
JOURNAL OF INTERNATIONAL COMMERCIAL LAW



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LOOKING THROUGH THE JUDICIAL LENS:
THE IMPLIED COVENANT OF GOOD FAITH AND FAIR DEALING
IN FRANCHISE RELATIONSHIPS

*Marvin E. Rooks**

INTRODUCTION

Oh frailty, thy name is contract, as the bard may have written in the Elizabethan times.¹ The law of contracts has undergone somewhat of a revolution, or evolution, in recent years and is continuing to evolve as it is shaped by the actions of legislators, the interpretations of courts, and most of all, the needs of the market place.² Law students enter into a labyrinth we call “Contracts I” and are generally given a historical perspective on the principles of contract. The students meet Rose the cow and are taught strict rules of how to form a contract and how to interpret a contract once it is formed.³ As all first-year law students learn within the first few weeks of their law school careers, there needs to be an offer followed by acceptance, both supported by consideration, in order for there to be a valid contract.⁴ This simple equation is the emphasis of nearly all of the early contract cases taught in law schools today.

It would also be fair to say, however, that many contract cases involve not just a single transaction between parties, but multiple transactions over an extended period of time. In such instances, the contracting parties often form a relationship that is not easily adjudicated under the most basic principles of contract law and is thereby subject to legal rules, presumptions, and equitable principles—such as the implied covenant of good faith and fair dealing—that are not always present in the express terms

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¹ Cf. WILLIAM SHAKESPEARE, *HAMLET* act. 1, sc. 2 (a play on Shakespeare’s oft quoted “[f]railty, thy name is woman”).

² Danielle Kie Hart, *Contract Law Now – Reality Meets Legal Fictions*, 41 U. BALT. L. REV. 1, 45 (2011).

³ *Sherwood v. Walker*, 33 N.W. 919, 920 (Mich. 1887).

⁴ 1 RICHARD A. LORD, *WILLISTON ON CONTRACTS* §§ 4:3, 6:1, 7:2 (4th ed. 2011).

of the contract and which are still being developed today.⁵ In modern times, a common form of such long-term contractual relationships arises in franchise agreements. As such, this article will critically examine recent developments by the courts of the implied covenant of good faith and fair dealing as applied to the franchise relationship, specifically the continuing debate regarding what principles govern the interpretation of a franchise agreement that is terminated before the contracted end date, and make recommendations as to the application of the implied covenant of good faith and fair dealing to the contractual relationship between franchisors and franchisees.

I. THE REALISTS ADDRESS THE PROBLEM OF HAL AND MARGE

The twentieth century saw a major movement in the interpretation of contracts, exemplified by the so-called “realist.”⁶ Karl Llewelyn and Soia Mentschikoff, the primary drafters of the Article II sales provision of the Uniform Commercial Code (“UCC”), were major proponents of the realist movement.⁷ The realists began by examining the real world of commercial law and commercial relationships and, based upon their observations, proposed the novel idea that, in addition to embodying a single or series of transactions, contracts can be viewed as a relationship that parties enter into in order to effectuate a mutual benefit.⁸ Among other endeavors, the realist sought to draft a code that would amend—or bend, depending upon your point of view—traditional contract concepts to be more user-friendly to the real world of commercial relations and thus provide a unified set of principles to govern commercial transactions.⁹ From such endeavor, the Uniform Commercial Code was born.¹⁰

The sales contract formation issues in Article II of the Uniform Commercial Code are a good illustration of the shift in contractual relations that was implemented by the realists.¹¹ Prior to the advent of the UCC, a sales contract required an offer from the prospective buyer and an

⁵ See Carmen D. Caruso, *Franchising's Enlightened Compromise: The Implied Covenant of Good Faith and Fair Dealing*, 26 *FRANCHISE L.J.* 207, 207–08 (2007).

⁶ Hart, *supra* note 2, at 30; see generally Karl N. Llewellyn, *What Price Contract? – An Essay in Perspective*, 40 *YALE L.J.* 704, 710 (1931).

⁷ John M. Breen, *Statutory Interpretation and the Lessons of Llewellyn*, 33 *LOY. L.A. L. REV.* 263, 268 (2000).

⁸ See Llewellyn, *supra* note 6, at 717.

⁹ See Breen, *supra* note 7, at 443.

¹⁰ *Id.*

¹¹ *Id.*; see Hart, *supra* note 2, at 30.

acceptance by the seller, both supported by consideration.¹² The seller's acceptance had to mirror the buyer's offer in all respects, meaning that the terms of the offer and acceptance had to be the same terms—colloquially called the “Mirror Image Rule.”¹³ If the seller's acceptance contained additional terms or terms that were inconsistent with the buyer's, then there was simply no contract, and the parties had to start over.¹⁴ The adoption of the UCC changed these long held principles in important ways so that the law better comported to the way that commercial transactions work in the real world.¹⁵

A simple hypothetical starring Hal and Marge exemplifies the real world of commercial transactions as observed by Llewellyn and Mentschikoff. In this hypothetical, Hal is the senior buyer for Acme Construction Company, and Marge is the purchasing agent for Smith Lumber Company. Hal and Marge have done business over the phone for twenty years with Hal purchasing all of his lumber needs for the construction company through Marge's lumber supply company. In a typical deal, Hal would telephone Marge and order a truck-load of lumber for a construction project. After exchanging pleasantries and asking about each others' families, Marge would say, “Yes, we have the lumber in stock, and the lumber can be delivered at this price, on this date, subject to these terms.” Hal would then mail (or, more recently, fax) a ten page purchase order to Marge, containing the terms discussed on the telephone on the first page and boiler plate language prepared by lawyers he had never met and which he would never read on the remaining nine pages. Buried on page seven would be a boilerplate provision stating that Hal's company, the buyer, would be entitled to any consequential damages that might arise as a result of faulty lumber. This meant that, in the future, if there was a personal injury that could be traced back to the lumber, Hal's company could seek compensation from the lumber supply company for any associated damages that exceeded the cost of the lumber.

Upon receiving Hal's purchase order, Marge would typically respond by sending a ten-page acknowledgement, with page one containing the terms discussed on the phone and the remaining nine pages containing boilerplate language that she has never read. Buried on page eight of Marge's acknowledgment was a provision stating that Marge's lumber

¹² LORD, *supra* note 4, at §§ 4:3, 6:1, 7:2.

¹³ See e.g., *Livingstone v. Evans*, [1925] 4 D.L.R. 769, 770–71 (Can. Alta. S.C.).

¹⁴ See LORD, *supra* note 4, at § 5:3; see also *Livingstone*, [1925] 4 D.L.R. at 770–71.

¹⁵ Russell A. Hakes, *Focusing on the Realities of the Contracting Process: An Essential Step to Achieve Justice in Contract Enforcement*, 12 DEL. L. REV. 95,112–13 (2011); see also U.C.C. § 2-207 (2011).

supply company would not be liable for any consequential damages as a result of the sale, and, if any personal injury occurred due to faulty lumber, Marge's company would be liable only for replacing the lumber.

Therefore, in a typical transaction between Hal and Marge, Hal's purchase order would contain an express consequential damages provision and Marge's acknowledgment would contain a directly conflicting waiver of consequential damages. As such, under the traditional principles of contract law, Hal and Marge were never parties to a contract because the offer (the purchase order) was not a mirror image of the acceptance (the acknowledgement),¹⁶ and, upon discovering this, Hal and Marge would have to completely start over in their business dealings.¹⁷

However, Llewellyn and Mentschikoff, who observed that such strict contract interpretation is not consistent with the commercial realities of the twentieth century, stepped in with the more lenient provisions of Article II of the UCC.¹⁸ For example, Llewellyn and Mentschikoff drafted UCC § 2-207 in order to address these commercial realities and crafted it to provide that, under certain conditions, a contract would exist and be enforceable in spite of inconsistent or additional terms in the offer and acceptance.¹⁹ Assuming that § 2-207 governed Hal and Marge's transaction—since Article II is applicable where both parties are merchants—²⁰then Hal and Marge would have a valid and enforceable contract that comports to their understanding of their transaction.²¹

The purpose of this hypothetical is to illustrate that the realists looked at commercial transactions as a relationship and sought to fashion contract law to better fit that perspective and to be more consistent with the economic realities of the twentieth century.²² In the above hypothetical, the business transactions between Hal and Marge were essentially a series of single transactions represented by individual contracts over a period of time. However, each specific transaction (such as the single transaction outlined above) although short in duration, could in fact be characterized as a relationship. But what if the business transactions between Hal and Marge were more than a series of individual contracts over a period of time? What if the transaction was a single contract governing a continuing relationship in which the parties contemplated doing business with each other over an

¹⁶ *Livingstone*, [1925] 4 D.L.R. at 770–71; LORD, *supra* note 4, at § 6:3.

¹⁷ *Livingstone*, [1925] 4 D.L.R. at 770–71; LORD, *supra* note 4, at § 6:3.

¹⁸ Llewellyn, *supra* note 6, at 737, 750.

¹⁹ U.C.C. § 2-207(3) (2011); *see* Breen, *supra* note 7, at 393.

²⁰ § 2-104(1).

²¹ § 2-207(1).

²² *See* Hart, *supra* note 2, at 80.

extended period of twenty or more years? Apparently, Llewellyn and Mentschikoff foresaw this possibility, and built into the UCC a standard that was intended to govern the manner in which two parties entering into a business transaction would deal with one another when undertaking a long-term transactional relationship.²³ As such, the UCC instills within every Article II business transaction an implied covenant that each party would act in good faith, which is defined by the UCC, and honed by judicial interpretation, as “honesty in fact.”²⁴ This implied covenant of good faith and fair dealing, however, cannot generally be used as an independent basis for a cause of action for breach of contract. Rather, the implied covenant must be brought as a derivative, or dependent, claim arising out of a breach of an express contractual provision.²⁵ As discussed below, this can have drastic consequences in the real world of the franchise relationship, due in part to the longevity of the relationship undertaken by franchisors and franchisees.

II. THE FRANCHISE RELATIONSHIP

At first glance, the concept of the franchise relationship may seem overwhelming and difficult to a practitioner who is unfamiliar with its nature. In its simplest form, the franchise relationship is a contractual one, whereby a franchisor licenses to a franchisee the right to distribute a specific product or service using a prescribed business format under the franchisor’s trade or service mark.²⁶ This concept of the modern franchise system has its origins in the early 1890’s, when Martha Melina Harper developed a new business model, which she used to open a network of 500 Harper Beauty Shops throughout the United States, Canada, and Europe.²⁷ In the 1950s and 1960s, franchising began to take off when chains such as McDonald’s and Burger King began marketing their successful business concepts to individuals in return for individuals paying for the right to use the successful business’s name and good will.²⁸ During this period, franchising was a “virtually unchecked” practice that developed rapidly in a

²³ U.C.C. § 1-203 (2011); Breen, *supra* note 7, at 288.

²⁴ § 1-203.

²⁵ Caruso, *supra* note 5, at, 207–08 (2007); § 1-203.

²⁶ *See* 16 C.F.R. § 436.1(h) (2012).

²⁷ Francine Lafontaine & Roger D. Blair, *The Evolution of Franchising and Franchise Contracts: Evidence from the United States*, 3 ENTREPRENEURIAL BUS. L.J. 381, 385 (2009).

²⁸ *Id.* at 386; Bus. Franchise Guide ¶ 105 (CCH).

“*laissez-faire* legal environment.”²⁹ In 1970, however, California enacted the Franchise Investment Law,³⁰ the first piece of legislation aimed at regulating franchise systems. The law was passed in response to complaints over franchise sales practices, which had a reputation for touting “rags to riches” stories aimed at inducing “an easily influenced and relatively unsophisticated audience to make investments in franchise opportunities.”³¹ Today, franchising is regulated, in part, by the Federal Trade Commission (“FTC”) under the FTC Rule with state law playing a major role in regulating the franchise system.³²

One of the hallmarks of the franchise relationship is that it is a long-term business relationship, similar to the on-going relationship between Hal and Marge described in Part I. However, where the Hal and Marge hypothetical involved a series of single transactions that spanned several years, the franchise relationship involves a single, unified business relationship between two parties that extends over a period of time, perhaps as long as twenty or thirty years. In the hypothetical described above, Hal and Marge are under no obligation to continue their business arrangement; it is a simple supplier/buyer relationship, in which either party can elect to discontinue doing business with the other at any time. In contrast, the participants in a franchise relationship, the franchisor and franchisee, are obligated to continue the business relationship they established at the founding of the contractual relationship. Furthermore, Hal and Marge have no agreement in place that will govern how they will interact with one another once each single transaction is complete. In the franchise

²⁹ Rochelle B. Spandorf & Mark B. Forseth, *Franchise Registration*, in *FUNDAMENTALS OF FRANCHISING* 125, 126 (Rupert M. Barkoff & Andrew C. Selden eds., 3d ed. 2008) (footnote omitted).

³⁰ CAL. CORP. CODE §§ 31000–31516 (West 2012) (effective Jan. 1, 1971).

³¹ Spandorf & Forseth, *supra* note 29, at 127.

³² 16 C.F.R. § 436 (2012). The FTC Rule, 16 C.F.R. § 436, states the minimum standards franchisors must meet in disclosure documents which franchisors must provide to prospective franchisees. *See* Spandorf & Forseth, *supra* note 29 at 132. However, the FTC Rule does not require these documents to be filed or reviewed by any federal regulatory body and registration of the franchise is not required. *Id.* at 131. States, on the other hand, play a major role in the regulation of franchises. *Id.* at 129-31. States are not preempted from establishing more stringent disclosure requirements, and may require the franchise to be registered or the disclosure documents to be filed with the appropriate state agency. *Id.* at 129-32. For a more detailed discussion of the franchise disclosure document see Judith M. Bailey & Dennis E. Weiczorek, *Franchise Disclosure Issues*, in *FUNDAMENTALS OF FRANCHISING* 95, 95–123 (Rupert M. Barkoff & Andrew C. Selden eds., 3d ed. 2008). For a more detailed discussion of franchise regulation and registration see Spandorf & Forseth, *supra* note 29, at 125–81.

relationship, however, the parties explicitly undertake a continuing relationship, which will hopefully be mutually beneficial.

The benefits of a franchise relationship can be easily illustrated in the simple example of a person wishing to open a restaurant. He or she essentially has the following two options: (1) open the restaurant from scratch or (2) “rent” an existing restaurant concept that has been developed by others. In the first option, starting a restaurant from scratch, he or she would have to form a business entity (i.e., a corporation), purchase or lease a suitable property upon which to operate the restaurant, and purchase or lease restaurant equipment. Additionally, he or she would be required to develop menus and a business plan, taking into consideration important factors such as food/cost ratios—a concept that he or she may have no experience in—and coming up with a clever restaurant name. The entrepreneur would then have to take steps, at both the state and federal level, to protect his or her right to be the exclusive owner of that name. This would be a crucial step in starting the restaurant because, if the restaurant eventually became successful and the owner wanted to operate other restaurants under the same name in other areas, he or she would want to ensure that competitors could not appropriate the name of his or her established and profitable restaurant.

There are, of course, many other complex steps necessary to establish a restaurant business, and, as a result, the person desiring to do so may believe that they do not possess the necessary qualifications or experience to implement such a business concept successfully. However, the second option of “renting” a restaurant concept eliminates some of the daunting complexities and provides an alternative route for an aspiring restaurateur to realize his or her dream of starting a restaurant.

Let us assume that a prospective restaurateur, whom we will call Harry, partially got his idea of starting a restaurant from frequenting one of his favorite eating establishments, “Burger King.” Harry discovered that, in exchange for “franchise fees,” he could run and have partial ownership of a Burger King business by acquiring or licensing from the owner, Burger King Corporation (“BKC”), the right to operate a restaurant under the name “Burger King,” and use the same concept which he found appealing, thereby avoiding many of the issues associated with opening a restaurant from scratch. Essentially, Harry would be acquiring the right to operate the Burger King Restaurant concept by paying an initial franchise fee to the owner, BKC. For this fee, Harry would obtain the right to use the name Burger King, as well as all of the signs and logos associated with a Burger King, which we refer to as “trade dress.” After paying his franchise fee and being accepted or approved by BKC as a potential franchisee, Harry would sign a franchise agreement, establishing a long-term relationship between

himself and BKC. After the agreement is signed, Harry would undergo an extensive training program conducted by the franchisor, during which he would learn, among other things: how to buy the raw materials for the food, how to make the food, how to acquire the necessary restaurant equipment, and how to follow the business and accounting principles established by BKC. Additionally, BKC would assist him in obtaining a location for his restaurant and buying or leasing necessary property. Harry would be guided through each step of this process by the franchisor, BKC, in lieu of undertaking every step by himself. More importantly, Harry would obtain the license or right to hold himself out as a Burger King restaurant and to use the Burger King name, which is of value to him because of its widespread name recognition.

After signing the franchise agreement and undergoing the above-mentioned training process, Harry would be a party to a *hopefully* long-term relationship with BKC, in which he would have continued authorization to use their name and logos and would rely upon Burger King's continued assistance and limited supervision in running his restaurant. In exchange for the training and assistance described above, Harry would pay periodic (generally monthly) royalties to BKC, at a rate defined as a percentage of his gross or net income as set forth in the franchise agreement. To run a Burger King restaurant, Harry would be relying on the expertise of others to literally set him up in the business. Harry would not own the Burger King name, nor would he own what is commonly called the "good will" of the business. Should the franchise relationship be terminated, Harry would have to cease doing business as a Burger King restaurant and give up all rights to many aspects of the Burger King business, including use of the Burger King name. Generally, Harry would also be required to sign an agreement not to compete with the franchisor Burger King in the event of a termination, which would preclude him from continuing in the restaurant business in a specific area and for a reasonable period of time after termination of the franchise agreement.

One could think of a franchise agreement as being similar to a prenuptial agreement entered into before marriage. While the dissimilarities are obvious, the similarities between the two agreements are intriguing. Both agreements envision a long-term relationship, whereby each party seeks to enter into a mutually beneficial relationship in order for each party to feel the relationship is successful. As such, the parties attempt to structure the agreement in such a way that both benefit by entering the agreement, while concurrently protecting their varied interests. Applying this principle in the context of a franchise agreement, the franchisor has the challenge of structuring the franchise business format so that the franchisee is able to run a successful franchise and, therefore, is able to pay royalties to

the franchisor. If the franchise agreement is well-structured, both the franchisor and franchisee will receive monetary benefits, and both parties will feel that the relationship is successful.

The challenge, however, arises when a franchise relationship sours and disputes arise within the context of the long-term franchise relationship. In such cases, the question becomes, “by what principles is the contract to be interpreted?” This question is being actively litigated in courts around the country without a coherent set of principles to guide the courts, not to mention franchisors or franchisees.³³ From the franchisor’s perspective, they have successfully negotiated a very tightly controlled franchise agreement over the years, which they have entered into with multiple franchisees. Therefore, they are primarily interested in a strict interpretation of contractual principles, without regard to the nature of the continuing relationship between the parties. Franchisees, on the other hand, in an effort to continue what has been a beneficial relationship, are looking more toward the long-term relational aspects between themselves and the franchisor. From this perspective, and because the franchisee historically comes from a weaker bargaining position than the franchisor, the franchisee has a desire for the courts to apply principles such as good faith on the part of the larger franchisor corporation.³⁴

With this background in mind, we now turn to an interesting pair of cases that were initiated by BKC in the U.S. District Court for the Southern District of Florida against several franchisees.³⁵ In these two cases, the court grappled with the issues of how to interpret and apply the concept of good faith and the implied covenant of good faith and fair dealing to a long-term franchise agreement.³⁶ Both cases centered around BKC’s imposition of a so-called “Value Menu” on its franchisees, under which the franchisees were required to sell a double cheeseburger for \$1.00, even though the cost

³³ See, e.g., *Wendy’s Int’l Inc. v. Saverin*, 337 F. App’x 471 (6th Cir. 2009); *Juarez v. Jani-King of Cal., Inc.*, 273 F.R.D. 571 (N.D. Cal. 2011); *JM Vidal, Inc. v. Texdis USA, Inc.*, 764 F. Supp. 2d 599 (S.D.N.Y. 2011); *Dunkin’ Donuts Franchised Rests. LLC v. Grand Cent. Donuts, Inc.*, No. CV 2007 4027(ENV)(MDG), 2009 WL 1750348 (E.D.N.Y. June 19, 2009).

³⁴ See Gillian K. Hadfield, *Problematic Relations: Franchising and the Law of Incomplete Contracts*, 42 STAN. L. REV. 927, 991–92 (1990) (arguing that because of the unequal bargaining power of franchisors and franchisees, courts should apply a “relational approach to the interpretation of franchise contracts and the resolution of franchise disputes” instead of strict contract principles).

³⁵ *Burger King Corp. v. E-Z Eating, 41 Corp.*, 572 F.3d 1306 (11th Cir. 2009); *Nat’l Franchisee Ass’n v. Burger King Corp.*, No. 09-23435-CIV, 2010 WL 4811912 (S.D. Fla. Nov. 19, 2010).

³⁶ *E-Z Eating, 41 Corp.*, 572 F.3d at 1308, 1312 n.8, 1313 n.10; *Nat’l Franchisee Ass’n*, 2010 WL 4811912, at *3–4, *6.

of producing the double cheeseburger was alleged to be \$1.29.³⁷ Essentially, the franchisees in both cases, among many other alleged causes of action, pled that BKC failed to act in good faith by requiring that its franchisees take a loss on the double cheeseburger.³⁸ The next part of this article will discuss the Burger King cases, which, although ultimately settled out of court, set forth important legal principles during the litigation. Then, this article will discuss recent and active pending litigation concerning the issue of franchise agreement interpretation based on contract law, in particular, as it applies to the covenant of good faith.

III. THE BURGER KING CASES: ANALYSIS UNDER A MICROSCOPE

A. *Burger King v. E-Z Eating*

Luan and Elizabeth Sadik (the “Sadiks”) were owners of five “in-line” Burger King restaurants in New York City, New York, which they operated under the corporate entity E-Z Eating Corporation (“E-Z Eating”).³⁹ In 2007, BKC filed a complaint against the Sadiks in the U.S. District Court for the Southern District of Florida, alleging that the Sadiks, through their corporate entity E-Z Eating, breached their franchise agreements (the “Franchise Agreements”) by ceasing to operate one of their restaurants, an act which constituted “abandonment” under the Franchise Agreements’ terms.⁴⁰ Additionally, BKC alleged that the Sadiks individually breached a personal guaranty (the “Guaranty”) that they had signed in exchange for financial assistance from BKC.⁴¹ In their answer, the Sadiks claimed, among other affirmative defenses, that BKC breached the Franchise

³⁷ *Nat’l Franchisee Ass’n*, 2010 WL 4811912, at *1; see *E-Z Eating, 41 Corp.*, 572 F.3d at 1309–10.

³⁸ *E-Z Eating, 41 Corp.*, 572 F.3d at 1311; *Nat’l Franchisee Ass’n*, 2010 WL 4811912, at *1.

³⁹ Defendants’ Answer and Affirmative Defenses to Plaintiff’s Complaint and Counterclaims at 9, *Burger King Corp. v. E-Z Eating 8th Corp.*, No. 07-20181-CIV (S.D. Fla. July 25, 2008), [hereinafter Defendant’s Answer], *aff’d* 572 F.3d 1306 (11th Cir. 2009). An “in-line” restaurant is defined in the Franchise Agreement: Non-Traditional Facility Addendum as a “[r]estaurant food service system having a limited seating capacity authorized and approved by BKC to be developed at selectively approved malls, food courts, strip shopping centers or other retail locations to serve a limited menu of Burger King products.” Defendants’ Answer, Composite Exhibit “B,” Non-Traditional Facility Addendum at 1.

⁴⁰ Complaint ¶¶ 27–31, *Burger King Corp. v. E-Z Eating 8th Corp.*, No. 07-20181-CIV (S.D. Fla. July 25, 2008), 2007 WL 605235 ¶¶ 27–31, [hereinafter *E-Z Eating 8th Corp. Complaint*], *aff’d* 572 F.3d 1306 (11th Cir. 2009).

⁴¹ *Id.* at ¶ 34.

Agreements by acting in bad faith in a manner that was contrary to the Sadiks's well-being.⁴²

1. Background

The Sadiks began operating Burger King franchises in 1996.⁴³ In 1999, the Sadiks opened their third and fourth franchises in New York City; and, in 2001, they opened another.⁴⁴ By 2001, "it was obvious to both [the Sadiks] and BKC that the BKC brand of restaurants was beginning to show failures in its product line," allegedly due to, *inter alia*, BKC's lack of marketing efforts and poor marketing strategy compared to other national chain restaurants.⁴⁵ In 2005, the Sadiks entered into an assistance agreement (the "Assistance Agreement") with BKC, resulting in the above-mentioned Guaranty, due to financial difficulties allegedly sustained because the franchised restaurants were not producing sufficient business and the Sadiks had begun to fall behind on royalty and advertisement payments owed to BKC under the Franchise Agreements.⁴⁶

During the four-year period leading up to the signing of the Assistance Agreement, BKC apparently made representations to the Sadiks that it had selected the E-Z Eating restaurants as among those they deemed valuable and would assist the Sadiks by providing them with operational "and/or" financial assistance, so that the restaurants would be able to better compete in their market.⁴⁷ This decision was supposedly based upon information gathered through BKC programs intended to streamline BKC's corporate and franchise operations by consolidating franchisees BKC deemed valuable.⁴⁸ The Sadiks argued that the representations made during this period caused them to forgo closing or selling their restaurants, as BKC had allowed similarly situated restaurants to do so without penalty.⁴⁹ In fact, in 2005, the Sadiks had initially sought permission to close or sell their restaurants, as required under the Franchise Agreements, believing BKC would grant permission since the Sadiks "forewent their opportunity previously to close or sell immediately the [r]estaurants based on BKC's

⁴² Defendants' Answer, *supra* note 39.

⁴³ *Id.* at 10.

⁴⁴ *Id.* at 9.

⁴⁵ *Id.* at 10.

⁴⁶ *Id.* at 11–12.

⁴⁷ *Id.* at 10.

⁴⁸ Defendants' Answer, *supra* note 39, at 10.

⁴⁹ *Id.* at 11.

representations.”⁵⁰ However, BKC denied the Sadiks’ request and, instead, extended credit to relieve the Sadiks’ indebtedness.⁵¹ According to the Sadiks, BKC promised that it would support the restaurants.⁵² This provision, however, was not explicitly included in the writing of the Assistance Agreement, which was executed on May 1, 2005.⁵³ Just before entering into the Assistance Agreement, BKC published guidelines concerning the implementation of the “Value Menu” it was seeking to eventually implement system-wide.⁵⁴ Among the provisions of the guidelines was a recommendation that any Burger King restaurant that was unable to overcome the negative financial impact of the Value Menu would be exempt from its requirements.⁵⁵ Because their restaurants were performing poorly, were in a location that would purportedly be exempt from the Value Menu, and they did not have enough financial resources to implement the proposed Value Menu, the Sadiks believed that their restaurants fell within the category of Burger Kings that would be exempt from implementing the Value Menu. It was around this time that BKC extended credit assistance to the Sadiks.⁵⁶

In February 2006, BKC implemented a nation-wide “Value Menu” with items to be sold at maximum price points established by BKC and required that the menu be sold at all U.S. restaurants, unless the franchisee applied in writing for and was granted an exception to the policy.⁵⁷ The Sadiks did not expect these exemption requirements.⁵⁸ The policy was distributed in a system-wide memorandum describing the new Value Menu, explaining the associated policies, and establishing how to apply for exemption from its implementation.⁵⁹ Among the exceptions to implementing the Value Menu outlined in the memorandum was a provision for in-line restaurants, which stated that a franchisee wishing to apply for such exception must do so in writing to the Division Vice

⁵⁰ *Id.*

⁵¹ *Id.* at 12.

⁵² *Id.*

⁵³ See Defendants’ Answer, Exhibit “C,” Assistance Agreement at 1, Burger King Corp. v. E-Z Eating 8th Corp., No. 07-20181-CIV (S.D. Fla. Feb. 11 July 25, 2008), *aff’d* 572 F.3d 1306 (11th Cir. 2009), 2008 WL 384554.

⁵⁴ Defendants’ Answer, *supra* note 39, at 12–13.

⁵⁵ *Id.* at 14.

⁵⁶ *Id.*

⁵⁷ Burger King Corp. v. E-Z Eating, 41 Corp., 572 F.3d 1306, 1309–10 (11th Cir. 2009).

⁵⁸ *Id.* at 1315.

⁵⁹ *Id.* at 1309–10.

President.⁶⁰ The Sadiks did not apply in writing for an exception.⁶¹ Instead, they relied upon the previous representations of BKC that they would not be subject to implementing the Value Menu.⁶² As a result, they did not implement the Value Menu in their restaurants.⁶³ BKC sent a demand for compliance letter stating, in substance, that, if the Sadiks/E-Z Eating did not implement the Value Menu within 48 hours, BKC would declare the Sadiks/E-Z Eating in default of the Franchise Agreements and that the Sadiks could not rely on the oral representations of BKC.⁶⁴ The Sadiks responded to the demand letter, stating that they had complied with the demand letter but believed they were eligible for the Value Menu exceptions.⁶⁵ Furthermore, the response letter outlined the Sadiks's understanding that the franchisees must initiate a BKC investigation by making a formal application for the Value Menu exception, remarked that the policy did not make sense, and requested a telephone call to discuss the matter.⁶⁶ It also noted that BKC had requested a meeting with the Sadiks/E-Z Eating and requested information regarding the agenda for such a meeting.⁶⁷ In April 2006, the Sadiks sent another letter to BKC asserting that they qualified for an exception from the Value Menu program, "yet for reasons that are unclear, BKC will not agree to the exemption."⁶⁸ BKC's attorney replied that she had not discussed the matter with BKC, but that if the defendants had submitted the requisite written request and back-up data for an exemption and had not received the exemption, then those restaurants did not qualify.⁶⁹

In January 2007, the Sadiks ceased operation of Burger King restaurant #12287 (referred to as "E-Z Eating 8th Corp." in litigation).⁷⁰ Then, in March 2007, the Sadiks ceased operation of Burger King restaurant #12288 (referred to as "E-Z Eating 46th Corp." in litigation).⁷¹ The following year, in a letter dated January 17, 2008, and after commencement of the action presently discussed, BKC formally declared the remaining

⁶⁰ *Id.*

⁶¹ *Id.* at 1315.

⁶² Defendants' Answer, *supra* note 39, at 14.

⁶³ *E-Z Eating 41 Corp.*, 572 F.3d at 1310.

⁶⁴ *Id.*

⁶⁵ *Id.*

⁶⁶ *Id.*

⁶⁷ *Id.*

⁶⁸ *Burger King Corp. v. E-Z Eating, 41 Corp.*, 572 F.3d 1306, 1310 (11th Cir. 2009).

⁶⁹ *Id.*

⁷⁰ *Id.* at 1311.

⁷¹ *Id.*

franchise agreements terminated and directed the Sadiks to cease operation of the subject Burger King restaurants, #11100 (referred to as “E-Z Eating 41st Corp.” in litigation) and #13447 (referred to as “E-Z Eating 47th Corp. in litigation”).⁷²

2. Relevant Procedural History

i. Prior Litigation

Litigation concerning the issues in this case arose in an earlier proceeding initiated by E-Z Eating and the Sadiks in August 2006, in the U.S. District Court for the Southern District of New York.⁷³ Burger King restaurants #12287 (“E-Z Eating 8th Corp.”), #11100 (“E-Z Eating 41st Corp.”), #12288 (“E-Z Eating 46th Corp.”), and #13447 (“E-Z Eating 47th Corp.”), as well as the Sadiks, were named as plaintiffs.⁷⁴ Arguing essentially the same facts as the 2007 case, E-Z Eating alleged: (1) common law fraud, based on representations made by BKC before the signing of the Assistance Agreement; (2) deceptive actions and practices under New York statute N.Y. GBL § 349; and (3) promissory estoppel.⁷⁵ Of notable difference, however, were allegations that BKC had an “ulterior motive” in seeking to have E-Z Eating keep their franchise restaurants operating despite financial difficulties.⁷⁶ BKC was preparing an initial public offering (“IPO”) of its stock to become a publicly traded company,⁷⁷ which was eventually made on February 16, 2006.⁷⁸ E-Z Eating alleged that, in anticipation of this IPO, BKC was attempting to promote its financial health by having franchisees participate in the “Value Menu,” thus triggering more interest from potential investors, regardless of the negative financial impact the “Value Menu” would have on the franchisees.⁷⁹ The Sadiks’ entire New York complaint, however, was dismissed without prejudice in deference to a forum selection clause in the Franchise Agreements, which stipulated that the parties agreed to litigate all grievances in the U.S. District Court for the

⁷² *Id.*

⁷³ Complaint ¶ 1, E-Z Eating 47 Corp. v. Burger King Corp., No. 06cv5990 (JES) (S.D.N.Y. Dec. 6, 2006), 2006 WL 2582087 ¶¶ 2, 8 [hereinafter E-Z Eating 47 Corp. Complaint].

⁷⁴ *Id.* ¶¶ 2, 8.

⁷⁵ *Id.* ¶¶ 42–61.

⁷⁶ *Id.* ¶¶ 32–36.

⁷⁷ *Id.* ¶¶ 32–33.

⁷⁸ *Id.* ¶ 32.

⁷⁹ E-Z Eating 47 Corp. Complaint, *supra* note 73, ¶¶ 37–41.

Southern District of Florida.⁸⁰ The allegations made by E-Z Eating as a defendant in Florida were essentially the same as those it made as a plaintiff in New York.⁸¹

ii. Present Procedural History

The procedural history of the present case involves a tedious exchange of claims, counterclaims, and motions to dismiss between BKC and the Sadiks. In early 2007, BKC filed an action in Florida for breach of contract against the Sadiks' Burger King restaurant #12287 ("E-Z Eating 8th Corp."),⁸² which E-Z Eating responded to with an answer and counterclaims. Eventually, BKC filed a motion to dismiss E-Z Eating's counterclaims, arguing, in substance, that:

(1) the defendants lacked standing to assert the counterclaims because they were "attempting to assert claims for relief based on the legal rights or interests of multiple entities that are not parties" to the case⁸³

(2) the counterclaim of common law fraud was not allowed because (a) the Assistance Agreement's integration clause barred the defendants from arguing that they detrimentally relied upon BKC's representations when entering into the Assistance Agreement, since that provision incorporated all prior negotiations and discussions between the parties and stating that the parties are not bound by any other agreement—there was no mention of the representations in the assistance agreement—and, as such, E-Z Eating could not rely to their detriment on extraneous representations in support of their allegations of fraud; and (b) the allegation of common law fraud was not plead with particularity as required by Rule 9(b) of the Federal Rules of Civil Procedure;⁸⁴

(3) the Sadiks/E-Z Eating failed to allege a breach of a contractual duty, since the provision they relied upon left the amount of support it would provide under § 6-I of the Franchise Agreement up to BKC's discretion; and⁸⁵

⁸⁰ E-Z Eating 47 Corp. v. Burger King Corp., No. 06cv5990 (JES) (S.D.N.Y. Dec. 6, 2006).

⁸¹ See E-Z Eating 47 Corp. Complaint, *supra* note 73.

⁸² Burger King Corp. v. E-Z Eating, 41 Corp., 572 F.3d 1306, 1311 (11th Cir. 2009).

⁸³ Plaintiff Burger King Corporation's Motion to Dismiss, or, Alternatively, Strike Counterclaim at 3, Burger King Corp. v. E-Z Eating 41 Corp., No. 07-20181-CIV (S.D. Fla. July 25, 2008) [hereinafter BKC's Motion to Dismiss], *aff'd* 572 F.3d 1306 (11th Cir. 2009).

⁸⁴ *Id.* at 5–11.

⁸⁵ *Id.* at 11.

(4) the defendants' claim for breach of implied duty of good faith and fair dealing fails because it cannot be maintained "(a) in derogation of the express terms of the underlying contract or (b) in the absence of breach of an express term of the underlying contract."⁸⁶

Additionally, BKC alleged that E-Z Eating's counterclaim was a "shotgun" pleading as it incorporated, by reference, each of its predecessor allegations to support the current allegation.⁸⁷ When BKC became aware that the Sadiks had closed a second restaurant (E-Z Eating 46th Corp.), thereby breaching the Franchise Agreement associated with that restaurant, BKC withdrew its motion to dismiss and filed an amended complaint naming EZ-Eating 46th Corp. as a third defendant, leaving the substance of the claims primarily unchanged.⁸⁸ The defendants—now E-Z Eating 8th Corp., E-Z Eating 46th Corp., and the Sadiks—filed their answer and affirmative defenses against BKC's amended complaint, alleging the same substantive set of facts, claims, and circumstances as their original answer and counterclaim.⁸⁹

BKC once again moved to dismiss the defendants' counterclaims, alleging the same grounds for dismissal, less the lack of standing argument.⁹⁰ In response, the defendants clarified that the basis for their counterclaims was not that BKC had induced the defendants to sign the assistance agreement, but that BKC had made representations that "induced the Defendants to stay in business" in a "calculated plan to retain Defendants as franchisees... in preparation of its impending [IPO]."⁹¹ The Sadiks/E-Z Eating further argued that, if this was the case, BKC "used its better leverage and empty promises of financial and operational assistance to entice the Defendants to sign the Assistance Agreement."⁹² Moreover, BKC's "unexpected" implementation of the "Value Menu" three days before its IPO demonstrated that BKC "never intended to permit Defendants to avoid the harsh financial effects of the [Value Menu], and the imposition was merely a strategic move on BKC's part."⁹³

⁸⁶ *Id.* at 13 (quoting *Burger King Corp. v. Weaver*, 169 F. 3d 1310, 1317–18 (11th Cir. 1999)).

⁸⁷ BKC's Motion to Dismiss, *supra* note 83, at 14.

⁸⁸ *Burger King Corp. v. E-Z Eating, 41 Corp.*, 572 F.3d 1306, 1311 (11th Cir. 2009).

⁸⁹ *Id.*

⁹⁰ BKC's Motion to Dismiss, *supra* note 83, at 1.

⁹¹ Defendants' Response in Opposition to Plaintiff's Motion to Dismiss, or, Alternatively, Strike Defendants' Counterclaims to Amended Complaint at 6–7, *Burger King Corp. v. E-Z Eating 41 Corp.*, No. 07-20181-CIV (S.D. Fla. July 25, 2008) [hereinafter Defendant's Response], *aff'd* 572 F.3d 1306 (11th Cir. 2009).

⁹² *Id.* at 6.

⁹³ *Id.* at 7.

As to their claims of breach of contract and breach of implied duty of good faith and fair dealing, the defendants argued that (1) they had set out factual averments that BKC would “surely dispute,” (2) BKC was attempting to make undetermined factual allegations on a record that had yet to be significantly developed, and (3) the defendants should have a right to attempt to meet their burden of proof on the elements of a breach of contract.⁹⁴ Furthermore, the defendants asserted that because they had set out a valid breach of contract claim and *then* brought their breach of implied covenant of good faith and fair dealing claim by incorporating the facts set forth in the former claim, they had properly plead a claim for the latter.⁹⁵

In response, BKC argued that the Sadiks’/E-Z Eating’s fraud claim was barred by the Assistance Agreement’s integration clause, as well as the release contained in the Assistance Agreement. Furthermore, BKC argued that the breach of contract claim also failed because the Sadiks’/E-Z Eating’s position was based on allegations that BKC breached a general obligation of support, yet, under Florida law, “there is no cause of action for breach of a general obligation of support of BKC’s Franchise Agreement.”⁹⁶ BKC then extended that reasoning and asserted that the claim for breach of implied covenant of good faith and fair dealing should also fail.

BKC eventually filed a motion for summary judgment asserting that there was no genuine issue of material fact for a trier of facts to decide.⁹⁷ In support, BKC cited that the Sadiks/E-Z Eating admittedly closed their restaurants prior to the termination date established by the Franchise Agreement and without BKC’s consent, which constitutes a material breach of the Franchise Agreement.⁹⁸ Additionally, BKC pointed out that the defendants’ counterclaims did not purport to defeat their motion for summary judgment and that each counterclaim failed as a matter of law because the defendants waived their right to make such claims in the Assistance Agreement.⁹⁹ Pertinent to a discussion of the implied covenant

⁹⁴ *Id.* at 13.

⁹⁵ *Id.* at 14.

⁹⁶ Burger King Corp.’s Reply Memorandum in Support of Its Motion to Dismiss, or, Alternatively, Strike Defendants’ Counterclaims to Amend Complaint at 8, Burger King Corp. v. E-Z Eating 41 Corp., No. 07-20181-CIV (S.D. Fla. July 25, 2008), *aff’d* 572 F.3d 1306 (11th Cir. 2009) (citing Burger King Corp. v. Hinton, 203 F. Supp. 2d 1357 (S.D. Fla. 2002)).

⁹⁷ Plaintiff/Counter-Defendant Burger King Corp.’s Dispositive Motion For Summary Judgment Against Defendants and Incorporated Memorandum of Law at 1, Burger King Corp. v. E-Z Eating 41 Corp., No. 07-20181-CIV (S.D. Fla. July 25, 2008) [hereinafter BKC’s Dispositive Motion for Summary Judgment], *aff’d* 572 F.3d 1306 (11th Cir. 2009).

⁹⁸ *Id.* at 2.

⁹⁹ *Id.*

of good faith and fair dealing, BKC argued that, “Defendants simply broadly charge the BKC’s actions somehow breach the implied duty... without citation to any particular contractual duty that BKC allegedly breached,” and that the breach relied upon was further insufficient as a matter of law because “the fact that BKC maintained the sole reasonable discretion to determine the way in which it provides the enumerated services in the Franchise Agreement bars Defendants’ breach of contract claim.”¹⁰⁰ Conceding to some of BKC’s arguments, the defendants voluntarily withdrew their claims for common law fraud and promissory estoppel.¹⁰¹

Regarding their other claims, however, the Sadiks/E-Z Eating filed a response to BKC’s motion for summary judgment arguing impossibility of performance as to BKC’s claim of breach of contract under the franchise agreement, citing that BKC had actual knowledge that the Value Menu was causing extreme loss to defendants and a previous failed attempt at a “99 Cent Menu” program some years earlier.¹⁰² Additionally, the defendants argued that if there was a breach, BKC would be unable to demonstrate that a breach was the “proximate cause of BKC’s lost future royalties.”¹⁰³ The defendants further argued that implementation of the Value Menu was a “*de facto* or constructive termination of defendant’s franchises,” which, in effect, proximately caused BKC’s lost royalties.¹⁰⁴ BKC countered that it was authorized under the Franchise Agreement to implement the Value Menu and that, as a result, E-Z Eating’s impossibility defense and its claims for breach of contract and breach of implied covenant of good faith claim all fail because there was no breach of the Franchise Agreement.¹⁰⁵ BKC asserted that the defendants misinterpreted the law (specifically *Burger King v. Hinton*¹⁰⁶) in support of their proposition that a franchisee’s breach

¹⁰⁰ *Id.* at 18–19.

¹⁰¹ Memorandum of Law in Response to Plaintiff Burger King Corp.’s Motion for Summary Judgment Against Defendant/Counterclaim Plaintiff’s E-Z Eating 8th Corp., E-Z Eating 46th Corp., Luan Sadik and Elizabeth Sadik at 2, n. 1, *Burger King Corp. v. E-Z Eating 41 Corp.*, No. 07-20181-CIV (S.D. Fla. July 25, 2008) [hereinafter Memorandum of Response to BKC], *aff’d* 572 F.3d 1306 (11th Cir. 2009).

¹⁰² *Id.* at 9.

¹⁰³ *Id.* (citing *Burger King v. Hinton, Inc.*, 203 F. Supp. 2d 1357, 1366–67 (S.D. Fla. 2002), holding a franchisee’s breach is not proximately connected to lost future royalties when the franchisor’s actions bring about the loss of future royalties).

¹⁰⁴ *Id.*

¹⁰⁵ Burger King Corporation’s Reply Memorandum in Support of Its Dispositive Motion for Summary Judgment Against Defendants at 4–5, *Burger King Corp. v. E-Z Eating 41 Corp.*, No. 07-20181-CIV (S.D. Fla. July 25, 2008) [hereinafter BKC Reply Memorandum], *aff’d* 572 F.3d 1306 (11th Cir. 2009).

¹⁰⁶ 203 F. Supp. 2d 1357 (S.D. Fla. 2002).

is not proximately connected to lost future royalties when the franchisor's actions bring about the loss of future royalties.¹⁰⁷ BKC distinguished *Hinton* based on the fact that it was BKC's decision to terminate that franchise agreement due to Hinton's breach of the Franchise Agreement.¹⁰⁸ As such, BKC argued that the governing principle was located in *Burger King v. Barnes*,¹⁰⁹ which held, *inter alia*, that the franchisee's abandonment of the restaurant in was the proximate cause of BKC's damages, and, as such, that Florida law entitled BKC to lost profits.¹¹⁰

The court ordered that all three pending cases be consolidated for pretrial procedures on interrelated claims between BKC and the Sadiks/E-Z Eating, and the cases were termed the "Cooke Action" (*Burger King v. E-Z Eating 8th Corp. & E-Z Eating 46th Corp.*), the "Jordan Action" (*Burger King v. E-Z Eating 41st Corp. & E-Z Eating 47th Corp.*), and the "Ungaro Action" (*E-Z Eating 41st Corp. & E-Z Eating 47th Corp. v. Burger King*).¹¹¹ In the Cooke Action, BKC claimed that E-Z Eating had breached their contract and sought lost profits due under the Franchise Agreement.¹¹² BKC filed a motion for summary judgment, which the court granted.¹¹³ In the Jordan Action, BKC's claims alleged unfair competition, trademark infringement, and breach of franchise agreement.¹¹⁴ In the Ungaro Action—the only action in which E-Z Eating was the plaintiff—E-Z Eating sought declaratory relief for BKC's breaches of contract and the implied covenant of good faith and fair dealing, a counterclaim they raised in answer to the Cooke Action and the Jordan Action.¹¹⁵

The judge then ordered consolidation of all three actions for trial and denied BKC's previous motion to dismiss.¹¹⁶ BKC's motion for summary judgment in the Cooke Action, however, was granted in part, only finding, as to liability, that the defendants defaulted on the Franchise Agreement by

¹⁰⁷ BKC Reply Memorandum, *supra* note 105, at 10–11.

¹⁰⁸ *Id.*

¹⁰⁹ 1 F. Supp. 2d 1367 (S.D. Fla. 1998).

¹¹⁰ BKC Reply Memorandum, *supra* note 105, at 10–12; *see Hinton Inc.*, 203 F. Supp. 2d at 1366–67.

¹¹¹ *Burger King Corp. v. E-Z Eating 41 Corp.*, 572 F.3d 1306, 1311–12 (11th Cir. 2009).

¹¹² *E-Z Eating 8th Corp. Complaint*, *supra* note 40, ¶¶ 28–31.

¹¹³ *E-Z Eating 41st Corp.*, 572 F.3d at 1312.

¹¹⁴ *Id.* at 1311.

¹¹⁵ *Id.* at 1312.

¹¹⁶ *Id.*

abandoning and closing the restaurants prior to expiration of their term and by failing to address BKC's claims and defenses.¹¹⁷

BKC's motion for summary judgment in the Cooke Action¹¹⁸ had been filed prior to initiation of the Ungaro and Jordan Actions and before the three actions were consolidated.¹¹⁹ Thus, the court's order granting BKC's motion for summary judgment, in part, was applied only to the Cooke Action and not the Ungaro or Jordan Actions. The court did not address the issue of damages in the Cooke Action order.¹²⁰

BKC filed a subsequent motion for summary judgment on the remaining claims, arguing that the defendants' affirmative defenses in the Jordan Action were identical to those which the court had already ruled on in the Cooke Action and which, according to BKC, were determined to be meritless by the same order.¹²¹ BKC also argued that E-Z Eating's counter-claims in the Jordan Action and claims in the Ungaro Action for breach of contract and breach of implied duty of good faith and fair dealing were duplicative causes of action.¹²² The court rejected this argument in its order partially granting BKC's motion for summary judgment, leaving the request for injunctive relief in the Ungaro Action the only remaining distinct cause of action, which the court had already refused by denying E-Z Eating's earlier motion for a preliminary injunction.¹²³

On July 25, 2008, the court granted BKC's motion for summary judgment on remaining issues in the Jordan Action and the Ungaro Action and awarded damages in the amount of \$770,547.55 for past due royalties, outstanding payments on a promissory note, and lost profits in the Cooke Action.¹²⁴

¹¹⁷ *Id.*

¹¹⁸ *Id.*

¹¹⁹ *E-Z Eating 41st Corp.*, 572 F.3d at 1312.

¹²⁰ *Id.* at 1312.

¹²¹ Plaintiff Burger King Corp.'s Motion for Summary Judgment Against Defendants on Remaining Claims and Incorporated Memorandum of Law at 2, *Burger King Corp. v. E-Z Eating 8th Corp.*, No. 07-20181-CIV (S.D. Fla. July 25, 2008), *aff'd* 572 F.3d 1306 (11th Cir. 2009).

¹²² *Id.* at 2.

¹²³ *Burger King Corp. v. E-Z Eating 8th Corp.*, No. 07-20181-CIV (S.D. Fla. July 25, 2008), *aff'd* 572 F.3d 1306 (11th Cir. 2008)

¹²⁴ *Burger King Corp. v. E-Z Eating 8th Corp.*, 572 F.3d 1306, 1312 (11th Cir. 2009).

B. *National Franchise Association v. Burger King Corporation*

1. Background

The National Franchise Association (“NFA”), on behalf of all BKC franchisees, brought action against BKC regarding the implementation of a policy requiring franchisees to sell the “Double Cheese Burger” and “Buck Double” hamburgers at a price of no more than \$1.00.¹²⁵ NFA brought claims for breach of contract and breach of implied covenant of good faith and fair dealing, and also sought declaratory relief that BKC’s Franchise Agreement does not obligate franchisees to comply with the price points set by BKC for products sold by the franchisees, including, but not limited to the Double Cheese Burger and Buck Double hamburgers.¹²⁶

The suit was premised upon BKC’s obligation under the franchise agreements to “establish, and cause approved suppliers to the BKC system to *reasonably comply* with, product, service and equipment specifications.”¹²⁷ NFA argued that nothing in the franchise agreement stated BKC has a right to impose mandatory price points for products sold by the franchisees.¹²⁸ Citing “decades” of practice to the contrary, NFA argued that BKC’s assertion of this right was unfounded and offered as evidence a 2002 memorandum, in which BKC acknowledged that “it has been BKC’s longstanding policy to allow each franchisee unfettered discretion to set all prices for products sold in the franchisee’s Burger King Restaurants as it sees fit.”¹²⁹ NFA observed that BKC had never unilaterally imposed price points for products sold by franchisees.¹³⁰ In addition, NFA pointed out that, in past practice, BKC had obtained a super-majority consent in a “show of support” vote among franchisees before introducing price points and that BKC’s proposal for introducing the Double Cheese Burger to sell at a price of \$1.00 had twice been rejected by the franchisees,

¹²⁵ Nat’l Franchisee Ass’n v. Burger King Corp., No. 09-23435-CIV, 2010 WL 4811912, at *1 (S.D. Fla. Nov. 19, 2010).

¹²⁶ *Id.* at *2.

¹²⁷ Class Action Complaint for Declaratory Relief; Jury Demand at ¶ 18, Nat’l Franchisee Ass’n v. Burger King Corp., No. 09-23435-CIV (S.D. Fla. Nov. 19, 2010) (emphasis added), 2010 WL 4811912 ¶ 18.

¹²⁸ *Nat’l Franchisee Ass’n*, 2010 WL 4811912 at *5.

¹²⁹ Amended Consolidated Class Action Complaint ¶¶ 35–36, Nat’l Franchisee Ass’n v. Burger King Corp., No. 09-23435-CIV (S.D. Fla. Nov. 19, 2010), 2011 WL 1186547 ¶¶ 35–36.

¹³⁰ *Id.* ¶ 35.

in large part because it was not economically feasible, as production costs exceeded this price point.¹³¹

2. Relevant Facts

The genesis of this dispute can be traced to October 15, 2002, when BKC issued a memorandum stating: “Recent changes in the law now allow BKC to establish a maximum price a franchisee can charge for certain products in certain situations.”¹³² NFA, however, argued that, despite changes in the law, each franchisee’s relationship with BKC is controlled by the law in effect at the time their individual franchise agreement with BKC was drafted, as that law is incorporated into each agreement as a matter of law when it is executed.¹³³

In 2005, BKC sought to introduce the \$1.00 Value Menu, as discussed above, and began the “show of support” process, stating that if the proposed Value Menu received positive support from 67.7% of the voting franchisees, then the Value Menu items would be required to be sold for no more than \$1.00.¹³⁴ This proposal passed and was implemented soon thereafter. In 2008, BKC sought to introduce the Double Cheese Burger to the Value Menu.¹³⁵ At that time, the NFA and franchisees objected to both BKC’s contention that it had the unilateral right to add items, and to BKC’s specific proposal to add the Double Cheese Burger to the Value Menu. BKC abandoned the proposal at that time due to the objections.¹³⁶ In 2009, BKC again attempted to introduce the Double Cheese Burger to the Value Menu through the “show of support” process, but this proposal was once again rejected, this time because it was not cost effective to franchisees.¹³⁷ Despite its failure through the “show of support” process, BKC announced that, starting October 19, 2009, it would require all franchisees to offer the Double Cheese Burger on the Value Menu for \$1.00.¹³⁸ NFA argues this is the first time BKC had ever attempted to impose a price point without majority consent though the “show of support” process.¹³⁹

¹³¹ *Id.* ¶¶ 43, 44, 58–64.

¹³² *Id.* ¶ 38.

¹³³ *Nat’l Franchisee Ass’n v. Burger King Corp.*, 715 F.Supp. 2d 1232, 1244 (S.D. Fla. 2010).

¹³⁴ Amended Consolidated Class Action Complaint, *supra* note 129, ¶ 39.

¹³⁵ *Nat’l Franchisee Ass’n*, 715 F.Supp. 2d at 1236.

¹³⁶ *Id.*

¹³⁷ Amended Consolidated Class Action Complaint, *supra* note 129, ¶¶ 59–61.

¹³⁸ *Id.* ¶ 62.

¹³⁹ *Id.* ¶ 81.

3. Relevant Procedural History

Soon after BKC's announcement, NFA filed an action for declaratory relief, seeking a declaration that the franchise agreements did not obligate the franchisees to comply with price points set by BKC for products sold by the franchisees, including the Double Cheese Burger.¹⁴⁰ BKC responded with a motion to dismiss, arguing that the court's decision in *BKC v. E-Z Eating*, holding that "there is simply no question that BKC had the power and authority under the Franchise Agreement to impose the Value Menu on its Franchisees,"¹⁴¹ resolved the dispute.¹⁴² BKC also argued that the claim should be dismissed because it was time barred by the statute of limitations and NFA lacked standing to bring the suit.¹⁴³ The court ruled that the franchise agreements granted BKC the right to set maximum price points for items and, therefore, that NFA's breach of the express contract claim failed.¹⁴⁴ However, the court further held that there was a material issue of fact concerning whether BKC breached the implied covenant of good faith and fair dealing.¹⁴⁵

Soon after, the court ordered NFA to file a motion for class certification relating to the implied covenant of good faith and fair dealing claim,¹⁴⁶ which NFA promptly complied with, as there were issues of law and fact common to all franchisees in a sufficiently numerous class.¹⁴⁷ Among the issues common to the class were: (1) whether the identical or materially similar contracts at issue were breached, (2) whether BKC requiring franchisees to sell the Double Cheese Burger and Buck Double for \$1.00 breached the franchise agreement, (3) whether BKC's history of dealing with the franchisees concerning the voting approval process created a reasonable expectation that the process would be followed, (4) whether BKC's "business care" test marketing of the Double Cheese Burger shows it acted in good faith, (5) whether the minimum cost at which a franchisee class could sell the Double Cheese Burger or Buck Double is less than

¹⁴⁰ See *id.* ¶ 79.

