Sanctions Accountability and Divestment Act of 2010 (“CISADA”).⁵ CISADA consists of a set of targeted economic

*Jennifer Kline would like to thank Paul Ferman, Michael Hedrick, Aaron Kane, Chrissy Kendall, Stacey Sklaver, and Tyler Stubbs for their help, support, and encouragement on this Comment.

1 Lloyds TSB Bank, plc, Office of Foreign Assets Control, MUL-4745344 (Settlement Agreement) at 2-3 (Dec. 22, 2009), *available at* http://www.treasury.gov/resource-center/sanctions/OFAC-Enforcement/Documents/lloyds_agreement.pdf.

2 *Id.*

3 *Id.*

4 *See infra* Part II.

5 *See* Comprehensive Iran Sanctions, Accountability, and Divestment Act, 22 U.S.C.A. §§ 8512-31 (West 2010).

sanctions called “smart sanctions.”⁶ CISADA prohibits or imposes strict conditions on correspondent banking with foreign financial institutions linked to funding Iran's WMD program.⁷

Correspondent banking consists of providing of financial transactions, including deposits and payments, by a United States financial institution for a foreign financial institution⁸ that does not have a physical presence in the United States.⁹ Correspondent banking runs a high risk of money laundering for illegal activities, including funding Iran's WMD program, because foreign financial institutions can access the United States banking system for a simple fee.¹⁰ Common correspondent banking activities such as wire transfers and payable through accounts (“PTA”) are difficult to track.¹¹ Wire transfers process transactions quickly without screening for the client's identity or the purpose of the transaction, while PTAs allow unidentified subaccount holders in foreign financial institutions to write checks and make deposits in the United States without transactional oversight.¹²

6 See Peter L. Fitzgerald, *Managing "Smart Sanctions" Against Terrorism Wisely*, 36 NEW ENG. L. REV. 957, 960-61 (2002). Traditional sanctions historically placed trade restrictions on entire countries. Smart sanctions, on the other hand, precisely target key individuals and companies to achieve policy goals in a specific geographic area of concern. This reduces the humanitarian costs often associated with blanket country-wide sanctions. *Id.*

7 H.R. COMM. ON FOREIGN AFFAIRS, 111TH CONG., SUMMARY OF H.R. 2194, THE COMPREHENSIVE IRAN SANCTIONS, ACCOUNTABILITY, AND DIVESTMENT ACT OF 2010, (2010), *available at* http://www.hcfa.house.gov/111/press_062410a.pdf.

8 Iranian Financial Sanctions Regulations, 75 Fed. Reg. 49,836, 49,840 (Aug. 16, 2010) (to be codified at 31 C.F.R. pt. 561).

9 MINORITY STAFF OF THE S. PERMANENT SUBCOMM. ON INVESTIGATIONS, 107TH CONG., REPORT ON CORRESPONDENT BANKING: A GATEWAY FOR MONEY LAUNDERING, at 11 (2001), *available at* http://hsgac.senate.gov/psi_finalreport.pdf.

10 See OFFICE OF THE COMPTROLLER OF THE CURRENCY, COMPTROLLER'S HANDBOOK: BANK SECRECY ACT/ANTI-MONEY LAUNDERING, at 21-26 (Dec. 2000), *available at* <http://www.occ.gov/static/news-issuances/memos-advisory-letters/2001/pub-advisory-letter-2001-7b.pdf> (reporting that correspondent banking with foreign financial institutions runs a high risk of money laundering).

11 *Id.*

12 *Id.*

Transactions shrouded in secrecy are conducive to money laundering. As a result, a comprehensive regulatory system is necessary to combat the risk of money laundering.¹³ CISADA limits the ability of foreign financial institutions to assist Iran's WMD program through correspondent banking in the United States,¹⁴ cutting Iran off from important access to the United States financial system. Access to this system is critical for Iran due to the high demand for United States dollars¹⁵ to finance both legitimate and illegitimate¹⁶ Iranian business.¹⁷ If the United States is to achieve its security objectives with respect to Iran's funding of WMD programs, the United States must preclude Iran from using the United States Financial System.

Nonetheless, the effectiveness of CISADA depends on its compliance and enforcement tools. These include auditing, self-reporting, certification,¹⁸ and due diligence.¹⁹ It remains unclear whether these tools

13 *Id.* at 22.

14 Iranian Financial Sanctions Regulations, 75 Fed. Reg. 49,836, 49,837-40 (Aug. 16, 2010) (to be codified at 31 C.F.R. pt. 561).

15 See Press Release, U.S. Dep't of the Treasury, Remarks by Treasury Secretary Paulson on Targeted Financial Measures to Protect Our National Security (June 14, 2007), <https://ustreas.gov/press/releases/hp457.htm> (affirming that the United States is the hub of the global financial system upon which illicit actors rely); see also MINORITY STAFF OF THE S. PERMANENT SUBCOMM. ON INVESTIGATIONS, 107TH CONG., REPORT ON CORRESPONDENT BANKING: A GATEWAY FOR MONEY LAUNDERING, at 11-12 (2001), available at http://hsgac.senate.gov/psi_finalreport.pdf (stating that most foreign financial institutions use United States dollars and United States correspondent banking accounts to provide international services).

16 See S.C. Res. 1929, at 1-4, U.N. Doc. S/RES/1929 (June 9, 2010) (resolving that Iranian efforts to develop a nuclear program are illegitimate because they are violations of international law). In particular, Iran has failed to meet the International Atomic Energy Agency's requirements for information exchange under its safeguard agreement. Iran has further neglected to comply with five United Nations Security Council Resolutions to suspend uranium enrichment activities. *Id.*

17 See U.S. Dep't of the Treasury, *supra* note 15 (revealing that financing of Iranian business has fallen dramatically and the risk of financing Iranian business with non-United States currencies remains high).

18 Certification requires United States financial institutions to verify that foreign financial institutions do not engage in prohibited activities.

19 Comprehensive Iran Sanctions, Accountability, and Divestment Act, 22 U.S.C.A. § 8513(e)(1)(A)-(D) (West 2010).

will successfully generate compliance with CISADA and achieve United States national security goals, namely to prevent proliferators accessing the United States financial system to pay for WMD components.²⁰ CISADA's main enforcement agency, the United States Department of the Treasury's ("Treasury") Office of Foreign Assets Control ("OFAC"),²¹ relies on institutional self-reporting of violations as its primary compliance mechanism, making CISADA's effectiveness uncertain.²²

This comment proposes that self-reporting from the private financial industry creates perverse incentives that CISADA's current compliance tools cannot overcome, largely due to a lack of regulatory clarity and oversight from OFAC. Creation of new legal enforcement tools and clarification of CISADA compliance conditions are necessary to deny Iranian WMD proliferator access to United States correspondent banking accounts.

Part I of this comment provides relevant background information on the applicable money laundering statutes upon which CISADA is modeled. Part II discusses recent bank settlement cases related to violations of United States financial sanctions against Iran. Part III analyzes the lack of incentive for self-reporting and the lack of regulatory clarity and oversight that will impair CISADA's effectiveness in preventing illicit actors from accessing the United States financial system. Finally, part IV proposes legal tools and language clarification to improve compliance with and enforcement of CISADA.

Part I: Background

CISADA's statutory language for restrictions on correspondent banking with foreign financial institutions is modeled closely on existing United States anti-money laundering laws. In particular, CISADA utilizes

20 See U.S. DEP'T OF THE TREASURY, STRATEGIC PLAN FISCAL YEARS 2007-2012, at 10, 25, available at <https://ustreas.gov/offices/management/budget/strategic-plan/2007-2012/strategic-plan2007-2012.pdf> (naming the prevention of WMD proliferator access to the United States financial system as a primary national security goal).

21 Iranian Transactions Regulations, 75 Fed. Reg. 59,611, 59,611-12 (Sept. 28, 2010) (to be codified at 31 C.F.R. pt. 360).

22 See 22 U.S.C.A. § 8513 (e)(1)(A)(D) (requiring reporting of transactions or suspicious activity under due diligence procedures relating to Iranian proliferation); Fitzgerald, *supra* note 6, at 962-64 (arguing that the effectiveness of OFAC's sanction implementation relies on voluntary compliance, but OFAC and the business community have combative relations).

many of the financial sanctions in Section 311 of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (“USA PATRIOT Act”), which is recognized as the most effective United States legislation for financial “smart sanctions.”²³ In turn, much of the USA PATRIOT Act's success is derived from the expansion and amendment of the money laundering principles established by the Bank Secrecy Act of 1970 (“BSA”).²⁴ As a result, it is essential to overview the BSA and USA PATRIOT Act anti-money laundering provisions to understand the implications of CISADA's correspondent banking restrictions more completely.

The BSA was the first federal legislation targeting money laundering.²⁵ In 1970,²⁶ Congress enacted the BSA to prevent the use of financial institutions as intermediaries for money laundering and other crimes.²⁷ The BSA requires financial institutions to keep detailed records of transfers.²⁸ This paper trail assists United States law enforcement to detect

23 See 22 U.S.C.A. § 8513; see also USA PATRIOT Act, 31 U.S.C. § 5318(i) (2006) (detailing the due diligence requirements of the USA PATRIOT Act for correspondent banking); COMMITTEE OF CONFERENCE, H.R. COMM. ON FOREIGN AFFAIRS, 111TH CONG., JOINT EXPLANATORY STATEMENT: H.R. 2194, THE COMPREHENSIVE IRAN SANCTIONS, ACCOUNTABILITY, AND DIVESTMENT ACT OF 2010 REPORT, at 18 (2010), available at http://www.hcfa.house.gov/111/press_062410d.pdf (describing CISADA's financial institution sanctions as being patterned after the effective section 311 of the USA PATRIOT Act).

