JOURNAL OF INTERNATIONAL COMMERCIAL LAW

VOLUME 5 FALL ISSUE NUMBER 1

JOURNAL OF INTERNATIONAL COMMERCIAL LAW

VOLUME 5 | FALL ISSUE | NUMBER 1

CONTENTS

ARTICLES

NOTES

JOURNAL OF INTERNATIONAL COMMERCIAL LAW

VOLUME 5 | FALL ISSUE | NUMBER 1

Cite as 5 GEO. MASON J. INT'L COM. L. ___ (2013)

The *George Mason Journal of International Commercial Law* is published three times per year. The *George Mason Journal of International Commercial Law* can be contacted as follows:

George Mason Journal of International Commercial Law
3301 N. Fairfax Drive, Arlington, VA 22201
http://www.georgemasonjicl.org/

The *George Mason Journal of International Commercial Law* is a traditional student-edited legal periodical at the George Mason University School of Law in Arlington, Virginia. Providing international scholars and practitioners a forum to exchange, develop, and publish innovative ideas, the *Journal* is uniquely situated to address the legal issues affecting international commerce. The *Journal* publishes scholarly, concise, and practical material from leading scholars and practitioners to provide a source of authority and analysis for the advancement of uniformity in the law underlying international commerce.

Subscriptions: Single issues are available for download online at http://www.georgemasonjicl.org. Print versions are available by request to the Managing Editor at the mail address listed above or by email at: managing@georgemasonjicl.org. Single issues may be purchased for $15 per copy for domestic and $18 for foreign subscribers.

Submissions: The Editors welcome submissions of unsolicited manuscripts. The *George Mason Journal of International Commercial Law* seeks to publish articles and essays making a significant, original contribution to the fields concerning international commerce. Footnotes should follow the form prescribed in *The Bluebook: A Uniform System of Citation* (19th ed. 2010). Articles must be both well written and completely argued at the time of submission. Manuscripts and editorial correspondence should be addressed to Senior Articles Editor, *George Mason Journal of International Commercial Law*, at the address listed above or by email at: articles@georgemasonjicl.org.

INVESTMENT DISPUTE RESOLUTION UNDER THE PROPOSED TRANSPACIFIC PARTNERSHIP AGREEMENT: PRELUDE TO A SLIPPERY SLOPE?

Leon E Trakman[*]

INTRODUCTION

The potential of the Transpacific Partnership ("TPP") to grow into a multilateral investment agreement is significant given the prospective number of participating members and the potential economic and political scope of the free trade and investment area. TPP investment enthusiasts are likely to envisage it as the continuation of an evolving multilateral investment process to replace in part the multilateral investment agreement that failed at the end of the 1990s[1] and as a template for other regions to replicate.[2] However economic and political significance are measured, a concluded Transpacific Partnership Agreement ("TPPA") will have an enormous impact on global investment law and practice, especially considering that global foreign direct investment ("FDI") has grown geometrically since 1970, exceeding $1.5 trillion by 2012.[3]

---

[*] Professor of Law and Past Dean, UNSW Law School; B Com, LLB (Cape Town), LLM, SJD (Harvard). I am indebted to colleagues at the Workshop on the ICSID held in Xi'an Jiaotong University, in China on 25-30 June 2012, organised by Professor Wenhau Shan, for their insights; to colleagues at the Workshop on the TPP negotiations held at the Melbourne Law School on 18 August 2012 organized by Tania Voon; and to Mark Feldman, Mark Kantor, Luke Nottage. Simon Brimsmead and Shiro Armstrong for their comments on a draft of this article. Particular thanks are owed to Kunal Sharma for his able research assistance. For background information, see Leon E. Trakman and Nick W. Nanieri, REGIONALISM IN INTERNATIONAL INVESTMENT LAW ch 12 (Oxford University Press, 2013).

[1] On attempts to develop a multilateral investment treaty, *see* CHRISTOPH SCHREUER & RUDOLF DOLZER, PRINCIPLES OF INTERNATIONAL INVESTMENT LAW, ch 1 (2008) [hereinafter SCHREUER & DOLZER]; Stephan W. Schill, *The Multilateralization of International Investment Law*, 1-5 (Society of Int'l Econ. L., Working Paper No. 18/08 2008) [hereinafter Schill Working Paper]; *See also* Organization for Economic Co-operation and Development, *The Multilateral Agreement on Investment Negotiating Text* (OECD, Apr. 24, 1998), http://italaw.com/documents/MAIDraftText.pdf [hereinafter OECD Agreement]; Katia Tieleman, *The Failure of the Multilateral Agreement on Investment (MAI) and the Absence of a Global Public Policy Network*, Global Public Policy Institute 17–20 (2000), http://www.gppi.net/fileadmin/gppi/Tieleman_MAI_GPP_Network.pdf.

[2] *See generally* Schill Working Paper, *supra* note 1, ch. I-VII (discussing non-ICSID methods of multilateralization and investment jurisprudence); Steffen Hindelang, *Bilateral Investment Treaties, Custom and a Healthy Investment Climate – The Question of Whether BITs Influence Customary International Law Revisited*, 5 J. WORLD INVESTMENT & TRADE 789 (2004).

[3] *See* U.N. CONF. ON TRADE AND DEVELOPMENT, WORLD INVESTMENT REPORT 2012, U.N. Doc. UNCTAD/WIR/202, U.N. Sales No. E.12.II.D.3 at xi (2012), [hereinafter WORLD INVESTMENT REPORT (2012)] *available at* http://www.unctad-docs.org/files/UNCTAD-WIR2012-Full-en.pdf.

Despite the potential benefit of a TPPA, there are controversial aspects in the unfolding TPP investment negotiations. The first aspect relates to Australia's participation in the negotiations on the proposed investment chapter of that Agreement,[4] with its position that it will not accept investor-state arbitration ("ISA"), which is the predominant mechanism for resolving investor-state disputes.[5] This raises significant questions about the ramifications of country specific exemptions from provisions in the TPPA. The second aspect relates to the prospects of one or more of the growing number of TPP participants changing their negotiating positions either to follow Australia's lead in rejecting ISA, or setting country specific conditions to their participation. Although China is not participating in the TPP negotiations, China, Canada and Mexico are recent participants and Japan joined the TPP negotiations in August 2013.[6] As a result, more is at stake in the TPP negotiations than Australia's rejection of ISA, although the ramification of that rejection itself is significant.[7]

The prospect of Australia seeking an exemption from ISA within a TPPA chapter on investment is probable at this time following from Australia's 2011 Trade Policy Statement that it would no longer enter into investment treaties

---

[4] *See* Press Release, Craig Emerson, Austl. Trade Minister, *Gillard Government Policy Statement: Trading Our War to More Jobs and Prosperity* (Apr. 2011) [hereinafter Emerson Policy Statement]. For a comment on the Australian Government's Policy Announced on April 12, 2011, *see* Jurgen Kurtz, *Australia's Rejection of Investor-State Arbitration: Causation, Omission and Implication*, 27 ICSID REV. 65 (2012); Luke Peterson, *Australia Rejects ISA Provision in Trade Agreements*, Don't Trade Our Lives Away (Apr. 14, 2011) http://donttradeourlivesaway.wordpress.com/2011/04/19/australia-rejects-investor-state-arbitration-provision-in-trade-agreements [hereinafter Peterson Blog]; Leon E. Trakman, *Investor State Arbitration or Local Courts: Will Australia Set a New Trend?*, 46 J. WORLD TRADE 83, (2012) [hereinafter Trakman WORLD TRADE]; *see* Leon E. Trakman, *Investor State Arbitration or Local Courts: Will Australia set a new Trend*, REGIONALISM IN INTERNATIONAL INVESTMENT LAW, (Leon E. Trakman & Nicola Ranieri, eds., 2013) [hereinafter Trakman *Investor-State Arbitration*].

[5] *See generally* CHRISTOPHER DUGAN, DON WALLACE, JR & NOAH RUBINS, INVESTOR-STATE ARBITRATION (2008); OXFORD HANDBOOK OF INTERNATIONAL INVESTMENT LAW (Peter Muchlinski, et. al. eds., 2008); CAMPBELL MCLACHLAN, ET. AL., INTERNATIONAL INVESTMENT ARBITRATION: SUBSTANTIVE PRINCIPLES (2008); NEW ASPECTS OF INTERNATIONAL INVESTMENT LAW (Philippe Kahn & Thomas W Walde eds., 2007); GUS VAN HARTEN, INVESTMENT TREATY ARBITRATION AND PUBLIC LAW (2007); R. DOAK BISHOP, ET AL., FOREIGN INVESTMENT DISPUTES: CASES, MATERIALS AND COMMENTARY (2005); INTERNATIONAL INVESTMENT LAW AND ARBITRATION: LEADING CASES FROM THE ICSID, NAFTA, BILATERAL TREATIES AND CUSTOMARY INTERNATIONAL LAW (Todd Weiler ed., INTERNATIONAL 2005); ARBITRATING FOREIGN INVESTMENT DISPUTES (Norbert Horn ed., 2004).

[6] *See U.S.-Japan Market Access Talks in TPP Not to Begin Until Late August*, Inside U.S. Trade (June 20, 2013) http://insidetrade.com/Inside-Trade-General/Public-Content-Special-Promo/us-japan-market-access-talks-in-tpp-not-to-begin-until-late-august/menu-id-1037.html.

[7] *See* FOREIGN INVESTMENT AND DISPUTE RESOLUTION LAW AND PRACTICE IN ASIA (Vivienne Bath & Luke Nottage eds., 2011) (discussing China's shifting Position in regard to investment arbitration).

that provided for ISA.[8] Australia's 2011 Trade Policy Statement changes a course which Australia had commenced in the early 1980's when it began concluding bilateral investment treaties ("BITs"), which included ISA provisions, with the notable exception of the Australia-United States Free Trade Agreement ("AUSFTA") that provides for judicial resolution of investor-state disputes.[9] The Australian Government has since implemented its 2011 Trade Policy Statement in a free trade agreement ("FTA") with Malaysia in May 2012 that does not include ISA. Nor has Australia's Liberal Government, elected in 2013, indicated that it will abandon the Policy Statement. ISA is also not included in the recent Investment Protocol contained in the 2013 amendment to the 1983 Australia New Zealand Closer Economic Trade Relations Act ("ANZCERTA").[10]

The issue of countries like Australia securing exemptions under the Investment Chapter tests the capacity of prospective investment agreements, such as the proposed TPPA, to maintain their authority if they grant country specific concessions too readily. As a result, Australia's potential exemption from ISA is significant for strategic political and economic reasons, well beyond Australia's impressive but limited share of the global investment market. First, such an exemption would exempt one country from an institution and process of dispute resolution that is central to the application of the Investment Chapter. Second, so long as there are reservations or exemptions from the TPPA, there is always the prospect that country specific annexes will grow, conceivably beyond workable limits. Third, prospective TPP members, notably Japan, are likely to engage in negotiations with pre-set agendas, including reservations about ISA.[11] Fourth, general and specific exemptions secured by negotiating parties to the TPP could lead to a two-tier,

---

[8] Emerson Policy Statement, *supra* note 4; Kurtz, *supra* note 4; Peterson Blog, *supra* note 4; Trakman WORLD TRADE, *supra* note 4; Leon E. Trakman, *Investor State Arbitration or Local Courts: Will Australia set a new Trend*, REGIONALISM IN INTERNATIONAL INVESTMENT LAW (Leon E. Trakman & Nick Ranierim, eds., 2013).

[9] *See* United States-Australia Free Trade Agreement, U.S.-Austl., May 18, 2004, 118 Stat. 919, [hereinafter AUSFTA] *available at* http://www.ustr.gov/trade-agreements/free-trade-agreements/australian-fta/final-text; Leon Trakman, *Foreign Direct Investment: An Australian Perspective*, 13 INT'L TRADE & BUS. 31, 79–81(2010); Peter Drahos & David Henry, *The Free Trade Agreement between Australia and the United States*, 328 BRIT. MED. J. 1271 (May 29, 2004).

[10] For details, including the full text of ANZCERTA, *see Australia – New Zealand Closer Economic Relations Trade Agreement*, Australian Gov't Dep't of Foreign Affairs and Trade (last visited Oct. 31, 2013 at 1:00 PM) http://www.dfat.gov.au/fta/anzcerta/.

[11] *See* Aurelia George Mulgan, *What can we expect from Japan's Prime Minister Abe on the TPP?*, East Asia Forum (Jan. 15, 2013), *available at* http://www.eastasiaforum.org/2013/01/15/what-can-we-expect-from-japans-prime-minister-abe-on-the-tpp/ (stating "[t]he criteria encompass the LDP's promise to oppose participation in the negotiations as long as they are premised on 'tariff abolition without sanctuary' as well as other conditions, including the rejection of numerical targets for cars and the investor-state dispute settlement clause, and the protection of food safety standards and Japan's universal healthcare system.").

or even a multi-tier, regional investment agreement. This could herald an assortment of BITs, or other side agreements between TPP states, as signatories to the TPPA seek to maximize benefits going beyond exemptions secured by some negotiating parties to the TPPA. Insofar as there is long standing concern about a "spaghetti bowl" of FTAs, the TPPA may result in a variety of disparate BIT side-agreements concluded between parties to the TPPA, accentuating concerns about a spaghetti bowl of BIT.[12] In addition, some existing and prospective TPP negotiating parties already have bilateral and multilateral FTAs with each other. For example, Australia has two agreements with Malaysia[13] and two with New Zealand.[14] Therefore, any TPPA will need a resolution on how to deal with existing FTAs and BITs. The prospect of complex country specific annexes, exemptions, and future BITs following Australia's probable exemption from ISA warrants particular consideration.

At the outset, the legal significance of Australia's position, viewed in isolation, should not be overstated. Australia is seeking an exemption from the ISA process only, not presumably from substantive protections that the TPPA will provide to investors such as "fair and equitable treatment"[15] and the

---

[12] 'Swimming in the spaghetti bowl' is a phrase that is attributed to prominent Columbia University economist, Jagdish Bhabwati, to describe the economic effect of multiple 'free' trade agreements. *See* Luis Abugattas Majluf, *Swimming in the Spaghetti Bowl: Challenges for Developing Countries Under the "New Regionalism"*, U.N. Conf. on Trade & Development, at 14–15 (2004*) available at* http://unctad.org/en/docs/itcdtab28_en.pdf. *See* Kenneth J. Vandevelde, *A Brief History of International Investment Agreements*, 12 U.C. DAVIS J. INT'L L & POL'Y 157, 172 (2005) (Vandevelde writes that in 1969 there were only 75 BITs. During the 70's, nine BITs were negotiated each year; that rate doubled in the 80's and increased significantly in the 1990's. That growth has slowed in the last five years, although the number of BITs has increased in 2012). *See also The ICSID Caseload – Statistics,* INTERNATIONAL CENTRE FOR SETTLEMENT OF INVESTMENT DISPUTES (2013) [hereinafter The ICSID Caseload], *available at* http://icsid.worldbank.org/ICSID/FrontServlet?requestType=ICSIDDocRH&actionVal=CaseLoadStatistics; *Research Note: Recent Developments in International Investment Agreements*, U.N. CONF. ON TRADE AND DEV. *Recent Developments in International Investment Agreements*, U.N. Doc. UNCTAD/WEB/ITE/IIT/2005/1(Aug. 30, 2005), *available at* http://www.unctad.org/sections/dite_dir/docs/webiteiit20051_en.pdf. *See generally*, Leon E Trakman, *Foreign Direct Investment: Hazard or Opportunity?* 41 GEO. WASH. INT'L. L. REV. 1 (2009) [hereinafter Trakman *FDI*].

[13] Malaysia-Australia Free Trade Agreement, Malay. – Austl., Feb. 27, 2009; ASEAN-Australia-New Zealand Free Trade Agreement, Austl. – N.Z., Nov. 16, 2001.

[14] Australia New Zealand Closer Economic Agreement, Austl. – N.Z. 2011; ASEAN-Australia-New Zealand Free Trade Agreement Austl. – N.Z., Nov. 16, 2001.

[15] On the 'fair and equitable' treatment standard in investment treaties*, see*, *e.g.*, Christoph Schreuer, *Fair and Equitable Treatment in Arbitral Practice*, 6 J. WORLD INV. & TRADE 357 (2005); ROLAND KLÄGER, FAIR AND EQUITABLE TREATMENT IN INTERNATIONAL INVESTMENT LAW (Cambridge Univ. Press, 2011); Andrew P. Tuck, *The 'Fair And Equitable Treatment' Standard Pursuant to the Investment Provisions of The U.S. Free Trade Agreements with Peru, Colombia and Panama*, 16 LAW & BUS. REV. AM. 385 (2010); Kenneth J. Vandevelde, *A Unified Theory of Fair and Equitable Treatment*, 43 N.Y.U. J. INT'L L. & POL. 43 (2010); Meg Kinnear, *The Continuing Development of the Fair and Equitable Treatment Standard*, in INVESTMENT TREATY LAW: CURRENT ISSUES III. REMEDIES IN INTERNATIONAL INVESTMENT 209 (Andrea K.

protection of the "legitimate interests" of investors.[16] The result would be that, were Australia to deny substantive protection to a foreign investor, that investor could bring an action against Australia before Australian courts charged with jurisdiction under Australia's proposed exemption from ISA under the TPPA. However, this presupposes that Australia would provide for such substantive protections in its domestic law, either in consequence of pre-existing Australian law, or by express or implied reference to the TPPA. If other countries also seek to exclude ISA through specific or general exemptions, and the substantive protections in the TPPA are incorporated into their domestic legal systems, their domestic courts would also be bound by those substantive provisions. The exemptions would only have the effect of displacing ISA as a process in favor of a domestic legal process. However, the substantive treaty obligations assumed by those countries under the TPPA would presumably remain in place, so long as they were incorporated expressly or by reference into domestic law.[17]

Bjorklund, Ian A. Laird & Sergey Ripinsky eds., 2009); Ian A Laird, *MTD Equity Sdn Bhd and MTD Chile S.A. v Republic of Chile — Recent Developments in the Fair and Equitable Treatment Standard*, TRANSNAT'L DISP. MGMT. (Oct. 2004); Courtney Kirkman, *Fair and Equitable Treatment: Methanex v United States and the Narrowing Scope of NAFTA Article 1105,* 34 LAW & POL'Y INT'L BUS 343 (2002).

[16] On 'legitimate expectations', *see* Saluka Investments BV (The Netherlands) v. The Czech Republic (Partial Award) (Arbitration under the UNCITRAL Rules, Mar. 17 2006) [304], *available at* http://italaw.com/documents/Saluka-PartialawardFinal.pdf; Waste Management, Inc v The United Mexican States (Final Award) (ICSID Arbitral Tribunal, Case No ARB(AF)/00/3 (NAFTA), Apr. 30 2004) [98], *available at* http://italaw.com/documents/laudo_ingles.pdf; International Thunderbird Gaming Corporation v. The United Mexican States (Arbitration under the UNCITRAL Rules (NAFTA), 26 Jan. 2006) [147] [hereinafter "*Thunderbird*"], *available at* http://italaw.com/documents/ThunderbirdAward.pdf; GAMI Investments Inc v. The Government of the United Mexican States (Final Award) (Arbitration under the UNCITRAL Rules, Nov. 15 2004) [100], *available at* http://www.state.gov/documents/organization/38789.pdf. *See also* Stephan W. Schill, *Fair and Equitable Treatment under Investment Treaties as an Embodiment of the Rule of Law*, (Inst. for Int'l Law & Justice, Working Paper No. 2006/6, Dec.2006; Stephan W. Schill, *The Relation of the EU and Member States in Investor-State Arbitration*, *in* REGIONALISM IN INTERNATIONAL INVESTMENT LAW (Leon E. Trakman & Nick Ranierim, eds., 2013). But *see* Francisco Orrego-Vicuna, *Foreign Investment Law: How Customary is Custom?* AM. SOC'Y OF INT'L L. PROCS. 98 (2005) ("fair and equitable treatment is not really different from the legitimate expectations doctrine as developed, for example by the English court and also recently by the World Bank Administrative Tribunal").

[17] The assumptions that resort to domestic courts of the host state to resolve an investor-state dispute would preserve the substantive treaty obligation of the host state is not self-evident. First, domestic courts may apply a strict principle of sovereign immunity by which the host state is immune from claims brought by foreign investors before domestic courts. Second, domestic courts may hold that domestic law ought to prevail over treaty law, such as on public policy grounds. Third, domestic courts may regard treaty law as executive action that is outside the judicial purview. On sovereignty and other 'national autonomy' defenses invoked by states, *see* REDEFINING SOVEREIGNTY IN INTERNATIONAL ECONOMIC LAW, Pt. 4 (Wenhau Shan et al, eds. 2008(commenting on the complexity of sovereignty in international investment law). *See generally* INTERNATIONAL ECONOMIC LAW AND NATIONAL AUTONOMY (Meredith Kolsky Lewis & Susy Frankel eds., 2010); ROBERT H. JACKSON, QUASI-STATES: SOVEREIGNTY,

The problem with the domestic legal process replacing the ISA process is that legal systems of countries negotiating the TPPA diverge, constitutionally and functionally, over the enforcement of substantive treaty obligations in their domestic legal systems in accordance with their discrete conceptions of state sovereignty. For example, courts in countries that adhere to an absolute theory of state sovereignty could conceivably decline to enforce ISA awards on grounds of sovereign immunity,[18] or more pervasively, on grounds of national security, public health, or environmental protection.[19] They could construe public policy constraints on foreign investors expansively while interpreting country specific exceptions in the TPPA in favor of the host state.[20] They could do so recognizing how difficult it is to enforce the international obligations of states that subject their accession to international conventions to conditions such as the power to invoke the defense of sovereign immunity in response to claims brought against them.[21] Such conditions also limit the scope of claims brought against states and their enterprises that are signatories to conventions such as the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards of 1958 (the "New York Convention"),[22] and the Convention on the International Center for the

---

INTERNATIONAL RELATIONS AND THE THIRD WORLD (1990); JOHN H. JACKSON, THE JURISPRUDENCE OF GATT AND THE WTO: INSIGHTS ON TREATY LAW AND ECONOMIC RELATIONS, ch. 18 (2000); Michael Reisman, *International Arbitration and Sovereignty,*18 ARB. INT'L (LCIA) 231 (2002); OPPENHEIM'S INTERNATIONAL LAW 927 (Sir Robert Jennings & Sir Arthur Watts eds., 1992).

[18] An assertion of state sovereignty would not be exceptional, given the historical practices of states, not limited to China. *See, e.g.*, Wenhau Shan, *China and International Investment Law*, *in* REGIONALISM IN INTERNATIONAL INVESTMENT LAW (Leon E. Trakman & Nick Ranierim, eds., 2013); Robert Stumberg, *Sovereignty by Subtraction: The Multilateral Agreement on Investment*, 31 CORNELL INT'L L. J. 491, 503–04, 523–25 (1998).

[19] *See, e.g.*, Nigel Blackaby*, Public Interest and Investment Treaty Arbitration*, *in INTERNATIONAL COMMERCIAL ARBITRATION: IMPORTANT CONTEMPORARY QUESTIONS 355* (*Albert Jan van den Berg ed.,* 2003); KYLA TIENHAARA, THE EXPROPRIATION OF ENVIRONMENTAL GOVERNANCE: PROTECTING FOREIGN INVESTORS AT THE EXPENSE OF PUBLIC POLICY, 152–57 (Cambridge Univ. Press, 2009).

[20] *See, e.g.*, Andrew Newcombe, *General Exceptions in International Investment Agreements*, SUSTAINABLE DEVELOPMENT IN WORLD INVESTMENT LAW 355 (Marie-Claire Cordonier Segger et al. eds., Kluwer, 2011).

[21] *See* Shan, *supra* note 18.

[22] On the conditional accession of states, like China, to the New York Convention, *see* Shan, *supra* note 18; The text of the New York Convention is available at *Convention on the Recognition and Enforcement of Foreign Arbitral Awards*, United Nations Commission on International Trade Law, (last visited at 2:00 PM on Oct. 31, 2013) http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/NYConvention.html. *See generally,* ALBERT VAN DER BERG, 50 YEARS OF THE NEW YORK CONVENTION (2009); HERBERT KRONKE ET. AL., RECOGNITION AND ENFORCEMENT OF FOREIGN ARBITRAL AWARDS: A GLOBAL COMMENTARY (2010).

Settlement of Investment Disputes between states and the investors of other states (the "ICSID Convention").[23]

Given these concerns, this paper has three key objectives. The first is to examine Australia's 2011 Trade Policy Statement rejecting ISA in light of the dispute settlement provisions in the draft Investment Chapter of the TPPA that was leaked to the public in June 2012.[24] The second is to analyze the potential value of ISA as compared to other mechanisms of dispute settlement, notably but not exclusively, resort to the domestic courts of state parties to the TPPA providing for such resort. The third is to consider both of these objectives in light of their wider political, economic and legal implications, well beyond Australia.

I. AUSTRALIA'S OBJECTION TO ISA

In its April 2011 Trade Policy Statement, the Australian Government enunciated that it "does not support provisions that would confer greater legal rights on foreign businesses than those available to domestic businesses."[25] In particular, it maintained that it will not "support provisions that would constrain the ability of Australian governments to make laws on social, environmental and economic matters in circumstances where those laws do not discriminate between domestic and foreign businesses."[26] As a result, it announced that it will "discontinue" the practice of including investor-state dispute resolution procedures in its treaties.[27] Furthermore, "[i]f Australian businesses are concerned about sovereign risk in Australian trading partner countries, they will need to make their own assessments about whether they want to commit to investing in those countries."[28] In effect, the Australian Government indicated that Australian businesses would need to assume the risk of being subject to the domestic courts of Australia's treaty partners, given the implication arising from Australia's Policy Statement that domestic courts will replace ISA in its future trade and investment treaties. The significance of this policy is the subject of a more detailed study by the author elsewhere.[29]

---

[23] See Shan, *supra* note 18. The ICSID Convention and Rules are available at: Rules, International Centre for Settlement of Investment Disputes, (last visited Jan. 27, 2012), http://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=ShowHome&pageName=Rules_Home; See generally Yaraslau Kryvol, International Centre for Settlement of Investment Disputes (ICSID) (Kluwer, 2013).

[24] Available at Citizens Trade Campaign, (last visited 2:30 PM on Oct. 31, 2013) http://www.citizenstrade.org/ctc/wp-content/uploads/2012/06/tppinvestment.pdf.

[25] *See* Emerson Policy Statement, *supra* note 4.

[26] *See id*.

[27] *Id.*

[28] *Id.*, at 1–2.

[29] *See* Trakman WORLD TRADE, *supra* note 4; Leon E Trakman, *Choosing Domestic Courts over Investor-State Arbitration: Australia's Repudiation of the Status Quo*, 35 UNSW L. J. 979 (2012).

The jurisdictional rationale for Australia's 2011 Trade Policy Statement is that investment disputes ought to be decided by the domestic courts of host states, not international tribunals.[30] The equitable rationale is that foreign investors should receive no better treatment than that which is accorded to local investors.[31] The public policy rationale is that, were ISA to privilege foreign investors, it would not serve the national interest, and if it fails to service the national interest, domestic courts ought to replace it.[32] As a result of these rationales, the Australian Government has sought to be excluded from any ISA provisions under the TPPA. An ancillary result is that Australia's future investment treaties are expected to provide that investor-state disputes be submitted to domestic courts for resolution, not unlike the dispute resolution provisions in the AUSFTA.[33]

The considered view to date is that TPP negotiators will provide Australia with an exemption from ISA provisions in the TPPA.[34] In support of this view is recognition that country specific exemptions are part and parcel of the negotiating process. In further support is the apparent dispelling of a one-size-fits-all TPPA in recognition of the disparate local requirements of the negotiating states.[35]

However, there is no published confirmation that the TPP negotiating parties have definitively agreed that Australia should be exempt from investor-state dispute settlement obligations. An implicit concern is that Australia's reasons for seeking an exemption from ISA could set a problematic precedent. First, Australia's reliance on domestic courts to resolve investor-state disputes, however seemingly legitimate for Australia, may be replicated by TPP states that do not adhere to the same kind of "rule of law" tradition that is adhered to by Australian courts, or that they have no "rule of law" tradition at all.[36]

---

[30] On the significance of this view under the revitalized "Calvo Doctrine", *See* Wenhua Shan, *From "North-South Divide" to "Private-Public Debate": Revival of the Calvo Doctrine and the Changing Landscape in International Investment Law* 27 NW. J, INT'L L. & BUS. 631 (2007); Bernardo Cremades, *Resurgence of the Calvo Doctrine in Latin America* 7 BUS. L. INT'L 53 (2006).

[31] *See* Trakman WORLD TRADE, *supra* note 4.

[32] *See generally* DAVID SCHNEIDERMAN, CONSTITUTIONALIZING ECONOMIC GLOBALIZATION: INVESTMENT RULES AND DEMOCRACY'S PROMISE, ch. 2, 6 (Cambridge Univ. Press 2008) (analysis of the view that, if investment arbitration privileges foreign investors, it undermines the national interest and democracy's "promise").

[33] *See* Trakman FDI, *supra* note 12, at 48–53; Thomas Westcott, *Foreign Investment Issues in the Australia-United States Free Trade Agreement*, (2006) *available at* http://archive.treasury.gov.au/documents/958/PDF/06_Foreign_investment_policy_AUSFTA.pdf.

[34] *See*, *infra* note 36.

[35] At this time, Australia's unwillingness to agree to ISA under the TPP is not viewed as fatal to its involvement in TPP negotiations. *See, e.g.*, *Australia to Reject Investor-State Dispute Resolution in TPP* Investment Treaty News, (13 Apr. 2012) *available at* http://www.iisd.org/itn/2012/04/13/news-in-brief-7/.

[36] *See Worldwide Governance Indicators*, World Bank (last visited Oct. 31, 2013) *info.worldbank.org/governance/wgi/index.aspx*.

Second, Australia's insistence that foreign investors should receive no greater rights than domestic investors could expose foreign investors to domestic judicial standards of treatment that are lower than TPP standards in jurisdictions that resist paying fair compensation for a nationalized, expropriated, or other government taking of foreign investment. As a result, granting a seemingly narrow concession over a process of dispute resolution to a developed country with limited global muscle like Australia could have significant economic, political, and legal repercussions for other countries and their investors. It may be that Australia is the only country seeking an explicit exemption from ISA, but other countries may also seek to limit the scope of ISA through general exceptions.

It is premature to sound any alarm bells. Even if Australia does secure exemptions from ISA under the TPPA, this does not infer that such exemptions will be unrestricted. Exemptions from TPPA provisions on ISA will depend on the kind of cost-benefit analysis that prevails at a changing negotiating table, including whether the perceived benefit to the TPP membership at large outweighs the cost of exempting one member country from ISA.

It is also conceivable that the Liberal Party, elected in 2013, will withdraw Australia's objections to ISA. It is possible, too, that this new Australian Government may use its stance on ISA as a bargaining chip in a trade-off for something it may want more, such as access to the United States sugar market, so long as doing so would not appear as an incendiary back-flip.[37]

Nor is the Australian Government necessarily steadfast in insisting that only domestic courts resolve investor-state disputes under other bilateral or regional investment treaties. Australia may modify its exclusion of ISA by agreeing to a two-tier dispute resolution system, providing for either ISA or domestic courts, depending on the investment treaty under negotiation.[38] Its choice may also hinge on seemingly peripheral events, such as whether or not it loses the ISA dispute brought by Philip Morris, under the Hong Kong Australian Free Trade Agreement, against Australia over domestic legislation requiring the plain packaging of cigarettes.[39]

---

[37] A possible indication that the Liberal Government, elected in 2013, might withdraw, in whole or part, from its Trade Policy Statement in relation to ISA, is reported to have arisen in treaty talks between Australia and Korea in October 2013. *See, e.g.*, Rowan Callick, "Korea Ready to Talk Turkey After FTA Hurdle Removed" (1 Nov.) at http://www.theaustralian.com.au/business/economics/korea-ready-to-talk-turkey-after-fta-hurdle-removed/story-e6frg926-1226750841630#:.

[38] *See* Leon E. Trakman, *Choosing Domestic Courts Over Investor-State Arbitration: Australia's Repudiation of the Status Quo*, 35 UNSW L. J. 979, 1006 (2012).

[39] This agreement is technically titled "Agreement between the Government of Hong Kong and the Government of Australia for the Promotion and Protection of Investments". On Philip Morris' initiation of an action against Australia under the Australia-Hong Kong Free Trade Agreement, *see Philip Morris Asia Initiates Legal Action Against the Australian Government Over*

In support of Australia's 2011 Trade Policy Statement in favor of domestic courts resolving investor-state disputes is the recent unsuccessful challenge of Philip Morris before the High Court of Australia.[40] However principled public health and environmental policies regulating the sale of cigarettes may be, the Philip Morris case is the subject of an ISA claim under the Hong Kong Australia Free Trade Agreement, not a judicial challenge.[41] As a result, Australia's 2011 Trade Policy Statement against ISA is only tangentially related to the Philip Morris case.

The central concern with Australia's 2011 Trade Policy Statement in favor of domestic courts deciding investor-state disputes is commercial, relating in particular to outbound investors.[42] Typifying this concern, the Australian Chamber of Commerce and Industry wrote to the Prime Minister of Australia in response to the Policy Statement, urging a reversion to Australia's longstanding treaty practice of adopting investor-state dispute settlement on a case-by-case basis.[43] The Chamber's underlying concern was that ISA provided protections for outbound investors from court systems of treaty partners that lacked established "rule of law" traditions.[44]

In order to analyze the wider political, economic and legal implications of Australia's 2011 Trade Policy Statement, this paper proceeds on the assumption that the Policy Statement will remain in place during the TPP negotiations and that Australia will continue to seek an exemption from ISA.