¹⁴¹ Defendant's Motion to Dismiss Class Action Complaint for Declaratory Relief at 2, Nat'l Franchisee Ass'n v. Burger King Corp., No. 09-23435-CIV (S.D. Fla. Nov. 19, 2010) [hereinafter Defendant's Motion to Dismiss Relief].

¹⁴² *Id.* at 2.

¹⁴³ *Id.*

¹⁴⁴ Nat'l Franchisee Ass'n v. Burger King Corp., 2010 WL 4811912, at *3 (S.D. Fla. Nov. 19, 2010).

¹⁴⁵ *Id.*

¹⁴⁶ *Id.*

¹⁴⁷ Plaintiff Nat'l Franchisee Ass'n's Motion for Class Certification at 9, Nat'l Franchisee Ass'n v. Burger King Corp., No. 09-23435-CIV (S.D. Fla. Nov. 19, 2010).

\$1.00, and (6) what the overall financial impact was on the class from the \$1.00 price point set for the Double Cheese Burger and Buck Double.¹⁴⁸

In response to NFA's motion for class certification, BKC argued that potential class members were, or potentially could be, in conflict with one another because many franchisees had reported they benefitted from the implementation of the \$1.00 Double Cheese Burger program and/or opposed filing the suit.¹⁴⁹ BKC also contended that NFA failed to meet the procedural requirements for class certification arguing that: (1) the facts set out by NFA differed fundamentally from the positions of many class members, so the typicality required under Rule 23(a) of the Federal Rules Of Civil Procedure was absent;¹⁵⁰ (2) NFA's conflict with other members of the class precluded NFA from meeting the requirements of Rule 23(b)(2) of the Federal Rules of Civil Procedure because some franchisees would be involuntarily added to the class despite their objections to the case, effectively forcing them to take a position against the \$1.00 Double Cheese Burger program that was contributing to the success of their business; and (3) NFA did not establish predominance under Rule 23(b)(3) because proof of each member's individualized circumstances would be necessary to adjudicate the class claims or defenses because historical performance and highly individualized issues regarding each restaurant would have to be introduced to show BKC breached their contract with each franchisee.¹⁵¹

In reply to BKC's response to class certification, NFA pointed out that disapproval by some class members does not preclude class certification because some divergence of opinion is inherent in any class action and BKC's assertions were based upon eighteen franchisees expressing support for the year-old \$1.00 Double Cheese Burger program.¹⁵² Furthermore, BKC's argument that some franchisees' positions in favor of selling Double Cheese Burgers at the \$1.00 price point were adverse to others in the class opposed to the price point was unfounded because any franchisee that wished to continue to sell the Double Cheese Burger at the price point would still be able to do so if NFA prevailed.¹⁵³ The relief sought was the ability to sell the Double Cheese Burger at any price the franchisee wishes,

¹⁴⁸ *Id.*

¹⁴⁹ Defendant Burger King Corp.'s Opposition to Plaintiff's Motion for Class Certification at 14, Nat'l Franchisee Ass'n v. Burger King Corp., No. 09-23435-CIV (S.D. Fla. Nov. 19, 2010) [hereinafter BKC Opposition to Certification].

¹⁵⁰ *Id.* at 16.

¹⁵¹ *Id.* at 17–18.

¹⁵² Plaintiff Nat'l Franchisee Ass'n's Reply Brief in Support of its Motion for Class Certification at 1–2, Nat'l Franchisee Ass'n v. Burger King Corp., 09-23435-CIV (S.D. Fla. Nov. 19, 2010) [hereinafter Nat'l Franchisee Ass'n's Reply].

¹⁵³ *Id.* at 6.

which was not inconsistent with any franchisee continuing to sell the items at the price point.¹⁵⁴ Additionally, the court would be able to redefine the class as it so chooses, for example, by excluding some purported members and including others.¹⁵⁵

In response to BKC's contentions that procedural requirements had not been met, NFA argued that it had satisfied the requirements of Rule 23(b)(2) because NFA sought primarily injunctive relief, and the rule authorizes "a remedy that, as a practical matter, affords injunctive relief or may serve as a later basis for injunctive relief."¹⁵⁶ NFA also asserted that it satisfied the requirements of Rule 23(b)(3) because the case fits a common fact pattern where predominance exists because the BKC's liability-creating actions toward the franchisees are uniform and controlling. NFA cited *Klay v. Humana*,¹⁵⁷ which states that common issues of fact or law predominate if they "have a direct impact on every class member's efforts to establish liability," which, in this case, would be BKC's imposition of the \$1.00 Double Cheese Burger on franchisees in violation of its normal procedures.¹⁵⁸

In August 2010, the court ordered that the NFA case be consolidated with another pending action, known as the "Family Dining" case, and denied NFA's motion for class certification, with the ability to renew the motion after a consolidated complaint had been filed.¹⁵⁹ NFA promptly filed its amended consolidated class action complaint and renewed motion, making the same allegations as originally set forth and seeking declaratory judgment and damages for breach of contract and express duty of good faith, breach of implied covenant of good faith and fair dealing, and violation of the Florida Deceptive and Unlawful Trade Practices Act.¹⁶⁰ BKC moved to dismiss, arguing, among other things, that NFA's action for declaratory judgment, which alleged that BKC lacked authority under its franchise agreements to set maximum price points was barred by the court's prior ruling on that issue and that NFA could only bring a claim for the

¹⁵⁴ *Id.* at 4–5.

¹⁵⁵ *Id.* at 7.

¹⁵⁶ *Id.* at 8 (quoting Adv. Comm. Note, 39 F.R.D. 69, 102 (1966)).

¹⁵⁷ 382 F.3d 1241 (11th Cir. 2004) ; *see id.* at 1255 (quoting *Ingram v. Coca-Cola Co.*, 200 F.R.D. 685, 699 (N.D. Ga. 2001)); *see also* *Allapattah Servs., Inc. v. Exxon Corp.*, 333 F.3d 1248, 1260-61 (11th Cir. 2003).

¹⁵⁸ Nat'l Franchisee Ass'n Reply, *supra* note 152, at 8.

¹⁵⁹ Consol. Class Action Complaint ¶ 2, Nat'l Franchisee Ass'n v. Burger King Corp., No. 09-23435-CIV (S.D. Fla. Nov. 19, 2010), 2010 WL 3900717 ¶ 2.

¹⁶⁰ *Id.* ¶¶ 62, 81.

breach of implied covenant of good faith and fair dealing.¹⁶¹ BKC further argued that NFA failed to sufficiently raise its factual claim that BKC acted in bad faith under its express contractual duty of good faith because NFA only alleged that the franchisees would have losses on a single product line.¹⁶² As to the claim for breach of implied covenant of good faith and fair dealing, BKC sought dismissal on the grounds that the duty of good faith was expressly set forth in the contract and the implied common law duty was therefore inapplicable.¹⁶³ The court granted BKC's motion to dismiss, ruling that NFA had failed to allege facts sufficient to support a claim for bad faith.¹⁶⁴ Subsequently, NFA successfully moved to have the order amended.¹⁶⁵

IV. GOOD FAITH VARIATIONS

As commentators have noted, the covenant of good faith and fair dealing has emerged in recent years as a "reasonable compromise" for many of the problems associated with the relational aspect of the franchise relationship.¹⁶⁶ The preceding cases, *Burger King v. E-Z Eating* and *National Franchise Association v. Burger King* (collectively the "Burger King cases"), illustrate what the majority of courts around the country have held with regards to application of the covenant of good faith and fair dealing, namely, that it may not serve as an independent cause of action for a breach of the franchise agreement.

The Burger King cases also illustrate many of the issues and hurdles associated with the concept of good faith in the franchise relationship in the context of the undefined aspects of the franchisor's ability to exercise discretion.¹⁶⁷ In many cases, a breach of the covenant of good faith is

¹⁶¹ Defendant Burger King Corp.'s Corrected Motion to Dismiss Plaintiff's Consol. Class Action Complaint, Motion to Strike Under Rule 12(f) and Supporting Memorandum of Law at 2, Nat'l Franchisee Ass'n. v. Burger King Corp., No. 09-23435-CIV, 2010 WL 4811912 (S.D. Fla. Nov. 19, 2010) [hereinafter BKC's Corrected Motion and Memorandum].

¹⁶² *Id.* at 8.

¹⁶³ *Id.* at 13.

¹⁶⁴ Nat'l Franchisee Assoc. v. Burger King Corp., No. 09-23435-CIV, 2010 WL 4811912 at *4 (S.D. Fla. Nov. 19, 2010).

¹⁶⁵ Plaintiffs' Motion to Alter or Amend, or to Vacate, the Court's Order Dismissing Their Case With Prejudice and for Leave to File an Amended Consol. Class Action Compliant and Supporting Memorandum of Law at 16, Nat'l Franchisee Assoc. v. Burger King Corp., No. 09 -23435-CV, 2010 WL 5881908 (S.D. Fla. Nov. 19, 2010); Nat'l Franchisee Assoc. v. Burger King Corp., No. 09-23435-CV (S.D. Fla. Feb. 10, 2011).

¹⁶⁶ See, e.g., Caruso, *supra* note 5, at 213.

¹⁶⁷ Hadfield, *supra* note 34, at 992.

asserted as a counterclaim by defendants after the franchise relationship has soured and the franchisor is either seeking to recover monies due under the franchise agreement or to terminate the franchise relationship.¹⁶⁸ One of the problems alluded to above is that the franchise agreement is an incomplete contract at the time the franchise relationship is formed.¹⁶⁹ This also encompasses situations in which a franchisee is not allowed to view the franchise operating manual, which is part of the contract, at the time the relationship is formed due to the proprietary nature of the information contained in the manual.¹⁷⁰ Additionally, in many cases “there will be no language in the written document to assist a court in determining whether a particular franchisor demand is legitimate and whether the franchisee’s behavior is in compliance or in violation of that demand.”¹⁷¹

In the majority of franchise agreements, the franchisor drafts the agreement in such a way as to leave open many aspects of the agreement in order to exercise substantial discretion in implementing certain provisions, such as setting menus, changing the trade dress, or setting prices.¹⁷² Additionally, the franchisee is usually not allowed to see the operating manual even though it forms a substantial part of the contract.¹⁷³ In these situations, commentators have noted that the covenant of good faith is intended to act as a gap filler by which neither party will undertake to do anything which would frustrate the purpose underlying contract,¹⁷⁴ but the way this gap filler is applied by the courts differs substantially from state to state.¹⁷⁵ In many jurisdictions, the covenant of good faith and fair dealing may not be pled as an independent cause of action for breach of contract,¹⁷⁶ much less as the tort of bad faith, despite its intended purpose of protecting the bargained-for interests of the parties.¹⁷⁷ While this may hold true for most jurisdictions, others have taken varied positions as to how the covenant of good faith and fair dealing operates in franchise agreements.

¹⁶⁸ See, e.g., *Dunkin’ Donuts Franchised Rests. LLC v. Grand Cent. Donuts*, No. CV 2007-4027(ENV)(MDG), 2009 WL 1750348, at *2 (E.D.N.Y. June 19, 2009).

¹⁶⁹ Hadfield, *supra* note 34, at 928.

¹⁷⁰ Cf. *id.* at 944; 16 C.F.R. § 436.2 (2012).

¹⁷¹ Hadfield, *supra* note 34, at 947.

¹⁷² *Id.* at 943–46.

¹⁷³ See *id.* at 947.

¹⁷⁴ See, e.g., Nicholas R. Weiskopf, *Wood v. Lucy: The Overlap Between Interpretation and Gap-Filling to Achieve Minimum Decencies*, 28 PACE L. REV. 219, 222 (2008).

¹⁷⁵ See Hadfield, *supra* note 34, at 984.

¹⁷⁶ See, e.g., Caruso, *supra* note 5, at 207.

¹⁷⁷ See, e.g., *id.* at 208.

In sampling many of the recent cases that have come down regarding the covenant of good faith in the franchise relationship, it appears that application of the covenant centers around three prominent theories of how the provision operates. In this section, I propose a new idea of how to deal with the interpretation of the covenant of good faith and fair dealing in the franchise agreement

A. *The Majority Rule*

In many jurisdictions around the United States, the prevailing view regarding the covenant of good faith is that, despite its intended purpose of protecting the parties' interests, it is not an independent cause of action for a breach of the franchise agreement.¹⁷⁸ Instead, there can be no cause of action for a breach of the implied covenant absent an allegation that an express term of the contract has been breached.¹⁷⁹ Accordingly, a franchisee must plead the covenant of good faith in relation to a breach of an express term of the contract.¹⁸⁰

Furthermore, such jurisdictions hold that the covenant serves only to “animate those express terms and supports a claim for breach of the express contract.”¹⁸¹ Under this view of the implied covenant of good faith and fair dealing, the covenant acts as a redundancy since it does not hold parties to any independent obligation except those expressed in the terms of the contract.¹⁸² In effect, the covenant does not impose an obligation on the party to act in a way consistent with the underlying contract; it only obligates the party to perform the provisions that are expressed in the contract in a manner consistent with good faith.

Take for instance, *Hardee's Food Systems v. Hallbeck*.¹⁸³ In that case, the defendant, Hallbeck, filed a counterclaim against Hardee's Food Systems (“Hardee's”), alleging that Hardee's breached the covenant of good faith and fair dealing by failing “to deliver to [the Hallbecks] a viable

¹⁷⁸ *E.g.*, *Tidmore Oil Co. v. BP Oil Co.*, 932 F.2d 1384, 1391 (11th Cir. 1991).

¹⁷⁹ *Payless Car Rental Sys., Inc. v. Elkik*, 702 S.E.2d 697, 700 (Ga. App. 2010) (quoting *Snow v. Ruden, McClosky, Smith, Schuster & Russell, P.A.*, 896 So. 2d 787, 792 (Fla. Dist. Ct. App. 2005); *see also* Caruso, *supra* note 5, at 208.

¹⁸⁰ *See* Caruso, *supra* note 5, at 208.

¹⁸¹ Caruso, *supra* note 5, at 208; *see also, e.g.*, *Tidmore Oil Co.*, 932 F.2d at 1391.

¹⁸² *Dunkin' Donuts Franchised Rests. LLC v. Grand Cent. Donuts*, No. CV 2007 4027(ENV)(MDG), 2009 WL 1750348, at *3 (E.D.N.Y. June 19, 2009).

¹⁸³ 776 F. Supp. 2d 949 (E.D. Mo. 2011).

franchise concept and a reasonable opportunity to succeed.”¹⁸⁴ The court held that, although Missouri law imposes an implied covenant of good faith and fair dealing in every contract as related to the “manner in which a party employs discretion conferred by a contract,” the covenant “cannot give rise to new obligations not otherwise contained in the contract’s express terms.”¹⁸⁵ The implied covenant simply prohibits one party from “depriving the other party of its expected benefit under the contract.”¹⁸⁶ Similarly, in *Teng Moua v. Jani-King of Minnesota*,¹⁸⁷ the U.S. District Court for the District of Minnesota stated that the implied covenant “serves only to enforce existing contractual duties, and not to create new ones.”¹⁸⁸ In both of these cases, the franchisee parties, Hallbeck and Teng Moua, failed to provide sufficient evidence to support a breach of contract claim and thus failed to allege a sufficient derivative cause of action for breach of the implied covenant of good faith and fair dealing by the franchisors, Hardee’s and Jani-King, respectively.¹⁸⁹

The U.S. District Court for the Western District of Pennsylvania has recognized three potential limitations of the scope of the implied duty of good faith and fair dealing under this majority view: (1) it may only be applied in limited circumstances, (2) it may not give rise to an independent cause of action, and (3) the implied duty may not override express contractual terms.¹⁹⁰

B. *The Minority Position*

Though the prevailing view described above is what has been favored in recent judicial decisions, courts in various jurisdictions around the country are opening up to the idea of treating the implied covenant of good faith and fair dealing as a gap-filling mechanism, due in part to the covenant’s malleable nature, as well as uncertainties inherent in the

¹⁸⁴ Defendant’s First Amended Answer, Defenses, Affirmative Defenses and Counterclaims ¶ 19, *Hardee’s Food Sys., Inc. v. Hallbeck*, 776 F. Supp. 2d 949 (E.D. Mo. 2011) (No. 4:09-cv-00664).

¹⁸⁵ *Hardee’s Food Sys., Inc.*, 776 F. Supp. 2d at 952–53 (quoting *BJC Health Sys. v. Columbia Cas. Co.*, 478 F.3d 908, 914 (8th Cir. 2007)).

¹⁸⁶ *Id.* at 953 (quoting *Morton v. Hearst Corp.*, 779 S.W.2d 268, 273 (Mo. App. 1989)).

¹⁸⁷ 810 F. Supp. 2d 882 (D. Minn. 2011).

¹⁸⁸ *Teng Moua v. Jani-King of Minnesota*, 810 F. Supp. 2d at 899 (quoting *Allen v. Thom*, No. A07-2088, 2008 WL 2732218, at *5 (Minn. Ct. App. July 15, 2008)).

¹⁸⁹ See *Hardee’s Food Sys. Inc.*, 776 F. Supp. 2d at 953; *Teng Moua*, 810 F. Supp. 2d at 904.

¹⁹⁰ *Martrano v. Quizno’s*, No. 08-0932, 2009 WL 1704469, at *18–19 (W.D. Pa. June 15, 2009).

franchise relationship.¹⁹¹ Pursuant to this view of the covenant of good faith and fair dealing, a party vested with the ability to exercise discretion under the franchise agreement must do so in good faith.¹⁹² If a franchisor exercises such discretion in a way as to frustrate the reasonable expectations of the franchisee, such exercise of discretion may constitute a breach of the underlying contract, even though no express term of the franchise agreement was breached. Pursuant to this view, then, the covenant acts to protect the bargained-for benefit of the parties by providing a cause of action for breach of the contract without breach of an express term because the exercise of discretion was such as to frustrate the parties' agreement.¹⁹³

New York, as well as Massachusetts, has adopted a version of this view within the franchise context. In *Coca Cola North America v. Crawley Juice, Inc.*,¹⁹⁴ the court alluded to the contours of the implied covenant in a dispute over a distribution agreement.¹⁹⁵ The court held that Coca Cola North America ("Coca Cola") had not breached the implied covenant of good faith and fair dealing because they had not acted in a way that would deprive the other party of the fruits of the bargained for contract.¹⁹⁶ Instead, Coca Cola had performed according to the express terms of the contract.¹⁹⁷ However, the court's analysis summarized New York's position by stating that the "scope of the potential liability for breach of the covenant is quite narrow: such a breach cannot give rise to liability if it merely replicates the liability for breach of the underlying contract, nor can it create new contractual rights or impose additional duties."¹⁹⁸ Yet, the New York court went on to expand on the implied covenant of good faith and fair dealing by stating that a breach of the covenant may occur "where the contract is not technically breached, but one party has acted to destroy or injure the right of the other party to receive the benefit of he contract."¹⁹⁹ This is an important departure from the majority rule as stated above. Instead of requiring that a

¹⁹¹ *Fleetwood v. Stanley Steamer Int'l.*, 725 F. Supp. 2d 1258, 1274 (E.D. Wash. 2010).

¹⁹² *See, e.g., Warren Distrib. Co. v. InBev USA L.L.C.*, No. 07-1053, 2010 WL 2326168, at *4 (D.N.J. June 7, 2010); *Coldwell Banker Real Estate, LLC, v. Plummer & Assocs.*, No. 09-1313, 2009 WL 3230840, at *3 (D.N.J. Oct. 2, 2009).

¹⁹³ *See Fleetwood*, 725 F.Supp. 2d at 1274; *Doyle v. Nutrilawn U.S., Inc.*, No. C09-0942JLR, 2010 WL 1980280, at *8 (W.D. Wash. May 17, 2010).

¹⁹⁴ Nos. 09-CV-3259, 09-CV-3260, 09-CV-3279, 2011 WL 1882845 (E.D.N.Y. May 17, 2011).

¹⁹⁵ *See Coca-Cola N. Am. v. Crawley Juice, Inc.*, 2011 WL 1882845, at *9.

¹⁹⁶ *See id.* at *9.

¹⁹⁷ *Id.* at *10.

¹⁹⁸ *Id.* at *9.

¹⁹⁹ *Id.* at *9 (quoting *Witherspoon v. Rappaport*, 65 F. App'x 356, 359 (2d Cir. 2003)).

breach of an express provision occur in order to have a valid claim for breach of the implied covenant of good faith and fair dealing, the covenant may give rise to an independent cause of action if a party has destroyed the right of the other party to receive the bargained-for fruits of the contract.

New Jersey courts have followed a formulation similar to that of New York and have interpreted the implied covenant of good faith and fair dealing as “having the effect of a commitment that ‘neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract.’”²⁰⁰ Again, due to the covenant’s ability to be brought as an independent cause of action against the alleged wrong-doer, this is an important departure point from the majority rule. The New Jersey Court went on to state that, “though a party may not have breached a contract’s express terms, it may be liable under this theory for engaging in conduct that frustrates the other party’s receipt of the bargained for benefit.”²⁰¹ Additionally, the New Jersey Supreme Court articulated a substantial test for determining whether the implied covenant has been breached:

[A] party exercising its right to use discretion in setting price under a contract breaches the duty of good faith and fair dealing if that party exercises its discretionary authority arbitrarily, unreasonably, or capriciously, with the objective of preventing the other party from receiving its reasonably expected fruits *under the contract*. Such risk clearly would be beyond the reasonable expectations of the parties at the formulation of a contract when parties reasonably intend their business relationship to be mutually beneficial. They do not reasonably intend that one party would use the powers bestowed on it to destroy unilaterally the other’s expectations without legitimate purpose.²⁰²

This articulated test is important for a variety of reasons, including its fundamental adherence to the principle that the implied covenant of good faith and fair dealing is intended to protect the bargained-for interest of the

²⁰⁰ *Coldwell Banker Real Estate, LLC. v. Plummer & Assocs., Inc.*, No. 09-1313, 2009 WL 3230840 at *3 (quoting *Sons of Thunder, Inc. v. Borden, Inc.*, 690 A.2d 575, 587 (N.J. 1997)).

²⁰¹ *Id.* at *3 (quoting *Brunswick Hills Racquet Club, Inc. v. Route 18 Shopping Ctr. Assocs.*, 864 A.2d 387, 396 (N. J. 2005)).

²⁰² *JOC, Inc. v. Exxonmobil Oil Corp.*, No. 08-5344, 2010 WL 1380750, at *5 (D.N.J. Apr. 1, 2010) (citing *Wilson v. Amerada Hess Corp.* 773 A.2d 1121, 1126 (N.J. 2001)) (emphasis in original).

parties. Here, despite what the express terms of the contract state, notions of a mutually beneficial relationship and the reasonable expectations of the parties are forced to the forefront and the realist perspective of how the relationship is intended to operate at its founding are considered. Additionally, the New Jersey Supreme Court's opinion sets forth a workable standard of arbitrariness, unreasonableness, and capriciousness, which has long been used elsewhere in law.²⁰³ The opinion also sets forth the concept of discretion, which forms an important part of the parties' franchise agreement. If one party exercises its vested discretion in such a way that the court finds its exercise arbitrary, unreasonable or capricious, then such a person could be held to violate the covenant of good faith.²⁰⁴ Indeed, in *JOC v. Exxonmobil Oil Corp.*,²⁰⁵ the U.S. District Court for the District of New Jersey found that the plaintiffs had alleged sufficient facts to proceed on a claim of breach of the implied covenant of good faith and fair dealing when they alleged that the defendant exercised discretion over pricing, rental rates, and other such discretionary decisions which the defendant allegedly knew would prevent the plaintiff from receiving the benefit of he bargained for contract.²⁰⁶

One must be careful, however, not to be subsumed by the covenant of good faith, as it does have its limits. In the New York case of *Yonaty v. Amerada Hess Corp.*,²⁰⁷ the court articulated one of the limits of the implied covenant of good faith and fair dealing by stating that "no obligation can be implied that would be inconsistent with other terms of the contractual relationship."²⁰⁸ Additionally, the court stated that "[t]o show a breach of the covenant... a plaintiff must show '(1) fraud, (2) malice, (3) bad faith, (4)

²⁰³ *JOC, Inc.*, 2010 WL 1380750, at *5; *see, e.g.*, *Rabb v. State Bd. Of Certified Pub. Accountants of La.*, 893 So. 2d 904, 906 (La. Ct. App. 2004) (stating the standard of appellate review of administrative agency decisions is that of arbitrary, capricious and "clearly unreasonable" in the context of certificate revocation of an accountant); *Citizens Alliance to Protect Our Wetlands v. Wynn*, 908 F. Supp. 825, 830 (W.D. Wash. 1995) (stating that, under the Administrative Procedures Act in the context of the issuance of a permit under the Clean Water Act by the Army Corp of Engineers to build a horseracing facility, a court may not set aside agency action unless it is arbitrary or capricious and there is no rational basis for the action); *Kiester v. Humana Hosp. Alaska, Inc.*, 843 P.2d 1219, 1223 (Alaska 1992) (explaining that a court reviews a hospital's denial of privileges to a doctor according to both procedural and substantive due process which requires that "procedures employed by the hospital are fair, that the standards set by the hospital are reasonable, and that they have been applied without arbitrariness and capriciousness").

²⁰⁴ *JOC, Inc.*, 2010 WL 1380750, at *5.

²⁰⁵ No. 08-5344, 2010 WL 1380750 (D.N.J. Apr. 1, 2010).

²⁰⁶ *Id.* at *6.

²⁰⁷ No. 3:04-CV-605, 2009 WL 2824733 (N.D.N.Y. Aug. 31, 2009).

²⁰⁸ *Id.* at *2.

other intentional wrongdoing, or (5) reckless indifference to the right of others such as gross negligence.”²⁰⁹ This imparts the very important limitation of bad motive into the equation of good faith, but still, there must be some affirmative action by the allegedly breaching party that injures the aggrieved party.

The Washington courts have also recognized similar contours to the covenant of good faith. For example, in *Fleetwood v. Stanley Steamer International, Inc.*,²¹⁰ the court described the doctrine of good faith as having a “malleable nature,” used in litigation to combat the “uncertainties inherent in franchise relationships,” with the covenant being most often applied to “the party assuming discretionary control in the agreement.”²¹¹ While the Washington Court declined to hold that Stanley Steamer breached the covenant of good faith, it did recognize the importance of the covenant’s role in the relationship between the franchisor and franchisee.²¹² The court stated that the covenant is designed to protect the parties’ reasonable expectations, but was reluctant to use the covenant “as a basis for redefining the parties’ relationship or for imposing unanticipated burdens or limitations on one of the parties.”²¹³ However, it is important to note that the court did not state that the covenant did not impose burdens on the parties.²¹⁴ Instead, it stated that the burden imposed on the parties is to exercise discretion in a reasonable manner and in good faith.²¹⁵ This is illustrated by the court’s recognition that “[a]t the outset of a franchise relationship there is undoubtedly an expectation on the part of all concerned that the system will grow and prosper.”²¹⁶ Additionally, the court observed that courts must look past what is stated in the franchise agreement because “[r]easonable expectations obviously cannot be judged solely on the basis of the gains anticipated by the contracting parties.”²¹⁷

C. *No Covenant of Good Faith*

While most of the country follows the above-mentioned philosophies regarding the covenant of good faith and fair dealing, there are several

²⁰⁹ *Id.*

²¹⁰ 725 F. Supp. 2d 1258 (E.D. Wash. 2010).

²¹¹ *Fleetwood v. Stanley Steamer Int’l.*, 725 F. Supp. 2d at 1274.

²¹² *Id.*

²¹³ *Id.*

²¹⁴ *See Id.* at 1274.

²¹⁵ *Id.*

²¹⁶ *Id.*

²¹⁷ *Fleetwood*, 725 F. Supp. 2d at 1274.

states which do not recognize the covenant of good faith. Furthermore, a few states allow parties to waive the covenant of good faith in franchise agreements. For instance, in *Tri-County Retreading v. Bandag*,²¹⁸ the Missouri Court of Appeals held that, under Iowa law, there is no implied covenant of good faith and fair dealing in fully integrated agreements.²¹⁹ In essence, the integration of the contract dictates that the parties have reached the full agreement and nothing outside the agreement may be considered as part of the agreement. The problem with this formulation is that it ignores the relational aspect of the parties within the franchise relationship and therefore fails to see all possible contingencies in a ten year, or longer, business relationship. This is untenable since economic conditions, as well as public preference toward a particular product, are liable to change during the course of the relationship. Additionally, such a standard ignores the realities of the operation of the franchise relationship and the reason why the relationship was entered into in the first place: commencement of a mutually beneficial long-term relationship intended to afford a degree of independence as well as dependence upon each of the parties.

The United States District Court for the Southern District of Indiana held that the courts rarely impose a common law duty of good faith and fair dealing where the terms of the agreement are clear and unambiguous.²²⁰ While this formulation is more based in the realities of the franchise agreement, it too ignores the idea that a contract which clearly vests discretion in a party may be breached due to that discretion being operated in such a way as to deprive the other party of the benefit of the contract and in essence destroy the relationship as it existed at the time the franchise agreement was entered into. In another vein, the Arkansas courts have allowed the parties to be able to waive the implied covenant of good faith and fair dealing in the franchise agreement by express term.²²¹ While freedom of contract is a cornerstone of modern contract theory, the ability to license the other party to act in bad faith seems to be an unconscionable exercise of the freedom of contract.

²¹⁸ 851 S.W.2d 780 (Mo. Ct. App. 1993).

²¹⁹ *Id.* at 784.

²²⁰ *Craig & Landreth, Inc. v. Mazda Motor of Am., Inc.*, 744 F. Supp. 2d 818, 826 (S.D. Ind. 2010); *see also* *Ennes v. H & R Block E. Tax Servs., Inc.*, No. 3:01CV-447, 2002 WL 226345, at *3 (W.D. Ky. Jan. 11, 2002) (holding that Kentucky does not recognize the implied covenant of good faith and fair dealing as giving rise to a separate tort action outside the context of insurance contracts even though franchisor could take unfair advantage of a franchisee).

²²¹ *Gunn v. Farmers Ins. Exch.*, 372 S.W.3d. 346, 351–52 (Ark. 2010).

CONCLUSION

There has been an evolution in the law of contracts that has been motivated by agreements that set forth long-term relations between the parties. We began with an examination of the changes brought about by the realists in the middle of the twentieth century, when they drafted Article II of the UCC. Article II's changes to contract law were dictated by the commercial realities of that time as evidenced by our illustration in the introduction of the commercial relationship between Hal and Marge.

During the 1970s the franchise relationship came to fruition and, as professor Hadfield noted in his above-quoted article, there was a need for more elasticity in construing the long-term franchise relationship.²²² A dichotomy developed between the franchisors who favored a more strict construction of the franchise agreement and the franchisees who desired more elastic standards of interpreting contractual provisions embodied by the implied covenant of good faith and fair dealing.

In examining the court decisions through the date of this article's publication, it is apparent that neither franchisors nor franchisees get everything they desire in contract interpretation. On one hand, the franchisors have not been able to convince the courts to adopt strict construction of the franchise contracts and, on the other hand, the courts have refused to pronounce a fiduciary relationship between franchisors and franchisees. In describing the tension between two parties to a business transaction that is governed by Article II principles, the authors of the textbook *Commercial Transactions: A Systems Approach* note, "unfortunately the Article II drafters were better at identifying the tension between freedom of contract and anti-oppression than they were at outlining specific factors to resolve it."²²³ The same observation can be made of regulatory efforts and judicial interpretation of franchise agreements. As Professor Hadfield aptly observed, the elasticity provided by the implied covenant of good faith and fair dealing appears to be a fair standard.²²⁴

Even though it may be difficult to enunciate factors that would apply in all franchise contract interpretation cases, there is a need for more uniformity in interpreting the implied covenant of good faith and fair

²²² See Hadfield, *supra* note 34, at 985 n.262; see Caruso, *supra* note 6, at 209.

²²³ LYNN M. LOPUCKI, ELIZABETH WARREN, DANIEL KEATING, & RONALD J. MANN, *COMMERCIAL TRANSACTIONS: A SYSTEMS APPROACH* (Aspen Publishers, 2009).

²²⁴ See Hadfield, *supra* note 34, at 984 (arguing that the covenant of good faith is a crucial means of aligning franchise contract dispute resolution with the reality of underlying franchise relationships).

dealing, due in large part to the national and international nature of franchises. This author would suggest the following:

- Courts should not interpret the franchise contract to change the deal, nor should they change express provisions upon which the parties have agreed.
- A waiver of the principle of good faith in interpreting a franchise agreement should be invalid *per se*.
- The only way a franchise relationship is going to be profitable or successful for both parties is that a win-win situation is created through the contractual relationship and judicial interpretation, focusing on the concept of discretion.

It is the opinion of this author that where discretion is authorized by express contract provisions, an operations manual, or any other document apart from the franchise agreement, that the implied covenant of good faith and fair dealing should be actively used as a standard by the court to produce a favorable and profitable relationship for both parties. At this point, it appears that the Washington and New York cases come close to these suggestions. This author encourages future courts to favor the position of those states in lieu of the majority rule, as set forth in the Burger King cases discussed in this article.

THE U.S. INTERNATIONAL TRADE COMMISSION
AND TRADE REMEDY INVESTIGATIONS:
10 SUGGESTIONS FOR IMPROVEMENT

Daniel B. Pickard*

INTRODUCTION

The United States International Trade Commission (“ITC”) is one of the most powerful, albeit least known, agencies in the Federal Government. The ITC is an independent, quasi-judicial, federal agency, which, in trade remedy investigations, determines whether a domestic industry is materially injured, or threatened with material injury, by dumped or subsidized imports.¹ The ITC’s decisions in these trade remedy cases, generally either antidumping or countervailing duty investigations,² can have major effects on both international trade and domestic industries, specifically by determining whether U.S. manufacturers and their workers are entitled to a remedy against unfair import competition.

This article examines the ITC’s current investigation procedures and suggests 10 changes that could be made to the statutes that govern the ITC and its reviewing courts.³ These suggestions are intended to create more

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¹ See 19 U.S.C. §§ 1330(a)–(b), 1337, 1677(7) (2006); see also *About the United States International Trade Commission*, UNITED STATES INT’L TRADE COMM’N, http://www.usitc.gov/press_room/about_usitc.htm (last visited Nov. 11, 2012).

² 19 U.S.C. §§ 1671, 1673a (2006).

³ Specifically, this article includes 10 recommendations for changes in the law as to the ITC and the authority of its reviewing courts. It should be noted that ITC injury determinations no longer cite to any economic modeling. See *Altx, Inc. v. United States*, 26 Ct. Int’l Trade 1425, 1431–32 (2002) (opining that the ITC used an economic model in the past to determine the effects of dumped imports, but no longer rely upon it), *aff’d*, 370 F.3d 1108 (Fed. Cir. 2004). Parties before the ITC, and the institution itself, would benefit from the use of sound economic modeling, which would provide additional guidance to counsel in formulating their arguments as well as protect the reputation of the agency for principled decision-making. This article addresses 10 proposed legal improvements, and therefore discussion of an increased role for economics in ITC determinations is beyond the scope of this paper.

accountability, efficiency, and meaningful judicial review of this important agency and its work.

I. OVERVIEW OF UNITED STATES TRADE REMEDY LAWS

Before proposing any improvements that could be made to the ITC's governing statutes and regulations, it is appropriate to first provide an overview of how antidumping and countervailing duty investigations are conducted. These two types of trade remedy investigations provide relief to U.S. manufacturers that have been injured, or are threatened with injury, as a result of unfairly priced imports.

Under the antidumping ("AD") statute,⁴ members of a particular domestic industry may petition the United States government to investigate imports of similar foreign goods.⁵ If unfair trade practices are discovered, the statute prescribes compensating duties.⁶ In order for such AD duties to be imposed, two threshold requirements must be met: (1) the imports are sold in the United States at less than fair value; and (2) the low-priced imports are a cause of, or threaten, material injury to the domestic industry that produces similar products.⁷ Similarly, in a countervailing duty ("CVD") investigation, the United States government must determine two elements of unfair trade practices before taking any remedial measures: (1) whether imports are being subsidized by the government of the exporting country, and (2) whether the subsidized imports are a cause of, or threaten, material injury to the corresponding domestic industry.⁸

Generally, AD and CVD investigations are conducted together on parallel tracks before both the ITC and the United States Department of Commerce ("Commerce").⁹ In both AD and CVD cases, the ITC determines whether a domestic industry is materially injured, or threatened with material injury, by the dumped or subsidized imports.¹⁰ In an AD case, Commerce ascertains whether the imported products are being sold at less than fair value—or "dumped"—into the United States market and

⁴ 19 U.S.C. §§ 1673, 1673a–1673h (2006).

⁵ §§ 1673, 1673a(b)(1).

⁶ § 1673.

⁷ *Id.*

⁸ 19 U.S.C. § 1671(a) (2006).

⁹ See UNITED STATES INT'L TRADE COMM'N, PUB. 4056, ANTIDUMPING AND COUNTERVAILING DUTY HANDBOOK II-3 (13th ed. 2008) [hereinafter ITC HANDBOOK], available at http://www.usitc.gov/trade_remedy/documents/handbook.pdf.

¹⁰ §§ 1671(a), 1673.

calculates a duty rate that appropriately offsets the extent of unfair pricing.¹¹ In a CVD case, Commerce is responsible for determining the nature and extent of subsidies provided by foreign governments to producers that are exporting merchandise to the United States.¹² Commerce then assesses a countervailing duty, or tax, on the subsidized imports in order to offset the effect of the subsidy.¹³

Domestic companies or industry trade associations can initiate the investigative process by simultaneously filing an antidumping and/or countervailing duty petition with both Commerce and the ITC.¹⁴ After the investigation is initiated, opposing and neutral companies that are involved in the production or import of the relevant product are required, under threat of subpoena, to provide information necessary to the investigation.¹⁵ Foreign producers who do not fully cooperate with the investigation may be subject to the application of “adverse inferences,” which, in effect, allows the relevant agency to draw negative inferences about the non-cooperative foreign producers in favor of the domestic producers who support the petition.¹⁶

Before imposing the relevant antidumping and/or countervailing duties, the ITC must first find that the imports are a cause of material injury, or threat thereof, to the corresponding United States industry.¹⁷ In this regard, “material injury” is defined simply as harm that is more than inconsequential, insignificant, or immaterial.¹⁸ As such, the domestic industry can demonstrate injury in a number of ways, most effectively through downward trends in financial data, including that related to production, shipments, profits, etc.¹⁹ Under relevant law, operating losses are not a necessary component of material injury if it is otherwise clear that

¹¹ § 1673; *see also* 19 U.S.C. § 1677(1) (2006) (specifying that the Secretary of Commerce is the “administering authority”).

¹² § 1671(a); *see also* § 1677(1) (specifying that the Secretary of Commerce is the “administering authority”).

¹³ § 1671(a).

¹⁴ 19 U.S.C. §§ 1671a(b), 1673a(b), 1677(9)(C)–(F) (2006).

¹⁵ *See, e.g.*, UNITED STATES INT’L TRADE COMM’N, OMB. NO. 3117-0016, U.S. PRODUCERS QUESTIONNAIRE (2011), *available at* http://www.usitc.gov/trade_remedy/documents/USProducerQuestionnaire.pdf (“This report is mandatory and failure to reply as directed can result in a subpoena or other order to compel the submission of records or information in your possession (19 U.S.C. § 1333(a)).”).

¹⁶ *See* 19 U.S.C. § 1677e(b) (2006).

¹⁷ 19 U.S.C. §§ 1671(a), 1673 (2006).

¹⁸ § 1677(7)(A).

¹⁹ § 1677(C)(iii).

the industry would have been better off absent the subject imports.²⁰ As long as the dumped and/or subsidized imports are found to be a cause of material injury or threat thereof, the ITC should make an affirmative determination, even if there are other, more significant causes of such injury or threat.²¹

In addition to antidumping and countervailing duty cases, the ITC also conducts the considerably less frequent trade remedy investigations known as “safeguards.”²² A safeguard investigation, also known as a “Section 201”, is potentially one of the strongest trade remedy actions under United States law, in part because it employs a broad range of trade remedies intended to help American producers adjust to increased competition from imports.²³

As early as 1934, the United States recognized that domestic producers could be harmed by an increase in imports and decided to provide relief, under certain conditions, to injured sectors of the economy.²⁴ Although foreign exporters were not necessarily trading unfairly, the general expansion in global trade increased domestic companies' need for flexibility to adjust to rapidly changing imports levels. Therefore, in the 1940s, the United States began to enter into trade agreements, most notably the General Agreement on Tariffs and Trade (“GATT”).²⁵ These trade agreements included “escape clause” or “safeguard” mechanisms to provide such needed relief.²⁶ Subsequently, Congress included Section 201 in the Trade Act of 1974, which mirrors the safeguard provisions contained in the GATT.²⁷ Commonly known as the “escape clause,” Section 201 allows the

²⁰ Daniel B. Pickard & Laura El-Sabaawi, *The Future of Rule 11 Sanctions for Unethical Conduct Before the U.S. Court of International Trade*, 19 TUL. J. INT'L & COMP. L. 587, 592 (2011); see § 1677(7)(C)(iii) (identifying what common factors are used to determine when a material injury or threat of a material injury has occurred, and does not include operating losses as a deciding factor).

²¹ See § 1677(7)(F)(ii) (limiting the factors which can be used to determine whether dumped or subsidized imports are a cause of material injury).

²² 19 U.S.C. § 2252(b)(1)(A) (2006).

²³ 19 U.C.C. § 2253(a)(3) (2006).

²⁴ STAFF OF H. COMM. ON WAYS AND MEANS, 105TH CONG., OVERVIEW AND COMPILATION OF U.S. TRADE STATUTES 99 (Comm. Print 1997) [hereinafter WAYS & MEANS].

²⁵ General Agreement on Tariffs and Trade, Oct. 30, 1947, 61 Stat. A-11, 55 U.N.T.S. 194 [hereinafter GATT 1947].

²⁶ See, e.g., *id.* at art. XIX.

²⁷ 19 U.S.C. § 2251 (2006).

President to take action in order to facilitate an injured domestic industry's efforts to adjust to import competition.²⁸

If the ITC makes an affirmative injury determination under Section 201, then the investigation proceeds to a remedy phase, in which the ITC recommends specific actions that can be taken to address and counteract the determined injury.²⁹ Once the ITC issues its recommendations, the President may authorize various remedial measures, such as: increasing or imposing duties, enforcing a tariff-rate quota, modifying or compelling quantitative restrictions, implementing adjustment measures, withdrawing or altering concessions provided to United States trading partners, and commencing negotiations with foreign governments to limit exports into the United States.³⁰

For these reasons, antidumping, countervailing duty, and safeguard investigations are extremely powerful tools and are of special importance to American workers and manufacturers who are being injured, or threatened with injury, by reason of import competition.

II. TEN SUGGESTIONS TO IMPROVE THE ITC AND JUDICIAL REVIEW

The ITC is the federal agency responsible for making injury determinations in trade remedy investigations.³¹ In the current era of economic crises and increased trade frictions, the United States laws governing how the ITC functions and conducts trade remedy investigations are of increased importance. This article presents 10 suggestions for improving and facilitating the important work performed by the ITC. These recommendations are intended to increase the fairness and efficiency of the ITC's crucial responsibilities in regard to remedying foreign entities' unfair trade practices, as well as provide for more meaningful judicial review of these determinations.

A. *Suggestion #1: ITC Decisions Should Have Precedential Value*

It is a hallmark of the common law system that judicial decisions have precedential value. The ITC's decisions, however, are *sui generis*, literally

²⁸ WAYS & MEANS, *supra* note 24 .

²⁹ 19 U.S.C. § 2252(e) (2006).

³⁰ 19 U.S.C. § 2253(a) (2006).

³¹ 19 U.S.C. § 1337(c) (2006).

meaning “of its own kind.”³² An adjudicative body applying a *sui generis* standard is not bound by its prior decisions.³³ Instead, the adjudicator makes decisions on a case-by-case basis. Indeed, the ITC has noted in various decisions that its determinations are not bound by potentially conflicting findings made in previous investigations, even if based on very similar facts.³⁴

Indeed, the CIT has affirmed that the ITC is under no obligation to follow its prior factual determinations in subsequent investigations.³⁵ Theoretically, if an ITC decision deviates from an “agency practice,” the ITC should provide “a reasoned explanation of its decision.”³⁶ Nevertheless, the ITC’s reviewing courts have accepted the *sui generis* nature of ITC determinations and rarely remand ITC decisions based on deviation from an established practice.³⁷

The original rationale behind the ITC’s *sui generis* standard was founded on the notion that cases alleging unfair import practices are rarely the same, and, as such, decisions in previous cases are of little guidance.³⁸

³² See, e.g., *Comm. for Fair Beam Imps. v. United States*, 27 Ct. Int’l Trade 932, 944 (2003) (“[I]t is an equally well-established proposition that the ITC’s material injury determinations are *sui generis*; that is, the agency’s findings and determinations are necessarily confined to a specific period of investigation with its attendant, peculiar set of circumstances.”) (alteration added), *aff’d*, 95 F. App’x. 347 (Fed. Cir. 2004). See also BLACK’S LAW DICTIONARY 1572 (9th ed. 2009).

³³ See *Citrosuco Paulista, S.A. v. United States*, 12 Ct. Int’l Trade 1196, 1209 (1988).

³⁴ *Light-walled Rectangular Pipe and Tube From Mexico and Turkey*, Inv. Nos. 731-TA-1054, 731-TA-1055, USITC Pub. 3728 (Oct. 12, 2004) (Final) at 6.

³⁵ See *Comm. for Fair Beam Imps.*, 27 Ct. Int’l Trade at 943 (recognizing the ITC arguments that because of the *sui generis* nature of its injury investigations there is a difference between “agency practice,” which would have precedential value, and case-specific determinations, which would not (citing *Ranchers-Cattlemen Action Legal Found. v. United States*, 23 Ct. Int’l Trade 861, 884–85 (1999))).

³⁶ See *Comm. for Fair Beam Imps.*, 27 Ct. Int’l Trade at 944. In *Usinor v. United States*, the Court did acknowledge that “each injury or investigation is *sui generis*, involving a unique combination and interaction of many economic variables,” and emphasized that the ITC “may not disregard previous findings of a general nature that bear directly upon the current review.” 26 Ct. Int’l Trade 767, 792 (2002).

³⁷ This is a considerable understatement. See, e.g., *Nucor Corp. v. United States*, 328 Ct. Int’l Trade 188, 233 (2004), *aff’d*, 414 F.3d 1331 (Fed. Cir. 2005).

³⁸ James Pomeroy Hendrick, a Deputy Assistant Secretary of the Treasury during the Kennedy and Johnson Administrations, noted the following in a 1964 article on the Antidumping Act:

The Tariff Commission, unlike American courts of law, is not bound by its own precedents. Even if it were, one must recognize that it is seldom that two cases are found which are truly alike. The elements may be

Now, however, due in equal parts to the importance of the ITC's quasi-judicial decisions and the significant due process rights that are at stake, it is time for the ITC to be subject to some form of binding precedent similar to the doctrine of *stare decisis*.

The application of *sui generis* increases the potential for arbitrary and capricious decision-making.³⁹ Our common law legal system is based on the notion that precedent provides a principled way to decide subsequent cases based on similar issues or facts. Specifically, it is axiomatic that justice requires similar cases to be decided similarly so that the law is predictable and the court produces consistent outcomes. As the ITC performs its functions in a quasi-judicial manner, both the institution and the parties before it would benefit from the application of at least a limited form of *stare decisis* to its determinations in these important matters.⁴⁰

similar, but often enough there can be subtle differences, apprehended only after careful study of the entire record, which justify an injury decision in one and a no-injury decision in the other case.

Armstrong Bros. Tool Co. v. United States, 84 Cust. Ct. 16, 36 (1980) (citing James Pomeroy Hendrick, *The United States Antidumping Act*, AM. J. INT'L L. 914, 924 (1964)). In a similar vein, another Assistant Secretary of the Treasury made the following observation in testimony before the House Ways and Means Committee:

To try to define "injury" is very much like trying to define precisely some of the phrases of the common law or of equity where the court's tradition may and should come to its judgment by weighing all of the factors in balance; and in any one case the balance may be very different from that of another. Injury to a large corporation or to the owner of a chain of stores may be very different from injury to the corner grocer. Injury to one industry may be very different from injury to another. Under the same set of facts mathematically opposite conclusions or differing conclusions could be drawn. These are questions of economics, not sensitive to either exact science or to predetermined close lines or channels of thought.

Id.

³⁹ See generally RICHARD J. PIERCE, JR., ADMINISTRATIVE LAW TREATISE 814 (Aspen Law & Bus. 4th ed. 2002) (discussing the need for agencies to discuss departures from precedent in order to limit agency discretion). Pierce states that "[a]n agency whose powers are not limited either by meaningful statutory standards or by legislative rules poses a serious potential threat to liberty and to democracy." *Id.* at 815. The treatise further elaborates that "[t]he dominant law clearly is that an agency must either follow its own precedents or explain why it departs from them." *Id.* at 817. The Commission's reliance on the *sui generis* doctrine frustrates the purposes of the above.

⁴⁰ The author notes that this could be achieved by either an Act of Congress amending the ITC's governing statutes or perhaps by amending other legal authorities (e.g. the Administrative Procedure Act (APA)) in order to require the ITC to provide appropriate deference to previous decisions. It is somewhat interesting to note that ITC injury investigations are not bound by the due process protections of the APA. See Taiwan

While each case will inherently pose its own unique set of facts, the analysis that the ITC performs should be consistent and provide guidance as to the likely outcome based on material facts and legal principles.

Therefore, in light of the importance of the work performed by the ITC, it would be appropriate to make sure that it is subject to disciplines of *stare decisis*. As indicated above, it is a distinctive feature of the common law system that judicial decisions have precedential value. The ITC's "quasi-judicial" decisions in trade cases should also have precedential value, as well as the other due process protections afforded by the application of the doctrine of *stare decisis*. The parties before the ITC, and the institution itself, would benefit from this increased requirement for determinations in antidumping and countervailing duty cases.⁴¹ Indeed, justice requires no less than predictable, consistent, and principled outcomes in these crucial determinations.

Semiconductor Indus. Ass'n v. United States, 24 Ct. Int'l Trade 220, 221 (2000) ("Antidumping proceedings, including the Commission's injury [to domestic industry] determination under 19 U.S.C. § 1673d(b) . . . 'are investigatory in nature,' rather than adjudicatory in nature. . . . As such, the provisions of the Administrative Procedure Act, . . . do not apply to the Commission's injury investigation.") (second alteration added) (citation omitted).

⁴¹ At a minimum, there would appear to be value in regard to applying the doctrine of *stare decisis* to the agency's interpretation of ambiguous statutes:

An agency's changing its interpretation of an ambiguous statute should raise concerns that policy preferences or political motives have replaced a principled approach to statutory interpretation and that pure legislative delegation has replaced meaningful limits on agency authority at *Chevron* step two. *Stare decisis* guards against these dangers, and *Chevron*'s justifications provide scant reason why the doctrine should not apply with equal force to the agency as to the judicial context. Indeed, maintaining agency flexibility seems to be the only coherent rationale for granting agencies open-ended reinterpretable authority. But even *Chevron*'s own arguments on this point fail to explain why the vast flexibility *Chevron*'s [sic] provides is necessary or optimal.

To be sure, agency flexibility will suffer under a regime of *stare decisis*. . . . But from the perspective of democratic governance and the integrity of the political process, the argument for *stare decisis* is strong.

Harold Greenberg, Why Agency Interpretations of Ambiguous Statutes Should be Subject to *Stare Decisis* (Jan. 2011) (unpublished comment, Harvard Law School), available at http://works.bepress.com/cgi/viewcontent.cgi?article=1000&context=haroldhank_greenberg.

B. *Suggestion #2: Chevron Deference Should be Eliminated to Increase Judicial Review by the CIT*

When challenged, ITC determinations are first reviewed by the CIT, a specialized Article III court with exclusive jurisdiction over certain international trade issues.⁴² For the reasons set forth below, it would be appropriate for ITC decisions to be subject to increased judicial review by the CIT and for such decisions to be denied deference under the standard established in *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*⁴³

Chevron deference—one of the bedrock principles of administrative law—requires courts of general jurisdiction to defer to an agency’s interpretation of a statute, as long as Congress has not directly addressed the precise question at issue and the agency’s interpretation is based on a reasonable construction of the statute.⁴⁴ The Supreme Court further addressed the issue of judicial deference to agency interpretations of statutory law in *United States v. Mead Corp.*,⁴⁵ which held that the administrative interpretation of a statutory provision is entitled to *Chevron* deference when Congress delegates the general authority to make rules carrying the force of law to that agency and the agency’s determination was an exercise of such delegated authority.⁴⁶ Deference to determinations in antidumping and countervailing duty cases was solidified post-*Chevron* in *American Lamb Co. v. United States*,⁴⁷ where the Federal Circuit held that the ITC was entitled to *Chevron* deference and that the ITC’s determinations need only be “sufficiently reasonable” to be upheld on review.⁴⁸

The logic behind *Chevron* deference, however, is that courts of general jurisdiction do not have expertise in the area of law under review; and, therefore, courts of general jurisdiction should not substitute their interpretation of a statute for that of the specialized agency in charge of administering the statute. In *Chevron*, Justice Stevens noted that interpreting a regulatory statute requires “more than ordinary knowledge

⁴² 28 U.S.C. § 1581 (2006).

⁴³ 467 U.S. 837 (1984).

⁴⁴ *Id.* at 842–43.

⁴⁵ 533 U.S. 218 (2001).

⁴⁶ *Id.* at 226–27.

⁴⁷ 785 F.2d 994 (Fed. Cir. 1986).

⁴⁸ *Id.* at 1001.

respecting the matters subjected to agency regulations.”⁴⁹ Justice Stevens further stated that agencies are better suited to interpret regulatory statutes because judges are not experts in each particular field, and regulatory interpretation often entails making policy choices, which are the realm of the political branches of government, not the courts.⁵⁰

The Customs Court Act of 1980 explicitly provides that the CIT has exclusive jurisdiction over, *inter alia*, antidumping and countervailing duty investigations and certain administrative decisions made by the United States Customs and Border Protection.⁵¹ Furthermore, the Customs Court Act provides the CIT with exclusive jurisdiction over certain cases arising under the Tariff Act of 1930 (“Tariff Act”),⁵² the Trade Act of 1974 (“Trade Act”),⁵³ and the Trade Agreements Act of 1979 (“Trade Agreements Act”).⁵⁴ Because decisions of the ITC, a specialized administrative body, are appealed to the CIT, a similarly specialized court of specialized jurisdiction, concerns that informed decisions made by a specialized tribunal could be overturned by an uninformed court of general jurisdiction are unfounded. Therefore, the underlying rationale of *Chevron* deference does not apply to ITC decisions that are reviewed by the CIT, and, accordingly, decisions of the ITC should not be granted *Chevron* deference. In other words, the decisions of the specialized ITC are reviewed by a Court that specializes in the same subject matter and accordingly the extreme deference of *Chevron* is unwarranted.