24 See Bank Secrecy Act, Pub. L. No. 91-508, 84 Stat. 1114 (1970) (codified as amended at 12 U.S.C. §§ 1829b, 1951-59 (2006) and at 31 U.S.C. §§ 5311-32 (2006)); USA PATRIOT Act, Pub. L. No. 107-56, §§ 301-77, 115 Stat. 272, 296-342 (2001) (codified as amended in scattered sections of U.S.C.); see also Financial Crimes Enforcement Network, Bank Secrecy Act, http://www.fincen.gov/statutes_regs/bsa (last visited Jan. 11, 2011) (listing the codified amendments to the BSA).

25 See Financial Crimes Enforcement Network, History of Anti-Money Laundering Laws, http://www.fincen.gov/news_room/aml_history.html (last visited Jan. 9, 2011).

26 *Id.*

27 OFFICE OF THE COMPTROLLER OF THE CURRENCY, *supra* note 10, at 1. The BSA was enacted to prevent the use of banks as intermediaries for criminal activity such as money laundering and drug trafficking. The modern BSA codifications combats gunrunning, fraud, and terrorism. *Id.*

28 See §§ 121, 123, 84 Stat. at 1116-17 (codified as amended at 12 U.S.C. §§ 1951, 1953 (2006)); see also OFFICE OF THE COMPTROLLER OF THE CURRENCY, *supra* note 10, at 8-9 (detailing that the BSA requires diligent recordkeeping to reconstruct transactions).

and prevent money laundering and deters United States financial institutions from engaging in illegal activities.²⁹ Since a financial institution's assets may be subject to forfeiture if traceable to money laundering activities,³⁰ the BSA's provisions encourage financial institutions to obtain information about potential clients in advance to avoid facilitating money laundering.³¹ In addition, the BSA requires financial institutions to make timely reports of suspicious activity related to transactions that might signify money laundering or other illegal activities.³² Finally, the BSA requires financial institutions to create internal programs for personnel training, independent testing, and internal controls to ensure compliance with the BSA's reporting and recordkeeping requirements.³³ CISADA implements similar recordkeeping and reporting requirements, as well as similar civil and criminal penalty structures for violations.³⁴

Congress has amended the BSA several times to enhance its effectiveness,³⁵ including the expansive anti-money laundering regulations

29 See §§ 121, 123, 84 Stat. at 1116-17 (codified as amended at 12 U.S.C. §§ 1951, 1953 (2006)) (recognizing the usefulness of recordkeeping for investigations, proceedings, and intelligence and counterintelligence activities); see also OFFICE OF THE COMPTROLLER OF THE CURRENCY, *supra* note 10, at 1 (outlining the use of reporting and recordkeeping to investigate and deter money laundering and illicit activities).

30 See §§ 125-27, 84 Stat. at 1117-18 (codified as amended at 12 U.S.C. §§ 1955-57 (2006)); see also OFFICE OF THE COMPTROLLER OF THE CURRENCY, *supra* note 10, at 3-4 (reporting that penalties for money laundering include forfeiture).

31 See Bank Secrecy Act, Pub. L. No. 91-508, 84 Stat. 1114 (1970) (codified as amended at 12 U.S.C. §§ 1829b, 1951-59 (2006) and at 31 U.S.C. §§ 5311-32 (2006)); see also OFFICE OF THE COMPTROLLER OF THE CURRENCY, *supra* note 10, at 1 (declaring that financial institutions must know their clients and their clients' businesses to avoid suspicious activity).

32 Suspicious Activity Report, 12 C.F.R. § 21.11 (2010); Reports by Banks of Suspicious Transactions, 31 C.F.R. § 103.18 (2010); see also OFFICE OF THE COMPTROLLER OF THE CURRENCY, *supra* note 10, at 11-12 (noting that the BSA requires diligent reporting of suspicious activity).

33 Procedures for Monitoring Bank Secrecy Act (BSA), 12 C.F.R. § 21.21 (2010); see also OFFICE OF THE COMPTROLLER OF THE CURRENCY, *supra* note 10, at 5-7 (stating that internal compliance programs are required to ensure compliance with the BSA).

34 See Comprehensive Iran Sanctions, Accountability, and Divestment Act, 22 U.S.C.A. § 8513(e) (West 2010); §§ 121-29, 84 Stat. at 1116-18 (codified as amended at 12 U.S.C. §§ 1951-59 (2006)).

35 OFFICE OF THE COMPTROLLER OF THE CURRENCY, *supra* note 10, at 1.

enacted in 2001 under Title III, the “International Money Laundering Abatement and Anti-Terrorist Financing Act,” of the USA PATRIOT Act.³⁶ Title III contains additional provisions to increase information gathering, recordkeeping, monitoring, reporting, and penalties to counter illegal activities such as money laundering.³⁷ Subtitle A implements the following international anti-money laundering measures: (1) minimum and enhanced due diligence standards for correspondent accounts; (2) customer identification verification methods; (3) a prohibition on correspondent banking with shell banks;³⁸ (4) forfeiture of assets and additional penalties for violations of the Act; and (5) improved international cooperation and information sharing for financial institutions.³⁹ CISADA has expressly incorporated the enhanced due diligence requirements outlined in Subtitle A.⁴⁰

Subtitle B establishes additional amendments and improvements to the BSA,⁴¹ focusing on reporting, anti-money laundering compliance programs, and civil and criminal penalties for violations.⁴² Subtitle B

36 See USA PATRIOT Act, Pub. L. No. 107-56, §§ 301-77, 115 Stat. 272, 296-342 (2001) (codified as amended in scattered sections of U.S.C.); see also Financial Crimes Enforcement Network, USA PATRIOT Act, http://www.fincen.gov/statutes_regs/patriot/index.html (last visited Jan. 10, 2011) (providing an overview of the USA PATRIOT Act provisions impacting financial institutions, including money laundering prevention and prosecution).

37 §§ 301-77, 115 Stat. at 296-342 (codified as amended in scattered sections of U.S.C.).

38 See MINORITY STAFF OF THE S. PERMANENT SUBCOMM. ON INVESTIGATIONS, 107TH CONG., REPORT ON CORRESPONDENT BANKING: A GATEWAY FOR MONEY LAUNDERING, at 1, 13 (2001), available at http://hsgac.senate.gov/psi_finalreport.pdf (defining a shell bank as a bank with no physical presence, such as an office or staff, in any country). Shell bank transactions are conducted almost entirely through correspondent banking accounts. *Id.* at 13.

39 §§ 311-30, 115 Stat. at 298-320 (codified as amended at 18 U.S.C. § 981 (2006) and at 31 U.S.C. §§ 5318-5318A (2006)).

40 Comprehensive Iran Sanctions, Accountability, and Divestment Act, 22 U.S.C.A. § 8513(e) (West 2010); § 312, 115 Stat. at 304-06 (codified as amended at 31 U.S.C. §§ 5318-5318A (2006)).

41 See §§ 351-66, 115 Stat. at 320-36 (Subtitle B); Financial Crimes Enforcement Network, *supra* note 36 (reporting that the USA PATRIOT Act expands liability for reporting).

42 §§ 351-66, 115 Stat. at 320-36 (codified as amended at 31 U.S.C. §§ 5312, 5318, 5321-22 (2006)).

provides for more stringent reporting and recordkeeping obligations for a broader range of financial transactions, including filing reports on currency transactions over \$10,000 and systematic reporting of suspicious activities.⁴³ To help law enforcement prevent and prosecute money laundering activities more efficiently,⁴⁴ these requirements apply to banks and non-traditional financial institutions, such as money transmitting businesses, commodity traders, brokers, and dealers.⁴⁵ Furthermore, Subtitle B increases civil and criminal penalties for reporting and compliance program violations, creating stronger deterrence of illegal activities for traditional and non-traditional financial institutions.⁴⁶ CISIDA incorporates subtitle B's penalties, reporting, and recordkeeping requirements.⁴⁷

Finally, Subtitle C enacts measures to combat currency smuggling and counterfeiting crimes.⁴⁸ The main implementation tools are forfeiture and prosecution using extraterritorial jurisdiction.⁴⁹ The extraterritorial jurisdiction amends the BSA and the Fraud Statute, 18 U.S.C. § 1029, to apply to any person outside of United States jurisdiction that commits or conspires to commit a fraudulent monetary transaction under United States law using a financial institution within United States jurisdiction.⁵⁰ This has particularly important implications for the extraterritorial reach of CISADA.

43 §§ 351-66, 115 Stat. at 320-36 (codified as amended at 31 U.S.C. §§ 5312, 5318, 5324, 5331 (2006)).

44 Financial Crimes Enforcement Network, *supra* note 36.

45 *See* §§ 356, 359, 115 Stat. at 324-25, 328-29 (codified as amended at 31 U.S.C. §§ 5312, 5318, 5330 (2006)).

46 *See* § 363, 115 Stat. at 322-23 (codified as amended at 31 U.S.C. §§ 5321-22 (2006)).

47 *See* Comprehensive Iran Sanctions, Accountability, and Divestment Act, 22 U.S.C.A. § 8513(e) (West 2010); §§ 351-66, 115 Stat. at 320-36 (codified as amended at 31 U.S.C. §§ 5312, 5318, 5321-22, 5324, 5330-31 (2006)).

48 §§ 371-77, 115 Stat. at 336-42 (codified as amended at 18 U.S.C. §§ 470-74, 476-82, 484, 493 (2006) and at 31 U.S.C. § 5322 (2006)).

49 §§ 371-72, 377, 115 Stat. at 336-39, 342 (codified as amended at 18 U.S.C. § 1029 (2006) and at 31 U.S.C. §§ 5317, 5322 (2006)).

50 *See* Fraud Statute, 18 U.S.C. § 1029 (2006); Bank Secrecy Act, Pub. L. No. 91-508, 84 Stat. 1114 (1970) (codified as amended at 12 U.S.C. §§ 1829b, 1951-1959 (2006) and at 31 U.S.C. §§ 5311-5330 (2006)); § 377, 115 Stat. at 342 (codified as amended at 18 U.S.C. § 1029 (2006)).