II. CHALLENGES TO ISA

Plain Packaging, Philip Morris Int'l (June 27, 2011) http://www.pmi.com/eng/media_center/press_releases/pages/PM_Asia_plain_packaging.aspx. *See generally* Tobacco Plain Packaging Act (No. 148, 2011) Austrl. *See also* Simon Chapman & Becky Freeman, *The Cancer Emperor's New Clothes: Australia's Historic Legislation for Plain Tobacco Packaging*, 5/5/10 BRIT. MED. J. 2436 (2010); Tania Voon & Andrew Mitchell, *Implications of WTO Law for Plain Packaging of Tobacco Products*, (Univ. of Melbourne Legal Stud. Research Paper No. 554, June 30, 2011), *available at* http://ssrn.com/abstract=1874593.

[40] JT Int'l SA v Commonwealth [2012] HCA 43 (Cth). For a review of all court documents on Philip Morris's unsuccessful constitutional challenge before the High Court of Australia, *see generally* British Am. Tobacco Australasia Ltd. v Commonwealth, [2010] HCA 43 (Oct. 5, 2012), *available at* http://www.hcourt.gov.au/cases/case-s389/2011); Philip Morris Ltd. v Prime Minister [2011] AATA 556 (Cth) (Philip Morris's unsuccessful claim against the Prime Minister of Australia).

[41] *See* Voon & Mitchell, *supra* note 39.

[42] Letter to the Prime Minister, Australian Chamber of Commerce and Industry (July 13, 2012) *available at* http://acci.asn.au/Research-and-Publications/Media-Centre/Media-Releases-and-Transcripts/Global-Engagement/Australian-Foreign-Investment-Requires-Right-to-Su.aspx.

[43] *Id.*

[44] *See supra* note 42; *see also* Luke Nottage, *Open Letter -Assessing Treaty Based Investor-State Dispute Settlement*, Japanese Law in Asia Pacific Socio-Economic Context, Univ. of Sydney (July 28, 2012) http://blogs.usyd.edu.au/japaneselaw/2012/07/assessing_treatybased_investor.html.

The TPP negotiators' preference for ISA over domestic courts is based neither wholly on precepts of objective rationality, nor upon pervasive notions of equality among states or their investors. Instead, it is about negotiating states calculating, in part, that their outbound investors are more likely to prevail before an expert international investment arbitration tribunal than a foreign court of the home state respondent to an investor-state dispute.[45] More often than not, states favor institutions for dispute resolution based on the capacity of those institutions to deliver results that treat their subjects abroad according to their preferred home state standards, rather than the standards of host partner states in which their subjects invest.[46] It would be unrealistic to expect sovereign states to insist otherwise.

Nor are TPP negotiating states blind to the pitfalls associated with the potential scope of treaty obligations giving rise to ISA claims. Recent model BITs, such as the United States Model BIT adopted in 2012 and the Canadian Model BIT, have restricted the scope of earlier model BITs, such as the United States Model BIT of 2004, in part in response to the increased number of claims by foreign investors.[47] In doing so, these model BITs have implicitly limited both the substantive and interpretative leeway of ISA tribunals by expanding on the scope of a regulatory expropriation,[48] eroding the divide between the "fair and equitable treatment" of foreign investors and the "minimum standards of treatment," and by limiting the "national treatment" standards accorded to foreign investors.[49] Recent BITs, notably treaties to

---

[45] This 'calculation' is likely to be based on the proposition that the domestic courts of states tend to favor that state over a foreign investor, particularly in domestic jurisdictions that allegedly fall short on the "rule of law" corruption index established by the World Bank. *See Worldwide Governance Indicators*, *supra* note 36.

[46] *See, e.g.*, Charles N. Brower and Lee A. Steven, *NAFTA Chapter 11: Who then Should Judge? Developing the International Rule of Law under NAFTA Chapter 11*. 2 CHI. J. INT'L L. 193, 193–95 (2001); David A. Gantz, *An Appellate Mechanism for Review of Arbitral Decisions in Investor-State Disputes: Prospects and Challenges*, 39 VAND. J. TRANSNAT'L L. 39, 45–46 (2006).

[47] *See* Andrew Newcombe, *Canada's New Model Foreign Investment Protection Agreement*, 2–6 (August 2004), http://ita.law.uvic.ca/documents/CanadianFIPA.pdf (describing changes to the Canadian Model Bilateral Investment Treaty); *See generally* Treaty Between the Government of the United States of America and the Government of [Country] Concerning the Encouragement and Reciprocal Protection of Investment, 2004 Model Bilateral Investment Treaty, [hereinafter 2004 U.S. Model BIT] *available at* http://www.state.gov/documents/organization/117601.pdf.

[48] On the history of expropriation in international law, *see* Patrick M. Norton, *A Law of the Future or a Law of the Past? Modern Tribunals and the International Law of Expropriation*, 85 AM J. INT'L L. 474, 493–95 (1991); John Herz, *Expropriation of Foreign Property,* 35 AM J. INT'L L. 243, 251 (1941); *see generally* G. C. Christie, *What Constitutes a Taking of Property under International Law?* 38 BRIT Y.B. INT'L L 307 (1962) (providing an overview of various decisions on expropriation).

[49] *See* Caroline Henckels, *Indirect Expropriation and the Right to Regulate: Revisiting Proportionality Analysis and the Standard of Review in Investor-State Arbitration*, 15 J. INT'L ECON. L. 223 (2012). On the application of minimal standards of treatment to a variety of specific defenses under earlier U.S. Model BITs, *see* Patrick Dumberry, *The Quest to Define "Fair and Equitable Treatment" for Investors Under International Law: The Case of the NAFTA Chapter 11*

which the United States is a party, include expanded subjective national security provisions; they also exempt measures taken by governments designed to protect domestic health, public morality, social welfare and sustainable development, among other domestic interests.[50] These developments are reflected further in recent agreements, such as the United States–Peru Free Trade Agreement[51] and the Singapore–India Economic Cooperation Agreement.[52]

The result of these developments is that countries like the United States, while endorsing ISA, are reducing its scope of application. Nor is the Australian Government alone in its aversion to various aspects of ISA. There is strong ideological and functional opposition to ISA beyond the Policy of Australia. In an open letter to the TPP negotiators, a group of influential judges, lawyers and legal academics from New Zealand, Australia, Canada and the United Kingdom, among other British Commonwealth countries, wrote: "As lawyers from the academy, bench and bar, legislature, public service, business and other legal communities in Asia and the Pacific Rim, we are writing to raise concerns about the Investment and Investor-State dispute arbitration provisions being considered in the on-going negotiations for a Trans-Pacific Partnership (TPP) agreement."[53] They raised a number of objections. Their first objection was to the broad definition of "investment," in particular on grounds that it did not require a foreign investor to make any

---

Pope & Talbot Awards, 3 J. World Investment 657, 663 (2002). *See also* Directorate for Financial and Enterprise Affairs, *Fair and Equitable Treatment Standard in International Investment Law*, 11–2 (Org. for Econ. Co-operation and Dev., Working Paper No. 2004/3, 2004), *available at* http://www.oecd.org/daf/inv/internationalinvestmentagreements/33776498.pdf. On the disparate application of the "fair and equitable treatment" standard by ISA tribunals, *see, e.g.*, Maffezini v. Spain, Case No. ARB/97/7 (ICSID Arbitral Tribunal, Nov 13, 2000) (the 'fair and equitable' treatment standard is uniform in international investment jurisprudence; rather the contrary is evident in a series of cases commencing with the ICSID award); MTD Equity Sdn Bhd & MTD Chile S.A. v. Chile, Case No ARB/01/7 (ICSID Arbitral Tribunal, May 25, 2004).

[50] *Compare* Treaty Between the Government of the United States of America and the Government of [Country] Concerning the Encouragement and Reciprocal Protection of Investment, 2012 Model Bilateral Investment Treaty, [hereinafter 2012 U.S. Model BIT] *available at* http://www.ustr.gov/sites/default/files/BIT%20text%20for%20ACIEP%20Meeting.pdf *with* 2004 US Model Bilateral Investment Treaty. *See supra* note 47. *See also* Kenneth J. Vandevelde, *Model Bilateral Investment Treaties: The Way Forward*, 18 SW. J. INT'L L. 307 (2011); Andrew Newcombe, *General Exceptions in International Investment* (BIICL Eighth Annual WTO Confernce, Draft Discussion Paper, 2008), *available at* http://www.biicl.org/files/3866_andrew_newcombe.pdf.

[51] *See* Peru Trade Promotion Agreement, US–Peru, art. 10.21, April 12, 2006 [hereinafter Peru FTA]; Free Trade Agreement, US–Colom., art. 10.21, Nov. 22, 2006 [hereinafter Colombia FTA]; Free Trade Agreement, S. Kor.–US, art. 11.21, June 30, 2007 [hereinafter Korean FTA].

[52] *See* Comprehensive Economic Cooperation Agreement between the Republic of India and the Republic of Singapore, India–Sing., June 29, 2005.

[53] *See An Open Letter from Lawyers to the Negotiators of the Trans-Pacific Partnership Urging the Rejection of Investor-State Dispute Settlement*, TPP Legal, (May 8 2012 Updated), *available at* http://tpplegal.wordpress.com/open-letter [hereinafter TPP Legal].

contribution to the host state economy.[54] Their second objection was to the breadth of the substantive obligations in the draft TPPA, specifically that they often grant foreign investors greater rights than those accorded to domestic investors under domestic law.[55] Their third objection was to the grant of injunctive relief brought by foreign investors against host states on grounds that this would create "severe conflicts of law."[56] Their fourth objection was to the broad interpretation of a government "measure" to include jury decisions in private contract litigation.[57] Their fifth objection was to the use of Most Favored Nation ("MFN") provisions to avoid "the deliberate decision of governments to require investors to pursue remedies in the domestic courts of the host nation, at least initially..."[58] Their sixth objection was to the rotating roles of lawyers as arbitrators and advocates "in a manner that would be unethical for judges."[59] Their final objection was to the exclusion of "non-investor litigants and other affected parties" from participating in ISA proceedings, on the grounds that this was contrary to basic principles of "transparency, consistency and due process."[60] Their emphatic conclusion was

---

[54] *Id.* at 1–2. ("However, the definition of 'covered investments' extends well beyond real property to include speculative financial instruments, government permits, government procurement, intangible contract rights, intellectual property and market share, whether or not investments have been shown to contribute to the host economy.").

[55] *Id.* at 2 ("Simultaneously, the substantive rights granted by FTA investment chapters and BITs have also expanded significantly and awards issued by international arbitrators against states have often incorporated overly expansive interpretations of the new language in investment treaties. Some of these interpretations have prioritized the protection of the property and economic interests of transnational corporations over the right of states to regulate and the sovereign right of nations to govern their own affairs.").

[56] *Id.* at 2 ("In several instances, arbitral tribunals have gone beyond awards of cash damages and issued injunctive relief that creates severe conflicts of law. For instance, a recent order by a tribunal in the case brought by Chevron against Ecuador under a U.S.-Ecuador BIT ordered the executive branch of that country to violate its constitutional separation of powers and somehow halt the enforcement of an appellate court ruling.").

[57] *Id.* at 2 ("The scope of government actions that arbitral tribunals have previously considered they may subject to review for possible violations of investor rights includes a ruling on jurisdiction in the *Loewen v. United States* case under the North American Free Trade Agreement (NAFTA) in January 5, 2001 that 'measures' include the function of a domestic court and the standing rules of civil procedure. The arbitral tribunal concluded that a jury decision in private contract litigation constituted a government measure that was subject to NAFTA's investor rules.").

[58] *Id.* at 2–3.

[59] TTP Legal, *supra* note 53, at 2–3. ("Moreover, the design of the Investor-State system tribunals allows lawyers to rotate between roles as arbitrators and advocates for investors in a manner that would be unethical for judges.").

[60] *Id.* ("The system also excludes the right for non-investor litigants and other affected parties to participate and fails to meet the basic principles of transparency, consistency and due process common to our legal systems. Investment arbitration as currently constituted is not a fair, independent, and balanced method for the resolution of disputes between sovereign nations and private investors."); *But see* James Harrison, *Recent Developments to Promote Transparency and Public Participation in Investment Treaty Arbitration*, 15 (Univ. of Edinburgh L. Sch. Working Paper No. 2011/01, 2011) *available at*

to call on "all governments engaged in the TPP negotiations to follow Australia's example by rejecting the Investor-State dispute mechanism and reasserting the integrity of our domestic legal processes."[61]

Of further note, Australia's 2011 Trade Policy Statement against agreeing to ISA in its FTAs and BITs is not entirely unprecedented including the exclusion of ISA from the AUSFTA,[62] and from recent regional trade and investment agreements.[63] As a result, the change in Australia's 2011 Trade Policy Statement, while conceivably unexpected, was not a bolt entirely out of the blue.

Australia's position is nevertheless anomalous. Australia is the only negotiating party that is explicitly resisting ISA in the TPP negotiations (although other negotiating parties may seek to accomplish comparable ends through general exemptions).[64] This raises important questions about the direct and indirect consequences of Australia seeking an exemption from ISA. In particular, what are the direct costs and benefits to the TPP if such an exemption is granted to Australia? More difficult to assess, what indirect and ancillary consequences are likely to flow from that exemption, in relation to other states and their investors?

III. THE COSTS AND BENEFITS OF ISA

A salient issue is whether the direct cost of exempting Australia from ISA outweighs the economic and political risk of other states opting out of ISA. This concern has historical roots, evidenced by countries withdrawing from ISA, such as the ISA administered by the ICSID Convention, in reaction to adverse ISA determinations and the perception that ISA favors developed

---

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1739181 (steps have been taken to allow for public participation under investment treaties through submission of amicus briefs).

[61] *Id.*

[62] *See generally* Drusilla K Brown et al., *Computational Analysis of the US FTAs with Central America, Australia and Morocco*, 28 WORLD ECON. 1441 (2005) (discussing the US-Australia Free Trade Agreement); Philippa Dee, *The Australia-US Free Trade Agreement: An Assessment* (Australian Nat'l Univ., Pac. Econ. Papers No. 345, 2005) (Paper prepared for the Senate Select Committee on the Free Trade Agreement between Australia and the United States of America, June 2004).

[63] *See* Emerson Policy Statement, *supra* note 4; Kurtz, *supra* note 4, at 84; Peterson Blog, *supra* note 4; Trakman WORLD TRADE, *supra* note 4, at 84; Leon E. Trakman, *Investor State Arbitration or Local Courts: Will Australia set a new Trend*, REGIONALISM IN INTERNATIONAL INVESTMENT LAW (Leon E. Trakman & Nick Ranierim, eds., 2013).

[64] *See* Emerson Policy Statement, *supra* note 4, at 9–14 (explaining the position of the Australian Government under Prime Minister Gillard); *see* OECD Agreement, *supra* note 2, at 77 (providing general exemptions for nations to the proposed Multilateral Agreement on Investment); Stoller Salon Article, *supra* note 1 (providing insights into the U.S. Position); SCHREUER & DOLZER *supra* note 1, at 20–21 (discussing the requirements of nations party to a treaty).

Western states.[65] There is also evidence of states, particularly in Latin America, favoring domestic courts over international tribunals resolving claims against states, and the prospect of states "domesticating" investor-state disputes.[66] This preference is reflected in resurrection of the Calvo Doctrine, originating in Argentina which holds that jurisdiction in international investment disputes lies with the country in which that investment is located.[67]

A further concern is that a two-tier system of ISA awards and domestic court decisions will lead to aberrant differences in the nature and application of TPP "laws". Investors will forum shop in pursuit of favorable investment courts, highlighting the institutional divergence between domestic court decisions and ISA awards.[68] This will lead to decisional uncertainty over the nature and application of international investment law. Speculation will arise over whether domestic courts will enforce ISA awards and on what grounds they will do so. Conflict will revolve around the failure of a domestic court of a state party to the TPPA to enforce an ISA award on public policy grounds. Dissention will arise over whether such action violates that state's multilateral

---

[65] Venezuela, Bolivia and Ecuador are countries on point. *See Denunciation of the ICSID Convention and BITS: Impact on Investor State Claims*, UNCTAD, IIA Issues Note No. 2, (Dec. 2010); *ICSID in Crisis: Straight-Jacket or Investment Protection*, BRETTON WOODS PROJECT, (July 10, 2009), http://www.brettonwoodsproject.org/art-564878; William W. Park, *Arbitrator Integrity, in* THE BACKLASH AGAINST INVESTMENT ARBITRATION, 189, 215–21, (Michael Waibel et al., eds. 2010); Trakman, *The ICSID in Perspective,* in REGIONALISM IN INTERNATIONAL INVESTMENT LAW, at 362–64 [hereinafter Trakman, *ICSID in Perspective*] (discussing withdrawals from the ICSID); Antonios Tzanakopoulos, *Denunciation of the ICSID Convention under the General International Law of Treaties*, *in* INTERNATIONAL INVESTMENT LAW AND GENERAL INTERNATIONAL LAW: FROM CLINICAL ISOLATION TO SYSTEMIC INTEGRATION? 75, 75–78 (Rainer Hofmann & Christian J. Tams eds., 2011); Markus Burgstaller & Charles B. Rosenberg, *Challenging International Arbitral Awards: To ICSID or not to ICSID?*, 27 ARB. INT'L 91 (2011); Ignacio A. Vincentelli, *The Uncertain Future of ICSID in Latin America*, 16 LAW & BUS. REV. AM. 409, 421–29 (2010); Scott Appleton, *Latin American Arbitration: The Story Behind the Headlines*, International Bar Association, (last visited Sept. 25, 2013) *available at* http://www.ibanet.org/Article/Detail.aspx?ArticleUid=78296258-3B37-4608-A5EE-3C92D5D0B979; Press Release, ICSID, Venezuela Submits a Notice under Article 71 of the ICSID Convention, (Jan. 26, 2012) *available at* http://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=OpenPage&PageType=AnnouncementsFrame&FromPage=Announcements&pageName=Announcement100.
For further background see generally R. Zachary Torres-Fowler, *Undermining ICSID: How The Global Antibribery Regime Impairs Investor-State Arbitration*, 52 VA. J. INT'L. L. 995 (2012); Tor Krever, *The Legal Turn in Late Development Theory: The Rule of Law and the World Bank's Development Model*, 52 HARV. INT'L L.J. 287 (2011); Karsten Nowrot, *International Investment Law and the Republic of Ecuador: From Arbitral Bilateralism to Judicial Regionalism*, 96 BEITRAGE ZUM TRANSNATIONALEM WIRTSCHAFSRECT 5 (2010).

[66] Park, *supra* note 65, at 216–17.

[67] *See* Emerson Policy Statement, *supra* note 4. For a description of the Calvo doctrine, *see generally* Shan, *supra* note 30, at 632–25.

[68] *See* MONIQUE SASSON, SUBSTANTIVE LAW IN INVESTMENT TREATY ARBITRATION: THE UNSETTLED RELATIONSHIP BETWEEN INTERNATIONAL AND MUNICIPAL LAW, at ch. 3 (2010) [hereinafter SASSON, INVESTMENT TREATY ARBITRATION] (discussing the tension between domestic and international laws with respect to investment law).

obligations, *inter alia*, under the New York Convention,[69] the ISCID Convention,[70] or customary international law.[71]

A contrary rationale is that a two-tier system that endorses both ISA and domestic judicial decisions neither undermines nor dislocates the TPPA; nor is it likely to impinge upon the jurisprudence that evolves from the TPPA.[72] First, ISA is itself an *ad hoc* dispute resolution process.[73] Second, the decisions of ISA tribunals bind only direct parties to ISA disputes, and may well diverge from one ISA tribunal to the next.[74] Third, the tension between international and domestic investment law and practice is pervasive, and not peculiar to the prospective TPPA.[75]

However, this reasoning is also subject to formal and substantive challenges in both dualist and monist legal systems, but for different reasons. In a purely monist legal system, international law is automatically incorporated into domestic law, such as when a state ratifies a BIT.[76] In a purely dualist system, international law remains distinct from national law and is incorporated into national law only if it is expressly adopted, such as through enabling legislation.[77] In the absence of adoption, domestic courts cannot take cognizance of international law.[78] While most legal systems are neither purely monist nor purely dualist, a state that adopts a predominantly monist legal system is likely to automatically incorporate treaties like the

---

[69] Blackby, *supra* note 20 at 356–58. *See, e.g.*, TIENHAARA *supra* note 19, at 151–57.

[70] For detailed information on the ICSID including the obligations of signatories to the ICSID Convention, *see* Trakman *Investor-State Arbitration*, *supra* note 4, at 253; ICSID Homepage, (last visited at 5:00 PM on Nov. 1, 2013), http://icsid.worldbank.org/ICSID/Index.jsp.

[71] For a discussion of customary international law see ANTHONY D'AMATO, THE CONCEPT OF CUSTOM IN INTERNATIONAL LAW, 87–89 (1971); H. THIRLWAY, INTERTAIONAL CUSTOMARY LAW AND ITS CODIFICATION (1972). For a discussion of sources and application of international investment law, see generally DOZLER & SCHREUER, *supra* note 1; INTERNATIONAL INVESTMENT LAW AND ARBITRATION: LEADING CASES FROM THE ICSID, NAFTA, BILATERAL TREATIES AND CUSTOMARY INTERNATIONAL LAW (Todd Weiler ed., 2005); Andreas F. Lowenfeld, *Investment Agreements and International Law*, 42 COLUM. J. TRANSNAT'L L. 123 (2003).

[72] *See* Leon E. Trakman, *Australia and the Future of Investor State Arbitration*, *in* THE FUTURE OF DISPUTE RESOLUTION, 236, ch. 21 (Michel Legg, ed., 2012) [hereinafter Trakman, *Austrailia and the Future*].

[73] *See, e.g.*, ZACHARY DOUGLAS, THE INTERNATIONAL LAW OF INVESTMENT CLAIMS, 74 (2009); Trakman, *Australia and the Future*, *supra* note 72, at 236.

[74] Trakman, *Australia and the Future*, *supra* note 72, at 236. While ISA awards are *ad hoc* and do not give rise to binding legal precedents, they are nevertheless part of the *opinion juris* of international investment law with sometimes significant persuasive authority. *See* Leon E. Trakman, *The ICSID under Siege* 45 CORNELL INT'L L. J. 603 (2012) [hereinafter Trakman, *ICSID Under Siege*].

[75] *See* SASSON, INVESTMENT TREATY ARBITRATION, *supra* note 68.

[76] Brindusa Marion, *The Dualist and Monist Theories: International Law's Comprehension of these Theories*, 10 JUD. CURRENT J., No. 1, at 3 (2007), *available at* http://revcurentjur.ro/arhiva/attachments_200712/recjurid071_22F.pdf.

[77] HANS KELSEN, PRINCIPLES OF INTERNATIONAL LAW, at 551–52 (Robert W. Tucker, ed.1966).

[78] Marion, *supra* note 76, at 2.

TPPA and international customary law, including ISA decisions, into domestic law.[79] This unifies international and domestic law. In contrast, in a predominantly dualist legal system, international investment law would have no standing before domestic courts unless and until that state explicitly adopts that international law.[80] This potential sublimation of international investment law would further erode investment law in which ISA tribunals already reach inconsistent decisions in interpreting treaties on a case-by-case basis.[81]

The problem is that when domestic courts "localize" international law differently in response to their discrete judicial traditions, this accentuates incongruent attributes that are already evident in international investment jurisprudence.[82] One result is that common law courts in dualist legal systems consider themselves bound by judicial precedent to apply pre-existing judicial decisions and civil law courts place greater weight on the *opinion juris*, the opinion of jurists including scholarly interpretations of provisions in civil law codes.[83] The result is further divergence over the interpretation of the TPPA as well as the substantive meaning accorded to the substantive protections of investors.[84]

Differences across domestic judicial traditions, coupled with already disparate international investment jurisprudence, compound the already worrisome perception that regional trade agreements and BITs have produced not only a "spaghetti bowl" of disparate treaty provisions,[85] but a disparate body of domestic and international investment laws and decisions.[86] If the

---

[79] *Id.* at 4.

[80] *Id.* at 2.

[81] *See* Trakman, *Australia and the Future*, *supra* note 72, at 236–37 (discussing complications of a dualist system).

[82] *Id.* at 236.

[83] *See* Mirjan Damaška, *The Common Law/Civil Law Divide: Residual Truth of a Misleading Distinction*, 49 Sup. Ct. Rev. 3, at 4–7 (2010).

[84] *See* Christoph Schreuer & Matthew Weiniger, *A Doctrine of Precedent?* in THE OXFORD HANDBOOK OF INTERNATIONAL INVESTMENT LAW 1188 (Peter Muchlinski, et al. eds.,2008) (discussing the absence of binding precedents, at least in principle, in international investment law). *See generally* Andrea K. Björklund, *Investment Treaty Arbitral Decisions as* Jurisprudence Constante, *in* INTERNATIONAL ECONOMIC LAW: THE STATE AND FUTURE OF THE DISCIPLINE 265, 271–72 (Colin Picker, et al. eds., 2008); Tai-Heng Cheng, *Precedent and Control in Investment Treaty Arbitration*, 30 FORDHAM INT'L L. J. 1014 (2007); Jeffery P. Commission, *Precedent in Investment Treaty Arbitration: A Citation Analysis of a Developing Jurisprudence*, 24 J. INT'L. ARB. 129 (2007); Judith Gill, *Is There a Special Role for Precedent in Investment Arbitration?, 25 ICSID* L. REV. 87 (2010); Gilbert Guillaume, *The Use of Precedent by International Judges and Arbitrators,* 2 J. INT'L DISP. SETTLEMENT 5 (2011); Gabrielle Kaufmann-Kohler, *Arbitral Precedent: Dream, Necessity or Excuse? – The 2006 Freshfields Lecture*, 23 ARB. INT'L 357 (2007).

[85] *See* Jeswald W. Salacuse & Nicolas P. Sullivan, *Do BITs Really Work: An Evaluation of Bilateral Investment Treaties and their Grand Bargain*, 46 HARV. INT'L. L.J. 67 (2005) (discussing how bilateral treaties work in practice).

[86] *See* Jurgen Kurtz, *Adjudging the Exceptional at International Investment Law: Security, Public Order, and Financial Crisis*, 59 INT'L & COMP. L.Q. 325 (2010) (discussing three different methodologies of treaty interpretation). *But see* William W Burke-White & Andreas von Staden,

TPP negotiations are intended to level the playing field of investment laws among member states, that leveling is somewhat undermined by the inconsistent treatment, not limited to enforcement, of otherwise comparable cases by domestic courts applying international investment laws differently.[87] The result is to further undermine the quest for a uniform body of investment treaty and customary law.[88]

Finally, treating the decisions of domestic courts as a constituent part of international investment jurisprudence is unlikely to unify the evolving law governing international investment practice. The fact that domestic law is considered a source of international law, notably as part of "the general principles of law recognized by civilized nations" under Article 38 of the International Court of Justice, is a burden as much as a benefit.[89] First, domestic courts will inevitably insist that actions directed at protecting the domestic interest comport with the "the law of civilized nations," whether or not international jurists would concur.[90] Second, international tribunals will face difficulties in dismissing erudite arguments presented in defense of domestic public policy on grounds that it is "uncivilized."[91] Third, such

---

Investment Protection in Extraordinary Times: The Interpretation and Application of Non-Precluded Measures Provisions in Bilateral Investment Treaties, 48 VA. J. INT'L L. 307 (2008) (discussing treaty provisions that explicitly exempt nations from treaty provisions during times of need allowing otherwise inconsistent decisions to be consistent with the treaty).

[87] *See generally* World Investment Report, UNCTAD, July 22, 2010, UNCTAD/WIR/2010, *available at* http://unctad.org/en/pages/DIAE/World%20Investment%20Report/WIR-Series.aspx (discussing the current state of world foreign investment).

[88] *See* Campbell McLachlan, *Investment Treaties and General International* Law, 57 INT'L & COMP. L.Q. 361, 363 (2008) (discussing tribunals reaching opposite conclusions on the same issue); Margrete Stevens, *The ICSID Convention and the Origins of Investment Treaty Arbitration, in* 50 YEARS OF THE NEW YORK CONVENTION (Albert Jan van den Berg, ed. 2009) (describing international investment law as a coherent system since the inception of the ICSID Convention).

[89] *See* Statute of the Int'l Ct. of Justice, Art. 38 (providing: "1. The Court, whose function is to decide in accordance with international law such disputes as are submitted to it, shall apply: a. international conventions, whether general or particular, establishing rules expressly recognized by the contesting states; b. international custom, as evidence of a general practice accepted as law; c. the general principles of law recognized by civilized nations; d. subject to the provisions of Article 59, judicial decisions and the teachings of the most highly qualified publicists of the various nations, as subsidiary means for the determination of rules of law. 2. This provision shall not prejudice the power of the Court to decide a case *ex aequo et bono*, if the parties agree thereto,") *available at* http://www.icj-cij.org/documents/index.php?p1=4&p2=2&p3=0.

[90] *See* Leon E. Trakman & Muthucumaraswamy Sornarajah, *A Polemic: The Case for and Against Investment Liberalization*, *in* REGIONALISM IN INTERNATIONAL INVESTMENT LAW, 499–514 (Leon E. Trakman & Nick Ranieri, eds. 2013).

[91] *Id.* at 499–502. The suggestion is not that domestic states should forego their policy making powers including in relation to foreign direct investment. The suggestion is only that, if domestic states do so disparately and inconsistently, there would be no place left for international investment law. The nature and operation of foreign direct investment would depend on the nuanced proclamations of a myriad of domestic states.

arguments are even more difficult to discount when they are applied to countries that subscribe to an absolute conception of sovereign immunity.[92]

A countervailing concern is that, in attempting to avoid fragmenting international investment law, an investment *ius cogens* will emerge that accentuates the advantages enjoyed by wealthy investors from developed countries and their investors over developing countries and their investors.[93] Given the institutional roots of international investment law in the Western liberal tradition, the fear is that ISA tribunals will adopt literal or textual methods in interpreting the TPPA and BIT side-agreements that tend to favor the dominant treaty partner.[94] If a literal interpretation of the text of the TPPA expressly permits a developing state to restrict market access to foreign investors, an ISA tribunal is unlikely to impute a "contextualized" meaning to that text that includes historical disadvantage.[95] The perceived malady is to marginalize the corrective justice claims that are often endemic to the national interests of developing countries. One political response is that developing countries will decline to conclude BITs or FTAs with developed countries, such as under the TPPA, or more probably they will conclude such treaties in the adventitious hope of avoiding investor-state disputes. Serious problems inevitably arise when such hopes are disappointed.[96]

These concerns about developing countries losing ISA claims relate less to irredeemable flaws in ISA than to limitations in the treaty making powers and legal capacity of developing countries to bring ISA claims under the TPPA or any other bilateral or multilateral investment treaty. Even if treaty literalism is perceived to sometimes impede substantive fairness in ISA determinations, that does not provide unqualified support for the contemplated alternative, namely, resort to domestic courts. Indeed, a preference for domestic litigation to resolve investor-state disputes may protract more than remedy deficiencies in ISA. The perception among some developing states is that the courts of wealthy developed states will rely on their common or civil law traditions, not least of all on the principle of freedom of contract, to

---

[92] *See id.* at 509–10; *see, e.g.*, Democratic Republic of the Congo v. FG Hemisphere Assocs. LLC (H.K.C.F.A., FACV5/2010). *See* also Simon McConnell et al., Sing. Int'l Arb. Ctr., Absolute State Immunity Prevents Enforcement of Arbitral Award in Hong Kong, *available at* http://www.siac.org.sg/index.php?option=com_content&view=article&id=312:absolute-state-immunity&catid=56:articles&Itemid=171 (discussing the holding in Dep. Rep. Congo).

[93] *See* Muthucumaraswamy Sornarajah, *The Case against an International Investment Regime*, *in* REGIONALISM IN INTERNATIONAL INVESTMENT LAW, 477 (Leon E. Trakman & Nick Ranieri, eds., 2013) [hereinafter Sornarajah *Case Against*].

[94] For discussion of other methods of treaty interpretation, *see* J. ROMESH WEERAMANTRY, TREATY INTERPRETATION IN INVESTMENT ARBITRATION, 37–97 (2012).

[95] *See* August Reinisch, *How Narrow Are Narrow Dispute Settlement Clauses in Investment Treaties?* 2 J. INT'L DISPUTE SETTLEMENT 115, 120 (2011) (discussing the restrictive construction of investment agreements).

[96] For discussion of different approaches that national law courts may adopt in considering such disputes, *see supra* text accompanying note 16.

insulate their outbound investors from the plight of developing countries that arguably contract with foreign investors out of economic necessity, not free choice.[97] However, concerns about the literal interpretation of investment treaties apply equally to domestic courts as they do to ISA tribunals. The proposition that domestic courts are subject to tried and tested domestic rules of evidence and procedure, the derogation of which give rise to an appeal, is offset by the fact that ISA arbitration, such as under the ICSID, is also subject to pre-set rules of procedure which, if violated, can lead to annulment proceedings.[98] The supposed insularity of ISA arbitration from domestic law and procedure is also disputable on grounds that ISA arbitrators cannot summarily disregard domestic law if an FTA, like the TPPA, treats that domestic law as the applicable law.[99] The rationale that domestic courts ought to accord no more than "national treatment" to foreign investors under domestic law is countered by the argument that investment treaties also provide for "national treatment" standards, which ISA arbitrators are bound to apply.[100]

As a result, the preference for ISA over domestic courts, or the converse, is inextricably contingent upon the value preferences of the proponent. The political reality is that, in exercising value preferences, countries are more likely to trust, not only their domestic courts, but also the laws and courts of other countries with which they share common social, economic, and legal traditions than those with which they do not.[101] Countries are also more likely to endorse a process of decision-making with which they identify than a process with which they do not identify.[102] Not only are countries likely to

---

[97] *See generally*, Leon E. Trakman, *Legal Traditions and International Commercial Arbitration*, 17 AM. REV. INT'L ARB. L. 1, 19–20, 26–28 (2006). On the significance of legal cultures, including regionally, in international investment law, *see e.g.*, Colin B. Picker, *International Investment Law: Some Legal Cultural Insights, in* REGIONALISM IN INTERNATIONAL INVESTMENT LAW, ch. 6 (Leon E. Trakman & Nick Ranieri, eds. 2013).