As discussed further below, the ITC, to some degree, has resisted the concerns of its reviewing courts. Indeed, even when an original determination is found to lack the support of substantial evidence or is otherwise contrary to law, the ITC rarely changes a determination to provide relief to the domestic industry. Removing the extremely deferential *Chevron* standard for the CIT’s review of ITC determinations would provide increased and more meaningful judicial review.

C. *Suggestion #3: The CIT Should Have Authority to Reverse a Negative ITC Decision*

The CIT has two powers when reviewing an ITC determination. The CIT can either (1) affirm the ITC’s determination, or (2) remand the ITC’s

⁴⁹ *Chevron*, 467 U.S. at 844.

⁵⁰ *Id.* at 865–66.

⁵¹ 28 U.S.C. § 1581(a), (c) (2006).

⁵² § 1581(a)–(c).

⁵³ § 1581(d).

⁵⁴ § 1581(e).

decision if such a determination is not supported by substantial evidence or is otherwise “not in accordance with law.”⁵⁵ The CIT likely will not have the authority to reverse an ITC decision even should it be determined to be unsupported by substantial evidence or if it should be found to be contrary to law.⁵⁶ The ITC, however, is not required to change its decision on remand; and, in fact, it rarely does.⁵⁷ In practice, even though an ITC decision may be factually or logically flawed, the ITC usually makes the same finding on remand as it did in its original decision, only with added justification to address the CIT’s specific concerns.⁵⁸ As such, the CIT is essentially prevented from reversing fatally flawed decisions by the ITC. This practice should be changed. The CIT should, in appropriate circumstances, have the authority to reverse negative decisions of the ITC in order to provide relief to American industries and their workers who have been injured as a result of unfairly priced imports.

The Federal Circuit has acknowledged the CIT’s near inability to reverse an ITC determination, stating that reversing a decision of the ITC is made incredibly difficult under 19 U.S.C. § 1516a—the statute providing for judicial review of antidumping and countervailing duty proceedings.⁵⁹ In essence, because the CIT only has remand authority, it has almost no power to force the ITC to change its findings, even when the ITC’s decision is determined to be fundamentally flawed.

To the best of the author’s knowledge, in the more than 30 years of judicial review, an originally negative ITC determination has been reversed to an affirmative decision providing relief to a domestic industry in only *one* instance.⁶⁰ In *Diamond Sawblades Manufacturers Coalition v. United States*,⁶¹ the ITC initially found that the United States diamond sawblades

⁵⁵ 19 U.S.C. § 1516a(b)(1)(B)(i), (c)(3) (2006).

⁵⁶ § 1516a(c)(3).

⁵⁷ Jay Charles Campbell, *The Trade Litigant’s Gauntlet: The Hanging Judge and the Teflon Tribunal*, 31 NW. J. INT’L L. & BUS. 1, 42 (2011).

⁵⁸ *Id.* at 3–4.

⁵⁹ *Nippon Steel Corp. v. United States*, 458 F.3d 1345, 1359 (Fed. Cir. 2006). The ITC made the argument that its determination could not be reversed under § 1516a, but the court affirmed the determination, and thus never addressed the ITC’s argument. *Id.* In dicta, the court mentioned that the CIT might be able reverse an ITC determination that is not based on substantial evidence if remand would be ineffective. *Id.*

⁶⁰ This instance was the focus of the case *Diamond Sawblades Mfrs. Coal. v. United States*. 32 Ct. Int’l Trade 134 (2008), *aff’d*, 612 F.3d 1348 (Fed. Cir. 2010). This author was lead counsel in *Diamond Sawblades*. See also Campbell, *supra* note 57, at 3–4 (stating that the ITC does not tend to reverse its determinations upon remand).

⁶¹ 32 Ct. Int’l Trade 134 (2008), *aff’d*, 612 F.3d 1348 (Fed. Cir. 2010).

industry was not harmed by imports from China and Korea, even though the sale prices of such imports were determined to be unfair.⁶² The decision to deny relief to the domestic industry was made despite evidence that American producers had lost market share and witnessed decreases in aggregate operating income, operating income margins, and return on assets during the period of investigation, while Chinese and Korean manufacturers gained market share.⁶³ On review, the CIT held that the ITC's findings of attenuated competition, as well as its price-effects analysis and findings on the threat of material injury, were not supported by substantial evidence, and the investigation was remanded back to the ITC for further proceedings.⁶⁴

On remand, the ITC again found that the domestic diamond sawblades industry was not materially injured by imports from China and Korea, but the ITC *did* reverse its position on the threat of material injury, finding that there was competitive overlap between American, Chinese, and Korean sawblades.⁶⁵ In other words, in its second decision, the ITC found that there was a causal relationship between the increased Chinese and Korean imports, the under-selling and price depression caused by the imports, and the deteriorating health of the domestic diamond sawblade industry.⁶⁶ This reversal, however, was not the result of any Commissioner changing his or her individual determination. Rather, it was the result of two new Commissioners joining the ITC.⁶⁷ The *Diamond Sawblade* case, as exceptional as it is, still reinforces the proposition that reversal authority is needed because the ITC has demonstrated an unwillingness to reevaluate prior negative determinations denying relief to United States manufacturers and their workers.⁶⁸

Over three decades of judicial review, remands of ITC determinations have rarely resulted in the Commission changing its denial of relief to American companies.⁶⁹ In order to promote meaningful judicial review,

⁶² *Diamond Sawblades and Parts Thereof From China and Korea*, Inv Nos. 731-TA-1092-1093, USITC Pub. 3862 (July 5, 2006) (Final) [hereinafter *Diamond Parts Final*] at 1.

⁶³ *Diamond Sawblades*, 32 Ct. Int'l Trade at 136.

⁶⁴ *Id.* at 146, 150–51.

⁶⁵ *Diamond Sawblades and Parts Thereof from China and Korea*, Inv. Nos. 731-TA-1092 and 1093, USITC Pub. 4007 (May 14, 2008) (Final) (Remand) [hereinafter *Diamond Parts Remand*] at 1, 3.

⁶⁶ *Id.* at 3–4.

⁶⁷ *See id.* at 1 n.2. Both new Commissioners, Irving A. Williamson and Dean A. Pinkert, made *de novo* determinations and found a threat of material injury in the remand decision. *Id.*

⁶⁸ *See Campbell, supra* note 57, at 42.

⁶⁹ *Id.* at 3–4.

Congress should act to explicitly provide the CIT with the power to, in appropriate circumstances, reverse a negative decision of the ITC, rather than simply remanding the case to the ITC for further justification.

D. *Suggestion #4: Federal Circuit Review Should be Limited to an Abuse of Discretion or Clearly Erroneous Standard*

Judicial review of ITC decisions in antidumping duty and countervailing duty cases is governed by 19 U.S.C. § 1516a, under which the initial review is before the CIT,⁷⁰ and appellate review is before the Federal Circuit.⁷¹ The standard of review for the CIT is set forth in section 1516a(b)(1)(B)(i), which states that “[t]he court shall hold unlawful any determination, finding, or conclusion found . . . in an action brought under paragraph (2) of subsection (a) of this section, to be unsupported by substantial evidence on the record, or otherwise not in accordance with law.”⁷² The statute, however, is silent as to what standard of review the Federal Circuit should apply when hearing appeals from the CIT regarding ITC decisions.⁷³

In *Atlantic Sugar, Ltd. v. United States*,⁷⁴ the Federal Circuit adopted the “substantial evidence” standard and stated that “[t]he statute specifies that the standard of judicial review of a final ITC material injury determination in an antidumping case is whether that determination is ‘unsupported by substantial evidence on the record, or otherwise not in accordance with law.’”⁷⁵ Thus, in *Atlantic Sugar*, the Federal Circuit essentially duplicated the CIT’s standard of review and denied granting any deference to the CIT’s decision. Instead of reviewing the CIT’s decision for error, *Atlantic Sugar* set the precedent for the Federal Circuit to essentially ignore CIT decisions and conduct *de novo* reviews of ITC findings for substantial evidence on the record.

The Federal Circuit’s duplicative standard of review, however, is not supported by the relevant statutes. In *Atlantic Sugar*, the Federal Circuit only cited 19 U.S.C. § 1516a(b)(1)(B) in its adoption of the substantial evidence standard.⁷⁶ As a Federal Circuit judge later observed, however,

⁷⁰ 19 U.S.C. § 1516a(a)(1) (2006).

⁷¹ 28 U.S.C. § 1295(a)(5) (2006).

⁷² 19 U.S.C. § 1516a(b)(1)(i) (2006).

⁷³ See generally § 1516a.

⁷⁴ 744 F.2d 1556 (Fed. Cir. 1984).

⁷⁵ *Id.* at 1559 (quoting 19 U.S.C. § 1516a(b)(1)(B)(i)).

⁷⁶ *Id.*

“[c]arefully read, section 1516a neither requires nor suggests the standard of review for [the Federal Circuit’s] review of decisions from the Court of International Trade.”⁷⁷

As noted above, 19 U.S.C. § 1516a(b)(1)(B)(i) states that “[t]he court shall hold unlawful any determination, finding, or conclusion found . . . *in an action brought under paragraph (2) of subsection (a) of this section*, to be unsupported by substantial evidence on the record, or otherwise not in accordance with law.”⁷⁸ Therefore, the quoted section only defines the court’s standard of review for actions brought under 19 U.S.C. § 1516a(a)(2)(A), which states “[w]ithin thirty days after . . . [an antidumping or countervailing duty order] . . . an interested party . . . may commence an action in the United States Court of International Trade.”⁷⁹ This means that “the court,” for the purposes of the whole of 19 U.S.C. § 1516a, is the CIT and *not* the Federal Circuit, and *Atlantic Sugar*’s sole reliance on 19 U.S.C. § 1516a in adopting the duplicative standard of review is mistaken.⁸⁰ 19 U.S.C. § 1516a does not mention any other court and, therefore, does not expressly provide a standard of review for the Federal Circuit.⁸¹

There are serious consequences arising from the Federal Circuit’s duplicative “substantial evidence” standard of review. By applying the same standard as the CIT and reviewing the ITC’s record for substantial evidence, the Federal Circuit renders the CIT’s review superfluous. Conducting a *de novo* review marginalizes the CIT’s decision and deprives the Federal Circuit of the CIT’s experience and expertise. Losing parties also have the perverse incentive to appeal to the Federal Circuit for what is effectively a second bite of the apple.

Furthermore, the Federal Circuit’s duplicative standard is inefficient and adds time and expense to the appeal process, while wasting scarce judicial resources. As such, the statute should be amended to expressly state that the Federal Circuit’s standard of review is the “abuse of discretion” or “clearly erroneous” standard. “Abuse of discretion may be found when: (1) the tribunal’s decision is clearly unreasonable, arbitrary, or fanciful; (2) the decision was based on an erroneous conclusion of law; (3) the tribunal’s findings are clearly erroneous; or (4) the record contains no evidence upon which the [lower court] rationally could have based its

⁷⁷ *Zenith Elecs. Corp. v. United States*, 99 F.3d 1576, 1580 (Fed. Cir. 1996) (Rader, J., concurring) (second alteration added).

⁷⁸ § 1516a(b)(1)(B)(i) (emphasis added).

⁷⁹ § 1516a(a)(2)(A)(ii) (second alteration added).

⁸⁰ *See generally* § 1516a; *Atlantic Sugar Ltd.*, 744 F.2d 1556 (Fed. Cir. 1984).

⁸¹ *See* § 1516a.

decision.”⁸² Similarly, under the “clearly erroneous” standard, an appellate court will not reverse a lower court unless it has a “definite and firm conviction that a mistake has been committed” by the lower court.⁸³

Replacing the Federal Circuit’s existing “de novo” standard with an “abuse of discretion” or “clearly erroneous” standard would restore the deference that an expert court such as the CIT should command and would remove an inefficient and completely duplicative standard. Additionally, it would promote efficiency because parties would be less likely to appeal to the Federal Circuit, thus reducing the amount of litigation in the federal courts. Perhaps most importantly, it would contribute to a more reasonable method of judicial review of ITC decisions.

E. *Suggestion #5: The ITC and Commerce Should Have One Common Administrative Protective Order*

In antidumping and countervailing duty investigations, the parties need assurances that the confidential business information they provide in the course of the proceedings will not be subject to public disclosure. To accommodate this reasonable expectation during the adjudication process, the ITC only releases confidential business information to authorized applicants under an “administrative protective order” (“APO”).⁸⁴ An APO requires authorized applicants not to divulge any designated confidential business information it obtains during the investigation and limits use of such information to the relevant adjudication.⁸⁵

Similarly, Commerce issues its own APOs during the course of antidumping and/or countervailing duty proceedings.⁸⁶ Commerce’s APO procedures are entirely separate from those of the ITC, and it will only disclose parties’ confidential business information to its own separately authorized APO applicants.⁸⁷

While the ITC and Commerce have similar processes for issuing APOs and handling confidential business information, the APOs are unique

⁸² Kevin Casey, Jade Camera & Nancy Wright, *Standards of Appellate Review in the Federal Circuit: Substance and Semantics*, 11 FED. CIR. B.J. 279, 286 (2001) (alteration added).

⁸³ *United States v. United States Gypsum Co.*, 333 U.S. 364, 395 (1948).

⁸⁴ UNITED STATES INT’L TRADE COMM’N, Pub. No. 3755, AN INTRODUCTION TO ADMINISTRATIVE PROTECTIVE ORDER PRACTICE IN IMPORT INJURY INVESTIGATIONS 1 (March 2005).

⁸⁵ *Id.* at 3; *see also* 19 C.F.R. §§ 210.34, 210.5 (2012).

⁸⁶ 19 U.S.C. § 1677f(c) (2006).

⁸⁷ § 1677f(c)(1)(A).

to each agency and violations under each carry separate and significant penalties.⁸⁸ The independent issuance of APOs by both the ITC and Commerce can create problems when the same parties are involved in proceedings before both agencies. For example, should it come to the attention of a domestic party authorized under both ITC and Commerce APOs that a foreign producer party made a factual assertion in the confidential business information it provided to Commerce that is in direct conflict with an assertion it made in the information it provided to the ITC, the domestic party would be unable to inform either federal agency of the foreign producer's misrepresentation. This is due to the concept of "crossing APOs," which holds that a party cannot inform the ITC of information that it received under an APO issued by Commerce, and *vice versa*.⁸⁹ This is akin to the left hand not knowing what the right hand is doing, and allows for too much gamesmanship in these important proceedings.⁹⁰

In addition, the different operating procedures of the ITC and Commerce lead to perverse incentives for parties that are involved in related proceedings before both agencies. Just as, in accordance with the rules of evidence, a court will instruct the finder of fact to make an adverse inference when a party fails to obey a subpoena to produce evidence,⁹¹ both the ITC and Commerce have the discretion to make adverse inferences when a party fails to cooperate with their proceedings.⁹² Commerce,

⁸⁸ See 19 C.F.R. §210.34(c); 19 U.S.C. § 1677f(f)(4).

⁸⁹ See, e.g., Summary of Commission Practice Relating to Administrative Protective Orders, 75 Fed. Reg. 66,127, 66,127 (Oct. 21, 2010) (stating that ITC's current application for disclosure of protected information "requires the applicant to swear that he or she will . . . [n]ot divulge any of the [privileged information] disclosed under this APO . . . to any person other than . . . [t]he person or agency from whom the [information] was obtained." (alterations added)).

⁹⁰ This is not a hypothetical problem. The author and other counsel who regularly practice before the ITC could cite numerous examples of foreign respondents who made certain factual representations to the Commerce Department in an attempt to lower their dumping margins, but denied the existence of these same facts to the ITC in an attempt to prevent a finding of a causal connection between the increased imports and harm to the domestic industry. Counsel is prevented from putting the contrary evidence on the record in the related proceedings (or providing detailed examples to non-APO signatories) as it would amount to an intentional violation of the APO and which carries potential significant penalties (including the option of referral for criminal prosecution). *Id.* at 66, 128.

⁹¹ See generally Annotation, *Adverse Inference From Failure of Party to Produce Available Witness or Evidence, as Affirmative or Substantive Proof*, 70 A.L.R. 1326 (1936).

⁹² 19 C.F.R. §§ 210.33, 351.308 (2012).

however, is more inclined to make an adverse inference than the ITC,⁹³ which means foreign parties have less incentive to provide information to the ITC and can hope to obtain a more favorable result by ignoring the ITC's request for information despite full cooperation with Commerce. Consequently, foreign parties may seek to maximize their own interests and undermine the integrity and purpose of the investigation by choosing to cooperate with Commerce proceedings, in order to avoid an adverse inference, while simultaneously stonewalling the ITC, where an adverse inference is unlikely.⁹⁴ This leads to much frustration for American companies that are adversaries of foreign parties in proceedings before both the ITC and Commerce because the United States companies cannot inform the ITC or Commerce of a foreign party's conflicting responses without exposing themselves to potentially significant penalties for APO violations.

To solve this imbalance between foreign party cooperation at the ITC and Commerce and to further protect United States companies, Congress should amend the Tariff Act to allow for greater information sharing between the ITC and Commerce. Instead of each agency issuing its own independent APO, there should be a "common" APO that applies to both agencies. That way, the confidential business information of parties would still be protected and available only to authorized applicants, but foreign parties would not have an incentive to cooperate incongruently with Commerce and the ITC. With a joint ITC-Commerce APO, foreign parties would not be rewarded for providing false and conflicting information to the agencies. A common APO system would also be more efficient, in that it would decrease the costs of gathering, accessing, and analyzing information. Therefore, a common APO system would result in more

⁹³ The Department of Commerce is more inclined to apply adverse facts available because the target of its investigations are specific companies. So should Company A refuse to participate to the best of its ability, Commerce had been willing to apply adverse facts to Company A's dumping margin calculation. The ITC's decision applies to all imports from a subject country and thus has been reluctant to apply adverse facts available for all producers because of one company's bad acts. *See generally* Diamond Parts Remand, *supra* note 65. Sadly, this appears to be true even when the bad acts are performed by several respondent companies and even when they represent the vast majority of all imports. *See id.*

⁹⁴ It is public knowledge that only 12 respondents in *Oil Country Tubular Goods from China* submitted questionnaire data to the ITC while 39 Chinese firms participated in the Department of Commerce investigation. Transcript of Hearing at 79–80, *In re* Certain Oil Country Tubular Goods (OCTG) from China, Inv. Nos. 701-TA-463 and 731-TA-1159, USITC Pub. 4124 (Dec. 1, 2009) (Final).

informed adjudications at both the ITC and Commerce, as well as more just outcomes for American companies and foreign parties.⁹⁵

F. *Suggestion #6: The Related Party Provision Should be Amended*

In trade remedy investigations, certain United States manufacturers do not support the petition brought by the other domestic producers in their industry. Such a situation might arise when an American producer has significant investments in a foreign country (*e.g.*, China) and is opposed to a trade remedy investigation targeting its own imports into the United States from this country. Even when the imports are, in fact, injuring the domestic industry, including *all* American producers, a United States producer with affected foreign investments may be disinclined to support a trade case if the value of its dumped imports is anticipated to be greater than the value of its United States production operations. Moreover, it is conceivable that a significant domestic producer in a particular U.S. industry might be a large multinational entity, with interests that, in the context of a certain trade remedy investigation, are adverse to the domestic industry and its workers.⁹⁶

The ITC has struggled with this factual scenario: a case in which the largest American producer in a domestic industry is opposed to trade relief for that domestic industry even though it is being injured as a result of low-priced imports.⁹⁷ In an effort to address this issue, Congress added a “related parties” provision to the ITC’s governing statute, which allows the ITC to exclude a domestic producer from its analysis if the domestic producer is a “related party” with interests not aimed at protecting domestic industries.⁹⁸

Currently, when conducting a trade remedy investigation, one of the ITC’s first tasks is defining which domestic producers are included and

⁹⁵ Moreover, and for the reasons discussed above, a foreign entity that chooses to only participate in Commerce’s proceedings but refuses to comply with information requests by the ITC should be deemed to be in non-compliance with both agency investigations. Consequently, it would be appropriate to apply Adverse Facts Available/Adverse Inferences against the noncomplying party in both the ITC and Commerce investigations.

⁹⁶ *See, e.g.*, Diamond Parts Final, *supra* note 62, at 11–13 (explaining exclusion of some domestic producers for the purpose of determining injury, and showing that some domestic producers import pieces of goods that are the subject of an ITC investigation).

⁹⁷ Transcript of Hearing at 18, *In re* Certain Steel Wire Garment Hangers from China, Inv. No TA-421-2 (Jan. 9, 2003) (showing that large domestic producers may oppose trade relief).

⁹⁸ 19 U.S.C. § 1677(4)(B)(i) (2006).

excluded from the investigation's defined "domestic industry."⁹⁹ The Tariff Act defines "domestic industry" as "the producers as a whole of a domestic like product, or those producers whose collective output of a domestic like product constitutes a major proportion of the total domestic production of the product."¹⁰⁰

During a trade remedy investigation, however, the ITC may exclude some producers from the domestic industry pursuant to the "related parties" provision discussed above.¹⁰¹ Specifically, under "appropriate circumstances," the ITC is allowed to "exclude from the domestic industry producers that are related to an exporter or importer of the [domestic like product], or which are themselves importers."¹⁰² The Tariff Act states that:

[A] producer and an exporter or importer shall be considered to be related parties, if . . . (I) the producer directly or indirectly controls the exporter or importer, (II) the exporter or importer directly or indirectly controls the producer, (III) a third party directly or indirectly controls the producer and the exporter or importer, or (IV) the producer and the exporter or importer directly or indirectly control a third party and there is reason to believe that the relationship causes the producer to act differently than a nonrelated producer.¹⁰³

Nevertheless, exclusion of related parties is not mandatory; rather, under the "appropriate circumstances" requirement, exclusion is at the ITC's discretion based upon the facts presented in each individual case.¹⁰⁴ As guidance, the ITC has established that:

The primary factors . . . examined in deciding whether appropriate circumstances exist to exclude related parties include: (1) the percentage of domestic production attributable to the importing producer; (2) the reason the U.S.

⁹⁹ § 1677(4)(A).

¹⁰⁰ *Id.*

¹⁰¹ § 1677(4)(B).

¹⁰² Polychloroprene Rubber From Japan, Inv. No. AA1921-129, USITC Pub. 3212 (July 26, 1999) (Review) at 6 (alteration added).

¹⁰³ § 1677(4)(B)(ii)(I)–(IV).

¹⁰⁴ *See, e.g.,* Torrington Co. v. United States, 16 Ct. Int'l Trade 220, 224 (1992); Sandvik AB v. United States, 13 Ct. Int'l Trade 738, 747–48 (1989); Empire Plow Co. v. United States, 11 Ct. Int'l Trade 847, 852 (1987).

producer has decided to import the product subject to investigation, *i.e.*, whether the firm benefits from the [less than fair value] sales or subsidies or whether the firm must import in order to enable it to continue production and compete in the U.S. market; and (3) the position of the related producers vis-a-vis the rest of the industry, *i.e.*, whether inclusion or exclusion of the related party will skew the data for the rest of the industry.¹⁰⁵

While the third factor, the party's position compared to the rest of the industry, seems to indicate that the ITC will exclude a related party if including its information would skew the industry data as a whole, the exact opposite is true in practice. Since the "related parties" provision was enacted, the ITC has consistently excluded relatively small related parties, but it has been reluctant to exclude particularly large domestic producers.¹⁰⁶ As a result, the ITC sometimes has counter-intuitively failed to exclude a related party even when that related party's inclusion had a significant effect on the overall industry data.¹⁰⁷ Ironically, the result of this policy, when consistently practiced, is that the related parties provision is only applied when it is irrelevant—when exclusion of the related party's data has no significant effect on the industry's data set.

To better realize the general intent and purpose of the trade remedy laws, Congress should make exclusion of domestic producers that are opposed to the investigation and are also importers and/or foreign producers mandatory for the ITC. Domestic producers in antidumping and countervailing duty investigations are already required to complete a "domestic producers questionnaire" that requests production information, sales and profit data, and an indication of whether the surveyed producer supports the trade investigation.¹⁰⁸ Therefore, the related party provision should be amended so that any American producer who is deemed a related party *and* does not support the case (as indicated on the questionnaire) should be excluded from the domestic industry definition. This would prevent companies with an interest in dumped imports that takes precedence

¹⁰⁵ Diamond Parts Final, *supra* note 62, at 11 n.56.

¹⁰⁶ Unfortunately, several of the most poignant examples of this phenomenon are protected from public disclosure by the ITC's administrative protective order. *See generally* ITC HANDBOOK, *supra* note 9, at II-24-II-27.

¹⁰⁷ *See, e.g.*, Diamond Parts Final, *supra* note 62, at 16-17.

¹⁰⁸ *See* UNITED STATES INT'L TRADE COMM'N, OMB. NO. 3117-0016, U.S. PRODUCERS QUESTIONNAIRE (2011), *available at* http://www.usitc.gov/trade_remedy/documents/US_ProducerQuestionnaire.pdf.

over their United States production operations from skewing the general industry's data set. Such an amendment would lessen the ITC's discretion, but it would also prevent large companies, who may have a stronger interest in dumped imports, from potentially sabotaging trade cases brought by companies whose primary interest is in protecting the domestic industry and its workers.

G. *Suggestion #7: The ITC Should Audit/Verify Respondents*

Under its regulations relating to practice and procedure, the ITC has the discretion to verify information received in the course of an antidumping or countervailing duty investigation.¹⁰⁹ In such investigations, questionnaires formulated by ITC staff are sent to domestic producers, importers, foreign producers, and—in final investigations—purchasers.¹¹⁰ The questionnaires request a variety of data including, but not limited to, production outputs, inventories, commercial shipments, export shipments, and costs of production, as well as financial data and price information.¹¹¹ While the ITC may audit or verify the responses to final questionnaires submitted during the course of an investigation, it is not under a legal obligation to do so.¹¹² It is this questionnaire data, however, that eventually forms the bulk of the agency's administrative record, so its accuracy has a significant bearing on the related investigation's outcome.

It is troubling to note that, in practice, when the ITC *does* audit or verify questionnaire responses, it generally only audits those of domestic producers, not those of foreign producers.¹¹³ It is fundamentally unfair that, in a government investigation, often only one side of the dispute is subjected to an audit. Moreover, the knowledge that the accuracy of information submitted by foreign producers usually is not subject to verification may incentivize companies to report less-than-accurate information in their questionnaire responses.

For instance, there seems to be an almost uncanny tendency of foreign producers, especially in cases involving steel products, to report capacity utilization rates of 99% or 100%.¹¹⁴ If these numbers are accurate, it would

¹⁰⁹ 19 C.F.R. § 207.4(b) (2012).

¹¹⁰ ITC HANDBOOK, *supra* note 9, at II-6-II-7, II-15.

¹¹¹ *Id.* at II-8-II-9, II-16-II-17.

¹¹² Nitrogen Solutions Fair Trade Comm. v. United States, 29 Ct. Int'l Trade 86, 91 (2005).

¹¹³ Chung Ling Co. v. United States, 16 Ct. Int'l Trade 636, 640-41 (1992).

¹¹⁴ See Diamond Parts Final, *supra* note 62, at 37 (stating that Chinese and Korean diamond sawblade producers produced at a capacity utilization rate of over 90 percent).

suggest that such foreign producers are incapable of increasing their exports to the United States. The suspicious consistency of the unverified 100% foreign capacity utilization rates has been a frequent topic of discussion, particularly among counsel to the domestic industry.¹¹⁵ Further fueling such conversation, the ITC has demonstrated that it is willing to accept the foreign producers' self-reported capacity utilization rates, despite public information that seems to directly contradict the data.¹¹⁶ If the ITC took steps to verify such reported data, it would increase the accuracy of its administrative record and improve the integrity of the ITC's investigative process.

Although the central focus of the ITC's investigation is the health of the domestic industry and, therefore, domestic producers are the presumptive targets for auditing, only auditing one-side of an investigation inevitably raises questions of fairness. As a matter of good practice, and to ensure that the outcome of antidumping and countervailing duty investigations is based on the most accurate evidence available, the ITC should audit the data reported by both domestic producers and foreign respondents equally.

H. *Suggestion #8: The ITC's Discretion to "Cumulate" Imports in Sunset Investigations Should Be Limited*

Five years after the ITC decides to provide relief in an antidumping or countervailing duty investigation, the agency must conduct a review to determine whether the dumping or countervailing subsidies that were originally determined to cause material injury to the domestic industry would continue to do so if the antidumping or countervailing duty was revoked.¹¹⁷ These investigations, known as "sunset" reviews, allow the domestic industry and other affected parties to present arguments related to the volume, price effect, and impact of imports on the domestic industry.¹¹⁸ The ITC evaluates these variables—along with other factors, such as improvements to the domestic industry as a result of the antidumping or

¹¹⁵ The author relies on his experience as a partner in the International Trade practice of Wiley Rein LLP in Washington, DC and as a former attorney-advisor in the Office of General Counsel of the U.S. International Trade Commission in support of these observations.

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¹¹⁷ 19 U.S.C. §1675(c)(1) (2006).

¹¹⁸ See §1675(c)(2) (2006); ITC HANDBOOK, *supra* note 9, at III-3, III-6–III-7.

countervailing order and whether the industry is vulnerable to material injury if the order is rescinded—to determine if the order should be revoked.¹¹⁹

During a sunset review, the ITC may “cumulatively assess the volume and effect of imports of the subject merchandise from all countries.”¹²⁰ Congress implemented this practice of evaluating the cumulated impact of imports from multiple countries in the Trade and Tariff Act,¹²¹ which sought to remedy the unpredictability and discrepancies in the Commission’s prior injury determinations.¹²² Prior to the Trade and Tariff Act, in cumulation determinations, the ITC “articulated a variety of differing criteria and conditions” and occasionally “imposed conditions which [did] not seem justified.”¹²³ Consequently, Congress acted to remove improper conditions for cumulation that had been imposed by the ITC by creating a provision in the statute that required cumulating subject imports from all sources that caused contemporaneous injury.¹²⁴

The Report of the House Ways and Means Committee (“Report”) accompanying the Trade Remedies Reform Act of 1984 sheds light on Congress’s rationale behind revising the cumulation provision.¹²⁵ The Report states that the purpose of cumulation is to prevent injury created by “simultaneous unfair acts or practices.”¹²⁶ The new cumulation provisions indicate that Congress intended the ITC to group countries together when the subject imports cause simultaneous injury to the domestic industry, even if these imports injure the domestic industry in different ways.¹²⁷ According to the Report, the Committee amended the cumulation provision

¹¹⁹ § 1675a(a)(1).

¹²⁰ § 1675a(a)(7). Under this statutory language, the ITC is allowed to combine import data from multiple countries in its causation analysis in order to evaluate the volume and price effects for an injury determination. *Id.*

¹²¹ See Trade and Tariff Act of 1984, Pub. L. No. 98-573, § 612(a)(2), 98 Stat. 2948, 3033 (codified at 19 U.S.C. § 1677(7) (2006)).

¹²² See Judith Hippler Bello & Alan F. Holmer, *The Trade and Tariff Act of 1984: Principal Antidumping and Countervailing Duty Provisions*, 19 INT’L LAW. 639, 659–63 (1985) (discussing the general lack of clarity in the ITC’s prior injury-determination regime and the changes made to it for the purpose of clarification).

¹²³ H.R. REP. NO. 98-725, at 36–37 (1984), *reprinted in* 1984 U.S.C.C.A.N. 5127, 5163–5164 (alteration added).

¹²⁴ *Id.*

¹²⁵ *Id.*; see also Dag Wilkinson, *The Trade and Tariff Act of 1984: Its Impact on Developing Countries*, 20 TEX. INT’L L.J. 453, 453–55 (1985).

¹²⁶ H.R. REP. NO. 98-725, at 37, *reprinted in* 1984 U.S.C.C.A.N. at 5164.

¹²⁷ See William B.T. Mock, Jr., *Cumulation of Import Statistics in Injury Investigations Before the International Trade Commission*, 7 NW. J. INT’L L. & BUS. 433, 434–35 (1986).

to allow cumulation of imports from multiple countries “that each account individually for a very small percentage of total market penetration, but when combined may cause material injury.”¹²⁸

The ITC has adopted, and the CIT and Federal Circuit have affirmed, incredible discretion in deciding whether or not to cumulate the injurious impact of imports from several countries.¹²⁹ This practice should be changed so that the intent of Congress’s delegation of authority is better taken into account. Otherwise, the ITC’s discretion allows its decisions in five-year reviews to become essentially unreviewable by courts. It is not in the interests of justice to grant the ITC so much discretion that it becomes a “black box” of decision-making.¹³⁰ Such seemingly unfettered decision-making in regard to cumulation makes it impossible for parties appearing before the ITC to make an informed prediction about whether or not the ITC will choose to cumulate imports in any particular case. The ITC has argued that because the statute states that it “may” cumulate imports, its use of ultimate discretion regarding whether or not to cumulate is properly granted under the language of the statute.¹³¹

The Federal Circuit has essentially upheld the ITC’s absolute power of discretion in regard to whether or not to cumulate, for whatever reason or lack thereof.¹³² In *Nucor Corp. v. United States*,¹³³ the ITC argued that in exercising that discretion, it is not required to consider the statutory purpose of determining if an exaggerated aggregate negative impact on the domestic industry resulting from imports from multiple countries is likely.¹³⁴ The Federal Circuit affirmed and determined that the ITC’s decision *need not* be guided, first and foremost, by a consideration of why cumulation is provided for by United States law.¹³⁵

¹²⁸ H.R. REP. NO. 98-725, at 37, *reprinted in* 1984 U.S.C.C.A.N. at 5164.

¹²⁹ *See, e.g., Nucor Corp. v. United States*, 32 Ct. Int’l Trade 1380, 1408, 1415 (2008), *aff’d*, 601 F.3d 1291, 1295–96, 1297 (Fed. Cir. 2010) (stating that the cumulation statute allows the ITC discretion as long as it follows a “reasonable and permissible interpretation” per 19 U.S.C. § 1675a(a)(7)).

¹³⁰ The term “black box” is often used in science to describe a process that can be viewed solely in terms of its input and output without any knowledge of its internal workings. David S. Caudill, *Barely Opening, Then Slamming Shut, Science’s “Black Box” in Law: A Response to Beecher-Monas’s Heuristics*, 23 *CARDOZO L. REV.* 1795, 1796 (2002). In other words, certain data goes into the box, and a result comes out, but no one knows which facts (or absence of facts) led to that outcome.

¹³¹ *Nucor Corp.*, 32 Ct. Int’l Trade at 1391.

¹³² *Nucor Corp.*, 601 F.3d at 1295–96, 1297.

¹³³ 32 Ct. Int’l Trade 1380 (2008), *aff’d*, 601 F.3d 1291 (Fed. Cir. 2010).

¹³⁴ *Nucor Corp.*, 32 Ct. Int’l Trade at 1391–92.

¹³⁵ *See Nucor Corp.*, 601 F.3d at 1296–97.

As mentioned previously, Congressional intent indicates that the purpose of cumulation is to ensure that the ITC's causation analysis captures the particularly extreme negative effects subject products being imported from multiple countries have on the domestic industry.¹³⁶ Such analysis ensures that significant aggregate injury is not overlooked in country-specific reviews, leading to what might be referred to as a domestic industry's "death by a thousand cuts." The ITC, however, has indicated that it is not guided by Congress's intent in enacting the law, and the courts have agreed.¹³⁷ This practice should be corrected.

To ensure that the ITC properly cumulates imports in sunset reviews, Congress should amend 19 U.S.C. § 1675a(a)(7) to state that, if the statutory requirements are satisfied, the ITC *must* cumulate and evaluate the hammering effects of contemporaneous imports. Removing the "may" and replacing it with "must" would require that the ITC "cumulatively assess the volume and effect of imports of the subject merchandise from all countries."¹³⁸ This simple modification would remove the ITC's seemingly unfettered discretion regarding cumulation and, accordingly, allow for greater transparency in five-year sunset reviews. This approach better reflects Congress's intent behind the cumulation provision and insures that the ITC's decision will be reviewable by the courts.

I. *Suggestion #9: The ITC's Causation Standard in Safeguard Cases Should Be Decreased*

This article has primarily focused on antidumping and countervailing duty investigations. However, as briefly mentioned in Section II, an important alternative to these trade remedy laws exists in Section 201 of the Trade Act of 1974.¹³⁹ This trade remedy is a "safeguard," which allows the President to enact a range of remedies to restore competition to the affected United States industry.¹⁴⁰ As safeguard cases are less disruptive to international trade than antidumping investigations, there may be some persuasive policy reasons to shift towards safeguard cases in the 21st century, but two major changes must be made to the relevant law before this

¹³⁶ H.R. REP. NO. 98-725, at 37 (1984), *reprinted in* 1984 U.S.C.C.A.N. 5127, 5164.

¹³⁷ 601 F.3d at 1296–97.

¹³⁸ The current statute is permissive, and does not mandate cumulation. 19 U.S.C. § 1675a(a)(7) (2006).

¹³⁹ 19 U.S.C. § 2251(a), (b)(1) (2006) (allowing the President to take appropriate action to remedy injuries to domestic producers resulting from unfair trade as identified by the ITC).

¹⁴⁰ § 2251(a).

is possible. More specifically: (1) there must be a lower causation standard, and (2) these cases must have less of a political element. This section will describe the rationale for lowering the causation standard in safeguard cases, which is fully in-line with our international treaty obligations.¹⁴¹ The potential to decrease the political element of a safeguard case and, under certain circumstances, create a right to relief as a matter of law, is described in the final section of this article.

Safeguard cases have their origin in the post-World War II era.¹⁴² As world trade liberalized, the United States entered into trade agreements that included escape clauses intended to protect domestic industries from rapid increases in imports.¹⁴³ These provisions were built in to provide temporary relief and give ailing industries time to generate profits, to reinvest those profits in factors of production, and to regain their competitive edge.¹⁴⁴ However, the effectiveness of this remedy in the United States has been compromised by use of the “substantial cause” standard, which places a significantly higher burden of proof on injured domestic industries than what is required under international obligations and, therefore, hinders such industries from benefitting from safeguard remedies.¹⁴⁵ Accordingly, Congress should act to lower the United States causation standard in these cases, thereby improving the effectiveness of safeguard remedies and better reflecting our international obligations.

Article XIX of the GATT allows contracting nations to utilize a general safeguard trade remedy. Article XIX(1)(a) states:

If, as a result of unforeseen developments and of the effect of the obligations incurred by a contracting party under this Agreement, including tariff concessions, any product is being imported into the territory of that contracting party in such increased quantities and under such conditions as to cause or threaten serious injury to domestic producers . . . the contracting party shall be free . . . to the extent and for such time as may be necessary to prevent or remedy such injury, to suspend the obligation in whole or in part or to withdraw

¹⁴¹ Mock, *supra* note 127, at 446–47 (stating that injury causation must be shown before a compensating duty may be assessed so as not to violate GATT provisions).

¹⁴² Wilkinson, *supra* note 125, at 457.

¹⁴³ *Id.* (stating that an escape clause, Article XIX, was included in the GATT after the United States insisted).

¹⁴⁴ RAJ BHALA, MODERN GATT LAW: A TREATISE ON THE GENERAL AGREEMENT ON TARIFFS AND TRADE 944 (2005).

¹⁴⁵ Mock, *supra* note 127, at 446.

or modify the concession.¹⁴⁶

Following the adoption of the GATT, the Uruguay Round Agreement on Safeguards (“Safeguards Agreement”) was drafted to clarify Article XIX’s safeguard provision.¹⁴⁷ Under both the GATT and the Safeguards Agreement, a contracting party may impose a safeguard remedy when imported products “cause or threaten to cause serious injury to the domestic industry.”¹⁴⁸ Article 4 section 2 of the Safeguards Agreement elaborates that “the competent authorities shall evaluate all relevant factors of an objective and quantifiable nature having a bearing on the situation of that industry.”¹⁴⁹ Specifically listed factors to be considered are:

[T]he rate and amount of the increase in imports of the product concerned in absolute and relative terms, the share of the domestic market taken by increased imports, changes in the level of sales, production, productivity, capacity utilization, profits and losses, and employment.¹⁵⁰

The Trade Act codifies Article XIX in United States law, with some slight modifications to the language of the original agreement.¹⁵¹ Section 201 of the Trade Act, for example, changed the United States safeguard causation standard from that dictated by the GATT and the Safeguards Agreement.¹⁵² According to Section 201, any good “being imported into the United States in such increased quantities as to be a *substantial cause of*

¹⁴⁶ General Agreement on Tariffs and Trade 1994, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, 1867 U.N.T.S. 187, 190 (1994) [hereinafter GATT 1994] (adopting the terms of GATT 1947 by reference); see GATT 1947 art. XIX(1)(A), *supra* note 25.

¹⁴⁷ Agreement on Safeguards, Apr. 15, 1994, Annex 1A, Legal Instruments – Results of the Uruguay Round, 1869 U.N.T.S. 154 (1994) [hereinafter Safeguards Agreement].

¹⁴⁸ *Id.* at art. 2(1). The language in the GATT is slightly different, requiring that a trade activity “cause or threaten to cause serious injury to domestic producers in that territory.” GATT 1994, *supra* note 146, at art. XIX(1)(a).

¹⁴⁹ Safeguards Agreement, *supra* note 147, at art. 4(2)(a).

¹⁵⁰ *Id.*

¹⁵¹ Compare, e.g., GATT 1994, *supra* note 146, at art. XIX(1)(a), with 19 U.S.C. § 2252 (2006); see also Daniel B. Pickard & Tina Potuto Kimble, *Can U.S. Safeguard Actions Survive WTO Review?: Section 201 Investigations in International Trade Law*, 29 LOY. L.A. INT’L & COMP. L. REV. 43, 45 (2007).

¹⁵² See Thomas J. Schoenbaum, *The International Trade Laws and the New Protectionism: The Need for a Synthesis with Antitrust*, 19 N.C. J. INT’L L. & COM. REG. 393, 406 n.65 (1994).

serious injury, or the threat thereof” may qualify the domestic industry for safeguard relief.¹⁵³ Section 201 subsequently defines “substantial cause” as a “cause which is important and not less than any other cause.”¹⁵⁴ The Trade Act’s legislative history explains that this “requires that a dual test be met—increased imports must constitute an important cause and be no less important than any other single cause.”¹⁵⁵

As asserted above, “substantial cause” is a higher standard than the “cause or threaten to cause serious injury” standard mandated by the GATT and the Safeguards Agreement.¹⁵⁶ Furthermore, it is considerably higher than the United States’ existing causation standard in antidumping and countervailing duty investigations.¹⁵⁷ This means that fewer American industries are afforded the protection of safeguard remedies. The “substantial cause” language of Section 201 requires the ITC, charged with determining whether a United States industry has been harmed and, if so, whether an influx of imports is the cause of that harm,¹⁵⁸ to apply an unnecessarily difficult causation analysis that is not required by the GATT or the Safeguards Agreement.

By unnecessarily increasing the evidentiary burden to prove causation, the “substantial cause” analysis has prevented American industries from acquiring a remedy under the safeguard law. Indeed, the absence of Section 201 investigations in the last ten years calls into question the practical availability of the United States safeguard provision. As evidenced by the number of antidumping and countervailing duty petitions being filed,¹⁵⁹ American industries are still being injured by increased import competition. Domestic industries, however, are overwhelmingly choosing to file antidumping and countervailing duty cases rather than

¹⁵³ 19 U.S.C. § 2251(a) (2006) (emphasis added).

¹⁵⁴ § 2251(b)(1)(B).

¹⁵⁵ S. REP. NO. 93-1298, at 120 (1974) *reprinted in* 1974 U.S.C.C.A.N. 7186, 7264.

¹⁵⁶ Schoenbaum, *supra* note 152 (“[T]he causation standard in the GATT escape clause differs from 201 in that it requires only that the injurious imports ‘cause’ serious injury or the threat thereof; the U.S. standard in 201 is ‘substantial cause.’”).

¹⁵⁷ *See* 19 U.S.C. §§ 1671(a), 1673 (2006) (each requiring a “material injury”); 19 U.S.C. § 1677(7)(A) (2006) (defining material injury as one that “‘material injury’ means an injury ‘which is not inconsequential, immaterial, or unimportant’”).

¹⁵⁸ *See* § 2252(b).

¹⁵⁹ *See, e.g.*, OFFICE OF INVESTIGATIONS, UNITED STATES INT’L TRADE COMM’N, IMPORT INJURY INVESTIGATIONS CASE STATISTICS (FY 1980-2008) 1 (2010), *available at* http://www.usitc.gov/trade_remedy/documents/historical_case_stats.pdf (showing 1,632 petitions filed from fiscal year 1980 to 2008).

safeguards.¹⁶⁰

Accordingly, Congress should act to reform the causation standard so that it does not reflect a standard that is higher than what our international treaty obligations require. Doing so would provide domestic industries that are injured as a result of increased import competition with an additional important tool for protecting their livelihood and remedying their situations.

J. *Suggestion #10: A Super-Majority Remedy Recommendation From The ITC Should Automatically Go Into Effect if the President Fails to Act*

In perhaps its boldest recommendation, this article proposes that, when the President fails to act after a super-majority of ITC Commissioners (at least four out of six Commissioners) has made an affirmative finding of material injury in a safeguards investigation and recommended a particular remedy, the domestic industry automatically should receive such remedy as a matter of law.

In a safeguards investigation, after an affirmative injury determination, the ITC is charged with making a recommendation to the President regarding the form and extent of relief that is appropriate.¹⁶¹ As the law currently stands, upon the completion of an investigation, the ITC must submit a recommendation to the President regarding what specific trade remedies are appropriate to provide safeguard relief.¹⁶² Following receipt of the ITC report, the President has 30 days to implement the recommended remedy, a modified version of the recommended remedy, or no remedy whatsoever.¹⁶³ The President is under no obligation to institute a recommended safeguard remedy, even after an affirmative determination by the ITC that a domestic industry is being seriously harmed.¹⁶⁴ The current law gives the President the discretion to weigh the reported harm to domestic industry against the potential political ramifications with affected

¹⁶⁰ See, e.g., UNITED STATES INT'L TRADE COMM'N, *The Year in Trade 2009: Operation of the Trade Agreements Program*, 2010 U.S. INT'L TRADE COMMISSION ANN. REP. 61, 2-1, available at <http://www.usitc.gov/publications/332/pub4174.pdf> (showing only one safeguard action filed with the ITC in fiscal year 2009).

¹⁶¹ § 2252(e)(1).

¹⁶² § 2252(e)(1)–(e)(2).

¹⁶³ § 2252(d)(2)(D).

¹⁶⁴ *Id.* (“[T]he President, if he considers provisional relief to be warranted and after taking into account the finding of the Commission under subparagraph (B), shall proclaim, for a period not to exceed 200 days, such provisional relief that the President considers necessary to prevent or remedy the serious injury” (emphasis added)).

trade partners.¹⁶⁵ Congress should remove this political calculation in certain, very narrow circumstances, specifically in order to allow a remedy to go into effect unless the President moves to block the relief.

This amendment would strengthen the safeguard provision as a viable trade remedy with practical and important protections in favor of the domestic industry, rather than political interests, as its core purpose. Currently, all safeguards cases require affirmative Presidential action in order for actual relief to be provided.¹⁶⁶ In contrast, antidumping and countervailing duty cases provide relief as a matter of law. Although the President is required under the law to make his determination within 30 days, there are examples of Presidents failing to meet this deadline by several months,¹⁶⁷ and an established track-record of Presidents outright denying recommended relief in safeguard cases.¹⁶⁸

The uncertainty connected with Presidential action could be avoided by allowing a safeguard remedy that is recommended by a super-majority of the ITC commissioners to go into effect after the 30 day period unless the President intervenes to prevent the trade remedy from taking effect. This affords the President political cover by allowing him to take no action and shifts the burden of protecting domestic industry directly to the ITC. Presidential inaction, relative to presidential action, is a lower barrier for the domestic industry, and will increase the probability that a domestic industry will receive safeguard remedies. This solution also allows safeguard remedies to more closely mirror antidumping and countervailing duty determinations, which do not require presidential action to go into effect.¹⁶⁹

Safeguard cases may, in certain circumstances, be a better alternative than antidumping or countervailing duty investigations. However, for this to occur the overly burdensome causation standard should be changed, and the extent of political discretion should be minimized. A change in the law allowing safeguard remedies to automatically enter into effect—for example, in the event of a super-majority ITC recommendation and a failure by the President to act to the contrary—would be a positive development for United States manufacturers. Indeed, removal of the overly strict

¹⁶⁵ See 19 U.S.C. § 2253(a)(2) (2006).

¹⁶⁶ 19 U.S.C. § 2251(a) (2006).

¹⁶⁷ See, e.g., Brian Balzer and Kyle Stiegert, *The European Union-United States Wheat Gluten Policy Dispute*, 30 J. FOOD DISTRIBUTION RES. 1, 1 (1999), available at <http://ageconsearch.umn.edu/bitstream/27387/1/30020001.pdf>.

¹⁶⁸ See, e.g., Jeanne J. Grimmett, CONG. RESEARCH SERV., R40844, CHINESE TIRE IMPORTS: SECTION 421 SAFEGUARDS AND THE WORLD TRADE ORGANIZATION 14 (WTO) (2011), available at http://assets.opencrs.com/rpts/R40844_20110131.pdf.

¹⁶⁹ See 19 U.S.C. §§ 1673d(c), 1671d(c) (2006).

causation standard and a decrease in the political element will in safeguard cases, and the broad range of relief connected with these trade remedy actions, will more easily allow injured American companies to adjust to increased and injurious competition from imports.

CONCLUSION

The United States trade remedy laws are of vital importance to American companies that have been injured as a result of increased import competition. The ITC, an independent, quasi-judicial agency is the body responsible for making consequential determinations in regard to whether American industries and their workers have in fact been harmed by such imports.¹⁷⁰ This article has presented ten suggestions for increasing the fairness and efficiency in the ITC's crucial work and in the judicial review by the federal courts charged with overseeing the legal adequacy of ITC determinations. This article's recommendations include requirements that ITC decisions have precedential value and, where appropriate, agency discretion be more limited by statute. Additionally, lesser and increased standards of judicial review are proposed for the CIT and the Federal Circuit, respectively. Other changes, detailed above, to ITC practice would increase the efficiency, effectiveness, and fairness of the Commission's investigation. Lastly, two significant changes to United States safeguards law are proposed in order to allow domestic companies to more fairly access these important remedies, which are intended to increase the competitiveness of American manufacturers.

The work of this powerful but little known agency may never have been more essential than it is today. The ten suggestions discussed above are intended to improve not only the efficiency of this vital work but to provide a more just process for the parties who appear before the ITC.

¹⁷⁰ See 19 U.S.C. §§ 1330(a)–(b), 1337, 1677(7) (2006); see also *About the United States International Trade Commission*, UNITED STATES INT'L TRADE COMM., http://www.usitc.gov/press_room/about_usitc.htm (last visited Nov. 11, 2012).

THE NEW FATF STANDARDS

Gary W. Sutton*

INTRODUCTION

The Financial Action Task Force (the “FATF”), which was established by the G-7 Summit held in Paris in 1989,¹ is a 36-member inter-governmental body mandated to set international standards (the “FATF Standards” or “Standards”) and to promote effective implementation of legal, regulatory, and operational measures for combating money laundering, the financing of terrorists and proliferation, and other related threats to the international financial system.² The Standards are comprised of the FATF’s Recommendations in furtherance of that mandate, corresponding Interpretive Notes, and a Glossary.³ In February 2012, following an intensive review process that extended over more than two

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¹ *History of the FATF*, FIN. ACTION TASK FORCE, <http://www.fatf-gafi.org/pages/aboutus/historyofthefatf/> (last visited Nov. 14, 2012). The G-7, or Group of 7, is an international group consisting of the finance ministers from the United States, Canada, Great Britain, France, Germany, Japan, and Italy. See, e.g., Andrew de Lotbinière McDougall, *International Arbitration and Money Laundering*, 20 AM. U. INT’L L. REV. 1021, 1029, 1029 n.28 (2005).

² *Who We Are*, FIN. ACTION TASK FORCE, <http://www.fatf-gafi.org/pages/aboutus/> (last visited Nov. 14, 2012) [hereinafter *Who We Are*].

³ As a general matter, the Recommendations state high-level principles, while the Interpretive Notes explain more specifically how countries are to comply with the Recommendations. In certain cases, the Glossary definitions may also contain specific requirements. See, e.g., Fin. Action Task Force [FATF], *International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation - the FATF Recommendations*, at 8 (Feb. 15, 2012) [hereinafter *2012 Standards*], available at [http://www.fatf-gafi.org/media/fatf/documents/recommendations/pdfs/FATF%20Recommendations%20\(approved%20February%202012\)%20reprint%20May%202012%20web%20version.pdf](http://www.fatf-gafi.org/media/fatf/documents/recommendations/pdfs/FATF%20Recommendations%20(approved%20February%202012)%20reprint%20May%202012%20web%20version.pdf).

years,⁴ the FATF announced its third revision (i.e., fourth version) of the FATF Standards.⁵ The new Standards (“2012 Standards” or “Revised Standards”), which will be implemented during upcoming compliance assessments, are the topic of this article, which will examine specific changes the FATF made in revising the 2003 version of the Standards and consider private sector comments that were directed at some of those changes.

The FATF Standards are used as a basis for conducting peer reviews, called “Mutual Evaluations,” of each member country’s anti-money laundering/combating the financing of terrorism (“AML/CFT”) regime.⁶ Since 2004, all of the 34 FATF member jurisdictions⁷ have undergone a Mutual Evaluation,⁸ each of which resulted in a lengthy Mutual Evaluation report⁹ that includes a detailed description of the specific country’s AML/CFT regime and a rating for its degree of compliance with each of the

⁴ FATF, *FATF’s Response to the Public Consultation on the Revision of the FATF Recommendations*, at 3 (Feb. 16, 2012) [hereinafter *FATF Response to Public*], available at <http://www.fatf-gafi.org/media/fatf/documents/publicconsultation/FATF%20Response%20to%20the%20public%20consultation%20on%20the%20revision%20of%20the%20FA20Recommendations.pdf>.

⁵ *2012 Standards*, *supra* note 3.

⁶ Each Mutual Evaluation involves a year-long process that includes an on-site visit by a team composed of several assessors from other member jurisdictions and headed by a representative of the FATF Secretariat. The assessment team prepares a draft Mutual Evaluation report that is discussed, frequently amended, and ultimately agreed by the Plenary. FATF, *Third Round of AML/CFT Mutual Evaluations: Processes and Procedures*, at 20–23 (Oct. 2009) [hereinafter *Third Round*], available at <http://www.fatf-gafi.org/media/fatf/documents/process%20and%20procedures.pdf>. The International Monetary Fund and World Bank also perform a limited number of FATF member assessments. *Id.* at 17–18. An assessment is based on the FATF Methodology. The Methodology used for the third round contains a detailed list of criteria corresponding to each Recommendation which forms the basis for assessing a country’s compliance with such Recommendation. See generally FATF, *Methodology for Assessing Compliance with the FATF 40 Recommendations and 9 Special Recommendations* (Feb. 2009) [hereinafter *2004 Methodology*], available at <http://www.fatf-gafi.org/media/fatf/documents/reports/methodology.pdf> (providing an overview, background, interpretation, and guidance on the methodology).