OFAC can now prosecute foreign financial institutions using United States correspondent accounts on behalf of actors linked to Iran's WMD program, regardless of how tangential the relationship may be between the foreign institution and the nefarious actors.⁵¹

In addition to the above financial regulations under Title III, the USA PATRIOT Act amends IEEPA to enhance OFAC's ability to implement sanctions passed under IEEPA's authority.⁵² IEEPA provides the President of the United States with the authority to investigate, regulate, or prohibit financial transfers to a foreign country or national upon declaration of a national emergency stemming from an extraordinary threat to national security, foreign policy, or the economy.⁵³ The USA PATRIOT Act expands the role of OFAC in executing the President's national emergency powers by clarifying OFAC's authority to block assets of suspicious actors, thus preventing the flight of assets.⁵⁴ The USA PATRIOT Act further authorizes OFAC to use classified information to make designations of suspicious actors⁵⁵ and to enforce economic and trade sanctions.⁵⁶

CISADA enhances the compliance measures and penalties implemented under the USA PATRIOT Act by extending United States restrictions on foreign financial institution transactions within the United

51 Cf. Edward L. Rubinoff and Shiva Aminian, *Recent U.S. and Multilateral Sanctions Against Iran: A New Framework?*, 931 PRACTISING L. INST. 209, 220-21 (2010) (contending that OFAC's extraterritorial reach under CISADA is an extension of the Iranian Transactions Regulations that enable the United States to sanction non-United States persons who have a tenuous connection to the United States).

52 *Counterterror Initiatives in the Terror Finance Program, Focusing on the Role of the Anti-Money Laundering Regulatory Regime in the Financial War on Terrorism, Better Utilization of Technology, Increased Information Sharing, Developing Similar International Standards, and the Formation of Terrorist Financing Operations Section (TFOS) Before the S. Comm. on Banking, Housing & Urban Affairs*, 108th Cong. 193 (2004) (statement of R. Richard Newcomb, Director, Office of Foreign Assets Control).

53 International Emergency Economic Powers Act, 50 U.S.C. §§ 1701-02 (2006).

54 Newcomb, *supra* note 52.

55 *Id.*

56 Office of Foreign Assets Control, About, <http://www.treasury.gov/about/organizational-structure/offices/Pages/Office-of-Foreign-Assets-Control.aspx> (last visited on Jan. 11, 2011).

States banking system.⁵⁷ CISADA was implemented in part as a response to the Financial Action Task Force's ("FATF") mandate to address new and emerging threats to global financing.⁵⁸ FATF imposes strict restrictions on all United States correspondent accounts with foreign financial institutions to prevent money laundering that might facilitate Iranian proliferation efforts.⁵⁹ In particular, the statute requires United States financial institutions engaged in correspondent banking with foreign financial institutions to perform audits and report suspicious activities related to Iranian proliferation efforts.⁶⁰ Additionally, United States financial institutions must certify that foreign clients are not knowingly engaging in proliferation-related activities and must establish due diligence policies pursuant to the USA PATRIOT Act.⁶¹ Finally, CISADA allows the Secretary of the Treasury to waive restrictions and penalties imposed on foreign financial institutions as necessary for the national interest of the United States.⁶²

Ultimately, CISADA is designed to drastically reduce access to the United States financial system by actors intending to finance Iran's WMD program.⁶³ CISADA is the cumulative effort by the United States

⁵⁷ See Comprehensive Iran Sanctions, Accountability, and Divestment Act, 22 U.S.C.A. §§ 8513 (West 2010); see also COMMITTEE OF CONFERENCE, H.R. COMM. ON FOREIGN AFFAIRS, 111TH CONG., JOINT EXPLANATORY STATEMENT: H.R. 2194, THE COMPREHENSIVE IRAN SANCTIONS, ACCOUNTABILITY, AND DIVESTMENT ACT OF 2010 REPORT, at 18-19 (2010), available at http://www.hcfa.house.gov/111/press_062410d.pdf (describing CISADA's financial institution sanctions as offensively extending the USA PATRIOT Act measures to foreign financial institutions).

⁵⁸ See 22 U.S.C.A. § 8513. The intergovernmental organization FATF develops policies to combat evolving financial system threats, such as money laundering and terrorist and WMD proliferation financing. In February 2010, the FATF appealed to its members to protect their correspondent accounts, which might be used by Iran to circumvent money laundering and terrorism countermeasures. *Id.*

⁵⁹ 22 U.S.C.A. § 8513.

⁶⁰ *Id.*; see USA PATRIOT Act, 31 U.S.C. § 5318(i)(2)(B)(ii) (2006) (requiring United States financial institutions to report suspicious transactions).

⁶¹ 22 U.S.C.A. § 8513; see 31 U.S.C. § 5318(i).

⁶² 22 U.S.C.A. § 8513.

⁶³ H.R. COMM. ON FOREIGN AFFAIRS, 111TH CONG., SUMMARY OF H.R. 2194, THE COMPREHENSIVE IRAN SANCTIONS, ACCOUNTABILITY, AND DIVESTMENT ACT OF 2010, (2010), available at http://www.hcfa.house.gov/111/press_062410a.pdf; U.S. DEP'T OF THE TREASURY, *supra* note 20.

government to counteract money laundering and illicit financial transactions that undermine national security.⁶⁴ As a result, the statute targets correspondent banking transactions using tools enacted by the BSA and the USA Patriot Act: reporting and due diligence requirements; civil and criminal penalties; and extraterritorial jurisdiction.⁶⁵

Part II: Case Studies of United States Sanction Enforcements Against Foreign Banks

Before examining CISADA's specific implementation issues, it is useful to understand the trend in recent OFAC financial sanction enforcement cases. Since December 2009, OFAC has announced three settlements concerning major international banks that violated IEEPA regulations related to Iran.⁶⁶ Brief case studies of OFAC's settlements with Credit Suisse AG ("Credit Suisse"), Lloyds, and Barclays Bank PLC ("Barclays") reveal that self-reporting of financial sanction violations remains sporadic.⁶⁷ Furthermore, foreign financial institutions intentionally remove or manipulate client identification information to evade financial sanctions.⁶⁸

The first OFAC settlement case in this series of financial sanction enforcements against Iran involved the Swiss bank, Credit Suisse.⁶⁹ Credit Suisse contacted OFAC in 2006 concerning a potential sanction violation

64 See 22 U.S.C.A. §§ 8512-31 (West 2010); *supra* notes 20, 25, 36 and accompanying text.

65 See 22 U.S.C.A. §§ 8512-31; Bank Secrecy Act, Pub. L. No. 91-508, 84 Stat. 1114 (1970) (codified as amended at 12 U.S.C. §§ 1829b, 1951-59 (2006) and at 31 U.S.C. §§ 5311-32 (2006)); USA PATRIOT Act, Pub. L. No. 107-56, §§ 301-77, 115 Stat. 272, 296-342 (2001) (codified as amended in scattered sections of U.S.C.).

66 Barclays Bank PLC, Office of Foreign Assets Control, MUL-488066 (Settlement Agreement), at 1-7 (Aug. 18, 2010) *available at* <https://ustreas.gov/offices/enforcement/ofac/civpen/penalties/08182010.pdf>; Lloyds TSB Bank, plc, *supra* note 1, at 1-8; Credit Suisse AG, Office of Foreign Assets Control, MUL-473923 (Settlement Agreement), at 1-9 (Dec. 16, 2009), *available at* <https://ustreas.gov/offices/enforcement/ofac/civpen/penalties/12162009.pdf>.

67 Barclays Bank PLC, *supra* note 66; Lloyds TSB Bank, plc, *supra* note 1, at 1-8; Credit Suisse AG, *supra* note 66.

68 *Id.*

69 Credit Suisse AG, *supra* note 66.

involving United States securities.⁷⁰ In its investigation, OFAC discovered that Credit Suisse had also systematically violated United States fund transfer restrictions with Iran since the 1990s.⁷¹ Specifically, Credit Suisse omitted or removed location and entity information from fund transfer forms to conceal the identity of an Iranian bank as the originator of the fund transfer requests. Credit Suisse then referenced itself as the ordering institution instead.⁷² Credit Suisse even developed an internal operating procedure specifically to evade United States sanctions.⁷³ This system utilized code names and limited the personnel who knew the Iranian client's identification, deliberately excluding Credit Suisse's compliance department from this knowledge.⁷⁴ In order to avoid criminal prosecutions for these calculated sanction violations, Credit Suisse agreed to pay a \$536 million fine, create an electronic database of internal documents related to the fund transfers from 2002 to 2007, and implement and certify sanction compliance training and a written bank-to-bank payment transfer policy.⁷⁵

Less than a week later, OFAC announced another settlement for Iranian financial sanction violations by the United Kingdom's Lloyds bank.⁷⁶ Lloyds manipulated and deleted wire transfer information relating to Iranian bank clients from the early 1980s until November 2003.⁷⁷ Lloyds' senior management continued to remove information to expedite wire transfers and intentionally evade OFAC filters designed to detect identification information for sanctioned actors.⁷⁸ The New York County District Attorney's Office apprised OFAC of these IEEPA violations in

⁷⁰ *Id.* at ¶ 3.

⁷¹ *Id.* at ¶¶ 3, 4, 7.

⁷² *Id.* at ¶ 8.

⁷³ *Id.* at ¶ 13.

⁷⁴ *Id.*

⁷⁵ Credit Suisse AG, Office of Foreign Assets Control, MUL-473923, (Deferred Prosecution) ¶¶ 3, 6 (Dec. 16, 2009), available at <http://www.jdsupra.com> (search for "MUL-473923").

⁷⁶ Lloyds TSB Bank, plc, *supra* note 1.

⁷⁷ *Id.* at ¶¶ 6, 12, 13.