[98] *See* Trakman, *ICSID Under Siege*, *supra* note 74.

[99] *Id.* at 652.

[100] This proposition is complicated, particularly by the fact that different national legal systems have incorporated investment law differently. *See* Sornarajah *Case Against*, *supra* note 93, at 475, 482.

[101] These observations are exemplified in Chapter 11 jurisprudence under the NAFTA, North American Free Trade Agreement Chap. 11, Dec. 17, 1992. *See, e.g.*, Loewen Group, Inc. v. US, ICSID Case No ARB(AF)/98/3, Award at 2, 9, 10 (June 26, 2003); *Mondev International Ltd v. US*, ICSID Case No ARB(AF)/99/2, Award, at 159 (Oct. 11, 2002). *See generally* William Dodge, *Loewen v. United States: Trials and Errors under NAFTA Chapter 11*, 52 DEPAUL L. REV. 563 (2002); Dana Krueger, *The Combat Zone: Mondev International, Ltd v. United States and the Backlash against NAFTA Chapter 11*, 21 B.U. INT'L L.J. 399 (2003) (arguing that, but for a technical time bar, two tribunal decisions— *Mondev* and *Loewen* — might have prevailed over American judicial decisions).

[102] The United States-Australia Free Trade Agreement permits domestic courts in each signatory state to resolve investor-state disputes, rather than rely on investor-state arbitration. *See* AUSFTA, *supra* note 9, at art. 11.16, 21. One of the rationales for this position was that the

reflect such preferences in negotiating standards of treatment and investor protections in treaties like the TPPA and BIT side-agreements, they are also likely to take account of the status of international investment law in states that assert strong claims to sovereign immunity in inculcating those preferences.

Ultimately, TPP negotiating parties will need to make normative choices. Some may conclude, as Australia has done, that an appeal to domestic courts is desirable on jurisdictional and substantive grounds.[103] Others may prefer BIT side-agreements in which they choose between ISA and domestic courts based on whether they deem that their partner country's domestic courts are reliable according to home state standards.[104] Others may adopt ISA uncontrovertibly, relying on annulment procedures, such as those contained in Article 52 of the ICSID Convention, to redress perceived failures of natural justice.[105]

One may conclude that, as a practical solution, TPP negotiating parties should simply be left to decide whether or not to engage in negotiations, and if so, whether to seek country-specific exemptions under the TPPA or through bilateral treaty negotiations that are suppletive to it. That would be consistent with the common practice of many states to enter into overlapping FTAs and BITs.[106] It would also allow states to determine whether to turn anomalies, such as the United States and Australia's choice of domestic courts over ISA under the AUSFTA, into a side-agreement norm.[107] The fact that Australia is likely to turn its anomalous endorsement of domestic courts into the norm could be replicated, albeit less invasively, by other states in concluding side-agreements with particular countries that provide for investor-state disputes to be resolved by domestic courts rather than ISA.

Others may conclude that neither ISA nor domestic courts are ideal forums in which to resolve investor-state disputes. They may require the parties to utilize measures such as negotiation and conciliation to resolve their differences, rather than treat such measures as mere waiting periods before embarking on ISA or resort to the domestic courts of the respondent state.[108]

United States and Australia share a common "rule of law" tradition. *See* Trakman FDI, *supra* note 12, at 27.

[103] *See* Australian Gov't Dep't of Foreign Affairs and Trade, *supra* note 10, at 14; Lawyers to the Negotiators of the Trans-Pacific Partnership, *supra* note 53, at 3.

[104] *E.g.*, Malaysia-Australia Free Trade Agreement, *supra* note 14; ASEAN-Australia-New Zealand Free Trade Agreement, *supra* note 14.

[105] *See* International Centre for Settlement of Investment Disputes Conventions art. 52, April 2006, ICSID/15,

[106] Meredith Kolsky Lewis, *Plurilateral Trade Negotiations: Supplanting or Supplementing the Multilateral Trading System?*, 17 ASIL INSIGHTS 17, July 12, 2013, *available at* http://www.asil.org/pdfs/insights/insight130712.pdf.

[107] *See* AUSFTA, *supra* note 9, at art. 11, 16, 21.

[108] *See* UN CONF. ON TRADE AND DEV., INVESTOR–STATE DISPUTES: PREVENTION AND ALTERNATIVES TO ARBITRATION, at 4–6, U.N. Doc. UNCTAD/DIAE/IA/2009/11 U.N. Sales No. E.10.II.D.11 (2010) [hereinafter UNCTAD ALTERNATIVES TO ARBITRATION], *available at* http://unctad.org/en/docs/diaeia200911_en.pdf.

These views are supported by the findings of the United Nations Conference on Trade and Development (UNCTAD) that resort to both arbitration and domestic courts was unduly costly, dilatory, and exacerbated conflict.[109] As a result, the UNCTAD expressed a strong preference for disputing parties to utilize conflict prevention and avoidance measures to resolve investment disputes before resorting to either ISA or domestic litigation.[110]

The functional assessment of different dispute resolution options is unlikely to yield the natural supremacy of one option over all others. ISA is not an elixir of perfection that ought to be perpetuated as of right. Like all institutions, it has its dimples and its warts.[111] Among other deficiencies, ISA determinations are sometimes inconsistent in otherwise comparable fact situations such as in relation to the defence of necessity.[112] Domestic courts resolving investment disputes is one alternative to arbitration in resolving disputes under the TPPA. Were the choice between them based on a careful assessment of the perceived quality of each, such as the effective and fair use of judicial or arbitral processes, one could attempt to measure those qualities in discrete cases in relation to the TPPA. However, ascribing quantitative attributes to competing decision-making processes in the political context of treaty negotiations cannot be wholly objective, despite efforts to depoliticize those processes.[113] Imputing normative assumptions to competing processes

---

[109] *See Id.* at 34.

[110] *Id.* at xxviii.

[111] For long-standing institutional arguments in favour of changing ISA dispute settlement procedures, *see, e.g.*, Brower & Steven, *supra* note 46, at 193–95; Jack J. Coe, Jr., *Domestic Court Control of Investment Awards: Necessary Evil or Achilles Heel within NAFTA and the Proposed FTAA*, 19 J. INT'L ARB. 185, 187 (2002); Gantz, *supra* note 46, at 54–57 (2006). *But see* William S. Dodge, *Case Report:* Waste Management, Inc v Mexico, 95 AM. J. INT'L L. 186, 182–92 (2001) (presenting the case for modeling Chapter 11 on the WTO appellate process).

[112] Eric David Kasenetz, *Desperate Times Call for Desperate Measures: The Aftermath of Argentina's State of Necessity and the Current Fight in the ICSID*, 41 GEO. WASH. INT'L L. REV. 709, 721–23, 726 (2010); Matthew Parish, *On Necessity*, 11 J. WORLD INVESTMENT & TRADE 169, 173 (2010); Antoine Martin, *International Investment Disputes, Nationality and Corporate Veil: Some Insights from Tokios Tokelés and TSA Spectrum De Argentina*, 8 TRANSNAT'L DISP. MGMT 1, 8 (2011); José E. Alvarez & Tegan Brink, *Revisiting the Necessity Defense: Continental Casualty v. Argentina* 6–11 (Int'l Law & Justice Working Paper No. 2010/3, 2010) *available at* http://www.iilj.org/publications/documents/2010-3.Alvarez-Brink.pdf; Tarcisio Gazzini, *Necessity in International Investment Law: Some Critical Remarks on CMS v. Argentina*, 26 J. ENERGY & NAT. RESOURCES L. 450, 450–51 (2008); José Rosell, *The CMS Case: A Lesson for the Future?*, 25 J. INT'L ARB. 493, 495 (2008). Susan D. Franck, *The Legitimacy Crisis in Investment Treaty Arbitration: Privatizing Public International Law through Inconsistent Decisions,* 73 FORDHAM L. REV. 1521, 1543–44 (2004-2005); Julie A. Maupin, *MFN-based Jurisdiction in Investor-State Arbitration: Is There Any Hope for a Consistent Approach?*, 14 J. INT'L ECON. L. 157 (2011).

[113] Ibrahim F. I. Shihata, *Towards a Greater Depoliticization of Investment Disputes: The Roles of ICSID and MIGA, in* INVESTING WITH CONFIDENCE: UNDERSTANDING POLITICAL RISK MANAGEMENT IN THE 21ST CENTURY 2, 9 (Kevin W. Lu et al. eds., 2009) (discussing old world views); *see generally* Susan D. Franck, *Foreign Direct Investment, Investment Treaty Arbitration, and the Rule of Law*, 19 PAC. MCGEORGE GLOBAL BUS. & DEV. L.J. 337, 355–64 (2007) (analyzing different views of the rule of law).

of dispute resolution in discrete contexts, such as to the influence of forum biases on ISA hearings in Latin American countries may also lack verification.[114]

Given these imponderables, the result may be that the choice between some form of ISA and litigation before domestic courts should be pragmatically determined on an ongoing basis, such as based on the manner in which ISA tribunals interpret the human rights obligations of party states under an applicable treaty like the TPPA.[115] However, it is too early to arrive at a generalized conclusion about the virtue of domestic judges deciding investment cases over ISA in relation to the prospective TPPA,[116] except to acknowledge a shift to domestic courts deciding investment disputes which began decades ago in Latin America with the once disavowed and now resurrected Calvo Doctrine.[117] Whatever the institution adopted to resolve investor-state disputes, not limited to litigation or arbitration, the imponderable is in determining how such concepts as the "rule of law" should be defined, applied, and enforced.[118] There are no fixed or infallible answers to these intertwined questions. Delicate issues arise for TPP negotiators from both

---

[114] *See generally* Susan D. Franck, *The ICSID Effect? Considering Potential Variations in Arbitration Awards*, 51 VA. J. INT'L L. 825–26 (2011) (Franck undertakes a quantative analysis of awards with Latin American countries as parties, and concluded that "on the whole, ... ICSID arbitration awards were not statistically different from other arbitral processes, which is preliminary evidence that ICSID arbitration was not necessarily biased or that investment arbitration operated in reasonably equivalent ways across forums."). For ICSID's figures indicating that foreign investors have won 48% of ICSID/Additional Facility cases, *see* The ICSID Caseload, *supra* note 12, at 13, *available at* http://icsid.worldbank.org/ICSID/FrontServlet?requestType=ICSIDDocRH&actionVal=CaseLoadStatistics. Based on Chart 12 in the same document, ICSID appears to have issued 150 awards in the aggregate.

[115] *See* Moshe Hirsch, *The Interaction between International Investment Law and Human Rights Treaties: A Sociological Perspective*, *in* MULTI-SOURCED EQUIVALENT NORMS IN INTERNATIONAL LAW 211, 214–18 (Tomer Broude & Yuval Shany eds., 2011); Sara L. Seck, *Conceptualizing the Home State Duty to Protect Human Rights, in* CORPORATE SOCIAL AND HUMAN RIGHTS RESPONSIBILITIES: GLOBAL LEGAL AND MANAGEMENT PERSPECTIVES, at 25, 34 (Karin Buhmann et al. eds., 2011). On alleged human rights abuses by transnational corporations, *see* Rachel J. Anderson, *Reimagining Human Rights Law: Toward Global Regulation of Transnational Corporations*, 88 DENV. U.L. REV. 183, 183–84 (2010). *See generally* John Ruggie, *Protect, Respect and Remedy: A Framework for Business and Human Rights* (Apr. 7, 2008), U.N. Doc. A/HRC/8/5 (presented to the United Nations Human Rights Committee).

[116] For an empirical study on trends, and biases, in the behavior of investment arbitrators, *see generally* Gus Van Harten, *Arbitrator Behaviour in Asymmetrical Adjudication: An Empirical Study of Investment Treaty Arbitration*, OSGOODE HALL L.J. (2012 forthcoming) *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2149207.

[117] *See e.g.*, Emerson Policy Statement, *supra* note 4, at 14; *see also* TPP Legal, *supra* note 54, at 3. *See generally* Carlos E. Alfaro & Pedro M. Lorenti, *The Growing Opposition of Argentina to ICSID Arbitral Tribunals: A Conflict between International and Domestic Law?*, 6 J. WORLD INVESTMENT & TRADE 417 (2005).

[118] *Compare* Brower & Steven, *supra* note 46 *with* Gantz, *supra* note 46.

developed and developing countries in attempting to answer these questions. These issues are addressed below.

IV. SUBMITTING A CLAIM TO ARBITRATION UNDER THE TPPA

The TPPA is virtually certain to provide expressly for ISA, which will include detailed ISA provisions, stipulations for the choice of institutions before which to bring ISA claims, and the terms and conditions governing ISA. It is probable too that the TPPA will provide for a range of dispute resolution avenues, recognizing particularly the ICSID and the Arbitration Rules of the United Nations Commission on International Trade Law ("UNCITRAL").[119] Draft article 12.18.3 of the TPPA provides that a claimant may submit a claim under

(a) the ICSID Convention and the ICSID Rules of Procedure for Arbitration Proceedings, provided that both the respondent and the Party of the claimant are parties to the ICSID Convention; (b) under the ICSID Additional Facility Rules, provided that either the respondent or the Party of the claimant is a party to the ICSID Convention; (c) under the UNCITRAL Arbitration Rules; or (d) if the claimant and respondent agree, to any other arbitration institution…, or under any other arbitration rules.[120]

This is a wide choice of arbitration institutions in which "any other arbitration rules" encompasses the varied rules of a multiplicity of international and regional arbitration associations dealing with private commercial disputes, well beyond ISA.[121] These provisions in the draft are likely to prevail, particularly given the consensual nature and extensive use of arbitration in general and the preference of different disputing parties to opt for different arbitral options, varying from institutional arbitration under the ICSID[122] to *ad hoc* arbitration under the UNCITRAL,[123] as well as to one or

---

[119] *See generally* 2010 UNCITRAL Rules on Arbitration, *available at* http://www.uncitral.org/uncitral/uncitral_texts/arbitration/2010Arbitration_rules.html; *see also* Claudia M Gross, *Current Work of UNCITRAL on Transparency in Treaty-Based Investor-State Arbitration*, ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, *available at* http://www.oecd.org/dataoecd/14/5/46770295.pdf.

[120] See TPPA Draft Investment Chapter, art. 12.18.3, *available at* http://www.citizenstrade.org/ctc/wp-content/uploads/2012/06/tppinvestment.pdf.

[121] *See generally* Leon E. Trakman, *Arbitrating Options: Turning a Morass into a Panacea*, 41(1) U.N.S.W. L.J. 292 (2008).

[122] S*ee Organizational Structure of the ICSID*, INTERNATIONAL CENTRE FOR SETTLEMENT OF INVESTMENT DISPUTES, (last visited July 1, 2011 at 1:30 PM) http://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=RightFrame&FromPage=Organization and Structure&pageName=Organization (for the organizational structure of the ICSID).

[123] Explanatory note of the UNCITRAL Secretariat on the Model Law of International Commercial Arbitration page 30. *Available at* http://www.uncitral.org/pdf/english/texts/arbitration/ml-arb/07-86998_Ebook.pdf. Of note, the

another commercial arbitration center. It is noteworthy too, that comparatively recent amendments to arbitration in the UNCITRAL Rules 2010 were influenced somewhat by the perceived needs of ISA.[124]

However, in practice, the parties to investor-state disputes may diverge over submitting investment disputes to both international commercial arbitration and ISA in particular. Developing countries may resist arbitration on the perceived grounds that it is secretive, unduly costly, and disproportionately favors developed states.[125] A concern relating to ISA is that it will imbed the commercial interests of inbound investors at the expense of the public policy interests of host states.[126] These concerns have some historical foundation in the dominance of developed Western countries in global trade and investment,[127] and in challenges directed at a "regimes theory" that is ascribed to cooperation among essentially liberal states.[128] A functional challenge to institutional ISA, such as under the ICSID, is the cost arising from the often complex nature of arbitration proceedings.[129] ISA proceedings are also perceived to be dilatory, difficult to manage, disruptive,

---

UNCITRAL Model Law has been widely adopted globally, including in Australia. *See International Arbitration Act 1974* Part III Division 2 (Austl.).

[124] Some of the 2010 amendments to the UNCITRAL rules were inspired by the rising use of the Rules in investor-State arbitrations. G.A. Res. 65/22, 1, *available* at http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/2010Arbitration_rules.html.

[125] Trakman, *ICSID in Perspective*, *supra* note 65 at 258.

[126] On this tension between the private and public nature of investor-state arbitration, *see* Leon E. Trakman, *The Twenty-First Century Law Merchant,* 48 AM. BUS. L. J. 775, 800–803 (2011); TPP Legal, *supra* note 54, at 2. *See generally* Kirkman, *supra* note 16; Schreuer, *supra* note 15; Tuck, *supra* note 16; Vandevelde, *supra* note 16.

[127] *See generally* James Oliver Gump, *The West and the Third World: Trade, Colonialism, Dependence, and Development* (review) 11(2) J. WORLD HIST. 396 (Fall 2000); THE THEORY OF CAPITALIST IMPERIALISM (D.K. Fieldhouse ed., 1967); FREE TRADE AND OTHER FUNDAMENTAL DOCTRINES OF THE MANCHESTER SCHOOL (Francis W. Hirst ed., 1968) (collection of speeches from the nineteenth century considering the development of free trade); P.J. Cain, *J.A. Hobson, Cobdenism, and the Radical Theory of Economic Imperialism, 1898–1914*, 31(4) ECON HIST. REV. 565 (1978).

[128] Developing states sometimes decry the shift in the "regime theory" by which powerful countries in the West have invoked customary law and treaty defenses such as the defense of necessity to foreign investors. *See* Sornarajah *Case Against*, *supra* note 94, at 479, 480; MUTHUCUMARASWAMY SORNARAJAH, THE INTERNATIONAL LAW ON FOREIGN INVESTMENT 142–43 (3d ed., Cambridge Univ. Press, 2010) (Outlining of the history of this division between capital exporter and importer states).

[129] *See* Schedule of Fees, International Centre for Settlement of Investment Disputes, (Jan. 1, 2012), *available at* http://icsid.worldbank.org/ICSID/FrontServlet?requestType=ICSIDDocRH&actionVal=scheduledFees&reqFrom=Main (indicating the cost of ICSID arbitration). The precise extent to which these costs inhibit participation by public interest groups is speculative, except that they seldom have deep pockets comparable to international corporate parties to state-investor disputes. For an economic rationalization of the costs of arbitration under investment treaties, *see generally* Susan D. Franck, *Rationalizing Costs in Investment Treaty Arbitration*, 88 WASH. U.L. REV. 769, 789, 815–16 (2011), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1781844.

unpredictable, and not subject to appeal.[130] Coupled with these challenges is the observation that low-income TPP negotiating countries may lack the resources to bear the legal fees and related costs of defending claims from well-resourced transnational investors.[131] Moreover, these countries often lack the econometric data to verify the adverse impact of foreign investment upon their local economies, such as upon the environment.[132] Heightening these cost constraints are the perceptions that complainant investors have deeper pockets than do many developing states[133] and that ISA arbitrators often have commercial rather than public international law backgrounds which favor investors over states.[134]

Nor are cost hurdles limited to developing states negotiating the TPPA and their investors. Studies on conflict resolution in international ISA by the UNCTAD criticize both arbitration and litigation, highlighting their complex nature, bottlenecks arising in proceedings, and the difficulty of managing such disputes in general.[135]

Further complicating ISA proceedings in particular is the lack of predictability of the metrics used to measure the performance of commercial or investment arbitration, including when predicting the time and cost

---

[130] On the absence of an appeal in ICSID arbitration, *see* Int'l Ctr. for Settlement of Inv. Disputes [ICSID], *Convention on the Settlement of Investment Disputes Between States and Nationals of Other States*, art. 53(1) ICSID/15, (Apr. 2006) [hereinafter *ICSID States and Nationals of Other States*] ("The award … shall not be subject to any appeal or to any other remedy except those provided for in this Convention."). The most significant remedy under the ICSID is the annulment of an award under Article 53. For decisions on the application by ISA parties for and the grounds for annulment of ICSID awards, *see generally* Lise Johnson, *Annulment of ICSID Awards: Recent developments*, Int'l Inst. For Sustainable Dev., Oct. 27-29, 2010), *available at* http://www.iisd.org/publications/pub.aspx?id=1423.

[131] *See, e.g.*, Schedule of Fees, *supra* note 132. *Memorandum on the Fees and Expenses of ICSID Arbitrators*, INT'L CTR. FOR SETTLEMENT OF INV. DISP., (July 6, 2005) http://icsid.worldbank.org/ICSID/FrontServlet?requestType=ICSIDDocRH&actionVal=Memorandum.

[132] *See, e.g.*, Hillary French, Capital Flows and the Environment, 22 FOREIGN POL'Y IN FOCUS 3, Aug. 1, 1998 ("As investors search the globe for the highest returns, they are often drawn to places endowed with bountiful natural resources but are handicapped by weak or ineffective environmental laws."). *See also Disadvantages of Foreign Direct Investment*, ECON WATCH. (June 30, 2010), http://www.economywatch.com/foreign-direct-investment/disadvantages.html.

[133] *See also* SORNARAJAH, *supra* note 131, at 142–43 (for an outline of the history of this division between capital exporter and importer states). On the risk of developed states resorting to double standards: i.e. using ISA to inhibit foreign governments from interfering with private investors, while deflecting ISA claims filed against themselves, *see, e.g.*, Guillermo Aguilar Alvarez & William W. Park, *The New Face of Investment Arbitration: NAFTA Chapter 11*, 28 YALE J. INT'L L. 365, 368–9 (2003).

[134] On this public-private tension, *see* Alex Mills, *The Public-Private Dualities of International Investment Law and Arbitration*, in EVOLUTION IN INVESTMENT TREATY LAW AND ARBITRATION, 97, 102 (Chester Brown & Kate Miles eds., Cambridge Univ. Press, 2011); Catherine A. Rogers, *International Arbitration's Public Realm*, (Social Science Res. Network, Working Draft No. 3, at 17, 2011); Franck, *supra* note 113, at 394; Alvarez & Park, *supra* note 136, at 394.

[135] U.N. CONF. ON TRADE AND DEV., *supra* note 108, at xxiii.

involved in ISA disputes.[136] This lack of predictability is due, in part, to unanticipated contingencies, such as disruption costs and delays arising from a due process challenge to an arbitrator,[137] the absence or illness of a party or arbitrator, managing third party interventions, and difficulty in enforcing an arbitration award.[138] It is true that these costs and delays arise in dispute resolution in general when proceedings are complex and involve significant claims, not limited to investor claims against host states.[139]

The alleged social cost is that ISA claims are brought more frequently against developing than developed countries. One can respond by noting the significant increase in inbound investment into developing markets in Asia, Africa and South America,[140] and by questioning whether inbound investors generally win more ISA cases than they lose. In fact, ICSID statistics suggest that foreign investors win only 48 percent of their claims.[141] However, this percentage of investor wins in ISA cases is offset by the percentage of unpublished ISA claims by investors from developed states which developing

---

[136] Daphna Kapeliuk, *The Repeat Appointment Factor: Exploring Decision Patterns of Elite Investment Arbitrators*, 96 CORNELL L. REV. 47, 53 (2010).

[137] On challenges to ICSID arbitrators, *see, e.g.*, Universal Compression International Holdings, S.L.U. v. The Bolivarian Republic of Venezuela, ICSID Case No. ARB/10/9 (May 20, 2011), *available at* http://italaw.com/documents/UniversalCompressionDecisiononDisqualification.pdf. Jan Paulsson, *Moral Hazard in International Dispute Resolution, 25 ICSID* L. REV 339, 5 (2010); *see also* Daphna Kapeliuk, *supra* note 139, at 53; *see generally* William W. Park, *Arbitrator Integrity: The Transient and the Permanent,* 46 SAN DIEGO L. REV. 629, 657–61 (2009); *but see* Leon E. Trakman, *The IBA Guidelines on Conflict of Interest in International Commercial Arbitration*, 10 INT'L ARB. L. REV. 124, 657 (2007).

[138] An assertion of sovereignty as the basis for not enforcing an arbitration award would not be exceptional, given the historical practices of states. *See, e.g.*, REDEFINING SOVEREIGNTY IN INTERNATIONAL ECONOMIC LAW, Part Four (Wenhua Shan et al. eds., 2008) (commenting on the complexity of sovereignty in international investment law including its use as a defense against the enforcement of decisions and awards against it). *See generally* Robert Stumberg, *Sovereignty by Subtraction: The Multilateral Agreement on Investment*, 31 CORNELL INT'L L. J. 491, 503–04, 523–25 (1998) (discussing sovereignty); KATIA YANNACA-SMALL, ARBITRATION UNDER INTERNATIONAL INVESTMENT AGREEMENTS, A GUIDE TO THE KEY ISSUES, at ch. 4 (Oxford, 2010).

[139] *See, e.g.*, Franck, *supra* note 132, at 769, 789, 815–16 (providing an economic rationalization of the costs of arbitration under investment treaties); Anthony Sinclair et al., *ICSID Arbitration: How Long Does It Take?*, 5 GLOBAL ARB. REV. 4, *available at* http://www.goldreserveinc.com/documents/ICSID%20arbitration%20%20How%20long%20does%20it%20take.pdf. *See also* Edward Baldwin, et al., *Limits to Enforcement of ICSID Awards*, 23 J. INT'L ARB. 1 (2006) (discussing "tactics" that may be employed in attempts to "delay" or "avoid" compliance with ICSID Awards).

[140] On growth of trade and investment in developing countries, see Peter Blair Henry & Prakash Kannan, *Growth and Returns in Emerging Markets, in* INTERNATIONAL FINANCIAL ISSUES IN THE PACIFIC RIM: GLOBAL IMBALANCES, FINANCIAL LIBERALIZATION, AND EXCHANGE RATE POLICY 241, 241 (Takatoshi Ito & Andrew K. Rose, eds., 2012), *available at* http://trade.ec.europa.eu/doclib/docs/2012/january/tradoc_148992.EN.pdf.

[141] On ICSID's figures, including that foreign investors have won only 48% of ICSID/Additional Facility cases, *see* The ICSID Caseload, *supra* note 12, at 13, Chart 9.

countries settle rather than incur the publicity, cost and possible failure to win such a dispute.[142] Notwithstanding these rationalizations of risks and social costs, the economic stakes involved in ISA disputes are often high. National sensitivities are usually in issue; damage to the reputation of states in general, and sometimes investors, potentially exceeds the already high costs of the dispute itself.[143]

Public interest interveners can clarify at least some social costs of adverse ISA determinations, usually to host states.[144] However, these interveners can do so only if they are privy to cost data, only if they can afford to petition to be heard,[145] only if their petitions are granted, and only if their evidence is deemed to be material.[146] Nor do revised ISA rules providing for open ISA hearings (such as under the NAFTA and ICSID)[147] assure either

---

[142] Trakman, *ICSID Under Siege*, *supra* note 74, at 619–20.

[143] *See* UN CONF. ON TRADE AND DEV., *supra* note 108, at xxiii ("the disadvantages of international trade and investment arbitration are found to be the large costs involved, the increase in the time frame for claims to be settled, the fact that ISDS cases are increasingly difficult to manage, the fears about frivolous and vexatious claims, the general concerns about the legitimacy of the system of investment arbitration as it affects measures of a sovereign State, and the fact that arbitration is focused entirely on the payment of compensation and not on maintaining a working relationship between the parties"). *See also* U.N. CONF. ON TRADE AND DEV., *Latest Developments in Investor-State Dispute Settlement*, 12, U.N. Doc. UNCTAD/IIA/No.1, (Mar. 2011) *available at* http://www.unctad.org/en/docs/webdiaeia20103_en.pdf.

[144] Trakman, *ICSID Under Siege*, *supra* note 74, at 618.

[145] On the cost hurdles faced by public interest organizations from a developing country, *see, e.g.*, *Aguas del Tunari, S.A. v. Republic of Bolivia,* ICSID Case No. ARB/02/3 (Oct. 21, 2005), *available at* http://ita.law.uvic.ca/documents/AguasdelTunari-jurisdiction-eng_000.pdf.

[146] On the standing of non-disputing parties under Chapter 11 of the NAFTA, *see generally* NAFTA Free Trade Comm'n, *Statement of the Free Trade Commission on Non-Disputing Party Participation* (Oct. 7, 2003), *available at* http://www.international.gc.ca/trade-agreements-accords-commerciaux/assets/pdfs/Nondisputing-en.pdf. On visits, inquiries and submissions by non-disputing parties under the ICSID, *see* ICSID Rules of Procedure for Arbitration Proceedings (ICSID/15, Apr. 2006) [hereinafter ICSID Arbitration Rules], Rule 37, *available at* http://icsid.worldbank.org/ICSID/StaticFiles/basicdoc/CRR_English-final.pdf. *See also* ICSID Procedural Order, February 2, 2011, inviting third parties to apply to submit *amici curiae* briefs under ICSID Arbitration Rule 37(2). On a petition to file an *amicus curiae* brief, prior to ICSID Procedural Order of Feb. 2 2011, *see* Suez, Sociedad General de Aguas de Barcelona et al. v. the Argentine Republic, ICSID Case No. ARB/03/19, Order in Response to a Petition by Five Non-Governmental Organizations for Permission to Make an Amicus Curiae Submission (Feb. 12, 2007). That Petition challenged the decision by the Government of Argentina to accede to the ICSID treaty on grounds that it violates the constitutional guarantees of citizens of Argentina to participate in proceedings. While the Government of Argentina was willing to hear the Petition, the Complainant was not. However, the Attorney General of Argentina published on the internet the information in his possession on the related cases. For different reactions to "requests" by civic interest groups to submit public interest briefs, *see*, GEA Group Aktiengesellschaft v. Ukraine, ICSID Case No. ARB/08/16, Award (Mar. 31, 2011); Talsud, S.A. v. United Mexican States, ICSID Case No. ARB(AF)/04/4, Award (June 16, 2010); Gemplus, S.A., SLP, S.A. and Gemplus Industrial, S.A. de C.V. v. United Mexican States, ICSID Case No. ARB(AF)/04/3, Award (June 16, 2010)

[147] On public access to Chapter 11 proceedings under the NAFTA, see NAFTA Free Trade Comm'n, *North American Free Trade Agreement Notes of Interpretation of Certain Chapter 11*

public ISA hearings or participation by interveners in proceedings.[148] It is noteworthy that in Philip Morris' ISA proceedings against Australia under the Hong Kong Australia FTA, Philip Morris has recently vetoed open hearings, although filings may be released and the decision is expected to be published.[149]

V. EXEMPTIONS FROM ISA

In rejecting ISA, Australia to date has adopted a stance that no other developed state has followed and none other appears to have endorsed in TPP negotiations. Australia's position, if sustained, is bold. As noted above, it is supported by a number of leading jurists in multiple common law jurisdictions. Nonetheless, Australia's close economic partner, New Zealand, has declined to follow Australia's lead to date.[150]

At its best, the attempt by Australia to negotiate an exemption from ISA in TPP negotiations is in its national interest. It aims to protect Australia, in negotiating treaties that exclude ISA, from the volatility and the high cost of ISA in which multinational companies like Philip Morris are able to lodge challenges to Australia's domestic public policies under one or another free trade or investment treaty.[151] Australia also has good reason to try to protect its public interests from aggressive foreign investors and to preserve the integrity of its local laws, notably on national security, public health and

---

Provisions (July 31, 2001), *available at* http://www.sice.oas.org/tpd/nafta/Commission/CH11understanding_e.asp.

[148] *See* Glamis Gold, Ltd. v. United States of America, NAFTA/UNCITRAL Arbitration Rules Proceeding, at 135 (ICSID June 8, 2009) (Award), *available at* http://www.state.gov/s/l/c10986.htm. For an example of denying third party access to documentation, *see* Suez, Sociedad General de Aguas de Barcelona S.A. and Vivendi Universal S.A v. Argentine Republic, ICSID Case No. ARB/03/19, ¶ 24 (May 19, 2005) (Order in Response to a Petition for Transparency and Participation as *Amicus Curiae*). *See also* Biwater Gauff (Tanzania) Ltd. v. United Republic of Tanzania, ICSID Case No. ARB/05/22 ¶¶ 70–72 (Feb. 2, 2007) (Procedural Order concerning a petition for *Amicus Curiae* Status).

[149] *See Philip Morris Vetoes Open Arbitration Hearings in Australia Case, but Filings May Be Released, and Tribunal Decisions Will Be Published*, IA REPORTER, *available at* http://www.iareporter.com/articles/20130110_1.

[150] The fact that the jurists who have publicly opposed ISA in the TPP include a significant number of New Zealand jurists might suggest that New Zealand is more likely to oppose ISA. However, there are a number of contrary indications. New Zealand does not have an FTA or BIT with the United States and would undoubtedly wish to have one, not least of all to have access to the large U.S. market for its agricultural goods. Were New Zealand to resist ISA, it may risk losing market access in the United States as elsewhere, and have to make concessions on such access in a manner it would prefer to avoid.