⁷ The FATF membership also includes two regional organizations. *FATF Members and Observers*, FIN. ACTION TASK FORCE, <http://www.fatf-gafi.org/pages/aboutus/membersandobservers/> (last visited Nov. 14, 2012) (containing a list of members).

⁸ See generally *Mutual Evaluations*, FIN. ACTION TASK FORCE, <http://www.fatf-gafi.org/topics/mutualevaluations/> (last visited Nov. 14, 2012) [hereinafter *Mutual Evaluations*] (listing the dates of the mutual evaluations).

⁹ Mutual Evaluation reports are generally 200–300 pages and sometimes longer.

Recommendations.¹⁰ Following each Mutual Evaluation, the FATF monitors each country in regard to specific Recommendations for which it received a low rating and requires the country to provide a series of periodic follow-up reports to the FATF detailing the country's progress until a satisfactory level of compliance with those Recommendations has been achieved.¹¹ In cases where progress isn't considered satisfactory, the Plenary takes a series of graduated steps, which may include a letter from the President to the country's appropriate government official stressing the importance of achieving a satisfactory level of compliance, a high-level mission from the FATF to the country to heighten its political awareness of the deficiencies, a public statement warning other members (and non-member countries) to consider the member's AML/CFT deficiencies, and ultimately, consideration by the FATF of whether a country's membership should be suspended.¹²

In addition to the FATF's procedures for addressing deficiencies of its own members, the FATF has historically taken a leading role in bringing international focus on jurisdictions around the world with weak AML/CFT regimes. Beginning in 1999 the FATF engaged in an initiative in which it identified jurisdictions globally with AML weaknesses; it identified a total of 23 such "Non-Compliant Countries or Territories," or "NCCTs," of which there were none remaining in this designation by October 2006.¹³ This process was reinvigorated in 2009, following a call by the G-20 to assess countries' compliance with international AML/CFT standards and to publicly identify high-risk jurisdictions¹⁴ and issue regular updates on

¹⁰ See, e.g., FATF, *Third Mutual Evaluation Report on Anti-Money Laundering and Combating the Financing of Terrorism: United States of America* (June 23, 2006) [hereinafter *U.S. Mutual Evaluation*], available at <http://www.fatf-gafi.org/media/fatf/documents/reports/mer/MER%20US%20full.pdf> (containing the FATF's third mutual evaluation of the United States).

¹¹ See, e.g., FATF, *Mutual Evaluation: 8th Follow Up Report: Anti-Money Laundering and Combating the Financing of Terrorism: China* (Feb. 17, 2012), available at <http://www.fatf-gafi.org/media/fatf/documents/reports/mer/Follow%20Up%20MER%20China.pdf> (providing an example of a follow up report on China's progress).

¹² *Third Round*, *supra* note 6, at 14.

¹³ See *About the Non-Cooperative Countries and Territories (NCCT) Initiative*, FIN. ACTION TASK FORCE, <http://www.fatf-gafi.org/topics/high-riskandnon-cooperative-jurisdictions/more/aboutthenon-cooperativecountriesandterritoriesncctinitiative.html> (last visited Nov. 14, 2012).

¹⁴ See Press Release, G-20 Leaders, Declaration on Strengthening the Financial System: London Summit, at 5–6 (Apr. 2, 2009), available at http://www.treasury.gov/resource-center/international/g7-g20/Documents/London%20April%202009%20Fin_Deps_Fin_Reg_Annex_020409_-_1615_final.pdf; Press Release, G-20 Leaders, Leaders' Statement: The Pittsburgh Summit, at 10 (Sept. 25, 2009), available at http://www.treasury.gov/resource-center/international/g7-g20/Documents/Pittsburgh_sum

jurisdictions with strategic deficiencies. Since June 2009, the FATF's International Cooperation Review Group ("ICRG") has been coordinating a worldwide review of all jurisdictions of a significant size with deficient AML/CFT regimes. Following each Plenary, the FATF issues two statements regarding these countries. One statement identifies "jurisdictions which have strategic AML/CFT deficiencies for which they have developed an action plan with the FATF," and calls on those countries to "complete the implementation of action plans expeditiously. . . ." ¹⁵ The other list, called FATF's "Public Statement," lists jurisdictions which have strategic AML/CFT deficiencies and which either have not committed to an action plan with the FATF, or have not made sufficient progress in addressing those deficiencies. These jurisdictions are either subject to a call by the FATF on its members to "consider the risks arising from the deficiencies associated with each jurisdiction," or in the most serious cases, a call "to apply counter-measures to protect the international financial system from the on-going and substantial money laundering and terrorist financing (ML/TF) risks emanating from the jurisdictions." ¹⁶ FATF members, as well as other jurisdictions, are expected to bring these FATF statements to the attention of their financial institutions. ¹⁷ Thus, although FATF membership and the Standards do not have the binding force of a treaty, the Mutual Evaluations, along with the follow-up and ICRG processes, generally provide significant incentives for all member countries, as well as other jurisdictions around the world, to improve their AML/CFT regimes. ¹⁸

mit_leaders_statement_250909.pdf?bcsi_scan_D92198957E035F0B=IUBct6cE6cl6JeuGQ
T0yT3RFdOAZAAAAmn19Gw==&bcsi_scan_filename=pittsburgh_summit_leaders_state
ment_250909.pdf.

¹⁵ See, e.g., *Improving Global AML/CFT Compliance: on-going process - 22 June 2012*, FIN. ACTION TASK FORCE <http://www.fatf-gafi.org/topics/high-riskandnon-cooperativejurisdictions/documents/improvingglobalamlcftcomplianceon-goingprocess-22june2012.html> (last visited Nov. 14, 2012).

¹⁶ See, e.g., *FATF Public Statement - 22 June 2012*, FIN. ACTION TASK FORCE, <http://www.fatf-gafi.org/topics/high-riskandnon-cooperativejurisdictions/documents/improvingglobalamlcftcomplianceon-goingprocess-22june2012.html> (last visited Nov. 14, 2012) [hereinafter *FATF Public Statement - 22 June 2012*].

¹⁷ See, e.g., Treas. Adv. FIN-2012-A008 (July 19, 2012), available at http://www.fin.cen.gov/statutes_regs/guidance/pdf/FIN-2012-A008.pdf (showing the United States' response to FATF actions).

¹⁸ It also bears noting that at this time "[a] large number of jurisdictions have not yet been reviewed by the FATF. The FATF continues to identify additional jurisdictions, on an on-going basis, that pose a risk to the international financial system." *FATF Public Statement - 22 June 2012*, *supra* note 16.

All of the FATF's formal decisions are made at the tri-annual meetings of the FATF Plenary,¹⁹ but most of the underlying and preparatory work is performed by one of the FATF's specialized working groups, including: the Working Group on Evaluations and Implementation ("WGEI"), which, among other duties, reviews and proposes revisions to the FATF Standards and Methodology;²⁰ the International Co-operation Review Group ("ICRG"), which identifies and engages with countries that have serious AML/CFT deficiencies and prepares statements targeting deficient countries that are approved and published by each FATF Plenary after each meeting;²¹ the Working Group on Typologies ("WGTP"), which identifies and analyses illicit finance threats including methods and trends,²² the Working Group on Terrorist Financing and Money Laundering, which responds to new and emerging threats, such as proliferation financing, refines standards, and develops guidance;²³ and the Global Network Coordination Group, which strengthens the capacity and coordination of the FATF-Style Regional Bodies ("FSRBs") that form the global network.²⁴

The FATF Standards are promoted outside of the 36 FATF members by a group of FSRBs, which have been established in different regions to disseminate the FATF standards around the world.²⁵ There are eight

¹⁹ *Who We Are*, *supra* note 2. In addition to the Plenary, the FATF is comprised of a small full-time Secretariat and a President selected from among its members who serve rotating one-year terms. *FATF Presidency*, FIN. ACTION TASK FORCE, <http://www.fatf-gafi.org/pages/aboutus/fatfpresidency/> (last visited Nov. 14, 2012); *FATF Secretariat*, FIN. ACTION TASK FORCE, <http://www.fatf-gafi.org/pages/aboutus/fatfsecretariat/> (last visited Nov. 14, 2012).

²⁰ FATF, *2008-2009 Fin. Action Task Force Annual Report*, at 8 (2009) [hereinafter *FATF 2008-2009 Annual Report*], available at <http://www.fatf-gafi.org/media/fatf/documents/reports/2008%202009%20ENG.pdf>.

²¹ *More About the International Co-Operation Review Group (ICRG)*, FIN. ACTION TASK FORCE available at <http://www.fatf-gafi.org/topics/high-riskandnon-cooperative-jurisdictions/more/moreabouttheinternationalco-operationreviewgroupicrg.html> (last visited Nov. 14, 2012).

²² *FATF 2008-2009 Annual Report*, *supra* note 20.

²³ *Id.*

²⁴ See FATF, *Annual Report 2011-2012*, at 34 (2012) available at <http://www.fatf-gafi.org/media/fatf/documents/brochuresannualreports/FATF%20annual%20report%202011%202012%20website.pdf> ("[The GNCG] provides a practical forum for exchanging experiences between the FSRB's and with the FATF and for developing high standards of work carried out by the various bodies and their secretariats." (alteration added)).

²⁵ See *Countries*, FIN. ACTION TASK FORCE, <http://www.fatf-gafi.org/countries/> (last visited Nov. 14, 2012) (showing a list of FSRBs, and which countries are members). *FATF 2008-2009 Annual Report*, *supra* note 20, at 7.

FSRBs, which, together with the actual FATF members, create a network of nearly 200 countries.²⁶

The Revised Standards, which will be applied by the FATF in its fourth round of Mutual Evaluations,²⁷ as well as by the FSRBs, are intended to “provide authorities with a stronger framework to act against criminals and address new threats to the international financial system.”²⁸ The timing of this most recent revision is consistent with the FATF’s practice of reviewing the Standards following each round of Mutual Evaluations.²⁹ As seems appropriate for any standard-setting body, the FATF conducts such a periodic review to ensure that its Standards are up-to-date and relevant, as well as to benefit from what it has learned from implementation, evaluation, and practice since the previous revision.³⁰ The FATF’s thorough review process included two public consultation papers,³¹ in which the FATF asked the Private Sector Consultative Forum (“Consultative Forum”) for input regarding standards that impact it directly.³² These papers resulted in substantial written comments from the private sector, as well as two consultation sessions.³³

²⁶ *FATF Members and Observers*, FIN. ACTION TASK FORCE, <http://www.fatf-gafi.org/pages/aboutus/membersandobservers/> (last visited Nov. 14, 2012).

²⁷ The fourth round of Mutual Evaluations is scheduled to begin in late 2013. FATF, *The Review of Standards: Preparation for the 4th Round of Mutual Evaluations, Second Public Consultation*, at 4 (June, 2011) [hereinafter *Second Preparation for 4th Round*], available at <http://www.fatf-gafi.org/media/fatf/documents/publicconsultation/Second%20public%20consultation%20document.pdf>.

²⁸ *FATF Steps Up the Fight Against Money Laundering and Terrorist Financing*, FIN. ACTION TASK FORCE (Feb. 16, 2012), <http://www.fatf-gafi.org/topics/fatfrecommendations/documents/fatfstepsupthefightagainstmoneylaundryandterroristfinancing.html>.

²⁹ Its third round of Mutual Evaluations was nearing its conclusion when the most recent process of reviewing the standards began in June 2009. *Second Preparation for 4th Round*, *supra* note 27.

³⁰ See *2012 Standards*, *supra* note 3 at 7. (Previous revisions to the Standards were completed in 1996 and 2003. Those revisions focused on broadening the scope of the Standards and addressing emerging threats).

³¹ FATF, *The Review of Standards: Preparation for the 4th Round of Mutual Evaluations*. (Oct. 2010) [hereinafter *First Preparation for 4th Round*], available at <http://www.fatf-gafi.org/media/fatf/documents/publicconsultation/First%20public%20consultation%20document.pdf>; *Second Preparation for the 4th Round*, *supra* note 27.

³² The Private Sector Consultative Forum is comprised of a large number of associations representing the financial services industries and DNFBP sectors that have participated in the review process as well as previous outreach efforts by the FATF. *FATF Meets With the Private Sector*, FIN. ACTION TASK FORCE, <http://www.fatf-gafi.org/documents/documents/fatfmeetswiththepriatesector.html> (last visited on Nov. 14, 2012).

³³ See generally *Review of the FATF Standards*, FIN. ACTION TASK FORCE, <http://www.fatfgafi.org/topics/fatfrecommendations/documents/reviewofthefatfstandards.hs>

Key changes announced by the FATF in the 2012 Standards include the inclusion of the risk-based approach,³⁴ increased transparency and international cooperation, expansion of operational standards, consideration of new threats and priorities, and clarification of certain Standards.³⁵ Another notable element of the Revised Standards is the incorporation of the Nine Special Recommendations into the general Recommendations of the 2012 Standards, in recognition of the related nature of the threats posed by money laundering and terrorist financing and complementary tools needed to address these risks.³⁶ When the standards were revised, some of the requirements contained in the Special Recommendations were integrated into related Recommendations, while other Special Recommendation requirements have been retained in a section in the 2012 Standards that addresses terrorist financing and proliferation.³⁷ As a result, there no longer are “Special Recommendations” included in the Standards, although the requirements addressing terrorist financing have been retained.³⁸

The 2012 Standards are grouped into the following seven categories: (1) Anti-Money Laundering and Combating the Financing of Terrorism (“AML/CFT”) Policies and Coordination, (2) Money Laundering and Confiscation, (3) Terrorist Financing and Proliferation, (4) Preventive Measures, (5) Transparency and Beneficial Ownership of Legal Persons and Arrangements, (6) Powers and Responsibilities of Competent Authorities and other Institutional Measures, and (7) International Cooperation.³⁹ This article considers the Revised Standards in the order that they are listed.

ml (last updated Aug. 10, 2012). The first paper was published in October 2010, one year after the FATF Plenary agreed on the list of issues to be considered, and was discussed with the private sector in January 2011. The second paper was published in June 2011 and was discussed at a consultation session in December 2011.

³⁴ The process through which a country or entity identifies and assesses its AML/CFT risks and applies commensurate measures to address those risks, as described in Recommendation 1. See discussion *infra* Recommendation 1.

³⁵ See FATF, *FATF Recommendations: Media Narrative*, at 1–2, [hereinafter *Media Narrative*] available at <http://www.fatf-gafi.org/media/fatf/documents/Press%20handout%20FATF%20Recommendations%202012.pdf> (last visited Nov. 14, 2012).

³⁶ See *History of the FATF*, FIN. ACTION TASK FORCE, <http://www.fatfgafi.org/pages/aboutus/historyofthefatf/> (last visited Nov. 14, 2012). Eight of the nine Special Recommendations, which address terrorist financing, were adopted following the 9/11 attack. *Id.* These were integrated into the Standards when they were revised in 2003, and a ninth Special Recommendation was added in 2004. *Id.* This created what was sometimes referred to as the “FATF 40 + 9.” *Id.*

³⁷ See *2012 Standards*, *supra* note 3, at 8.

³⁸ *Id.*

³⁹ See *id.* at 4–5.

In this article, I closely examine the Revised Standards to pinpoint the substantive changes that have been made to the 2003 Standards,⁴⁰ and also explain why Recommendations that have been modified, may not be substantively different. In this regard, I will also consider the 2004 Methodology,⁴¹ which was used to assess countries' compliance with the 2003 Standards. This article also discusses some of the comments received from the private sector during the public consultation period and examines their impact on the Revised Standards. This article does not attempt to discuss the Revised Standards in their entirety, but focuses on modifications from the 2003 Standards (as augmented by the 2004 Methodology).

ANALYSIS OF THE REVISED STANDARDS' MODIFIED RECOMMENDATIONS

A. *AML/CFT Policies and Coordination*

Recommendation 1. Assessing risk and applying a risk-based approach

Recommendation 1 of the 2012 Standards, "Assessing risk and applying a risk-based approach," is one of only two that have no parallel in the 2003 Standards.⁴² In consultation with relevant private sector industries, during 2006 through 2008 the FATF developed and published several guidance documents outlining the high-level principles of the risk-based approach and discussing good private sector practices in utilizing the approach.⁴³ The official adoption of the risk-based approach in the Standards is a significant step and indicates the extent to which this approach is now widely accepted as the appropriate approach—to be utilized by all countries across all industries and all sizes of institutions—

⁴⁰ FATF, *FATF Standards: FATF 40 Recommendations October 2003 (incorporating all subsequent amendments until October 2004)* (2010) [hereinafter *2003 Standards*], available at <http://www.fatf-gafi.org/media/fatf/documents/FATF%20Standards%20%2040%20Recommendations%20rc.pdf>.

⁴¹ See *2004 Methodology*, *supra* note 6. The detailed criteria contained in the 2004 Methodology are based primarily on the 2003 Standards, but also contain some additional requirements not always explicit in the Standards. Because these criteria were, in effect, requirements in assessments, this article considers such requirements to be part of the 2003 Standards, for purposes of discussing changes from those Standards.

⁴² Compare *2012 Standards*, *supra* note 3, with *2003 Standards*, *supra* note 41.

⁴³ See, e.g., FATF, *Guidance on the Risk-Based Approach to Combating Money Laundering and Terrorist Financing: High Level Principles and Procedures*, (June 2007) [hereinafter *Guidance on RBA*], available at <http://www.fatf-gafi.org/media/fatf/documents/reports/High%20Level%20Principles%20and%20Procedures.pdf>.

for most effectively preventing and detecting money laundering and terrorist financing.

Recommendation 1 requires that FATF member countries “identify, assess, and understand the [Money Laundering and Terrorist Financing (“ML/TF”)] risks for the country,” and apply a risk-based approach to ensure that the measures taken are commensurate with the risks identified.⁴⁴ This analysis should be an “essential foundation to efficient allocation of resources” throughout the AML/CFT regime.⁴⁵ Per the Revised Standards, countries should also require their financial institutions and designated non-financial businesses and professions (“DNFBPs”)⁴⁶ to perform a similar risk assessment in order to effectively mitigate their ML/TF risks.⁴⁷

The Interpretive Note (“Note”) to Recommendation 1 points out that countries need to consider the AML/CFT capacity and experience of particular sectors because the risk-based approach affords discretion to financial institutions and DNFBPs, and such discretion is more appropriately given to sectors with greater capacity and experience.⁴⁸ In addition, under the Note, countries must require enhanced measures for higher risk situations, and may permit simplified measures where risks are lower.⁴⁹

The Note’s subparts contain specific obligations and required decisions regarding risk assessment, management, and mitigation for countries, as well as financial institutions and DNFBPs. Each member country is obligated to “take appropriate steps” to identify and assess its ML/TF risks, to keep its assessments up-to-date, and to provide “appropriate information” to competent authorities, financial institutions, and DNFBPs regarding these risks and how they might be mitigated.⁵⁰ Although this might have been viewed as an implicit requirement under the 2003 Standards, its explicit inclusion in the Revised Standards could become a significant additional obligation, should it be interpreted in Mutual Evaluations as requiring more extensive documentation of a country’s ML/TF risk analysis than was produced previously.⁵¹ The Note

⁴⁴ 2012 Standards, *supra* note 3, at 11.

⁴⁵ *Id.*

⁴⁶ The DNFBPs include casinos, real estate agents, dealers in precious metals and stones, lawyers, accountants, and trust and company service providers. *See id.* at 112–13.

⁴⁷ *Id.* at 11.

⁴⁸ *Id.* at 31. In general financial institutions, including banks, securities firms and insurance companies, have greater AML/CFT capacity and experience than DNFBPs. *Id.*

⁴⁹ 2012 Standards, *supra* note 3, at 31. *See also* 2003 Standards, *supra* note 41, at 5.

⁵⁰ 2012 Standards, *supra* note 3, at 32.

⁵¹ *See id.* This new requirement, like many others, will need to be applied in the context of Mutual Evaluations, at which time a determination will be made as to how it will

also includes provisions permitting a jurisdiction to exempt a financial institution or DNFBP from certain Recommendations, in limited circumstances, where there is a proven low risk of money laundering or where an activity is carried out on an occasional or very limited basis such that there is a low risk of money laundering or terrorist financing.⁵²

Financial institutions and DNFBPs are also required to identify and assess their ML/TF risks, to document their assessments, and to keep them up-to-date.⁵³ The Note states, however, that individual risk assessments are not necessary in cases where competent authorities have determined that a financial institution or DNFBP has “clearly identified and understood” its risks.⁵⁴ Regardless, financial institutions and DNFBPs must always have policies, controls, and procedures in place to mitigate the risks that are identified either by the institution itself or by its country, to monitor the implementation of such controls, and to enhance the controls when necessary.⁵⁵ The Note contains relatively detailed requirements applicable to financial institutions and DNFBPs with regard to these expectations for risk assessments.⁵⁶

The private sector comments were generally supportive of the universal application of the risk-based approach, both for regulated entities and for their supervisors. Some commenters noted that, in order to fully implement a risk-based system in which risks are assessed and resources prioritized, countries should be required (and not just permitted) to allow simplified measures for lower risk situations. Commenters also urged increased sharing of information by the public sector regarding potential risks.⁵⁷

Recommendation 1, in conjunction with its Interpretive Note, not only sets out the expectation that all countries will apply the risk-based approach to AML/CFT, but also contains new requirements for member countries and the private sector with regard to performing and updating risk

be interpreted. For example, assessors will have to determine whether a country’s risk assessment must be set forth in one comprehensive document, or whether a country can demonstrate an adequate risk assessment based on a variety of sources.

⁵² *Id.* at 32. These exemptions were effectively included in the 2003 standards, by virtue of their inclusion in the definition of “Financial Institution.” *2003 Standards*, *supra* note 41, at 16–17.

⁵³ *2012 Standards*, *supra* note 3, at 33.

⁵⁴ *Id.*

⁵⁵ *Id.*

⁵⁶ *Id.*

⁵⁷ *See, e.g.*, Letter from International Banking Federation, to John Carlson, Principal Administrator, FATF Secretariat 3, (Jan. 12, 2011), <http://www.ibfed.org/download/6546> [hereinafter *IBFed January Letter*].

assessments.⁵⁸ The impact of this new requirement on both countries and the private sector could be substantial, particularly in the cases of countries and industries that have not previously conducted or documented their risk assessments.⁵⁹

Recommendation 2. National cooperation and coordination⁶⁰

The first paragraph of Recommendation 2 of the 2012 Standards, “National cooperation and coordination,” sets out a new requirement that countries promulgate regularly-reviewed national AML/CFT policies informed by specific risk circumstances and “designate an authority or have a coordination or other mechanism . . . responsible for such policies.”⁶¹ The second paragraph of Recommendation 2 requires countries to have mechanisms that enable competent authorities to cooperate and coordinate concerning the development of AML/CFT strategies, at both policy and operational levels.⁶² The latter paragraph is substantially similar to Recommendation 31 of the 2003 Standards, with one significant modification; it now contains a new requirement that, in addition to money laundering and terrorist financing, AML/CFT policies and operations must also address efforts to combat the financing of proliferation of weapons of mass destruction.⁶³ This is a result of, and consistent with, the inclusion in the 2012 Standards of Recommendation 7, “Targeted financial sanctions related to proliferation.”⁶⁴

⁵⁸ 2012 Standards, *supra* note 3, at 11, 31–33.

⁵⁹ See, e.g., DEP'T OF TREASURY, MONEY LAUNDERING THREAT ASSESSMENT WORKING GRP., U.S. MONEY LAUNDERING THREAT ASSESSMENT (Dec. 2005), available at <http://www.treasury.gov/resource-center/terrorist-illicit-finance/Documents/mlta.pdf> (providing an example of a United States' risk assessment).

⁶⁰ 2012 Standards Recommendation 2 corresponds, in part, to Recommendation 31 of the 2003 Standards. See 2012 Standards, *supra* note 3, at 4 (showing the new recommendation numbers with the corresponding recommendations from 2003).

⁶¹ *Id.* at 11.

⁶² *Id.*

⁶³ *Id.*

⁶⁴ See *id.* at 13 (requiring countries to implement financial sanctions on persons or entities designated by the United Nations Security Council pursuant to resolutions that relate to preventing the financing of proliferation).

B. *Money Laundering and Confiscation*

Recommendation 3. Money laundering offence⁶⁵

Revised Standards Recommendation 3, “Money laundering offence,” combines two Recommendations previously published in the 2003 Standards: Recommendation 1, dealing with criminalization and predicate offenses; and Recommendation 2, concerning criminal intent and legal persons.⁶⁶ Although the text of 2012 Standards Recommendation 3 is considerably shorter than that of 2003 Recommendations 1 and 2, all of the requirements that were contained in the 2003 versions of Recommendations 1 and 2, as well as certain essential criteria from the 2004 Methodology, are included in Recommendation 3 or its Interpretive Note.⁶⁷ There is, however, still a significant change to the Recommendation 3 requirements when considered in light of the definition of “designated categories of offences” provided in the Revised Standards’ Glossary.⁶⁸ In the 2012 Standards, the definition of “designated categories of offences” has been expanded to include “tax crimes (related to direct taxes or indirect taxes).”⁶⁹ Additional material published by the FATF explains that this expansion is meant to include “serious tax crimes,” a category that the FATF does not define and the scope of which will be determined through the upcoming Mutual Evaluation process.⁷⁰ This means that, to be compliant with the Revised Standards, countries will now have to include serious tax crimes as predicate offenses to money laundering.

The Glossary definition of “smuggling” has been similarly expanded. The parenthetical “(including in relation to customs and excise duties and taxes)” has been added to the 2003 definition and appears in the Revised

⁶⁵ 2012 Standard Recommendation 3 corresponds with Recommendations 1 and 2 of the 2003 Standards. *Id.* at 4.

⁶⁶ 2012 Standards, *supra* note 3, at 12. 2003 Standards, *supra* note 41, at 3–4.

⁶⁷ 2012 Standards, *supra* note 3, at 12, 34–35. 2003 Standards, *supra* note 41, at 3. See also 2004 Methodology, *supra* note 6 (describing the essential criteria of Recommendations 1 and 2 of the 2003 Standards).

⁶⁸ 2012 Standards, *supra* note 3, at 111–12.

⁶⁹ *Id.* at 112. Cf. 2003 Standards, *supra* note 41, at 15 (not listing tax crimes as one of the designated categories of offences).

⁷⁰ See FATF, *FATF Recommendations: Media Narrative*, *supra* note 35, at 2, available at <http://.fatf-gafi.org/media/fatf/documents/Press%20handout%20FATF%20Recommendations%202012.pdf> (last visited Nov. 14, 2012) (“The list of predicate offences for money laundering has been expanded to include serious tax crimes.”); 2012 Standards, *supra* note 3, at 34. Paragraph 2 of the Interpretive Note states that “[c]ountries should apply the crime of money laundering to all serious offenses . . .”). *Id.* (ellipsis added).

Standards' Glossary.⁷¹ The FATF explains that this modification is intended as a clarification “to contribute to better coordination between law enforcement, border and tax authorities, and remove potential obstacles to international cooperation regarding tax crimes.”⁷²

The inclusion of tax crimes as predicate offenses received a mixed response from the private sector. Some financial representative bodies supported it, while DNFBPs and others generally opposed it. The concerns expressed included: (1) the scope of tax crimes, with a strong preference for including only “serious tax crimes;” (2) the inherent difficulty for the private sector to detect and identify tax crimes for purposes of suspicious transaction reporting;⁷³ and (3) “the need for a level playing field,” i.e., ensuring that different countries consider similar tax crimes as having the same degree of seriousness.⁷⁴ The private sector also noted that it is challenging to identify and isolate the proceeds specifically connected to a tax crime.⁷⁵ It remains to be seen how these concerns will be addressed going forward. Mutual Evaluation reports will have to make individual determinations as to whether countries have properly included “serious” tax crimes as money laundering predicates, so as to comply with the Revised Standards. These determinations, in turn, will ultimately determine the full significance of this change to the Standards.

Recommendation 4. Confiscation and provisional measures⁷⁶

Recommendation 4, “Confiscation and provisional measures,” has been revised, primarily as a result of the FATF’s decision to eliminate confusion by transferring to it certain requirements previously included in Special Recommendation III of the 2003 Standards.⁷⁷ As a result,

⁷¹ 2012 Standards, *supra* note 3, at 112.

⁷² Media Narrative, *supra* note 35, at 2.

⁷³ See, e.g., IBFed January Letter, *supra* note 57, at 4.

⁷⁴ FATF Response to Public, *supra* note 4, at 3.

⁷⁵ See *id.* (indicating that the private sector lacks expertise to identify and detect tax crimes).

⁷⁶ Recommendation 4 of the 2012 Standards corresponds with Recommendation 3 of the 2003 Standards. 2012 Standards, *supra* note 3, at 4.

⁷⁷ *Id.* at 12; see also FATF, FATF IX Special Recommendations at 8 (Oct. 2001) [hereinafter *Special Recommendations*], available at <http://www.fatf-gafi.org/media/fatf/documents/reports/FATF%20Standards%20%20IX%20Special%20Recommendations%20and%20IN%20rc.pdf> (describing the requirements of Special Recommendation III). The majority of the requirements set forth in Special Recommendation III of the 2003 Standards now appear in Recommendation 6 of the 2012 Standards. 2012 Standards, *supra* note 3, at 13.

Recommendation 4 now addresses confiscation and provisional measures pertaining to criminal proceedings relating not only to money laundering and predicate offenses (as was covered in 2003's Recommendation 3), but also relating to the financing of terrorism, which was previously covered in Special Recommendation III of the 2003 Standards. This is accomplished by two changes in the first paragraph of Recommendation 4: (1) a requirement that countries adopt confiscation and provisional measures similar to those set forth in the Terrorist Financing Convention,⁷⁸ in addition to those required by the Vienna and Palermo Conventions,⁷⁹ and (2) the addition to the 2003 Standard's Recommendation 3 requirement that countries are able to confiscate property laundered, and proceeds from money laundering or predicate offenses, the requirement that "competent authorities" are also able to confiscate "property that is the proceeds of, or used in, or intended or allocated for use in, the financing of terrorism, terrorist acts or terrorist organizations"⁸⁰ As mentioned above, this change was made in order to distinguish a country's authority to freeze and confiscate terrorist-related assets in a criminal investigation or prosecution (now covered in this Recommendation), from a country's authority to implement the United Nations Security Council Resolution ("UNSCR") "Targeted Financial Sanctions" requirement.⁸¹ This change was made primarily to eliminate confusion with respect to Special Recommendation III caused by combining requirements relating to terrorist financing in the context of criminal authorities, with those requirements in the context of administering a targeted sanctions regime.⁸² This change does not give rise to additional aggregate requirements.⁸³

The second paragraph of Recommendation 4 requires that relevant confiscation and provisional measures provide enforcing parties with the

⁷⁸ *Id.* at 12. The International Convention for the Suppression of the Financing of Terrorism, which was referred to in the Interpretive Note to Special Recommendation III, requires (Art. 8) that each State Party "shall take appropriate measures . . . for the identification, detection and freezing or seizure of any funds used or allocated for the purpose of committing" terrorist financing offenses, as well as proceeds derived from such offenses. United Nations International Convention for the Suppression of the Financing of Terrorism, art. 8, Dec. 9, 1999, 2178 U.N.T.S. 197 (ellipsis added) [hereinafter *Terrorist Financing Convention*].

⁷⁹ *2012 Standards, supra* note 3, at 12.

⁸⁰ *Id.*

⁸¹ See discussion *infra* Recommendation 6.

⁸² *FATF Response to Public, supra* note 4, at 7–8.

⁸³ *2012 Standards, supra* note 3, at 12. The 2004 Methodology also included the requirement to be able to confiscate property that is indirect proceeds, income or profits from proceeds, or proceeds held by third parties. *2004 Methodology, supra* note 6, at 19. These are not included in the Revised Standards.

authority to “take steps that will prevent or void actions that prejudice the country’s ability to freeze or seize,” as well as to recover, property subject to confiscation.⁸⁴

An Interpretive Note has also been added to Recommendation 4, which requires countries to implement mechanisms that will enable “authorities to effectively manage and, when necessary, dispose of, property that is frozen or seized . . . both in the context of domestic proceedings, and pursuant to requests by foreign countries.”⁸⁵

C. *Terrorist Financing and Financing of Proliferation*

Recommendation 5. Terrorist financing offence⁸⁶

Recommendation 5 of the Revised Standards, “Terrorist financing offence,” is the same as Special Recommendation II of the 2003 Standards in substance, but differs from Special Recommendation II in form.⁸⁷ Recommendation 5 requires countries to criminalize terrorist financing on the basis of the Terrorist Financing Convention⁸⁸ and states that they “should criminalise not only the financing of terrorist acts but also the financing of terrorist organisations and individual terrorists even in the

⁸⁴ *Id.* This largely incorporates the 2003 Methodology (criteria 3.6), but adds a reference to the country’s ability to “freeze or seize” property subject to confiscation. *Id.* In addition, countries are required to consider adopting measures that allow non-conviction based confiscation, or that require an offender to demonstrate the lawful origin of property allegedly liable to confiscation, to the extent consistent with domestic laws. *Id.* These were only suggested for possible consideration in the 2003 version of Recommendation 3. *See 2003 Standards, supra* note 41, at 4.

⁸⁵ *2012 Standards, supra* note 3, at 36. This Note also applies in relation to a similar new requirement in Recommendation 38 regarding freezing and confiscation of property pertaining to mutual legal assistance. *See id.* at 102.

⁸⁶ Recommendation 5 of the Revised Standards corresponds to Special Recommendation II of the 2003 Standards. *Id.* at 4.

⁸⁷ *Compare Special Recommendations, supra* note 77, at 2, with *2012 Standards, supra* note 3, at 13.

⁸⁸ The United Nations Terrorist Financing Convention sets forth the acts that constitute the offense of the financing of terrorism and requires State Parties to criminalize such acts. *Terrorist Financing Convention, supra* note 78. The Interpretive Note to Special Recommendation II notes that “[a]lthough the [Terrorist Financing] Convention had not yet come into force at the time that SR II was originally issued in October 2001—and thus is not cited in the SR itself—the intent of the FATF has been from the issuance of SR II to reiterate and reinforce the criminalisation standard as set forth in the Convention (in particular, Article 2). The Convention came into force in April 2003.” *Special Recommendations, supra* note 77, at 4 n.1 (alterations added).

absence of a link to a specific terrorist act or acts.”⁸⁹ While both of these requirements were contained in the 2003 Standards, they were included in the Interpretive Note to Special Recommendation II, rather than in the text of the Special Recommendation itself.⁹⁰ The remaining parts of Special Recommendation II’s Interpretive Note now appear in Recommendation 5’s Interpretive Note or the Revised Standards’ Glossary.⁹¹

Recommendation 6. Targeted financial sanctions related to terrorist and terrorist financing⁹²

Recommendation 6 of the 2012 Standards, “Targeted financial sanctions related to terrorism and terrorist financing,” contains some substantive changes from its predecessor, Special Recommendation III of the 2003 Standards. Recommendation 6 is now uniquely focused on “targeted financial sanctions,” a new term defined in the Glossary to mean “both asset freezing and prohibitions to prevent funds or other assets from being made available, directly or indirectly, for the benefit of designated persons and entities.”⁹³ The Recommendation states that the sanctions are to comply with UNSCRs relating to the prevention and suppression of terrorism and terrorist financing, including UNSCR 1267 and its successor UNSCRs⁹⁴ and 1373.⁹⁵ As noted above, the second paragraph of Special

⁸⁹ 2012 Standards, *supra* note 3, at 13.

⁹⁰ Special Recommendations, *supra* note 77, at 4–5.

⁹¹ 2012 Standards, *supra* note 3, at 37, 117, 121. The “Objective” and “Characteristics of the terrorist financing offense” in the Interpretive Note to Recommendation 5 includes all of the corresponding requirements in the Interpretive Note to Special Recommendation II. The defined terms “funds,” “terrorist,” “terrorist act,” “terrorist financing,” and “terrorist organization” have been moved to the 2012 Standards’ General Glossary from the Interpretive Note to Special Recommendation II without change in substance.

⁹² Recommendation 6 of the Revised Standards corresponds to Special Recommendation III of the 2003 Standards. *Id.* at 4.

⁹³ *Id.* at 13, 113, 120. The definition of the term “designated persons or entities” has been expanded from the 2003 definition of “designated person” to include (a) for purposes of Recommendation 6, individuals, groups and undertakings designated by the 1267 Committee or the 1988 Committee, and natural or legal persons designated by jurisdictions pursuant to UNSCR 1373, and (b) for purposes of Recommendation 7, natural or legal persons designated by UNSCR 1718 or 1737 or their successors, or by the respective UN Sanctions Committee. *Id.* at 113–14.

⁹⁴ *Id.* at 13. See generally S.C. Res. 1267, U.N. Doc. S/RES/1267 (Oct. 15, 1999), available at <http://www.un.org/sc/committees/1267/> (stating that UNSCR 1267 required countries to freeze funds or other assets owned or controlled by Al-Qaida, the Taliban, Usama bin Laden, or associated persons). When issued, UNSCR 1267 had a time period of one year; however, successor UNSCRs extend or are otherwise directly related to it.

Recommendation III, which required measures to “enable the competent authorities to seize and confiscate property that is the proceeds of, or used in, or intended or allocated for use in, the financing of terrorism, terrorist acts, or terrorist organizations[,]” now appears in the Revised Standards Recommendation 4.⁹⁶

Recommendation 6’s Interpretive Note is also somewhat different from that of Special Recommendation III. It has been reorganized and is generally aligned with the framework reflected in the FATF International Best Practices Paper, “Freezing of Terrorist Assets (October 2003).”⁹⁷ This framework requires that countries (1) establish procedures to identify and initiate designation proposals meeting the criteria of UNSCRs 1267 and its successor resolutions and UNSCR 1373, including a competent authority or court that deliberates on proposals for designations; (2) freeze and prohibit dealing in funds or other assets of designated persons and entities suspected of being associated with terrorists; and (3) implement due process measures, including delisting, unfreezing, and providing access to such frozen funds or assets.⁹⁸ In particular, the Interpretive Note expands upon the required identification and designation procedures, and the necessary authority for such procedures; these procedures were not explicit in the Interpretive Note to Special Recommendation III.⁹⁹ Among the other technical changes are a listing of UNSCR 1267’s successor resolutions¹⁰⁰ and the move to the Glossary of the definitions contained in the Interpretive Note to Special Recommendation III.¹⁰¹

The private sector was generally supportive of the changes to Special Recommendation III. Most of the comments focused on using consistent terminology, which the FATF successfully accomplished in its revisions.¹⁰²

⁹⁵ See S.C. Res. 1373, U.N. Doc. S/RES/1373 (Sept. 28, 2001), available at <http://www.un.org/News/Press/docs/2001/sc7158.doc.htm> (stating that the Resolution requires countries to freeze the funds or other assets of persons who commit, attempt to commit, or participate in, terrorist acts, and of persons and entities acting on behalf of such persons). Each country must have the authority to designate such persons, and to examine and give effect to such actions of other jurisdictions.

⁹⁶ 2012 Standards, *supra* note 3, at 12; *Special Recommendations*, *supra* note 7777, at 2 (alteration added).

⁹⁷ FATF, *International Best Practices: Freezing of Terrorist Assets*, at 3 (Oct. 3, 2003), available at <http://www.fatf-gafi.org/media/fatf/documents/recommendations/International%20BPP%20Freezing%20of%20Terrorist%20Assets%20SR%20III%20Cover%202012.pdf>.

⁹⁸ 2012 Standards, *supra* note 3, at 39–46.

⁹⁹ *Id.* at 40–42.

¹⁰⁰ *Id.* at 39.

¹⁰¹ *Id.* at 109–23.

¹⁰² *FATF Response to Public*, *supra* note 4, at 7.

In response to private sector concerns, Recommendation 6's Interpretive Note includes a reference stating, in effect, that when determining the limits of or fostering widespread support for a counter-terrorist financing ("CTF") regime, countries must respect human rights and the rule of law, in addition to rights of innocent third parties.¹⁰³ The Interpretive Note also requires that countries inform persons designated on the Al-Qaida Sanctions List of the availability of the United Nations Office of the Ombudsperson to accept de-listing petitions,¹⁰⁴ and requires that countries have mechanisms for communicating de-listings and un-freezings to the financial sector immediately upon taking such action and for providing adequate guidance on the financial sector's obligations with respect to these actions.¹⁰⁵

Recommendation 7. Targeted financial sanctions related to proliferation

The 2012 Standards' Recommendation 7 is entirely new. It requires countries "to implement targeted financial sanctions to comply with United Nations Security Council resolutions relating to the prevention, suppression and disruption of proliferation of weapons of mass destruction and its financing."¹⁰⁶ The Revised Standards' Recommendation 7 is based upon, and largely tracks the language of, Recommendation 6, except that Recommendation 7 is directed at complying with UNSCRs that relate to preventing the proliferation and financing of weapons of mass destruction ("WMD"),¹⁰⁷ as opposed to terrorism and terrorist financing.¹⁰⁸

¹⁰³ 2012 Standards, *supra* note 3, at 39.

¹⁰⁴ *Id.* at 44. This is required by UNSCR 1904. S.C. Res. 1904, U.N. Doc. S/RES/1904 (Dec. 17, 2009), available at [http://www.un.org/ga/search/view_doc.asp?symbol=S/RES/1904\(2009\)](http://www.un.org/ga/search/view_doc.asp?symbol=S/RES/1904(2009)).

¹⁰⁵ 2012 Standards, *supra* note 3, at 45.

¹⁰⁶ *Id.* at 13. (explaining that "[t]hese resolutions require countries to freeze without delay the funds or other assets of, and to ensure that no funds and other assets are made available, directly or indirectly, to or for the benefit of, any person or entity designated by, or under the authority of, the United Nations Security Council under Chapter VII of the Charter of the United Nations.")

¹⁰⁷ See generally *id.*; S.C. Res. 1718, U.N. Doc. S/RES/1718 (Oct. 14, 2006), available at [http://www.un.org/ga/search/view_doc.asp?symbol=S/RES/1718\(2006\)](http://www.un.org/ga/search/view_doc.asp?symbol=S/RES/1718(2006)) (showing that UNSCR 1718 (2006) imposes a series of economic and commercial sanctions on the Democratic People's Republic of Korea (North Korea) in the aftermath of that nation's claimed nuclear test of October 9, 2006, and 1737 (2006), requires Iran to suspend certain "proliferation sensitive nuclear activities," places several prohibitions on all states with regards to Iran's nuclear activities, imposes a freeze on those assets supporting or associated with Iran's nuclear proliferation activities and establishes a committee to oversee their implementation).

The Interpretive Note to Recommendation 7 similarly tracks that of Recommendation 6, but with a few differences.¹⁰⁹ Recommendation 7's Interpretive Note focuses on the UNSCRs that contain designations, or the relevant UNSC Committee established for the purpose of making designations, while Recommendation 6's Interpretive Note focuses on the responsibilities of individual countries.¹¹⁰ This difference arises because under Recommendation 7 (as well as under the relevant UNSCRs), unlike Recommendation 6, countries are under no specific obligation to implement procedures and mechanisms for proposing designations to the UN. Instead, countries could consider developing such capability. Accordingly, the Interpretive Note to Recommendation 7 recognizes that designations are originated by UN members and points to the 1718 and 1737 UN Committee guidelines, which call for member submissions and contain the criteria that would be needed for proposed designations (which must be made by the relevant UN Committee).¹¹¹ In addition, whereas the focus of Recommendation 6 on preventing terrorist financing is included in other areas of the Standards, including the criminalization of terrorist financing, suspicious transaction reporting, preventive measures, and international cooperation, requirements relevant to the prevention of WMD proliferation are limited to Recommendations 7 and 2.¹¹² Finally, Recommendation 7's Interpretive Note contains a specific requirement that countries adopt measures to monitor financial institutions' and DNFBPs' compliance with these obligations and that noncompliance should be subject to sanctions.¹¹³ In contrast, sanctions for noncompliance with Recommendation 6 are covered by Recommendation 35, which is the general sanctions standard.¹¹⁴

Some private sector commenters opposed extending targeted financial sanctions to proliferation financing.¹¹⁵ In response to private sector

¹⁰⁸ It also bears noting in both cases that, while the relevant UNSCRs include a broad range of requirements, including travel bans and activity-based financial prohibitions, these Recommendations address only implementation of the asset freezing provisions and related prohibitions contained in the UNSCRs. *See generally 2012 Standards, supra* note 3, at 13.

¹⁰⁹ *Id.* at 47. The sections have identical titles except for the second, which is entitled "Designations" rather than "Identifying and Designating Persons and Entities Financing or Supporting Terrorist Activities." *Id.*

¹¹⁰ *See generally id.* at 39–53.

¹¹¹ *Id.* at 48.

¹¹² *Id.* at 11, 13.

¹¹³ *2012 Standards, supra* note 3, at 50.

¹¹⁴ *Id.* at 26.

¹¹⁵ One commenter noted that, for the great majority of transactions, financial institutions do not have sufficient information to distinguish between ordinary, innocent transactions, and those involving WMD, and urged that primary responsibility for

requests that the Standards be more explicit regarding human rights, Recommendation 7's Interpretive Note includes a requirement that de-listing procedures should be in accordance with the "Focal Point" mechanism established under UNSCR 1730,¹¹⁶ as well as requirements for communicating de-listings and un-freezings to the financial sector and providing appropriate guidance.¹¹⁷

The addition of Recommendation 7, ensuring implementation of targeted financial sanctions called for by UNSCRs that are aimed at preventing the financing of the proliferation of WMD, represents a significant expansion by the FATF of its original mandate of preventing money laundering, as expanded in 2001 to include terrorist financing, and demonstrates the organization's ability to expand its scope in order to combat the financial aspects of other serious threats to world security.¹¹⁸

Recommendation 8. Non-profit organisations¹¹⁹

The text of Recommendation 8 in the 2012 Standards, "Non-profit organisations," is identical to that of Special Recommendation VIII in the 2003 Standards.¹²⁰ The Interpretive Note to Recommendation 8 is also substantively identical to the Interpretive Note to Special Recommendation VIII.¹²¹ The only two technical changes made in converting Special Recommendation VIII to Recommendation 8 were (1) moving the definitions to the Glossary and (2) adding a "Resources for Supervision,

preventing such transactions should rest with customs and export control officials. *See* Letter from International Banking Federation, to John Carlson, Principal Administrator, FATF Secretariat, 6–7 (Sept. 20, 2011), <http://www.ibfed.org/download/7115>.

¹¹⁶ *2012 Standards, supra* note 3, at 50. *See also* S.C. Res. 1730, U.N. Doc. S/RES/1730 (Dec. 19, 2006), *available at* [http://www.un.org/ga/search/view_doc.asp?symbol=S/RES/1730\(2006\)](http://www.un.org/ga/search/view_doc.asp?symbol=S/RES/1730(2006)) (requesting that the UN Secretary General establish a focal point to receive de-listing requests).

¹¹⁷ *2012 Standards, supra* note 3, at 51.

¹¹⁸ *Id.* The FATF mandate was initially expanded to refer to WMD proliferation financing in 2008. *See Ministers renew the mandate of the Financial Action Task Force until 2020*, FIN. ACTION TASK FORCE (Apr. 20, 2012), <http://www.fatf-gafi.org/topics/fatfgeneral/documents/ministersrenewthemandateofthefinancialactiontaskforceuntil2020.html>. The 2012 mandate further expands upon this.

¹¹⁹ Recommendation 8 of the 2012 Standards corresponds with Special Recommendation VIII of the 2003 Standards. *2012 Standards, supra* note 3, at 4.

¹²⁰ *Compare id.* at 13, with *Special Recommendations, supra* note 77, at 3.

¹²¹ *Compare 2012 Standards, supra* note 3, at 54–58, with *Special Recommendations, supra* note 77, at 20–24.

Monitoring, and Investigation” section, which was previously covered globally by Recommendation 30 in the 2003 Standards.¹²²

D. *Preventive Measures*

Recommendation 9. Financial institution secrecy laws¹²³

The Revised Standards' Recommendation 9, “Financial institution secrecy laws,” is identical to the 2003 Standards' Recommendation 4.¹²⁴ It states that “[c]ountries should ensure that financial institution secrecy laws do not inhibit implementation of the FATF Recommendations.”¹²⁵ Recommendation 9 has no corresponding Interpretive Note.

The FATF considered the impact of data protection and privacy requirements¹²⁶ on the implementation of the FATF standards, recognized that such requirements can in some cases limit—or conflict with—the implementation of AML/CFT requirements, and sought private sector input regarding this complex area.¹²⁷ In response, the private sector noted potential restrictions on the ability of financial institutions to (1) rely on third parties for certain CDD requirements (as permitted by Recommendation 17) and (2) implement financial group compliance programs (as required by Recommendation 18), that could arise as a result of data protection requirements.¹²⁸ Despite its efforts, the FATF was ultimately unable to identify and articulate a solution in the Revised Standards, but it has noted the need to work with other international bodies in order to endeavor to resolve these issues.¹²⁹ To the extent that an effective AML/CFT regime requires that government authorities have

¹²² 2012 Standards, *supra* note 3, at 58. In the 2012 Standards each Recommendation (where appropriate) contains its own requirement for adequate resources (e.g., Recommendations 26, 28-30 and 32), rather than addressing resources globally through a separate recommendation. *Compare id.* at 23–25, with 2003 Standards, *supra* note 40 at 11. This change was made in order that the adequacy of resources could be assessed in connection with each relevant standard.

¹²³ Recommendation 9 in the 2012 Standards corresponds with Recommendation 4 in the 2003 Standards. *Id.* at 4.

¹²⁴ *Compare id.* at 14, with *Special Recommendations*, *supra* note 77, at 4.

¹²⁵ 2012 Standards, *supra* note 3, at 14.

¹²⁶ *See, e.g.*, Directive 95/46/EC of the European Parliament and of the Council of 24 October 1995 on the Protection of Individuals with Regard to the Processing of Personal Data and on the Free Movement of Such Data, 1995 O.J. (L 281/31).

¹²⁷ *FATF Response to Public*, *supra* note 74, at 9.

¹²⁸ *See, e.g.*, *IBFed January letter*, *supra* note 58, at 3–4; *FATF Response to Public*, *supra* note 4, at 9.

¹²⁹ *See FATF Response to Public*, *supra* note 4, at 9.

access to financial or other information regarding individuals, and to the extent that a data privacy regime may restrict or prohibit such access, these represent diametrically opposed interests, that it would seem may only be resolved either by extremely artful negotiations, or the willingness of either or both regimes to compromise (or both). Thus far this has not been achieved.

Recommendation 10. Customer due diligence¹³⁰

The Revised Standards' Recommendation 10, "Customer due diligence," along with its Interpretive Note, was one of the Recommendations that received the greatest amount of attention during the FATF review and private sector consultations.¹³¹ Although the text of Recommendation 10 was not significantly modified from its predecessor, the 2003 Standards' Recommendation 5, the Interpretive Note has substantial changes.¹³²

The third paragraph of Recommendation 10 is new in form (but not substance). It states: "The principle that financial institutions should conduct [customer due diligence ("CDD")] should be set out in law. Each country may determine how it imposes specific CDD obligations, either through law or enforceable means."¹³³ This text is based upon, and replaces, the requirements contained in the 2004 Methodology's asterisked criteria that required certain CDD measures to be set out in "law or regulation."¹³⁴

¹³⁰ Recommendation 10 in the Revised Standards corresponds to Recommendation 5 in the 2003 Standards. *2012 Standards*, *supra* note 3, at 4.

¹³¹ *Id.* at 14–15, 59–66. See generally FATF, *Consultation on Proposed Changes to the FATF Standards: Compilation of Responses from Designated Non-Financial Business and Professions (DNFBPs)* (2011) [hereinafter *First Compilation of Responses from DNFBPs*], available at <http://www.fatf-gafi.org/media/fatf/documents/publicconsultation/First%20public%20consultation%20document%20responses%20dnfbp.pdf> (providing some examples of comments relating to customer due diligence). 2003's Recommendation 5 was the longest Recommendation with the greatest number of requirements. *2003 Standards*, *supra* note 41, at 4–5, 18–21. In addition, the requirements pertaining to beneficial ownership identification have proven among the most challenging Standards for countries to implement. See, e.g., *First Compilation of Responses from DNFBPs*, *supra* at 57 ("In practice, much of the beneficial ownership information that might be required is not available through independent channels.").

¹³² Compare *2012 Standards*, *supra* note 3, at 14–15, 59–66, with *2003 Standards*, *supra* note 41 at 4–5, 18–19.

¹³³ *2012 Standards*, *supra* note 3, at 14 (alterations added).

¹³⁴ See *id.* at 14. See also *2004 Methodology*, *supra* note 667, at 9. This requirement, which also applies to certain elements of Recommendations 11 and 20, is explained in an Interpretive Note entitled "Legal Basis of Requirements on Financial Institutions and

In the fourth paragraph of Recommendation 10, which addresses the CDD measures to be taken, subsection (c) was modified to read as follows: “(c) *Understanding and, as appropriate*, obtaining information on the purpose and intended nature of the business relationship.”¹³⁵ By adding “*Understanding and, as appropriate . . .*” to this subsection, it appears that the financial institution is not necessarily required to obtain information about the purpose and intended nature of the business relationship, so long as it “understands” its purpose and intended nature, and (presumably) can demonstrate that it does.

The fifth paragraph of Recommendation 10 was edited by deleting more than three sentences that referred to considering risk, and replacing the edited text with the clause: “using a risk-based approach (RBA) in accordance with the Interpretive Notes to this Recommendation and to Recommendation 1.”¹³⁶

Finally, a parenthetical was added to the seventh paragraph of Recommendation 10, as follows: “Where the financial institution is unable to comply with the applicable requirements under paragraphs (a) to (d) above (subject to appropriate modification of the extent of the measures on a risk-based approach), it should be required not to open the account . . .”¹³⁷ The addition of the parenthetical reiterates that the extent of the four CDD measures is subject to adjustment based on an analysis of the relevant risks.

Unlike Recommendation 10 itself, the Interpretive Note to Recommendation 10 is substantively different from its 2003 counterpart, the Interpretive Note to Recommendation 5.¹³⁸ These changes and additions are discussed below in the order of their subheadings.

Subheading A, “Customer Due Diligence and Tipping-Off,” contains no substantive changes, but subheading B, “CDD – Persons Acting on Behalf of a Customer,” has one new element.¹³⁹ Subheading B extends to individual customers, the requirements in the 2003 Interpretive Note that financial institutions verify the identity of any person purporting to act on behalf of a legal person or arrangement and to confirm that such person is in fact properly authorized to do so.¹⁴⁰ The 2003 Interpretive Note to

DNFBPs,” placed at the end of the 2012 Standards’ Interpretive Notes section and discussed at the end of this article.

¹³⁵ *2012 Standards, supra* note 3, at 14 (emphasis added).