⁷⁸ *Id.* at ¶ 8.

2007 and OFAC investigated.⁷⁹ Lloyds ultimately agreed to pay a \$217 million settlement, provide all United States payment messages from 2002 to 2007 to OFAC, and implement an annual audit of United States payments with an independent consultant.⁸⁰

Finally, OFAC settled with the United Kingdom's Barclays in August 2010 for violations of IEEPA financial sanctions relating to Iran.⁸¹ Barclays voluntarily disclosed its sanction violations to OFAC in May 2006.⁸² The voluntary disclosure revealed that Barclays systematically obscured and removed identification information of sanctioned Iranian financial institutions, including Iran's Central Bank, from 1987 until at least 2004.⁸³ Barclays also utilized a wire transfer filter to identify and interdict sanctioned party transactions in order to remove offending information or substitute Barclay's sundry account number prior to processing payments.⁸⁴ Barclays agreed to pay a \$176 million fine and annually review its policy and procedures for sanctions compliance with an independent consultant.⁸⁵ The settlement also included employee training to deal with United States financial sanctions and the creation of a database of United States payment messages from 2000 to 2007.⁸⁶

As illustrated, foreign financial institutions are intentionally and systematically evading Iranian financial sanctions.⁸⁷ These case studies further demonstrate how OFAC's enforcement of financial sanctions relies heavily upon voluntary disclosures or information provided by other

⁷⁹ *Id.* at ¶ 3.

⁸⁰ *Id.* at ¶¶ 5, 17-19.

⁸¹ Barclays Bank PLC, *supra* note 66.

⁸² *Id.* at ¶ 3.

⁸³ *Id.* at ¶¶ 4-6.

⁸⁴ *Id.* at ¶¶ 7, 8.

⁸⁵ *Id.* at ¶¶ 21, 22.

⁸⁶ Barclays Bank PLC, Office of Foreign Assets Control, MUL-488066, (Deferred Prosecution) ¶ 7 (Aug. 18, 2010), *available at* <http://www.courthousenews.com/2010/08/19/Barclays.pdf>.

⁸⁷ Barclays Bank PLC, *supra* note 66; Lloyds TSB Bank, plc, *supra* note 1, at 1-8; Credit Suisse AG, *supra* note 66.

government agencies.⁸⁸ Although Barclays voluntarily disclosed its intentional removal and manipulation of identification information to circumvent United States sanctions,⁸⁹ Credit Suisse's institutionalized efforts to evade Iranian financial sanctions were only discovered as part of an investigation of a different violation.⁹⁰ This relatively haphazard approach to sanction enforcement is indicative of the potential implementation issues OFAC will face in trying to implement CISADA effectively for correspondent banking functions.

Fortunately, the studies also reveal that OFAC's enforcement of financial sanctions resulted in high settlement payments, as well as provisions for continued oversight by OFAC for the violating institutions.⁹¹ Credit Suisse, in particular, agreed to a hefty \$536 million fine,⁹² which may deter correspondent banking violations under CISADA in the first place. In addition, since Barclays paid less than a quarter of Credit Suisse's settlement fine for virtually identical sanction violations⁹³ other financial institutions currently in violation of CISADA may choose to disclose their violations rather than wait to be detected. Nonetheless, OFAC's reliance on sanction enforcement by other agencies and voluntary compliance by

88 *Id.*

89 Barclays Bank PLC, *supra* note 66, ¶¶ 3-6.

90 Credit Suisse AG, *supra* note 66.

91 See Barclays Bank PLC, *supra* note 66; Lloyds TSB Bank, plc, *supra* note 1, at 1-8; Credit Suisse AG, *supra* note 66; Australia and New Zealand Banking Group, Ltd., Office of Foreign Assets Control, MUL-464334 (Settlement Agreement), at 2-3 (Aug. 21, 2009), available at http://www.treasury.gov/resource-center/sanctions/OFAC-Enforcement/Documents/anz_08242009.pdf; ABN AMRO Bank N.V., Financial Crimes Enforcement Network, No. 2005-5 (Assessment of Civil Money Penalty), at 3, 7-8 (Dec. 19, 2005), available at http://www.fincen.gov/news_room/ea/files/abn_assessment.pdf; Office of Foreign Assets Control, Civil Penalties Information, <https://ustreas.gov/offices/enforcement/ofac/civpen/index.shtml> (follow the hyperlinks for OFAC Enforcement Actions By Year) (providing information on OFAC's five financial institution sanction enforcement cases since 2003 that resulted in settlement payments and agreements for OFAC monitoring of compliance programs and independent audits).

92 Credit Suisse AG, *supra* note 75, ¶ 3.

93 Barclays Bank PLC, *supra* note 66; Credit Suisse AG, *supra* note 66.

financial institutions⁹⁴ poses serious concerns for the proper implementation and enforcement of CISADA.

Part III: Implementation Issues – the Lack of Institutional Incentive

CISADA, like its statutory predecessors, relies on financial institutions to self-report suspicious activities concerning client transactions in order to meet their reporting, compliance program, and certification obligations.⁹⁵ Unfortunately, financial institution incentives to comply with additional monetary transaction restrictions do not inherently coincide with the U.S. foreign policy objectives underlying the promulgation of CISADA. In fact, CISADA's main foreign policy objective of blocking Iranian WMD proliferation access to the United States financial system⁹⁶ leaves no room for financial institutions to consider profit margins or entrepreneurialism. Although CISADA provides for stringent civil and criminal penalties,⁹⁷ the specter of monetary fines and imprisonment may be insufficient to deter financial institutions from pursuing profitable correspondent banking activities with questionable foreign financial institutions. This would almost certainly undermine self-reporting mechanisms as the primary line of defense against illicit utilization of correspondent bank accounts.

CISADA's threatened penalties may be insufficient for several reasons. First, financial institutions are private institutions that must remain competitive in order to survive. Much like any private corporation, financial institutions undergo a cost-benefit analysis in determining to what extent they will comply with sanctions.⁹⁸ As a result, financial institutions must balance tangible and intangible costs and benefits when determining whether to pursue transactions potentially linked to Iranian proliferation.

94 Barclays Bank PLC, *supra* note 66; Lloyds TSB Bank, plc, *supra* note 1; Credit Suisse AG, *supra* note 66.

95 See Comprehensive Iran Sanctions, Accountability, and Divestment Act, 22 U.S.C.A. § 8513 (West 2010) (referencing USA PATRIOT Act, 31 U.S.C. § 5318(i) (2001)); *supra* notes 32-33, 42-43 and accompanying text.

96 U.S. DEP'T OF THE TREASURY, *supra* note 20.

97 22 U.S.C.A. § 8513(e)(2).

98 See Fitzgerald, *supra* note 6, at 981 (arguing that in a competitive marketplace even legitimate businesses will be disinclined to comply with regulations unless their competitors do the same, especially when the risk of being detected for a violation appears low).

Second, the incentives to comply with the statute are not apparent given the ambiguity in CISADA's language and OFAC's relatively weak implementation capabilities.

A. Tangible and Intangible Cost-Benefit Considerations

Cost-benefit analysis for financial institutions focuses in large part on tangible concerns, such as the potential loss of profits due to the exclusion of transactions with certain foreign clients.⁹⁹ Due to the severe consequences of illicitly assisting Iranian actors,¹⁰⁰ a high profit margin exists for risky financing of Iranian actors through correspondent banking accounts.¹⁰¹ In addition, sanctions put United States companies at a competitive disadvantage with respect to potentially lucrative projects in Iran.¹⁰² Indeed, the costs of sanctions can be very large for United States financial institutions, especially when a major economic force, such as Iran and its oil market, is prohibited from United States investment or financial transactions.¹⁰³ Based on these incentives, financial institutions are disinclined to perform extensive due diligence that limits their business operations and profitability with foreign financial institutions if they do not think their competitors will do the same.¹⁰⁴

99 See Charles Breckinridge, *Sanction First, Ask Questions Later: The Shortsighted Treatment of Iran Under the Iran and Libya Sanctions Act of 1996*, 88 GEO. L.J. 2439, 2460 (2000) (stating that sanctions commercially injure United States companies that cannot participate in valuable Iranian projects).

100 See Orde F. Kittrie, *New Sanctions for a New Century: Treasury's Innovative Use of Financial Sanctions*, 30 U. PA. J. INT'L L. 789, 797-98 (2009) (detailing that eighty banks globally have withdrawn from Iran and leading financial institutions have scaled back their business with Iran).

101 Cf. Breckinridge, *supra* note 99, at 2460-62 (illustrating how companies that avoided United States sanctions have obtained lucrative Iranian projects).

102 See *id.* (declaring that United States companies were excluded from valuable Iranian projects because of sanctions).

103 See CONGRESSIONAL BUDGET OFFICE, THE DOMESTIC COSTS OF SANCTIONS ON FOREIGN COMMERCE, at IX, 6, 10 (1999), available at <http://www.cbo.gov/ftpdocs/11xx/doc1133/tradesanc.pdf> (reporting that sanctions increase the cost of foreign investment and exporting and importing goods and services to sanctioned companies, particularly in markets with no readily available substitutes).

104 See Fitzgerald, *supra* note 6, at 981 (contending that in a competitive marketplace businesses will be disinclined to screen all transactions in compliance with regulations unless their competitors do the same).