[151] On the Philip Morris dispute, *see* Philip Morris Int'l *supra* note 39; Tobacco Plain Packaging Act, *supra* note 39; Chapman & Freeman, *supra* note 39; Voon & Mitchell, *supra* note 39; JT Int'l v. Commonwealth, *supra* note 40; British Am. Tobacco Austl., Ltd. v. Commonwealth, *supra* note 40. On Philip Morris's Unsuccessful claim against the Prime Minister of Australia, *see* Philip Morris, Ltd. v. Prime Minister, *supra* note 40.

environmental grounds.[152] Australia is also reinforced in its stand by the failure in 2012 of Philip Morris in its constitutional challenge to Australia's "right" to require the plain packaging of cigarettes before the High Court of Australia.[153] However, this victory of Australia in its highest domestic court may be short-lived, as Ukraine, in which Philip Morris has offices and operations, has brought a claim against Australia to the World Trade Organization which Australia may not win.[154]

There are six key impediments to a country like Australia achieving its objectives by rejecting ISA in TPP negotiations. First, Australia's reliance on domestic courts to resolve conflicts with inbound investors like Philip Morris may not achieve its public policy aspirations such as to protect public health or the environment. Foreign investors may well mount formidable claims against Australia before its domestic courts that are both economically debilitating and politically damaging to Australia.[155] Second, foreign investors in Australia can bring an action against Australia before a foreign court under a BIT or FTA that does not provide for ISA, such as under the AUSFTA, with comparable results.[156] There is no indication that Australia will attempt to renegotiate FTAs and BITs that precede the 2011 Trade Policy Statement and that make provision for ISA. Third, Australia's 2011 Trade Policy Statement against providing for ISA in future BITs or FTAs does not prevent an investor from lodging an ISA claim against Australia under a pre-existing BIT that provides for ISA, such as the Hong Kong Australia FTA.[157] Fourth, Australia's insistence on being exempted from ISA in the TPPA may isolate it

---

[152] *See* John Hilvert, *Aussie Negotiator Declines TPP Assurances*, IT NEWS (Mar. 8, 2012), http://www.itnews.com.au/News/292937,aussie-negotiator-declines-tpp-assurances.aspx; Mike Masnick, *Significant Concerns about TPP Raised Down Under*, TECHDIRT (June 6, 2012) http://www.techdirt.com/articles/20120605/03172719203/significant-concerns-about-tpp-raised-down-under.shtml.

[153] *See* British Am. Tobacco Austl., Ltd., *supra* note 40; *see* JT Int'l SA, *supra* note 40; Philip Morris, Ltd. v. Prime Minister, *supra* note 40. *See also* Press, Release, Australian Minister for Trade and Competitiveness, High Court Ruling Bolsters Australia's WTO Case for Plain Packaging (Aug. 20 2012), *available at* http://trademinister.gov.au/releases/2012/ce_mr_120820.html.

[154] *See* WTO, Dispute Settlement, *Australia — Certain Measures Concerning Trademarks and Other Plain Packaging Requirements Applicable to Tobacco Products and Packaging*, WT/DS434/R (Sept. 28 2012), *available at* http://www.wto.org/english/tratop_e/dispu_e/cases_e/ds434_e.htm. *See also* Christine Kerr, *Appeal to WTO May Yet Deliver Big Tobacco Victory*, THE AUSTRALIAN, Aug. 18, 2012, *available at* http://www.theaustralian.com.au/national-affairs/appeal-to-wto-may-yet-deliver-big-tobacco-victory/story-fn59niix-1226452794144. *See generally*, Andrew Mitchell & Tania Voon, *TDM Special Issue on Legal Issues in Tobacco Control*, 5 TRANSNAT'L DISP. MGMT. (2012) *available at* http://www.transnational-dispute-management.com/journal-browse-issues-toc.asp?key=43.

[155] *See, e.g.*, Philip Morris Int'l, *supra* note 39.

[156] *See id*.

[157] *See generally*, British Am. Tobacco Austl. v. Commonwealth, *supra* note 40; JT Int'l SA v. Commonwealth, *supra* note 40; Philip Morris Ltd. v. Prime Minister, *supra* note 40.

from other negotiating states that adopt ISA, however reluctantly they do so. Fifth, Australia's rejection of ISA may expose Australian investors abroad to foreign courts of host states whose treatment of foreign investors falls short of the standards of transparency that are adopted by Australian courts, or for that matter, by ISA tribunals.[158] For example, approximately 76 percent of cases in which investment treaty awards were rendered[159] involved states that fell on or below NUMBER 50 on the Transparency scale of the 2008 International Corruption Perception Index. That number increased to 84 percent when cases involving the United States and Canada were excluded.[160] Over 69 percent of the cases involved states that fell at or below NUMBER 70 on that Transparency Scale.[161] The World Bank's Worldwide Governance Indicator ("WGI") also indicated that 68 percent of those States were in the bottom 60 percent of the 2008 International Corruption Perception Index for the "rule of law."[162] However much one can question any corruption perception index or governance indicator, aspirant investors have credible reason to avoid investing in a state that has a low score on such corruption perception indices including not submitting an ISA claim to its domestic courts.

The sixth and final reason why the rejection of ISA in the TPP negotiations fails to protect Australia's national interests, or the interests of any country following its lead, stems from the existence of preferable alternatives. Australia could negotiate bilateral caps on treaty protection accorded to foreign investors set at Australia's minimum standards of treatment accorded to such investors. Alternatively, Australia could negotiate broader general exceptions or exclusions of entire measures with existing or new treaty partners, such as exceptions relating to intellectual property, or more specifically in relation to public health and environmental safety measures. In both cases, such action would provide at least some protection to Australia from the activities of inbound investors, such as to regulate the sale of cigarettes and drugs, as well as the emission of toxic gas and related hazardous substances.

A tentative conclusion is that the choice of domestic litigation over ISA is neither compelling in itself, nor compelling to a number of domestic judicial systems that apparently fail benchmark indicators of compliance with the "rule

---

[158] *See* Trakman, *Australia and the Future*, *supra* note 72, at 236–37.

[159] Up to June 2006. Mark Kantor, *The Transparency Agenda for UNCITRAL Investment Arbitrations: Looking in all the Wrong Places*, Inst. Int'l L. & Just., at 10 (Jan. 22, 2011) *available at* http://www.iilj.org/research/documents/IF2010-11.Kantor.pdf.

[160] Kantor, *supra* note 159, at 10; *see also* Susan Franck, *Empirically Evaluating Claims about Investment Treaty Arbitration,* 86 N.C. L. REV. 1 (2007) *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=969257.

[161] Kantor, *supra* note 159. Kantor's calculations are based on information contained in the list of States in Annex 1 of Franck, *supra* note 160.

[162] *See Worldwide Governance Indicators*, *supra* note 36.

of law." As a result, the virtue of domestic litigation is contingent, not only on the general preferences of those who subscribe to a judicial or an arbitral process, but on the trust placed in national courts in particular jurisdictions. If a choice is made between domestic courts applying allegedly comparable standards of transparency and ISA, a domestic appeals process is ordinarily more robust than an ISA annulment procedure.[163] For example, annulment under Article 75 of the ICSID Convention is ordinarily limited to jurisdictional grounds.[164] An appeal from the decision of a domestic court can be both jurisdictional and substantive.[165]

However, the systemic benefit of resorting to domestic courts is offset by the systemic benefits associated with ISA. The proposition that domestic courts in "rule of law" jurisdictions apply established domestic rules of evidence and procedure to disputes is offset by the fact that ISA rules of procedure are also established, such as under the ISCID Convention.[166] The supposed insularity of ISA arbitration from domestic law and procedure is also disputable on grounds that ISA arbitrators cannot summarily disregard domestic law, particularly if ISA awards are to be enforced domestically.[167] A foreign investor that wins an ISA dispute, but cannot enforce it before the applicable domestic court, ultimately wins nothing of substance.[168] Although it is difficult to make clear choices between ISA and domestic courts in the abstract, careful research into the nature and operation of domestic judicial systems, including possible obstacles to enforcing ISA awards, will help to inform such choices.[169]

Australia's unwillingness to agree to ISA by treaty is not a death knell for Australian outbound investors, or for outbound investors from Australia's treaty partners. Australian outbound investors have several choices. They can engage in FDI in states that have BITs with Australia, such as the United States, and in whose courts Australian investors are reasonably comfortable.

---

[163] On ICSID Annulment Proceedings, *see* Johnson, *supra* note 130.

[164] *See* Trakman, *ICSID Under Siege*, *supra* note 74, at 650.

[165] While presented as an advantage, some TPP countries are likely to resist substantive review, not only under the TPP, but due to resistance to substantive review in administrative law more generally.

[166] *See* the ICSID Caseload, *supra* note 12; ICSID Arbitration Rules, *supra* note 149; Trakman, *ICSID in Perspective*, *supra* note 65.

[167] *See, e.g.*, Schreuer, *supra* note 15, at 386; *see* Trakman, *ICSID in Perspective*, *supra* note 65, at 361.

[168] *See* Stevens, *supra* note 88 at 71–72. For more on the difficulties arising in the recognition and enforcement of transnational arbitration, see *ICSID States and Nationals of Other States*, *supra* note 130, at art. 53(1).

[169] *See* Caroline Henckels, *Balancing Investment Protection and the Public Interest: The Role of the Standard of Review and the Importance of Deference in Investor-State Arbitration,* 4 J. INT'L DISP. SETTLEMENT (forthcoming 2013) (manuscript at 13–14); *see also* Simon Butt, *Foreign Investment in Indonesia: The Problem of Legal Uncertainty*, *in* FOREIGN INVESTMENT AND DISPUTE RESOLUTION LAW AND PRACTICE IN ASIA, at 133 (Vivienne Bath & Luke Nottage, eds. 2011).

Outbound investors can invest in countries in whose courts they do not trust by acquiring residence or domicile in an intermediary country and relying on a BIT between that intermediary and the host country that provides for ISA.[170] Intermediary states, in turn, can provide foreign investors with residential or domiciliary status that enables an investor to lodge a claim against an allegedly recalcitrant state under a BIT between the intermediary and that recalcitrant state. The outbound investors of Australia's partner states, under treaties providing for investors to submit claims to domestic courts, have similar options.[171]

The Australian Government is an incidental beneficiary of resort by its outbound investors to intermediary states. It can conclude BITs providing for investor-state disputes to be resolved by domestic courts, relying on its outbound investors to bring ISA claims through intermediary states against BIT partner states that have low Corruption Perception Index scores. The Australian Government can also decline to intervene diplomatically on behalf of such outbound Australian investors.[172] There is no shortage of potential intermediary states to which outbound investors may have resort. Notable among these states are the Netherlands Antilles and Mauritius, which both have stable financial systems and transparent and investor-friendly tax regimes.[173] States that follow Australia's lead–directly or indirectly through general TPP exemptions or side-agreements–are likely to secure comparable benefits.

The practice of foreign investors bringing ISA or other claims through intermediary states is also not unprecedented. "Brazil has effectively insulated itself from ISA by declining to ratify any of its investor-state treaties; its investors abroad have transacted through 'good governance' intermediary states."[174] As a result, in declining to ratify BITs, Brazilian companies can

---

[170] It is arguable that, in proceeding under the Hong Kong-Australia Free Trade Agreement, Philip Morris resorted to Hong Kong as an intermediary state from which to launch its ISA claim. On the Philip Morris Dispute, *see* Philip Morris Int'l *supra* note 39; Tobacco Plain Packaging Act, *supra* note 39; Chapman & Freeman, *supra* note 39; Voon & Mitchell, *supra* note 39; JT Int'l v. Commonwealth, *supra* note 40; British Am. Tobacco Austl., Ltd. v. Commonwealth, *supra* note 40. On Philip Morris's Unsuccessful claim against the Prime Minister of Australia, see Philip Morris, Ltd. v Prime Minister, *supra* note 40. *See also* Trakman WORLD TRADE, *supra* note 4, at 87–89.

[171] For more information on such intermediary states, *see* WORLD INVESTMENT REPORT (2012), *supra* note 3.

[172] *See, e.g.*, Trakman WORLD TRADE, *supra* note 4, at 99.

[173] *See, e.g.*, *Netherland Antilles—Forming a Private, Limited Liability Company*, INT'L BUS. CO. FORMATION, INC., http://www.ibcf.com/jurisdiction.php?source=&country=Netherland%20Antilles (last visited Sept. 29, 2013 at 3:00 PM) (describing how to form a private, limited liability company in the Netherlands and why to do so).

[174] Leon E. Trakman, *Australia's Rejection of Investor-State Arbitration: Sign of Global Change*, *in* REGIONALISM IN INTERNATIONAL INVESTMENT LAW (Leon E. Trakman & Nicola Ranieri, eds., 2013) at 380.

gain access to resource wealthy countries like Venezuela without exposing Brazil to investor-state claims brought under a BIT.[175] Such a practice could also be accomplished through a denial of benefits clause such as under article 17(2) of the U.S. Model BIT.[176]

However, investor treaty-shopping for intermediary states is not risk free. In particular, an ISA claim brought through an intermediary state, as a forum of convenience, may fail on the jurisdictional ground that the claimant's legal connection to the intermediary state is insufficiently substantial to lodge a claim from that state.[177] That risk is conceivably accentuated as more states strive for intermediary status, seeking to provide investors with ever readier means of establishing legal connections to investor targeted states. Coupled with these developments is the likelihood of regulators, including ISA tribunals, establishing rules to regulate investor treaty-shopping, which intermediary states will undoubtedly follow by promulgating countervailing measures designed to circumvent those regulations.

Even if Australia continues to seek an exemption from ISA in the TPP negotiations, it may well remain as a negotiating party. It may also set a precedent for other states to replicate, directly or otherwise. The opportunity to participate in possibly the second largest free trade area after the European Union, and possibly even larger, is too good to bypass.[178] However, over the longer term, Australia may find itself in a lonely place at the end of a long table of contrary minded states, and Australia's outbound investors may be exposed to the domestic courts of negotiating states that do not have the "rule of law" traditions to which Australia subscribes.

More important than Australia's potential isolation as the only TPP negotiating state to reject ISA to date, is the risk of national courts in other TPP negotiating states asserting domestic jurisdiction over treaty obligations on grounds of sovereign immunity, or on more general grounds to protect the public policy of the forum.[179] Such states do not need the equivalent of

---

[175] *See, e.g.*, Ricardo Ortíz, *The Bilateral Investment Treaties and the Cases at ICSID: The Argentine Experience at the Beginning of the XXI Century* at 7 (Foro Ciudadano de Partcipación por la Justicia y los Derechos Humanos, Argentina, 2006) (Jan Stehle trans.), *available at* http://fdcl-berlin.de/fileadmin/fdcl/Publikationen/FOCO-ICSID-engl-2006.pdf (Table 2 notes that Brazil had entered into 14 BITs by 2006, but had not ratified any of them).

[176] *See* 2004 U.S. Model BIT, *supra* note 47, at art. 17(2) ("A Party may deny the benefits of this Treaty to an investor of the other Party that is an enterprise of such other Party and to investments of that investor if the enterprise has no substantial business activities in the territory of the other Party and persons of a non-Party, or of the denying Party, own or control the enterprise.").

[177] Trakman *ICSID under Siege*, *supra* note 74, at 620.

[178] *See, e.g.*, Press Release, Daniel Kalderimis & Chapman Tripp, *Investor-State Arbitration Not Deal Breaker for TPP Negotiations* (May 11, 2012), *available at* http://www.chapmantripp.com/publications/Pages/Investor-state-arbitration-not-deal-breaker-for-TPP-negotiations.aspx.

[179] *See* GUS VAN HARTEN, *supra* note 5, at 188; AARON COSBEY, ET AL.,. INT'L INST. FOR SUSTAINABLE DEV., INVESTMENT AND SUSTAINABLE DEVELOPMENT: A GUIDE TO THE USE AND

Australia's exemption from ISA to deny the "rights" of foreign investors. However, Australia's exemption may reinforce such invasive state practices. However much Australia incorporates treaty obligations into domestic law and however circumscribed Australia's exemption from ISA may be, other states may free ride on Australia's exemption for the opposite purpose: to subordinate their treaty obligations to domestic legal requirements.[180] In this sense, providing Australia with an exemption from ISA may be a dangerous precedent.

CONCLUSION

The TPP is in its early stage of development. At present, it is difficult to anticipate how negotiations will impact on the nature of an already stratified body of international investment law and practice. It is also difficult to identify the extent to which the TPP will serve as an umbrella multilateral agreement on investment law, mushrooming into a series of BITs that may diverge both *inter se* and from the TPPA itself. It may be that such mushrooming of BITs will not eventuate, but that the TPPA will address issues systematically, such as by imposing uniform performance requirements[181] and by regulating non-conforming measures.[182] Alternatively, the TPPA may include selective country-specific reservations. The likely outcome is that the negotiators will seek both ends: to establish a systematic treaty while also providing country-specific exceptions.

It is reasonable to infer that the TPPA will provide for ISA from which only Australia will seek an exemption. It is also likely that this exemption will be permitted, although precisely how it will be framed remains unclear. It is probable too that the TPPA will include country annexes based on negotiated exclusions for individual countries on a host of matters, not limited to modified dispute resolution provisions.

Thus, more important than the purported exemption of one country from ISA is the prospect that negotiating states will seek a range of exceptions to the application of the TPPA's Investment Chapter. The more diffuse and individuated these exceptions are, the more complex and also the more diluted the TPPA is likely to become. If the TPPA embraces high-sounding

---

POTENTIAL OF INTERNATIONAL INVESTMENT AGREEMENTS, at 7 (2004) *available at* http://www.iisd.org/pdf/2004/investment_invest_and_sd.pdf.

[180] *See* Kantor, *supra* note 159, at 10 (demonstrating that approximately 76% of the cases in which investment treaty awards were rendered up to June 2006 involved states that fell at or below Number 50 on the Transparency International's 2008 Corruption Perception Index). *See also* Franck, *supra* note 160, at 1–6 (Presenting empirical data confirming concern about states that score low on 'corruption' indices overusing public policy defenses against foreign investor claims).

[181] *See Trans-Pacific Partnership*, CITIZENS TRADE CAMPAIGN, ¶ 12.7, http://www.citizenstrade.org/ctc/wp-content/uploads/2012/06/tppinvestment.pdf.

[182] *Id*. at ¶ 12.9.

requirements for state parties which are followed by numerous country-specific exemptions, it may lose its legitimacy as a coherent regional agreement and possibly, as a template for a future multilateral investment agreement. If the TPPA spurns a host of BITs between and among its signatories, it may lose its cogency as an umbrella agreement. In effect, the BITs that evolve out of the TPPA may become more important to their signatories than the Investment Chapter in the TPPA itself.

Regarding dispute resolution in particular, the choice of the TPP negotiating parties is not solely between ISA and litigation. Conflict prevention and avoidance measures sometimes are preferable to both.[183] "Multi-tiered" dispute resolution provisions can allow the parties to agree upon a progressive process, moving from an obligation to negotiate and/or conciliate and failing that, a right to arbitrate or litigate, or conceivably, to both.[184] It is noteworthy that the UNCTAD considered conflict prevention and avoidance sufficiently important to devote a detailed study to it.[185]

It is not persuasive to insist that ISA is inherently superior to litigation because arbitrators are investment specialists, while domestic judges operate as courts of general jurisdiction. Neither ISA under a prospective TPPA nor litigation under any exemption or side-agreement ensures equitable and transparent procedures or sound substantive determinations. Evidence of an unjust expropriation is both legally and factually informed: it calls for good judgment, along with investment expertise. It raises difficult questions of law, such as about the nature of an "investor" and an "investment" in respect of which states diverge, and one would expect, arbitrators would as well.[186]

A defense of ISA under a prospective TPPA is that, while it does not lead to judicial precedent as common law lawyers conceive of it, reliance on ISA is more stabilizing than reliance on a plethora of different local laws and

---

[183] *See* UNCTAD ALTERNATIVES TO ARBITRATION, *supra* note 108, at 139–40. International investment claims and decisions are available at *Investment Claims*, OXFORD UNIV. PRESS (last visited on Nov. 3, 2013), http://www.investmentclaims.com.

[184] *See* KLAUS PETER BERGER, PRIVATE DISPUTE RESOLUTION IN INTERNATIONAL BUSINESS: NEGOTIATION, MEDIATION, ARBITRATION, at 74–78 (Kluwer, 2d rev. ed., 2006).

[185] *See* UNCTAD ALTERNATIVES TO ARBITRATION, *supra* note 108, at 139–40.

[186] On the diverse nature of an "investment," *see* Andrea K. Bjorklund, *The Emerging Civilization of Investment Arbitration*, 113 PENN. STATE L. REV. 1269, 1297 (2009); Joseph M. Boddicker, *Whose Dictionary Controls?: Recent Challenges to the Term "Investment" in ICSID Arbitration*, 25 AM. U. INT'L L. REV. 1031, 1034–35 (2010); Julien Burda, *A New Step Towards a Single and Common Definition of an Investment? – Comments on the Romak versus Uzbekistan Decision*, 11(6) J. WORLD INV. & TRADE 1085 (2010); Noah Rubins, *The Notion of "Investment" in International Investment Arbitration*, *in* ARBITRATING FOREIGN INVESTMENT DISPUTES, 283–84 (Norbert Horn, ed., 2004). *See generally* Julian Davis Mortenson, *The Meaning of "Investment": ICSID's Travaux and the Domain of International Investment Law*, 51(1) HARV. INT'L L. J. 257 (2010).

procedures that domestic courts apply to foreign investors and investments.[187] However fragmented different standards of treatment accorded to foreign investors may be under customary international law, and however difficult it may be to identify cohesive principles out of *ad hoc* (and sometimes unpublished) arbitration awards, international investment jurisprudence does exist.[188]

Finally, there is the indirect cost that exempting Australia from ISA under the proposed TPPA will produce a slippery slope along which other states will secure more troubling exemptions. In particular, they will secure country-specific exemptions that not only limit the scope of ISA, but subject foreign investors to a range of domestic requirements that impinge upon foreign investment. The potential result is that host states will invoke a combination of sovereign immunity, public policy, restrictive treaty interpretation, and possibly *force majeure*, to resist enforcement of a decision or award against them, whether or not such action violates their obligations under the New York Convention, the ICSID, or the UNCITRAL Rules.[189]

Should investor-state disputes shift from ISA to the domestic courts of host states, outbound investors will be exposed to disparate measures of domestic due process in which few states endorsed the Hague Convention on the Recognition and Enforcement of Foreign Judgements in Civil and Commercial Matters (1971) and state endorsements of the Draft Hague Principles on Choice of Law remain uncertain.[190] The challenge for investors seeking to enforce awards through the domestic courts of states with high corruption indices and low "rule of law" scores indices will heighten the risks of investors being denied due process of law. A likely result is that foreign investors, apprehensive about local courts, will lodge ISA claims against a host state from an intermediary state with which that host state has a BIT or FTA that includes ISA. The effect is likely to be the continued expansion of ISA as a variable and *ad hoc* body of international investment law. These developments are not inextricably linked to the unfolding TPPA. What is

---

[187] For further reading on the development of international investment norms, *see Current International Investment Issues*, Foreign Inv. Review Bd. (last visited Sept. 30, 2013 at 2:30 PM), http://www.firb.gov.au/content/international_investment/current_issues.asp?NavID=60.

[188] On such authorities, *see, e.g.*, SCHREUER & DOLZER, *supra* note 1. *But see* Sornarajah, *supra* note 94, at 486–88.

[189] *See* U.N. CONF. ON TRADE & DEV., *Latest Developments in Investor-State Dispute Settlement*, 12–13, U.N. Doc. UNCTAD/IIA/No.1 (Apr. 2012) *available at* http://unctad.org/en/PublicationsLibrary/webdiaeia2012d10_en.pdf.

[190] On the draft Hague Principles on Choice of Law, *see* Hague Conference on Private International Law, *Draft Hague Principles on the Choice of Law in International Contracts*, *available at* www.hcch.net/upload/wop/contracts2012principles_e.pdf. *See also* Hague Conference on Private International Law, Convention On the Recognition and Enforcement of Foreign Judgments in Civil and Commercial Matters, Feb. 1, 1971, *available at* http://www.hcch.net/index_en.php?act=conventions.text&cid=78 (demonstrating potential pitfalls investors may face).

different is that forum shopping under a TPPA, with potentially varied country specific exemptions and reservations, is likely to exacerbate the lack of uniformity, consistency, and predictability of international investment law.[191] If these results under international investment law are pitted against the arbitrary application of standards of treatment and review by domestic courts to foreign investors, forum shopping that attenuates an already variable ISA jurisprudence may be a hazard well worth assuming.[192]

[191] For further reading on attempts to redress consistencies in international arbitration, not limited to investor-state arbitration, *See* Tzanakopoulos, *supra* note 65; Jan Paulsson, *International Arbitration and the Generation of Legal Norms: Treaty Arbitration and International Law*, *in* International Arbitration 2006: Back to Basics? (Albert Jan van den Berg ed., 2007); Andreas von Staden, *Towards Greater Doctrinal Clarity in Investor-State Arbitration: The CMS, Enron and Sempra Annulment Decisions,* 2 Czech Y.B. Int'l L. 207 (2011) (explaining tensions under U.S.-Argentina BIT caused by the Argentine economic crisis).

[192] Henckels, *supra* note 172, at 3–4.

DO SOCIAL TIES MATTER IN CORPORATE GOVERNANCE? THE MISSING FACTOR IN CHINESE CORPORATE GOVERNANCE REFORM

Yu-Hsin Lin[*]

I. INTRODUCTION

Since the Asian financial crisis in the late 1990s, "model" corporate-governance practices from the United States have been promoted and implemented in various countries in Asia. The "law and finance" literature has demonstrated that laws governing investor protection play an important role in the development of financial markets.[1] Asian countries have adopted these "best practices" in the hope that strengthening investor-protection laws would boost lagging investment and capital markets. One of the most important best practices adopted involves enhancing board independence and requiring independent directors on boards. In the past decade, many Asian countries have adopted new laws to require independent directors on the boards of public companies. The widespread adoption of independent directors in Asia has drawn scholarly attention on how these reformed boards fit into the local legal systems.[2] Table 1 shows the progress of adoption of independent directors in Asian countries in the past decade.

---

[*] Assistant Professor, College of Law, National Chengchi University (Taiwan). J.S.D., Stanford Law School. A shorter version of this paper was presented at Symposium of Corporate Governance in the Post, Post-World: The Public/Private Debate held at the University of Auckland Business School, Auckland, New Zealand and the 9th Asian Law Institute (ASLI) Annual Conference held at the National University of Singapore, Singapore. This paper was presented at The 30th Annual Conference of the European Association of Law and Economics held at University of Warsaw, Warsaw, Poland. Thanks to participants at those conferences and editors of this journal for helpful comments. Any errors remain mine.

[1] *See* Simeon Djankov, Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *The Law and Economics of Self-Dealing*, 588 J. FIN. ECON. 430 (2008); Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *What Works in Securities Laws?*, 61 J. FIN. 1 (2006); Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert W. Vishny, *Law and Finance*, 106 J. POL. ECON. 1113 (1998).

[2] *See generally* Donald C. Clarke, *The Independent Director in Chinese Corporate Governance*, 31 DEL. J. CORP. L. 125 (2006) (arguing that "[t]he proponents of the institution of independent directors misconceive the nature of corporate governance problem in China…" and analyzing the reasons why this new institution does not function as hoped); Yu-Hsin Lin, *Overseeing Controlling Shareholders: Do Independent Directors Constrain Tunneling in Taiwan?*, 12 SAN DIEGO INT'L L.J. 363 (2011) (evaluating the effectiveness of the transplanted institution, independent director, in Taiwan by empirically assessing the extent to which independent directors constrain tunneling by controlling shareholders); Umakanth Varottil, *Evolution and Effectiveness of Independent Directors in Indian Corporate Governance*, 6 HASTINGS BUS. L.J. 281 (2010) (examining the transplantation of independent directors in India and evaluating the effectiveness of such institution); Chao Xi, *In Search of an Effective Monitoring Board Model: Board Reforms and the Political Economy of Corporate Law in China*,

Table 1 The Adoption of Independent Directors in Asian Countries[3]

Jurisdiction	Year	Requirements Regarding Independent Directors
China	2001	Boards should have at least two independent directors, and independent directors should not constitute less than one-third of the members of any board.
Hong Kong	2012	At least one-third of an issuer's board should be independent non-executive directors (INEDs)
India	1999	At least one-third of board directors should be independent if the chairman is a non-executive director. If he or she is an executive chairman, or a non-executive chairman linked to the promoter (i.e., a controlling shareholder), then one-half of the directors should be independent.
Indonesia	2004	The board of commissioners of a newly listed company must have at least thirty percent independent commissioners. The board of directors must have at least one "unaffiliated" director. The number of independent commissioners must be in proportion to the number of shares owned by non-controlling shareholders, but at least thirty percent.
Japan	2009	Listed companies are required to secure at least one independent director or one statutory auditor.
Korea	1998	At least one-fourth of the board must be "outside" directors. Certain companies (determined by Presidential Decree) must have three or more outside directors (and more than one-half their board).
Malaysia	2000	A listed issuer must ensure that at least two directors or one-third of the board of directors of a listed issuer, whichever is the higher, are independent directors. If the number of directors of the listed issuer is not three or a multiple of three, then the number nearest one-third must be used.
Philippines	2000	Boards should have at least two independent directors or at least one-fifth of the board's directors should be independent, whichever is lesser—but not less than two.
Singapore	2005	The issuer's board must have at least two non-executive directors who are independent and free of any material business or financial connection with the issuer.

22 CONNECTICUT J. INT'L L. 2 (2006) (exploring the "forces that have shaped the evolution of Chinese legal rules on board governance").

[3] ASIAN CORPORATE GOVERNANCE ASS'N (ACGA), Paper on Independent Directors in Asia (Aug. 2010), *available at* http://www.acga-asia.org/content.cfm?SITE_CONTENT_TYPE_ID=14&FULLSTORY=0&START_ROW=6; HONG KONG EXCHANGES & CLEARING LTD. ("HKEx"), MAIN BOARD LISTING RULES: RULES GOVERNING THE LISTING OF SECURITIES ON THE STOCK EXCHANGE OF HONG KONG LIMITED, ch. 3, Rules 3.10A & 3.11, *available at* http://www.hkex.com.hk/eng/rulesreg/listrules/mbrules/documents/chapter_3.pdf; Lin, *supra* note 2, at 379 t.1.

Taiwan	2002	Since 2002, newly listed firms must have at least two independent directors and one independent supervisor. In 2011, the regulator mandated that all public financial firms and those non-financial listed firms with equity value over NT $10 billion (US $345 million) should have at least two independent directors on their board (and not less than twenty percent of the board should be independent directors).
Thailand	2006	Independent directors should constitute at least one-third of the board and should number no fewer than three.

Although the institution of independent-directors has been a popular regulatory measure in Asia, scholars in the United States have cast doubt on the over-reliance on independent directors to address corporate governance issues.[4] This popular structural reform has given rise to a well-recognized puzzle in the United States, where scholarly studies have found no statistically significant relationship between board independence and overall firm value.[5] Furthermore, empirical studies have found no evidence that audit committees consisting of only independent directors exhibit enhanced firm value.[6] This puzzle suggests that independent directors do not improve overall firm performance. If this is so, have all the efforts of these Asian countries been in vain? If not, then what would explain the puzzle?

If our intuitive faith in independent directors is correct, one explanation to the puzzle would be that current independent directors are not independent enough.[7] Current worldwide *ex ante* regulations regarding definitions of

---

[4] *See* Lisa M. Fairfax, *The Uneasy Case for the Inside Director*, 96 IOWA L. REV. 127, 130–33 (2010) [hereinafter Fairfax Inside Director] (questioning the current regulatory trend of favoring independent directors over inside directors); Nicola Faith Sharpe, *The Cosmetic Independence of Corporate Boards*, 34 SEATTLE U. L. REV. 1435, 1435 (2011) (arguing that current regulation only "takes into account only a corporate director's relationship with the corporation but not the tools a director needs to achieve substantive independence."); Nicola Faith Sharpe, *Process Over Structure: An Organizational Behavior Approach to Improving Corporate Boards*, 85 S. CAL. L. REV. 261, 263–68 (2012) (suggesting that corporate board reform should stress on the process by which directors interact with management instead of the structure of the board).

[5] See Sanjai Bhagat & Bernard Black, The Uncertain Relationship Between Board Composition and Firm Performance, 54 BUS. LAW 921, 950 (1999); Benjamin E. Hermalin & Michael S. Weisbach, Boards of Directors as an Endogenously Determined Institution: A Survey of the Economic Literature, 9 ECON. POL'Y REV. 7, 12 (2003); see also Sanjai Bhagat & Bernard Black, The Non-Correlation Between Board Independence and Long-Term Firm Performance, 27 J. CORP. L. 231, 238–39 (2002); Bernard Black, Hasung Jang, & Woochan Kim, Does Corporate Governance Predict Firms' Market Values? Evidence from Korea, 22 J. L. ECON. & ORG. 366, 369–71 (2006).

[6] *See* Roberta Romano, The Sarbanes-Oxley Act and the Making of Quack Corporate Governance, 114 YALE L.J. 1521, 1530–32 (2005).

[7] *But see* Benjamin Hermalin & Michael Weisbach, *Endogenously Chosen Boards of Directors and Their Monitoring of the CEO*, 88 AM. ECON. REV. 96, 96–97 (1998) (noting another explanation would be that board structures are usually voluntarily chosen and are endogenous to other firm characteristics); *accord* Renee Adams, Benjamin Hermalin & Michael Weisbach, *The*

'independence', including those adopted by the NYSE and NASDAQ, are concerned largely with employment, financial, and business relations.[8] However, the seemingly tightened definitions cannot ensure the impartiality of directors. In the case of Enron, a report from the United States Senate reveals that several of the independent directors had close personal relationships with Chairman and CEO Kenneth Lay.[9] Although United States federal laws do not address the issue of social or personal relationships, state courts exercise *ex post* judicial review over the true independence of independent directors in shareholder-derivative suits or suits concerning conflict of interest transactions.[10] In Asia, most countries did not have such *ex post* judicial review in place when they transplanted the new institutional form because shareholder suits are not common in these countries.[11] Furthermore, such judicial review is unlikely to develop in the near future unless these countries adopt major reforms that would stimulate shareholder suits. Therefore, there is no legal safeguard governing the social ties between independent directors and corporate insiders in Asia.