¹³⁶ *Id.* at 15 (emphasis added). The reference to the RBA in the 2012 Standards made it possible to substantially shorten the text of the above paragraph.

¹³⁷ *Id.*

¹³⁸ *Compare id.* at 59–66, with *2003 Standards, supra* note, at 18–21.

¹³⁹ *2012 Standards, supra* note 3, at 59.

¹⁴⁰ *Id.*

Recommendation 5 did not apply this requirement to individual customers.¹⁴¹

Subheading C, entitled “CDD for Legal Persons and Arrangements,” contains new text.¹⁴² The new text explains that the purpose of the CDD requirements is twofold: (1) “to prevent the unlawful use of legal persons and arrangements, by gaining a sufficient understanding of the customer,” and (2) “to take appropriate steps to mitigate the risks” associated with the customer.¹⁴³ The specific requirements for customer identification and verification are similar to those articulated in the 2003 Interpretive Note, except that the 2012 Interpretive Note requires identification of “persons having a senior management position,” while the 2003 Interpretive Note only required identification of directors.¹⁴⁴ The Interpretive Note to Recommendation 10 also requires “the address of the registered office, and, if different, a principal place of business,” while 2003’s Interpretive Note to Recommendation 5 simply required an address.¹⁴⁵

The requirements for identifying and verifying the identity of the customer’s beneficial owner have undergone more substantial revisions. While 2003’s Interpretive Note to Recommendation 5 spoke generally about “identifying the natural persons with a controlling interest and . . . who comprise the mind and management of the legal person or arrangement,”¹⁴⁶ the 2012 Standards’ Interpretive Note to Recommendation 10 now sets forth a new step-by-step process to satisfy the beneficial ownership identification requirement for legal persons: “(i.i) The identity of the natural persons . . . who ultimately have a controlling ownership interest in a legal person;” “(i.ii) to the extent there is doubt under (i.i) . . . the identity of the natural persons (if any) exercising control of the legal person . . . through other means; and . . . (i.iii) [w]here no natural person is identified under (i.i) or (i.ii) above . . . the relevant natural person who holds the position of senior managing official.”¹⁴⁷

For “legal arrangements” (i.e., trusts), the Interpretive Note to Recommendation 10 specifies obtaining “the identity of the settlor, the trustee(s), the protector (if any), the beneficiaries or class of beneficiaries, and any other natural person exercising ultimate effective control over the

¹⁴¹ 2003 Standards, *supra* note 41, at 18–21.

¹⁴² 2012 Standards, *supra* note 3, at 59–60.

¹⁴³ *Id.* at 60.

¹⁴⁴ Compare *id.* at 60, with 2003 Standards, *supra* note 41, at 19.

¹⁴⁵ Compare 2012 Standards, *supra* note 3, at 60, with 2003 Standards, *supra* note 41, at 19.

¹⁴⁶ 2003 Standards, *supra* note 41, at 19.

¹⁴⁷ 2012 Standards, *supra* note 3, at 60–61 (alterations added) (footnote omitted).

trust”¹⁴⁸ This is more prescriptive than the corresponding requirements contained in the 2003 Standard.

Certain other CDD requirements for legal persons and arrangements were unchanged, including taking reasonable measures to verify the identity of the beneficial owner, and an exemption from beneficial ownership requirements for publicly traded companies.¹⁴⁹

In the 2012 Standards, Recommendation 10 also has a new subheading D, “CDD for Beneficiaries of Life Insurance Policies,” and, in relation to life insurance, the Glossary has a new definition of “beneficiary.”¹⁵⁰ The 2003 Interpretive Note to Recommendation 5 stated that identification and verification of the identity of the beneficiary under a life insurance policy “should occur at or before the time of payout or the time where the beneficiary intends to exercise vested rights under the policy.”¹⁵¹ The 2012 Standards’ Interpretive Note to Recommendation 10 now states that financial institutions should identify the beneficiary by name or otherwise obtain sufficient information about the characteristics or class to be able to identify the beneficiary, as the case may be, then maintain this information in accordance with the requirements of Recommendation 11.¹⁵² Financial Institutions must also verify the beneficiary’s identity at the time of payout; include the beneficiary as a relevant risk factor in determining whether enhanced due diligence is required, and, if it is required, take reasonable measures to identify and verify the beneficial owner of a beneficiary who is a legal person or arrangement.¹⁵³ Finally, the Interpretive Note requires that a financial institution that is unable to comply with these requirements should consider filing a suspicious transaction report (“STR”).¹⁵⁴ As a result of the public consultation, the Interpretive Note to Recommendation 10 also states that verification of beneficiaries need only occur “at the time of payout,” and the reference in the 2003 Interpretive Note to verification “before the time the beneficiary intends to exercise vested rights” was deleted, in recognition that beneficiaries have no “vested rights” prior to payout.¹⁵⁵

¹⁴⁸ *Id.* at 61.

¹⁴⁹ *Id.* The Interpretive Note to Recommendation 10 extends this to majority-owned subsidiaries of publicly traded companies. *Id.*

¹⁵⁰ *Id.* at 61, 109–10.

¹⁵¹ *2003 Standards, supra* note 41, at 20.

¹⁵² *2012 Standards, supra* note 3, at 15, 61.

¹⁵³ *Id.* at 61.

¹⁵⁴ *Id.* at 62.

¹⁵⁵ *Id.* at 61.

The 2012 Standards' Recommendation 10's subheading E, "Reliance on Identification and Verification Already Performed," is unchanged from 2003's Interpretive Note to Recommendation 5, and subheading F, "Timing of Verification," was changed only by deleting a reference to life insurance beneficiaries (now covered in subheading D), and by deleting an outdated reference to the Basel CDD Paper of 2001.¹⁵⁶ Subheading G, "Existing Customers," was revised to be more specific than its corresponding provision in 2003's Interpretive Note to Recommendation 5, which referred to the Basel CDD Paper for guidance.¹⁵⁷ The new provision is based on the corresponding provision from the 2004 Methodology that requires the application of CDD measures to existing customers "on the basis of materiality and risk," with an additional requirement that CDD applied to existing customers should take "into account whether and when CDD measures have previously been undertaken and the adequacy of data obtained."¹⁵⁸

The 2012 Standards added a new subheading H, entitled "Risk Based Approach," to Recommendation 10's Interpretive Note, which primarily lists numerous examples relevant to assessing and mitigating risk.¹⁵⁹ Subheading H contains seven subsections, and begins with the admonition that "[t]he examples . . . are not mandatory elements of the FATF Standards, and are included for guidance only."¹⁶⁰ The first, entitled "Higher Risks," expands substantially on corresponding information in 2003's Interpretive Note to Recommendation 5 and the 2004 Methodology.¹⁶¹ It includes examples of types of customers, countries, and products or transactions that may carry higher ML/TF risk and, thereby, require enhanced CDD measures.¹⁶² Some of the examples are based upon similar material in the FATF's Guidance on RBA.¹⁶³

The next subsection in subheading H, entitled "Lower Risks," notes that there are circumstances where the risk of money laundering or terrorist financing may be lower and, thus, it "could be reasonable for a country to

¹⁵⁶ Compare *id.* at 61–62, with 2003 Standards, *supra* note 41, at 20 & n.10 (citing BASEL COMM. ON BANKING SUPERVISION, CUSTOMER DUE DILIGENCE FOR BANKS (2001), available at <http://www.bis.org/publ/bcbs85.pdf>).

¹⁵⁷ Compare 2012 Standards, *supra* note 3, at 62, with 2003 Standards, *supra* note 41, at 20.

¹⁵⁸ 2012 Standards, *supra* note 3, at 15, 62. 2004 Methodology, *supra* note 6, at 15–19.

¹⁵⁹ 2012 Standards, *supra* note 3, at 63.

¹⁶⁰ *Id.*

¹⁶¹ Compare *id.* with 2003 Standards, *supra* note 41, at 19–21, and 2004 Methodology, *supra* note 6, at 17–19.

¹⁶² 2012 Standards, *supra* note 3, at 63–64.

¹⁶³ Guidance on RBA, *supra* note 433, at 23–25.

allow its financial institutions to apply simplified CCD measures.”¹⁶⁴ This subsection also includes examples, taken largely from 2003’s Interpretive Note to Recommendation 5 and the Guidance on RBA, of potential lower risk factors for the customer; product, service, transaction or delivery channel; or country.¹⁶⁵

The third subheading H subsection, “Risk variables,” is also based on the Guidance on RBA.¹⁶⁶ It explains that financial institutions should take certain variables into account—such as the purpose of an account, the level of assets in an account, or regularity of the business relationship—that may increase or decrease the potential risk of that account.¹⁶⁷

The fourth subsection in subheading H, entitled “Enhanced CDD measures,” contains examples of some of the enhanced measures financial institutions may take in higher risk situations and is based primarily on the 2003 Standards’ Recommendation 11¹⁶⁸ and the measures previously required by Recommendation 6 of the 2003 Standards.¹⁶⁹

The fifth subheading H subsection, entitled “Simplified CDD Measures,” lists examples of possible measures financial institutions may take when risk is low.¹⁷⁰ The sixth subsection, entitled “Thresholds,” notes that the maximum threshold for occasional transactions is \$15,000 (USD/EUR), including transactions “carried out in a single operation or in several operations that appear to be linked.”¹⁷¹ This subsection states a requirement that was contained in the 2004 Methodology.¹⁷²

The final subsection in subheading H, entitled “Ongoing due diligence,” requires that financial institutions “ensure that documents, data or information collected under the CDD process is kept up-to-date and relevant by undertaking reviews of existing records”¹⁷³ This requirement is of particular importance with respect to higher-risk

¹⁶⁴ 2012 Standards, *supra* note 3, at 64.

¹⁶⁵ 2003 Standards, *supra* note 41, at 21; Guidance on RBA, *supra* note 433, at 25-26.

¹⁶⁶ Compare 2012 Standards, *supra* note 3, at 65, with Guidance on RBA, *supra* note 433, at 24–25.

¹⁶⁷ 2012 Standards, *supra* note 3, at 65.

¹⁶⁸ *Id.* (directed at “complex, unusual large transactions”), with 2003 Standards, *supra* note 41, at 7 (stating that R11 is directed at “complex, unusual large” transactions).

¹⁶⁹ 2003 Standards, *supra* note, at 5–6.

¹⁷⁰ 2012 Standards, *supra* note 3, at 66.

¹⁷¹ *Id.*

¹⁷² 2004 Methodology, *supra* note 6, at 24 n.23.

¹⁷³ 2012 Standards, *supra* note 3, at 66 (ellipsis added).

customers and is based on a nearly identical requirement in the 2004 Methodology.¹⁷⁴

The private sector had substantial comments regarding this Standard, which focused on the general challenges of determining beneficial ownership, the cost and burden involved (particularly with a universal rather than risk-based requirement), and their strong preferences in favor of a risk-based requirement and, when applicable, for permitting it to be based on a minimum percentage for ownership. Private sector comments also suggested eliminating the “mind and management” standard as particularly difficult to define, and instead clarifying as much as possible which individuals need to be identified. Commenters also observed that the public sector authorities that create legal entities should be required to facilitate access to beneficial ownership information.¹⁷⁵

Although Recommendation 10 has not changed substantially, its Interpretive Note has been substantively revised. The most significant modification is the method for determining the beneficial ownership of a financial institution’s customer, which was included as a means of addressing many private sector comments, as well as what had been a very problematic requirement for most countries in the third round of assessments. Although the new Interpretive Note’s revised formulation may well lead to further questions,¹⁷⁶ it appears to be of greater clarity and somewhat easier to apply than the old Interpretive Note to Recommendation 5’s reference to “persons with a controlling interest” and who “comprise the mind and management”¹⁷⁷

Also of note, Recommendation 10’s Interpretive Note states that a threshold percentage for ownership may be appropriate. It will be interesting to observe in the course of the fourth round of Mutual Evaluations, the extent to which these changes in fact clarify the requirement in practice and result in increased compliance. In addition, the Interpretive Note has been lengthened substantially by the inclusion of numerous examples of the risk-based approach, although with the

¹⁷⁴ Compare *id.*, with 2004 Methodology, *supra* note 6, at 17.

¹⁷⁵ See FATF Response to Public, *supra* note 4, at 3–5.

¹⁷⁶ See, e.g., Letter from the American Bar Association, to John Carlson, Principal Administrator, FATF Secretariat, 4 (Sept. 16, 2011), http://www.americanbar.org/content/dam/aba/uncategorized/2011/gao/2011sept16_gatekeep_1.authcheckdam.pdf [hereinafter *ABA Letter*] (asserting that phrases such as “controlling ownership interest in a legal person” and “natural persons exercising control through other means” will need further clarification).

¹⁷⁷ See 2003 Standards, *supra* note 41, at 19.

admonition that these are examples only and not to be viewed as requirements.¹⁷⁸

Recommendation 11. Record-keeping¹⁷⁹

The 2012 Standards' Recommendation 11, "Record-keeping," tracks the 2003 version of Recommendation 10 very closely.¹⁸⁰ The few changes include text, appearing in the second paragraph, that was taken from the 2003 version of Recommendation 11 and refers to retaining "the results of any analysis undertaken (e.g. inquiries to establish the background and purpose of complex, unusual large transactions),"¹⁸¹ as well as a new paragraph stating that the requirement for financial institutions to maintain records of transactions and information obtained through the CDD measures must be codified in domestic law.¹⁸² The 2012 Standards has no Interpretive Note for Recommendation 11.

Recommendation 12. Politically exposed persons¹⁸³

Recommendation 12 of the 2012 Standards, "Politically exposed persons," includes some significant substantive additions from the requirements of its predecessor in the 2003 Standards, Recommendation 6.¹⁸⁴ While 2003's Recommendation 6 addressed only foreign politically-exposed persons ("Foreign PEPs"), the 2012 Standards' Recommendation 12 expands its requirements to include individuals who are, or have been, entrusted domestically with prominent public functions ("Domestic PEPs") and persons entrusted with a prominent function by an international organization ("IO PEPs").¹⁸⁵ The revised Recommendation requires

¹⁷⁸ See *2012 Standards*, *supra* note 3, at 8 ("These examples are not mandatory elements of the FATF Standards, and are included for guidance only.").

¹⁷⁹ The 2012 Standards' Recommendation 11 corresponds to the 2003 Standards' Recommendation 10. *Id.* at 4. Recordkeeping is important for many reasons, including for law enforcement investigations and prosecutions, as well as for financial institutions to monitor their customers' transactions and report those that may be suspicious.

¹⁸⁰ Compare *id.* at 15, with *2003 Standards*, *supra* note 41, at 7.

¹⁸¹ *2012 Standards*, *supra* note 3, at 15.

¹⁸² *Id.* This requirement reflects a similar requirement contained in the 2004 Methodology that certain recordkeeping requirements had to be in "law or regulation." *2004 Methodology*, *supra* note 6, at 9. See discussion *infra* Part H.

¹⁸³ The Revised Standard's Recommendation 12 corresponds to the 2003 Standards' Recommendation 6. *2012 Standards*, *supra* note 3, at 4.

¹⁸⁴ Compare *id.* at 16, with *2003 Standards*, *supra* note 41, at 5–6.

¹⁸⁵ *2012 Standards*, *supra* note 3, at 16.

financial institutions to take “reasonable measures” to determine whether a customer or beneficial owner is a Domestic PEP or an IO PEP.¹⁸⁶

In cases of a higher-risk business relationship with Domestic or IO PEPs, the financial institutions should apply the measures referred to in paragraphs (b), (c), and (d) of Recommendation 12, which require them to obtain senior management approval, take reasonable measures to establish source of wealth and funds, and conduct enhanced monitoring.¹⁸⁷ Thus, once Domestic or IO PEPs have been identified in a “higher risk business relationship,” a requirement that is risk-based in itself, the financial institution is required to take the same measures as it would for Foreign PEPs.¹⁸⁸ These changes are implemented by adding a second paragraph to new Recommendation 12 and expanding the PEP definition from a definition limited to Foreign PEPs in the 2003 Standards’ Recommendation 6, to distinct definitions of Foreign PEP, Domestic PEP, and IO PEP in the Revised Standards’ Glossary.¹⁸⁹

The 2012 Standards’ Interpretive Note to Recommendation 12 requires that financial institutions take “reasonable measures” to determine, no later than the time of payout, whether beneficiaries of life insurance policies and/or, where required, the beneficial owner of the beneficiary are PEPs.¹⁹⁰ Where there are higher risks identified,¹⁹¹ in addition to normal CDD, the financial institution should inform senior management before the payout, conduct enhanced scrutiny of the “whole business relationship with the policyholder,” and consider filing an STR.¹⁹²

The addition of Domestic PEPs to this Recommendation was among the most controversial changes in terms of the private sector consultation.¹⁹³ Many private sector commenters objected to the extension on the basis that,

¹⁸⁶ *Id.* This is distinguished from the 2003 requirement that financial institutions have “appropriate risk management systems” to identify Foreign PEPs, whether as customer or beneficial owner. *2003 Standards, supra* note 41, at 5–6.

¹⁸⁷ *2012 Standards, supra* note 3, at 16.

¹⁸⁸ *Id.*

¹⁸⁹ *Id.* at 118–19. In addition, the requirements to include family members and close associates of PEPs, and customers whose beneficial owners are PEPs, are set forth in the text of the Recommendation, rather than in the definition or the 2004 Methodology, as was the case in 2003’s Recommendation 6. *Id.* at 16. These are changes in form rather than substance.

¹⁹⁰ *Id.* at 67.

¹⁹¹ The FATF does not define “higher risks” in this context, but see discussion *supra* Recommendation 10 (discussing use of the term “risk-based” in Recommendation 10).

¹⁹² *2012 Standards, supra* note 3, at 67. The 2003 Standards’ Interpretive Note to Recommendation 6 encouraged countries to extend the requirements of 2003’s Recommendation 6 to domestic PEPs. *2003 Standards, supra* note 41, at 22.

¹⁹³ See generally *First Compilation of Responses from DNFBSs, supra* note 131.

given limited resources, this would be an unwarranted additional time and cost burden, and that it is far more efficient (and appropriate) to leave it to each jurisdiction to best address the risk of domestic corruption.¹⁹⁴ Other commenters went further and suggested that the risk-based approach should be applied to foreign as well as domestic PEPs.¹⁹⁵ This alternative was rejected, on the bases that foreign PEPs continue to present a significant risk of corruption, and that implementation of the risk-based approach for foreign PEPs would represent an inappropriate weakening of the standards.¹⁹⁶ The private sector also suggested that the FATF define “family members” and “close associates,” that national authorities should publish lists of PEPs, and that guidance is needed in identifying which family members and close associates should be considered PEPs.¹⁹⁷ The FATF rejected the suggestion that the terms be defined because the meaning of these terms could differ substantially with the culture and risks specific to each country and, therefore, flexibility is needed.¹⁹⁸ The suggestion that countries publish lists of PEPs was also rejected on several grounds: that such lists could reduce the amount of attention that financial institutions devote in identifying and assessing risks of potential corruption, such lists would be difficult to keep up to date, and the authorities would not necessarily be able to take into account all the information that financial institutions develop through their due diligence process.¹⁹⁹ The FATF has announced that it intends to issue guidance that will facilitate compliance with the new requirements of Recommendation 12 and include how to identify PEPs, their family members and close associates.²⁰⁰

Recommendation 13. Correspondent banking²⁰¹

Recommendation 13 of the 2012 Standards, “Correspondent banking,” adopted the 2003 Standards’ Recommendation 7 without significant change.²⁰² Subparagraph (d) was modified slightly, and now requires financial institutions to “clearly understand,” rather than to “document,” the

¹⁹⁴ See, e.g., *IBFed January Letter*, *supra* note 57, at 6–7.

¹⁹⁵ *FATF Response to Public*, *supra* note 4, at 6.

¹⁹⁶ *Id.*

¹⁹⁷ *Id.*

¹⁹⁸ *Id.*

¹⁹⁹ *Id.*

²⁰⁰ See *id.* (“FATF is intending to develop further guidance on the issue, and this would include guidance on how to identify a PEP, his/her family members and close associates.”).

²⁰¹ The Revised Standards’ Recommendation 13 corresponds to the 2003 Standards’ Recommendation 7. *2012 Standards*, *supra* note 3, at 4.

²⁰² Compare *id.* at 16, with *2003 Standards*, *supra* note 41, at 6.

respective responsibilities of each institution.²⁰³ In subparagraph (e), the previous requirement that the respondent bank verify “the identity of and perform[] ongoing due diligence on the customers” with direct access to payable-through accounts has been shortened to simply require that the respondent bank has “conducted CDD” on such customers, which has the same meaning.²⁰⁴

In addition, prohibitions on establishing or continuing correspondent banking relationships with shell banks and permitting their accounts to be used by shell banks, previously published as a part of the 2003 Standards’ Recommendation 18, have been incorporated in this 2012 Standards Recommendation, thus (together with Recommendation 26) eliminating Recommendation 18 in its 2003 form as a stand-alone recommendation.²⁰⁵

The Interpretive Note to Recommendation 13 states that “similar relationships” to which the requirements should also apply include “those established for securities transactions or funds transfers, whether for the cross-border financial institution as principal or for its customer.”²⁰⁶ This text was taken from a footnote to the 2004 Methodology.²⁰⁷ The 2012 Standards’ Interpretive Note to Recommendation 13 also contains the definition of “payable-through account.”²⁰⁸

Recommendation 14. Money or value transfer services²⁰⁹

Although the text of Recommendation 14 in the 2012 Standards, even with its Interpretive Note, is substantially shorter than the combined text of the 2003 provisions it is based on, Special Recommendation VI and the Interpretive Note to Special Recommendation VI, the three “core elements” (as listed in the Interpretive Note to Special Recommendation VI) have

²⁰³ 2012 Standards, *supra* note 3, at 16

²⁰⁴ 2003 Standards, *supra* note 41, at 6. 2012 Standards, *supra* note 3, at 16.

²⁰⁵ Compare 2012 Standards, *supra* note 3, at 16, 23, with 2003 Standards, *supra* note 41, at 9.

²⁰⁶ 2012 Standards, *supra* note 3, at 68.

²⁰⁷ 2004 Methodology, *supra* note 6, at 20 n.14.

²⁰⁸ 2012 Standards, *supra* note 3, at 68. This was defined in the Glossary to the 2003 Standards. 2003 Standards, *supra* note 41, at 17.

²⁰⁹ The Revised Standards’ Recommendation 14 corresponds to the 2003 Standards’ Special Recommendation VI. 2012 Standards, *supra* note 3, at 4. Because “money and value transfer services” fall within the definition of “financial institution,” they are already subject to several other standards, and arguably this Recommendation is unnecessary. It was included in the 2003 standards in order to bring attention to the fact that many jurisdictions were not taking sufficient action to regulate remittance activity outside of the banking sector. Because the third round of assessments showed low levels of compliance, it was determined appropriate to retain this as a separate standard.

been retained.²¹⁰ The three core elements state that jurisdictions (1) “should require licensing or registration of persons providing money/value transfer services” (“MVTS”), (2) “should ensure that [MVTS] are subject to applicable [standards],” and (3) can “impose sanctions on [MVTS] . . . that operate without a license . . . and fail to comply with” the applicable standards.²¹¹ For emphasis, Recommendation 14 explicitly requires that countries proactively reach out to identify MVTS without a license and apply appropriate sanctions.²¹²

Special Recommendation VI contained several references to, and a discussion of, “informal systems” and “alternative remittance systems.”²¹³ To avoid possible confusion, the FATF does not use these terms in the 2012 Standards’ Recommendation 14 or its Interpretive Note, but such systems continue to be subject to the Recommendation.²¹⁴ The fact that agents must be individually licensed or registered, or alternatively, maintained on a list by their MVTS provider, was moved from the Interpretive Note to Special Recommendation VI to an explicit statement in Recommendation 14 and continues to apply.²¹⁵ Finally, the FATF changed the definition of “MVTS” in the Glossary by removing references to the banking system and, instead, including a reference to “new payment methods,” reflecting this emerging potential AML/CFT risk.²¹⁶

Recommendation 15. New technologies²¹⁷

Recommendation 15 in the 2012 Standards, “New technologies,” is based upon, and expands on, one of the two elements of the 2003 Standards’ Recommendation 8, Risks relating to new technologies.²¹⁸ The new Recommendation 15 is more specific, in that it requires countries and financial institutions to identify and assess the risks relating to “(a) the development of new products and new business practices, including new

²¹⁰ Compare *id.* at 13, with *Special Recommendations*, *supra* note 77, at 13.

²¹¹ *Special Recommendations*, *supra* note 77, at 13.

²¹² *2012 Standards*, *supra* note 3, at 17 (“Countries should take action to identify natural or legal persons that carry out MVTS without a license or registration, and to apply appropriate sanctions.”).

²¹³ *Special Recommendations*, *supra* note 77, at 13–15.

²¹⁴ See *2012 Standards*, *supra* note 3, at 17, 69.

²¹⁵ *Id.* at 17; *Special Recommendations*, *supra* note 77, at 14.

²¹⁶ *2012 Standards*, *supra* note 3, at 118; *2004 Methodology*, *supra* note 6, at 61, 68.

²¹⁷ The Revised Standards’ Recommendation 15 corresponds to the 2003 Standards’ Recommendation 8. *2012 Standards*, *supra* note 3, at 4.

²¹⁸ Compare *id.* at 17 (entitled “New Technologies”), with *2003 Standards*, *supra* note 41, at 6 (discussing threats arising from “new or developing technologies”).

delivery mechanisms, and (b) the use of new or developing technologies for both new and pre-existing products.”²¹⁹ Recommendation 15 also requires financial institutions to assess relevant new products, practices, or technologies prior to launch and to take appropriate measures to manage and mitigate the associated risks.²²⁰

The requirements in Recommendation 15’s 2003 predecessor, Recommendation 8, relating to non-face-to-face transactions have largely been incorporated into the Risk Based Approach section of the 2012 Standards’ Interpretive Note to Recommendation 10.²²¹

Recommendation 16. Wire transfers²²²

Recommendation 16 and its Interpretive Note contain some of the most significant revisions from the corresponding requirements as they appear in the 2003 Standards’ Special Recommendation VII and the Interpretive Note to Special Recommendation VII. Among these changes are the required inclusion of beneficiary information in all wires, a definition for and inclusion in the Standard of “cover payments,” the application of some requirements to wire transfers below the threshold amount, freezing requirements for intermediary financial institutions, and new requirements regarding MVTs providers and prepaid cards.²²³

While the 2003 Standards’ Special Recommendation VII and its Interpretive Note required that cross-border wire transfers include the originator’s basic information, the 2012 Standards’ Recommendation 16 and its Interpretive Note contain a new requirement dictating that, for all “qualifying wire transfers,”²²⁴ “ordering” (i.e., originating) financial institutions must ensure that (1) all “required” originator information is “accurate” (i.e., verified),²²⁵ and (2) all “required” beneficiary information

²¹⁹ 2012 Standards, *supra* note 3, at 17.

²²⁰ *Id.*

²²¹ Compare *id.* at 59–66 (discussing the risk based approach), with 2003 Standards, *supra* note 41, at 6 (“[F]inancial institutions should . . . address any specific risks associated with non-face to face business relationships or transactions.” (alterations added)).

²²² The 2012 Standards’ Recommendation 16 corresponds to the 2003 Standards’ Special Recommendation VII. 2012 Standards, *supra* note 3, at 4.

²²³ *Id.* at 17, 70–75.

²²⁴ *Id.* at 71, 74 (describing qualifying wire transfers as all wire transfers above the applicable threshold of USD/EUR 1000).

²²⁵ *Id.* at 70–72. Although the required originator information is unchanged from the 2003 Special Recommendation VII Interpretive Note, the verification requirement is new. See generally *Special Recommendations*, *supra* note 77, at 17.

is included. The “required” beneficiary information includes the name of the beneficiary, the account number (when an account is used to process the transaction), or in the absence of an account, a unique transaction reference number.²²⁶ This change was adopted largely due to the abuses of “cover payments,” a new term in the Standards that describes a payment made through one or more correspondent banks to settle, or “cover,” a wire transfer message that simultaneously travels directly from the originator’s bank to the beneficiary’s bank.²²⁷ Although cover payments can bring greater efficiency for banks that execute large numbers of wire transfers, they can expose intermediary banks to increased risk of unknowingly facilitating illicit activities, since they would be unaware of the message going directly from the originator’s to the beneficiary’s bank. The recognition of this risk also led the FATF to include an explicit statement that cover payments, as well as serial payments, are subject to the requirements of this Recommendation.²²⁸

Intermediary financial institutions are now required to (1) ensure that all beneficiary (as well as originator) information that accompanies a wire transfer is retained with the wire, and (2) “take reasonable measures to identify cross-border wire transfers that lack required originator [and beneficiary] information. [These] measures should be consistent with straight-through processing.”²²⁹ Because straight-through (i.e., automated) processing makes it impracticable to manually ensure at the time of processing that wires contain all required information, the automated system must be able to detect wire transfers lacking all required information. They must also “have effective risk-based policies and procedures for determining: (i) when to execute, reject, or suspend [a non-complying wire transfer] . . . and (ii) the appropriate follow-up action.”²³⁰ In addition, the text of Recommendation 16 contains the requirement “that, in the context of processing wire transfers, financial institutions take freezing

²²⁶ *2012 Standards, supra* note 3, at 71.

²²⁷ The Interpretive Note to Recommendation 16 defines a “Cover payment” as “a wire transfer that combines a payment message sent directly by the ordering financial institution to the beneficiary financial institution with the routing of the funding instruction (the cover) from the ordering financial institution to the beneficiary financial institution through one or more intermediary financial institutions.” *2012 Standards, supra* note 3, at 73.

²²⁸ *2012 Standards, supra* note 3, at 70. For a thorough discussion of the risks presented by cover payments and common supervisory expectations to bring about greater transparency, see BASEL COMM. ON BANKING SUPERVISION, DUE DILIGENCE AND TRANSPARENCY REGARDING COVER PAYMENT MESSAGES RELATED TO CROSS-BORDER WIRE TRANSFERS (2009), available at <http://www.occ.gov/news-issuances/bulletins/2009/bulletin-2009-36b.pdf>.

²²⁹ *2012 Standards, supra* note 3, at 72 (alterations added).

²³⁰ *Id.* (alterations added).

action and should prohibit conducting transactions with designated persons and entities,” as required by Recommendation 6 (targeted financial sanctions).²³¹ These are all new requirements for intermediary financial institutions.

Beneficiary financial institutions are required to take reasonable measures to identify cross-border wire transfers that lack required beneficiary (as well as originator) information, and to verify the identity of the beneficiary of qualifying wire transfers (if not previously verified) and maintain the information as required by the 2012 Standards’ Recommendation 11. These requirements relating to beneficiary information are new to the Revised Standards. Beneficiary financial institutions (like intermediary financial institutions) also must have “effective risk-based policies and procedures for determining (i) when to execute, reject, or suspend [a non-complying wire transfer], and (ii) the appropriate follow-up action,” also a new requirement.²³²

Under the 2012 Standards’ Recommendation 16 and its Interpretive Note, cross-border wire transfers below the applicable threshold (USD/EUR 1000) also must now contain the originator and beneficiary’s names, an account number (where an account is used) or unique transaction reference number that permits traceability of the transaction, and “the originator’s address, or national identity number, or customer identification number, or date and place of birth.”²³³ It also requires that the originator’s information be verified if there is a suspicion of money laundering or terrorist financing.²³⁴ The 2003 version of Special Recommendation VII and the Interpretive Note to Special Recommendation VII did not require identification of either the originator or the beneficiary for such low-value non-qualifying wire transfers.²³⁵ In addition, the ordering financial institution (1) must now ensure that the required information in all cross-border wire transfers, above or below the threshold, is included, and (2) should not be allowed to execute the transfer if it does not comply with these requirements.²³⁶

²³¹ *Id.* at 17.

²³² *Id.* at 72. Beneficiary financial institutions were required to have effective risk-based procedures in place to identify wire transfers lacking complete originator information. *See Special Recommendations, supra* note 77, at 19.

²³³ *Id.* 71 (footnote omitted).

²³⁴ *Id.*

²³⁵ *Special Recommendations, supra* note 77, at 17. Thus, the only difference now in the information required for qualifying and non-qualifying wire transfers is that qualifying wire transfers must include the originator’s address, identity number, customer identification number or date and place of birth.

²³⁶ *2012 Standards, supra* note 3, at 72.

The 2012 Standards' Interpretive Note to Recommendation 16 contains a new subsection requiring MVTs providers to comply with Recommendation 16 in all countries in which they operate, either directly or through an agent.²³⁷ In cases where the provider controls both the ordering and beneficiary side of a wire transfer, it must also take into account all of the information on both sides of the order to determine whether an STR should be filed.²³⁸ Then, if an STR is needed, the provider must file it in any country affected by the suspicious wire and must "make relevant transaction information available to the Financial Intelligence Unit" ("FIU") of that country.²³⁹ These are new explicit requirements under the 2012 Standards.

In addition, the 2003 Standards' Special Recommendation VII and its Interpretive Note contained an exception for credit or debit card transactions, as long as the card numbers accompanied the transfers and the card is not used to pay for the money transfer itself.²⁴⁰ The new Interpretive Note to Recommendation 16 treats prepaid cards the same as credit and debit cards, so when a prepaid card is used to create a person-to-person wire transfer, the transaction is covered by Recommendation 16, and the necessary information must be included in the message.²⁴¹

Finally, a requirement in Interpretive Note to Special Recommendation VII that countries monitor compliance by financial institutions with applicable wire transfer regulations and subject those failing to comply to sanctions, is not included in new Recommendation 16. However, this omission does not indicate that this is no longer a requirement, but rather that it is covered by Recommendations 26 and 27.

The private sector raised several issues regarding the proposed changes to the requirements to this Standard. These include the need for the FATF to consider the value of the additional information to be obtained, in relationship to the cost to financial institutions to implement the changes, understanding better the current procedures used by financial institutions to screen wire transfers for sanctioned parties and to resolve potential false positives, how to address blank fields in a wire transfer, and what country's sanction program applies when a financial institution receives a wire transfer that originates in another country.²⁴²

²³⁷ *Id.* at 73.

²³⁸ *Id.*

²³⁹ *Id.*

²⁴⁰ *Special Recommendations, supra* note 77, at 18.

²⁴¹ *2012 Standards, supra* note 3, at 70.

²⁴² *See, e.g., IBFed January Letter, supra* note 57, at 11–12.

Recommendation 17. Reliance on third parties²⁴³

In the 2012 Standards, several changes were made when the 2003 version of Recommendation 9 was redefined as Recommendation 17, “Reliance on third parties.” One change was made to clarify that financial institutions are permitted to rely on DNFBPs, as well as on other financial institutions, to identify and verify the identity of the customer and beneficial owner and obtain information about the purpose and nature of the account, so long as the certain criteria are satisfied.²⁴⁴ The FATF made a more significant change to Recommendation 17 by adding a new paragraph with reduced requirements for a financial institution that wants to rely on a member of the same “financial group.”²⁴⁵ This new paragraph provides that when (1) the group applies CDD and record-keeping requirements consistent with the 2012 Standards’ Recommendations 10, 11 and 12 and implements AML/CFT programs consistent with the Revised Standards’ Recommendation 18; and (2) such implementation is supervised at the group level by a competent authority, then the relying financial institution is not required to satisfy criteria (b) and (c) of Recommendation 17.²⁴⁶ In addition, regarding criteria (d), the relying institution need not consider the level of risk in the country where the relied-upon institution is based if any higher country risk is mitigated by group AML/CFT policies.

An Interpretive Note has also been added to Recommendation 17 that explains the difference between “third-party reliance” and “outsourcing” or “agency.”²⁴⁷ The Interpretive Note also clarifies that “relevant competent authorities” means both the home authority, which should understand group policies and controls, and host authorities, which should be involved for the branches and subsidiaries.²⁴⁸ The Interpretive Note further explains that “third parties” may include both “financial institutions [and] DNFBPs that

²⁴³ The Revised Standards’ Recommendation 17 corresponds to the 2003 Standards’ Recommendation 9. *2012 Standards, supra* note 3, at 4.

²⁴⁴ *Id.* at 18, 76. This was achieved by adding “or monitored” to criteria (c).

²⁴⁵ *Id.* at 18. A corresponding definition of the new term “financial group” has been added to the Glossary. *Id.* at 115.

²⁴⁶ *Id.* (requiring that copies of relevant CDD and other documentation will be made available upon request without delay, and that the third party being relied upon is regulated or supervised for, and complies with, Recommendations 10 and 11).

²⁴⁷ *Id.* at 76. In third-party reliance pursuant to Recommendation 17, the third party is a regulated financial institution or DNFBP that typically has an existing independent business relationship with the customer and applies its own CDD procedures. *See id.* In an agency or outsourcing scenario, the agent or outsourced entity is typically not a regulated financial institution and applies the CDD procedures of the relying financial institution.

²⁴⁸ *2012 Standards, supra* note 3, at 76.

are supervised or monitored and otherwise meet the requirements under Recommendation 17.”²⁴⁹

All of the abovementioned changes and clarifications made to Recommendation 17 were requested by the private sector through the Consultative Forum.²⁵⁰ Another modification that was urged by the private sector but was not accepted was to relieve the relying financial institution of liability in the event that the relied-upon third party failed to adequately perform any of Recommendation 10's CDD requirements in its elements (a) through (c).²⁵¹ Rather, Recommendation 17 continues to place “ultimate responsibility” on the relying financial institution, based on the FATF's belief that this is an essential component of an effective CDD process, as well as the practical reality that in the event of a failure by the third party to conduct adequate CDD, the supervisor of the relying institution would have no sanctioning authority over the third party.²⁵²

Recommendation 18. Internal controls and foreign branches and subsidiaries²⁵³

The Revised Standards' Recommendation 18, “Internal controls and foreign branches and subsidiaries,” and its Interpretive Note include all the requirements applicable to financial institutions previously contained in 2003's Recommendation 15, as well as some new obligations applicable to financial groups.²⁵⁴ In the Revised Standards, financial groups are required to “implement group-wide programmes against money laundering and terrorist financing, including policies and procedures for sharing information within the group for AML/CFT purposes.”²⁵⁵ The Interpretive Note to Recommendation 18 goes on to require that the group programs should: apply to all branches and majority-owned subsidiaries, cover the three required elements, be appropriate to the business of the branches and

²⁴⁹ *Id.* (alteration added).

²⁵⁰ See *First Compilation of Responses from DNFBCPs*, *supra* note 131, at 81 (indicating that the private sector noted that data protection requirements in some jurisdictions could limit reliance); see also *FATF Response to Public*, *supra* note 4 at 8.

²⁵¹ See *First Compilation of Responses from DNFBCPs*, *supra* note 131, at 62–63 (describing some of the issues with reliance).

²⁵² *2012 Standards*, *supra* note 3, at 18.

²⁵³ The Revised Standards' Recommendation 18 corresponds to the 2003 Standards' Recommendations 15 and 22. *Id.* at 4.

²⁵⁴ *2003 Standards*, *supra* note 41, at 8; *2012 Standards*, *supra* note 3, at 18, 77.

²⁵⁵ *2012 Standards*, *supra* note 3, at 18.

subsidiaries, and be implemented effectively at that level.²⁵⁶ The programs should include policies and procedures for sharing information required for AML/CFT risk management.²⁵⁷ Group-level compliance, audit, and/or AML/CFT functions should be provided with customer, account, and transaction information from branches and subsidiaries when necessary for AML/CFT purposes, and adequate safeguards on the confidentiality and use of information should be in place.²⁵⁸ As noted above in relation to the 2012 Standards' Recommendation 9, the private sector has noted that data protection and privacy requirements may limit the extent for permissible cross-border group-wide sharing of customer information.²⁵⁹

Recommendation 18 and its Interpretive Note also include the requirements previously contained in the 2003 Standards' Recommendation 22.²⁶⁰ Recommendation 18 now requires financial institutions to “ensure that their foreign branches and majority-owned subsidiaries apply AML/CFT measures consistent with the home country requirements implementing the FATF Recommendations through the financial groups' programmes against money laundering and terrorist financing.”²⁶¹ 2003's Recommendation 22 contained substantially the same requirement, but without an explicit reference to group programs.²⁶² In cases where the host country doesn't permit implementation of the home country's higher measures, the Interpretive Note to Recommendation 18, like 2003's Recommendation 22, requires the financial institution to report this to its home country supervisor.²⁶³ The Interpretive Note to Recommendation 18 now also requires that, in such a case, the financial institution must take “additional measures to manage the money laundering and terrorist financing risk,” and if such measures are not sufficient, the home country supervisor “should consider additional supervisory actions, including placing additional controls on the financial group, including, as appropriate, requesting the financial group to close down its operations in the host country.”²⁶⁴ Thus, Recommendation 18 and its Interpretive Note have gone somewhat beyond the corresponding requirements in the 2003 Standards.

²⁵⁶ *Id.* at 77. The three required elements are: (1) internal policies, and procedures and controls; (2) training; and (3) audit. *Id.*

²⁵⁷ *Id.*

²⁵⁸ *Id.*

²⁵⁹ See discussion *supra* Recommendation 9.

²⁶⁰ 2003 Standards, *supra* note 41, at 9; 2012 Standards, *supra* note 3, at 18, 77.

²⁶¹ 2012 Standards, *supra* note 3, at 18.

²⁶² 2003 Standards, *supra* note 41, at 9.

²⁶³ 2012 Standards, *supra* note 3, at 77.

²⁶⁴ *Id.*

Recommendation 19. Higher-risk countries²⁶⁵

The 2012 Standards' Recommendation 19 and its Interpretive Note contain several changes from the 2003 Standard they are based on, Recommendation 21, many of which involve more precise terminology.²⁶⁶ While 2003's Recommendation 21 required financial institutions to give "special attention" to business relationships and transactions with persons, companies, and financial institutions from countries "which do not or insufficiently apply the FATF Recommendations,"²⁶⁷ the new Recommendation 19 in the 2012 Standards requires that financial institutions "apply enhanced due diligence" to relations and transactions "from countries for which this is called for by the FATF," and goes on to require that "[t]he type of enhanced due diligence measures applied should be effective and proportionate to the risks."²⁶⁸ The Interpretive Note to Recommendation 19 refers to the enhanced due diligence measures listed in paragraph 20 of the Interpretive Note to Recommendation 10 as possible measures that could be undertaken;²⁶⁹ 2003's Recommendation 21 did not contain such a list.²⁷⁰

While 2003's Recommendation 21 required that countries be able to apply countermeasures "where . . . a country continues not to apply or insufficiently applies"²⁷¹ the FATF Standards, the revised Recommendation 19 requires, more specifically, that countries "are able to apply appropriate countermeasures when called upon to do so by FATF [as well as independent of such a call]," and that such countermeasures are effective and proportionate to the risks.²⁷² The Interpretive Note to Recommendation 19 contains a list of nine examples of possible countermeasures, whereas the 2004 Methodology included five.²⁷³

²⁶⁵ The Revised Standards' Recommendation 19 corresponds with the 2003 Standards' Recommendation 21. *Id.* at 4.

²⁶⁶ Compare 2003 Standards, *supra* note 41, at 9 (providing details about when to apply countermeasures), with 2012 Standards, *supra* note 3, at 19, 78 (stating only that countries should be able to apply countermeasures).

²⁶⁷ 2003 Standards, *supra* note 41, at 9.

²⁶⁸ 2012 Standards, *supra* note 3, at 19 (alteration added).

²⁶⁹ *Id.* at 78.

²⁷⁰ See 2003 Standards, *supra* note 41, at 9.

²⁷¹ *Id.* (ellipsis added).

²⁷² 2012 Standards, *supra* note 3, at 19 (alterations added).

²⁷³ 2004 Methodology, *supra* note 6, at 30; 2012 Standards, *supra* note 3, at 78. Examples of new countermeasures include prohibiting financial institutions from relying on third parties located in the country concerned to conduct elements of CDD; requiring

Recommendation 20. Reporting of suspicious transactions²⁷⁴

Recommendation 20 in the 2012 Standards, “Reporting of suspicious transactions,” corresponds to Recommendation 13 and Special Recommendation IV of the 2003 Standards. Recommendation 20 is nearly identical to 2003’s Recommendation 13 combined with Special Recommendation IV.²⁷⁵ The only difference is that in the 2012 Recommendation 20, the reporting requirement must be codified in the “law” of the country, whereas in 2003’s Recommendation 13, the requirement had to be in “law or regulation.”²⁷⁶ The Interpretive Note to the new Recommendation 20 includes an explanation of the reference to “terrorist financing” in the Recommendation, in order that it also covers the requirements of Special Recommendation IV.²⁷⁷ The Recommendation 20 Interpretive Note also incorporates a requirement, previously contained in the 2004 Methodology, that the reporting requirement should be a “direct mandatory obligation” and that so-called “indirect reporting” is not acceptable.²⁷⁸ As a result of the inclusion of tax evasion in the list of predicate offenses, the Interpretive Note appropriately omits the element of 2003’s Interpretive Note to Recommendation 13 that required suspicious transactions to be reported regardless of whether they are thought to involve tax matters.²⁷⁹

financial institutions to review and amend, or terminate, correspondent relationships with financial institutions in the country concerned; requiring increased supervisory examination and/or external audit requirements for branches and subsidiaries of financial institutions based in the country concerned; and requiring increased external audit requirements for financial groups with respect to any of their branches and subsidiaries located in the country concerned. *2012 Standards, supra* note 3, at 78.

²⁷⁴ The 2012 Standards’ Recommendation 20 corresponds to the 2003 Standards’ Recommendation 13 and Special Recommendation IV. *Id.* at 4.

²⁷⁵ *Id.* at 19; *2003 Standards, supra* note 41, at 8; *Special Recommendations, supra* note 77, at 2.

²⁷⁶ See discussion *infra* Part H.

²⁷⁷ See *2012 Standards, supra* note 3, at 81; *Special Recommendations, supra* note 77, at 2.

²⁷⁸ See *2012 Standards, supra* note 3, at 79; *2004 Methodology, supra* note 6, at 25.

²⁷⁹ *2003 Standards, supra* note 41, at 22.

Recommendation 21. Tipping-off and confidentiality²⁸⁰

Recommendation 21 of the 2012 Standards is one of the few Recommendations that was literally unchanged from its 2003 version, Recommendation 14.²⁸¹

The 2003 Interpretive Note to Recommendation 14 provided that “where lawyers, notaries, other independent legal professionals and accountants acting as independent legal professionals seek to dissuade a client from engaging in illegal activity, this does not amount to tipping off.”²⁸² This text was appropriately moved to the Interpretive Note to the 2012 Standards’ Recommendation 23, which addresses, among other subjects, STR obligations of DNFBPs.²⁸³

Recommendation 22. DNFBPs: Customer due diligence²⁸⁴

The 2012 Standards’ Recommendation 22 is substantively unchanged from 2003’s Recommendation 12. The Interpretive Note to the 2012 Standards’ Recommendation 22 incorporates the requirements from the 2004 Methodology that real estate agents should comply with Recommendation 10 requirements with respect to both purchasers and sellers of the property, and that casinos “ensure that they are able to link [CDD] information for a particular customer to the transactions that the customer conducts in the casino.”²⁸⁵

Recommendation 23. DNFBPs: Other measures²⁸⁶

The 2012 Standards’ Recommendation 23, together with its Interpretive Note, is substantively unchanged from the 2003 Standards’ requirements under Recommendation 16 and the Interpretive Note to Recommendation 16.²⁸⁷ The Interpretive Note to Recommendations 22 and 23 includes a new statement added to clarify that, to comply with the two

²⁸⁰ The Revised Standards’ Recommendation 21 corresponds to the 2003 Standards’ Recommendation 14. *2012 Standards, supra* note 3, at 4.

²⁸¹ *See id.* at 19; *2003 Standards, supra* note 41, at 8.

²⁸² *2003 Standards, supra* note 41, at 22.

²⁸³ *2012 Standards, supra* note 3, at 82.

²⁸⁴ The Revised Standards’ Recommendation 22 corresponds to the 2003 Standards’ Recommendation 12. *Id.* at 4.

²⁸⁵ *Id.* at 81 (alteration added); *2004 Methodology, supra* note 6, at 24, n.22 & 24.

²⁸⁶ The Revised Standards’ Recommendation 23 corresponds to the 2003 Standards’ Recommendation 16. *2012 Standards, supra* note 3, at 4.

²⁸⁷ *2003 Standards, supra* note 41, at 8; *2012 Standards, supra* note 3, at 20, 82.

Recommendations, countries need not issue laws or enforceable means that relate exclusively to the relevant DNFBPs, so long as long as they are subject to laws or enforceable means covering the relevant activities.²⁸⁸

E. *Transparency and Beneficial Ownership of Legal Persons and Arrangements*

Recommendation 24. Transparency and beneficial ownership of legal persons

The Revised Standards' Recommendation 24 is based on Recommendation 33 of the 2003 Standards.²⁸⁹ The changes to the text of Recommendation 24 include an added reference to preventing misuse of legal entities for terrorist financing (as well as money laundering) and added references to “bearer share warrants”²⁹⁰ and “nominee shareholders”²⁹¹ and directors,²⁹² in addition to “bearer shares,”²⁹³ as matters for which jurisdictions need to take effective measures to prevent their misuse.²⁹⁴

More significantly, the Revised Standards include a detailed Interpretive Note to Recommendation 24, while the 2003 version of Recommendation 33 had no Interpretive Note.²⁹⁵ The new Interpretive Note has its origin in the 2004 Methodology, which listed three “examples” for ensuring adequate transparency: (1) central registration (up-front disclosure), (2) requiring company formation agents to obtain the information, and (3) relying on investigative and other law enforcement

²⁸⁸ 2012 Standards, *supra* note 3, at 80.

²⁸⁹ *Id.* at 5.

²⁹⁰ A certificate giving the bearer the right to buy securities at a stated price for a stated period or at any time in the future. See THOMAS P. FITCH, *DICTIONARY OF BANKING TERMS* 501 (6th ed. 2012).

²⁹¹ A registered owner of shares, if different from the beneficial owner, who acts as owner of record. See *id.* at 314.

²⁹² An individual appointed as director to sign documents for the company should the beneficial owner not want his or her name to be connected with it, and who typically will have no knowledge of the company's affairs or accounts, cannot control or influence it, and will not act unless instructed to by the beneficial owner. See, e.g., *Abusive Offshore Tax Avoidance Schemes – Glossary of Offshore Terms*, INTERNAL REVENUE SERV. <http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Abusive-Offshore-Tax-Avoidance-Schemes---Glossary-of-Offshore-Terms> (last updated Aug. 1, 2012).

²⁹³ “Bearer shares refers to negotiable instruments that accord ownership in a legal person to the person who possesses the bearer share certificate.” 2012 Standards, *supra* note 3, at 109.

²⁹⁴ Compare *id.* at 22, with 2003 Standards, *supra* note 41, at 11.

²⁹⁵ 2012 Standards, *supra* note 3, at 83–87.

powers.²⁹⁶ The 2004 Methodology further noted that these examples are complementary and that countries “may find it highly desirable and beneficial to use a combination of them.”²⁹⁷ This vague criterion resulted in considerable difficulty in achieving consistency in assessments, which were almost universally very low.²⁹⁸

The Interpretive Note to Recommendation 24 goes well beyond the examples listed in the 2004 Methodology. It contains detailed requirements that are summarized below.²⁹⁹

The first three subsections of the 2012 Standards’ Interpretive Note to Recommendation 24 set out the primary requirements for basic and beneficial ownership.³⁰⁰ As an initial matter, countries should have “mechanisms” that identify and describe the different types, forms and basic features of legal persons, the process for their creation, and the means of obtaining basic and beneficial ownership information.³⁰¹ The mechanisms should also make this information publicly available and assess the ML/TF risks associated with the different types of legal persons.³⁰²

The Interpretive Note divides information regarding a legal person into “Basic Information” and “Beneficial Ownership Information.”³⁰³ Basic Information includes (a) the name of legal person, proof of incorporation, legal form and status, address of registered office, basic regulating powers, and a list of directors (all of which should be recorded in a “company registry”)³⁰⁴; and (b) a shareholder register containing names of shareholders and number and categories of shares held.³⁰⁵ The company should maintain the shareholder register required in (b) within the country, unless the company or company registry holds Beneficial Ownership Information within the country, in which case the shareholder registry need not be in the country, but still must be available promptly upon request.³⁰⁶

²⁹⁶ 2004 Methodology, *supra* note 6, at 39.

²⁹⁷ *Id.*

²⁹⁸ *See, e.g., Mutual Evaluations, supra* note 8 (providing mutual evaluations which contain examples of the difficulties with compliance).

²⁹⁹ 2012 Standards, *supra* note 3, at 83–87.

³⁰⁰ *Id.* at 83–85.

³⁰¹ *Id.* at 83.

³⁰² *Id.*

³⁰³ *Id.* at 83–85.

³⁰⁴ For example, the records maintained by the Secretary of a State in the United States.

³⁰⁵ *Id.* at 83–84.

³⁰⁶ 2012 Standards, *supra* note 3, at 83–84.

Countries are required to ensure that Beneficial Ownership Information³⁰⁷ is either (a) maintained by the company at a specified location in the country, or (b) can be determined in a timely manner by a competent authority by “mechanisms.”³⁰⁸ The Interpretive Note to Recommendation 24 lists three such “mechanisms” for meeting these requirements: (a) requiring companies or company registries to hold the information, (b) requiring companies to take “reasonable [(i.e., risk-based)] measures” to obtain and hold the information, and (c) using existing information, including that held by financial institutions or DNFBPs, competent authorities, the company, or stock exchanges.³⁰⁹ The Interpretive Note further requires that countries oblige companies to cooperate with competent authorities in determining the beneficial owner, by such means as requiring an individual and/or a DNFBP in the country to be authorized to provide Basic Information and available Beneficial Ownership Information, and/or “[o]ther comparable measures, specifically identified by the country, which can ensure cooperation.”³¹⁰ The information referred to must be maintained for at least five years after the company ceases to exist.³¹¹

Basic Information must be accurate and updated.³¹² Beneficial Ownership Information must be accurate, kept as current as possible, and updated within a reasonable period following any change.³¹³ “Competent authorities . . . should have all powers necessary to obtain timely access to [both types of information]”³¹⁴ Company registries should facilitate timely access by financial institutions, DNFBPs, and foreign competent authorities to, at a minimum, the Basic Information.³¹⁵

This Recommendation was one of the most heavily discussed in private sector comments and the Consultative Forum. Many private sector representatives pointed out the difficulty (as well as the considerable expense) of an “up-front” disclosure system, due to the challenges of defining “beneficial owner” in other than a conceptual manner, the reality that virtually all legal entity formation systems are based upon legal

³⁰⁷ See *id.* at 83 n.10 (defining Beneficial Ownership by reference to information referred to in the 2012 Standards’ Interpretive Note to Recommendation 10).

³⁰⁸ *Id.* at 84.

³⁰⁹ *Id.* (alteration added) (footnote omitted).

³¹⁰ *Id.* at 85. (alteration added).

³¹¹ *Id.*

³¹² 2012 Standards, *supra* note 3, at 85.

³¹³ *Id.*

³¹⁴ *Id.* (alterations added).