The lack of available information about OFAC sanction enforcement cases further complicates the cost-benefit analysis of lucrative correspondent banking accounts, leading financial institutions to feel insulated from the risk of being detected for violations.¹⁰⁵ In particular, OFAC does not publicize information about the effectiveness of its sanctions implementation efforts, making the risk of prosecution appear minimal.¹⁰⁶ Until the early 1990s, OFAC only directly provided major commercial banks with information about rules implementing sanctions.¹⁰⁷ OFAC also posted notices of licenses and changes in the Treasury Department Annex Building¹⁰⁸ and responded to inquiries from other institutions that had compliance questions.¹⁰⁹ Even today, OFAC uses a variety of distribution methods that contain varying levels of detail, including the Federal Register, press releases, and OFAC's website.¹¹⁰

OFAC also does not enforce economic sanction regulations strictly due to resource constraints and policy considerations of balancing business needs¹¹¹ with anti-terrorism and nonproliferation objectives.¹¹² In the past, the United States' interest in avoiding conflicts with companies and political allies resulted in erratic enforcement of financial sanctions.¹¹³ More importantly, OFAC has a lack of funding for its ever-enlarging role as the implementation and enforcement branch of economic sanctions.¹¹⁴

105 See Fitzgerald, *supra* note 6, at 981 (maintaining that businesses perceive the risk of OFAC enforcement of a sanction violation as low).

106 *Id.*

107 Peter L. Fitzgerald, "If Property Rights Were Treated Like Human Rights, They Could Never Get Away With This": *Blacklisting and Due Process in U.S. Economic Sanctions Programs*, 51 HASTINGS L.J. 73, 120-21 (1999).

108 *Id.* at 121.

109 *Id.*

110 See *id.* at 123, 128.

111 Fitzgerald, *supra* note 6, at 963, 980-81.

112 U.S. DEP'T OF THE TREASURY, *supra* note 20.

113 See Breckinridge, *supra* note 99, at 2452 (citing the Clinton administration's sporadic enforcement of the Iran and Libya Sanctions Act to avoid upsetting foreign allies).

114 See Fitzgerald, *supra* note 6, at 962 (outlining the funding issues for OFAC's vast sanction program duties that impair OFAC's ability to handle additional sanctions); Office

OFAC's workforce and budget are distributed among licensing and sanction program responsibilities, in addition to enforcing civil penalties for violations.¹¹⁵ Furthermore, OFAC oversees nineteen sanction programs.¹¹⁶ As a result of OFAC's limited capacity to oversee and enforce its numerous sanction programs,¹¹⁷ it is likely that financial institutions are going to trivialize the risk of being prosecuted for a violation of CISADA. It may be quite profitable to pursue risky behavior due to this low likelihood of penalties, and, as a result, the incentive to self-report violations is virtually nonexistent.

Despite an increase in suspicious activity reports filed by financial institutions since the enactment of the USA PATRIOT Act in 2001,¹¹⁸ due diligence has not necessarily improved.¹¹⁹ Rather, financial institutions may be participating in "defensive filing" to protect themselves from penalties without improving their oversight.¹²⁰ As a result, OFAC must now sift

of Foreign Assets Control, *supra* note 56.

115 Office of Foreign Assets Control, Civil Penalties and Enforcement Information, <http://www.treasury.gov/resource-center/sanctions/CivPen/Pages/civpen-index2.aspx> (last visited on Jan. 13, 2011); Office of Foreign Assets Control, Sanctions Programs, <http://www.treasury.gov/resource-center/sanctions/Programs/Pages/Programs.aspx> (last visited on Jan. 13, 2011); *see* Office of Foreign Assets Control, OFAC Reporting and License Application Forms, <http://www.treasury.gov/resource-center/sanctions/Pages/forms-index.aspx> (last visited on Jan. 13, 2011) (providing license applications relating to sanctioned country programs).

116 Office of Foreign Assets Control, Sanctions Programs, <http://www.treasury.gov/resource-center/sanctions/Programs/Pages/Programs.aspx> (last visited on Jan. 13, 2011).

117 Fitzgerald, *supra* note 6, at 962.

118 FINANCIAL CRIMES ENFORCEMENT NETWORK, THE SAR ACTIVITY REVIEW: BY THE NUMBERS (2008), *available at* http://www.fincen.gov/news_room/rp/files/sar_by_num_09.pdf (showing a growth of over five times the number of suspicious activity reporting from 2001 to 2006).

119 *See* Michael Levi & Peter Reuter, *Money Laundering*, 34 CRIME & JUST. 289, 340-42 (2006) (suggesting that the increase in suspicious activity reporting may be a result of banks filing to protect themselves without improving due diligence).

120 *See* Indranil Ganguli et al., *Third AML-Directive: Europe's Response to the Threat of Money Laundering and Terrorist Financing: Part III*, 126 BANKING L.J. 787, 813-14 (2009) (describing the trend in over-compliance with suspicious activity reporting by United States financial institutions to avoid the risk of fines); Levi, *supra* note 119 (noting that an increase in suspicious activity reporting to protect banks may not correlate with improved due diligence efforts).

through an even higher volume of potentially non-credible suspicious activity reports in order to find legitimate threats, further taxing OFAC's capacity.¹²¹

The cost-benefit analysis of complying with financial regulations on correspondent banking accounts also includes intangible considerations, such as damage to an institution's reputation should it be prosecuted for violating CISADA.¹²² The damage to reputation could be devastating given the highly emotional United States foreign policy objectives behind CISADA: the prevention of instability and danger that will almost certainly exist if Iran, a sponsor of extraterritorial terrorism, successfully develops a nuclear weapons program.¹²³ In addition, foreign financial institution violators could damage the reputation of countries in which they are jurisdictionally domiciled, potentially causing political and financial conflicts for countries that have supported United Nations sanctions against Iran's nuclear program.¹²⁴

Finally, the cost-benefit analysis for financial institutions includes the actual costs of complying with the strict financial sanctions under CISADA.¹²⁵ OFAC creates a new set of regulations every time new economic sanctions must be implemented.¹²⁶ However, OFAC has not

121 Cf. Ganguli, *supra* note 120 (warning that the increased number of tenuously based suspicious activity reports poses a serious challenge to the Financial Crimes Enforcement Network's institutional capacity).

122 See Benjamin Mojuye, *What Banks Need to Know About the Patriot Act*, 124 BANKING L.J. 258, 272 (2007) (stating that financial institutions will likely suffer severe reputation damage for anti-money laundering sanction violations).

123 See U.S. DEPT OF THE TREASURY, *supra* note 20 (emphasizing the threat an Iranian nuclear weapon poses to United States and global security); Andrew Hudson, *Not a Great Asset: The UN Security Council's Counter-Terrorism Regime: Violating Human Rights*, 25 BERKELEY J. INT'L L. 203, 206 (2007) (reporting on the stigma attached to being a terrorist supporter); U.S. Department of State, Background Note: Iran, <http://www.state.gov/r/pa/ei/bgn/5314.htm> (last visited Jan. 13, 2011) (declaring that Iran is known for supporting terrorism abroad).

124 See Kittrie, *supra* note 100, at 816-17 (emphasizing the reputational risk to foreign financial institutions and foreign governments of handling illicit business with Iran that is contrary to international law); U.S. Dep't of the Treasury, *supra* note 20.

125 See Peter L. Fitzgerald, *Smarter "Smart" Sanctions*, 26 PENN ST. INT'L L. REV. 37, 51 (2007) (arguing that OFAC needs to make the sanction compliance costs for financial institutions more commercially feasible).

126 Fitzgerald, *supra* note 6, at 966.

collaborated with the regulated community to ensure that implementation is commercially practicable for all members.¹²⁷ The burden of performing audits, reporting, certification, and due diligence in determining the identification and innocence of all users of a correspondent banking account under CISADA may be prohibitive for smaller financial institutions.¹²⁸

The implementation costs for CISADA are diverse. Compliance program costs include: (1) additional personnel for oversight; (2) personnel training to identify and manage correspondent banking risks; (3) software for automated review of wire transfers; and (4) productive hours spent on performing compliance tasks, including filing forms, certification, coordination between bankers and compliance personnel, and creating effective implementation programs.¹²⁹ All of these costs potentially detract from a financial institution's ability to engage in activities that are more profitable. In addition, the virtually limitless amount of public information available about certain foreign financial institutions could make performance of due diligence prohibitively time consuming and expensive.¹³⁰ Furthermore, obtaining certification that foreign financial institutions do not provide services to shell banks¹³¹ and obtaining lists of foreign bank customers may be impracticable under foreign bank secrecy laws in certain countries.¹³²

127 Fitzgerald, *supra* note 6, at 964, 981 (advising OFAC to consult with the regulated community to determine what compliance programs would not be overly burdensome).

128 22 U.S.C.A. § 8513(e)(1)(A-D); *cf.* Robert E. O'Leary, *Improving the Terrorist Finance Sanctions Process*, 42 N.Y.U. J. INT'L L. & POL. 549, 568 (2010) (asserting that the burden on small charities to ensure the final use of its contributions will not violate sanctions may be too high).

129 See MINORITY STAFF OF THE S. PERMANENT SUBCOMM. ON INVESTIGATIONS, 107TH CONG., REP. ON CORRESPONDENT BANKING: A GATEWAY FOR MONEY LAUNDERING, at 1, 11, (2001), available at http://hsgac.senate.gov/psi_finalreport.pdf.

130 Special Due Diligence Programs for Certain Foreign Accounts, 71 Fed. Reg. 496, 502 (Jan. 4, 2006).

131 Correspondent Accounts for Foreign Shell Banks, 67 Fed. Reg. 60,562, 60,568 (Sept. 26, 2002) (to be codified at 31 C.F.R. pt. 103).