Empirical studies provide solid evidence of the effects that social ties among board directors have on corporate governance.[12] Studies also show that the effectiveness of independent directors depends on the information environment of the firm.[13] Yet social ties sometimes provide independent directors access to inside information, which may strengthen the effectiveness of their decision-making efforts.[14] All of these findings suggest that independent directors are working in a corporate environment that is far more

---

Role of Boards of Directors in Corporate Governance: A Conceptual Framework & Survey, 48 J. ECON. LIT. 58 (2010).

[8] NEW YORK STOCK EXCHANGE ("NYSE") LISTED COMPANY MANUAL § 303A.02 (2012), *available at* http://nysemanual.nyse.com/LCMTools/PlatformViewer.asp?selectednode=chp_1_4&manual=%2Flcm%2Fsections%2Flcm-sections%2F.

[9] United States Senate, The Role of the Board of Directors in Enron's Collapse 8 (July 8, 2002) [hereinafter Report on Enron]. The Senate opined: Enron Board members uniformly described internal Board relations as harmonious. They said that Board votes were generally unanimous and could recall only two instances over the course of many years involving dissenting votes. The Directors also described a good working relationship with Enron management. Several had close personal relationships with Board Chairman and Chief Executive Officer (CEO) Kenneth L. Lay.

[10] *See* Donald C. Clarke, *Three Concepts of the Independent Director*, 32 DEL. J. CORP. L. 73, 110 (2007).

[11] *Id.* at 110 n. 144.

[12] Byoung-Hyoun Hwang & Seoyoung Kim, *It Pays to Have Friends*, 93 J. FIN. ECON.138, 139–41 (2009) [hereinafter Hwang & Kim 2009]; Byoung-Hyoun Hwang & Seoyoung Kim, *Social Ties and Earnings Management*, 10–12 (Feb. 6, 2012), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1215962 [hereinafter Hwang & Kim 2012].

[13] *See generally* Ran Duchin, John G. Matsusaka & Oguzhan Ozbas, *When Are Outside Directors Effective?*, 96 J. FIN. ECON. 195 (2010) [hereinafter DMO 2010].

[14] *See* Frederick Tung, *The Puzzle of Independent Directors: New Learning*, 91 B.U. L. REV. 1175, 1189–90 (2011).

complicated than we expected and that we may need to refine our expectations about independent directors' capacities.[15]

Most East Asian countries have been influenced by traditional Chinese culture. *Guanxi* (personal connections or interpersonal relationships) has been an important pillar of Chinese culture and has profoundly affected the operations of corporate society. China and Taiwan are the only two Asian countries where Chinese is the official language and the roots of Chinese culture run deep. Although many East Asian countries have transplanted the institution of independent directors from the United States, it is particularly interesting to observe how social ties function in Chinese and Taiwanese corporate boards and whether such functioning contributes to a "transplant effect", a term referring to the ineffectiveness of legal transplantation due to different preconditions between the origin country and the transplanting country.[16]

To lay the foundation for this article's discussion of the effects that board members' mutual social ties have on corporate governance, Part II evaluates the functions and the effectiveness of the boards by drawing on theoretical and empirical studies. Part III reviews recent empirical studies on these effects and discusses the legal control exercised by Delaware corporate law over social ties among board members.[17] Part IV empirically assesses the effects of board members' mutual social ties on the functioning of independent directors in Taiwan and China, two societies deeply influenced by traditional Chinese culture. Part V concludes that social ties do matter in corporate governance

---

[15] *Id.* at 1190.

[16] Daniel Berkowitz, Katharina Pistor & Jean-Francois Richard, *Economic Development, Legality, and the Transplant Effect*, 47 EUR. ECON. REV. 165, 168 (2003) (Countries that receive foreign legal systems without similar predispositions are much more constrained in developing an effective legal system, and thus suffer from the so-called "transplant effect").

[17] For the classic statement of state competition see William Cary, *Federalism and Corporate Law: Reflection upon Delaware*, 83 YALE L.J. 663, 663–70 (1974). For recent discussion about the intrusion of federal law to state corporate law, *see generally* Mark J. Roe, *Delaware's Competition*, 117 Harv. L. Rev. 588 (2003) [hereinafter Roe Delaware's Competition]; William B. Chandler III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. 953 (2003); Renee M. Jones, *Rethinking Corporate Federalism in the Era of Corporate Reform*, 29 IOWA J. CORP. L. 625, 627–29 (2004) (The preeminence of Delaware corporate law among United States state corporate laws is well-recognized among scholars and practitioners. More than 50 percent of all public-listed companies in the United States, including 63 percent of the Fortune 500, are incorporated in the state of Delaware. In recent years, the expansion of federal law in internal corporate governance of public companies has intruded the traditional domain of state corporate law and has drawn scholarly discussion about the future of Delaware state corporate law. The competition of corporate law has morphed from state-to-state competition to state-to-federal competition); Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 IOWA J. CORP. L. 1, 57–59 (2002); Mark J. Roe, *Delaware's Politics*, 118 HARV. L. REV. 2491 (2005); Mark J. Roe, *A Spatial Representation of Delaware-Washington Interaction in Corporate Lawmaking*, 2012 COLUM. BUS. L. REV. 553 (2012); Mark J. Roe, *The Shareholder Vote and Its Political Economy, in Delaware and in Washington*, 2 HARV. BUS. L. REV.1 (2012).

and urges Chinese policy-makers to implement legal reforms that would address social ties between independent directors and corporate insiders.

II. RETHINKING BOARD FUNCTIONS AND EFFECTIVENESS

THE ADVISORY AND MONITORING ROLES OF BOARDS

Corporate boards of directors are at the apex of corporate internal control systems and are responsible for final corporate decisions.[18] The boards not only advise management on corporate strategy, but also monitor management. The advisory and monitoring roles of boards sometimes overlap.[19] Boards seeking to give effective advice to management rely on management to first provide them with accurate information. On the one hand, boards will advise management more effectively if management provides it with more sound information. But on the other hand, providing more information to boards exposes management to more effective monitoring.[20]

In theory, shareholders want CEOs to share sufficiently sound information with boards so that boards can give sound recommendations to management and effectively monitor management. In practice, however, CEOs face a trade-off in sharing reliable information with their respective boards. Assuming a moral hazard problem presents itself and that CEOs' preferred projects are different from shareholders', CEOs would be hesitant to share firm-specific information with their own boards if those boards are independent and intensely monitoring their own CEOs. As a result, the advisory and monitoring roles of boards may conflict with each other.[21] Economic theories suggest that it may be optimal for shareholders to choose a friendly board that does not monitor too intensely and with whom the CEO is willing to share information.[22]

In his 2011 article, Faleye provides empirical evidence showing that advisory and monitoring roles do conflict.[23] The study classified board

---

[18] Eugene Fama & Michael Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 311 (1983).

[19] See Donald C. Langevroot, Commentary: Puzzles About Corporate Boards and Board Diversity, 89 N.C. L. REV. 841, 842–45 (2011); Amy L. Hillman & Thomas Dalziel, Boards of Directors and Firm Performance: Integrating Agency and Resource Dependence Perspectives, 28 ACAD. MGMT. REV. 383, 384–88 (2003).

[20] *See generally* Renee Adams et al., *supra* note 7.

[21] Renee B. Adams & Daniel Ferreira, *A Theory of Friendly Boards*, 62 J. FIN. 217, 218–19 (2007).

[22] *Id.* at 229–31. See also Andres Almazan & Javier Suarez, *Entrenchment and Severance Pay in Optimal Governance Structures*, 58 J. FIN 519, 519–20 (2003); Donald C. Langevoort, *Resetting the Corporate Thermostat: Lessons from the Recent Financial Scandals About Self-Deception, Deceiving Others and the Design of Internal Controls*, 93 GEO. L.J. 285, 304–08 (2004).

[23] Olubunmi Faleye, Rani Hoitash & Udi Hoitash, *The Costs of Intense Board Monitoring*, 101 J. FIN. ECON. 160, 180 (2011).

committees as either monitoring committees or advising committees and categorized audit, compensation, and nomination committees as monitoring committees.[24] The study defined directors as monitoring-intensive if they served on at least two of the three principal monitoring committees and defined boards as monitoring-intensive if a majority of their members were monitoring-intensive directors.[25] In addressing the quality of board-advising functions, the study used acquisition performance and corporate investments in innovation as proxies of innovation.[26] A major finding was that firms with monitoring-intensive boards exhibited worse acquisition performance and less innovation than did firms with weakly monitoring boards, implying that intense monitoring could compromise board-advisory functions.[27]

The question is whether boards with intense monitoring and weak advising functions would be most likely to strengthen or to weaken firm value.[28] Faleye found that monitoring-intensive boards are associated with a statistically significant reduction of 12.1 percentage points in Tobin's *q*, a proxy for firm value.[29] There are many possible explanations for the loss in firm value. Because of time constraints, increases in directors' time spent monitoring management could reduce the time available to the directors for advising management. In addition, monitoring-intensive directors would perceive themselves as corporate monitors rather than advisors and thus are reluctant to provide strategic advice. On the other hand, CEOs tend to share less information with monitoring-intensive boards, and this could result in poorer board advice.[30]

Empirical research supports the theoretical hypothesis that the advisory and monitoring roles of boards are sometimes in conflict with each other. In general, research suggests that the net effect of increased monitoring is negative, especially in larger firms where the firms' needs on board advising is greater than smaller firms because their operations are more complex, or when firms are in need of their own board's advice on specific value-creating activities, such as corporate acquisitions and investments in research and development.[31]

---

[24] *Id.*, at 164.
[25] *Id.*
[26] *Id.*, at 170–73.
[27] *Id.*, at 170.
[28] James D. Westphal, *Board Games: How CEOs Adapt to Increases in Structural Board Independence from Management*, 43 ADMIN. SCI. Q. 511, 512–13 (1998); Benjamin Hermalin & Michael Weisbach, *supra* note 7, at 96–97.
[29] Faleye, *supra* note 23, at 175 ("Tobin's *q* is defined as total assets minus the book value of equity plus the market value of equity, divided by the book value of assets").
[30] *Id.* at 175.
[31] *Id.* at 175–78.

Boards tend to rely on management to provide them with sound information with which they can make effective decisions. This pattern is also true for outside directors. Some observers are skeptical about the effectiveness of outside directors because they are thought to possess information inferior to that of insiders on boards. Theoretical research shows that the effectiveness of outsiders in both advisory and monitoring functions depends on the information environment of the firm.[32] Therefore, it would be reasonable to suspect that prior research could not find statistically significant relations between board independence and firm performance partly because the research had omitted a very important variable: information cost.

In their 2010 article, Duchin, Matsusaka, and Ozbas conducted an empirical study testing the impact of information cost on the effectiveness of outside directors.[33] They constructed firm-specific proxies for the cost of outsiders' becoming informed. Those proxies included the number of analysts posting firm-related forecasts in a given year, the dispersion of analyst forecasts, and the analyst-forecast error.[34] These variables rested on the availability, homogeneity, and accuracy of analysts' quarterly earnings forecasts.[35]

First, Duchin, Matsusaka, and Ozbas estimated the relation between board independence and firm performance in general.[36] Consistent with prior research studies, they found no significant relation between the two.[37] Nevertheless, they noted a significant improvement in performance of the firms in the lowest information cost quartile as the percentage of outsiders on a board increases.[38] For firms in the highest information cost quartile, their performance deteriorated when the percentage of outsiders on the board increased.[39] The research suggests that the effectiveness of outside directors depends on information costs.[40] In addition, the researchers found that firms

---

[32] *See* Adams & Ferreira, *supra* note 21.

[33] Ran Duchin et al., *supra* note 13, at 197–211.

[34] *Id.* at 201–02:

> [t]he dispersion of analyst forecasts is measured as the standard deviation of earnings forecasts across analysts prior to a quarterly earnings announcement, normalized by the firm's total book assets and averaged across four quarters in a given year. The analyst forecast error is measured as the absolute difference between the mean analyst earnings forecast prior to a quarterly earnings announcement and the actual earnings, normalized by the firm's total book assets and averaged across four quarters in a given year.

[35] *Id.*

[36] *Id.*

[37] *Id.*

[38] *Id.* at 204.

[39] *Id.*

[40] *Id.* at 204–06.

do take information costs into consideration when composing their boards.[41] Firms with higher information costs have fewer outsiders on the boards and those with lower information costs have more outsiders on the boards.[42] In line with theoretical research, Duchin, Matsusaka, and Ozbas uncovered empirical evidence that it may be optimal for insiders to control some boards, and that recent regulations mandating outsider control of boards could harm firm value of certain firms.[43]

SOCIAL TIES AS SOURCES OF INFORMATION

Theoretical and empirical research has shown that information is essential to the effectiveness of outside directors in both the monitoring and advising functions.[44] Hence, sources of information are an important factor.[45] Most outside directors obtain inside information from the CEO. Theory suggests that if the interests of a CEO differ from those of the firm's shareholders, the CEO faces a trade-off in sharing information with the board. If outside directors are independent and monitor intensely, the CEO will likely be unwilling to share information. In that situation, outside directors lose an important source of inside information and their performance declines. It is therefore optimal to have a friendly board.[46] Westphal examined whether social ties between outside directors and their CEO would increase board involvement and firm performance.[47] To identify social ties, Westphal relied on surveys of corporate directors and CEOs that asked the respondents whether they were friends with each other or mere acquaintances.[48] The research study shows that social ties can contribute to board effectiveness and firm performance by fostering collaboration between CEOs and directors in the strategy-making process without reducing board control.[49]

---

[41] *Id.* at 211.

[42] *Id.* at 212.

[43] *Id.*

[44] *See e.g.*, Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1541 (2007).

[45] *Id.*

[46] *See generally* Adams & Ferreira, *supra* note 21, at 80 ("[W]hen it is likely that directors possess valuable information about an acquisition, the returns of the acquirer are higher on announcement of the acquisition for bidders with more friendly boards").

[47] James D. Westphal, *Collaboration in the Boardroom: Behavioral and Performance Consequences of CEO-Board Social Ties*, 42 ACAD. MGMT J. 7, 16–19 (1999) (social ties among corporate leaders could help secure outside resources the firm might need and facilitate inter-firm resource dependence); *see* James D. Westphal et al., *The Strategic Impetus for Social Network Ties: Reconstituting Broken CEO Friendship Ties*, 27 STRAT. MGMT. J. 425, 426 (2006).

[48] Westphal, *supra* note 47, at 13–14; Westphal et al., *supra* note 47, at 433 (it is common in social network research to ask the respondent to identify their perceived level of friendship with others).

[49] Westphal, *supra* note 47, at 20; Westphal et al., *supra* note 47, at 442–43.

III. DO SOCIAL TIES MATTER IN CORPORATE GOVERNANCE?

EMPIRICAL FINDINGS

Although social ties can help facilitate information exchange between CEOs and outside directors, they can cast doubt on the independence of outside directors and the effectiveness of their monitoring activities.[50] Studies have examined the effects that social ties can have on outside directors' monitoring function.[51] In testing the monitoring effectiveness of outside directors with social ties, studies have used different proxies including CEO-compensation level, earnings management, and financial-reporting quality.[52]

Recent theoretical work has presented economic models that probe into the relations between social networks and corporate governance.[53] Theory suggests that social connections between board members tend to impede governance effectiveness because boards, desirous of preserving their social capital, are reluctant to undertake an intense monitoring of CEOs.[54] In addition, social networks can reduce the precision of information collected and used by board members in deciding resource allocation.[55] While precise information may improve resource allocation, it could also raise the probability of detecting CEO's siphoning of corporate assets.[56] Therefore, board members with social ties to CEOs tend not to collect precise information in order to preserve social capital.[57]

Subrahmanyam presented empirical evidence on social networks and corporate governance.[58] The study uses age differences, occupation, ethnicity, gender, and familial relationships between CEOs and board members as proxies for social networks.[59] Subrahmanyam's empirical tests present compelling evidence that when boards consist of both fewer members who are CEOs and greater non-Caucasian representation, the corresponding firms are better governed and executive compensation is lower than would otherwise be the case.[60] Given that the majority of board members of United States

---

[50] *See* James D. Westphal & Poonam Khanna, *Keeping Directors in Line: Social Distancing as a Control Mechanism in the Corporate Elite*, 48 ADMIN. SCI. Q. 361, 363, 385–91 (2003) (studies have shown that social ties among board members and CEOs would have adverse effects on governance).

[51] *Id.* at 362–63.

[52] *Id.* at 377–78.

[53] Avanidhar Subrahmanyam, *Social Networks and Corporate Governance*, 14 EUR. FIN. MGMT. 633, 636–45 (2008).

[54] *Id.*

[55] *Id.*

[56] *Id.*

[57] *Id.*

[58] *Id.*

[59] *Id.* at 649.

[60] *Id.* at 649 (the quality of governance was measured by the governance index obtained from Andrew Metrick's website).

companies are Caucasian, research results suggest that firms' governance can improve when social networks between board members and CEOs are minimal or absent.[61] In sum, Subrahmanyam's work suggests that social ties can reduce board's monitoring capabilities and increase CEO compensation, which lead to lower shareholder value.[62]

Hwang and Kim examined the social ties between board directors and CEOs within individual Fortune 100 firms and the association between these ties and executive compensation.[63] The researchers identified social ties by noting board directors and CEOs' shared backgrounds, including mutual alma mater, military service, regional origin, academic major, and industry, and found that the percentage of independent boards dropped from eighty-seven percent to sixty-two percent when screenings indicated that there were shared backgrounds.[64] Using CEO compensation as a proxy for directors' monitoring level, the researchers tested the association of social ties among board members on CEO compensation.[65] They found that the CEOs of companies with socially independent boards received significantly lower compensation than CEOs of companies with non-independent boards, suggesting that social ties do impair the impartiality of outside directors and diminish their monitoring function.[66]

Following up on their prior research, Hwang and Kim further examined the effects of social ties between CEOs and audit committee members on audit committees' oversight capabilities and, in particular, on the firms' financial reporting process.[67] The researchers found that social ties, defined by shared backgrounds, between audit committee members and CEOs are more prevalent than conventional ties, as captured by the law since Sarbanes-Oxley Act of 2002 ("SOX").[68] The samples of this study include Fortune 100 firms as declared in 1996 and 2005.[69] The researchers built a social index which represents the average number of ties each audit committee member has with the CEO.[70] In twenty-five percent of the sample firms, the average social ties of each audit committee member to the CEO is greater than 1.0; in 2.4% of the samples firms, the average number is greater than 2.0, suggesting a strong presence of social ties in Fortune 100 firms. Each audit committee member, on average, has 0.6 social ties and 0.1 conventional ties to the CEO.[71] Since the samples span the period from 1996 to 2005, it is expected that

---

[61] *Id.* at 647–53.
[62] *Id.* at 647–53.
[63] *See* Hwang & Kim 2009, *supra* note 12, at 139–44.
[64] *Id.*
[65] *Id.* at 145–48.
[66] *Id.* at 145–48.
[67] *Id.* at 10.
[68] *Id.*
[69] *Id.*
[70] *Id.*
[71] *Id.*

conventional ties will not be prevalent because all audit committee members are supposed to meet the independence requirements set by 2002 SOX and later-published rules of NYSE and NASDAQ.[72]

Hwang and Kim further examined the association between audit committee members' social ties and the firms' earnings-management practices.[73] The major responsibility of an audit committee is to oversee the integrity of a firm's financial reporting system.[74] Earnings management refers to attempts by the management to influence or manipulate reported earnings.[75] Earnings management practices are usually associated with fraud and threaten the integrity of a firm's financial reporting system.[76] Hwang and Kim used abnormal (i.e. discretionary) accruals as proxies for earnings-management activities and examined the association between social ties of audit committee members and abnormal accruals.[77] They found that the association between abnormal accruals and the extent of audit-committee members' social ties to the CEO is substantially stronger than the association between abnormal accruals and audit-committee members' conventional ties to the CEO.[78] This finding suggests that mutual qualities foster relationship building and that social ties can impair the oversight ability of audit committees, as evidenced by facilitation of earnings-management practices.[79]

Empirical research shows that social ties between independent directors and CEOs do compromise the monitoring ability of independent directors. However, because social ties could foster information exchange – which is essential for independent directors' execution of their responsibilities – social ties between independent directors and CEOs could foster board collaboration and improve boards' advisory function. Finally, whether social ties increase or decrease firm value will depend on each firm's specific current status, such as a firm's development stage and a firm's complexity. The optimal composition of boards may vary among different firms and at different stages of development.

---

[72] *Id.* at 19–20.
[73] *Id.* at 7.
[74] *Id.* at 1.
[75] *Id.* at 7.
[76] *Id.* at 15.
[77] *Id.* at 7–8.
[78] *Id.* at 10–12.
[79] *Id.* at 10–12.

CONTROL OVER SOCIAL TIES UNDER UNITED STATES LAW

United States scholars have long been aware of the social and psychological causes of bias that could impair independent directors' impartiality.[80] Directors may be biased by group loyalty, friendship, and other non-pecuniary self-interests that are not captured by current regulations of independence.[81] This theory of structural bias suggests that even if an independent director does not have financial or employment ties with a firm, he may still be biased in making decisions because of the social pressures generated from his personal relationship with other board members or management.[82] Drawing on structural bias theory, scholars have called for more stringency in the controls over social ties that could affect the independence of independent directors.[83]

In the United States, internal governance of corporations has long been the domain of state corporate law.[84] Although federal law has intruded into corporate governance following serious financial shenanigans, the regulatory power of American states over the internal affairs of a corporation are largely intact.[85] Since federal laws and rules promulgated by listing agents regarding independent directors do not take into account social ties of independent directors, it is particularly important to analyze how state laws respond to this issue.[86] Delaware law is said to be the "mother of all corporate law" because of the large number of public companies incorporated in Delaware.[87] This section will briefly introduce current definition of independence under federal

---

[80] See Victor Brudney, The Independent Director — Heavenly City or Potemkin Village?, 95 HARV. L. REV. 597, 597 (1982); see generally James D. Cox & Harry L. Munsinger, Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion, 48 LAW & CONTEMP. PROBS. 83 (1985).

[81] Marleen A. O'Connor, *The Enron Board: The Perils of Groupthink*, 71 U. Cin. L. Rev. 1233, 1242–47 (2003); Antony Page, *Unconscious Bias and the Limits of Director Independence*, 2009 U. ILL. L. REV. 237, 249–55 (2009); Julian Velasco, *Structural Bias and the Need for Substantive Review*, 82 WASH. U. L. Q. 821, 853–70 (2004).

[82] Brudney, *supra* note 80, at 611–12.

[83] Lisa M. Fairfax, *Sarbanes-Oxley, Corporate Federalism, and the Declining Significance of Federal Reforms on State Director Independence Standards*, 31 OHIO N.U. L. REV. 381, 383 (2005) (arguing that Sarbanes-Oxley Act should regulate director independence in a manner that would account for social ties); Velasco, *supra* note 81, at 870–74.

[84] *See* Edgar v. MITE Corp., 457 U.S. 624, 645 (1982) (Under the internal affair doctrine, the internal affairs, e.g. conflicts between shareholders and directors, will be governed by the state law where the corporation is incorporated. Therefore, by choosing the state of incorporation, companies choose the state corporate law that will govern its internal affairs).

[85] *See* Roe Delaware's Competition, *supra* note 17, at 596–97.

[86] *See* Jill E. Fisch, *The New Federal Regulation of Corporate Governance*, 28 HARV. J.L. & PUB. POL'Y 39, 45 (2004); *see also* Usha Rodrigues, *The Fetishization of Independence*, 33 J. CORP. L. 447, 465 (2008).

[87] Hillary Sale, *Delaware's Good Faith*, 89 CORNELL L. REV. 456, 457 (2004); *see also* Rodrigues, *supra* note 86, at 464.

law and Delaware law, and how Delaware courts address the issue of social ties in the absence of black-letter laws.

A. Federal Law: The Case of Enron, SOX and Listing Agents' Rules

At the time Enron collapsed in December 2001, Enron's board of directors had seventeen board members, two of whom were senior officers of the company.[88] The other fifteen members were outside directors, and several had more than twenty years of experience on Enron's board. All of the board members had sophisticated business and investment experience and considerable expertise in accounting and derivatives.[89] Nevertheless, they breached their fiduciary duties by allowing Enron to engage in high risk accounting, inappropriate conflict of interest transactions, extensive undisclosed off-the-books activities, and excessive executive compensation.[90]

After Enron's dramatic collapse, the United States Senate conducted an investigation into Enron's board.[91] The report shows that most of Enron's board members had considerable financial relationships with the company.[92] These financial ties included additional consulting fees paid to individual directors, donations by Enron to organizations where board members served as presidents, substantial business relationships between Enron and firms where board members served in high ranking positions, etc.[93] The report concluded that the independence of the Enron board members was compromised by these financial ties.[94]

In response to Enron's debacle, the federal government enacted SOX to redefine the meaning of independence for directors.[95] SOX requires all audit committee members be independent and defines independence from the perspective of compensation and employment.[96] To qualify as independent, a director may not, "other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee (i) accept any consulting, advisory, or other compensatory fee from the issuer; or (ii) be an affiliated person of the issuer or any subsidiary thereof."[97] SOX further requires the Securities Exchange Commission ("SEC") to direct national

---

[88] Enron, Annual Report 2000, *available at* http://picker.uchicago.edu/Enron/EnronAnnualReport2000.pdf.

[89] S. Rep. No. 80-393.

[90] *Id.*, at 11–14.

[91] *See generally* William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. R. 1275 (2002).

[92] S. Rep. No. 80-393, at 51–53.

[93] *Id.* at 51–52.

[94] *Id.* at 51.

[95] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 of the United States Code).

[96] Sarbanes-Oxley Act of 2002 §301 (m)(3)(A), (B).

[97] *Id*. at § 301 (m)(3)(B).

securities exchanges, including NYSE and NASDAQ, and national securities associations to adopt rules in compliance with the new act.[98] NYSE and NASDAQ have since adopted rules to require each member of the audit committee to be independent.[99] The listing agents went further to require (1) majority of the board be composed of independent directors,[100] (2) both nominating committee and compensation committee be composed entirely of independent directors,[101] and (3) the definition of independence be extended from employment relationship to financial and business relationship.[102]

---

[98] *Id*. at § 301 (m)(1)(A).

[99] NYSE LISTED COMPANY MANUAL § 303A.07 (a) (2012), *available at* http://nysemanual.nyse.com/LCMTools/PlatformViewer.asp?selectednode=chp_1_4&manual=%2Flcm%2Fsections%2Flcm-sections%2F; NASDAQ, MARKETPLACE RULES r.5605(c)(2)(A) (2012), *available at* http://nasdaq.cchwallstreet.com/NASDAQTools/PlatformViewer.asp?selectednode=chp%5F1%5F1%5F4%5F1&manual=%2Fnasdaq%2Fmain%2Fnasdaq%2Dequityrules%2F.

[100] NYSE LISTED COMPANY MANUAL, *supra* note 99, at § 303A.01; NASDAQ, MARKETPLACE RULES *supra* note 99, at r.5605(b)(1).

[101] NYSE LISTED COMPANY MANUAL *supra* note 99, at §§ 303A.04(a), 303A.05(a); NASDAQ, MARKETPLACE RULES *supra* note 99, at r.5605(A)(6)-(7).

[102] For definition of "independence," *see* NYSE LISTED COMPANY MANUAL *supra* note 99, at § 303A.02:

> (a)(i) No director qualifies as "independent" unless the board of directors affirmatively determines that the director has no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company).
>
> (b) In addition, a director is not independent if:
>
> (i) The director is, or has been within the last three years, an employee of the listed company, or an immediate family member is, or has been within the last three years, an executive officer, of the listed company.
>
> (ii) The director has received, or has an immediate family member who has received, during any twelve-month period within the last three years, more than $120,000 in direct compensation from the listed company, other than director and committee fees and pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service).
>
> (iii) (A) The director is a current partner or employee of a firm that is the listed company's internal or external auditor; (B) the director has an immediate family member who is a current partner of such a firm; (C) the director has an immediate family member who is a current employee of such a firm and personally works on the listed company's audit; or (D) the director or an immediate family member was within the last three years a partner or employee of such a firm and personally worked on the listed company's audit within that time.
>
> (iv) The director or an immediate family member is, or has been with the last three years, employed as an executive officer of another company where any of the listed company's present executive officers at the same time serves or served on that company's compensation committee.
>
> (v) The director is a current employee, or an immediate family member is a current executive officer, of a company that has made payments to, or received payments from, the listed company for property or services

However, the seemingly tightened definition of director independence still cannot ensure the impartiality of directors. In the case of Enron, the report from the United States Senate reveals that many of the independent directors had served on the board for more than twenty years and had close personal relationships with Chairman and CEO, Kenneth Lay.[103] Nevertheless, the definition of independence under SOX and listing agents' rules do not exclude personal relationships or social ties. So could such close social ties among board members have contributed to Enron's debacle?

Enron Board members uniformly described internal Board relations as harmonious. They said that Board votes were generally unanimous and could recall only two instances over the course of many years involving dissenting votes. The Directors also described a good working relationship with Enron management. Several had close personal relationships with Board Chairman and Chief Executive Officer (CEO) Kenneth L. Lay.[104]

From the Senate's report, it seems that close social ties do correlate with harmonious board relations, unanimous board decisions and good working relationships with the management. This harmonious atmosphere may have created a structural bias of the independent directors, leading them to approve a series of conflict of interest transactions proposed by management, and ultimately leading to the collapse of the Enron Empire.[105] Nevertheless, federal law is silent on this important issue.[106]

B. State Law: The Law of Delaware

Delaware does not require "independent directors" on corporate boards; hence, Delaware General Corporation Law does not set an explicit standard for director independence.[107] Instead, Delaware General Corporation Law leaves the corporations to decide the number and qualifications of their board members as well as the structure of the board.[108] Nevertheless, Delaware courts have created a regulatory framework where decisions made by

---

> in an amount which, in any of the last three fiscal years, exceeds the greater of $1 million, or 2% of such other company's consolidated gross revenues.

NASDAQ provides similar definition, see NASDAQ, MARKETPLACE RULES *supra* note 99, at r.5605(a)(2).

[103] S. Rep. No. 80-393, at 8.

[104] *Id.*

[105] *See* Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation*, 69 U. CHI. L. REV. 1233, 1241–42 (2002) ("[i]t turns out that the independence of virtually every board member [of Enron], including Audit Committee members, was undermined by side payments of one kind or another. Independence also was compromised by the bonds of long service and familiarity"). *See also* O'Connor, *supra* note 81.

[106] Fairfax Inside Director, *supra* note 4, at 146–47.

[107] Clarke, *supra* note 10, at 102.

[108] DEL. CODE ANN. tit. 8, § 141 (b), (2010).

disinterested and independent boards will not be substantively reviewed by the court (the "business judgment rule"), and thus, the directors will be shielded from potential liabilities.[109] To enjoy the benefit of business judgment rule and avoid potential liabilities, Delaware corporations voluntarily retained outside directors who are disinterested in specific transactions and/or are independent even before the enactment of SOX. Delaware courts grant directors protection from liability if the decision was made solely by disinterested and/or independent directors in three types of suits: dismissing shareholder derivative suits against directors, approving conflict of interest transactions where directors or officers' interests are involved, and taking defensive measures against hostile takeovers.[110]

In determining the independence of directors, the courts of Delaware apply a case-by-case approach and review the factual allegations to determine the independence of an independent director.[111] Delaware courts look to whether the decision under review "is based on the corporate merits of the subject before the board rather than extraneous considerations or influences."[112] Delaware courts hold the view that a plaintiff must show a "domination and control" relationship among directors.[113] Substantial shareholding or even majority ownership of a company alone would not rebut the presumption of independence.[114] Plaintiffs must show that "the Board is either dominated by an officer or director who is the proponent of the challenged transaction or that the Board is so under his influence that its discretion is "sterilize[d]"."[115] For example, in *Rales v. Blasband*, Supreme Court of Delaware held that two directors were not independent based on their employment relationships because one of them was the President and CEO of

---

[109] Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1984) (whether "(1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment").

[110] Laura Lin, *The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence*, 90 NW. U. L. REV. 898, 904–11 (1996).

[111] *Aronson*, 473 A.2d at 814 ("[a]s to the former inquiry, directorial independence and disinterestedness, the court reviews the factual allegations to decide whether they raise a reasonable doubt, as a threshold matter, that the protections of the business judgment rule are available to the board"); Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1049 (Del. 2004) ("Independence is a fact-specific determination made in the context of a particular case."); *see* also Elizabeth Cosenza, *The Holy Grail of Corporate Governance Reform: Independence or Democracy?*, 2007 BYU L. REV. 1, 29 (2007); Rodrigues, *supra* note 86, at 465, 483–84.

[112] *Aronson*, 473 A.2d at 816 ("[i]ndependence means that a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences").

[113] *Aronson*, 473 A.2d at 815–16.

[114] *Aronson*, 473 A.2d at 815; *see also* Rales v. Blasband, 634 A.2d 927 (Del. 1993) (holding that factual allegations must give reasonable doubt as to directors' independent and disinterred business judgment); Levine v. Smith, 591 A.2d 194, 205 (Del. 1991) (holding that shareholder must plead particularized facts creating reasonable doubt to soundness of challenged transaction).