³¹⁵ *Id.*

(nominal) ownership, and that under many systems an entity lacks the legal authority, as well as the practical ability, to pierce through potentially many ownership layers to the ultimate individual owner.³¹⁶ As a result, the 2012 Standards' Interpretive Note to Recommendation 24 requires that legal entities obtain and record certain Basic Information, and provides two primary means for compliance with the beneficial ownership requirement: (1) identify the beneficial owner at formation and update the identification following any change, or (2) have mechanisms in place to obtain Beneficial Ownership Information when needed.³¹⁷ Based upon past assessments, although many countries presumably comply with the requirements for Basic Information, very few countries have implemented an up-front Beneficial Ownership Information system.³¹⁸ It remains to be seen how many will do so, as opposed to attempting to comply by having mechanisms to determine the beneficial owner when necessary.

The Interpretive Note to Recommendation 24 further provides that countries should take measures to prevent the misuse of bearer shares, bearer share warrants, nominee shares, and nominee directors.³¹⁹ Examples of possible mechanisms are listed.³²⁰ Some private sector commenters asserted that there would be difficulties with the FATF's two proposed means of preventing nominee shares misuse: (1) requiring disclosure of the nominator to the company and any relevant registry (which would arguably defeat the purpose of using a nominee),³²¹ and (2) requiring nominee shareholders to be registered (which they asserted would be cumbersome).³²² The Interpretive Note also provides that countries should take similar measures and impose similar requirements with regard to foundations, Anstalt,³²³ and limited liability partnerships—taking into

³¹⁶ See, e.g., *ABA Letter*, *supra* note 176 at 5–6; *First Compilation of Responses from DNFBSs*, *supra* note 131, at 49 (showing the Federation of European Accountants comment that “[i]t must be clear that a professional does not have the investigation powers of criminal authorities to identify the ultimate beneficial owner.” (alteration added)).

³¹⁷ *2012 Standards*, *supra* note 3, at 84.

³¹⁸ See, e.g., *Mutual Evaluations*, *supra* note 8 (providing examples of prior assessments).

³¹⁹ *2012 Standards*, *supra* note 3, at 85.

³²⁰ *Id.* at 85–86.

³²¹ A private sector commenter noted three important objectives for the use of nominee shareholders: personal privacy, personal safety in high-risk jurisdictions, and the need for anonymity for certain business transactions. See, e.g., *ABA Letter*, *supra* note 176, at 7–8.

³²² See, e.g., *Second Preparation for the 4th Round*, *supra* note 27, at 6 (discussing the possibility of implementing these proposals).

³²³ A type of corporate body found in certain civil law countries, including Liechtenstein. See, e.g., I.R.S. Chief Couns. Mem. AM2009-012 (Oct. 16, 2009),

account their different forms and structures—and should take the same action for other types of legal persons—taking into consideration the level of money laundering or terrorist financing risk.³²⁴ There must be clear responsibility to comply with the requirements and liability and sanctions for failure.³²⁵ Finally, countries must provide effective international cooperation in relation to basic and beneficial ownership information and monitor the quality of assistance they receive from other countries to their requests.³²⁶

Recommendation 25. Transparency and beneficial ownership of legal arrangements

The Revised Standards' Recommendation 25, "Transparency and beneficial ownership of legal arrangements," is based on the 2003 Standards' Recommendation 34.³²⁷ The Revised Standards' changes to the text of Recommendation 25 are minimal.³²⁸ The FATF's revisions include a new reference to preventing misuse for terrorist financing (as well as money laundering) and an additional requirement that countries consider facilitating access to beneficial ownership and control information by financial institutions and DNFBPs.³²⁹

As was the case with the Revised Standards' Recommendation 24, the most significant change made to Recommendation 25 is an added Interpretive Note. In the 2003 Standards, Recommendation 34 was similar to Recommendation 33 in that it had only a Methodology containing three examples of ways to increase transparency: (1) central registration, (2) reliance on trust service providers, and (3) reliance on investigative powers.³³⁰ This vagueness made assessment very difficult and frequently resulted in "Not Applicable" ratings for civil law countries that do not recognize trusts,³³¹ while common law countries nearly universally received low ratings.³³²

available at <http://www.irs.gov/pub/irs-utl/am2009012.pdf> (stating that Anstalts are a type of business entity under Treas. Reg. § 301.7701-2(a)).

³²⁴ 2012 Standards, *supra* note 3, at 86.

³²⁵ *Id.*

³²⁶ *Id.* at 86–87.

³²⁷ *Id.* at 5.

³²⁸ Compare *id.* at 22, with 2003 Standards, *supra* note 41, at 12.

³²⁹ 2012 Standards, *supra* note 3, at 22.

³³⁰ 2004 Methodology, *supra* note 6, at 40–41.

³³¹ See, e.g., *First Compilation of Responses from DNFBPs*, *supra* note 131, at 90 (containing an observation from the Society of Trust and Estate Practitioners that "[r]ecommendation 34 was judged "not applicable" for Switzerland on the grounds that

The 2012 Standards' Interpretive Note to Recommendation 25 contains detailed requirements, as summarized below.³³³ Countries must require trustees of express trusts governed under their laws to obtain and hold accurate and current beneficial ownership information regarding the trust, including information on the settlor, trustees, protector, beneficiaries, and any other natural persons exercising ultimate effective control over the trust.³³⁴ Countries must also require trustees to disclose their status to financial institutions and DNFBPs when acting as trustee, and may not be prohibited "from providing competent authorities with any information relating to the trust; or from providing financial institutions or DNFBPs, upon request, with information on the beneficial ownership [or] assets of a trust to be held or managed" ³³⁵ These requirements may be implemented either via legislative action or through common law.³³⁶ Countries must ensure that "trustees are either legally liable for any failure to perform [these obligations]; or that there are effective, proportionate and dissuasive sanctions . . . for [any failure] to comply."³³⁷ In addition, in an effort to address issues raised by certain civil law countries, the Interpretive Note states that countries are not required to give legal recognition to trusts.³³⁸

Countries are further encouraged to ensure that other authorities and entities hold information on trusts with which they have a relationship.³³⁹ Examples of sources for such information include trust registries, tax authorities, and other agents and service providers to trusts.³⁴⁰ Countries

Swiss law does not recognise trusts." (alteration added)). FATF member countries fall generally into three categories as regards trusts: countries whose law provides for trusts and recognizes and enforces domestic and foreign trusts (common law countries such as the United States and U.K.); countries whose law does not provide for the creation of trusts but that, as parties to the 1985 Hague Convention on the Law Applicable to Trusts and their Recognition ("Hague Convention"), recognize trusts subject to foreign law (e.g., Italy and The Netherlands); and countries whose law neither permits trusts to be created nor recognizes foreign trusts (e.g., Norway and Sweden). Countries in this latter category generally received "Not Applicable" ratings, although financial institutions in such countries may maintain accounts for trusts. *See generally Mutual Evaluations, supra* note 8 (providing examples of prior assessments).

³³² *See, e.g., U.S. Mutual Evaluation, supra* note 10 at 237–39.

³³³ *2012 Standards, supra* note 3, at 88.

³³⁴ *Id.*

³³⁵ *Id.* (alterations added) (footnote omitted).

³³⁶ *Id.* at 89.

³³⁷ *Id.* (alterations added).

³³⁸ *Id.*

³³⁹ *2012 Standards, supra* note 3, at 88.

³⁴⁰ *Id.*

should also consider facilitating access by financial institutions and DNFBBs to trust information held by these sources.³⁴¹

Competent authorities must be able to obtain timely access to information held by trustees and other parties, including financial institutions and DNFBBs, on beneficial ownership, residence of the trustee, and trust assets the trustee holds or manages.³⁴² “Professional trustees”³⁴³ must be required to maintain beneficial ownership information for five years after their relationship ceases, and countries are encouraged to require non-professional trustees to maintain the information for the same period.³⁴⁴ Countries must have effective, proportionate, and dissuasive sanctions for failing to grant competent authorities access to the information on trusts referred to above.³⁴⁵

In the case of any legal arrangement with a similar structure or function, countries should take measures similar to those required for trusts in order to achieve similar levels of transparency.³⁴⁶ Countries should provide rapid and effective international cooperation in relation to information on trusts and other legal arrangements.³⁴⁷ Countries should ensure that there are clear responsibilities to comply with these requirements contained in the revised Recommendation 25’s Interpretive Note and sanctions for failing to grant competent authorities access to information regarding the trust.³⁴⁸

Recommendation 25 also received a substantial number of comments from the private sector; nearly all from trust attorneys in common law countries seeking to explain relevant aspects of trust law and suggest how such elements should be reflected in the 2012 Standards.³⁴⁹ Specifically, the comments urged that the 2012 Standards’ obligations should focus on, and be consistent with, the existing legal obligations of trustees, and opposed any requirement of maintaining “trust registries.”³⁵⁰ Both of these

³⁴¹ *Id.* at 89.

³⁴² *Id.* at 88.

³⁴³ This term is not defined in the Standards. *See generally id.* at 109–23 (glossary).

³⁴⁴ *Id.* at 88.

³⁴⁵ *2012 Standards, supra* note 3, at 89.

³⁴⁶ *Id.*

³⁴⁷ *Id.*

³⁴⁸ *Id.*

³⁴⁹ *See, e.g., First Compilation of Responses from DNFBBs, supra* note 131, at 84–99 (providing examples of comments from The Society of Trust and Estate Practitioners and STEP Bermuda).

³⁵⁰ *See, e.g.,* Letter from American College of Trust and Estate Counsel, to John Carlson, Principal Administrator, FATF Secretariat, (Aug. 8, 2011), http://www.actec.org/Documents/misc/ACTEC_FATF_Comments_08_08_2011.pdf.

suggestions were ultimately incorporated into the 2012 Standards' Interpretive Note.³⁵¹ Commenters further urged the FATF to explicitly shift the ultimate responsibility for compliance with the Recommendation from the country whose law governs a trust, to the country where the trust is managed, in recognition of the fact that the country whose law governs a trust would have no power over a trustee or trust in situations where the trustee resides, and the trust is managed, in another country.³⁵² This suggestion, however, was not included in Recommendation 25's Interpretive Note, as it could have upset the consensus that had been reached.³⁵³ Hopefully its omission does not lead to confusion in upcoming Mutual Evaluations.

F. *Powers and Responsibilities of Competent Authorities, and Other Institutional Measures*

Recommendation 26. Regulation and supervision of financial institutions³⁵⁴

The 2012 Standards' Recommendation 26 contains several changes from its 2003 predecessor, Recommendation 23, none of which are clearly substantive. In the second paragraph, Recommendation 26 now explicitly requires that countries apply consolidated group supervision to financial institutions that are subject to the Core Principles: banks, securities firms, and insurance companies.³⁵⁵ This would generally require that the supervisor of the head institution of the financial group implement

³⁵¹ See *FATF Response to Public*, *supra* note 4, at 5; *2012 Standards*, *supra* note 3, at 88.

³⁵² See, e.g., *Response from the Society of Trust and Estate Practitioners*, SOCIETY OF TRUST AND ESTATE PRACTITIONERS, 6–7 (Sept. 13, 2011), <http://www.step.org/pdf/FATF%20Sep%2011Final%20response.pdf?link=contentMiddle>; *First Compilation of Responses from DNFBPs*, *supra* note 131, at 97 (stating that STEP Bermuda believed that “[i]t would be preferable . . . for trustees’ residence . . . to be the basis of regulatory responsibility for a trust.” (alterations added)).

³⁵³ *2012 Standards*, *supra* note 3, at 89.

³⁵⁴ The 2012 Standards' Recommendation 26 corresponds to the 2003 Standards' Recommendation 23. *Id.* at 5.

³⁵⁵ *Id.* at 23. This would have been an implicit requirement under the 2003 Standards, through its reference to the Core Principles, but now is explicit and will be specifically assessed in Mutual Evaluations. *2003 Standards*, *supra* note 40, at 9–10; *2004 Methodology*, *supra* note 6 at 31–32. In addition, the 2004 Methodology requires that directors and senior management of Core Principles institutions be subject to “fit and proper” tests; this is not explicit in the 2012 Standards. *2004 Methodology*, *supra* note 6 at 31.

procedures to supervise or monitor the group for AML/CFT purposes, including any group-wide program implemented pursuant to the requirements of Recommendation 18. In addition, in the first paragraph, the phrase “or financial supervisors” was added following “competent authorities” with reference to taking the necessary measures to prevent criminals from holding interests or management functions in financial institutions.³⁵⁶ This change is not substantive, but was necessary as a result of changes in the definitions of these and related terms.³⁵⁷ Similarly, in the third paragraph, the word “monitoring” has replaced the word “oversight,” for consistency when addressing the required form of supervision of non-Core Principles financial institutions.³⁵⁸ Finally, a sentence from 2003’s Recommendation 18 prohibiting the establishment or continued operation of shell banks has been added to the end of the first paragraph.³⁵⁹ This provision was transferred to the 2012 Recommendation 26 because the FATF felt that efforts to eliminate shell banks have been largely successful and there is no longer a need for a separate recommendation addressing that issue.

The Interpretive Note to Recommendation 26 has been expanded well beyond the 2003 Standards’ Interpretive Note to Recommendation 23, which was limited to reviews of licensing of controlling interests in financial institutions for AML/CFT purposes.³⁶⁰ The revised Interpretive Note to Recommendation 26 appropriately extends the risk-based approach to supervision and explains how this is to be properly implemented.³⁶¹ The expanded Interpretive Note, which is based, in part, on the Guidance on

³⁵⁶ *Id.*

³⁵⁷ See discussion *infra* Recommendation 28. In the 2012 Standards, “competent authorities” continues to be the all-encompassing term for those government authorities with responsibilities for combating money laundering and terrorist financing, although the definition has been revised to include a list of several specific types of authorities, including supervisors. *2012 Standards, supra* note 3, at 110. The definition of “supervisor” has been expanded to include, in addition to the public authorities with responsibilities for ensuring compliance by financial institutions and DNFBPs with AML/CFT requirements, certain non-public bodies with the same responsibilities, so long as they are empowered by law to exercise these functions and supervised by a competent authority. *Id.* at 120. The primary reason for this addition was to include as “financial supervisors” certain regulators for the securities industry in particular countries (often referred to in those countries as “self-regulatory organizations” or “SROs”) that satisfy these standards.

³⁵⁸ *Id.* at 23. See also, *id.* at 17 (stating that MVTS are to be subject to “effective systems of monitoring . . .”) (ellipsis added).

³⁵⁹ *Id.* at 23; *2003 Standards, supra* note 41, at 9.

³⁶⁰ *2003 Standards, supra* note 41, at 23.

³⁶¹ *2012 Standards, supra* note 3, at 90–91.

RBA,³⁶² explains that the risk-based approach to supervision means the “process by which a supervisor, according to its understanding of the risks, allocates its resources to AML/CFT supervision; and . . . the specific process of supervising institutions that apply an AML/CFT risk-based approach.”³⁶³ It further clarifies that this approach allows supervisors to direct more resources to areas perceived to present higher risks, thereby utilizing their resources more effectively.³⁶⁴ This approach requires the supervisor to have a thorough understanding of the money laundering and terrorist financing risks in the specific country, as well as on-site and off-site access to all relevant information on the domestic and foreign risks relevant to customers, and products and services of the supervised institutions.³⁶⁵ In implementing their risk-based approach, supervisors need to take into account the degree of discretion allowed to the regulated institutions.³⁶⁶

The Interpretive Note to Recommendation 26 also requires that countries ensure their supervisors have adequate financial, human, and technical resources, sufficient operational independence to ensure freedom from undue influence, and processes to ensure high professional standards.³⁶⁷ The 2003 Standards contained a separate Recommendation mandating this requirement.³⁶⁸

Recommendation 27. Powers of supervisors

The 2012 Standards' Recommendation 27 includes the contents of 2003's Recommendation 29 with only minor modifications.³⁶⁹ In Recommendation 27, the FATF broadened its description of the function of supervisors by changing “monitor” to “supervise or monitor,” to be

³⁶² See generally *Guidance on RBA*, *supra* note 433, at 12–20 (describing what effective risk-based AML/CFT supervision requires).

³⁶³ *2012 Standards*, *supra* note 3, at 90.

³⁶⁴ *Id.*

³⁶⁵ *Id.*

³⁶⁶ *Id.*

³⁶⁷ *Id.* at 90–91.

³⁶⁸ See *2003 Standards*, *supra* note 41, at 11 (showing that Recommendation 30 contained this requirement).

³⁶⁹ *2012 Standards*, *supra* note 3, at 5. The 2004 Methodology included some specific requirements regarding inspections, as well as the power of supervisors to inspect without a court order, that are not explicitly included in the 2012 Standards. *2004 Methodology*, *supra* note 6 at 36.

consistent with Recommendation 26.³⁷⁰ The 2012 Recommendation 27 also contains a new sentence regarding sanctions that was taken from 2003's Recommendation 17 and references the 2012 Standards' Recommendation 35 in connection with the authority to impose sanctions.³⁷¹

Recommendation 28. Regulation and supervision of DNFBPs³⁷²

The 2012 Standards' Recommendation 28, regarding regulation and supervision of DNFBPs, is an expanded version of 2003's Recommendation 24.³⁷³ Part (a) of new Recommendation 28 is identical to its counterpart in 2003's Recommendation 24, and the first paragraph of part (b) was changed only to reflect changes to the 2012 Standards' terminology.³⁷⁴ In addition, whereas the 2003 Standards' Recommendation 24 required a competent authority to take necessary measures to prevent criminals from holding or being the beneficial owner of, having a significant or controlling interest in, functioning as a manager of, or operating a casino.³⁷⁵ The 2012 Standards' Recommendation 28 has broadened these requirements so that they apply to all DNFBPs, include taking measures to prevent criminals and their associates from being "professionally accredited" (referring to "fit and proper" tests as an example), and refer to enforcement by the supervisor or SRB.³⁷⁶ The revised Recommendation 28 also includes a reference to imposing sanctions, in line with Recommendation 35, to deal with any failure to comply.³⁷⁷ Finally, Recommendation 28 has an Interpretive Note

³⁷⁰ Compare 2012 Standards, *supra* note 3, at 23, with 2003 Standards, *supra* note 41, at 9.

³⁷¹ 2012 Standards, *supra* note 3, at 23; see also discussion *infra* Recommendation 35.

³⁷² The Revised Standards' Recommendation 28 corresponds to the 2003 Standards' Recommendation 24. 2012 Standards, *supra* note 3, at 5.

³⁷³ Compare *id.* at 23–24, with 2003 Standards, *supra* note 41, at 10.

³⁷⁴ Recommendation 28 substitutes the terms "supervisor" and "self-regulatory body" for "government authority" and "self-regulatory organization," respectively. 2012 Standards, *supra* note 3, at 24. "Supervisor" is now the generic term for authorities responsible for ensuring compliance by DNFBPs (as well as financial institutions) with AML/CFT requirements. *Id.* at 120. The newly defined term "self-regulatory body," or "SRB," has replaced the term "self-regulatory organization" or "SRO" from the 2003 Standards. *Id.* at 24. Also, the definition of SRB is somewhat stricter than "SRO," inasmuch as an SRB must be authorized to "enforce rules to ensure that high ethical and moral standards are maintained by those practising the profession," in order to fit the SRB definition. See *id.* at 120.

³⁷⁵ 2003 Standards, *supra* note 41, at 10.

³⁷⁶ 2012 Standards, *supra* note 3, at 23–24.

³⁷⁷ *Id.* at 24.

that sets forth certain principles applicable to the risk-based approach to supervision of DNFBPs, analogous to the Interpretive Note to Recommendation 26.³⁷⁸

Recommendation 29. Financial intelligence units (“FIU”)³⁷⁹

The 2012 Standards’ Recommendation 29, read together with its Interpretive Note, is a modified version of 2003’s Recommendation 26.³⁸⁰ The revised Recommendation 29 clarifies, broadens, and, in some respects, strengthens the core functions of an FIU. Recommendation 29 now clearly states that the FIU’s functions are to (1) receive and analyze STRs, in addition to other information required by the jurisdiction relevant to money laundering, predicate offenses, and terrorist financing, and (2) disseminate the results of its analysis.³⁸¹ Recommendation 29’s new reference to predicate offenses is important because it ensures consistency with the Revised Standards’ requirements in Recommendations 30, 32 and 37.³⁸²

Recommendation 29’s Interpretive Note has been expanded substantially from its counterpart in the 2003 Standards. It notes that there are different models for an FIU, and that the Recommendation applies to each of them.³⁸³ It explicitly states that “[t]he FIU serves as the central agency for the receipt of disclosures filed by reporting entities,” and that it should include other information required by national legislation, such as cash transaction and wire transfer reports.³⁸⁴ The Interpretive Note to Recommendation 29 emphasizes the FIU’s analysis function, and states that the “FIU analysis should add value to the information received” by it (a newly articulated requirement), and that FIUs should be encouraged to use analytical software, but that “such tools cannot fully replace the human judgment element of analysis.”³⁸⁵ It also describes two types of analysis: (1) operational analysis, which focuses on specific targets, and (2) strategic analysis, which identifies money laundering trends and patterns.³⁸⁶ The

³⁷⁸ *Id.* at 90, 92.

³⁷⁹ The Revised Standards’ Recommendation 29 corresponds to the 2003 Standards’ Recommendation 26. *Id.* at 5.

³⁸⁰ *See id.* at 24, 93–95; 2003 Standards, *supra* note 41, at 10–11.

³⁸¹ 2012 Standards, *supra* note 3, at 24.

³⁸² *See* discussion *infra* Recommendations 30, 32, and 37.

³⁸³ The FIU Models include law enforcement, administrative, judicial, or hybrid. *See, e.g., What is an FIU?, THE EGMONT GRP. OF FIN. INTELLIGENCE UNITS*, <http://www.egmontgroup.org/about/what-is-an-fiu> (last visited Nov. 14, 2012).

³⁸⁴ 2012 Standards, *supra* note 3, at 93.

³⁸⁵ *Id.*; *see also* 2003 Standards, *supra* note 41, at 10–11 (listing no such requirement).

³⁸⁶ 2012 Standards, *supra* note 3, at 93.

strategic analysis function will be significant in terms of the new requirement for a national risk assessment that FATF sets out in the Revised Standards' Recommendation 1, as it should provide very useful information regarding a country's AML/CFT risks.

Recommendation 29's Interpretive Note further requires that the FIU be capable of two types of dissemination.³⁸⁷ The first type of dissemination is spontaneous (i.e., proactive) dissemination of the information reported to the FIU, as well as the results of the FIU's analyses, "when there are grounds to suspect money laundering, predicate offences or terrorist financing."³⁸⁸ The second type of dissemination is new and furthers the 2012 Standards' Recommendation 31.³⁸⁹ It requires dissemination by the FIU upon request of competent authorities under Recommendation 31, although the FIU should retain ultimate discretion regarding analysis or dissemination.³⁹⁰

Both Recommendation 29 and its Interpretive Note mandate that the FIUs have the power "to obtain and use additional information from reporting entities, as needed to perform its analysis properly."³⁹¹ Previously, the 2003 Standards' Recommendation 26 limited this scope to information held by competent authorities.³⁹² In addition, the Note states that, in order to conduct their analysis function, "FIU's should have access to the widest possible range of financial, administrative, and law enforcement information," including public source information, information collected or maintained by other authorities, and also required to have access, when appropriate, to commercially held data.³⁹³

Recommendation 29's Interpretive Note further establishes information security and confidentiality requirements and mandates operational independence and autonomy.³⁹⁴ It clarifies that, where an FIU is part of an existing authority, its "core functions should be distinct from those of the other authority."³⁹⁵ It requires that the FIU have adequate financial, human, and technical resources,³⁹⁶ that it "has regard to the Egmont Group Statement of Purpose and its Principles for Information

³⁸⁷ *Id.* at 94.

³⁸⁸ *Id.*

³⁸⁹ *Compare id.* at 94, with 2003 Standards, *supra* note 41, at 11.

³⁹⁰ 2012 Standards, *supra* note 3, at 94.

³⁹¹ *Id.* at 93–94.

³⁹² 2003 Standards, *supra* note 41, at 10–11.

³⁹³ 2012 Standards, *supra* note 3, at 94.

³⁹⁴ *Id.* at 94–95.

³⁹⁵ *Id.* at 95.

³⁹⁶ *Id.*; see also 2003 Standards, *supra* note 41, at 11.

Exchange Between [FIUs],” and that it applies for membership in the Egmont Group.³⁹⁷ Finally, the requirement to “consider the feasibility and utility” of large transaction reporting, which was formerly contained in 2003’s Recommendation 19, has been added to Recommendation 29’s Interpretive Note, as it was not considered of sufficient importance to constitute a stand-alone Recommendation.³⁹⁸

Recommendation 30. Responsibilities of law enforcement and investigative authorities³⁹⁹

The 2012 Standards’ Recommendation 30, which was based on 2003’s Recommendation 27, is closely related to the revised Recommendation 31.⁴⁰⁰ Recommendation 30 addresses the responsibilities of law enforcement and investigative authorities, while Recommendation 31 addresses their powers.⁴⁰¹ Together, the two Recommendations clarify and strengthen these elements.

Recommendation 30 of the 2012 Standards adds that the existing requirement that law enforcement authorities have responsibility for money laundering and terrorist financing investigations, must be “within the framework of national AML/CFT policies,” thus linking this law enforcement function with the “national cooperation and coordination” requirements of Recommendation 2. Recommendation 30 also requires that, “[a]t least in . . . cases related to major proceeds-generating offences . . . designated law enforcement authorities should develop a pro-active parallel financial investigation [defined in the Interpretive Note] when pursuing money laundering, associated predicate offences, and terrorist financing, include[ing] cases where the associated predicate offense occurs outside the jurisdictions.”⁴⁰² Furthermore, countries now must designate a

³⁹⁷ 2012 Standards, *supra* note 3, at 95 (alterations added); *cf.* 2003 Standards, *supra* note 41, at 23 (stating that formerly, an FIU was to “consider” this). The Egmont Group is an informal group of FIUs formed in 1995 that meet regularly to find ways to cooperate, particularly in the areas of information exchange, training, and sharing expertise. See *About, THE EGMONT GRP. OF FIN. INTELLIGENCE UNITS*, <http://www.egmontgroup.org/about> (last visited Nov. 14, 2012).

³⁹⁸ Compare 2012 Standards, *supra* note 3, at 95 (incorporating the language into another recommendation), with 2003 Standards, *supra* note 41, at 9 (providing a separate recommendation).

³⁹⁹ The Revised Standards’ Recommendation 30 corresponds to the 2003 Standards’ Recommendation 27. 2012 Standards, *supra* note 3, at 5.

⁴⁰⁰ See discussion *infra* Recommendation 31.

⁴⁰¹ 2012 Standards, *supra* note 3, at 24–25.

⁴⁰² *Id.* at 24 (alterations added).

competent authority to expeditiously identify, trace, and initiate actions to freeze and seize property which may be subject to confiscation, and must⁴⁰³ make use of permanent or temporary multi-disciplinary groups specialized in financial investigations and conduct cooperative or joint investigations when necessary with authorities in other countries.

The Interpretive Note to Recommendation 30 expands the role of financial investigators by stating that the Recommendation is applicable to “those competent authorities, which are not law enforcement authorities, per se, but which have the responsibility for pursuing financial investigations of predicate offences, to the extent [they] are exercising functions [described in] Recommendation 30.”⁴⁰⁴ The Interpretive Note to Recommendation 30 states that anti-corruption authorities may be designated to investigate money laundering and terrorist financing offenses relating to corruption offenses, in which authorities should also have sufficient powers, and now includes definitions of “financial investigation” and “parallel financial investigation.”⁴⁰⁵ Finally, the authorities must have adequate resources and maintain high professional standards.⁴⁰⁶

Recommendation 31. Powers of law enforcement and investigative authorities⁴⁰⁷

In the 2012 Standards, Recommendation 31 is focused more generally on powers of law enforcement authorities.⁴⁰⁸ Accordingly, Recommendation 31 includes the material from 2003’s Recommendation 28 as well as some provisions from 2003’s Recommendation 27.⁴⁰⁹ Recommendation 31, in substance, tracks 2003’s Recommendation 28 in terms of the power to obtain access to all necessary documents and information.⁴¹⁰ The revised Recommendation 31 also adds a reference to terrorist financing investigations, and refers explicitly to the taking of witness statements, which was in the 2004 Recommendation 28

⁴⁰³ See *id.* at 120 (indicating that the word “should” is equivalent to the word “must” in the 2012 Standards).

⁴⁰⁴ *Id.* at 96 (alterations added).

⁴⁰⁵ *Id.*

⁴⁰⁶ *Id.*

⁴⁰⁷ The 2012 Standards’ Recommendation 31 corresponds to the 2003 Standards’ Recommendations 27 and 28. *2012 Standards, supra* note 3, at 5.

⁴⁰⁸ *Id.* at 25.

⁴⁰⁹ *Id.*; *2003 Standards, supra* note 41, at 11.

⁴¹⁰ Compare *2012 Standards, supra* note 3, at 25, with *2003 Standards, supra* note 41, at 11.

Methodology.⁴¹¹ In addition, Recommendation 31 requires that countries ensure the availability of a wide range of suitable investigative techniques, including “undercover operations, intercepting communications, accessing computer systems and controlled delivery.”⁴¹² Furthermore, Recommendation 31 requires that financial investigators have access to mechanisms to determine, in a timely manner, whether natural or legal persons own or control accounts and to identify assets without prior notification to the owner.⁴¹³ Finally, when conducting investigations, Recommendation 31 provides that authorities should be able to ask for all relevant information held by the FIU, rather than waiting to be provided with such information.⁴¹⁴ As noted above, under the 2012 Standards’ Recommendation 29, the FIU will have discretion as to whether to provide any such information.⁴¹⁵

Recommendation 32. Cash couriers⁴¹⁶

The FATF adopted the 2012 Standards’ Recommendation 32 from the 2003 Standards’ Special Recommendation IX nearly verbatim.⁴¹⁷ The only difference between the old and new recommendations is that the 2012 Standards’ Recommendation 32 has an added reference to currency or bearer negotiable instruments related to “predicate offenses,” in addition to terrorist financing or money laundering.⁴¹⁸ Similarly, the Interpretive Note to Recommendation 32 is nearly identical to the Interpretive Note to Special Recommendation IX in substance.⁴¹⁹ The most significant change is the addition of a somewhat detailed description of the three types of declaration system,⁴²⁰ which was taken from the FATF’s “Best Practices” paper⁴²¹ and

⁴¹¹ 2012 Standards, *supra* note 3, at 25; 2004 Methodology, *supra* note 6, at 35–36.

⁴¹² 2012 Standards, *supra* note 3, at 25; *cf.* 2003 Standards, *supra* note 41, at 11 (showing Recommendation 27 which only “encouraged” countries to support and develop such techniques).

⁴¹³ 2012 Standards, *supra* note 3, at 25.

⁴¹⁴ *Id.*

⁴¹⁵ See *supra* text accompanying note 390.

⁴¹⁶ The Revised Standards’ Recommendation 32 corresponds to the 2003 Standards’ Special Recommendation IX. 2012 Standards, *supra* note 3, at 5.

⁴¹⁷ Compare *id.* at 25, with Special Recommendations, *supra* note 77, at 3.

⁴¹⁸ 2012 Standards, *supra* note 3, at 25.

⁴¹⁹ Compare *id.* at 98–101, with Special Recommendations, *supra* note 77, at 25–27.

⁴²⁰ These three systems are (1) where all travellers complete a written declaration, (2) where only travellers carrying amounts above a threshold complete a declaration, and (3) where travellers orally declare the amount they are carrying.

should provide greater clarity regarding the requirements of each. The Interpretive Note to Recommendation 32's "Sanction" section includes a new reference to "predicate offenses" and a "resources" paragraph.⁴²² The definitions, which have been placed at the end of the Interpretive Note, contain non-substantive changes in "false declaration" and "false disclosure."⁴²³

Recommendation 33. Statistics

The Revised Standards' Recommendation 33 is based on the 2003 Standards' Recommendation 32.⁴²⁴ The first sentence of Recommendation 33 has been rewritten for greater simplicity and clarity, but the Recommendation contains no substantive change.⁴²⁵

Recommendation 34. Guidance and feedback⁴²⁶

The Revised Standards' Recommendation 34 is adapted from, and nearly identical to, 2003's Recommendation 25.⁴²⁷ The only revision that was made, however, is one of substance. Whereas 2003's Recommendation 25 applied only to "competent authorities," the revised Recommendation 33 applies to "competent authorities, supervisors and SRBs."⁴²⁸ As a result of this change, SRBs will now be subject to Recommendation 34.⁴²⁹ In contrast, under 2003's Recommendation 25, it was optional for SROs (which roughly corresponded to SRBs under the Revised Standards) to establish guidelines for DNFBBs.⁴³⁰ In addition, the 2003 Standards' Interpretive Note to Recommendation 25 stated that, when considering feedback, "countries should have regard to the FATF Best Practices

⁴²¹ FATF, *International Best Practices: Detecting and Preventing the Cross-Border Transportation of Cash by Terrorists and Other Criminals*, at 4 (Feb. 12, 2005), available at <http://www.fatfgafi.org/media/fatf/documents/recommendations/International%20BPP%20Detecting%20and%20Preventing%20illicit%20cross-border%20transportation%20SR%20IX%20%20COVER%202012.pdf>.

⁴²² *2012 Standards*, *supra* note 3, at 100.

⁴²³ *Id.* at 100–01

⁴²⁴ *Id.* at 5.

⁴²⁵ Compare *id.* at 26, with *2003 Standards*, *supra* note 41, at 11.

⁴²⁶ The 2012 Standards' Recommendation 34 corresponds to the 2003 Standards' Recommendation 25. *2012 Standards*, *supra* note 3, at 5.

⁴²⁷ Compare *id.* at 26, with *2003 Standards*, *supra* note 41, at 10.

⁴²⁸ *2012 Standards*, *supra* note 3, at 26; *2003 Standards*, *supra* note 41, at 10.

⁴²⁹ *2012 Standards*, *supra* note 3, at 26.

⁴³⁰ See *2004 Methodology*, *supra* note 6, at 33.

Guidelines on Providing Feedback to Reporting Financial Institutions and Other Persons.”⁴³¹ The 2012 Standards’ Recommendation 33 has no Interpretive Note, as the Best Practices document has become obsolete.

Recommendation 35. Sanctions

The Revised Standards’ version of Recommendation 35 corresponds to 2003’s Recommendation 17.⁴³² Recommendation 35, while similar in substance to the 2003 Recommendation 17, contains some changes. By its terms, the revised Recommendation 35 only applies to the “natural or legal persons covered by Recommendation 6, and 8 to 23,” while the 2003 Standards’ Recommendation 17 contained no similar limitation.⁴³³ This reflects the fact that the FATF has chosen to apply this Recommendation to the specified Recommendations (primarily the “Preventive Measures”), while several other Recommendations contain their own sanctions requirement.⁴³⁴ In addition, Recommendation 35 incorporates a requirement that “[s]anctions should be applicable not only to financial institutions and DNFBPs, but also to their directors and senior management,” which previously appeared in the 2004 Methodology.⁴³⁵

G. *International Cooperation*

Recommendation 36. International instruments⁴³⁶

The Revised Standards’ Recommendation 36, which is a revision of the 2003 Standards’ Recommendation 35 and Special Recommendation I, adds the United Nations Convention against Corruption, 2003 to the list of international conventions that member countries are required to “become

⁴³¹ 2003 Standards, *supra* note 41, at 23.

⁴³² 2012 Standards, *supra* note 3, at 5.

⁴³³ *Id.* at 26; 2003 Standards, *supra* note 41, at 9.

⁴³⁴ Because Recommendation 35 requires sanctions for natural or legal persons who fail to comply with AML/CFT requirements, those Recommendations where AML/CFT requirements are not relevant (e.g., Recommendations 7, 24 and 25) are not included under Recommendation 35. In addition, certain other Recommendations (e.g., Recommendations 7, 24, 25, 27 and 28) contain a specific reference to sanctions authority in the Recommendation or in the Interpretive Note. See 2012 Standards, *supra* note 3, at 23–24, 50, 86, and 89.

⁴³⁵ *Id.* at 26 (alteration added); 2004 Methodology, *supra* note 6, at 28.

⁴³⁶ The 2012 Standards’ Recommendation 36 corresponds to the 2003 Standards’ Recommendation 35 and Special Recommendation I. 2012 Standards, *supra* note 3, at 5.

party to and implement fully.”⁴³⁷ This Convention was listed as an “Additional (i.e., optional) Element” in the 2004 Methodology (Recommendation 6);⁴³⁸ its addition is a further example of the emphasis on anti-corruption measures in the Revised Standards. The Recommendation also adds to the list of examples of relevant regional conventions countries are “encouraged” to ratify and implement; the Council of Europe Convention on Cybercrime (2001) and the Council of Europe Convention on Laundering, Search, Seizure and Confiscation of the Proceeds from Crime and on the Financing of Terrorism (2005).⁴³⁹

Recommendation 37. Mutual legal assistance

The 2012 Standards’ Recommendation 37, in effect, replaces 2003’s Recommendation 36, Recommendation 37, and parts of Special Recommendation V.⁴⁴⁰ The Revised Standards’ Recommendation 37 also incorporates some new requirements. In a change parallel to that made in several other Recommendations in the 2012 Standards, including Recommendations 29 and 32, Recommendation 37 adds the explicit requirement that mutual legal assistance should be provided in relation to investigations, prosecutions and related proceedings of “associated predicate offenses” as well as of money laundering and terrorist financing.⁴⁴¹ Recommendation 37 also adds several new requirements to those that were previously included in 2003’s Recommendations 36 and 37. These include that countries should: (1) “have an adequate legal basis for providing assistance and, where appropriate, should have in place treaties, arrangements or other mechanisms to enhance cooperation;”⁴⁴² (2) “use a central authority, or another established official mechanism, for effective transmission and execution of requests,” and maintain a “case management system;” and (3) maintain the confidentiality of requests and the information in them, “subject to fundamental principles of domestic law, in

⁴³⁷ *Id.* at 27.

⁴³⁸ 2004 Methodology, *supra* note 6, at 19–20.

⁴³⁹ 2012 Standards, *supra* note 3, at 27. 2003’s Recommendation 35 listed the predecessor Convention of 1990. 2003 Standards, *supra* note 41, at 12.

⁴⁴⁰ 2012 Standards, *supra* note 3, at 5.

⁴⁴¹ *Id.* at 27.

⁴⁴² *Id.* The “adequate legal basis for providing assistance” requirement is completely new. See 2003 Standards, *supra* note 41, at 12. The reference to treaties, arrangements, or other mechanisms to enhance cooperation was applicable under Special Recommendation V with respect to proceedings regarding terrorist acts, financing, and organizations, and therefore is a new requirement with respect to proceedings regarding money laundering and associated predicate offenses. See *Special Recommendations*, *supra* note 77, at 2.

order to protect the integrity of the investigation or inquiry,” and inform the requesting country promptly if unable to comply.⁴⁴³

The 2012 Recommendation 37 clarifies a 2004 Methodology requirement which stated simply that “the powers of competent authorities required under [Recommendation 28 (now Recommendation 31)] should also be available for use in response to requests for mutual legal assistance.”⁴⁴⁴ In part due to the expansion of the powers now to be available under Recommendation 31, 2012 Recommendation 37 now requires that, of the powers to be available under Recommendation 31, those relating to “the production, search and seizure of information, documents or evidence (including financial records) from financial institutions and other persons, and the taking of witness statements,” as well as “a broad range of other powers and investigative techniques,” should be available in response to requests for mutual legal assistance, as well as “in response to direct requests from foreign judicial or law enforcement authorities to domestic counterparts,” if consistent with their domestic framework.⁴⁴⁵ The 2012 Standards’ Recommendation 37 now requires that a country seeking mutual legal assistance must “make best efforts to provide complete factual and legal information that will allow for timely and efficient execution of requests, including any need for urgency . . . send requests using expeditious means . . . [and] make best efforts to ascertain legal requirements and formalities” before sending the request.⁴⁴⁶ Finally, the Recommendation requires countries to render mutual legal assistance in the absence of dual criminality, “if the assistance does not involve coercive actions.”⁴⁴⁷

Recommendation 38. Mutual legal assistance: freezing and confiscation

The 2012 Standards’ Recommendation 38 is based on the 2003 Standards’ Recommendation 38 and parts of Special Recommendation V.⁴⁴⁸ The 2012 Standards’ Recommendation 38 requires that countries have effective mechanisms for managing property or instrumentalities, or

⁴⁴³ 2012 Standards, *supra* note 3, at 27.

⁴⁴⁴ *Id.*; 2004 Methodology, *supra* note 6, at 43 (alterations added).

⁴⁴⁵ 2012 Standards, *supra* note 3, at 28.

⁴⁴⁶ *Id.* (alterations added).

⁴⁴⁷ *Id.* at 27. 2003’s Recommendation 37 required this “to the greatest extent possible.” 2003 Standards, *supra* note 41, at 12. This is a somewhat weaker standard, inasmuch as it is more difficult to assess in a Mutual Evaluation.

⁴⁴⁸ 2012 Standards, *supra* note 3, at 5.

property of corresponding value that has been frozen, seized, or confiscated in response to a foreign country's request.⁴⁴⁹ In addition, the Recommendation now imposes new requirements in two situations. First, countries must have the authority to respond to requests made on the "basis of non-conviction-based confiscation[s] . . . and related provisional measures, unless [it] is inconsistent with fundamental principles of domestic law;" and, based on Recommendation 38's Interpretive Note, countries should have such power, "at a minimum in circumstances when a perpetrator is unavailable by reason of death, flight, absence, or [is] unknown."⁴⁵⁰ Second, countries must be able to share confiscated property among or between other countries, particularly when confiscation results directly or indirectly from coordinated law enforcement action.⁴⁵¹

Recommendation 39. Extradition

The Revised Recommendation 39 corresponds to 2003's Recommendation 39 and parts of Special Recommendation V.⁴⁵² The requirements for extradition in this Recommendation have been expanded and strengthened in certain respects. The Revised Standards' Recommendation 39 requires that countries have clear and "efficient processes for the timely execution of extradition requests, including prioritization when appropriate;" that they maintain a case management system to monitor progress; and that they "not place unreasonable or unduly restrictive conditions on the execution of requests" and "ensure they have an adequate legal framework for extradition (which was implied under the 2003 version of Recommendation 39)."⁴⁵³

Furthermore, the 2012 Standards' Recommendation 39 requires that, "[c]onsistent with fundamental principles of domestic law, countries . . . have simplified extradition mechanisms, such as[:] allowing direct transmission of requests for provisional arrests between appropriate authorities, extraditing persons based only on warrants of arrests or

⁴⁴⁹ *Id.* at 28.

⁴⁵⁰ *Id.* at 28, 102 (alterations added). Any such authority in cases of requests based on non-conviction-based confiscation was "encouraged" by 2003's Recommendation 38. *2003 Standards, supra* note 41, at 13. There is some ambiguity in the Interpretive Note as to whether this requirement is to apply, even if "inconsistent with fundamental principles of domestic law." *See 2012 Standards, supra* note 3, at 102. This may be another issue that will be resolved in the context of Mutual Evaluations.

⁴⁵¹ *Id.* This was something countries were only required to consider in the 2003 Standards. *See 2003 Standards, supra* note 41, at 24.

⁴⁵² *2012 Standards, supra* note 3, at 5.

⁴⁵³ *Id.* at 29.

judgments, or introducing a simplified extradition of consenting persons who waive formal extradition proceedings.”⁴⁵⁴ Previously, under 2003’s Recommendation 39, countries were only required to “consider” such simplified extradition mechanisms.⁴⁵⁵

Recommendation 40. Other forms of international cooperation⁴⁵⁶

The 2012 Standards’ Recommendation 40 and its Interpretive Note, which correspond to Recommendation 40 and part of Special Recommendation V in the 2003 Standards and cover international cooperation through methods other than mutual legal assistance or extradition, have been expanded in several respects. The 2012 Recommendation 40 adds to the 2003 version the requirement that countries should have a “lawful basis for providing cooperation,” and that, if needed, bilateral and multilateral agreements, such as Memorandums of Understandings (“MOUs”), “should be negotiated and signed in a timely [manner] with the widest range of foreign counterparts.”⁴⁵⁷ Recommendation 40 also contains a new requirement that there be “clear and efficient processes for the prioritization and timely execution of requests”⁴⁵⁸

The 2012 Standards’ Interpretive Note to Recommendation 40 is substantially longer and more detailed than its 2003 counterpart.⁴⁵⁹ It imposes new obligations on the requesting party: that it “provide complete factual and, as appropriate, legal information;” that it include any need for urgency; and that it identify the anticipated use of such information.⁴⁶⁰ The Interpretive Note to Recommendation 40 further provides that a competent authority should not refuse a request on the grounds that “there is an inquiry, investigation or proceeding underway in the requested country,

⁴⁵⁴ *Id.* (alterations added).

⁴⁵⁵ See 2003 Standards, *supra* note 41, at 13.

⁴⁵⁶ The Revised Standards’ Recommendation 40 corresponds to the 2003 Standards’ Recommendation 40 and part of Special Recommendation V. 2012 Standards, *supra* note 3, at 5; 2003 Standards, *supra* note 40 at 13–14; and Special Recommendations, *supra* note 77, at 2.

⁴⁵⁷ 2012 Standards, *supra* note 3, at 29–30 (alteration added). See also 2003 Standards, *supra* note 41, at 13–14 (lacking this requirement in 2003).

⁴⁵⁸ *Id.* at 30. See also 2003 Standards, *supra* note 41, at 13–14 (lacking this requirement in 2003).

⁴⁵⁹ Compare 2012 Standards, *supra* note 3, at 103–106 (18 paragraphs), with 2003 Standards, *supra* note 41, at 24 (4 paragraphs).

⁴⁶⁰ 2012 Standards, *supra* note 3, at 103.

unless the assistance would impede that inquiry,” or because “the nature or status . . . of the requesting counterpart authority is different from that of its foreign counterpart.”⁴⁶¹

Part B of the 2012 Standards’ Interpretive Note to Recommendation 40, entitled “Principles Applicable to Specific Forms of International Cooperation,” contains more specific provisions pertaining to cooperation among FIUs, among financial supervisors, and among law enforcement authorities, and expands some of the requirements under 2003’s Recommendation 40. For example, an FIU would now be required to be able to exchange with its foreign counterparts information it can access or obtain; this would include information it must now be able to obtain from financial institutions pursuant to Recommendation 29.⁴⁶² Moreover, financial supervisors must be able to not only conduct inquiries on behalf of foreign counterparts, but also, “as appropriate, to authorize or facilitate the ability of foreign counterparts to conduct inquiries themselves in the country, in order to facilitate group supervision.”⁴⁶³

Furthermore, law enforcement authorities must “be able to form joint investigative teams to conduct cooperative investigations and, when necessary . . . establish bilateral or multilateral arrangements to enable such joint investigations.”⁴⁶⁴ In addition, unlike the 2004 Methodology for Recommendation 40, which addressed exchanges of information with non-counterparts as optional,⁴⁶⁵ the Revised Standards’ Interpretive Note requires countries to permit exchanges of information indirectly with non-counterparts, *i.e.*, the requested information passes “from the requested authority through one or more domestic or foreign authorities before being received by the requesting authority.”⁴⁶⁶ The 2012 Interpretive Note to Recommendation 40 further “encourages” countries to permit the exchange of information with non-counterparts directly.⁴⁶⁷

⁴⁶¹ *Id.* (ellipsis added).

⁴⁶² *Id.* at 104.

⁴⁶³ *Id.* at 105.

⁴⁶⁴ Compare *id.* at 104–06 (ellipsis added) (including these statements broadening the scope), with 2003 Standards, *supra* note 41, at 13–14, 24 (with a more narrow scope).

⁴⁶⁵ 2004 Methodology, *supra* note 6, at 46.

⁴⁶⁶ 2012 Standards, *supra* note 3, at 106.

⁴⁶⁷ *Id.*

H. *Interpretive Note: Legal Basis of Requirements on Financial Institutions and DNFBPS*

This Interpretive Note, not associated with any particular Recommendation in the 2012 Standards but rather with all the Standards, defines two important terms and sets forth two important principles. The terms are (1) “law,” which essentially means legislation enacted through a Parliamentary process,⁴⁶⁸ and (2) “Enforceable means,” which includes regulations as well as guidelines and other documents, so long as they are enforceable.⁴⁶⁹

All requirements in the Standards applicable to financial institutions and DNFBPs must be set forth in law or enforceable means.⁴⁷⁰ This in effect carried forward a similar requirement in the 2003 standards, but which used the terms “law or regulation” and “other enforceable means.”⁴⁷¹ The purpose of this requirement is to ensure that compliance by countries with the standards is based on laws, or other enforceable and sanctionable measures, and not on mere “guidance” or “best practices” which are not enforceable, and noncompliance which is not subject to sanction.⁴⁷² Because of the wide divergence of legal and regulatory systems used in FATF member countries, as well as methods for imposing requirements on financial institutions and DNFBPs, this requirement has led to very complicated discussions and distinctions within the FATF in assessing different countries’ compliance with the Standards.

The second principle contained in this Interpretive Note is that certain requirements in the 2012 Standards’ Recommendations 10, 11, and 20 must be contained in law.⁴⁷³ This emphasizes and modifies a requirement, previously in the 2004 Methodology, that certain essential criteria had to be contained in “law or regulation,” defined in the 2004 Methodology to include both legislation and implementing regulations.⁴⁷⁴ Now, per the revised Recommendations 10, 11, and 20, the corresponding requirements must be satisfied solely through measures that meet the Glossary definition of “law.”⁴⁷⁵ The FATF’s rationale for this is that certain requirements

⁴⁶⁸ See *id.* at 107 (“The notion of law also encompasses judicial decisions that impose relevant requirements, and which are binding and authoritative in all parts of the country”).

⁴⁶⁹ *Id.*

⁴⁷⁰ *Id.*

⁴⁷¹ 2003 Standards, *supra* note 41, at 18.

⁴⁷² See 2012 Standards, *supra* note 3, at 107 (“There must be sanctions for non-compliance . . . which should be effective, proportionate and dissuasive.” (ellipsis added)).

⁴⁷³ *Id.*

⁴⁷⁴ 2004 Methodology, *supra* note 6, at 9, 67.

⁴⁷⁵ 2003 Standards, *supra* note 41, at 14–15, 19, 107.

considered of paramount importance must be contained in legislation, in order for the country to show sufficient political will to impose and enforce such requirements in a manner that cannot be easily revoked or rescinded. This requirement could be disadvantageous for countries with a legislative system like the United States, where the legislative body traditionally places very general requirements in legislation and authorizes appropriate regulatory bodies to impose more specific requirements through implementing regulations.

CONCLUSION

As a result of its review process, the FATF has made some significant changes to its Standards, including the following: the incorporation of the risk-based approach into the Standards (Recommendations 1, 10 and 26); the extension of the Standards to encompass some new threats, including the addition of tax crimes as a predicate offense (Recommendation 3) and the extension of the Standards to the financial sanctions called for by UNSCRs aimed at preventing WMD proliferation (Recommendation 7); an increased emphasis on fighting corruption, by covering domestic as well as foreign PEPs (Recommendation 12) and requiring ratification and implementation of the UN Convention Against Corruption (Recommendation 36); requiring greater transparency in cross-border wire transfers (Recommendation 16); greater specificity in the requirements aimed at increased transparency of ownership of legal entities and arrangements (Recommendations 24 and 25); increased emphasis in AML/CFT requirements (including supervision) at the financial group level (Recommendations 18 and 26); enhanced responsibilities and powers for law enforcement (Recommendations 29, 30 and 31); and an expanded scope of international cooperation between authorities in different jurisdictions (Recommendations 36 through 40).

The FATF has announced that it is in the process of developing a revised Methodology that will be used in evaluating compliance with the 2012 Standards.⁴⁷⁶ The FATF has also announced that the new Methodology will entail a much greater emphasis on effectiveness. Thus, the FATF is not only revising the 2004 Methodology to be technically consistent with the Revised Standards, in order to assess for technical compliance with them, but is also developing an effectiveness component to

⁴⁷⁶ FATF, *Annual Report 2011-2012*, at 20 (Oct., 11 2012), available at <http://www.fatf-gafi.org/media/fatf/documents/process%20and%20procedures.pdf> (“The FATF is working closely with its delegations and other assessing bodies, including the IMF, the World Bank, and the FSRBs to develop the methodology for assessing the level of compliance with the new FATF Recommendations.”).

the Methodology.⁴⁷⁷ This will be a significant change from the 2004 Methodology, which was highly focused on technical compliance, and where effectiveness was considered only in more general terms.⁴⁷⁸ This will mark a substantial additional challenge for the FATF, as well as its members. Presumably, all will agree that effectiveness in preventing, detecting, disrupting, and prosecuting money laundering and terrorist financing activity is ultimately what jurisdictions should be striving for; however, it is certainly much more difficult to objectively determine the effectiveness of an AML/CFT regime, than to measure the extent to which countries have enacted a particular set of laws and regulations. The degree to which the FATF can be successful in this endeavor will only become evident through the next round of assessments, scheduled to begin late this year.⁴⁷⁹

⁴⁷⁷ See Bjørn S. Aamo, President, Fin. Action Task Force, FATF President's Speech at the Asia Pacific Group (APG) on Money Laundering 15th Annual Meeting (July 17, 2012), available at <http://www.fatf-gafi.org/documents/documents/fatfpresidentsspeechattheapganannualmeetingjuly2012.html> ("This new round of mutual evaluations will place a much stronger emphasis on the assessment of effective implementation of the revised FATF Standards, and not only technical compliance.").

⁴⁷⁸ See *2004 Methodology*, *supra* note 6, at 9.

⁴⁷⁹ See *Second Preparation for the Fourth Round*, *supra* note 27, at 4.

WORKING TOWARDS COMPLIANCE: ADDRESSING CHINESE EXPORT CREDIT PROGRAMS

*Sabrina Cotter**

INTRODUCTION

In 2011, the United States Export-Import Bank (the “United States Bank”) secured over 700 American jobs in Erie, Pennsylvania when it helped General Electric (“GE”) match a financing offer from the Chinese Export-Import Bank (the “Chinese Bank”).¹ At stake was a U.S.D. \$500 million contract to supply diesel-electric locomotives to Pakistan.² The Chinese Bank offered to finance the deal at below market rates – in breach of international standards – in order to give its exporter an advantage in the bidding process.³ Although the Pakistani government favored GE for the high quality of its merchandise, a deal of this magnitude is often decided not only by the price and quality of the goods, but by the terms of available financing.⁴

The United States Bank is usually not privy to the details of the Chinese Bank’s financing offers, making it time-consuming and difficult to ascertain the terms – and expensive to match them. This time, however, the United States Bank discovered the terms of the Chinese Bank financing package from the Pakistani government and matched it.⁵ By equalizing the financing offers, the United States Bank allowed GE to compete with foreign producers on a “level playing field” – where success is determined on the basis of the price and quality of the merchandise. This little-known function of the United States Bank is critical to the success of American

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¹ *Oversight and Reauthorization of the Export-Import Bank of the United States: Hearing Before the S. Comm. Banking, Housing, and Urban Affairs*, 112th Cong. 8 (2011) (statement of Fred P. Hochberg, President and Chairman, Exp.-Imp. Bank of the United States), available at http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=100f85f4-3c96-489b-8e4e-e6dcbec96838 [hereinafter *Oversight*].