132 See Special Due Diligence Programs for Certain Foreign Accounts, 72 Fed. Reg. 44,768, 44,771 (Aug. 9, 2007) (outlining potential issues obtaining lists of foreign bank customers for correspondent banking accounts because of privacy laws in foreign countries); see also MINORITY STAFF OF THE S. PERMANENT SUBCOMM. ON

OFAC has responded to these concerns by emphasizing a risk-based approach to the implementation of CISADA regulations.¹³³ This approach focuses on the history of the foreign financial institution's practices, as well as the nature of the correspondent banking account, to determine the probability that the foreign financial institution will engage in illicit correspondent banking activities.¹³⁴ Unfortunately, this highly discretionary risk-based approach highlights a major challenge to successful implementation of CISADA. The lack of clear obligations in the regulatory language of CISADA undermines compliance due to general uncertainty concerning requirements and the possibility of abuse of language ambiguities.¹³⁵ This is particularly problematic because the success of the reporting, certification, and compliance program requirements under CISADA¹³⁶ depends almost exclusively on self-reporting by financial institutions.¹³⁷ Financial institutions are faced with a compliance paradigm that provides an incentive to cheat: either over-comply with suspicious activity reporting to avoid violation penalties without improving due diligence procedures¹³⁸ or avoid self-reporting entirely since it is statistically unlikely that OFAC will enforce any violations.¹³⁹ As a result,

INVESTIGATIONS, 107TH CONG., REP. ON CORRESPONDENT BANKING: A GATEWAY FOR MONEY LAUNDERING, at 39-40, (2001), *available at* http://hsgac.senate.gov/psi_finalreport.pdf (finding that bank secrecy laws stop the flow of information necessary to identify money launderers).

133 *See* Special Due Diligence Programs for Certain Foreign Accounts, 71 Fed. Reg. at 502 (regulating that United States financial institutions must maintain adequate due diligence policies and procedures to evaluate the money laundering risks posed by correspondent accounts and to detect and report any suspected or known money laundering activity under OFAC's risk-based approach to implementing CISADA). Factors to consider in the risk-based approach include the nature of: (1) the foreign financial institution's business and markets; (2) the United States institution's relationship with the foreign institution; and (3) the correspondent account type. *Id.*

134 *Id.* at 502-03.

135 *See* Fitzgerald, *supra* note 125, at 38 (positing that greater certainty regarding regulatory obligations would improve compliance).

136 Comprehensive Iran Sanctions, Accountability, and Divestment Act, 22 U.S.C.A. § 8513(e)(1)(B)-(D) (West 2010).

137 *See id.* § 8513(e)(1)(B); Fitzgerald, *supra* note 6, at 964 (stating that the effectiveness of OFAC's regulations depends more upon voluntary compliance by businesses than OFAC enforcement).

138 Ganguli, *supra* note 120.

139 *Cf.* Fitzgerald, *supra* note 6, at 981 (arguing that businesses will not screen all

financial institutions may become complacent in reviewing their correspondent banking accounts,¹⁴⁰ with potentially dire consequences for United States national security.¹⁴¹

B. Mixed Incentives Stemming from Ambiguous Language and Requirements

The lack of clarity in CISADA's statutory language and subsequent OFAC regulations creates additional uncertainty for financial institutions beyond the confusion caused by OFAC's ambiguous risk-based approach to implementation.¹⁴² For instance, certification that a foreign financial institution's customer is not knowingly engaging in activity to assist Iran's WMD program is required to be "to the best of the knowledge of the domestic financial institution."¹⁴³ This gives little guidance about the minimum requirements that qualify as having "knowledge" about illegal correspondent banking activities under CISADA.¹⁴⁴

OFAC recently attempted to address this problem by promulgating definitions for terms in CISADA. OFAC designated "knowingly" to mean that an actor had "actual knowledge, or should have known, of the conduct, the circumstance, or the result."¹⁴⁵ Even though "actual knowledge" is

transactions in compliance with regulations in order to remain competitive, especially when the risk of OFAC enforcement of a sanction violation is perceived as low).

140 Cf. Lawrence A. Cunningham, *Evaluation and Response to Risk by Lawyers and Accountants in the U.S. and E.U.*, 29 J. Corp. L. 267, 305 (2004) (explaining that audit controls under the USA PATRIOT Act provide assurances but also can create complacency).

141 See U.S. DEPT OF THE TREASURY, *supra* note 20 (emphasizing the importance of freezing money intended for WMD proliferation).

142 See Special Due Diligence Programs for Certain Foreign Accounts, 72 Fed. Reg. 44,768, 44,769 (Aug. 9, 2007) (highlighting privacy laws in foreign countries that may inhibit identifying all correspondent bank account users through due diligence); Special Due Diligence Programs for Certain Foreign Accounts, 71 Fed. Reg. 496, 502 (Jan. 4, 2006) (elucidating concerns about due diligence procedures); Correspondent Accounts for Foreign Shell Banks, 67 Fed. Reg. 60,562, 60,568 (Sept. 26, 2002) (to be codified at 31 C.F.R. pt. 103) (commenting on potential certification issues).

143 Comprehensive Iran Sanctions, Accountability, and Divestment Act, 22 U.S.C.A. § 8513(e)(1)(C) (West 2010).

144 22 U.S.C.A. § 8513(e)(1)(C).

145 Iranian Financial Sanctions Regulations, 75 Fed. Reg. 49,836, 49,840 (Aug. 16, 2010)

usually interpreted to mean “direct or clear knowledge,”¹⁴⁶ the definition for “should have known” in OFAC's regulations remains discretionary. The term “should have known” could refer to constructive knowledge acquired when “a person exercising due diligence should have discovered the probability” or had “reason to suspect the probability of any manner of wrongdoing.”¹⁴⁷ However, the term could instead refer to a person acquiring knowledge through actual perception or observation of the event or activity.¹⁴⁸ These varied standards of knowledge enable financial institutions to determine their compliance with CISADA in a number of different ways, depending on what is most convenient to their purposes, which will likely result in less effective overall implementation of the statute.

CISADA's statutory language is equally ambiguous when defining due diligence requirements, referring simply to the USA PATRIOT Act's due diligence procedures.¹⁴⁹ Under the USA PATRIOT Act, there is a requirement of general due diligence to identify actors and report suspicious activities.¹⁵⁰ The procedures for general due diligence only expressly include the use of “appropriate” policies and procedures to detect money laundering and ascertain the identity of nominal and beneficial owners.¹⁵¹ The difficulty in interpreting these due diligence standards under CISADA becomes apparent in the implementation stage. The term “appropriate” gives virtually unlimited discretion to financial institutions to determine how actively they will monitor correspondent banking accounts for statutory compliance.

Fortunately, CISADA also incorporates the enhanced due diligence requirements under the USA Patriot Act, which are more clearly written.

(to be codified at 31 C.F.R. pt. 561).

146 *Williams v. Great W. Cas. Co.*, No. 5:08CV137, 2009 WL 4927710, at *4 (N.D.W. Va. 2009).

147 *Zola v. Gordon*, 685 F. Supp. 354, 367 (S.D.N.Y. 1988).

148 *See United State v. Sinclair*, 109 F. 3d 1527, 1536 (10th Cir. 1997).

149 22 U.S.C.A. § 8513(e)(1)(D) (referencing USA PATRIOT Act, 31 U.S.C. § 5318(i) (2006)).

150 31 U.S.C. § 5318(i)(3)(A)-(B).

151 *Id.* § 5318(i)(1)(3)(A).

Enhanced due diligence applies if the actor has been specifically designated by OFAC as requiring special measures relating to money laundering concerns. Enhanced due diligence is also required if the actor has an offshore banking license that prohibits conducting banking activities onshore with the country that issued the license.¹⁵² The enhanced due diligence procedures are more specific than the general due diligence procedures, and it limits application to pre-designated and offshore actors. These procedures require United States financial institutions to determine the identity of all owners of the foreign bank and any additional foreign financial institutions using that bank for correspondent banking activities.¹⁵³ United States financial institutions must also conduct enhanced scrutiny of account activities under these due diligence procedures.¹⁵⁴

Importantly, while the enhanced due diligence procedures are relatively straightforward, the majority of due diligence implementation will occur under the regular due diligence requirements. If an actor is not blacklisted by OFAC or operating on an offshore license, the actor is not subject to enhanced due diligence requirements. Financial institutions must determine what constitutes “appropriate” due diligence procedures and to whom those procedures should apply. This makes implementation of CISADA due diligence requirements discretionary and likely inconsistent among financial institutions.

Overall, the perceived costs and benefits of compliance with CISADA for financial institutions make effective implementation and self-reporting of violations unlikely. Difficulties in interpreting how to implement CISADA, lack of OFAC enforcement and oversight, costs of compliance programs, and potential loss of profits weigh heavily against effective implementation and compliance. Greater oversight and enforcement that is more stringent are needed to increase reputational costs and tip the cost-benefit analysis for financial institutions towards full compliance.

¹⁵² *Id.* § 5318(i)(2)(A)(i)-(ii).

¹⁵³ *Id.* § 5318(i)(2)(B)(i)(iii).

¹⁵⁴ *Id.* § 5318(i)(2)(B)(ii).

Part IV: Measures to Enhance CISADA Effectiveness Domestically

Implementation of three key enforcement tools and legal standards could enhance CISADA's effectiveness: (1) an enforcement body in OFAC; (2) a safe harbor clause for innocent mistakes resulting in violations of CISADA; and (3) clarified statutory language.

A. Enforcement Body

OFAC needs an enforcement body to gather intelligence and investigate suspected violations.¹⁵⁵ Currently, OFAC relies upon information from self-reporting financial institutions¹⁵⁶ and coordination with other government agencies, including the Departments of State, Defense, Commerce, Homeland Security, and Justice.¹⁵⁷ An enforcement body would enable OFAC to obtain firsthand information about suspicious activities to supplement potential gaps created by a lack of incentive to self-report¹⁵⁸ or a lack of inter-governmental coordination. This would increase the efficiency and speed of OFAC investigations and enforcement of CISADA. As a result, financial institutions would likely comply more fully with CISADA because of the increased chance in violation detection and punishment.¹⁵⁹ Financial institutions would almost certainly act to avoid civil and criminal penalties and reputational harm that damage their bottom line.¹⁶⁰

OFAC can use the Department of Commerce's Office of Export Enforcement ("OEE") under the Bureau of Industry and Security as a useful

155 Cf. O'Leary, *supra* note 128, at 574-79 (advocating the creation of a National Security Sanctions Court to oversee OFAC designations so OFAC can focus on building evidence against violators).