[115] *Levine*, 591 A.2d at 205.

the defendant company and the other is the President of a company where defendant directors are directors and major shareholders.[116]

In addition, Delaware courts also take allegations of social or personal relationships seriously. Delaware courts generally hold that mere friendships are not at a level where they create bias in decision making.[117] A mere allegation that the controlling shareholder and the independent director are very close friends is not enough to prove that the independent director lacks sufficient independence.[118] Underpinning the claims against social or personal relationships is the concept of structural bias. In general, the Delaware courts express skepticism about structural bias,[119] and rule in line with economists' "reputation argument", according to which directors try hard to avoid bias in order to preserve their reputation in the independent-director market.[120] Hence, unless substantial evidence arises supporting the claim that an independent director "would be more willing to risk his or her reputation than risk the relationship with the interested director," the court holds the view that even if structural bias exists, structural bias can be avoided by independent directors.[121]

However, there are cases in which Delaware courts rebutted assertions pointing to the independence of directors if substantial evidence revealed close social or professional relationships among directors. In particular, in cases

---

[116] *Blasband*, 634 A.2d at 936–37.

[117] *Stewart*, 845 A.2d at 1050.

> *But*, to render a director unable to consider demand, a relationship must be of a bias-producing nature…. Allegations of mere personal friendship or a mere outside business relationship, standing alone, are insufficient to raise a reasonable doubt about a director's independence…. [S]ome professional or personal friendships, which may border on or even exceed familial loyalty and closeness, may raise a reasonable doubt whether a director can appropriately consider demand. This is particularly true when the allegations raise serious questions of either civil or criminal liability of such a close friend. Not all friendships, or even most of them, rise to this level. (emphasis added).

[118] *See Aronson*, 473 A.2d at 816–17 ("The director's approval, alone, does not establish control, even in the face of Fink's 47% stock ownership…. Therefore, we cannot conclude that the complaint factually particularizes any circumstances of control and domination to overcome the presumption of board independence, and thus render the demand futile."); *Stewart*, 845 A.2d, at 1051–52 ("Mere allegations that they move in the same business and social circles, or a characterization that they are close friends, is not enough to negate independence for demand excusal purposes.").

[119] *Aronson*, 473 A.2d at 815 n.8; *Stewart*, 845 A.2d, at 1052-53.

[120] Eugene Fama & Michael Jensen, *Separation of Ownership and Control*, 26 J. L. & ECON. 301, 315 (1983); *see also Stewart*, 845 A.2d at 1052.

[121] *Stewart*, 845 A.2d at 1052 n. 32; Page, *supra* note 81, at 258–86; (contemporary psychological research studies recognize another prototype of bias—"unintentional bias," which results from unconscious cognitive processes. Because such bias is "involuntary" and "unconscious," it can occur even when the decision maker intentionally seeks to avoid biases. Commentators argue that because decision makers are unaware of such bias, the reputation argument supported by economists thus is unsustainable).

involving special litigation committees (SLC), the corporation and the SLC lost the protection of presumption of independence once it established the SLC to consider whether to pursue litigation against its directors. In this situation, the corporation bears the burden of proving the independence of its SLC members.[122] In *Biondi v. Scrushy*, the Delaware Court of Chancery questioned the independence of two members of the SLC because of their long-standing personal ties with the defendant director.[123] Furthermore, in the case of *In re Oracle Derivative Litigation*, the Delaware Court of Chancery found that members of the SLC, who were both Stanford University professors, lacked independence because several defendant directors also had substantial financial and professional ties to Stanford University where the SLC members were employed.[124]

In situations where a corporation is considering a merger or acquisition, especially in cases involving management interests, a corporation would establish a special negotiating committee composed of disinterested and independent directors to consider the transaction. In *In re Loral Space and Communication*, the Court of Chancery of Delaware found the chairman of the special negotiating committee to be a non-independent director because he was a close friend of the controlling shareholder and had a substantial business relationship with the controlling firm. In the context of a special negotiating committee, the courts evaluate not only the relationships among members of the committees and interested parties but also "whether the committee members in fact functioned independently."[125] In the same case, the court found another member of the special negotiating committee not independent mainly because he did not demonstrate the knowledge and the inclination to effectively perform his duty.[126]

A key factor affecting the outcome of litigation concerning director independence is the burden of proof. Social ties are personal and confidential in nature. It would be hard for everyone to prove another's personal relationship without going through discovery. Through discovery, both parties are forced to provide confidential information that helps the court to determine the independence of directors. The party that bears the burden of proof usually fails to meet his burden if the case does not go through discovery.

For example, in cases involving a special litigation committee, according to the rules established in *Zapata v. Maldonado*, the court applies a two-stage test when shareholders challenge the committee's decision to not pursue the suit.[127] "First, the Court should inquire into the independence and good faith

---

[122] Zapata v. Maldonado, 430 A.2d 779, 788 (Del. 1981).

[123] Biondi v. Scrushy, 820 A.2d 1148, 1166 (Del. Ch. 2003).

[124] In re Oracle Corp Derivative Litigation, 824 A.2d 917, 947–48 (Del. Ch. 2003); *see also* Rodrigues, *supra* note 86, at 474–76.

[125] Kahn v. Tremont Corp., 694 A.2d 422, 429–30 (Del. 1997).

[126] *In re* Loral Space & Commc'ns Inc., 2008 WL 4293781, 22 (Del.Ch. 2008).

[127] *Maldonado*, 430 A.2d at 779, 788.

of the committee and the bases supporting its conclusions."[128] In this stage, the company bears the burden of proving committee members' independence and good faith and the reasonableness of the decision. In addition, discovery procedure applies in the first-stage inquiries.[129] This procedural change has significant effects on the outcome of claims. In situations where a company establishes a special litigation committee, the members of the special litigation committee lose the protections associated with presumptions of independence. In *Beam v. Stewart*, the Delaware Court of Chancery took the view that "[t]he special litigation committee bears the burden of 'establishing its own independence by a yardstick that must be 'like Caesar's wife'—'above reproach.'"[130]

In addition, with the application of discovery procedures to contexts where significant confidential information about personal relations would not be released otherwise, the burden of proving the independence of special litigation committee members is very high. In *Beam v. Stewart*, the Delaware Court of Chancery highlighted the profound impact of these procedural differences: "[a]s a practical matter, the procedural distinction relating to the diametrically-opposed burdens and the availability of discovery into independence may be outcome-determinative on the issue of independence."[131] Even if a company passes a first-stage review and establishes the independence of its special litigation committee, Delaware courts still use their own "independent business judgment" to substantively review the decisions of special litigation committees.[132] *Zapata*'s second-stage substantive review suggests that Delaware courts are well aware of structural bias issues in situations involving special litigation committees.[133]

In sum, the burden of proof and the applicability of discovery procedure are factors that are key to the outcome of suits challenging director independence from the perspective of personal relationships. Except in cases

---

[128] *Id.*

[129] *Id.*, at 788 ("Limited discovery may be ordered to facilitate such inquiries. The Corporation should have the burden of proving independence, good faith and a reasonable investigation, rather than presuming independence, good faith and reasonableness.").

[130] *Stewart*, 845 A.2d, at 1055 (quoting Lewis v. Fuqua, 502 A.2d 962, 967 (Del. Ch. 1985)).

[131] *Id.*

[132] *Maldonado*, 430 A.2d at 789 ("The Court should determine, applying its own independent business judgment, whether the motion should be granted."). Conversely, New York State took an opposite position. The New York Court of Appeals ruled that courts shall not second guess the decision of a special litigation committee if the committee's members pass the first-stage test of independence. *See* Auerbach v. Bennett, 393 N.E.2d 994, 1001–03 (N.Y. 1979).

[133] *Maldonado*, 430 A.2d. at 789:

> The second step provides, we believe, the essential key in striking the balance between legitimate corporate claims as expressed in a derivative stockholder suit and a corporation's best interests as expressed by an independent investigation committee…. The Court of Chancery should, when appropriate, give special consideration to matters of law and public policy in addition to the corporation's best interests.

where the defendant company or director bears the burden of proof, such as the ones involving special litigation committees,[134] it is very difficult for shareholders to meet the burden and challenge social ties among board members. Some scholars have questioned the presumption of director independence in cases involving structural bias and called for more judicial power in reviewing the substantive merits of independent directors' decisions.[135] More challenges based on personal relationships have been raised in recent years, questioning the independence of directors in the United States.[136] Although it is not easy for plaintiffs to successfully rebut the presumption of independence, the courts nevertheless take allegations of personal relationships seriously. In practice, lawyers have also advised their clients to take into account personal relationships when selecting members for special committees.[137] This development is worth the notice of countries that have transplanted the institution of independent directors.

---

[134] The burden of proof in pre-suit demand cases is on the plaintiffs. However, where the special litigation committee sought dismissal of lawsuit already filed, the "SLC members are not given the benefit of the doubt as to their impartiality and objectivity. They, rather than plaintiffs, bear the burden of proving that there is no material question of fact about their independence." London v. Tyrrell, C.A. No. 3321-CC, at *41 (Del. Ch. 2010).

[135] *See generally* Kenneth B. Davis, *Structural Bias, Special Litigation Committees, and the Vagaries of Director Independence*, 90 IOWA L. REV. 1305 (2005); Velasco, *supra* note 81; *cf.* Rachel A. Fink, *Social Ties in the Boardroom: Changing the Definition of Director Independence to Eliminate "Rubber-Stamping" Boards*, 79 S. CAL. L. REV. 455 (2006) (looking to stock exchanges, instead of Delaware courts, to examine the social ties among board members by proposing to require all listed firms to have board-rating agencies score the independence of director nominees).

[136] Booth Family Trust v. Jeffries, 640 F.3d 134, 137 (6th Cir. 2011) (applying Delaware law); S. Muoio & Co. LLC v. Hallmark Entertainment Investments Co., et al., C.A. No. 4729-CC (Del. Ch. Mar. 9, 2011); London C.A. No. 3321-CC, at *41; Sutherland v. Sutherland, 958 A.2d 235, 236–37 (Del. Ch. 2008).

[137] Mark D. Gerstein & Bradley C. Faris, *Latham & Watkins Special Negotiating Committees: If, When, Who and How —A Guide for the General Counsel*, 23 (January 2012) *available at* http://www.lw.com/thoughtLeadership/special-negotiating-committees (last visited July 30, 2013).

IV. SOCIAL TIES IN CHINESE CORPORATE BOARDS

Central to Chinese culture is the concept of *guanxi*, which roughly translates into personal connections, or interpersonal relationships.[138] This component of Chinese culture dominates every aspect of social life in Chinese societies, including in the business world.[139] In contemporary Chinese societies, *guanxi* remains so powerful that, if left unregulated, it could endanger the core value of independent directors—independence.

Another central feature of Chinese societies is the extraordinary degree to which harmony is prized and conflict is avoided.[140] This cultural respect for harmony can, like *guanxi*, powerfully affect group cohesion, which is an important source of structural bias. This section reviews the process by which Taiwan and China undertook a legal transplantation of independent directors, and analyzes the effects that independent directors' social ties to controlling shareholders or corporate insiders can have on corporate governance.

TAIWAN

A. Corporate Governance in Taiwan

The most important challenge in corporate governance in Taiwan is to constrain controlling shareholders' extraction of private benefits from minority shareholders. The corporate ownership of Taiwanese public companies is concentrated, family-owned, and divergent in its control rights and cash-flow rights.[141] Yeh and Woidtke found that seventy-two percent of Taiwanese public firms had a controlling shareholder and that, among them, eighty-three percent were family controlled.[142] The largest shareholders of Taiwan's non-financial firms controlled 62.69% of the board seats and 49.55% of the statutory-auditor positions. Hence, large shareholders in Taiwan not only own public firms but manage and control them as well.

---

[138] Thomas Gold, Doug Guthrie & David Wank, *An Introduction to the Study of Guanxi* in SOCIAL CONNECTIONS IN CHINA: INSTITUTIONS, CULTURE, AND THE CHANGING NATURE OF "GUANXI" 3–4 (Cambridge University Press, 2002).

[139] E.g. Lisa A. Keister, *Guanxi in Business Group: Social Ties and the Formation of Economic Relations* in SOCIAL CONNECTIONS IN CHINA: INSTITUTIONS, CULTURE, AND THE CHANGING NATURE OF "GUANXI" 77–79 (Cambridge University Press, 2002); Seung Ho Park & Yadong Luo, *Guanxi and Organizational Dynamics: Organizational Networking in Chinese Firms*, 22 STRAT. MGMT. J. 455, 455–56 (2001).

[140] There is an old Chinese saying, "he weigui," which means "Harmony is prized."

[141] Yin-HuaYeh, Tsun-Siou Lee & Tracie Woidtke, *Family Control and Corporate Governance: Evidence from Taiwan,* 2 INT'L REV. FIN. 21, 30–31 (2001).

[142] Yin-Hua Yeh & Tracie Woidtke, *Commitment or Entrenchment? Controlling Shareholders and Board Composition*, 29 J. BANKING & FIN. 1857, 1874 (2005).

Corporate control in East Asian countries is typically enhanced by pyramid structures and cross-holding among firms.[143] Bebchuk, Kraakman, and Triantis (2000) applied the term *controlling-minority structure* to the pattern of ownership that, through structural devices, separates controllers' *ownership* rights (cash-flow rights) from controllers' *control* rights (voting rights).[144] In 2005, the average control rights of the largest shareholders in Taiwanese non-financial firms was 29.81%, however, the average cash-flow rights were only 22.13%.[145] The discrepancies between cash-flow rights and voting rights provide controlling shareholders strong incentives to siphon out corporate assets to their own pockets at the expense of minority shareholders. In addition, controlling shareholders' control over the firms provides further opportunities for such misconduct.[146]

The corporate-board structure of Taiwan generally follows the Japanese governance structure, which is a modified version of the German governance structure. In Germany, supervisory boards have the right to appoint or remove directors; however, in Japan and Taiwan, supervisors are nominated by boards and elected by shareholders.[147] In addition, statutory supervisors or statutory auditors in Taiwan act individually, not collectively like their German and Japanese counterparts.[148] According to the Corporation Law of Taiwan, a statutory auditor is an independent supervisory institution responsible for

---

[143] A pyramid structure refers to an ownership structure where the controlling shareholder holds shares of one company, which in turn holds shares of another company. The controlling shareholder thus controls these two companies. This process can be repeated a number of times and thus creates a pyramid of companies that are controlled by the controlling shareholder. Cross-holding refers to a situation where a subsidiary owns shares of the parent company. *See* Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Corporate Ownership Around the World*, 54 J. FIN. 471, 473 (1999); Stijn Claessens, Simeon Djankov & Larry H.P. Lang, *The Separation of Ownership and Control in East Asian Corporations*, 58 J. FIN. ECON. 81, 93 (2000).

[144] Lucian Aye Bebchuk, Reinier Kraakman & George Triantis, Stock Pyramids, Cross-Ownership and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control From Cash-Flow Rights, CONCENTRATED CORPORATE OWNERSHIP 295, 295 (Randall K. Morck, ed., 2000).

[145] The cross-shareholding structure and the pyramidal structure are the most common structures that controlling shareholders use to create deviations in Taiwanese public companies. YIN-HUAYEH & CHEN-EN KO, DE RI MEI HAN GEGUO DULI DONGSHI, SHENJI WEIYUAN HUIJI JITA ZHUANMEN WEIYUAN HUI FAZHI GUIFANJI SHIWU YUNZUO QINGKUANG [THE LAW AND PRACTICES OF INDEPENDENT DIRECTORS, AUDIT COMMITTEES, AND OTHER FUNCTIONAL COMMITTEES IN GERMANY, JAPAN, THE UNITED STATES, AND SOUTH KOREA], FINANCIAL SUPERVISORY COMMISSION OF TAIWAN 294 (January 2006), *available at available at* http://www.fsc.gov.tw/ch/home.jsp?id=194&websitelink=multiSTUDY_list.jsp&parentpath=0,7,72 (last visited Nov. 25, 2013).

[146] Bebchuk, Kraakman & Triantis, *supra* note 144, at 295.

[147] Ronald J. Gilson & Curtis J. Milhaupt, *Choice as Regulatory Reform: The Case of Japanese Corporate Governance*, 53 AM. J. COMP. L. 343, 348 (2005).

[148] *Id*. at 347–48 (Japan reformed its statutory auditor system in 1993 requiring companies to establish a board of statutory auditors and have at least one member of the auditor board to be an outside auditor. Before this reform, the law in Japan requires statutory auditors to perform their duties individually).

auditing the business conditions of companies and for evaluating the performance of companies' boards of directors and managers.[149] However, a statutory auditor has the right only to attend board meetings, not the right to vote. In addition, the pre-reform law set no qualification for statutory auditors. In the past, many statutory auditors are relatives or friends of the given companies' founding families, controlling shareholder, directors, or top executives. Therefore, most statutory auditors of Taiwanese public companies are just "rubber stamps".[150]

B. The Reform

To equip a controlled board with checks-and-balances powers, the Taiwanese regulatory authority introduced the institution of the "independent director". In 2002, the TSE began taking a leading role in requiring all newly listed companies to have at least two independent directors and one independent statutory supervisor.[151] In 2006, Taiwan's Congress revised the Securities and Exchange Law to introduce the institution of independent directors, essentially giving public companies the option to choose whether or not they would have independent directors.[152] In the meantime, to speed up the pace of reform, the law authorized the Financial Supervisory Commission to implement the law in stages.[153]

In March 2006, Taiwan's Financial Supervisory Commission ("FSC") mandated that all public financial firms and those non-financial listed firms with equity valued over NT$50 billion (US$1.6 billion) have at least two independent directors on their boards, and that the total number of independent directors should be no less than one-fifth the number of board members.[154] On March 22, 2011, the FSC further expanded the mandate to firms with equity valued over NT$10 billion (US$345 million).[155] As of August 2013, there were 425 out of 809 TSE-listed companies whose boards had at least one

---

[149] GONG SI FA [Company Act] art. 218, 219 (2012) (Taiwan).

[150] ZHENG QUAN JIAO YI FA [Securities and Exchange Act] art. 14-2 (2006) (Taiwan); FIN. SUPERVISORY COMM'N, Jing-Kuan-Cheng-1-Tzu-0950001616-Hao, Mar. 28, 2006. (abolished on March 22, 2011).

[151] *See* Taiwan Stock Exchange Corporation Rules Governing Review of Securities Listings, art. 9(I)(9) (2013).

[152] ZHENG QUAN JIAO YI FA [Securities and Exchange Act] art. 14-2 (2006) (Taiwan).

[153] For a detailed description of corporate-board reform in Taiwan, see Lin, *supra* note 2, at 395-97; LEN-YU LIU, YI-CHING TU, YU-HSIN LIN & CHRISTOPHER CHEN, THE ELECTION OF INDEPENDENT DIRECTOR AND CORPORATE GOVERNANCE 3-10 (2013).

[154] FIN SUPERVISORY COMM'N, Jing-Kuan-Cheng-1-Tzu-0950001616-Hao, Mar. 28, 2006. (abolished on March 22, 2011), *available at* http://www.selaw.com.tw/Scripts/Query1B.asp?no=3G01000%AA%F7%BA%DE%C3%D2%A4%40++++++++++++++++0950001616++&K1=%BFW%A5%DF%B8%B3%A8%C6&StartDate=20060301&EndDate=20060331 (last visited Dec. 3, 2013).

[155] FIN SUPERVISORY COMM'N, Jing-Kuan-Cheng-Fa-Tzu-1000010723-Hao, (Mar. 22, 2011).

independent director.[156] That is, 52.53% of the TSE-listed companies had at least one independent director on their board. Only 17% (137 out of 809) of TSE-listed companies adopted the United States-style board structure by establishing audit committees and abolishing statutory supervisors.[157] Still, 47.47% of TSE-listed firms did not have any independent directors.

C. Social Ties as Information Exchange

Forty independent directors of Taiwanese public companies were interviewed for this study.[158] The purpose of the interviews was to identify and characterize the kinds of personal relationships that existed between independent directors and controlling shareholders and whether social ties served as a useful source of information exchange.

Of the forty independent directors interviewed by this study, nineteen used the term "very close friend" to describe their relationship with controlling shareholders, other directors or CEOs within a given firm, and fourteen other independent directors stated that they were personally acquainted with controlling shareholders, other directors or CEOs within a given firm, but were not "very close friends" with these individuals. Only seven of the interviewees had not known the controlling shareholders, other directors or CEOs before being invited to join the board.

The interview results are stunning. Almost half of the independent directors described controlling shareholders, other directors or CEOs of the firms as "very close friends." While public companies are required to disclose

---

[156] TAIWAN STOCK EXCHANGE, The Pubic Information Database, Information on Independent Directors, *available at* http://mops.twse.com.tw/mops/web/t93sb05 (last visited September 22, 2013).

[157] TAIWAN STOCK EXCHANGE, The Pubic Information Database, Information on the Establishment of Board Subcommittees, *available at* http://mops.twse.com.tw/mops/web/t100sb03_1(last visited September 22, 2013).

[158] This research study adopted semi-standardized and in-depth interviews, where the author/interviewer generally followed a set of predetermined questions but was allowed to make adjustments depending on the situation. Bruce L. Berg & Howard Lune, *Qualitative Research Methods for the Social Sciences* 112–13 (8th ed. 2012). Semi-structured interviews are appropriate when respondents have information or knowledge that the researcher may not have thought of in advance. Sharlene Nagy Hesse-Biber & Patricia Leavy, *The Practice of Qualitative Research* 125–26 (2006). Quantitative research studies usually require probability sampling where each unit in the population must have "an equal and independent chance of inclusion" in the sample and the parameters required for creating such samples are quite restrictive. However, social science research studies often examine situations where probability samples are not feasible; hence, researchers tend to rely instead on nonprobability sampling strategies. Nonprobability sampling tends to be the norm in social science qualitative research. Some of the commonly used nonprobability samples are convenience samples, purposive samples, snowball samples, and quota samples. Snowball sampling is similar to convenience sampling and is most popular among studies concerning various classes of deviance, sensitive topics, or difficult-to-reach populations. Since corporate directors in general are difficult to reach, this research study adopted convenience sampling and snowball sampling. Berg & Lune, at 50–53.

the financial, familial, and business relations among independent directors, the companies and corporate insiders, almost no formal sources of information identify their close personal relationships. But such social ties might hinder the monitoring ability of independent directors. Although the interview results are hard to generalize because of the limited number of samples involved, most interviewees agreed that a majority of independent directors in Taiwan had some degree of *guanxi* with their controlling shareholders or other corporate insiders.[159]

Independent directors have long been criticized as outsiders who rely on the firm and corporate insiders to provide information needed for carrying out directors' duties.[160] There is an information asymmetry between independent directors and controlling shareholders, who are usually also managers in Taiwanese firms. It is hard for independent director candidates to decide whether to join a board if they were not first to obtain adequate information about the firm. Interestingly, to screen firms and decide whether to accept the offer, the key criterion used by independent directors in Taiwan is not the corporate governance of a company but the integrity of controlling shareholders or other corporate insiders.

The interview results reveal that the interviewed independent directors were usually assessing the integrity of controlling shareholders on the basis of personal relationships with corporate insiders.

> I have my own criteria: a person must be someone whom I can trust and who has a good reputation; otherwise, I wouldn't dare to join… I think the attitude of the key leader is very important. Basically, close personal relationship constitutes independent directors' personal trust in the key leader.[161]

The survey also shows that more than fifty-five percent of the interviewed independent directors in Taiwan had personally known their own firm's controlling shareholders, other directors or CEOs for more than ten years. In other words, more than half of the independent directors had personally known their own firm's major corporate insiders for a long time

---

[159] Interview No. 3 (Sept. 30, 2008), at 1; Interview No. 4 (Oct. 7, 2008), at 1; Interview No. 18 (Feb. 18, 2009), at 2; Interview No. 20 (Feb. 19, 2009), at 1; Interview No. 21 (Feb. 25, 2009), at 1.

[160] Brudney, *supra* note 82, at 598 n.3; Adams & Ferreira, *supra* note 21, at 218–19.

[161] Interview No. 14 (Nov. 11, 2008), at 2. *See* also Interview No. 7 (Oct. 12, 2008), at 1 ("How do I decide whether to take on the position? The first thing is the integrity of the leader. If the leader or the management team always follows the rules, the job of the independent director becomes easier because the cost of monitoring isn't high."); Interview No. 3 (Sept. 30, 2008), at 5 ("When I'm considering accepting a position [as an independent director], I will first see who invites me to join the board. He should be a person I can trust because I'll need to be extra cautious when taking on such a responsibility.").

before deciding to join the firm. Independent directors' trust in major corporate insiders appears to have rested on a long-standing acquaintanceship or even friendship between them. It can be inferred from the interview results that independent directors' strong personal trust in their own firm's corporate insiders alleviates independent directors' concerns about transparency and information asymmetry.

> If you doubt every report presented to you, the job of an independent director would be endless... I think that independent directors' trust in the firm should rest on long-term personal familiarity with and trust in the integrity of the major corporate insiders. In addition, the company should perform well. On the basis of these two assumptions, independent directors can monitor [the company] and make reasonable judgments.[162]

The strong social ties between independent directors and controlling shareholders may be an inevitable result of introducing a new outside institution to a closed and dominated board because an independent director eventually needs the support of controlling shareholders in order to be elected. Yet the close personal relationships raise concerns over the impartiality and independence of the independent directors.

Firms also screen potential independent director candidates before nomination. A firm that believes in good corporate governance seeks independent directors who are truly independent and would help them to do their job satisfactorily by providing them with abundant resources. For example, Taiwan Semiconductor Manufacturing Company ("TSMC") has searched for candidates in law firms and accounting firms, rather than candidates whom the executives know personally. TSMC places considerable value on candidates who are established in their respective fields of practice and have expertise that is helpful to the company. In contrast, a firm that only wants a window-dressing director looks for someone who is willing to be a rubber stamp for board decisions.

Except in a few large companies, most leaders of public companies in Taiwan seek independent directors with whom these leaders have personal relationships. As mentioned, controlling shareholders seek suitable independent directors. There also exists information asymmetry between candidates and controlling shareholders about the qualification and integrity of independent director candidates. *Guanxi* has been an important source of reliable information in Chinese society. It is no surprise that controlling shareholders seeking to fill a vacant board position would first invite someone with whom they have already established *guanxi*.

---

[162] Interview No. 7 (Oct. 12, 2008), at 3.

Nevertheless, *guanxi* might compromise independence. Commentators in several Asian regions, such as China, India, South Korea and Taiwan, have cast doubt on the independence of independent directors.[163] Many of the independent directors in this region are nominated by controlling shareholders.[164] Their close relationship with controlling shareholders is also definitely one of the major concerns:

> In many companies, it is the controlling shareholders [, rather than an independent nomination committee,] who invite someone to be nominated as independent director. In addition, many of them maintain good relationships with the major shareholders and executives. They [the independent directors] might politely remind the management [of potential pitfalls] to a certain point. However, I think the role of these [independent] directors is limited.[165]

CHINA

A. Corporate Governance in China

The two most prominent issues in Chinese corporate governance are single-shareholder dominance (*yigududa*) and insider control (*neiburenkongzhi*).[166] The ownership of Chinese listed companies is highly concentrated and the single most important dominant shareholder of listed companies is the state. Within the share-split mechanism, most state shares are not transferable. In 2008, the largest shareholders of over sixty-three percent of listed companies owned more than fifty percent of their respective companies' shares, which means that in each of the seventy-three percent of listed companies, the largest shareholder had absolute control over the

---

[163] Hui-Hsin Wang & Guo-Dong Huang, *Lai Yin-Zhao: Duli Dongshi Weibi Duli* [*Independent Directors Are Not Necessarily Independent*], JINGJI RIBAO [ECONOMIC DAILY], Feb. 5, 2007 (Taiwan) *available at* http://pro.udnjob.com/mag2/fn/storypage.jsp?f_ART_ID=31087; Editorial, *Wanshan Shangshi Gongsi Duli Dongshi Zhidu de Jianyi* [*Suggestions for the Institution of Independent Directors for Public Companies*]; ZHANGQUAN SHIBAO [SECURITIES TIMES], April 18, 2009 (China), http://news.cnyes.com/dspnewsS.asp?cls=listnews24hr&fi=\NEWSBASE\20090418\WEB357; D. Murali, *Truly Independent Directors, A Rarity*, THE HINDU BUSINESS LINE, Jan. 22, 2009 (India), *available at* http://www.thehindubusinessline.com/2009/01/22/stories/2009012250220900.htm.

[164] ORG. FOR ECON CO-OPERATION & DEV. ("OECD"), Board Member Nomination and Election 58–59 (2012).

[165] Interview No. 18 (Feb. 18, 2009), at 2.

[166] Yuan Tan, Jingjifa Shiyexia de Duli Dongshi Zhidu Wanshan Yanjiu [Research on the Institution of Independent Directors from the Perspective of Economic Law], HUAZHONG SHIFANG DAXUE XUEBAO (RENWEN SHEHUI KEXUEBAN) [JOURNAL OF HUAZHONG NORMAL UNIVERSITY (HUMANITIES AND SOCIAL SCIENCES)], No. 3, at 18 (2012).

corresponding company. Among these largest shareholders, eighty-nine percent were the state.[167] In a survey of over 1,104 companies listed on the Shanghai and Shenzhen stock exchanges, the largest shareholder of each listed company on average owned 44.86% of shares and the second largest shareholder owned 8.22%. The average percentage of total shareholdings held by the first three largest shareholders was close to sixty percent.[168]

While the presence of a controlling shareholder reduces both the likelihood and the severity of managerial agency problems, it nevertheless suffers from private benefits agency problems, where controlling shareholders extract private benefits at a cost to minority shareholders.[169] Dominant control wielded by a single shareholder can further exacerbate the problem of "private benefits of control". Having the state as the largest shareholder further complicates the problem. The prominent issue of insider control is related to the "private benefits of control" problem in China, where Chinese listed companies suffer harshly from the problem under the country's extremely distorted ownership structure, which allows for inefficient monitoring control by the country's single largest shareholder, the state.[170] With dominant control, insiders could easily siphon out corporate assets and resources through related party transactions or other means.[171]

B. The Reform

Introducing the institution of independent directors to the boards of Chinese listed companies is one of the major regulatory measures that the Chinese government has taken to address the issue that most corporate boards are dominated and controlled by single-shareholders and insiders. On August 16, 2001, the CSRC issued its *Guidance Opinion on the Establishment of an Independent Director System in Listed Companies* (the "CSRC Independent Director Opinion"), which is the most comprehensive regulatory measure taken by the Chinese government so far regarding its imposition of independent directors on listed companies. According to the CSRC Independent Director Opinion, all listed companies were required to have at least two independent directors by June 30, 2002 and such directors were to

---

[167] Shaolong Jiang, *Churang Guoyouguying Jiangu Gefang Liyi [Interest Balances in the Sale of State Shares]*, Zhengquan Shibao [Securities Times], Apr. 17, 2008, *available at* http://www.cnetnews.com.cn/2008/0417/819760.shtml (last visited Sept. 20, 2012).

[168] Ying Chen, *Research on the Independent Director Institution in China*, 2005 (7) ZHONGYANG CAIJING DAXUE XUEBAO [JOURNAL OF CENTRAL UNIVERSITY OF FINANCE & ECONOMICS] 55, 58 (2005).

[169] *See* Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785, 785–86 (2003).

[170] Wen-Chieh Wang, Corporate Governance of China Listed Companies under Share Splitting: An Examination of Controlling Shareholders, 122 CHENGCHI L. REV. 201, 219–20 (2011).

[171] Clarke, *supra* note 2, at 147–48.

constitute at least one-third of each board by June 30, 2003.[172] The CSRC further provides detailed regulation of the qualifications, independence, nomination, election, obligations, and responsibilities of independent directors.

Following the CSRC Independent Director Opinion, the CSRC issued several regulatory rules guiding the operation of the independent-director mechanism in Chinese listed companies.[173] A 2005 amendment to the PRC Company Law formally stipulated that all listed companies should have independent directors on their boards.[174] Although the 2005 amendment did not identify specific requirements and responsibilities of independent directors, it confirmed the requirement for independent directors in Chinese listed companies.[175]

C. Renqing Dongshi (Favor Directors)

In the years since 2001, when CSRC published the CSRC Independent Director Opinion, the most notable criticism of independent directors in China has centered on their independence—or, more appropriately, their *lack* of independence—from controlling shareholders and other corporate insiders.[176] Since most nominations of independent directors still lie in the hands of boards controlled by dominant shareholders under the current corporate-ownership structure, most independent directors are beholden to dominant shareholders.[177] In a survey by the Listed Companies Association of Shanghai, fifty-five percent of independent directors were nominated by major shareholders and twenty-seven percent by corporate executives. Since major

---

[172] China Securities Regulatory Commission, *Guanyu Zai Shangshi Gongsi Jianli Duli Dongshi Zhidu de ZhidaoYijian* [Guidance Opinions on the Establishment of an Independent Director System for Listed Companies] art. 1(3), issued Aug. 16, 2001 [hereinafter CSRC Independent Director Opinion]; The Company Law of China provides that a company limited by shares should have five to nineteen directors. *See Zhonghua Renmin Gongheguo Gongsi Fa [Company Law of the People's Republic of China]*, as amended Oct. 27, 2005, art. 109 *available at* http://english.sse.com.cn/aboutsse/support/law/c/Companies%20Law%20of%20the%20People's%20Republic%20of%20China.pdf (last visited Dec. 3, 2013). [hereinafter China Company Law].