² *Id.*

³ *Id.*

⁴ *Id.*

⁵ *Id.*

exporters competing for international contracts. Unfortunately, this outcome is difficult to achieve.

China's export credit regime poses a unique challenge to American export interests.⁶ The Chinese government offers trade finance packages that support the sale of Chinese goods at below capital-market rates.⁷ China's extensive government resources, coupled with its lack of transparency, have made it difficult for the United States Bank to compete with its Chinese counterpart for major international contracts.⁸ However, the Chinese market holds enormous opportunity for American businesses, and it will undoubtedly play a key role in the future of international commerce.⁹ The United States must determine the best legal mechanism to encourage China to comply with international trade standards, without triggering a retaliatory response that would jeopardize the expansion of American exports into China.

Export-Import Banks are government-backed agencies that help domestic exporters seize opportunities in international markets.¹⁰ The banks offer financing in the form of officially supported export credits.¹¹ Export credits are a form of subsidy in which the government assumes an exporter's risk of a foreign buyer's default.¹² Export credits come in the form of direct loans, guarantees, or insurance, and are typically used in medium to long-term financing situations in which traditional private financing is not available because of the high risk.¹³ The United States Bank strives to level the playing field for American exporters by matching the financing that other governments provide to their exporters.¹⁴ Most countries now have some form of Export Credit Agency that facilitates the export of that country's goods and services to other developing and

⁶ EXP.-IMP. BANK OF THE UNITED STATES, REPORT TO THE U.S. CONGRESS ON EXPORT CREDIT COMPETITION AND THE EXPORT-IMPORT BANK OF THE UNITED STATES, 108 (2011), available at http://www.exim.gov/about/library/reports/competitiveness-reports/upload/2010_Competitiveness_Report-1.pdf.

⁷ *Id.* at 108.

⁸ See *Oversight*, *supra* note 1, at 8.

⁹ See THE U.S.-CHINA BUS. COUNCIL, EXECUTIVE SUMMARY, SPECIAL REPORTS: US EXPORTS TO CHINA: 2000-2010, https://www.uschina.org/public/exports/2000_2010/2010-state-export-report-executive-summary.pdf (last visited Oct. 11, 2011).

¹⁰ Janet Koven Levit, *Bottom-Up International Law Making: Reflections on the New Haven School of International Law*, 32 YALE J. INT'L L. 393, 400 (2007).

¹¹ *Id.*

¹² *Id.*

¹³ *Id.* at 147.

¹⁴ *Id.* at 148, 158-59.

developed markets.¹⁵ Therefore, failure to provide the same services to American firms would put them at a comparative disadvantage when vying for foreign business.¹⁶

Theoretically, international trade promotes efficiency by allowing states to produce goods and services in which they have a comparative advantage, while importing those that are more cheaply developed elsewhere.¹⁷ In reality, exports are heavily influenced by political relationships between states, and each state must find an acceptable balance between protecting domestic industries and engaging with foreign markets.¹⁸ Economists disagree, however, on the appropriate level of government intervention in trade between states.¹⁹ Proponents of Export Credit Agencies claim that they provide a vital service by correcting market failures that prevent companies from exporting at the optimal level.²⁰ The most widely cited market failure is imperfect information regarding exporting opportunities, available financing, and export regulations.²¹ Advocates contend that a national government is in the unique position of having both the resources and the incentive to step in and correct this inefficiency.²²

Opponents of export credit programs argue that they are ineffective, inefficient, and damaging to private sector financing, specifically, and international free-trade efforts, generally.²³ These critics claim that the free market will optimize the level of exports and that export credits create market distortions that benefit select industries to the detriment of the economy as a whole.²⁴ In addition, economists worry that government funding of exports could lead to an international “race to the bottom” with states becoming entangled in “subsidy wars” that undermine the benefits of international trade.²⁵ In response to this legitimate concern, several international trade organizations have developed criteria governing the

¹⁵ *See Id.* at 158.

¹⁶ SHAYERAH ILIAS ET AL., CONG. RESEARCH SERV., R41929, BOOSTING U.S. EXPORTS: SELECTED ISSUES FOR CONGRESS 24 (2011).

¹⁷ *Id.* at 9.

¹⁸ *See Id.*

¹⁹ *Id.* at 27.

²⁰ *Id.* at 24.

²¹ *Id.*

²² ILIAS, *supra* note 16.

²³ *Id.* at 27.

²⁴ *Id.*

²⁵ *Id.*

terms and conditions of such lending.²⁶ Unfortunately, enforcement of the export credit criteria has been costly and uneven, especially in regards to developing countries, like China, that do not belong to the Organization for Economic Cooperation and Development (“OECD”).²⁷

Section one of this note examines United States-China trade history, compares the export credit programs of the two countries, and outlines the international legal framework for export credits. Section two analyzes the difference between the OECD Arrangement on Officially Supported Export Credits (“the Arrangement”) and the World Trade Organization (“WTO”) rules under the Agreement on Subsidies and Countervailing Measures (“ASCM”) and postulates that the OECD Arrangement provides the most effective legal framework for encouraging transparency and compliance in China’s export credit programs.

I. BACKGROUND

A. *History of United States-China Trade Relations*

The United States opened trade relations with China in 1980 through a bilateral trade agreement (the “1980 Agreement”).²⁸ Under the 1980 Agreement, the two countries agreed to afford each other “most-favored-nation treatment” and to establish “their trade relations on a non-discriminatory basis.”²⁹ The treaty also included an explicit agreement to “facilitate the availability of official export credits on the most favorable terms appropriate under the circumstances.”³⁰ However, certain provisions of the “Jackson-Vanik Amendment”³¹ of the Trade Act of 1974³² prohibited

²⁶ See WORLD TRADE ORGANIZATION, AGREEMENT ON SUBSIDIES AND COUNTERVAILING MEASURES, PART II: PROHIBITED SUBSIDIES, PART III: ACTIONABLE SUBSIDIES Art. 3-7 available at http://www.wto.org/english/docs_e/legal_e/24-scm_01_e.htm [hereinafter *ASCM*]; ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT (OECD), *THE ARRANGEMENT ON GUIDELINES FOR OFFICIALLY SUPPORTED EXPORT CREDITS: GENERAL PROVISIONS: STATUS*, 5, 25 TAD/PG(2011)13, 1 Sept. 2011, available at <http://www.oecd.org/officialdocuments/displaydocumentpdf?cote=tad/pg%282011%2913&doclanguage=en> [hereinafter *Arrangement*].

²⁷ See EXP-IMP BANK OF THE UNITED STATES, PREPARED REMARKS AT THE EXPORT-IMPORT BANK ANNUAL CONFERENCE (statement of Fred P. Hochberg, President and Chairman, Exp.-Imp. Bank of the United States) (2012), available at <http://www.exim.gov/newsandevents/events/speechesandtestimony/Ex-Im-Bank-president-Fred-Hochberg-speaks-at-Ex-Im-Bank-2012-annual-conference.cfm>.

²⁸ T.I.A.S. No. 9630, 31 U.S.T. 4651, 1980 WL 309100 (U.S. Treaty).

²⁹ *Id.*

³⁰ *Id.*

³¹ 19 U.S.C.A § 2432 (2006).

normalized trade relations with Marxist-Leninist countries, and as a result, trade relations with China had to be renewed annually through a Presidential waiver.³³ Congress could have overturned this annual waiver, leaving the status of the 1980 Agreement uncertain and putting stress on the relationship between the two countries.³⁴

Since that first agreement, the United States and China have entered into several agreements concerning questions of market access, intellectual property rights, and agricultural cooperation.³⁵ In 1999, China and the United States signed a new bilateral treaty in anticipation of China's accession to the WTO.³⁶ WTO accession procedure calls for bilateral negotiations between the applicant state and any concerned member state.³⁷ As part of the negotiations between the United States and China, the United States retained the right to treat China as a non-market economy for twelve years following its accession into the WTO.³⁸ As a result, the United States was allowed to "proclaim increased duties or other import restrictions" when Chinese imports were considered to be causing a "market disruption."³⁹ Then in 2000, the Permanent Normal Trade Relations for China Act (the "PNTR Act") amended the Trade Act of 1974 and rendered the Jackson-Vanik Amendment inapplicable to China.⁴⁰ While these steps helped to stabilize trade relations between the two countries, there remained an air of distrust and hostility.

The PNTR Act established various Congressional committees to monitor China's compliance with its trade as well as human rights commitments.⁴¹ These requirements are unique to China in United States trade legislation.⁴² When the United States signed bilateral trade agreements with the former Soviet bloc countries and even with the U.S.S.R. directly, it did not require the wide array of compliance

³² Trade Act of 1974, Pub. L. No. 93-618, 88 Stat. 1978 (1975) (codified as amended at 19 U.S.C.A. ch. 12).

³³ Leo Wise, *Trading with China*, 38 HARV. J. ON LEGIS. 567, 567 (2001); see Ex. Ord. No. 12167, Oct. 23, 1979, 44 F.R. 61167.

³⁴ Wise, *supra* note 33, at 568.

³⁵ 22 U.S.C.A. § 6901 (2000).

³⁶ Wise, *supra* note 33, at 571.

³⁷ WORLD TRADE ORGANIZATION, ACCESSIONS, http://www.wto.org/english/thewto_e/acc_e/acc_e.htm [hereinafter ACCESSIONS].

³⁸ Trade Act of 1974 §41, Pub. L. No. 93-618, 88 Stat. 1978 (1975) (codified as amended at 19 U.S.C.A. ch. 12).

³⁹ Pub. L. No. 106-286, § 103 October 10, 2000, 114 Stat 880.

⁴⁰ Wise, *supra* note 33, at 571.

⁴¹ *Id.* at 579.

⁴² *Id.*

monitoring programs utilized in the Chinese agreement.⁴³ These unusually stringent standards and restrictions further undermined trust and cooperation between the two countries. China's meteoric rise as an economic world power, coupled with its protectionist policies and export-driven economy, has added to the fears in the United States that China represents a threat to American interests.⁴⁴

Despite the political and economic tensions between the two countries, China is the third largest market for United States exports, behind Canada and Mexico.⁴⁵ In 2010, China imported U.S.D. \$91.9 billion of American goods.⁴⁶ Exports to China rose 32% in 2010 and have risen by at least 15% annually since 2000.⁴⁷ In fact, total American exports to China rose by 468% between 2000 and 2010, compared to a 55% increase in total American exports to the rest of the world.⁴⁸ Not only does China represent a consistent and expanding market for American exports, generally; it is also the third largest market for goods and services produced by American small businesses.⁴⁹ However, there is still significant room for growth in American exports to China. According to the U.S.-China Business Council, "the United States [is] only the fifth-largest source of imports" to China and the United States' share of imports has actually declined since 2000.⁵⁰

In response to the current recession, the Obama administration has made expansion of American exports a priority.⁵¹ In the 2010 National Export Initiative, the President outlined a strategy to boost the ailing United States economy by improving access to export financing, including export credits.⁵² The Administration cited the need to "create good high-paying jobs" through exports and vowed to help American companies increase exports to foreign markets.⁵³ Although the Chinese market is one of the fastest growing economies in the world, the United States has struggled to

⁴³ *Id.*

⁴⁴ See generally CRAIG K. ELWELL ET AL., CONG. RESEARCH SERV., RL33604, IS CHINA A THREAT TO THE U.S. ECONOMY? (2007).

⁴⁵ THE U.S.-CHINA BUS. COUNCIL, *supra* note 9.

⁴⁶ *Id.*

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ *Id.*

⁵⁰ *Id.*

⁵¹ See Exec. Order No. 13,534, 3 C.F.R. 198 (2011).

⁵² *Id.*

⁵³ *Id.*

gain access to its consumers.⁵⁴ In addition, the Chinese Bank provides trade finance packages to Chinese firms at below market rates, allowing Chinese competitors to outbid American firms for other international contracts.⁵⁵ In light of the contraction of economic opportunities at home, the United States has refocused on the necessity of improving and expanding trade relations with China.⁵⁶

In recent years, the United States has engaged with China to solve trade finance and other issues through the U.S.-China Strategic and Economic Dialogue (the “S&ED”).⁵⁷ The S&ED is the second generation of the Strategic Economic Dialogue, which was established in 2006 between former President George W. Bush and Chinese President Hu Jintao.⁵⁸ In 2009, President Obama and President Hu agreed to continue the long-term, high-level strategic discussions but split the program into two separate tracks – one strategic and one economic.⁵⁹ The economic track, run by the Secretary of the Treasury, focuses on financial and economic issues, including export finance.⁶⁰

Since President Obama assumed office, there have been four economic track sessions.⁶¹ These sessions have aimed to deepen bilateral cooperation and expand Chinese participation in international economic forums, as well as to encourage the continued reform of Chinese economic policies.⁶² Specifically, the May 2010 S&ED session produced a pledge to “[e]stablish a cooperative mechanism between the U.S. Export-Import Bank and the Export-Import Bank of China on trade finance, and to develop initiatives to promote exports by [small and medium sized firms].”⁶³ Two of the other pledges were to “[s]ign a cooperation protocol on small and medium sized firms (SMEs)” and to “[b]oost investment opportunities and transparency.”⁶⁴ Despite this language, China is not mentioned in the United States Bank’s strategic plan for 2010 through 2015, which was

⁵⁴ See THE U.S.-CHINA BUS. COUNCIL, *supra* note 9 (“America’s share of imports into China has fallen to 7 percent from 10 percent in 2000, making the United States only the fifth-largest source of imports there.”).

⁵⁵ See *Oversight*, *supra* note 1.

⁵⁶ See WAYNE M. MORRISON, CONG. RESEARCH SERV., RL33536, CHINA- U.S. TRADE ISSUES 43 (2012).

⁵⁷ *Id.*

⁵⁸ *Id.*

⁵⁹ *Id.*

⁶⁰ *Id.* at 43–44.

⁶¹ *Id.* at 43–45.

⁶² Morrison, *supra* note 56, at 43–44.

⁶³ *Id.* at 44.

⁶⁴ *Id.*

published by the Bank two months after these encouraging objectives were set in the S&ED.⁶⁵

The United States Bank's strategic plan outlines specific goals and objectives, the first of which is to "[e]xpand awareness of Ex-Im Bank services through focused business development and effective partnerships."⁶⁶ This goal asserts that the United States Bank must develop partnerships and identify strategic outreach areas in order to maximize job creation and growth.⁶⁷ One of the specific objectives highlighted under this overarching goal is to "[t]arget business development to countries with high potential for U.S. export growth."⁶⁸ The plan then identifies nine "focus countries" in which to concentrate outreach efforts.⁶⁹ The countries are selected based on the size of their export market for American firms, their projected growth and infrastructure needs, and the United States Bank's current penetration into their markets.⁷⁰ Despite meeting all of these criteria, China is not one of the nine countries identified.⁷¹

For the countries that are identified, including India, Brazil, and Vietnam, the plan indicates that the United States Bank should develop an outreach strategy that includes identifying targeted buyers in the public and private sectors, as well as areas where pre-approved credit facilities can be utilized to support SMEs.⁷² The strategic plan strives to "create an integrated business development function to manage activity and outcome-based measures in [the target countries]" and to "[a]lign senior bank officials' outreach with these high-priority countries."⁷³

Given that China faces a looming threat of WTO action from the European Union or the United States for its expansive export subsidy program, the S&ED offers an alternative forum for China to accede to international standards before being faced with expensive litigation.⁷⁴ The

⁶⁵ See EXP-IMP BANK OF THE UNITED STATES, EX-IM BANK STRATEGIC PLAN 2010-2015, 11 (2010), available at http://www.exim.gov/about/library/reports/otherreports/upload/ExImBankStrategicPlan2010_15-1.pdf [hereinafter *Strategic Plan*].

⁶⁶ *Id.* at 11.

⁶⁷ *Id.*

⁶⁸ *Id.* at 12.

⁶⁹ *Id.*

⁷⁰ *Id.*

⁷¹ *Strategic Plan*, *supra* note 65, at 12.

⁷² *Id.*

⁷³ *Id.*

⁷⁴ INSIDE U.S. TRADE'S WORLD TRADE ONLINE, CHINESE EXPORT FINANCING UNDER SCRUTINY AT S&ED: TREASURY OFFICIAL, (May 5, 2011) <http://insidetrade.com/Inside-US-Trade/Inside-U.S.-Trade-05/06/2011/chinese-export-financing-under-scrutiny-at-saamped-treasury-official/menu-id-710.html>.

S&ED meetings are generally comprised of the top fifteen to twenty agency heads from each country, striving to address the long-term and over-arching challenges that confront both sides.⁷⁵ While this forum provides an invaluable opportunity to build partnership and understanding between the United States and China, its centralized and high-level structure may not be the best way to affect the United States' goals of achieving greater market access and collaboration on the ground level.

B. *Export-Import Bank Programs in the United States and China*

The Export-Import Bank of the United States was created by executive order in 1934 “in an effort to stimulate the economy” through exports in the face of the Great Depression.⁷⁶ The Export-Import Bank Act of 1945 eventually established the United States Bank as a United States government corporation and outlined the law that still largely governs the United States Bank's activities.⁷⁷ As a government corporation, the United States Bank's existence is contingent on its periodic reauthorization, which must clear the Senate Committee on Banking, Housing, and Urban Affairs, be passed by both houses of Congress, and be signed into law by the President.⁷⁸ A Board of Directors appointed by the President manages the Bank.⁷⁹

The United States Bank offers several financial instruments that contribute to its mission of “turn[ing] export opportunities into real sales that help to maintain and create U.S. jobs and contribute to a stronger national economy.”⁸⁰ The primary products offered include direct loans, working capital and loan guarantees, and commercial and political risk insurance.⁸¹ The Bank can extend these tools directly to foreign buyers of American goods, or to private lenders who would not be willing to finance risky export ventures without the backing of the United States Bank.⁸² United States Bank products are backed by the full faith and credit of the

⁷⁵ MORRISON, *supra* note 56, at 43.

⁷⁶ David Brack Bryant, *The Export-Import Bank: It's History, Function, and the Reauthorization Act's Impact on the United States and Latin America*, 9 LAW & BUS. REV. AM. 743, 744 (2003).

⁷⁷ *Id.*

⁷⁸ *Id.*

⁷⁹ *Id.* at 745.

⁸⁰ EXP.-IMP. BANK OF THE UNITED STATES, ABOUT US: WHO WE ARE, <http://.exim.gov/about/whoweare> (last visited October 18, 2012).

⁸¹ Bryant, *supra* note 76, at 746–47.

⁸² Janet Koven Levit, *The Dynamics of International Trade Finance Regulation: The Arrangement on Officially Supported Export Credits*, 45 HARV. INT'L L.J. 65, 73 (2004).

United States government, which allows private lenders to offset their exposure to the export transaction against the United States Bank guarantee.⁸³ Therefore, the lenders are able to provide financing that would have otherwise been unavailable to an aspiring American exporter.⁸⁴ However, United States Bank financing is not available for all potential export transactions.

In order for a transaction to be granted financing assistance from the United States Bank, the product, producer, buyer, and the structure of the deal must all meet the specific criteria of the Bank.⁸⁵ The United States Bank is only permitted to fund the export of goods or services that meet the required threshold of content made in the United States.⁸⁶ In addition, because the United States Bank is not permitted to compete with private sources of financing, it “operates in a narrow band, creating additional exports that are not attractive financing candidates in the private sector but nonetheless offer the United States government a ‘reasonable assurance of repayment.’”⁸⁷ Potential projects are subject to restrictions based on the type of product, the identity of the purchaser, and the possible uses for the good or service.⁸⁸ The Bank must also consider whether there might be adverse impacts on human rights, American jobs, and a host of other political considerations.⁸⁹

In comparison, the Chinese export finance system has significantly fewer restrictions and exponentially deeper pockets. China’s export financing infrastructure consists of three main institutions: Sinosure, the China Development Bank, and the Chinese Export-Import Bank.⁹⁰ Sinosure provides short, medium, and long-term export credit and foreign investment insurance.⁹¹ Sinosure also offers direct lines of credit and comprehensive support to companies in strategic industries, such as telecommunications and photovoltaics.⁹² Neither the United States, nor any other G7 country, offers such a program.⁹³ The China Development Bank also supports

⁸³ *Id.* at 72–73.

⁸⁴ *Id.* at 73–74.

⁸⁵ *Id.* at 74.

⁸⁶ *Id.*

⁸⁷ *Id.* at 73–74 (quoting 12 U.S.C.A. § 635(b)(1)(B) (West 2012)).

⁸⁸ Levit, *supra* note 82 at 74.

⁸⁹ *Id.*

⁹⁰ EXP.-IMP. BANK, *supra* note 6, at 108.

⁹¹ *Id.* at 111.

⁹² *Id.* at 111–12.

⁹³ *Id.* at 112.

strategic industries with direct loans.⁹⁴ In 2010, the Development Bank issued over \$112 billion in foreign loans to Chinese companies doing business overseas.⁹⁵ For the purposes of this note, I will focus on the Chinese Bank programs, which are closely analogous to United States Bank export credit programs.

The Chinese Bank provides concessional loans, lines of credit, and guarantees.⁹⁶ The Concessional Loan Program is loosely comparable to the concept of “official development assistance,” which provides loans containing at least a 25% grant to developing countries for “anti-poverty” projects.⁹⁷ However, the Chinese Bank is believed to provide these loans for projects not directly tied to development initiatives, at terms as low as 1-2% interest with a twenty to thirty year repayment schedule.⁹⁸ Generally, international standards require repayment schedules of twenty years or less at Commercial Interest Reference Rates (CIRR).⁹⁹ In addition, the concessional loans are given as a form of “tied aid,” which requires that the recipient country use the funds to purchase Chinese goods.¹⁰⁰ Tied aid is a prohibited practice according to international standards, except for loans made to least-developed countries.¹⁰¹ Although there are no official figures published on the volume of China’s tied aid loans, annual volume is estimated to be in the billions of dollars.¹⁰² China is not a member of the OECD and is therefore not bound by the terms of the Arrangement.¹⁰³ Since the United States is a participant in the Arrangement, it abides by the various restrictions that the Arrangement outlines regarding terms of repayment, interest rates, and restrictions on concessional lending.¹⁰⁴

The Chinese Bank also extends individual lines of credit to Chinese companies in order to finance the export of Chinese goods and services to complete projects in foreign countries.¹⁰⁵ A single line of credit under this program has been known to exceed \$1 billion, and the total volume of these

⁹⁴ *Id.*

⁹⁵ *Id.*

⁹⁶ EXP.-IMP. BANK, *supra* note 6, at 108–110.

⁹⁷ *Id.* at 110.

⁹⁸ *Id.*

⁹⁹ *Id.* at 109–13

¹⁰⁰ *Id.* at 108.

¹⁰¹ *Id.*

¹⁰² EXP.-IMP. BANK, *supra* note 6, at 109.

¹⁰³ *Id.* at 108.

¹⁰⁴ 12 U.S.C.A. § 635 (2006).

¹⁰⁵ EXP.-IMP. BANK, *supra* note 6, at 109.

loans in 2010 is believed to have been over \$30 billion.¹⁰⁶ In addition to the tied aid and general industry funding programs, the Chinese Bank provides about \$3-5 billion annually in financing for specific export transactions,¹⁰⁷ such as the Pakistan locomotive project discussed in the introduction to this note.

In these transactions, the Chinese Bank competes directly with the United States Bank to facilitate its exporter's competitiveness in international markets. Unfortunately, the United States Bank is regularly unable to match financing packages offered by China Bank, which provides more favorable terms than international standards allow.¹⁰⁸ The United States Bank protests that Chinese subsidies distort the export market and unfairly disadvantage United States exporters by preventing competition based on the quality and price of exported goods.¹⁰⁹ The United States government contends that China's extensive program of export support is in violation of WTO regulations on export subsidies and international standards established by the OECD.¹¹⁰ In aggregate, the Chinese export credit programs are estimated to total over \$100 billion a year.¹¹¹

C. *The International Framework for Export-Import Banks Generally*

During the 1960s, the export credit system began to drag states into a costly and inefficient subsidy war.¹¹² States were competing for export market share by offering below market interest rates and financing packages through their export credit agencies.¹¹³ Each state fought to make its own exports the most attractive, resulting in rising government costs and severe market distortions.¹¹⁴ When the oil crisis took hold in the early 1970s, it made the export financing battle prohibitively expensive and prompted the beginning of international cooperation to set standards for export credit programs.¹¹⁵ Finance ministers from major exporting countries first discussed an agreement in 1973, and in 1976, member countries of OECD

¹⁰⁶ *Id.*

¹⁰⁷ *Id.* at 109–10.

¹⁰⁸ *Id.* at 110, 112–13.

¹⁰⁹ *See generally Id.* at 110–17.

¹¹⁰ *Id.* at 110.

¹¹¹ EXP.-IMP. BANK, *supra* note 6, at 113.

¹¹² Levit, *supra* note 82, at 66.

¹¹³ *Id.*

¹¹⁴ *Id.* at 75–76.

¹¹⁵ *Id.*

formed the “Consensus on Converging Export Credit Policies.”¹¹⁶ In 1978, this agreement matured into the Arrangement on Guidelines for Officially Supported Export Credits (the “Arrangement”).¹¹⁷

The goal of the Arrangement is to “facilitate fair, efficient and transparent competition among OECD members and other partners.”¹¹⁸ Essentially, the Arrangement is meant to “level the playing field” by preventing competition between export credit agencies so that the exporters themselves can compete fairly on the basis of the price and quality of their goods.¹¹⁹ Although the Arrangement is not legally binding, it nevertheless enjoys widespread compliance from OECD member countries.¹²⁰

On its website, the OECD describes the Arrangement as a “‘gentlemen’s agreement’ under which governments negotiate, monitor, and review the rules, conditions, and changing market realities that impact the use of state financing in trade.”¹²¹ However, because the Arrangement is administered through the OECD, pressure to comply with the terms of the Arrangement generally extends only as far as the OECD’s 34 member countries.¹²²

Unfortunately, this excludes some major emerging economies that have become significant players in the export market, such as India and China.¹²³ In 2010, at the OECD’s 50th anniversary celebration, the Secretary General recognized that “our next major objective must be extending existing co-operation to the emerging economies, which represent a new and important group of global export competitors.”¹²⁴

Although the major developing countries are not participants in the Arrangement, they are still subjected to Arrangement terms indirectly through their membership in the WTO. The ASCM separates subsidies into two classes: prohibited subsidies, which are conditioned upon export performance or local content requirements; and actionable subsidies, which

¹¹⁶ *Id.* at 76.

¹¹⁷ *Id.*

¹¹⁸ *Trade, supra* note 27.

¹¹⁹ *See Levit, supra* note 82, at 77.

¹²⁰ *Id.* at 77, 88–91.

¹²¹ *Trade, supra* note 27.

¹²² ORGANISATION FOR ECONOMIC COOPERATION AND DEVELOPMENT (OECD), MEMBERS AND PARTNERS, <http://www.oecd.org/about/membersandpartners/> (last visited October 18, 2012).

¹²³ *Id.*

¹²⁴ *Trade, supra* note 27.

includes all other kinds of subsidies.¹²⁵ Actionable subsidies require a showing of adverse effects on the domestic market of a member country, impairment of benefits, or serious prejudice.¹²⁶ Prohibited subsidies are considered per se actionable and only require evidence that the prohibited subsidy exists.¹²⁷

Export credits, export credit guarantees, and export insurance programs are all prohibited subsidies, unless they are provided at premium rates that are sufficient to cover the cost of administering them.¹²⁸ Export credits are also illegal if “they are used to secure a material advantage in the field of export credit terms.”¹²⁹ However, the ASCM pulls directly from the Arrangement to create a safe-haven for the use of export credits under certain terms and conditions.¹³⁰ The ASCM provides that any export credit issued within the interest rate provisions proscribed by the Arrangement will not be considered a prohibited subsidy.¹³¹ A credit that offers more favorable rates than the OECD minimum would therefore be illegal and challengeable in the WTO Dispute Settlement Body (“DSB”).¹³²

The allusion to the Arrangement in the ASCM has been interpreted by WTO Panels as “evolutionary” in nature – meaning the current version’s Arrangement rates are incorporated into WTO law.¹³³ Therefore, although only OECD Participants can update the Arrangement, changes to the Arrangement’s interest provisions would be binding on all WTO members.¹³⁴ Brazil has challenged this setup as procedurally flawed because the ASCM could essentially be altered without the necessary

¹²⁵ Petros C. Mavroidis, Patrick A. Messerlin & Jasper M. Wauters, *THE LAW AND ECONOMICS OF CONTINGENT PROTECTION IN THE WTO*, 400–01 (Alan O. Sykes et al. eds., 2008).

¹²⁶ *Id.* at 401.

¹²⁷ *Id.*

¹²⁸ WORLD TRADE ORGANIZATION, TREATMENT OF GOVERNMENT SUPPORT FOR EXPORT CREDITS AND GUARANTEES UNDER THE AGREEMENT ON SUBSIDIES AND COUNTERVAILING MEASURES, TN/RL/GEN/66, 11 Oct. 2005 available at https://docs.wto.org/dol2fe/Pages/FE_Search/FE_S_S009-1.aspx?language=E&CatalogueIdList=74984&CurrentCatalogueIdIndex=0&FullTextSearch=.

¹²⁹ ASCM, *supra* note 26, at Annex I.

¹³⁰ WORLD TRADE ORGANIZATION, *supra* note 128.

¹³¹ *Id.*

¹³² See ASCM, *supra* note 26 (WTO Subsidies and Countervailing Measures Agreement, PART II: PROHIBITED SUBSIDIES, Art. 3–7, at Art. 4).

¹³³ WORLD TRADE ORGANIZATION, *supra* note 128.

¹³⁴ WORLD TRADE ORGANIZATION, EXPORT CREDITS IN THE WTO, TN/RL/W/5, 26 Apr. 2002, available at https://docs.wto.org/dol2fe/Pages/FE_Search/FE_S_S009-1.aspx?language=E&CatalogueIdList=40749,2597&CurrentCatalogueIdIndex=0&FullTextSearch=.

consensus of members.¹³⁵ Brazil advocated an amendment that would tie the ASCM to the interest rate provisions in the Arrangement as they were at the end of the Uruguay Round.¹³⁶ However, no such change has been implemented.¹³⁷

In the event that a WTO member believes that another member is supporting a prohibited subsidy, the complaining member can request consultations with the offending country.¹³⁸ A request for consultations must include a statement of evidence regarding the nature and existence of the challenged subsidy.¹³⁹

II. ANALYSIS

Two major bodies of law shape the international system of export credit regulation: the ASCM and the Arrangement.¹⁴⁰ While the Arrangement is considered non-binding “soft law,” its interest rate provisions have been codified into public international law through the safe-haven provision of the ASCM.¹⁴¹ The ASCM is considered “hard law” and is binding on the actions of member countries, with violations resulting in punitive enforcement action against the perpetrator.¹⁴²

Realistically, all public international law is to some degree soft because there is no direct enforcement mechanism at work to demand compliance.¹⁴³ Any enforcement procedure ultimately relies on the cooperation of sovereign nations to comply with a ruling or take action against a non-compliant member. However, the differences between the two systems may prove instructive on eliciting Chinese compliance. Since the Arrangement is considered soft law, it anticipates, and therefore guards against, the natural inclination of participants to shirk the agreement when it proves inconvenient.¹⁴⁴

While the Arrangement and the ASCM strive to achieve the same results, there are several instructive differences between the two systems. Divergences in accession, rule-making, and enforcement procedures

¹³⁵ WORLD TRADE ORGANIZATION, *supra* note 128.

¹³⁶ WORLD TRADE ORGANIZATION, *supra* note 134.

¹³⁷ WORLD TRADE ORGANIZATION, *supra* note 128.

¹³⁸ ASCM, *supra* note 26, at Art. 4.1.

¹³⁹ *Id.* at Art. 4.2.

¹⁴⁰ *See* Levit, *supra* note 83, at 119–21.

¹⁴¹ *Id.* at 115–16, 119–21.

¹⁴² *Id.* at 120–21.

¹⁴³ *Id.* at 115–116.

¹⁴⁴ *Id.* at 115–18.

elucidate the effects of subtle variations in compliance mechanisms in international trade law. Although shortcomings in international law are often blamed on the absence of strong commitments and substantial enforcement mechanisms, the juxtaposition of these two systems shows that a soft approach might achieve a greater degree of compliance from emerging economies, such as China.

A. *The Arrangement's Undefined Legal Status Provides Reputational Capital with Minimal Legal Risk*

The Arrangement offers China a forum to build trust and transparency in the realm of international trade finance. The legally ambiguous form of the Arrangement provides reputational capital with very little legal risk. Given China's reticence to taking a leadership position in international regulatory matters, the Arrangement's fluid structure would most likely be an attractive option. Considering that over half of all trade subsidy challenges globally are levied against Chinese products,¹⁴⁵ it is in the government's immediate and long-term interest to cultivate international goodwill in order to minimize litigation costs. China's participation would also benefit the United States, as China would be drawn into substantive discussions that would help shape the future of export credit regulation. Presumably, if China were integrally involved in developing regulations, they would be more inclined to adhere to them. The Arrangement's low barriers and vague legal status encourage an important first step toward compliance – substantive engagement in the regulatory process.

The Arrangement does not require a lengthy and complex accession process.¹⁴⁶ Countries may join the Arrangement simply by applying its guidelines and then receiving an invitation from existing participants to become a member.¹⁴⁷ Countries may also participate in Arrangement discussions as observing members, as China currently does under the Aircraft Sector Understanding.¹⁴⁸ Participants may also withdraw at any time by providing notice to the other Participants.¹⁴⁹ In contrast, accession

¹⁴⁵ Ding Qingfen, *US Finding Bodes Ill For China's Exporters*, CHINA DAILY, Oct. 29, 2011, http://www.chinadaily.com.cn/usa/business/2011-10/29/content_13999737.htm.

¹⁴⁶ *Arrangement*, *supra* note 26, at 5 (Current participants can invite other OECD members and non-members to become participants).

¹⁴⁷ *Id.* at 9.

¹⁴⁸ ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, AIRCRAFT SECTOR UNDERSTANDING: SIGNING CEREMONY REMARKS BY ANGEL GURRIA, 25 Feb. 2011, http://www.oecd.org/document/18/0,3746,en_21571361_44315115_47211602_1_1_1_1,00.html.

¹⁴⁹ *Arrangement*, *supra* note 26, at 7.

to the WTO requires extensive hearings and negotiations to address the concerns of each member state.¹⁵⁰ The applicant's membership is only granted when concerned states have worked out individualized bi-lateral agreements with the applicant and every member state assents.¹⁵¹

Although it seems counterintuitive, a less demanding legal structure may produce better compliance results from China than the regimented ASCM structure. The Arrangement's regime is based on positive reinforcement and the benefits to participants are significant. For example, China would be able to help shape the direction of future export finance regulations because rules are promulgated based on the unanimous consensus of participants.¹⁵² As a participant, China would be able to prevent the formulation of new standards that would be too costly or detrimental to its emerging economy. Instances, and therefore costs, of future litigation may also decline as a result of this rule-making power.

Another benefit of the Arrangement's flexible structure is its use of a notification and matching procedure in lieu of formal litigation.¹⁵³ Although the Arrangement does import a sanction-based mechanism through its association with the ASCM,¹⁵⁴ China is already exposed to the ASCM system through its WTO membership. Therefore, China would not expose itself to an additional adjudicatory system by participating in the Arrangement. In addition, if China joined the Arrangement and determined that the costs of transparency were too high, it could simply withdraw from the Arrangement and, because of its soft law form, suffer only reputational repercussions.¹⁵⁵

Despite the indefinite legal status of the Arrangement, its reputational bonds are quite strong. Not only does the small, relatively constant representation provide a "club like" atmosphere of mutual trust and respect, it also greatly compounds reputational repercussions from non-compliance.¹⁵⁶ In contrast to the WTO, which has 153 member states,¹⁵⁷ the Arrangement has only nine participants (counting the European Union as one).¹⁵⁸ This small group consists exclusively of major players in the

¹⁵⁰ See *ACCESSIONS*, *supra* note 37.

¹⁵¹ *Id.*

¹⁵² Levit, *supra* note 82, at 109.

¹⁵³ *Arrangement*, *supra* note 26, at 10.

¹⁵⁴ ASCM, *supra* note 26, at Annex I (k).

¹⁵⁵ *Arrangement*, *supra* note 26, at 7.

¹⁵⁶ Levit, *supra* note 82, at 107–08.

¹⁵⁷ WORLD TRADE ORGANIZATION, MEMBERS AND OBSERVERS, http://www.wto.org/english/thewto_e/whatis_e/tif_e/org6_e.htm (last updated 24 August 2012).

¹⁵⁸ *Arrangement*, *supra* note 26, at 5.

export finance market, which results in focused debate and meaningful progress on export finance issues. Representatives to the WTO are general ambassadors charged with pursuing a wide array of trade-related initiatives.¹⁵⁹ In comparison, representatives to the Arrangement are usually lifetime bureaucrats from each country's export credit agency.¹⁶⁰ These representatives have direct responsibility for the export credit programs and policies in their own countries, including responsibility for negotiating and implementing the agreed upon standard.¹⁶¹

B. *The Arrangement Encourages Ex-Ante Resolution of Conflicts Instead of Ex-Post Litigation*

The Arrangement's soft law flexibility could be a useful tool for China as it works to liberalize and balance its economy. As the former Chinese ambassador to the WTO noted, "new challenges are rising for Chinese exports" as a result of the global recession.¹⁶² Contracted global demand and increased litigation against Chinese export programs have slowed China's export driven economy.¹⁶³ In response to the recent intensification of international scrutiny, the Chinese government has pledged to expand imports in order to balance trade and mollify competitors.¹⁶⁴

Similar to the conditions that gave birth to the Arrangement, the current economic recession seems to have highlighted the dangers of an overly export reliant economy and illuminated the benefits of minimizing costly disputes. Although China still enjoys a significant trade surplus, trade remedy cases have hurt Chinese exports and are expensive to defend.¹⁶⁵ It is unrealistic to assume that trade disputes between the United States and China would dissipate if China were to join the Arrangement. However, the dispute resolution mechanisms available under the

¹⁵⁹ See AMBASSADOR MICHAEL PUNKE, DEPUTY USTR, OFFICE OF THE UNITED STATES TRADE REPRESENTATIVE, <http://www.ustr.gov/about-us/biographies-key-officials/ambassador-michael-punke-deputy-ustr>.

¹⁶⁰ Levit, *supra* note 83, at 108–09.

¹⁶¹ *Id.*

¹⁶² Qingfen, *supra* note 145.

¹⁶³ *Id.*

¹⁶⁴ WORLD TRADE ORGANIZATION, *TRADE POLICY REVIEW REPORT BY THE SECRETARIAT: CHINA*, WT/TPR/S/230/Rev.1, 5 July 2010, available at https://docs.wto.org/dol2fe/Pages/FE_Search/FE_S_S0091.aspx?language=E&CatalogueIdList=105258&CurrentCatalogueIdIndex=0&FullTextSearch=.

¹⁶⁵ Qingfen, *supra* note 145.

Arrangement would provide an alternative forum to solve disagreements before final financing deals are reached.

One such mechanism is the enquiry system.¹⁶⁶ The enquiry system allows participants to ask other participants for the most favorable terms that they would be willing to support for any given project.¹⁶⁷ Enquiries must include the anticipated offer of the enquirer and a list of the addressees on the enquiry.¹⁶⁸ Copies of all documentation surrounding enquiries must also be sent to the Secretariat in the interest of transparency.¹⁶⁹ This system permits Participants to ascertain the competing financing offers and effectively “level the playing field” on any given deal.

The Arrangement also provides for unilateral derogation from the terms of the Arrangement, as long as the derogating party provides notice to the other Participants ahead of time.¹⁷⁰ This notice-and-match function provides countries the flexibility to deviate from Arrangement rules while preserving the spirit of fair play. When a country notifies the Participants of its intention to deviate from the Arrangement, the other Participants are given the opportunity to match the deviant offer.¹⁷¹ As long as notification protocol is met, any such deviation is not considered a violation of the Arrangement.¹⁷²

Additionally, if the United States had reasonable grounds to believe that China continued to offer export credit terms outside of the scope of the Arrangement without proper notification, it could inform the Secretariat and request Special Consultations.¹⁷³ This procedure would require China to clarify the terms of its financing offer and, if disagreement persists, to convene a Participant meeting to discuss the terms.¹⁷⁴

Another option would be to create a Common Line, which would allow the United States and China to establish a recognized and legitimate exception to Arrangement rules.¹⁷⁵ The Arrangement defines a common line as follows:

¹⁶⁶ *Arrangement*, *supra* note 26, at 29.

¹⁶⁷ *Id.*

¹⁶⁸ *Id.*

¹⁶⁹ *Id.*

¹⁷⁰ *Id.* at 26.

¹⁷¹ *Id.* at 25.

¹⁷² Levit, *supra* note 82, at 113.

¹⁷³ *Arrangement*, *supra* note 26, at 26.

¹⁷⁴ *Id.*

¹⁷⁵ *Id.* at 30–31.

[A]n understanding between the Participants to agree, for a given transaction or in special circumstances, on specific financial terms and conditions for official support. The rules of an agreed Common Line supersede the rules of the Arrangement only for the transaction or in the circumstances specified in the Common Line.¹⁷⁶

The Common Line mechanism allows deviations from Arrangement provisions where the issue is reoccurring or falls outside the scope of Arrangement procedures. The goal of these flexible remediation options is to resolve export credit disputes prior to closing a financing deal. These processes foster trust and transparency and lower transactional costs by avoiding ex-post litigation.

C. *Extent of Current Engagement with China on Export Issues*

So far, the United States government has elected to employ a highly centralized carrot-and-stick approach to guide China toward opening its markets and reducing its government subsidies for exports. The largest stick in the United States arsenal for combating China's unfair trade practices is the WTO. Since China became a member of the WTO in 2001, it is bound by WTO regulations regarding export subsidies, even though it is not a member of the OECD arrangement from which the bulk of the WTO regulations are derived. Some American groups have advocated for the government to file a WTO challenge regarding China's excessive export subsidies.¹⁷⁷ Proponents of this course of action cite the documented and "egregious" violations of international rules and call for a more hard-lined stance to protect American jobs and industry.¹⁷⁸

The WTO system has proven to be a useful tool for the airing of United States grievances regarding Chinese trade practices, and the United States has enjoyed some recent success in the battle to eliminate China's illegal trade subsidies.¹⁷⁹ For example, in June 2011, the Obama

¹⁷⁶ *Id.* at Annex XI (b).

¹⁷⁷ Inside U.S. Trade's World Trade Online, *AFL- CIO Calls for WTO Challenge of Chinese Export Credit Practices*, China Update, CHINATRADEEXTRA.COM (May 26, 2011), available at <http://insidetrade.com/Inside-US-Trade/Inside-U.S.-Trade-05/27/2011/china-update/menu-id-710.html>.

¹⁷⁸ *Id.*

¹⁷⁹ OFFICE OF THE UNITED STATES TRADE REPRESENTATIVE, CHINA ENDS WIND POWER EQUIPMENT SUBSIDIES CHALLENGED BY THE UNITED STATES IN WTO DISPUTE, (June 2011), available at <http://www.ustr.gov/about-us/press-office/press-releases/2011/june/china-ends-wind-power-equipment-subsidies-challenged>.

Administration challenged a Chinese program that supplied several hundred million dollars in grants to encourage Chinese wind turbine manufacturers to purchase domestic parts instead of importing them.¹⁸⁰ Subsidies that support the use of domestic instead of imported materials are prohibited by WTO rules and could result in trade retaliation measures if not eliminated within a reasonable amount of time following a dispute settlement decision.¹⁸¹ China agreed to abolish the grant program after formal WTO consultations with the United States and before a dispute settlement panel was established.¹⁸² In all three challenges that the United States has brought against China for export subsidy violations, China has voluntarily ended the challenged program before an official dispute settlement case was launched.¹⁸³

While the three-for-three record on export subsidy challenges at the WTO is impressive, it is not necessarily the best or most effective way to combat China's extensive export subsidy regime. Although the WTO provides a forum to confront and eliminate individual policies, it is a time consuming and expensive process to bring a case to dispute settlement at the WTO. Before the U.S. can pressure China to dismantle a prohibited subsidy program through WTO consultations, it must first collect information and evidence about the subsidy in question.¹⁸⁴ Since China's export credit programs are not transparent, the United States has to expend enormous amounts of time and energy to collect the necessary information.¹⁸⁵ Without substantial evidence demonstrating that an export credit constitutes a prohibited subsidy, a WTO challenge can languish at the consultation stage for years without progressing to a dispute settlement action and resolution.¹⁸⁶

Due to the extensive nature of the Chinese export financing system, the elimination of a single grant program or loan fund is unlikely to have a

¹⁸⁰ *Id.*

¹⁸¹ WORLD TRADE ORGANIZATION, UNDERSTANDING ON RULES AND PROCEDURES GOVERNING THE SETTLEMENT OF DISPUTES, art. 22.1, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 2, Legal Instruments https://docs.wto.org/dol2fe/Pages/FE_Search/FE_S_S009-1.aspx?Language=E&catalogueidlist=63650,65701¤tcatalogueidindex=0&fulltextsearch=

¹⁸² OFFICE OF THE UNITED STATES TRADE REPRESENTATIVE, *supra* note 179.

¹⁸³ *Id.*

¹⁸⁴ ASCM, *supra* note 26, at Art. 4.1.

¹⁸⁵ OFFICE OF THE UNITED STATES TRADE REPRESENTATIVE, *supra* note 179.

¹⁸⁶ *See* WORLD TRADE ORGANIZATION, CHINA – GRANTS, LOANS AND OTHER INCENTIVES, DISPUTE DS387, 19 Dec. 2008 *available at* http://www.wto.org/english/tratop_e/dispu_e/cases_e/ds387_e.htm.

profound effect on the overall playing field.¹⁸⁷ In comparison, the Arrangement includes an information sharing provision that, if applied to China, would improve the United States Bank's ability to compete with – and to some extent control – the terms offered by the Chinese Bank. Under the Arrangement, Participants are required to inform other Participants of the terms and conditions of any offered export credit package.¹⁸⁸ Participants must also share information with non-Participants on a reciprocal basis.¹⁸⁹ In the short term, China may be made vulnerable to DSB proceedings at the WTO as a result of the Arrangement's extensive notification and information sharing provisions. Shared data concerning China's offered export credits could be used against it in WTO proceedings if the credit terms fell below ASCM standards. However, the Arrangement offers several built-in alternatives to DSB proceedings that would hopefully allow China to negotiate more suitable ex-ante solutions, thereby reducing their exposure to litigation at the WTO. This would force transparency into the Chinese export credit regime and eliminate much of the current excessive cost of bringing an enforcement action at the WTO. In addition, the prospect of having to disclose export credit deal terms should accelerate China's transition away from use of prohibited subsidies in general – a transition that, according to WTO rules, should have been completed by 2008.¹⁹⁰

Unfortunately, the WTO's adoption of the Arrangement's notification and information sharing provisions is extremely unlikely in the near future. Any modification to ASCM language would have to be made by a consensus of WTO Members. Although the nine members that are currently participants to the Arrangement would likely support such a change, it is unlikely that all members, and especially developing countries, would support the alteration. As a result, hopes have instead hinged on convincing China to become a participant in the Arrangement, thus voluntarily and unilaterally exposing itself to the notification and information provisions.¹⁹¹ Although the Arrangement does not include an enforcement mechanism grounded in public international law, Arrangement rules allow for the matching of below-market terms offered by another country.

¹⁸⁷ *See Id.*

¹⁸⁸ *Arrangement, supra* note 26, at 5.

¹⁸⁹ *Id.*

¹⁹⁰ ASCM, *supra* note 26, at Art. 29.2.

¹⁹¹ Levit, *supra* note 83, at 111–12.

Any increase in transparency that could be achieved through increased Chinese participation in Arrangement procedures would enable the United States to more easily identify and match Chinese credit offers.

CONCLUSION

Although China and the United States have a complicated and tumultuous trade history, the two countries must cooperate to confront the looming challenges of international trade finance. In order to coax China into a more open and accountable application of export credit programs, the United States must use a combination of challenges under the WTO ASCM, high level cooperation through the S&ED, and increased information sharing through OECD Arrangement notification procedures. In order to create a more substantive impact on the trade relationship, the United States must convince China that it is in its interest to reform its current system, increase imports, promote competition, and respect the internationally established rules of trade finance. The legal framework for improving competitiveness and transparency already exists in the Arrangement. The challenge will be making the terms of that framework acceptable to developing countries without sacrificing the benefits and integrity of the system.

CLASSIFICATION WARS: THE UNITED STATES COURT OF INTERNATIONAL
TRADE AND THE EXPANDING TARIFF CLASSIFICATION MANDATE

*Justin Du Mouchel**

INTRODUCTION

The division of labor in tariff classification involving the Harmonized Tariff Schedule of the United States (HTS)¹ seems to be in flux, shifting gradually from agencies to courts. In the landmark case of *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*,² the Supreme Court shaped the contours of administrative law by requiring deference to agency regulations as long as they reflect a permissible construction of a statute.³ With its opinion in *United States v. Mead Corp.*,⁴ the Supreme Court made it clear that the *Skidmore v. Swift & Co.*⁵ standard, that a ruling is only controlling if it is persuasive, applied to Customs and Border Protection (Customs) tariff classification rulings.⁶ However, under *United States v. A. Johnson & Co.*,⁷ an importer has a dual burden of proving that its proposed tariff classification is correct while also disproving the government's classification.⁸ Congress should consider enacting a statute to use in close cases, when Customs' heading argument is acceptable but not necessarily

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¹ 19 U.S.C. § 1202 (2006). The HTS can be obtained as a download at the website for the U.S. International Trade Commission, <http://www.usitc.gov>.

² 467 U.S. 837, 843 (1984). This case would have the Court of Trade defer to agency determinations of their regulations unless the agency has not made a “permissible construction of the statute.” *Id.*

³ *Id.* at 842–44 (1984) (establishing three steps to be used by a court reviewing an agency decision: first, the court must ask whether there is an evident congressional intent for the issue at hand; second, is there a discernible express delegation of power to construe the statute; third, if the answer to the second step is no, is some type of implicit delegation meant to take the place of the express delegation?).

⁴ 533 U.S. 218, 234–35 (2001) (holding that *Chevron* left the *Skidmore v. Swift & Co.* standard intact, and that the tariff classification ruling at hand did not require *Chevron* deference. The Court went on to mention that classification rulings were special in this way, and were “beyond the *Chevron* pale”).

⁵ 323 U.S. 134 (1944).

⁶ See *Mead Corp.*, 533 U.S. at 234–39.

⁷ 588 F.2d 297 (C.C.P.A. 1978).

⁸ *Id.* at 301.

better than the importer's.⁹ Such a rule would enable the United States Court of International Trade (Court of Trade) to use the importer's classification to establish a clearer interpretation of the HTS.¹⁰ This type of rule would be consistent with the shift toward a greater level of judicial review of Customs decisions and would be another positive step toward ensuring greater standardization of HTS heading and subheading interpretations.

The *Skidmore* reasoning focuses on allocating the decision-making function to administrative adjudications rather than rule-makings.¹¹ *Skidmore* deference is a step in the right direction, requiring the Court of Trade to defer to an agency ruling only when it is "persuasive."¹² When the Customs tariff ruling is as persuasive as the importer's tariff classification, the Court of Trade and the Circuit Court of Appeals for the Federal Circuit (Circuit Court) should have the discretion to resolve the classification dispute by promulgating the importer's tariff classification *sua sponte*.

Considering their expertise and unique judicial viewpoint,¹³ the Court of Trade and Circuit Court should have an expanded ability to review Customs' tariff classification rulings because courts bring special legal

⁹ The HTS is divided into headings and subheadings to help classify items for the purpose of assessing tariffs. See Heather Pinnock & Joe Shankle, *The Harmonized Tariff Schedule of the United States and Tariff Classification*, in U.S. CUSTOMS : A PRACTITIONER'S GUIDE TO PRINCIPLES, PROCESSES, AND PROCEDURES 39, 41 (Michael D. Sherman, J. Steven Jarreau & John B. Brew eds., 2009) (stating that a glance at the initial six numbers for each subheading provides the chapter, heading, and subheading for each part); LESLIE ALAN GLICK, *GUIDE TO UNITED STATES CUSTOMS AND TRADE LAWS: AFTER THE CUSTOMS MODERNIZATION ACT 22-23* (3d ed. 2008).

¹⁰ The presumption of correctness afforded to the government's tariff classification can lead to unfair results when the government fails to offer a good tariff classification, but the importer does not overcome the burden by offering a good alternative classification. *Jarvis Clark Co. v. United States*, 733 F.2d 873, 876 (Fed. Cir. 1984).

¹¹ *Skidmore v. Swift & Co.*, 323 U.S. 134, 140 (1944). In particular, the case involved the Swift & Co. employees bringing an action against the business under the Fair Labor Standards Act for overtime, liquidated damages, and other remedies. *Id.* at 135. The main issue involved how much deference the conclusions of the Administrator of the Act should be given concerning the compensation of the employees. *Id.* at 137-38.

¹² See *id.* at 140 (stating that the following factors indicate a ruling's ability to persuade: evidence of thorough consideration, the validity of the reasoning contained, whether the ruling is consistent with prior output, and other factors which give the ruling a power to persuade when there is no ability to control).

¹³ ISAAC UNAH, *THE COURTS OF INTERNATIONAL TRADE: JUDICIAL SPECIALIZATION, EXPERTISE, AND BUREAUCRATIC POLICY-MAKING* 87 (1998) (stating that the judges of specialized courts command a wealth of legal and technical knowledge of the issues within their jurisdiction).

expertise to determinations that agencies lack.¹⁴ One way to expand the role of courts in tariff classification rulings would be for Congress to pass a statute granting the Court of Trade the authority to overcome Customs' presumption of correctness in tariff classifications *sua sponte*.¹⁵ In particular, the Court of Trade could disregard Customs' presumption of correctness and interpret the particular HTS heading or subheading at issue if it sees an opportunity to set a clearer interpretation standard.¹⁶ Though this proposed rule would add to the Court of Trade's discretion, it could ensure greater consistency in tariff classification cases, which would allow importers to operate with greater certainty and confidence.¹⁷ In close cases where both the agency and the importer make compelling arguments, the Court of Trade could override Customs' presumption of correctness and interpret the statute in a manner that clarifies its interpretation. In other words, the proposed statute would allow the court to set precedent that could clarify particular HTS headings for all importers.¹⁸ Furthermore, even if the Court of Trade obtained greater discretionary power, its decisions would still be limited by the guiding statutes provided under the HTS.¹⁹

Importantly, the Court of Trade and Circuit Court already have a substantial role in the clarification of ambiguous headings under the HTS. For example, the courts developed methods of statutory interpretation for issues such as determining the classification of a product that falls into multiple categories.²⁰ Between these methods and the courts' life-tenured,

¹⁴ See *id.* at 87 (stating that the judges of specialized courts possess an understanding of the legal background concerning the pertinent issues along with bureaucratic policies).

¹⁵ A *sua sponte* rule could further ensure that the Court of Trade remains independent of Customs' influence in classification decisions. See *Rollerblade, Inc. v. United States*, 112 F.3d 481, 483–84 (Fed. Cir. 1997) (stating that the Court of Trade should make its evaluation of tariff classification independently of Customs).