156 See *supra* note 22 and accompanying text.

157 See U.S. DEP'T OF THE TREASURY, *supra* note 20, at 47 (listing collaboration between the U.S. Department of the Treasury and other United States agencies on strategic goals).

158 See Fitzgerald, *supra* note 6, at 979-981 (arguing that the lack of highly visible enforcement actions creates an incentive to not comply because it seems unlikely that violations will be enforced).

159 Cf. Fitzgerald, *supra* note 6, at 981 (stating that businesses ignore OFAC's regulations because they perceive a low risk of enforcement of violations).

160 See Fitzgerald, *supra* note 125 (revealing that financial institutions are reducing business with Iran to avoid reputational harm and fines).

model of an enforcement body.¹⁶¹ OEE operates in nine United States field offices and employs law enforcement officers to conduct investigations of export violations.¹⁶² In addition, OEE trains agents to conduct site visits to determine the level of risk involved with certain controlled item exports.¹⁶³ Like OFAC, OEE utilizes information from a variety of sources, including voluntary self-disclosures of violations.¹⁶⁴ However, OEE's ability to collect its own intelligence and use trained law enforcement officers for compliance makes OEE's enforcement efforts more agile, more direct, and more likely to catch and deter noncompliance than OFAC's near-total reliance on self-disclosures.¹⁶⁵

An OFAC enforcement body modeled on OEE's site inspection agents would increase direct oversight on compliance programs and procedures under CISADA.¹⁶⁶ OFAC would be better able to review suspicious activity and require the performance of independent audits to satisfy any concerns relating to a United States correspondent banking account with a foreign financial institution.¹⁶⁷ Audits are a critical component of verifying the adequacy of the compliance programs required by CISADA; thus, an enforcement body that could oversee appropriate independent auditing would be extremely useful in advancing CISADA's policy objective of preventing Iranian proliferation.¹⁶⁸ Similarly, an enforcement body would be able to verify certifications that foreign financial institutions were not knowingly engaging in proliferation-related

161 Bureau of Industry and Security, Export Enforcement, <http://www.bis.doc.gov/complianceandenforcement/index.htm#oee> (last visited on Jan. 13, 2011).

162 *Id.*

163 *Id.*

164 *Id.*

165 See Bureau of Industry and Security, *supra* note 161; *supra* note 22 and accompanying text.

166 See Comprehensive Iran Sanctions, Accountability, and Divestment Act, 22 U.S.C.A. § 8513 (West 2010); Bureau of Industry and Security, *supra* note 161.

167 See Cunningham, *supra* note 140, at 295 (audits provide assurances of compliance).

168 See Gregory Husisian, *U.S. Regulation of International Financial Institutions: It's Time for an Integrated Approach to Compliance*, 127 Banking L.J. 195, 198 (2010) (stating that independent auditing is essential to confirm compliance with sanction regulations).

activity.¹⁶⁹ Furthermore, direct oversight of due diligence procedures and internal controls would improve implementation of CISADA¹⁷⁰ while enabling financial institutions to interact more closely with OFAC and enhance the efficacy of their compliance programs.

An OFAC enforcement body that provides effective sanction oversight and enforcement would greatly strengthen CISADA's ability to deter illicit use of correspondent banking in the United States. For instance, the case studies of Barclays, Lloyds, and Credit Suisse suggest that monetary fines and possible damages to corporate reputations are insufficient to deter illicit financial activities with Iranian clients.¹⁷¹ However, if OFAC would continue to aggressively pursue sanction violations by high profile foreign financial institutions through an enforcement body, it would probably win large civil penalty settlements for these violations.¹⁷² As a result, OFAC enforcements would have an increasingly strong deterrent effect on future violations.

The potential precedent set by future cases similar to Barclays, Lloyds, and Credit Suisse would discourage foreign financial institutions from pursuing correspondent banking with the United States on behalf of individuals linked to Iran's WMD program.¹⁷³ First, financial institutions would comply with CISADA to protect their profits, especially if they perceive their competitors as being compelled to comply fully with CISADA as well.¹⁷⁴ Second, if the international community continues to agree on the central importance of curtailing Iran's pursuit of WMD, particularly nuclear weapons,¹⁷⁵ the cost of reputational damage if prosecuted for violating CISADA would continue to increase.¹⁷⁶ An

169 See 22 U.S.C.A. § 8513(e)(1)(C).

170 See *id.* § 8513(e)(1)(D).

171 See *supra* Part II.

172 See *supra* notes 91-93 and accompanying text.

173 See *supra* notes 91-93 and accompanying text.

174 See Fitzgerald, *supra* note 6, at 981.

175 See *supra* note 16.

176 See Kittrie, *supra* note 100, at 816-17 (outlining the reputational risk to United States and foreign financial institutions of handling illegitimate business with Iran).

efficient OFAC enforcement body would increase awareness and concern over sanction enforcement among foreign financial institutions with the result being an increase in CISADA's deterrent effect.¹⁷⁷

Although a more effective implementation of CISADA would likely cause foreign financial institutions to rethink assistance to Iran's WMD program, foreign financial institutions could simply shift from the United States banking system to other major financial systems in the European Union ("EU") or Asia.¹⁷⁸ However, the use of other systems to avoid United States sanction penalties would probably not be particularly profitable or successful at money laundering or otherwise illicitly funding the Iranian WMD program.¹⁷⁹ Correspondent banking tends to be a concentrated industry due to economies of scale that can be achieved by large-scale correspondent banking practices.¹⁸⁰ In particular, the United States banking system is a large market for correspondent banking accounts due to the United States' importance to international trade and the high demand for the United States dollar.¹⁸¹

In addition, a growing international consensus that Iran must be prevented from developing nuclear weapons has resulted in autonomous sanctions from the EU, Canada, and Japan prohibiting correspondent banking accounts with Iranian banks.¹⁸² While none of these sanctions go as

177 See *supra* notes 158-159 and accompanying text.

178 See Kittrie, *supra* note 100, at 815 (reporting that many foreign financial institutions have responded to United States' sanctions by terminating business with Iran in United States dollars but not other currencies).

179 See *id.* (stating that most major foreign financial institutions have drastically reduced business with Iran).

180 See R. Alton Gilbert, *Economies of Scale in Correspondent Banking*, 15 J. MONEY, CREDIT & BANKING 483 (1983) (explaining that a correspondent bank that services numerous clients experiences economies of scale compared to a smaller correspondent bank because it has greater stability in its balances, which lowers transaction costs when managing its reserve position).

181 See *supra* note 15 and accompanying text.

182 See Council Common Position (EC) No. 2007/140/CFSP of 26 July 2010, art.11, L 195/45; Canada Ministry of Foreign Affairs and International Trade, Statement by Minister Cannon on Iran Sanctions, <http://www.international.gc.ca/media/aff/news-communicues/2010/237.aspx?lang=eng> (last visited on Jan. 13, 2011); Japan Ministry of Foreign Affairs, Accompanying Measures Pursuant to United Nations Security Council Resolution 1929, http://www.mofa.go.jp/region/middle_e/iran/measures_unsc_1009.html

far as CISADA in restricting correspondent banking transactions with any financial institution linked to Iranian proliferation,¹⁸³ they represent strong support for the nonproliferation foreign policy goals of the United States.¹⁸⁴ Furthermore, the EU's Third Anti-Money Laundering Directive requires all EU correspondent banking accounts with foreign financial institutions to exercise stringent due diligence requirements,¹⁸⁵ similar to CISADA's enhanced due diligence procedures.¹⁸⁶ This is vital to the success of CISADA because the EU, Canada, and Japan represent significant financial actors in the international banking system outside of the United States. The general support of these countries for financial sanctions to halt Iranian development of a WMD program¹⁸⁷ will likely reduce the ability of foreign financial institutions to evade United States restrictions on correspondent banking by using other major banking systems.

The significant drawback of this proposed enforcement body is its expense, given OFAC's financially strained condition.¹⁸⁸ Although funding is a serious problem, the United States government has repeatedly demonstrated its commitment to combating money laundering and illicit financial activities that support proliferation of WMD.¹⁸⁹ Congress has demonstrated a strong intent to protect United States national security through the implementation of economic sanctions.¹⁹⁰ Therefore, Congress should be willing to invest in a tool that would drastically improve the successful implementation of non-proliferation policies.

(last visited on Jan. 13, 2011).

183 See Comprehensive Iran Sanctions, Accountability, and Divestment Act, 22 U.S.C.A. § 8513(c)(1) (West 2010); *supra* note 182 and accompanying text.

184 See U.S. DEP'T OF THE TREASURY, *supra* note 20.

185 Council Directive 2005/60/EC, art. 13, ¶ 3, 2005 O.J. (L 309) 25.

186 22 U.S.C.A. § 8513(c)(1)-(2).

187 See *supra* note 182 and accompanying text.

188 Fitzgerald, *supra* note 6, at 962-65.

189 See 22 U.S.C.A. §§ 8512-31; Bank Secrecy Act, Pub. L. No. 91-508, 84 Stat. 1114 (1970) (codified as amended at 12 U.S.C. §§ 1829b, 1951-59 (2006) and at 31 U.S.C. §§ 5311-32 (2006)); USA PATRIOT Act, Pub. L. No. 107-56, §§ 301-77, 115 Stat. 272, 296-342 (2001) (codified as amended in scattered sections of U.S.C.).

190 See 12 U.S.C. §§ 1829b, 1951-59; 22 U.S.C.A. §§ 8512-31; 31 U.S.C. §§ 5311-32.

In addition, an enforcement body would enjoy some economies of scale from the United States government, which already coordinates with numerous agencies that gather intelligence on terrorism and WMD proliferation.¹⁹¹ Information sharing would enable the government to reduce costs by synergizing efforts to gather and analyze information. Finally, increased future compliance due to the enhanced capability of the enforcement body to prosecute violations of CISADA would eventually reduce the oversight and prosecution costs of the body.