[173] *See* China Securities Regulatory Commission, *Shangshi Gongsi Zhili Zhunze* [Principles of Corporate Governance for Listed Companies], ch. 5, issued Jan. 7, 2002; *see also* China Securities Regulatory Commission, Guanyu Jiaqiang Shehui Gongzhonggu Gudong Quanyi Baozhang de Ruogan Guiding [Several Provisions for Enhancing the Protection of Investors' Rights], art. 2, issued Dec. 7, 2004.

[174] *See* China Company Law, *supra* note 172, at art. 123.

[175] China Company Law, *supra* note 172, at art. 123 (stipulating only that listed companies should have independent directors and that the State Council should promulgate relevant rules).

[176] Xi, *supra* note 2, at 17–18 (in the prevailing practice, controlling shareholders appoint their social friends to independent-director positions).

[177] *See* CSRC Independent Director Opinion, *supra* note 172, at § 4(1): ("A listed company's board of directors, supervisory board and shareholders who individually or together hold not less than 1% of the shares in the listed company may nominate candidates for Independent Director. Such directors will be decided through election by the shareholders' general meeting.").

shareholders have controlled most corporate executives in recent years, we can calculate that major shareholders have nominated over eighty percent of independent directors during this same timeframe.[178] With the largest major shareholder in Chinese capital markets being the state, "China's corporate governance regime can never wholeheartedly sanction a system in which independent directors can obstruct the wishes of dominant shareholders."[179]

Commentators have coined the term '*renqing dongshi*' (roughly translated as "favor directors") in referring to independent directors who join a board simply because of their close personal relationships with corporate insiders, and have coined another term, '*huaping dongshi*' (roughly translated as "vase directors") in referring to independent directors whose function is no more than window-dressing.[180] The popularity of these two terms reflects not only the ineffectiveness of Chinese independent directors but also public concerns over social ties among independent directors and corporate insiders.

Culture has also helped reinforce the social ties among independent directors and controlling shareholders or corporate insiders. *Guanxi* and *renqing* (favor) are core concepts and practical principles in Chinese social relationships.[181] *Guanxi* is more close to the concept of social ties or personal relationships.[182] On the other hand, the concept of *renqing* operates more like the rules of *guanxi*, such as how you should treat someone you know.[183] The rule of *renqing* actually operates beyond the rule of reciprocity and it can be manifested in an old Chinese saying, "If you have received a drop of beneficence from other people, you should return to them a fountain of beneficence."[184] Therefore, if you receive a favor from other people, you should return them not just a favor but much more than that.

---

[178] Chaobin Xie, Jiegouyu Qianhe [Deconstruction and Embeddedness] 185 (2006).

[179] Clarke, *supra* note 2, at 215.

[180] Xinrong Guan, Duli Dongshi Zhiduyu Gongsi Zhili: Fali he Shijian [Independent Director System and Corporate Governance: Theory and Practice] 321 (2004) ("vase directors" is a term first famously used by Jiahao Chen, the independent director of ZhengbaiwenCorporation, which was accused and penalized by the CSRC for misrepresentation and violation of GAAP rules in 2001. Jiahao Chen characterized himself as a "vase director" to defend himself from possible penalties levied by the CSRC).

[181] Park & Luo, *supra* note 139, at 456–57.

[182] *See* Roderick W. Macneil, *Contract in China: Law, Practice, and Dispute Resolution*, 38 STAN. L. REV. 303, 385–86 (1986) The term 'relations' has a special meaning in Chinese. It connotes the meaning of 'relationship' in the sense of a long-term relationship with a friend or acquaintance, but it also connotes the meaning of 'connection', in the sense of being socially or politically well connected. It is not always used in a pejorative sense, but often has an instrumental, if not a sleazy, flavor. The word is often used when someone does something that might be impossible without the help of the person with whom he has "relations." "Relations" play a crucial part in all aspects of Chinese life, even more important than the part played by "connections" in the West.

[183] Randall Peerenboom, *Seek Truth from Facts: An Empirical Study of Enforcement of Arbitral Awards in the PRC*, 49 AM. J. COMP. L. 249, 319–20 (2001).

[184] The old Chinese saying is "Dishui Zhien Dang Yongquan Xiangbao."

If we understand that a component of traditional and contemporary Chinese culture is the belief that one favor deserves another—and perhaps even better—favor, then we can see that the term '*renqing dongshi*' (favor directors) refers to those independent directors who join a board because they owe controlling shareholders or corporate insiders a favor and they return those corporate insiders a favor by being nominally independent directors. In this situation, we cannot expect these "favor directors" to act with impartiality in the best interests of the corporation. It was reported in 2011 that China's top fifty listed companies collectively employed a total of thirty-four independent directors who were retired government officials. By retaining former government officials, these enterprises want not only to take advantage of these government officials' *guanxi* in the public sector, but also to use the independent-director position as a kind of gift, presented to these retired officials as a *renqing* (i.e., a favor); that is, as a way of thanking the retirees for various benefits they might have bestowed on the given enterprise during their time in elected or appointed office.[185]

Ping Jiang, a well-known law professor and former President of China University of Political Science and Law, once said in a conference that, from his practical experience of serving as an independent director in various posts, independent directors in China are basically window-dressing.[186] He also confessed that the corporate insiders who invited him to serve as an independent director had all been his close friends basically asking him to do them a "favor."

> As far as I see it, independent directors in the companies where I participated are no more than a "vase" or "decoration." The CSRC has made the independent-director system mandatory, and I think boards in general truly don't want independent directors. Personally, the people who invited me to serve as an independent director were all close friends asking me to do them a favor. We're close, so I wouldn't turn my back on them.[187]

---

[185] Ruizhuo Sun, Tuixiu Gaoguanren Dudong Yingdang Yanjin [Retired Government Officials Should Be Prohibited from Being Independent Directors], SHENZHEN ECONOMIC DAILY A12 (Jul. 7, 2011), *available at* http://szsb.sznews.com/html/2011-07/07/content_1648933.htm (last visited Sept. 24, 2012).

[186] Ping Jiang, Weiguo Wang, and Xudong Zhao, *Duli Dongshi Sanrentan [A Talk on Independent Directors by Three Masters]*, Gaofeng Duihua in Fada Mingshang Jingji Falu Wang [Top Dialogues in CCELaws] (Feb. 26, 2004), available at http://article.chinalawinfo.com/Article_Detail.asp?ArticleId=28364.

[187] Jiang et al, *supra* note 186.

It is commonplace for independent directors in China to have close personal relationships with controlling shareholders or corporate insiders.[188] With boards dominated and controlled by insiders (the so-called "insider-control problem"), the given corporate environment seems to not encourage truly independent directors.[189] Reported interviews from China have yielded findings similar to those stemming from Taiwan: companies there have tended to hire independent directors who have *guanxi* with controlling shareholders or corporate insiders and who would not vote against controlling shareholders.

> How do boards choose [independent directors]? Corporate insiders want someone who has been working well with them. And board members wouldn't choose a stranger. He [a candidate for a position of independent director] should come with recommendations, or have some relationship with certain board members, or be highly reputable.[190]

OTHER INSTITUTIONAL FACTORS

Given the existence of unintentional bias and Delaware courts' increasing awareness of personal relationships' effects on director independence, countries that have transplanted the institution of independent directors from the United States should pay more attention to the issue of structural bias. Close relationships between independent directors and controlling shareholders are not constitutive of a phenomenon unique to Taiwan and China; rather it is a common issue faced by most Asian countries.

In Taiwan and China, as in many other Asian countries (e.g., India, Japan and South Korea), a sophisticated system of commercial courts and a complementing legal system do not exist to provide the kind of *ex post* judicial

---

[188] Jianchuan Lee, *A Research on the Independent Director System*, Bilateral Perspective of Jurisprudence and Management, at 290–92 (2004).

[189] Shaoming Liu, Zhongguo Zhengjianhui Shangshibu Zhuren Yang Hua: Ying QianghuaDudong de DulixingZuoyong [Director of the CSRCDepartment of Listed-Company Supervision, Hua Yang: We Should Enhance the Independence of Independent Directors], SHANGHAI FINANCIAL NEWS A07 (Dec. 15, 2006).

[190] XIE, *supra* note 178, at Appendix 1: Interview Transcripts 01-05, at 32; *See also* Leeping Lei, Jiaoshoudeng Silei Xianren Longduan Dudong [Four Types of People Who, Like Professors, Have Plenty of Time, Occupy the Market of Independent Directors], 21 SIJI JINGJI BAODAO [21ST CENTURY ECONOMIC REPORT] 15 (Sept. 1, 2011), *available at* http://biz.cn.yahoo.com/ypen/20110901/563130.html (last visited Sept. 24, 2012) (where the Director of the Corporate Governance Research Center at Beijing Normal University stated in an interview, "If our [Chinese] independent directors were not recommended by major shareholders, they must have been recommended by managers. This fact basically means that they must serve the interests of major shareholders and managers.").

review found in the United States.[191] Shareholder derivative suits, for example, are almost unheard of in Taiwan and China owing to the various procedural hurdles set in those countries' respective corporation law.[192] In addition, neither Taiwanese nor Chinese courts have yet to adopt the business judgment rule. Because of these local conditions, *ex post* judicial review of director independence does not exist in either Taiwan's or China's current legal system, and is unlikely to develop there in the near future.

Additionally, Taiwanese and Chinese courts have yet to recognize the role of independent committees in resolving conflicts of interest, a fact that, in turn, limits the function of independent directors and the value they can create. Therefore, corporate insiders generally lack the incentive to hire truly independent directors not only because no one will review the substantive independence of independent directors, but also because corporations would not benefit from having truly independent directors.[193] This is the problem with trying to transplant an isolated legal mechanism into a different legal system without complementary institutions.

V. CONCLUSION

Empirical studies have shown that social ties can compromise independent directors' monitoring capacity and, thus, do matter in corporate governance. However, current regulations do not address social relations while defining director independence. United States corporations elect independent directors because the United States legal system makes it worthwhile—it protects management from liability in shareholder suits. Delaware courts have recognized the good-faith use of independent directors by management in self-dealing transactions and have provided safe harbors in which managers can undertake transactions that are approved by disinterested directors.[194] Meanwhile, United States courts can review the disinterestedness and independence of directors when transactions are challenged by shareholders.

The problem of transplanting independent directors to other countries lies in the lack of complementary institutions that make such arrangements meaningful in the transplanting countries. These complementary institutions cannot be built in one night but the regulations can. Therefore, the fastest way for policy-makers to institute change is to change the related laws and

---

[191] Gilson & Milhaupt, *supra* note 147, at 369–72; Varottil, *supra* note 2, at 325–26 (presenting survey and interview data revealing that the general practice of nominating independent directors in Indian listed companies has been for the promoters to identify people known to them or with whom they have significant comfort levels); OECD, *supra* note 164.

[192] See Yu-Hsin Lin, *Modeling Securities Class Action Outside the United States: The Role of Nonprofits in the Case of Taiwan*, 4 NYU J. L.& BUS. 143, 164–65 (2007).

[193] Clarke, *supra* note 2, at 209–10.

[194] *Id.*

regulations. Many Asian countries have changed their laws and regulations, but have undertaken no changes to critical institutional settings related to the transplantation of independent directors. Therefore, it is the case that not only would companies lack an incentive to appoint truly independent directors, but also no institution would check on the true independence of directors. Asian countries are sacrificing the core value of system, independence.

The situation is even worse in Chinese societies, whose shared traditional and contemporary culture prizes harmony and interpersonal relations. In the business world, social ties among board members further enhance collegial board culture, facilitating boards' advisory function but weakening their monitoring function. The main legislative objective of importing the institution of independent directors from the United States to China and Taiwan has been to decrease insider control over boards and to provide a checks-and-balances system capable of controlling private benefits of control enjoyed by controlling shareholders. However, the current Taiwanese and Chinese regulatory regimes' failure to address the issue of social ties, whether through *ex ante* regulation or *ex post* judicial review, strongly suggests that the legislative objective of the institution of independent directors will remain unachieved and unachievable.

This article urges Chinese policy-makers to rethink the current definition of "independence" and the effect of independent directors' social ties to controlling shareholders or corporate insiders. Social ties, on the one hand, can serve as an effective source of information for independent directors, who in turn can be more effective in providing advice to the management. But on the other hand, social ties can be detrimental to independent directors' monitoring capabilities. All countries that transplant independent directors should be aware that the institution of independent directors will most likely lose its core value to the firm if there is no legal control over social ties.

THE ACE IN THE HOLE: WHY THE UNLAWFUL INTERNET GAMBLING ENFORCEMENT ACT DID NOT CATEGORICALLY BAN ONLINE POKER IN THE UNITED STATES

Thomas A. Flynn [*]

INTRODUCTION

The American online poker market is begging to be served.[1] If an entrepreneur wanted to provide for this market and was looking to turn a profit, how would they go about doing it? Some American media would have you believe that an American-accessible online poker website is shady, illegal, and a ticking time bomb for Department of Justice ("DOJ") prosecution that would turn such an investment into a lost cause and a lawsuit.[2] But not so fast...the status of online poker in the United States ("U.S.") is not as clear as the media classifications would have you believe. Online poker has not been categorically banned, and the DOJ's reasons for initiating lawsuits are not as simple as "online poker is illegal in the U.S." While, right now, online poker is nearly dead in the U.S.,[3] its near extinction may be for different reasons than most people think. "Congress is currently discussing whether or not to pass legislation that would allow online poker in most states, but the likely outcome is far from clear."[4] What happens if that bill never becomes law? Will online

---

[*] George Mason University School of Law J.D. Candidate 2014. I would like to thank Kaitlin Wojnar, Al Bender, Stephen Caruso and Nicholas Dilenschneider for help with editing. Also, special thanks to Kathleen Flynn for assistance with editing, researching, and helping out her little brother who wishes he was half the writer she is. Finally, thanks to Sandra Flynn, for all of her inspiration.

[1] TIM JOHNSON, *FRUSTRATED ONLINE-POKER PLAYERS BET ON COSTA RICA*, MCCLATCHY DC (JULY 29, 2012), HTTP://WWW.MCCLATCHYDC.COM/2012/07/29/157699/FRUSTRATED-US-ONLINE-POKER-PLAYERS.HTML#STORYLINK=CPY.

[2] *See, e.g.*, Nathan Vardi, *Are the Feds Cracking Down on Online Poker?* FORBES MAGAZINE, (Mar. 1, 2010, 5:40 PM), *available at* http://www.forbes.com/forbes/2010/0301/gambling-bluffing-government-internet-web-online-poker.html.

[3] It should certainly be noted that as of this writing many sites do still accept American players. However, many American players have chosen to move out of the U.S. and play from foreign countries because these locations offer more options. These players are known as American poker "refugees." In fact, these "refugees" became such a sensation that an entire business based upon the relocation of American online players exists. *See* http://www.pokerrefugees.com (last visited Nov. 12, 2012).

[4] *See* Brian T. Yeh & Charles Doyle, Cong. Research Serv., RS22749, Unlawful Internet Gambling Enforcement Act (UIGEA) and Its Implementing Regulations (2012), *citing Tax Proposals Related to Legislation to Legalize Internet Gambling: Hearing Before the House Comm. On Ways and Means*, 111th Cong., 2nd sess. (2010) (statement of Rep. McDermott) ("[E]very day millions of Americans gamble on the Internet. Prohibition hasn't prevented the millions of Americans who want to gamble online from doing it. It has forced internet gambling

poker cease to exist in the U.S. for the rest of time? This Comment will argue that online poker is not categorically banned in the U.S. and analyze exactly how the Unlawful Internet Gambling Enforcement Act ("UIGEA" or the "Act")[5] should be interpreted to allow online poker companies to continue to service and profit off of American players. With pro-poker legislation still an uncertainty,[6] a strict and exact interpretation of the UIGEA may be the only option that entrepreneurs have if they want to tap into the lucrative market of Americans[7] trying to play online poker.

Much has been written and argued on the benefits of legalizing online poker.[8] Such policy proposals, however, are not the focus of this Comment. Rather, this Comment contends that the laws, regulations, and lawsuits regarding online poker did not categorically ban online poker in the U.S. and that there is still a way for investors to tap into the American market if they structure their online poker website to meet UIGEA specifications.[9]

This Comment will begin with a background of both the structure and text of the UIGEA, as well as a summary of charges the DOJ has brought against existing online poker companies. It will then argue that, based on the text and timing of the UIGEA, as well as the settlement between the DOJ and the online poker companies, the UIGEA was not intended to be a categorical ban on online poker, nor should it be interpreted as one. Next, the Comment will describe how an online poker site open to American players and in compliance with the UIGEA would operate. Lastly, the Comment will advocate for the proposition that if online poker companies only allowed

---

operators to work offshore, it has put consumers at risk, and it sent billions in dollars of revenue to other nations.").

[5] 31 U.S.C. § 5361 (2006).

[6] For an assessment of the likelihood of pro-online poker legislation passing, *see* Howard Stutz, *Lobbyist: Online Poker Will Need 'Gamblers Luck' to Pass*, LAS VEGAS REV. J., Oct. 2, 2012, *available at* http://www.lvrj.com/business/at-gaming-industry-s-premier-trade-show-all-eyes-are-on-congress-and-internet poker-172334091.html.

[7] "In fact, after Black Friday, American online poker players have chosen to leave the country to play in countries that recognize the value of an online poker industry – and they are taking their money with them. In fact, a Maryland native who won millions at this year's World Series of Poker now lives in Canada so he can play online." John Pappas, *The DOJ Has Spoken: It's Time For Congress To Legalize Online Poker* (Aug. 9, 2012, 2:35 PM), http://www.forbes.com/sites/realspin/2012/08/09/the-doj-has-spoken-its-time-for-congress-to-legalize-online-poker/.

[8] Yeh & Doyle, *supra* note 4, *citing Tax Proposals Related to Legislation to Legalize Internet Gambling: Hearing Before the House Comm. On Ways and Means*, 111th Cong., 2nd sess. (2010) (statement of Rep. Frank) ("Billions of dollars in taxes . . . remain uncollected. Enacting these bills would bring this industry out of the shadows, benefit consumers and ensure that all of the revenue does not continue to exclusively benefit offshore operators.").

[9] *See* Pappas, *supra* note 7.

Americans living in states where such games were legal to play poker and avoided illegal activity unassociated with the UIGEA, they would be free to operate in the U.S.

I. BACKGROUND

A. Brief History of Online Poker

Online Poker has a relatively short yet consistent history. The first real-money, online hand was dealt in 1998, and as of this writing, the game has been consistently played online for every hour of every day since its inception.[10] Online poker consists of virtual tables that often visually look just like real poker tables.[11] The gambling process consists of players signing up for an account, making a deposit of real money (as opposed to what is known as "play money" - poker with no real money at risk) and then joining a table to play.[12] Tables exist to accommodate games valued from one cent to millions of dollars.[13] After playing, players can withdraw their money and receive it in a variety of ways, including via bank transfer or personal check.[14] Both deposits and withdrawals are often made through a third party transaction,[15] but not always.[16] In sum, the easiest way to think of an online poker account is simply as a bank account - it consists of both deposits and withdrawals.

Online poker is a sensation for a variety of reasons. Two obvious examples are ease of access and profitability. Players from anywhere in the world can compete with each other without ever having to leave the comfort of their living rooms. This ease of access cuts out a lot of costs, for example, driving to a casino, parking, walking to the poker room, and tipping dealers are all no longer necessary when playing online poker.[17] Online tables can also deal more hands per hour than a human dealer because they can use a random

---

[10] For a more in depth discussion of online poker's history, *see History of Online Poker: Part 1*, COURTSIDE POKER (Oct. 19, 2010), http://www.courtsidepoker.com/2010/10/history-of-online-poker-part-i.html.

[11] *Id.*

[12] *Id.*

[13] The biggest pot in online poker history (as of this writing) involved a win of about 1.3 million dollars. http://pokerati.com/2010/01/the-biggest-online-poker-hand-in-history-last-year-20sunday-morning-video/.

[14] For an in depth discussion of the deposit and withdrawal methods of various online poker websites, *see Online Poker Deposit Options – Poker Payment Methods*, POKERLISTINGS. http://www.pokerlistings.com/online-poker-deposit-options (last visited Dec. 28, 2013).

[15] For example Neteller or Western Union.

[16] *Online Poker Deposit Options*, *supra* note 14.

[17] While there is still a "rake" in online poker, which is the fee each player pays per hand or per tournament, one of the benefits of online poker from a player's perspective is that they do not have to tip the dealer.

number generator[18] to produce virtual cards rather than physical cards, which need to be shuffled. Playing more hands gives better players an improved chance to win because increased volume decreases variance (it is the same reason that an elite sports team is more likely to be an inferior opponent in a seven-game series versus one game).[19] For example, if the best poker player in the world were to play one hand of poker against the worst poker player in the world, the outcome would not be certain because the worst player could simply be dealt the better hand and win. However, if the two players played several thousand hands, the best poker player in the world would almost certainly turn a profit because over the course of the many games, the worst poker player in the world would have numerous opportunities to misplay hands and the best player would have many opportunities to play well.

This is one of the concepts that makes online poker a goldmine for winning players and this moneymaking potential is what enticed millions of Americans to play online, which, in turn, led to massive profits for online poker companies.[20] As a result, both American players and online poker companies were benefitting from the existence of online poker.[21] However, many online poker companies operated overseas, so most of the casino profits earned from the American player market went to foreign companies.[22]

Likely in response to this imbalance, Congress passed the UIGEA as a midnight rider on the Security and Accountability for Every Port Act of 2006 (the "Safe Port Act").[23] The Act put the online poker world (at least for Americans) into an uncertain state because companies and players did not know how the law would affect online gambling in the U.S.[24] In the immediate aftermath, players were not sure whether and to what extent online poker was legal in the U.S., and the millions of Americans who continued to

---

[18] A mathematical program which generates a set of numbers which pass a randomness test. An analog device that generates a randomly fluctuating variable, and usually operates from an electrical noise source. *Random Number Generator Definition,* MCGRAW-HILL SCIENCE & TECHNOLOGY DICTIONARY, *available at* http://www.answers.com/topic/random-number-generator (last visited Nov. 13, 2012).

[19] A discussion on variance and probability can be found at http://www.thepokerbank.com/strategy/other/variance/.

[20] An estimated 2.5 million American players played and bet $30 billion annually every year. Vardi *supra* note 2.

[21] *Id.*

[22] *See id.* ("PokerStars and Full Tilt Poker. Together they account for maybe 70% of the $1.4 billion in revenue the U.S. industry brought in last year.")

[23] Safe Port Act of 2006, Pub. L. No. 109-347, 120 Stat. 1884.

[24] For a thorough discussion on the implications of the 2006 law, see, e.g., Mattia V. Corsiglia Murawski, The Online Gambling Wager: Domestic And International Implications Of The Unlawful Internet Gambling Enforcement Act Of *2006*, 48 SANTA CLARA L. REV. 441 (2008).

play did so at their own risk, with no government protection or guarantee that their online bankrolls would be safe.[25]

On April 15, 2011—a day now coined "Black Friday" by the poker community—the DOJ and federal authorities accused three enormous online poker websites of evading the UIEGA in order to continue to benefit from the American player market.[26] Those three websites[27] were temporarily shut down for both foreign and domestic players, and the online poker world was sent into a state of panic. Players were uncertain about the status of their funds and were concerned about when they would be allowed to play online poker again.[28]

As of this writing, only a handful of lesser-known online poker websites still exist for American players. These websites present two problems main problems for players: (1) uncertainty regarding the safety of deposits and player funds and (2) lack of players making the games less enjoyable and less profitable.[29] This comment will solve those issues by providing a clear UIGEA framework for poker companies to follow.

The analysis will rely on a thorough examination of the UIGEA text, as well as an inspection of skill versus luck arguments as they pertain to state statutes allowing or prohibiting citizens from playing online poker. This Comment is not attempting to recommend a way in which to break a law, rather, it will argue that based on the actual text of the UIGEA, and the implications of the Black Friday indictment,[30] online poker is not categorically banned in the United States, and a foreign company could provide online poker services to American players if they structured their website to follow the UIGEA.

B. Enacting the UIGEA

---

[25] Much of the confusion came from the online poker sites' insistence that the games they were offering were legal. *See* Vardi, *supra* note 2 ("PokerStars, situated on the Isle of Man, claims it has legal opinions from five U.S. law firms saying it is not violating any laws.").

[26] *See* Darren Rovell, *Insider Breakdown Of Poker's Black Friday*, CNBC SPORTS BUSINESS REPORTER (Apr. 19, 2011, 3:06 PM), http://www.cnbc.com/id/42649117/Insider_Breakdown_Of_Poker_s_Black_Friday.

[27] PokerStars, Full Tilt Poker, and Absolute Poker.

[28] *See* Rovell, *supra* note 26 ("Online poker in the United States at this time is completely wiped out. There are few small operators in the black market who are still operating, but these were very big and very reputable major international companies – billion dollar corporations which are regulated in the UK, in France, in Italy, they can no longer operating [sic] here.")

[29] One of the keys to a good online poker website is volume. Volume allows users to pick the tournaments or cash games they want to play at the stakes they want to play at the time of the day they want to play. *See e.g.,* Donovan Panone, *Perspectives on Volume & Variance*, (Oct. 15, 2010), http://www.pokerology.com/poker-articles/poker-tournaments-volume-variance/.

[30] *See infra* Part I.D.

The UIGEA was signed into law by former President George W. Bush on October 13, 2006 as Title VIII of the Safe Port Act.[31] The Safe Port Act was passed as "An Act to improve maritime and cargo security through enhanced layered defenses, and for other purposes."[32] Besides the UIGEA, the Safe Port Act has nothing to do with online poker. The first four titles (a total of eight titles) of the Safe Port Act are: Title 1 – Security of United States Seaports, Title 2 – Security of the International Supply Chain, Title 3 – Administration (pertaining to the Office of Security Cargo Policy), and Title 4 – Agency Resources in Oversight.[33] Then-Senate Majority Leader Bill Frist was responsible for attaching the UIGEA to the Safe Port Act.[34] On Wednesday, September 16, 2006, *The Washington Post* wrote: "Senate Majority Leader Bill Frist is trying to use a bill authorizing U.S. military operations, including in Iraq and Afghanistan, to prohibit people from using credit cards to settle Internet gambling debts."[35] Because Frist spoke of the bill in the politically important state of Iowa soon after it was passed, the article goes on to contend that he pushed the bill to bolster a possible 2008 Republican presidential bid--presumably to demonstrate his conservative stance towards online gambling.[36]

Whittier Law School Professor I. Nelson Rose, a leading expert on gaming law, wrote:

> This bill was rammed through Congress by a failed politician, then-Majority Leader of the U.S. Senate, Bill Frist (R.-TN). Frist planned to run for President and wanted to gain points with a then-powerful Congressman from Iowa, Jim Leach (R.-IA), who actively opposed Internet gambling. Because almost no one else in the Senate cared either way about the issue, Frist had a problem. He couldn't get a prohibition bill to the floor for a vote. So, Frist added his Internet gambling Act to a completely unrelated bill dealing with port security. In a cynical move, he risked the safety of the U.S. in its war

---

[31] 31 U.S.C. § 5361 (2006).

[32] Safe Port Act of 2006, Pub. L. No. 109-347, Introduction, 120 Stat. 1884.

[33] *Id.* at § 1.

[34] Nancy Zuckerbrod, Frist Targets Internet Gambling, WASH. POST (Sept. 13, 2006, 9:05 PM), available at http://www.washingtonpost.com/wp-dyn/content/article/2006/09/13/AR2006091301708_pf.html.

[35] *Id.*

[36] *Id.*

> against Islamist terrorists to show his right-wing religious base that he opposed gambling.[37]

While it is unclear exactly what Senator Frist's underlying intentions were at the time, it is clear that the UIGEA was passed under less than stellar conditions and without substantial approval for an independent online gambling bill. Regardless of its path to approval, the UIGEA was eventually implemented and had an immediate effect on the online poker world.[38]

Understanding the UIGEA's legislative and political history is important because it illustrates that, given the wording of the text and conditions which led to the passing of the bill, Congress almost certainly did not intend a categorical ban of online poker. The UIEGA states: "New mechanisms for enforcing gambling laws on the Internet are necessary because traditional law enforcement mechanisms are often inadequate for enforcing gambling prohibitions or regulations on the Internet, especially where such gambling crosses State or national borders."[39]

The referenced "traditional law enforcement mechanism" pertaining to online poker is the Wire Act,[40] which essentially imposed fines aimed to deter online players from transferring bets or making wagers through interstate wires. Recent legal analysis provided by the DOJ supports the UIGEA's inadequacy claim regarding the Wire Act: "[I]nterstate transmissions of wire communications that do not relate to a 'sporting event or contest' fall outside the reach of the Wire Act."[41] This clarification of the Wire Act's purpose supports Congress' stated goals (regarding the UIGEA) of better enforcement of online transactions, as the Wire Act did not apply to online poker.[42]

C. What Exactly Does the UIGEA Do?

On April 10, 2012, the Congressional Research Service provided an analysis of the UIGEA: "Unlawful Internet Gambling Enforcement Act

---

[37] I. Nelson Rose, *The Politics Behind the U.S. Internet Gaming Bills*, GAMBLING AND THE LAW, http://www.gamblingandthelaw.com/index.php/articles/257-the-politics-behind-the-us-internet-gaming-bills (last visited Nov. 13, 2012).

[38] Party Poker, one of the biggest online poker websites at the time, left the American market. *PartyPoker Leaves the US Market* (Oct. 2006), http://www.flopturnriver.com/partypoker-leaves-us-market.php (last visited Nov. 12, 2012).

[39] 31 U.S.C. § 5361 (2006).

[40] 18 U.S.C. § 1084 (1961).

[41] Press Release, Department of Justice – Opinions of the Office of Legal Counsel, Whether Proposals By Illinois And New York to Use the Internet and Out-Of-State Transaction Processors to Sell Lottery Tickets to In-State Adults Violate The Wire Act (Sept. 20, 2011) (*available at* http://www.justice.gov/olc/2011/state-lotteries-opinion.pdf).

[42] *Id.*

(UIGEA) and Its Implementing Regulations" (the "Report").[43] The Report states: "The Unlawful Internet Gambling Enforcement Act (UIGEA) seeks to cut off the flow of revenue to unlawful Internet gambling business. It outlaws receipt of checks, credit card charges, electronic funds transfers, and the like by such businesses."[44] Importantly, the Report points out that the Act asks for the assistance of banks, credit card issuers, and other payment systems to help the Federal Government block illegal transactions from taking place.[45] "To that end, it authorizes the Treasury Department and the Federal Reserve System (the Agencies), in consultation with the Justice Department, to promulgate implementing regulations."[46]

Facially, the wording of the UIGEA does not appear to ban online poker outright.[47] There could be many reasons for this congressional inaction. For example, Senator Frist may have thought such an action would make the originating bill less likely to pass; he may not have had a clear plan for implementing and enforcing such a large prohibition; or, perhaps, he simply did not have the time to attach a more expansive version of the bill and had to settle for the less comprehensive UIGEA. Regardless, the wording of the UIGEA lends itself to a more liberal interpretation than an outright ban of online poker.[48] Instead, the Act concentrates on transactions. In some sense, it aims to cut off the head of the industry rather than eliminating it all together. "The final rule addresses the feasibility of identifying and interdicting the flow of illicit Internet gambling proceeds in five payment systems: card systems, money transmission systems, wire transfer systems, check collection systems, and the Automated Clearing House."[49] It charges companies dealing with Internet gambling operators, such as banks and credit card processors, with the task of ensuring that the poker companies they deal with are operating legitimately.[50] This means that these companies must independently fulfill all elements of the UIGEA, including taking specific steps to ensure that any gambling business they deal with can show that their transactions are legal[51].[52]

As the Report makes clear, the Act is intended to hit poker companies where it hurts—their money, which would then make it difficult to recruit players.[53] By outlawing tainted transactions from illegal internet gambling

---

[43] Yeh & Doyle, *supra* note 4.
[44] *Id.*
[45] *Id.*
[46] *Id.*
[47] 31 U.S.C. § 5361 (2006).
[48] *Id.*
[49] Yeh & Doyle, *supra* note 4.
[50] *Id.*
[51] *See* discussion *infra* at I.E.
[52] Yeh & Doyle, *supra* note 4.
[53] *Id.* at 1 n.3.

companies, Congress—through the use of agency enforcement[54]—created very difficult waters for online poker companies to navigate. This legislation led to the unusual situation in which some American players were legally allowed to deposit money under the UIGEA while others were not.[55] As discussed, *infra*, it was online poker companies, however, that eventually violated the UIGEA,[56] and it ended up costing those companies millions of dollars.[57]

The UIGEA is confusing because, rather than promulgating new restrictions, it actually operates by further enforcing already existing law.[58] Essentially, it aims to improve enforcement of state and federal anti-gambling laws that are already in place.[59] The Report states: "unlawful Internet gambling' does not specify what gambling activity is illegal; rather, the statute relies on underlying federal or state gambling laws to make that determination-that is, UIGEA applies to an Internet bet or wager that is illegal in the place where it is placed, received, or transmitted."[60]

In other words, the UIGEA aims to simplify a difficult problem—enforcing state and federal law in an online world in which locations and IP addresses are not always easy to place. By further regulating transactions to online poker websites from states in which online poker is not allowed, Congress clarified and eased enforcement techniques for any law enforcement agencies attempting to enforce such laws.[61]

The most important provision of the Act is "No person engaged in the business of betting or wagering may knowingly accept, in connection with the participation of another person in unlawful Internet gambling."[62] The Act then goes on to list the different forms of unacceptable transactions,[63] ranging from credit card transactions to acceptance of personal checks.[64] In sum, the Act takes transactions that were already illegal under existing federal and state statutes, discussed *infra*, and provides another layer of illegality by specifying what types of transactions apply and providing enhanced damages should these existing laws be violated.[65] If online poker were illegal in all states, the UIGEA would apply in a fairly simple way. State online poker laws, however,

---

[54] See *infra* Part I.C.1.