¹⁶ See J. Antonin Scalia, *Judicial Deference to Administrative Interpretations of Law*, 1989 DUKE L.J. 511, 515 (1989) (opining about *Chevron* deference and positing that the interpretive method courts apply to statutes cannot possibly be completely separated from the task of choosing the best policy, and therefore it seems bizarre to make an argument that policymaking should only be left to agencies).

¹⁷ *Jarvis Clark Co. v. United States*, 733 F.2d 873, 876–77 (Fed. Cir. 1984) (asserting a desire for certainty and uniformity in tariff classifications to create a clearer policy environment for importers).

¹⁸ See UNAH, *supra* note 13, at 63 (stating that judgments are a tool that specialized courts may use to ensure uniformity in agency action).

¹⁹ See *infra* Part II for a list of the guiding statutes.

²⁰ See *infra* Part II.B. The court is assisted here by guiding statutes such as the General Rules of Interpretation. See *infra* Part II.

specialist judges, there exists a level of expertise which will set appropriate standards of interpretation upon which importers may rely.²¹

Additionally, the courts seem to be better at setting standard interpretations of the HTS than the underlying agencies. Though both courts and agencies deal with fact-specific applications of the HTS to particular goods, Customs tariff classification rulings apply only to the specific imported good at issue for each individual importer and do not have the precedential value of court decisions.²²

Part I of this Comment will lay out the creation of the Court of Trade and the Circuit Court's jurisdiction. Then, it will detail the method through which an importer achieves review by the Court of Trade for a classification ruling. Next, the Comment will discuss how the framework of the Court of Trade and Circuit Court's deference to Customs determinations on tariff classifications has changed over time. Part II will analyze how the Court of Trade and Circuit Court interpret the HTS headings, and some of the methods used to resolve tariff classification disputes. Part III will explain the logic of the proposed statute and potential issues resulting from its implementation.

I. A TRUNCATED HISTORY OF TARIFF CLASSIFICATION JURISPRUDENCE

The Constitution provides the very first United States tariff law, allowing Congress to institute duties, imposts, and excises.²³ Such duties, imposts, and excises must be uniform throughout the nation.²⁴ The first court that dealt exclusively with these matters was the Board of General Appraisers, an Article I court composed of nine judges who were under the

²¹ Richard L. Revesz, *Specialized Courts and the Administrative Lawmaking System*, 138 U. PA. L. REV. 1111, 1111 (1990); Bernd G. Janzen, *Area Summary: International Trade Decisions of the Federal Circuit: Three Years of Vigorous Review*, 52 AM. U. L. REV. 1027, 1130 (2003).

²² *United States v. Mead Corp.*, 533 U.S. 218, 232–33 (2001) (stating that a Customs classification is only controlling between itself and the particular importer, and that others who rely on it are warned against doing so); see Scott H. Segal & Stephen J. Orava, *A Review of Recent Decisions of the United States Court of Appeals for the Federal Circuit: Playing the Zone and Controlling the Board: The Emerging Jurisdictional Consensus and the Court of International Trade*, 44 AM. U. L. REV. 2393, 2423–24 (1995); see also Revesz, *supra* note 21, at 1117 (one reason to favor specialized courts is their ability to promote a consistency and common vision of a statutory scheme).

²³ Hon. Gregory W. Carman, *Perspective: Jurisdiction and the Court of International Trade: Remarks of the Honorable Gregory W. Carman at the Conference on International Business Practice Presented by the Center for Dispute Resolution on February 27-28, 1992*, 13 NW. J. INT'L L. & BUS. 245, 246 (1992).

²⁴ *Id.*

supervisory power of the Secretary of the Treasury.²⁵ The Board of General Appraisers was then established in 1890 and became the United States Customs Court in 1926.²⁶ This court possessed largely the same powers as its predecessor.²⁷ It was not until 1956 that the United States Customs Court was given its designation as an Article III court under the Constitution.²⁸ The court gained the ability to grant injunctive relief under the 1979 Trade Agreements Act and, in 1980, gained the same powers in both law and in equity possessed by district courts of the United States under 28 U.S.C. § 1585.²⁹

As the volume and complexity of trade issues increased, doubts arose about whether district courts had jurisdiction, and it was clear that the Customs Court's jurisdiction had to be clarified.³⁰ Jurisdictional issues became significant hurdles for importers, and plaintiffs often encountered difficulty determining whether to bring actions in the district courts or the Customs Court because the latter had such limited powers.³¹ Many plaintiffs faced dismissal for lack of jurisdiction or denial of relief when they chose to bring suits in the district courts.³² As a result, Congress transformed the Customs Court into the Court of Trade.³³

The Customs Courts Act of 1980 established the Court of Trade.³⁴ The Act expanded the Court of Trade's jurisdiction to review Customs determinations under 28 U.S.C. § 1581, unlike the original Customs Court.³⁵ Similar to its predecessor, the Court of Trade is an Article III court whose jurisdiction is limited to administrative decisions which adversely affect import transactions.³⁶ The court continues to review the decisions of agencies, such as Customs, just as the United States Customs Court did before it.³⁷

²⁵ *Id.*

²⁶ *Id.*

²⁷ *Id.*

²⁸ *Id.* at 246–47.

²⁹ *Id.* at 247; GLICK, *supra* note 9, at 157.

³⁰ Carman, *supra* note 23, at 247.

³¹ *Id.* at 247.

³² *Id.* at 248.

³³ *Id.*

³⁴ David M. Cohen, *Recent Decisions of the Court of International Trade Relating to Jurisdiction: A Primer and a Critique*, 58 ST. JOHN'S L. REV. 700, 700 (1984).

³⁵ *Id.*

³⁶ Patrick J. Rohan, Preface to *The United States Court of International Trade: Perspectives from the First Annual Judicial Conference*, 58 ST. JOHN'S L. REV. 685, 685 (1984).

³⁷ *Id.* at 686.

The Circuit Court is an Article III court created by the amalgamation of the appellate division of the United States Court of Claims and the United States Court of Customs and Patent Appeals.³⁸ The Circuit Court's subject matter jurisdiction is much broader than that of the Court of Trade, covering not only international trade, but also intellectual property and government contracts.³⁹ The twelve judge court tends to adjudicate appeals in panels of three or more.⁴⁰

While the Court of Trade originally examined the growing number of trade law disputes,⁴¹ the Circuit Court's expanded jurisdiction allowed it to be a check on the Court of Trade. Ultimately, Congress had to decide how to ensure greater predictability and uniformity in trade law.⁴² The end result was greater judicial review of trade classification determinations.⁴³

A. *The Court of Trade and Circuit Court's Jurisdiction*

Statutes limit the Court of Trade's jurisdiction.⁴⁴ The court has exclusive subject matter jurisdiction over the limited number of situations defined in 28 U.S.C. § 1581 (a)–(h).⁴⁵ For example, 28 U.S.C. § 1581(a) grants the court exclusive jurisdiction regarding a denied Customs protest,⁴⁶ and 29 U.S.C.S. § 1514(a) lists the types of actions that merit a protest.⁴⁷ An importer can get a Customs ruling determining the tariff classification of

³⁸ Kevin J. Fandl, *A Review of Recent Decisions of the United States Court of Appeals for the Federal Circuit: Area Summary: 2010 International Trade Law Decisions of the Federal Circuit*, 60 AM. U. L. REV. 1121, 1122 (2011).

³⁹ *Id.*

⁴⁰ *Id.*

⁴¹ Carman, *supra* note 23, at 248.

⁴² UNAH, *supra* note 13, at 19.

⁴³ *Id.* at 19. Congress's decision to concentrate judicial review over international trade law in one specialist court may have been a means of controlling forum shopping, and ensuring that there were checks on Customs' power. *Id.*

⁴⁴ John B. Brew, *Administrative and Judicial Review of U.S. Customs and Border Protection Decisions*, in U.S. CUSTOMS : A PRACTITIONER'S GUIDE TO PRINCIPLES, PROCESSES, AND PROCEDURES 155, 174 (Michael D. Sherman, J. Steven Jarreau & John B. Brew eds., 2009).

⁴⁵ 28 U.S.C. § 1581 (a)–(h) (2006).

⁴⁶ § 1581(a). § 1581(i) is a residual provision which can only be used if an importer cannot get jurisdiction under § 1581(a)–(h). § 1581(i).

⁴⁷ 19 U.S.C. § 1514(a) (2006). The statute lists a number of situations where a protest may be appealed to the Court of Trade, including: the appraised value of the merchandise at issue, classifications, duties and rates payable due to classifications, and others. *Id.*

a piece of merchandise by requesting one directly from the agency.⁴⁸ The result is a binding, written ruling concerning the merchandise in question.⁴⁹

An importer who is unhappy with the agency's determination may protest Customs' treatment of the imported merchandise.⁵⁰ There are two avenues to begin an agency determination appeal to the Court of Trade. Under 28 U.S.C. § 1581(a), an importer must have: (1) its entry protest denied by Customs; (2) paid all duties or other outstanding fees; and (3) issued a summons before 180 days elapse from the time of Customs' denial of the entry protest.⁵¹ Alternately, an importer may file a summons and complaint even before the issuing of a Customs ruling if the importer can show that "irreparable harm" will result without judicial review.⁵² The Court of Trade has jurisdiction over this type of an action under 28 U.S.C. § 1581(h).⁵³ Much of the time the Court of Trade will perform a *de novo* review of Customs' facts and legal conclusions, though the presumption of correctness of Customs determinations under *Mead* lessens this discretion.⁵⁴

In the United States judicial system, the Court of Trade shares its duty to interpret tariffs with the Circuit Court. The final Court of Trade decision may therefore be appealed to the Circuit Court under 28 U.S.C. § 1295(a)(5).⁵⁵ Questions of fact are only reversible if "clearly erroneous."⁵⁶ The Circuit Court reviews questions of law, such as the interpretation of HTS headings and subheadings, under a *de novo* standard because Congress wanted a check on the Court of Trade, just as the Court of Trade is a check on Customs.⁵⁷ The notice of appeal must be filed within 60 days of the Court of Trade's entry of a judgment, and further appeals from Circuit Court decisions are reviewable by the Supreme Court.⁵⁸

Classification decisions involve two steps. First, the court must ascertain the meaning of the tariff provision under the HTS, which is a

⁴⁸ GLICK, *supra* note 9, at 31.

⁴⁹ *Id.*

⁵⁰ Aaron Franklin, Commentary, *Developments in Cases Arising Under 28 U.S.C. § 1581(a) During 2009*, 42 GEO. J. INT'L L. 531, 533 (2011).

⁵¹ *Id.*

⁵² Brew, *supra* note 44, at 174–75.

⁵³ *Id.*

⁵⁴ *Id.* at 173; *see also* Rollerblade, Inc. v. United States, 112 F.3d 481, 484 (Fed. Cir. 1997) (stating that the Court of Trade has a statutory mandate to make a correct tariff classification independently of Customs).

⁵⁵ Brew, *supra* note 44, at 175.

⁵⁶ *Id.*

⁵⁷ *See id.* at 175–76.

⁵⁸ *Id.* at 176.

question of law.⁵⁹ Second, the court must ascertain the particular heading for the merchandise, which is a question of fact.⁶⁰ Recent case law shows that the Court of Trade and Circuit Court hold Customs' tariff classification rulings to a very high standard.⁶¹ The Court of Trade must use the deference associated with the *Skidmore* standard to follow a Customs ruling.⁶² Through its *Skidmore* opinion, the Supreme Court established that a Customs classification ruling is entitled to deference when it displays: thoroughness, valid reasoning, consistency with other classifications, a formal process when making the classification, and other evidence of a "power to persuade."⁶³

B. *The Need for Greater Consistency and Predictability in HTS Interpretation*

Ultimately, the question of how to establish the best interpretation practices does not only affect the Court of Trade, Circuit Court, and Customs. The development of clearer standards for classification interpretation is an important goal for international commercial transactions in a broad sense. The national total of items imported through trade increased so much over time that Americans now prefer to buy a growing share of products produced in other nations. The U.S. Census Bureau estimates that in 2011, imports totaled \$2.2 trillion in goods.⁶⁴

Any importer who dreams of selling items in the United States must learn the HTS and attempt to find some way of construing the statute before making decisions about whether or not to ship a particular product to the

⁵⁹ *Processed Plastic Co. v. United States*, 473 F.3d 1164, 1168–69 (Fed. Cir. 2006); *Bausch & Lomb, Inc. v. United States*, 148 F.3d 1363, 1365 (Fed. Cir. 1998).

⁶⁰ *Processed Plastic Co.*, 473 F.3d at 1168–69; *Bausch & Lomb, Inc.*, 148 F.3d at 1365.

⁶¹ *United States v. Mead Corp.*, 533 U.S. 218, 237–38 (2001) (recognizing that the *Skidmore* standard is in place and applies when there is no discernible statutory intent to delegate the ability to create rules having the force of law).

⁶² *See id.* at 232 (stating that Customs classifications rulings fall outside of the *Chevron* deference scheme); *see also* Gilbert Lee Sandler & Morgan L. Frohman, Commentary, *International Trade Review: The Year In Review: 28 U.S.C. § 1581(a) Decisions in 2007 by the CIT and Others*, 40 GEO J. INT'L L. 183, 194 (2008) (though the *Skidmore* standard was not initially a concern in Customs litigation, the *United States v. Haggart Apparel Co.* and *Mead Corp.* opinions changed this).

⁶³ *Rockwell Automation, Inc. v. United States*, 31 Ct. Int'l Trade 692, 699 (2007).

⁶⁴ *Foreign Trade – U.S. Trade with World, Seasonally Adjusted*, U.S. CENSUS BUREAU, <http://www.census.gov/foreign-trade/balance/c0004.html> (last visited Dec. 14, 2012). The \$2.2 trillion figure is in nominal dollars, and is not seasonally adjusted unless otherwise noted. *Id.*

United States.⁶⁵ For instance, to determine the size of an import duty, an importer must analyze the headings and subheadings of the HTS. Thus, before an international commercial transaction or any resultant international commercial legal issue may arise, an importer must calculate or consider the costs involved in bringing a particular item to the United States markets.⁶⁶

An importer's cost estimate becomes complicated by the fact that tariff classification rulings by Customs do not bind other parties and have little precedential value unless they are written rulings responding to specific classification requests.⁶⁷ To get some sense of how items might be classified under the HTS, importers must read the opinions of the Court of Trade and Circuit Court concerning classification rulings to learn the applicable legal standards. A review of the opinions will give some insight into the way that the Court of Trade and Circuit Court construe the HTS and also into how Customs may construe the HTS once given guidance from the courts.⁶⁸ Since court opinions have precedential value, even flawed opinions help importers.⁶⁹ A more predictable interpretive environment is crucial for importers seeking to establish whether the lack of reliable precedent currently offered by Customs classification rulings makes it profitable to enter United States markets.⁷⁰

⁶⁵ Pinnock & Shankle, *supra* note 9, at 39 (stating that importers are focused on the bottom line question of how much it will cost them to move their goods into the United States).

⁶⁶ *Id.*

⁶⁷ *United States v. Mead Corp.*, 533 U.S. 218, 232–33 (2001) (stating that a Customs classification is only controlling between itself and the particular importer, and that others who rely on it are warned against doing so).

⁶⁸ GLICK, *supra* note 9, at 32–33 (providing specific instructions for Customs, including how broadly to apply the principles based on which party won).

⁶⁹ The likelihood of finding an opinion that classifies a particular imported item is low because even small differences in product characteristics may lead to a different treatment under the HTS. However, an importer will face the same problem when seeking a Customs classification ruling for a particular item. This Comment's thesis is based on the fact that a court's legal opinion will provide binding precedent that an importer may rely upon, as opposed to the Customs' classification ruling that is only binding on the importer who requests it. The court opinion will thus provide a better indication of how an imported item might be treated if Customs disagrees with a classification, and the importer goes to the Court of Trade to resolve the dispute.

⁷⁰ *See Jarvis Clark Co. v. United States*, 733 F.2d 873, 876–77 (Fed. Cir. 1984) (asserting a desire for certainty and uniformity in tariff classifications to create a clearer policy environment for importers).

II. THE GUIDING PRINCIPLES OF HTS INTERPRETATION

When reviewing Customs' tariff classification rulings, the Court of Trade and Circuit Court must follow certain statutory constraints.⁷¹ The first source of guidance is the HTS itself, composed of headings and subheadings.⁷² After consulting the headings and subheadings, the court will also look to mandatory sources of guidance, such as the General Rules of Interpretation (General Rules) and section and Chapter Notes.⁷³ The General Rules are part of the HTS.⁷⁴ Courts must use the General Rules while reviewing a classification case after considering the headings and subheadings of the HTS.⁷⁵ Other mandatory sources include the section and Chapter Notes of the HTS.⁷⁶ In addition to the language of the headings and subheadings, General Rules, and section and Chapter Notes, there are many helpful persuasive authorities.⁷⁷

When interpreting the HTS, the Court of Trade may change the implementation of the statute enough so that it arrives at a different result than the one intended by the legislature that enacted the statute. Therefore, the Court of Trade must do its best to follow the will of the legislature when interpreting the statute.⁷⁸ To address this issue, the court opts for a

⁷¹ ENI Tech. Inc. v. United States, 641 F. Supp. 2d 1337, 1349 (Ct. Int'l Trade 2009) (stating that a court's interpretation analysis must begin in the headings, subheadings, Chapter Notes and sections of the HTS); GLICK, *supra* note 9, at 22–24.

⁷² Pinnock & Shankle, *supra* note 9, at 41 (stating that a glance at the initial six numbers for each subheading provides the chapter, heading, and subheading for each part); GLICK, *supra* note 9, at 22–23.

⁷³ Rockwell Automation, Inc. v. United States, 31 Ct. Int'l Trade 692, 701 (2007).

⁷⁴ Millenium Lumber Distribution, Ltd. v. United States, 31 Ct. Int'l Trade 575, 578 (2007), *aff'd*, 558 F.3d 1326 (Fed. Cir. 2009); *Rockwell Automation, Inc.*, 31 Ct. Int'l Trade at 703 (stating that the General Rule 1 mandates that the Court of Trade review a classification ruling using the HTS headings and any applicable section or Chapter Notes); GLICK, *supra* note 9, at 23.

⁷⁵ Baxter Healthcare Corp. of P.R. v. United States, 182 F.3d 1333, 1337 (Fed. Cir. 1999).

⁷⁶ StoreWALL, LLC v. United States, 644 F.3d 1358, 1362 (Fed. Cir. 2011).

⁷⁷ These include the Explanatory Notes of the HTS and prior Customs rulings. *N. Am. Processing Co. v. United States*, 236 F.3d 695, 698 (Fed. Cir. 2001); *Millenium Lumber Distribution, Ltd.*, 31 Ct. Int'l Trade at 579. The Explanatory Notes may be relied upon where their text is not ambiguous, and there are not any persuasive countervailing reasons to do so. *Nat'l Presto Indus., Inc. v. United States*, 783 F. Supp. 2d 1287, 1291 (Ct. Int'l Trade 2011).

⁷⁸ Robert A. Anthony, *Which Agency Interpretations Should Bind Citizens and the Courts?*, 7 YALE J. ON REG. 1, 4 (1990).

combination of the textualist, structuralist, and legislative history approaches.⁷⁹

As mentioned in Part I, there is a pressing need for a method of interpretation that will provide a useful guidepost to importers.⁸⁰ Numerous commercial transactions and matters of commercial law rest upon the potential duties levied against an imported item.⁸¹ As a means of answering this call to action, the Court of Trade and Circuit Court employ numerous methods of interpretation of the HTS, which have the positive result of creating clearer precedent for importers and Customs. These methods discussed below include: (1) the use of commercial or common meaning;⁸² (2) the essential character test;⁸³ (3) the use analysis;⁸⁴ (4) the comparison of *eo nomine* and use provisions;⁸⁵ (5) the use of canons of interpretation;⁸⁶ and (6) responding to matters of first impression.⁸⁷ Part III details the reasons why a Customs ruling's presumption of correctness for tariff classification should be a discretionary matter for the Court of Trade.⁸⁸ This part also deals with the potential problems involved with greater Court of Trade review.⁸⁹

A. *Common or Commercial Meaning*

The Court of Trade is very practical in its tariff opinions, seeking as often as possible to make interpretations that will conform to underlying

⁷⁹ Hon. Edward D. Re, *State of the Court: The United States Court of International Trade-Three Years Later*, 58 ST. JOHN'S L. REV. 685, 692, 696–97 (1984) (stating that questions of interpretation are not often so clear cut that the plain language of the statute resolves its interpretation, and that the court may have to act to fill the “gaps” in the statute. In performing this function, the court attempts to act as an agent of the legislature, seeking to maintain consistency with its will).

⁸⁰ *See supra* Part I.B.

⁸¹ *See* Pinnock & Shankle, *supra* note 9, at 39 (stating that importers are focused on the bottom line question of how much it will cost them to move their goods into the United States).

⁸² *See infra* Part II.A.

⁸³ *See infra* Part II.B.

⁸⁴ *See infra* Part II.C.

⁸⁵ *See infra* Part II.D.

⁸⁶ *See infra* Part II.E.

⁸⁷ *See infra* Part II.F.

⁸⁸ *See infra* Part III.A.

⁸⁹ *See infra* Part III.B.

commercial and common meanings.⁹⁰ When Congress does not express its intent in the statutes, courts interpreting the HTS will read the heading terms under their common and commercial meanings.⁹¹ *Airflow Technology, Inc. v. United States*⁹² is an example of how the Court of Trade deals with this statutory interpretation issue.

In *Airflow Technology, Inc.* two headings governed a filter used to separate particulate matter from air.⁹³ To decide which heading was more appropriate, the Court of Trade reviewed *GKD-USA, Inc. v. United States*,⁹⁴ which defined straining cloths by relying on the item's common meaning.⁹⁵ The Court of Trade recognized that the common meaning of an undefined item or material should control.⁹⁶ The Circuit Court then endorsed the Court of Trade's use of this method, although it concluded that the Court of Trade should have classified the material as a "filter cloth" rather than a "strainer cloth."⁹⁷

When the Court of Trade confronts an undefined term, it also utilizes a definition that comports with commercial standards.⁹⁸ As an example, in *Arko Foods International, Inc. v. United States*⁹⁹ the Court of Trade addressed a classification dispute involving a substance called mellorine, which is like ice cream but has some vegetable fat substitute in it.¹⁰⁰ Both parties agreed that the heading for "ice cream and other edible ice" applied,

⁹⁰ *StoreWALL, LLC v. United States*, 644 F.3d 1358, 1363 (Fed. Cir. 2011) (stating that unless the HTS defines a term, its meaning will be the same as its common or commercial meaning without any evidence to the contrary).

⁹¹ *Pillowtex Corp. v. United States*, 171 F.3d 1370, 1374 (Fed. Cir. 1999); *see also* *Timber Prods. Co. v. United States*, 30 Ct. Int'l Trade 1632, 1643 (2006) (the party attempting to prove a commercial meaning must show that it is general, or is widely used, definite, or capable of being understood, and uniform, or is used the same way over a large area), *aff'd*, 515 F.3d 1213 (Fed. Cir. 2008).

⁹² 524 F.3d 1287 (Fed. Cir. 2008).

⁹³ *Id.* at 1289–90. Note that the Explanatory Notes of the HTS require the selection of the most specific heading when multiple headings apply to a given item. *Id.* at 1290.

⁹⁴ 20 Ct. Int'l Trade 749 (1996).

⁹⁵ *Airflow Tech., Inc.*, 524 F.3d at 1290.

⁹⁶ *Id.*

⁹⁷ *Id.* at 1291–92 (stating that straining cloths are used to separate solids from liquids, where filter cloths could be used either to separate solids from liquids or to remove solids from gases).

⁹⁸ Common and commercial meanings might not always be the same, but it is likely that if an importer is familiar with one, the other meaning is understood as well. Importers should have a good idea of either meaning based on their knowledge of the trade. An importer likely has a good idea about how customers use and talk about its products.

⁹⁹ 654 F.3d 1361 (Fed. Cir. 2011).

¹⁰⁰ *Id.* at 1362.

but the parties disagreed about whether the merchandise was an item of milk, resulting in a subheading dispute.¹⁰¹ The Court of Trade held that the item was edible ice, and the Circuit Court upheld the Court of Trade's judgment after using a combination of the common meaning and the essential character tests.¹⁰²

Importantly, if the Court of Trade can disregard Customs' presumption of correctness *sua sponte*, it can use good arguments by importers to set an HTS interpretation standard that is more in line with underlying commercial reality. In close cases, an importer trying to prove commercial meaning holds the burden of proof.¹⁰³ However, if Customs and the importer are equally persuasive, the Court of Trade could use its *sua sponte* discretion to find for the importer's commercial meaning. Allowing the Court of Trade this power would serve the interest of creating greater conformity in interpretation. By focusing on commercial and common meaning, the Court of Trade makes it easier for importers to understand where they stand under the HTS. In fact, the Court of Trade makes use of commercial dictionaries and industry definitions when applicable.¹⁰⁴ The consistency with commercial practices and an importer's understanding of the product at issue undoubtedly facilitates commercial transactions and resultant commercial legal matters.

B. *Essential Character Test*

When an item could fall under multiple headings, the Court of Trade or Circuit Court must choose which one applies. To accomplish this goal, the courts use an essential character test. The goal of the essential character analysis is to find the particular element or material that defines the merchandise's core or essential characteristic.¹⁰⁵ According to an Explanatory Note cited in *Home Depot U.S.A., Inc. v. United States*,¹⁰⁶ the analysis could involve "the nature of the material or component, its bulk, quantity, weight or value, or . . . the role of a constituent material in relation to the use of the goods."¹⁰⁷

¹⁰¹ *Id.* at 1363.

¹⁰² See *infra* Part II.B for discussion of the essential character test; *Arko Foods Int'l, Inc.*, 654 F.3d at 1363, 1364–65, 1366.

¹⁰³ GLICK, *supra* note 9, at 28.

¹⁰⁴ Claire R. Kelly, *Remnants of Customs Litigation: Jurisdiction and Statutory Interpretation*, 26 BROOK J. INT'L L. 861, 881 (2001).

¹⁰⁵ *Dell Prods. LP v. United States*, 642 F.3d 1055, 1057–58 (Fed. Cir. 2011); see also GLICK, *supra* note 9, at 23.

¹⁰⁶ 491 F.3d 1334 (Fed. Cir. 2007).

¹⁰⁷ *Id.* at 1336–37.

One recent case turning on the use of an essential character test is *Arko Foods International, Inc.*¹⁰⁸ The Circuit Court referred to the Food and Drug Administration statute about mellorine, and considered the fact that the substance has very little milk powder.¹⁰⁹ After considering these factors, the Circuit Court affirmed the Court of Trade's judgment regarding the classification of mellorine, which was not an item of milk.¹¹⁰

The downside to the essential character test is that it may be difficult to determine the essential or core characteristic of a complex piece of merchandise. However, the essential character test is a product of statutory language, and the Court of Trade and Circuit Court maintain responsibility for determining a reliable means of interpreting the statute and finding a useful test when Customs or other agency interpretations are inadequate.¹¹¹ Once established, Customs and importers may use the same test and interpretive methods when determining the proper classification of a product.

In addition to providing useful analysis to Customs and importers, the Court of Trade's judgment will provide binding precedent, an additional aid to importers. Should the Court of Trade be able to use its discretion regarding Customs' presumption of correctness *sua sponte*, the court could take more opportunities to show the agency and importers a reliable way of administering the test.

C. *Configuration of Parts and Classification by Use*

Aside from defining merchandise according to its essential character, the Court of Trade seeks to classify items in a manner reflecting use, as opposed to just the language of the HTS headings or subheadings. One established rule reflecting this tendency is that items obtain a classification based on a characteristic that is "fixed with certainty" and that is a discernible portion of a final product when imported.¹¹² For example, the Court of Trade will consider whether an item requires substantial additional processing before ultimate use in a consumer good or whether the item will

¹⁰⁸ *Arko Foods Int'l, Inc. v. United States*, 654 F.3d 1361, 1365 (Fed. Cir. 2011).

¹⁰⁹ *Id.*

¹¹⁰ *Id.* at 1366.

¹¹¹ *Re, supra* note 79, at 692, 696–97 (stating that questions of interpretation are not often so clear cut that the plain language of the statute resolves its interpretation, and that the court may have to act to fill the "gaps" in the statute. In performing this function, the court attempts to act as an agent of the legislature, seeking to maintain consistency with its will).

¹¹² *Millenium Lumber Distribution, Ltd. v. United States*, 31 Ct. Int'l Trade 575, 580 (2007), *aff'd*, 558 F.3d 1326 (Fed. Cir. 2009).

be used as a material component in a finished product.¹¹³ In *Millenium Lumber Distribution Ltd. v. United States*,¹¹⁴ the Circuit Court affirmed the Court of Trade determination by ruling that even if the importer did not recut the wooden materials used in the trusses, the court was not “fixed with certainty” that the importer would use the merchandise for that particular purpose.¹¹⁵

The principal use analysis is another method of classifying items based on their use. In *Inabata Specialty Chemicals v. United States*,¹¹⁶ the Court of Trade lists a number of factors that are useful when analyzing an item’s principal use.¹¹⁷ The factors, which come from *United States v. Carborundum Co.*,¹¹⁸ include: (1) physical attributes of the item; (2) trade channels of the merchandise; (3) the end purchaser’s expectations; (4) the environment of the item’s sale; (5) the use of the item in a fashion that is definitive of the class; (6) whether the item can be used in a manner that defines its class; and (7) whether the trade recognizes the use of the item in this way.¹¹⁹ After an analysis of these factors, the Court of Trade determined that the item at issue did classify as a pain reliever and that this determination was consistent with the item’s market use.¹²⁰

These two tests are important because they make a classification contingent upon real world use or functionality of the item. The “fixed with certainty” test attempts to determine whether the good is finished or unfinished. By using the *sua sponte* discretion regarding Customs’ presumption of correctness, the Court of Trade could apply this test so that importers and Customs would have guidance in the same. Therefore, when an importer has an item that is hard to classify, it can perform the “fixed with certainty” test to determine whether its item is an unfinished part or a finished good.

Similarly, if an importer tries to get a classification for some item that is a part of another product, the importer may use the principal use test to discover which heading applies. As the *Carborundum Co.* factors show, the courts attempt to conform their judgments to the way that importers do business. The courts are sorting items based on real world use. If the

¹¹³ *Id.* (stating that the parties both acknowledge that a substantial amount of cutting must be performed before the wooden items can be used in a truss design).

¹¹⁴ 558 F.3d 1326 (Fed. Cir. 2009).

¹¹⁵ *Id.* at 1330.

¹¹⁶ 29 Ct. Int’l Trade 419 (2005).

¹¹⁷ *Id.* at 425.

¹¹⁸ 536 F.2d 373 (C.C.P.A. 1976).

¹¹⁹ *Id.* at 377.

¹²⁰ *Inabata Specialty Chems.*, 29 Ct. Int’l Trade at 425.

item's principal use is as a part of something else, the analysis gives useful classification guidance. If the Court of Trade has the discretion not to follow Customs' presumption of correctness *sua sponte*, it may use this method, in combination with the "fixed with certainty" test, to create a judgment which gives the importers and Customs greater guidance.

D. *Eo Nomine and Use Provisions*

The HTS generally classifies items by name or by use. Name provisions under the HTS, known as "*eo nomine* provisions," are so named because the tariff heading gives the item's name.¹²¹ Use provisions are tariff headings that describe the item's use.¹²² However, a particular item may sometimes be classifiable under multiple headings, spanning both name and use. General Rule 3(a) requires that when an item is classifiable under more than one HTS heading, the heading providing the most specific description of the item will provide the correct classification.¹²³ Legal precedent requires the selection of a use provision over an *eo nomine* provision.¹²⁴

The line between use provisions and *eo nomine* provisions is not as clear as it may initially seem. Occasionally, the Court of Trade and Circuit Court have been known to read "use" into a provision, creating a use provision where none existed.¹²⁵ For example, in a concurring opinion, Circuit Judge Dyk looked at the headings corresponding to a system of hooks of unit furniture and noted that the majority should have read it as a use provision because the subheadings rely on the use of the item.¹²⁶ He then went on to reference the Explanatory Notes, in particular those pertaining to unit furniture.¹²⁷ He stated that even though the Chapter Notes do not explicitly say that an item is being "used for" a particular purpose,

¹²¹ *StoreWALL, LLC v. United States*, 644 F.3d 1358, 1365 (Fed. Cir. 2011) (Dyk, J., concurring).

¹²² *Id.*

¹²³ *BASF Corp. v. United States*, 30 Ct. Int'l Trade 227, 252 (2006), *aff'd*, 497 F.3d 1309 (Fed. Cir. 2007).

¹²⁴ *Id.*

¹²⁵ Though this may initially seem problematic, the Court of Trade and Circuit Court can perform this conversion as a means of ensuring future consistency between HTS headings and subheadings. See *Minnetonka Brands, Inc. v. United States*, 24 Ct. Int'l Trade 645, 651 (2000) (stating that though the applicable subheading did not specify use, the idea of use is inherent in the definition of a toy, and thus the subheading should be read as a use provision).

¹²⁶ *StoreWALL, LLC*, 644 F.3d at 1366–67 (Dyk, J., concurring).

¹²⁷ *Id.* at 1365.

the Circuit Court had read use into tariff headings before.¹²⁸ As an example, he cited *Minnetonka Brands, Inc. v. United States*,¹²⁹ where the Circuit Court said that an item's classification as a toy depended on its use as such even though the heading said nothing of use.¹³⁰ Circuit Judge Dyk's interpretation was consistent with an analysis of the hook system's principal use, which was not as a rack to hang things.¹³¹

The choice of a use provision over an *eo nomine* provision is another method of attempting to provide some consistency between the different headings and subheadings of the HTS. This approach is valuable to importers because they can attempt to emulate this trend in classifying their goods according to principal use. Furthermore, choosing the use provision over the name provision also makes commercial sense. Importers likely have an idea of how consumers will use their products. By selecting a use provision over a name provision, the importer should better understand where the particular item falls under the HTS.¹³² Nonetheless, the downside to this approach is that certain items may have many uses and attempting to discern a primary use may be difficult.

If the Court of Trade can choose not to follow Customs' presumption of correctness *sua sponte*, it could perform the *eo nomine* and use provision analysis in close cases. These are cases where Customs' analysis is moderately persuasive, but there is an equally persuasive alternate classification that would make more sense to importers and could create important precedent if the court rules in favor of the importer. The proposed *sua sponte* statute would allow the court to directly address the need for precedent that presents a clearer statutory framework for importers. The court issues a judgment, as opposed to Customs, which issues a ruling.¹³³ Thus, the Court of Trade's decision will set a more authoritative precedent than Customs could, which is important to help clarify HTS classifications for importers.

¹²⁸ *Id.*

¹²⁹ 24 Ct. Int'l Trade 645 (2000).

¹³⁰ *StoreWALL, LLC*, 644 F.3d at 1365.

¹³¹ *Id.* at 1366 (Dyk, J., concurring) (stating that Additional Rule of Interpretation 1(a) would allow consideration of the item's principal use immediately before, or on the date of importation, and that the system was not used as a rack).

¹³² This is the same analysis performed by Circuit Judge Dyk in *StoreWALL, LLC*, who used research about the end consumer use of the item to be classified. *See id.* (stating that available information indicated that the system's primary use by consumers was not as a rack).

¹³³ *See United States v. Mead Corp.*, 533 U.S. 218, 233 (stating that a Customs classification is only controlling between itself and the particular importer, and that others who rely on it are warned against doing so).

E. *Canons of Interpretation*

In addition to the Court of Trade's and Circuit Court's traditional methods of interpreting tariff provisions, they also make limited use of canons of interpretation. These include, but are not limited to, *eiusdem generis*¹³⁴ and *expressio unius est exclusio alterius*.¹³⁵ *Eiusdem generis* is a principle applied when a general word follows a list of specific words, which then leads one to interpret the general word as being of the same kind as the remainder of the list.¹³⁶ *Expressio unius est exclusio alterius* is a principle meaning the expression of one thing is the exclusion of those not mentioned.¹³⁷

As an example, in *Airflow Technology, Inc.*, a "straining cloth" was a material "used in oil presses or the like."¹³⁸ Airflow argued that the principle of *eiusdem generis*, as applied to the terms "or the like" and "oil presses," indicated that the merchandise had to separate liquids from solids.¹³⁹ The Circuit Court agreed, reasoning that "or the like" applied to the phrase "of a kind used in oil presses" and not "straining cloth."¹⁴⁰

Another classic canon of interpretation that is invoked from time to time in tariff classification cases is *expressio unius est exclusio alterius*.¹⁴¹ In *ENI Technology Inc. v. United States*,¹⁴² ENI had a product called an RF Generator, which Customs classified as a "static converter."¹⁴³ ENI thought that its RF Generators were either semiconductor processing machines or "physical vapor deposition apparatuses."¹⁴⁴ Upon a consultation of IEEE 100, a technical dictionary, the court found a commercial definition containing a number of individual devices, each accompanied by a described function of its use.¹⁴⁵ The Court of Trade then employed

¹³⁴ Barbara S. Williams, *Critical Decisions by the U.S. Court of Appeals for the Federal Circuit and the U.S. Court of International Trade in Customs 28 U.S.C. § 1581(a) Cases*, 41 GEO. J. INT'L L. 161, 167 n.39 (2009).

¹³⁵ Franklin, *supra* note 50, at 551.

¹³⁶ Gregory R. Englert, *The Other Side of Eiusdem Generis*, 11 SCRIBES J. LEGAL WRITING 51, 51 (2007).

¹³⁷ Stephen M. Durden, *Textualist Canons: Cabining Rules or Predilective Tools*, 33 CAMPBELL L. REV. 115, 130–31 (2010).

¹³⁸ *Airflow Tech. v. United States*, 524 F.3d 1287, 1290 (Fed. Cir. 2008).

¹³⁹ *Id.* at 1292.

¹⁴⁰ *Id.*

¹⁴¹ Franklin, *supra* note 50, at 551.

¹⁴² 641 F. Supp. 2d 1337 (Ct. Int'l Trade 2009).

¹⁴³ *Id.* at 1342.

¹⁴⁴ *Id.*

¹⁴⁵ *Id.* at 1353–54.

expressio unius est exclusio alterius to decide that devices not listed as static converters were not static converters, and the RF generator was an unlisted machine because it could convert alternating current (AC) to another fixed-frequency AC.¹⁴⁶

The classical canons of interpretation are useful for statutes. The use of the canons is often a means of trying to preserve the intentions of the drafting parties while attempting to execute the law in the face of ambiguity. Though this may sometimes result in an interpretation slightly different from the legislature's intent, there is a benefit when consistency is an issue.¹⁴⁷ In a field such as international trade, clearer standards are necessary for businesses to operate efficiently. Importers want standards of interpretation they can rely upon, and the Court of Trade can create those standards by interpreting HTS headings and subheadings in a consistent manner using canons of interpretation.¹⁴⁸ This sets guidelines through binding precedent that both importers and Customs can implement for a more consistent statutory scheme. In addition, even though the Court of Trade attempts to interpret the HTS in a manner intended by legislators, if the court strays too far from the original legislative intent, the legislature can create more precise laws.¹⁴⁹ Ultimately, if the Court of Trade chooses not to follow Customs' presumption of correctness *sua sponte*, it could use the canons of interpretation in a way that will make the statutory scheme clearer for importers, increasing confidence and opportunities for trade.

F. *Matters of First Impression*

The Court of Trade also sometimes resolves a matter of first impression. When the court performs this duty, it may develop a new and manageable standard of interpreting the HTS language. As an example, the Court of Trade recently dealt with the issue of items "put up in sets for retail sale" as a matter of first impression.¹⁵⁰

In *Dell Products LP v. United States*,¹⁵¹ the Court of Trade and Circuit Court had to determine whether secondary laptop batteries were part

¹⁴⁶ *Id.* at 1354.

¹⁴⁷ Consistency with the statutory scheme established by Congress is the utmost goal, and the Court of Trade and Circuit Court should not stray much from the legislative intent.

¹⁴⁸ See Pinnock & Shankle, *supra* note 9, at 39 (stating that importers are focused on the bottom line question of how much it will cost them to move their goods into the United States).

¹⁴⁹ *Re*, *supra* note 79, at 692, 696–97.

¹⁵⁰ *Dell Prods. LP v. United States*, 642 F.3d 1055, 1057–58 (Fed. Cir. 2011).

¹⁵¹ *Id.*

of a retail set with the computer or a separate item.¹⁵² The Court of Trade agreed with Customs, concluding that the secondary batteries were not a part of retail sets with the laptop but, rather, accessories customers could purchase independently.¹⁵³ Upon appeal to the Circuit Court, Dell argued that classification must happen according to their configuration upon entry to the United States, not at the time of retail sale.¹⁵⁴ The Circuit Court referred to an Explanatory Note when making its decision, and noted importers do not have to repackage an item that is part of a set.¹⁵⁵ The Circuit Court affirmed the Court of Trade's judgment by recognizing that the secondary batteries were properly "other storage batteries," and that Customs was consistent in its interpretations of this rule.¹⁵⁶

The Court of Trade's classification of merchandise in a manner consistent with its commercial sale, as opposed to its shipping or retail conditions, simplifies matters for individual importers. This clarification practice is useful because it will allow an importer to consider the current condition of the item when making a decision whether or not to import it into the country. If the Court of Trade may choose not to follow Customs' presumption of correctness *sua sponte*, the court can fill the interstices of the HTS by resolving matters of first impression.¹⁵⁷ As the ruling in *Dell Products LP* illustrates, the Court of Trade does favor consistency in how the HTS is applied, giving Customs credit in its consistent application of a set rule.¹⁵⁸ This is important because it helps to give the agency guidance on how to interpret the statute. If Customs is consistent in its interpretations, importers will recognize this fact, resulting in a clearer policy framework that enables further trade.

¹⁵² *Id.* at 1057.

¹⁵³ *Id.*

¹⁵⁴ *Id.* at 1058. Dell said that it should not matter what their intention was when they packaged the secondary batteries for shipment, and that items packaged in a particular way for shipment should be treated as packaged for sale. *Id.* at 1059.

¹⁵⁵ *Dell Prods. LP*, 642 F.3d at 1059–60.

¹⁵⁶ *Id.* at 1060–61 (stating that Customs had been consistent with other items that were not included in retail packages, such as computer speakers).

¹⁵⁷ *See Re, supra* note 79, at 692, 696–97 (1984) (stating that the court does this by examining legislative history, and trying to give effect to the legislative purpose of the statute at hand).

¹⁵⁸ *Dell Prods. LP*, 642 F.3d at 1060–61; *see also* UNAH, *supra* note 13, at 113 (1998) (noting a study demonstrating that the Court of Trade tends to defer to agencies around 60 percent of the time).

III. THE LOGIC OF THE *SUA SPONTE* DISREGARD OF CUSTOMS' PRESUMPTION OF CORRECTNESS

The Court of Trade already uses a number of tools to promote uniformity in the application of the HTS. These tools include: common or commercial meaning, the essential character test, use analysis, comparison of *eo nomine* and use provisions, canons of interpretation and responding to matters of first impression.¹⁵⁹ The Court of Trade should have the ability to rebut Customs' presumption of correctness *sua sponte* in classification cases where there is an identifiable reason to establish better HTS interpretation standards. The current environment of deference to Customs hampers the implementation of clearer interpretive standards for the HTS statute.¹⁶⁰

A. *The Logic of the Proposed Rule*

Sometimes there may be close cases where Customs' reasoning is persuasive, and the importer also presents a compelling argument. In that situation, Customs' argument may win simply because of the presumption of correctness given to the agency.¹⁶¹ In those cases, the court should follow the importer's reasoning as a policy issue as long as there is a good reason to favor the importer's reasoning as a means of clarifying the HTS headings. If the Court of Trade could act *sua sponte* in this instance, it could ensure that future importers have a more coherent picture of an item classification. Indeed, this would be a means of fulfilling the court's duty to fill the gaps in statutory language and create a more reliable interpretation of the HTS.¹⁶² It is possible that the Court of Trade may also see a policy reason for interpreting the HTS in a particular manner, and this consideration should also factor into the decision whether to disregard Customs' presumption.¹⁶³

¹⁵⁹ See *supra* Part II.A–F for other tools and practices of the Court of Trade.

¹⁶⁰ The presumption of correctness afforded to the government's tariff classification can lead to unfair results when the government fails to offer a good tariff classification, but the importer does not overcome the burden by offering a good alternative classification. *Jarvis Clark Co. v. United States*, 733 F.2d 873, 876 (Fed. Cir. 1984).

¹⁶¹ See *id.*

¹⁶² Re, *supra* note 79, at 692, 696–97 (stating that the court does this by examining legislative history and trying to give effect to the legislative purpose of the statute at hand).

¹⁶³ See Scalia, *supra* note 16, at 515 (positing that the interpretive method courts apply to statutes cannot possibly be completely separated from the task of choosing the best policy, and therefore it seems bizarre to make an argument that policymaking should only be left to agencies).

There are two main issues involved in the court's item classification duties under the HTS. First, the Court of Trade attempts to ensure consistency for importers, who desire reliable and consistent statutory interpretation.¹⁶⁴ Second, the Court of Trade administers uniformity in the classification rulings issued by Customs. It is incredibly important that the Court of Trade fulfill both objectives. There are numerous instances where the Court of Trade and Circuit Court used their interpretive tools in an attempt to ensure smoother interpretation of the HTS.¹⁶⁵ The courts strive to clarify the statutory scheme to establish a useful framework. These duties' importance will only increase as trade and international transactions for goods increase.¹⁶⁶

In particular, the importance of the Court of Trade's ability to set statutory interpretation standards for Customs is extremely relevant. Some evidence suggests that Congress intended the court to be a check on the agency.¹⁶⁷ In fact, remarks given by legislators around the time of creation of the specialized court show that they wanted to create a body which could improve the uniformity of the nation's trade law.¹⁶⁸ Given this history, a new rule granting the Court of Trade further discretion by allowing it to disregard Customs' presumption of correctness seems to be another way of ensuring that the court fulfills its mission. This ability would become another invaluable tool for promoting clearer and more importer-friendly trade law.¹⁶⁹ This choice, rather than accounting for every possible contingency in the HTS, shows that the Court is a gatekeeper for desirable policy.¹⁷⁰ Thus, legislators use the Court of Trade to limit Customs from straying too far from the desired regulatory scheme.¹⁷¹

¹⁶⁴ See Pinnock & Shankle, *supra* note 9, at 39 (stating that importers are focused on the bottom line question of how much it will cost them to move their goods into the United States).

¹⁶⁵ See *supra* Part II.A–F for examples.

¹⁶⁶ U.S. CENSUS BUREAU, *supra* note 64.

¹⁶⁷ UNAH, *supra* note 13, at 19 (opining that Congress's decision to concentrate judicial review over international trade law in one specialist court may have been a means ensuring that there were checks on Customs' power); Cass R. Sunstein, *Interpreting Statutes in the Regulatory State*, 103 HARV. L. REV. 405, 445 (1989) (stating that a general rule of deference to agencies would be undesirable because many statutes were conceived as fetters for administrative authorities).

¹⁶⁸ UNAH, *supra* note 13, at 18–19.

¹⁶⁹ Courts are already involved in policy making on a regular basis. See Scalia, *supra* note 16, at 515.

¹⁷⁰ UNAH, *supra* note 13, at 19 (stating that Congress chose to rely on the expertise of the specialist court rather than attempt to spell everything out in the statute).

¹⁷¹ *Id.* at 62.

In addition, this proposed *sua sponte* rule need not lead to any contradiction with past precedent. The *Skidmore* standard only requires the Court of Trade to defer to a Customs ruling as long as the agency's argument is persuasive.¹⁷² By disregarding Customs' presumption of correctness, the court indicates that its argument is not persuasive enough. In this way, the new rule is consistent with the Supreme Court's mandate for the Court of Trade to defer to the agency only as long as Customs makes the better argument.¹⁷³

The Court of Trade also has better tools to promote greater uniformity and compliance with its interpretations of the HTS than Customs. Generally speaking, one of the best methods of ensuring compliance with its rulings is the fact that the court issues binding judgments.¹⁷⁴ Furthermore, the ruling and reasoning in an opinion apply to more parties than those involved in the particular dispute. This power is a great boon to the court in fulfilling its role as a gatekeeper for clearer and more consistent interpretation of the HTS.¹⁷⁵ The Court of Trade may also hold those who do not follow its judgments in contempt to enforce its decisions.¹⁷⁶ Finally, the power to remand a determination to Customs is another good way to ensure more uniformity in the interpretation of tariff headings.¹⁷⁷

It is also worth noting that, in close cases, the Court of Trade's use of its *sua sponte* discretion to disregard Customs' presumption of correctness could serve to reduce the court's caseload in the long term. It is in the self-interest of each court to minimize its case load by providing clearer statutory interpretations. The more chances the Court of Trade has to promulgate its interpretive methods, the more likely it is that importers and Customs can resolve disputes on their own. As a matter of fact, Customs must apply principles of interpretation established by the Court of Trade and Circuit Court under 19 C.F.R. § 152.16, creating uniformity.¹⁷⁸ Docket control is an important consideration because world trade continues to grow and the Court of Trade's docket becomes more crowded.¹⁷⁹

¹⁷² *Skidmore v. Swift & Co.*, 323 U.S. 134, 140 (1944).

¹⁷³ *United States v. Mead Corp.*, 533 U.S. 218, 231–32, 234 (2001) (concluding that tariff classification rulings require less deference than the *Chevron* standard calls for).

¹⁷⁴ UNAH, *supra* note 13, at 63.

¹⁷⁵ *See Revesz*, *supra* note 21, at 1117 (one reason to favor specialized courts is their ability to promote a consistency and common vision of a statutory scheme).

¹⁷⁶ UNAH, *supra* note 13, at 63.

¹⁷⁷ *Re*, *supra* note 79, at 695.

¹⁷⁸ GLICK, *supra* note 9, at 32–33 (providing specific instructions for Customs, including how broadly to apply the principles based on which party won).

¹⁷⁹ *See* U.S. CENSUS BUREAU, *supra* note 64.

There is also reason to believe that the Court of Trade would sparingly use the *sua sponte* discretion not to follow Customs' presumption of correctness. In many past cases, the Court of Trade deferred to Customs' determination of a particular classification ruling.¹⁸⁰ This means that the court, while aware of its gatekeeper role, is selective about when it forces the agency to change its operations. The Court of Trade's tendency to carefully examine and follow Customs' reasoning under *Skidmore* implies that the court would not use its new discretion unless some overriding reason presented itself.¹⁸¹

When considering the adoption of a *sua sponte* statute, the stakes are no less than the United States' reputation as a nation that facilitates international trade.¹⁸² The United States has an interest in promoting a reputation as a country that is willing to trade with others on equal terms.¹⁸³ Consistency in the application of the HTS to importers may help to promote the country's image as a fairer trading partner.

B. *The Problems Involved With Greater Court of Trade Review*

There are numerous upsides to adopting the *sua sponte* rule, but there may be downsides as well. The Court of Trade could potentially abuse its new power. This problem is probably insignificant, however, for a few reasons. First, the Court of Trade's slightly expanded ability to interpret HTS headings has a limit, which is its desire to produce useful interpretations. Second, the Circuit Court has the ability to review Court of Trade decisions,¹⁸⁴ and no court wants to be overturned. Due to the existence of the appeals system, the Court of Trade must always be aware of the fact that the Circuit Court can overturn its decisions.¹⁸⁵ If the court abuses its discretion, it will have to deal with its bad reasoning upon remand from the Circuit Court.

¹⁸⁰ UNAH, *supra* note 13, at 113 (finding through a study that the Court of Trade tends to defer to agencies around 60 percent of the time).

¹⁸¹ *Skidmore v. Swift & Co.*, 323 U.S. 134, 140 (1944).

¹⁸² UNAH, *supra* note 13, at 15.

¹⁸³ *Id.*

¹⁸⁴ GLICK, *supra* note 9, at 163 (stating that the court has exclusive jurisdiction over any appeals from the Court of Trade).

¹⁸⁵ *See* Brew, *supra* note 44, at 175 (stating that the Court of Trade's judgments are reviewable by the Circuit Court).

There is also the potential for the court's capture by special interest groups.¹⁸⁶ Giving the Court of Trade more power in the form of the *sua sponte* disregard of Customs' presumption of correctness could be deleterious in this situation. Capture may be possible, but judges tend to enjoy more insulation than agencies from outside pressure because agencies are part of the political branches.¹⁸⁷ Though the court is not a part of the political branches, there is a possibility that certain groups could lobby for appointments to the court. There is evidence to suggest, however, that the influence on the judicial process is negligible.¹⁸⁸ A judge's pay and tenure are severed from the political processes.¹⁸⁹ Therefore, a judge has a greater independence from political interest groups than an agency.

CONCLUSION

Currently, there is a statutory presumption of correctness for Customs' classification determination that an importer must overcome by a preponderance of the evidence.¹⁹⁰ As this Comment demonstrated, Congress should adopt a new rule giving the Court of Trade the authority to rebut Customs' presumption of correctness for classification rulings *sua sponte*. The proposed rule would give the Court of Trade the marginal discretion to make tariff classification determinations *sua sponte*, but the court could uphold Customs rulings with persuasive reasoning under the *Skidmore* standard.¹⁹¹

Some deference to Customs, while required, is also valuable. However, the Court of Trade and Circuit Court have the expertise to promulgate more reliable HTS interpretation standards for importers because court opinions provide binding precedent that tariff classification

¹⁸⁶ Jeffrey W. Stempel, *Two Cheers for Specialization*, 61 BROOK. L. REV. 67, 100 (1995) (stating that it is not clear whether the specialist courts are susceptible to interest group pressuring).

¹⁸⁷ *Id.* at 106.

¹⁸⁸ *Id.*

¹⁸⁹ *Id.*

¹⁹⁰ *Rollerblade, Inc. v. United States*, 112 F.3d 481, 483–84 (Fed. Cir. 1997); *Rockwell Automation, Inc. v. United States*, 31 Ct. Int'l Trade 692, 701 (2007).

¹⁹¹ This additional ability to find facts would not be inconsistent with the current division of labor between the Court of Trade and Customs. See Gail T. Cumins, Allison M. Baron & Sara Nordin, Commentary, *Cases Under 28 U.S.C. § 1581(a)*, 38 GEO. J. INT'L L. 11, 20–21 (2006) (citing *Reser's Fine Foods, Inc. v. United States* as an example that the Court of Trade need not heed the presumption of correctness of Customs' factual finding for a summary judgment motion because if the parties agree that there is no issue of material fact, then the Court of Trade may begin the HTS heading interpretation without assuming that Customs made the correct classification).

rulings executed by agencies do not. This approach would also be consistent with Congress's desire for a check upon agencies.¹⁹² The standards promulgated by the Court of Trade and Circuit Court could lead to further consistency and predictability for importers resulting in beneficial effects on trade and international commercial law.¹⁹³

¹⁹² Sunstein, *supra* note 167, at 445 (stating that a general rule of deference to agencies would be undesirable because many statutes were conceived as fetters for administrative authorities).

¹⁹³ UNAH, *supra* note 13, at 92; *see* Pinnock & Shankle, *supra* note 9, at 39 (stating that importers are focused on the bottom line question of how much it will cost them to move their goods into the United States).