B. Safe Harbor

OFAC should create a safe harbor clause under CISADA for financial institutions that comply with the statute but make an innocent mistake or technical violation.¹⁹² This clause could be modeled on CISADA's safe harbor clause for insurance underwriters who are exempt from liability for innocent mistakes if they practiced due diligence procedures and controls.¹⁹³ An innocent mistake would not constitute a violation of CISADA where (1) the U.S. financial institution had no knowledge that a foreign financial institution was linked to Iran's WMD program; (2) the U.S. financial institution had no bad faith intent to circumvent CISADA; and (3) the facts relating to the foreign financial institution could reasonably be interpreted by the U.S. financial institution to not represent a potential violation of CISADA.¹⁹⁴

Implementation of CISADA can be very complicated, especially for smaller financial institutions with more limited resources¹⁹⁵ for compliance

191 See *supra* note 157 and accompanying text.

192 See Fitzgerald, *supra* note 125, at 46 (advocating for a safe harbor from liability for innocent mistakes).

193 COMMITTEE OF CONFERENCE, H.R. COMM. ON FOREIGN AFFAIRS, 111TH CONG., JOINT EXPLANATORY STATEMENT: H.R. 2194, THE COMPREHENSIVE IRAN SANCTIONS, ACCOUNTABILITY, AND DIVESTMENT ACT OF 2010 REPORT, at 12 (2010), available at http://www.hcfa.house.gov/111/press_062410d.pdf. The safe harbor sanctions exemption is designed to protect insurance underwriters who use due diligence practices but inadvertently provide insurance for activities that could contribute to Iran's ability to import refined petroleum. *Id.*

194 See *United States v. N. Pac. Ry. Co.*, 242 U.S. 190, 194 (1916) (outlining the factors involved in an innocent mistake analysis).

195 See *supra* note 128 and accompanying text.

personnel and software;¹⁹⁶ thus, the odds that an innocent mistake will occur are reasonably high. The complexity of due diligence screening for customer identification information, performing independent audits and certifications, and reporting suspicious activities related to Iranian proliferation efforts is immense, particularly for smaller institutions.¹⁹⁷ In addition, certification that foreign clients are not knowingly engaging in proliferation-related activities and the establishment of due diligence policies under CISADA¹⁹⁸ can be complex and fraught with potential areas for innocent mistakes.

As a result, financial institutions are unlikely to report unintentional violations if the mere act of reporting the violation will result in penalties. A safe harbor clause would improve self-reporting by financial institutions that made an innocent mistake and want to rectify their compliance programs and efforts. Unfortunately, the innocent mistake test that would be applied to the safe harbor clause is imperfect. Specifically, the presumption in favor of a U.S. financial institution's reasonable interpretation of the facts surrounding whether a foreign financial institution is in violation of CISADA is subjective. Nonetheless, the knowledge and bad faith elements can be analyzed objectively based on evidence from the recordkeeping, reporting, and due diligence efforts of the United States financial institution.¹⁹⁹

C. Clarification

OFAC should also clarify certain terms and how to interpret them to enhance compliance with CISADA. First, OFAC should establish minimal requirements for compliance procedures based on financial institution size²⁰⁰ and risk assessments of potential financial partners.²⁰¹ This would

196 See MINORITY STAFF OF THE S. PERMANENT SUBCOMM. ON INVESTIGATIONS, 107TH CONG., REP. ON CORRESPONDENT BANKING: A GATEWAY FOR MONEY LAUNDERING, at 1, 11, (2001), available at http://hsgac.senate.gov/psi_finalreport.pdf.

197 See *supra* note 128 and accompanying text.

198 22 U.S.C.A. § 8513(e)(1)(C-D).

199 See 242 U.S. at 194 (stating that innocent mistakes should be excused based on evidence of good faith).

200 See Fitzgerald, *supra* note 125 (explaining that OFAC needs to make the costs of sanction compliance for smaller financial institutions more commercially feasible); cf. O'Leary, *supra* note 128 (highlighting that the burden on small charities to ensure the final use of its contributions will not violate sanctions may be too high).

help reduce the burden on small institutions by allowing them to have a more simplified compliance package tailored to their specific needs and limitations.

Second, OFAC should clarify factors that weigh into the materiality of a violation under CISADA and the related penalty scheme. Based on OFAC considerations in previous economic sanction settlements, factors to clarify the materiality of the violation should include: (1) the institutionalization of internal procedures to evade CISADA;²⁰² (2) the extent of efforts to evade compliance, including omission or removal of information relating to a sanctioned entity;²⁰³ (3) the use of the ordering institution's information instead of the sanctioned entity's name, address, and account; and (4) the use of wire transfer filters to interdict and alter sanctioned entity transactions.²⁰⁴ The level of penalties associated with these varying degrees of material violations should follow a sliding scale similar to OFAC's settlement determinations. Factors to consider when weighing the penalty to apply should include whether a financial institution voluntarily terminates conduct, cooperates fully with OFAC, and demonstrates good conduct and full compliance in the future.²⁰⁵ As a result, more explicit guidelines pertaining to the materiality of CISADA violations and the corresponding penalties would likely deter flagrant violations.

It is possible that a sliding scale of penalties based largely on the level of cooperation of offending financial institutions during the settlement process will incentivize some financial institutions to evade sanctions and then present themselves as cooperative upon being caught for violations. However, good faith is implied in all of the elements OFAC considered in

201 Special Due Diligence Programs for Certain Foreign Accounts, 72 Fed. Reg. 44,768, 44,769 (Aug. 9, 2007); Special Due Diligence Programs for Certain Foreign Accounts, 71 Fed. Reg. 496, 502 (Jan. 4, 2006); *see also* Fitzgerald, *supra* note 125, at 52-53.

202 Credit Suisse AG, *supra* note 66, at ¶ 13.

203 *Id.* at ¶ 8.

204 Barclays Bank PLC, *supra* note 66, at ¶¶ 7, 8.

205 *See* Barclays Bank PLC, Office of Foreign Assets Control, MUL-488066, (Deferred Prosecution) (Aug. 18, 2010), *available at* <http://www.courthousenews.com/2010/08/19/Barclays.pdf> (weighing Barclay's violations and remedial actions in determining the details of the settlement agreement); United States v. Credit Suisse AG, No. 1:09-cr-00352-RCL (Deferred Prosecution) (D.D.C. Dec. 16, 2009) (calculating Credit Suisse's violations and remedial actions into the settlement agreement).

the prior enforcement settlements.²⁰⁶ Furthermore, OFAC can expressly make a showing of good faith a prerequisite for reducing penalties along the sliding scale. Clearer guidelines on materiality and penalty schemes would further deter cheating because financial institutions would be on notice of specific enforceable actions and the pursuant costs.

Finally, OFAC should improve the availability and clarity of information about designated entities, especially contact and account information, for financial institutions to confirm whether an actor is designated as being linked to Iran's WMD program.²⁰⁷ Increased publication of information about actors linked to Iranian proliferation through designation lists on the OFAC website would help prevent financial institution violations of CISADA and provide an affirmative conveyance of "knowledge" to trigger prosecution of any violations.²⁰⁸ A possible model to increase the availability of information about actors linked to Iranian proliferation is the Treasury's Weekly Bulletin Search in the Office of the Comptroller of the Currency.²⁰⁹ Creating a similar "bulletin" with information about mergers, addresses, branches, subsidiaries, and certifications for foreign financial institutions would substantially improve the ability of United States financial institutions to evaluate the risk of a potential correspondent banking client abroad.²¹⁰ This would help financial institutions to comply more accurately with CISADA while also allowing OFAC to share information about new front companies or other means of evasion that certain actors are currently utilizing to access the United States financial system.

206 *Id.*

207 Fitzgerald, *supra* note 125, at 41, 44.

208 See Fitzgerald, *Pierre Goes Online: Blacklisting and Secondary Boycotts in U.S. Trade Policy*, 31 VAND. J. TRANSNAT'L L. 1, 33 (1998) (affirming that a government declaration that an actor is linked to Iranian proliferation conveys affirmative knowledge about sanction violations).

209 Office of the Comptroller of the Currency, Weekly Bulletin Search, <http://www.occ.gov/tools-forms/tools/licensing/weekly-bulletin-corp-apps-search.html> (last accessed on Jan. 13, 2011).

210 *See id.*

Conclusion

CISADA represents a cumulative effort by the United States to prevent money laundering and illicit transactions that endanger United States national security.²¹¹ Unfortunately, the overall effectiveness of this statute and its compliance tools remains unclear. CISADA relies heavily on self-reporting, including user certifications based on the best knowledge of United States financial institutions,²¹² which may be deceived by ever-shifting front companies and evasive measures by Iran. Due diligence and audits for correspondent banking with foreign financial institutions may not be sufficient to protect against industrious Iranian actors.²¹³ Instead, OFAC needs to create an enforcement body to investigate potential violations, expressly include a safe harbor clause for innocent mistakes, and codify factors relating to materiality of violations and corresponding penalty schemes in order to increase compliance with CISADA. By reducing the burden of compliance for financial institutions and increasing the risk of being prosecuted for violations, OFAC can improve compliance with CISADA through clearer regulations and increased information sharing. In doing so, OFAC would protect more strongly the foreign policy objectives of the United States, including the prohibition of proliferator access to the United States banking system to pay for WMD-related components.²¹⁴

211 See 22 U.S.C.A. §§ 8512-31 (West 2010); *supra* notes 20, 25, 36 and accompanying text.

212 Comprehensive Iran Sanctions, Accountability, and Divestment Act, 22 U.S.C.A. § 8513(e)(1)(B-C) (West 2010).

213 *Id.* § 8513(e)(1)(A)(D).

214 U.S. DEP'T OF THE TREASURY, *supra* note 20.