[55] *See infra* Part II.F.1.

[56] *See infra* at Part II.A.

[57] Gary Wise, *PokerStars Settles, Acquires FTP*, ESPN POKER (July 31, 2012, 5:25 PM), *available at* http://espn.go.com/poker/story/_/id/8218085/pokerstars-reaches-settlement-department-justice-acquires-full-tilt-poker.

[58] *See generally*, Yeh & Doyle, *supra* note 4.

[59] *Id.*at 1 n.3.

[60] *Id.* at 2 (internal citations omitted).

[61] *See generally,* Yeh & Doyle, *supra* note 4.

[62] 31 U.S.C. § 5363 (2006).

[63] 31 U.S.C. § 5363(1)-(4) (2006).

[64] *Id.*

[65] 31 U.S.C. § 5363(1)-(4) (2006); 31 U.S.C. § 5366.

are not always that simple;[66] and, in turn, the UIGEA becomes more difficult to apply.

1. Punishment Under the UIGEA

"A violation of UIGEA is subject to a criminal fine of up to $250,000 (or $500,000 if the defendant is an organization), imprisonment of up to five years, or both."[67] Also, any person or entity may be subject to both civil and regulatory enforcement actions under 31 U.S.C. § 5366(b).[68]

2. Five Elements of the UIGEA

So what exactly must take place to fulfill the "unlawful Internet gambling" wording that, in turn, triggers a violation under federal and state law? When broken down, the statute explicitly requires that an online poker bet satisfy the following four elements in order to constitute a violation: (1) place a bet or wager ("Element 1"), (2) on the internet ("Element 2"), (3) knowingly ("Element 3"), and (4) in a jurisdiction where external laws (either state or federal) make such a bet illegal ("Element 4").[69] There is a fifth element that is not explicit in the text of the statute, but it is crucial in that it provides for exceptions to the UIGEA requirements. As stated in the Report: "[T]his statutory definition expressly exempts certain intrastate and intratribal Internet gambling operations, including state lotteries and Indian casinos that operate under state regulations or compacts."[70] This means that certain (domestic) companies were excluded from the scope of the UIGEA[71].[72] For the intrastate exception to apply, a bet must: "(1) be made and received in the same state; (2) comply with applicable state law that authorizes the gambling and the method of transmission including any age and location verification and security requirements; and (3) not violate various federal gambling laws."[73]

---

[66] *See* discussion *infra* at Part II.F.1.

[67] Yeh & Doyle, *supra* note 4 *citing* 31 U.S.C. §5366(a) (2006).

[68] *Id.* at 1.

[69] *Id.* at 2.

[70] *Id.*

[71] This explains why a state like Nevada could theoretically open and operate an online casino but could only offer service to Nevada residents. It is not clear if such a company would be profitable—software and operating costs would be difficult to overcome because there are only 2,758,931 people in all of Nevada and only a small percentage of those would likely be playing online poker. U.S. CENSUS, Cumulative Estimates of Resident Population Change for the United States, Regions, States, and Puerto Rico and Region and State Rankings: April 1, 2010 to July 1, 2012 *available at* http://www.census.gov/popest/data/national/totals/2012/index.html.

[72] Yeh & Doyle, *supra* note 4.

[73] *Id.*

These exemptions essentially protect any intrastate online gambling that states may already have on the books or would hope to set up in the future,[74] as well as Indian casinos that exist in many areas of the United States. In light of these five elements, it appears the UIGEA was passed as an attempt to strictly regulate international companies, while providing as much leeway as possible for domestic entities by enforcing looser regulations. "The legislative history of UIGEA indicates that Congress wanted the law, in part, to address the perceived problem of foreign Internet gambling operations that made their services available to U.S. customers."[75] The elements of the statute and all other indications point to the conclusion that the purpose of the UIGEA was to regulate international companies and leave the domestic side alone. Finally, there are UIGEA exemptions that justify certain bets, so the fifth element required in order for a bet to be illegal requires a company to not qualify for an exemption ("Element 5").[76]

---

[74] *See* Theo Emery, *Disputes in Washington End Online Gambling Program*, N.Y. TIMES, Feb. 12, 2012, *available at* http://www.nytimes.com/2012/02/16/us/disputes-end-online-gambling-deal-in-washington-dc.html?pagewanted=all&_r=2&.

[75] Yeh & Doyle, *supra* note 4 *citing* H. Rept. 109-412 (Pt.1), at 8 (2006) ("[The Act's] primary purpose is to give U.S. law enforcement new, more effective tools for combating offshore Internet gambling websites that illegally extend their services to U.S. residents via the Internet."); H. Rept. 109-412 (Pt. 2), at 8 (2006) ("The booming industry of offshore websites accepting bets and wagers from persons located in the United States raises a number of social and criminal concerns related to Internet gambling.").

[76] *See* 31 U.S.C §5362(10)(B)(i) (2006).

3. Defining Bets or Wagers under the UIGEA

There is a vast legal history determining the proper way to define what makes something a game of chance, and this history and its application will be discussed, *infra*, in the "Skill v. Chance" section of this Comment. For now, it is important to acknowledge that it is not entirely clear how state and federal courts will determine what exactly a game of chance is and, in turn, what should be considered a game of skill. The UIGEA describes a bet or wager to be the "staking or risking by any person of something of value upon the outcome of a contest of others, a sporting event, or a game subject to chance, upon an agreement or understanding that the person or another person will receive something of value in the event of a certain outcome."[77] Facially, the wording "subject to chance" appears to have a long-armed nature—meaning that it encompasses as much as possible.[78] The wording "subject to chance" certainly appears to encompass poker, and the DOJ's indictment of three major poker sites on Black Friday[79] made it evident that the congressional wording of "subject to chance" was indeed written to include poker.[80]

The Report, however, clarifies what exactly the UIGEA covers: "The statutory definition includes lottery participation, gambling on athletic events, and information relating to financing a gambling account."[81] This seemingly straightforward and broad definition, however, is qualified:

> But a 'bet or wager' does not include the following: securities transactions; commodities transactions; over-the-counter derivative instruments; indemnity or guarantee contracts; insurance contracts; bank transactions; games or contests in which the participants do not risk anything but their efforts; or certain fantasy or simulation sports contests.[82]

In sum, stock market-type gambles, as well as contract-style gambles, are permitted, as are any bank-related transactions and games in which there is nothing to lose. These rules etch out a clear basis for enforcement agencies to regulate online poker, as well as online blackjack, craps, roulette, and other

---

[77] 31 U.S.C. §5362(1)(A) (2006).

[78] *Id.*

[79] *See infra* Part I.D.

[80] Press Release, S.D.N.Y., Manhattan U.S. Attorney Announces $731 Million Settlement Of Money Laundering And Forfeiture Complaint With Pokerstars And Full Tilt Poker (July 31, 2012) [hereinafter Press Release, S.D.N.Y., Settlement], *available at* http://www.justice.gov/usao/nys/pressreleases/July12/pokersettlement.html.

[81] Yeh & Doyle, *supra* note 4. *citing* 31 U.S.C. § 5362.

[82] *Id.* at 2–3.

conventional casino games (assuming the transaction or bet is an unlawful one).[83]

Confused yet? Figuring out what the UIGEA means might be a game of chance in itself. In fact, in 2009, the UIGEA survived a lawsuit challenging the statute for being unconstitutionally vague.[84] The U.S. Court of Appeals for the Third Circuit held that the statute was not constitutionally vague because a person of ordinary intelligence could understand the law, noting that any vagueness problems were rooted in underlying state law, as the UIGEA only aims to regulate state laws that already exist outlawing such bets.[85] In other words, although there is no specific UIGEA vagueness problem, the vagueness issue regarding online poker legality may still exist at the state level.

Element 1 is the heart of the UIGEA, as it defines what constitutes a bet or wager. Element 5 regards exceptions to the UIGEA. These exceptions have already been addressed *supra*. Element 2 of the UIGEA, "on the internet," is fairly self-explanatory. The UIGEA specifically defines "Internet" as "the international computer network of interoperable packet switched data networks."[86]

This leaves Element 3 and Element 4, around which much of this Comment's discussion -an analysis and recommendation on providing online poker for Americans while fulfilling the requirements of the UIGEA- will focus. Before looking at the existing state law framework for online gambling (Element 4) and the legal meaning of knowingly placing or receiving an online bet (Element 3), it is important to understand exactly what happened to the online poker world when the UIGEA took effect, why it happened, and what the current world of online poker looks like.

---

[83] 31 U.S.C. §5362(1)(B)-(E) (2006).

[84] Interactive Media Entm't & Gaming Ass'n v. Att'y Gen. of the U.S., 580 F.3d 113, 116–17 (3d Cir. 2009).

[85] *Id.*

[86] 31 U.S.C. § 5362(5) (2006).

D. Black Friday

On April 15, 2011, the U.S. Attorney for the Southern District of New York filed an indictment against the founders of PokerStars,[87] Full Tilt Poker, and Absolute Poker—the three largest poker websites providing service to the United States—along with eight other online poker companies.[88] The charges included bank fraud, conspiracy, violating UIGEA, money laundering, and operating an illegal gambling business.[89] The online poker world was thrown into a state of utter panic and uncertainty. The period following the indictment consisted of general confusion among poker players and the spread of various theories on how the situation would turn out.[90] The indicted online poker websites were frozen to all players (including foreign players) after charges were filed, which in turn froze hundreds of millions of dollars of players' funds.[91] Rumors swirled, including everything from a European purchase of Full Tilt Poker and the possibility of players getting paid back[92] to the frightening possibility of players simply never seeing their money again.[93]

Eventually PokerStars paid back their players and began providing service to foreign players only.[94] What came next was the groundbreaking announcement that PokerStars, the world's largest poker website, had purchased Full Tilt Poker.[95] This announcement gave American and International players collective hope—it meant that the Full Tilt brand name still had value and, presumably, that PokerStars would pay back those who had frozen funds.[96] As of this writing, however, although American players have been refunded from accounts associated with PokerStars, they have not been reimbursed from those tied to Full Tilt Poker.[97] The DOJ has announced that

---

[87] Nathan Vardi, *PokerStars: Online Gambling's Quiet Giant*, FORBES MAGAZINE (Feb. 10, 2010, 6:00 PM), *available at* http://www.forbes.com/2010/02/10/internet-gambling-pokerstars-business-beltway-pokerstars.html.

[88] *See* Rovell *supra* note 26.

[89] See Press Release, S.D.N.Y., Settlement, supra note 80.

[90] Chad Holloway, The Black Friday Timeline: One Year Without Online Poker, POKERNEWS, (April 15, 2012) http://www.pokernews.com/news/2012/04/the-black-friday-timeline-one-year-without-online-poker-12445.htm.

[91] *Id.*

[92] Lance Bradley, *Tapie Abandons Full Tilt Poker Acquisition; PokerStars Steps Up?* (Apr. 24, 2012), *available at* http://news.bluffmagazine.com/tapie-abandons-full-tilt-poker-acquisition-pokerstars-steps-up-26724/.

[93] Holloway, *supra* note 90.

[94] *Id.*

[95] Caroline Winter, *PokerStars Strikes U.S. Deal to Buy Full Tilt Poker*, BUSINESS WEEK (July, 31, 2010), *available at* http://www.businessweek.com/articles/2012-07-31/pokerstars-strikes-u-dot-s-dot-deal-to-buy-full-tilt-poker.

[96] *Id.*

[97] It is not entirely clear why PokerStars was able to pay players back and Full Tilt Poker was not; it may have to do with the contrast in which the businesses were run: Full Tilt Poker was

American players will be paid back through a structured filing of claims,[98] but such refunds have not yet been settled.

E. Compliance with the UIGEA

A financial transaction provider complies with the UIGEA when it (1) "relies on and complies with the procedures of a designated payment system," (2) "identifies and blocks restricted transactions," and (3) otherwise prohibits restricted transactions.[99] According to the UIGEA, the most efficient means of complying with the UIGEA is through adequate due diligence when dealing with customers who initially deposit onto the site.[100] The Report provided two further steps[101] for a provider looking to engage in transactions with a customer, such as a bank taking transactions from an online poker company, to ensure compliance: (1) performing due diligence at the outset of business with the customer—essentially an enhancement of the UIGEA wording—and (2) determining the risk and likelihood of the customer engaging in Internet gambling.[102] If the customer (online poker company) appears to present a risk of engaging in Internet gambling, the provider (bank) must acquire evidence of the customer's legal authority to engage in the Internet gambling business and written proof, provided by the customer, of any changes to its legal authority.[103] Lastly, the provider must acquire a third party certification assuring the legality of the Internet gambling business, especially regarding age and location verification of participants.[104] Obviously these requirements are not exactly straightforward. While a provider could choose their own means for compliance, strictly upholding the UIGEA adjusted guidelines for compliance would likely be the best way to avoid a UIGEA violation. Providers should be advised that this is the best approach to handling UIGEA requirements.

---

accused of being a "Ponzi scheme". *See, e.g.*, Nathan Vardi, *Feds call Full Tilt Poker a Massive Ponzi Scheme*, FORBES MAGAZINE (Sept. 11, 2011), *available at* http://www.forbes.com/sites/nathanvardi/2011/09/20/feds-call-full-tilt-poker-a-massive-ponzi-scheme/.

[98] Gary Wise, *PokerStars Settles, acquires FTP*, ESPN POKER (July 31, 2012, 5:25 PM), http://espn.go.com/poker/story/_/id/8218085/pokerstars-reaches-settlement-department-justice-acquires-full-tilt-poker.

[99] 31 U.S.C. § 5364 (c)(1)(A)-(B) (2006).

[100] Yeh & Doyle, *supra* note 4 *citing* 73 Fed. Reg. 69,394 (Nov. 18, 2008).

[101] Provided in UIGEA Amendments made with a compliance date of June 1, 2010. *Id.* at 4 *citing* 74 Fed. Reg. 65, 687 (Dec. 1, 2009).

[102] *Id.* at 5.

[103] *Id.* at 5–6.

[104] *Id.* at 6.

II. ANALYSIS

A. Alleged Violations and the Department of Justice Settlement

On July 31, 2012, the Department of Justice announced a settlement with PokerStars regarding an amended civil forfeiture complaint filed in September 2011.[105] The press release stated: "On October 13, 2006, the United States enacted the Unlawful Internet Gambling Enforcement Act ("UIGEA"), making it a federal crime for gambling businesses to 'knowingly accept' most forms of payment 'in connection with the participation of another person in unlawful Internet gambling."[106]

With this statement, the DOJ clarified what the enactment of the UIGEA would mean for the online poker community in the United States. The press release continued: "Despite the passage of the UIGEA, Full Tilt Poker, PokerStars, and Absolute Poker/Ultimate Bet ('the Poker Companies'), each located offshore, continued operating in the United States."[107] This statement appears to stand for the proposition that any existence of foreign operated online poker in the U.S. post-UIGEA was illegal at the time; this conclusion misinterprets the UIGEA. The amended complaint accused the poker companies of circumventing various laws because American banks were unwilling to process their transactions.[108] It stated: "For example, the Poker Companies arranged for the money received from U.S. gamblers to be disguised as payments to hundreds of non-existent online merchants purporting to sell merchandise such as jewelry and golf balls."[109] The complaint continued: "Of the billions of dollars in payment transactions that the Poker Companies deceived U.S. banks into processing, approximately one-third or more of the funds went directly to the Poker Companies as revenue through the 'rake' charged to players on almost every poker hand played online."[110]

Based on the charges and eventual settlements, the evidence appears to show that the Poker Companies acted fraudulently, cheated their players, deceived the American government, and lied about transactions;[111] what is

---

[105] Press Release, S.D.N.Y., Settlement, *supra* note 80.

[106] *Id.*

[107] *Id.*

[108] Verified Complaint ¶¶ 26-31, United States v. PokerStars, WEST 1449657 (S.D.N.Y. 2011) (No. 11 Civ. 2564).

[109] Press Release, S.D.N.Y., Manhattan U.S. Attorney Announces $731 Million Settlement Of Money Laundering And Forfeiture Complaint With Pokerstars And Full Tilt Poker (July 31, 2012) (*available at* http://www.justice.gov/usao/nys/pressreleases/July12/pokersettlement.html).

[110] *Id.*

[111] *Id.*

unclear is to what extent the UIGEA was violated. Much of the alleged illegal activity is straightforward, such as bank fraud, illegitimate payment transactions, and deception of financial institutions.[112] Whether transactions between American players and foreign online poker companies would still be treated as UIGEA violations absent allegations such as bank fraud or conspiracy, however, is left to be pondered. It appears that most internet gambling charges are ancillary:

> From time to time, they have brought criminal cases against some involved in dealing in the proceeds from Internet gaming- principally against those involved in the push when funds are paid to players- and usually only when alleged illegal gambling activity is joined with other allegedly illegal conduct, such as bank fraud or unlicensed money transmitting.[113]

Because UIGEA prosecution has typically come coupled with allegations of fraud or similar offenses,[114] it is unclear what exactly courts are willing to consider legal or illegal transactions under the UIGEA. Additionally, because PokerStars settled without admitting guilt,[115] it is unclear exactly which violations the DOJ would have been able to show the company had committed. Because the bank fraud and various accusations appeared to be clear violations of several different laws, a settlement was a logical resolution to the dispute—but not necessarily for UIGEA-specific reasons.

---

[112] *Id.*

[113] Jeremy D. Frey & Barry Boss, *Hold'Em or Draw: The Strange Case of U.S. Enforcement Efforts Against Internet Gambling and Peer-to-Peer Poker*, 6 WCR 217 (Mar. 15, 2011), *available at* http://www.pepperlaw.com/publications_update.aspx?ArticleKey=2040).

[114] Press Release, S.D.N.Y., Settlement, *supra* note 80.

[115] *Id.*

B. Three Reasons that the UIGEA did Not Categorically Ban Online Poker

In reference to its settlement with PokerStars, the DOJ asserted: "Today's settlements demonstrate that if you engage in conduct that violates the laws of the United States, as we alleged in this case, then even if you are doing so from across the ocean, you will have to answer for that conduct and turn over your ill-gotten gains."[116] Again, it is unclear whether the DOJ is referring to bank fraud and money laundering charges or simply the act of offering online poker to American players. Part of the settlement also included the specification that "PokerStars is prohibited from offering online poker in the U.S. for real money unless and until it is legal to do so under U.S. law."[117] The DOJ press release[118] appears to work under the assumption that the 2006 passing of the UIGEA was a categorical block of all foreign-run online poker companies from accepting any American player's transactions.[119] It was not. There are three predominant reasons why:

(1) **The Timing.** If the DOJ considered any bet from any American player on a foreign online poker website to be an automatic violation, why would they wait five years to file a lawsuit considering all three of the websites in question had been up and running since before the UIGEA was even passed? The fairly logical answer is simply that they needed time to put together a lawsuit and bring the exact charges they wanted—fraud, for example. It is also possible that the DOJ was waiting until they could seize as many funds as possible from the online poker companies to deter possible future violations. Both of these explanations are plausible, but neither explains why these charges could not have taken place immediately after the UIGEA was passed (2006).

(2) **The Text.** If the UIGEA were a categorical block on online bets, why would it textually specify that it depended on federal and state laws already in place to enforce a violation?[120] The text could have simply stated: "All American players are hereby banned from making a bet on any foreign run poker website." As noted, *supra*, the UIGEA has five elements that must be satisfied in order to find a transaction to be a violation. If the UIGEA were a categorical ban on all foreign based online poker for American players, why go to these lengths? One view might be that the UIGEA was designed to enhance the punishment for something Congress already considered illegal for the most part, but the actual text of the UIGEA does not support this theory. The text of the UIGEA specifies how a financial transaction provider can be in

---

[116] *Id.*
[117] Press Release, S.D.N.Y., Settlement, *supra* note 80.
[118] *Id.*
[119] *Id.*
[120] 31 U.S.C. § 5363 (2006).

compliance with the UIGEA.[121] If the legislators viewed the UIGEA as a categorical ban on online poker for American players, there would have been no purpose of writing a section explaining how banks can ensure compliance by investigating the legality of the company they are receiving online transactions from; all online transactions from foreign companies involving gambling would just be illegal.

(3) **The Settlement.** The settlement specifies that PokerStars cannot offer online poker for "real money unless and until it is legal to do so under U.S. law."[122] Why would the settlement require this specification if offering real money games was already categorically illegal under U.S. law? In other words, why would part of a settlement consist of an agreement to refrain from performing something that was already illegal? The settlement confiscated $731 million dollars,[123] and it would make much more sense for the DOJ to allow PokerStars to do whatever they want and to continue to bring lawsuits if they actually believe that online poker is categorically illegal in the U.S.

Given these reasons, the DOJ's statement that "[d]espite the passage of the UIGEA, Full Tilt Poker, PokerStars, and Absolute Poker/Ultimate Bet ('the Poker Companies'), each located offshore, continued operating in the United States,"[124] appears to be more of a *qualification* than an accusation. One possibility is the DOJ wanted to explain that the UIGEA made it more difficult for foreign companies to continue to operate in the United States, and the decision by PokerStars (and the others) to continue to operate led to the settlement and the loss of hundreds of millions of dollars. It makes much more sense that the DOJ statement was a qualification rather than a conclusion that foreign online poker was categorically banned to Americans after the UIGEA came into existence.

---

[121] 31 U.S.C. § 5364(c) (1),(2) (2006).
[122] Press Release, S.D.N.Y., Settlement, *supra* note 80.
[123] *Id.*
[124] *Id.*

C. Specific Violations

The DOJ's indictment listed nine total counts of illegal acts against multiple defendants,[125] and eleven defendants were charged with conspiracy to violate the UIGEA.[126] PokerStars, Full Tilt Poker, and Absolute Poker were all charged with a "violation of the UIGEA" as well as "operation of illegal gambling business."[127] It appears from the press release that the Department of Justice filed the indictment under the UIGEA while relying on already existing bank fraud and conspiracy charges[128].[129]

A memorandum of law regarding the indictment described two charges. First, the Poker Companies were charged "with conspiring to violate the Unlawful Internet Gambling Enforcement Act ("UIGEA"), 31 U.S.C. § 5363, in violation of Title 18, United States Code, § 371; violating the UIGEA; operating illegal gambling businesses, in violation of Title 18, United States Code, Sections 1955."[130] Second, they were charged with "conspiring to commit wire fraud and bank fraud, in violation of Title 18, United States Code, Section 1349; and conspiring to launder money, in violation of Title 18, United States Code, Section 1956(h). It was unsealed on or about April 15, 2011."[131]

To clarify, 18 U.S.C. § 371 prohibits conspiracy to commit offense or defraud in the United States,[132] and 18 U.S.C. § 1955 (the "Illegal Gambling Business Act") is a Prohibition of Illegal Gambling Businesses.[133] This means that the UIGEA charge was brought with the underlying law being conspiracy, bank fraud, and illegal gambling business.[134] As previously noted, it is unclear exactly how the Department of Justice would treat an online poker site that offered real money bets to American players but did not engage in bank fraud

---

[125] Press Release, S.D.N.Y, Manhattan U.S. Attorney Charges Principals of Three Largest Internet Poker Companies with Bank Fraud, Illegal Gambling Offenses and Laundering Billions in Illegal Gambling Proceeds (Apr. 15, 2011) [hereinafter Press Release, S.D.N.Y., Charges], *available at* http://www.justice.gov/usao/nys/pressreleases/April11/scheinbergetalindictmentpr.pdf.

[126] *Id.*

[127] *Id.*

[128] Count one of the indictment was Conspiracy to violate the UIGEA. Because of the nature of the UIGEA text (its reliance on preexisting laws), it is unclear exactly what a conspiracy to violate the UIGEA means. Determining this charge is similar to the entire issue, which is – what exactly did these Poker companies do to violate UIGEA?

[129] Press Release, S.D.N.Y., Charges, *supra* note 125.

[130] Verified Complaint, U.S. v. PokerStars, WEST 1449657 (S.D.N.Y. 2011) (Memorandum of Law in Support of the Government's Motion for Expedited Discovery Relating to Fugitive Disentitlement and To Stay Consideration of Pokerstars' Motion to Dismiss).

[131] *Id.*

[132] 18 U.S.C. § 371 (1948).

[133] 18 U.S.C. § 1955 (1970).

[134] Press Release, S.D.N.Y., Charges, *supra* note 125.

and conspiracy. This makes the § 1955 operation of an illegal gambling business all the more important. Exactly how far does this law go and what does it mean for the UIGEA?

D. 18 U.S.C. § 1955 Operation of an Illegal Gambling Business

Section 1955 of Title 18 of the U.S. Code provides: "Whoever conducts, finances, manages, supervises, directs, or owns all or part of an illegal gambling business shall be fined under this title or imprisoned not more than five years, or both."[135] Based on its text, this statute does not appear to be specifically aimed at international companies, which may explain the congressional desire for the UIGEA.

The statute continues:

> (b) As used in this section—
>
> (1) "illegal gambling business" means a gambling business which--
>
> (i) is a violation of the law of a State or political subdivision in which it is conducted;
>
> (ii) involves five or more persons who conduct, finance, manage, supervise, direct, or own all or part of such business; and
>
> (iii) has been or remains in substantially continuous operation for a period in excess of thirty days or has a gross revenue of $2,000 in any single day.[136]

Similar to the UIGEA, the Illegal Gambling Business Act relies on already existing law to dictate which types of actions are prohibited. The Illegal Gambling Business Act, however, only lists state law as determinant,[137] where the UIGEA lists both state and federal laws.[138] This means the most likely explanation for the 18 U.S.C. § 1955 violation listed in the Department of Justice indictment is that the poker companies were serving American players in states in which online poker is illegal. Because state poker laws are not always clear,[139] online poker companies tended to accept anyone who was

---

[135] 18 U.S.C. § 1955(a) (1970).
[136] 18 U.S.C. § 1955(b)(1)(i)-(iii) (1970).
[137] 18 U.S.C. § 1955(b)(1)(i) (1970).
[138] 31 U.S.C. § 5362(10)(A) (2006).
[139] Discussed *supra* at Part II.F.1.

willing to deposit[140] and operated under the assumption that the UIGEA and Illegal Gambling Business Act did not apply to poker.[141] This was a reasonable conclusion considering the Illegal Gambling Business Act reads: "**(2)** 'gambling' includes but is not limited to pool-selling, bookmaking, maintaining slot machines, roulette wheels or dice tables, and conducting lotteries, policy, bolita or numbers games, or selling chances therein."[142] By negative inference, an online poker company could have reasonably concluded that the law did not apply to poker since poker was not explicitly described in the text and other games were (but they would still need to assess the relevant state law since the UIGEA supports both state and federal law). In fact, before settling, the defendants made just this claim.[143] The Poker Companies' motion to dismiss claimed: "the first claim should be dismissed because online poker does not violate the only state law even potentially alleged to be a predicate to the IGBA claim – New York's Penal Law § 225.05. Like the [Illegal Gambling Business Act], Section 225.05 does not purport to apply to businesses located in foreign jurisdictions."[144]

However, the UIGEA was much more likely to apply to poker considering the political context[145] and timing in which it was passed. The UIGEA states: "New mechanisms for enforcing gambling laws on the Internet are necessary because traditional law enforcement mechanisms are often inadequate for enforcing gambling prohibitions or regulations on the Internet, especially where such gambling crosses State or national borders."[146] This provision was likely a specific response to the poker boom, which occurred after Chris Moneymaker won the 2003 World Series of Poker.[147] However, just because the UIGEA may have been signed with poker in mind does not mean that a UIGEA charge can be justified under the Illegal Gambling

---

[140] *See* Vardi *supra* note 2, *available at* http://www.forbes.com/forbes/2010/0301/gambling-bluffing-government-internet-web-online-poker.html. ("PokerStars, situated on the Isle of Man, claims it has legal opinions from five U.S. law firms saying it is not violating any laws.").

[141] See Absolute Poker Co-Owner Pleads Guilty To Conspiracy To Violate UIGEA, Wire Fraud, And Mail Fraud In Connection With Internet Poker Site Operation, FUERST LAW BLOG (Dec. 27, 2011, 2:15 PM), http://www.fuerstlaw.com/wp/index.php/27/absolute-poker-co-owner-pleads-guilty-to-conspiracy-to-violate-uigea-wire-fraud-and-mail-fraud-in-connection-with-internet-poker-site-operation/ ("Internet poker site operators have argued that UIGEA does not apply because poker should be classified as a game of skill, not a game of chance, and thus beyond the reach of UIGEA.").

[142] 18 U.S.C. § 1955(b)(2) (1970).

[143] United States v. PokerStars, No. 11 CIV 2564, 2011 WEST 1449657 (S.D.N.Y. 2011) (motion to dismiss filed by defendant, p.23).

[144] *Id.*

[145] Rose, *supra* note 37.

[146] 31 U.S.C. § 5361(a)(4) (2006).

[147] *The 2003 Poker Boom Explained: The Moneymaker Effect* (Sept. 16, 2012), http://www.ruffpoker.com/blog/the-2003-poker-boom-explained-the-moneymaker-effect/.

Business Act if that statute does not apply to poker, as claimed in the defendants' motion to dismiss. In sum, a future UIGEA charge would fail on Illegal Gambling Business Act support if either (a) the Illegal Gambling Business Act did not apply to poker or (b) the Illegal Gambling Business Act did not apply because all bets being accepted were from states in which online poker was legal.[148]

E. Summary of the Charges and What They Mean

The DOJ considered the Illegal Gambling Business Act applicable to poker and accused the poker companies of violating the UIGEA by means of violating the Illegal Gambling Business Act.[149] Because the Illegal Gambling Business Act depends on state law[150] and the UIGEA depends on preexisting laws (in this case the Illegal Gambling Business Act), in order for a UIGEA violation to exist, a state law violation must have existed under the Illegal Gambling Business Act. In sum, it is very difficult to determine how exactly the online poker companies violated the UIGEA regarding the actual online poker taking place.

Assume, for example, that a man commits bank robbery, murder, conspiracy, and tax evasion, all in the same day. Also, assume that the evidence showing the man committed the murder is so indisputable that no one would ever question his guilt. The man may plead guilty to murder because he does not believe he has any chance of winning in court.[151] Once the plea takes place, it appears on the surface that the man is guilty of everything he is accused of, but the plea tells us nothing about whether or not the man evaded taxes. In a way, that is what happened with the Poker Companies and the UIGEA.

In its complaint, the DOJ listed one of the Poker Companies' alleged offenses as conspiracy in violation of the UIGEA.[152] Had that been the only charge the DOJ brought, this would be an entirely different story, and the rules regarding what types of bets are and are not allowed under the UIGEA would be much clearer. Because the Poker Companies committed such a clear and

---

[148] *See infra* at Part II. F.1.

[149] The listed charge read "Conspiracy to Violate Unlawful Internet Gambling Enforcement Act". *See* Press Release, S.D.N.Y., Charges, *supra* note 125.

[150] The motion to dismiss filed by defendants argued that New York state had no law prohibiting online poker bets which could then bring an Illegal Gambling Business Charge. *United States v. PokerStars*, 2011 WL 1449657 (S.D.N.Y.) (motion to dismiss filed by defendant, p.23).

[151] Also assume the prosecutors are satisfied with the guilty plea to murder only.

[152] The listed charge read "Conspiracy to Violate Unlawful Internet Gambling Enforcement Act." *See* Press Release, S.D.N.Y., Charges, *supra* note 125. Again, what is clear is that a UIGEA violation took place; it is unclear exactly in what way it was violated.

obvious violation of the UIGEA through both bank fraud and money laundering,[153] it is difficult to determine whether the companies would have been indicted simply for providing online poker to Americans. Based on the statutes, timing of the indictment, and wording of the UIEGA, the answer is this: if online poker companies only provide poker to Americans living in states where such games are legal and do not commit bank fraud (or any other exterior violations), they are free to operate in the United States. With that conclusion in mind, the next step in this Comment's analysis is to assess the state law protection before determining exactly what an online poker company's business would look like when operating in compliance with the UIGEA.

F. State and Federal Poker Laws (UIGEA Element 4)

We have established that the UIGEA is a larger law that relies on the existence of state and federal laws. Recall that the fourth element of a UIGEA violation is: "(4) in an area in which external laws make such a bet illegal."[154] This element is about violating an already existing state or federal law. We have discussed the Illegal Gambling Business Act, but what else would a company have to look out for? "The primary statutes employed by federal prosecutors seeking forfeitures and considering criminal cases include 18 U.S.C. § 1955, the Illegal Gambling Business Act (IGBA); 18 U.S.C. §1084, known as the Wire Act; and 18 U.S.C. §1960, the illegal money-transmitters law."[155] Further statutes are "18 U.S.C. §§1014 and 1344 (bank fraud) and 18 U.S.C. §1956 (money laundering)."[156]

Avoiding the Illegal Gambling Business Act requires a company to simply avoid service to certain states.[157] Since the DOJ announced that the Wire Act does not extend to poker, it is no longer a concern for poker companies.[158] Avoiding bank fraud and money laundering is self-explanatory, so the only remaining concern is 18 U.S.C. § 1960. That statute (the illegal money-transmitters law) reads: "**(a)** Whoever knowingly conducts, controls, manages, supervises, directs, or owns all or part of an unlicensed money

---

[153] *See supra* Part II.C.

[154] *See supra* Part I.C.2.

[155] Jeremy D. Frey & Barry Boss, *Hold'Em or Draw: The Strange Case of U.S. Enforcement Efforts Against Internet Gambling and Peer-to-Peer Poker*, 6 WCR 217 (Mar. 15, 2011) (*available at* http://www.pepperlaw.com/publications_update.aspx?ArticleKey=2040).

[156] *Id.*

[157] 18 U.S.C. § 1955(b)(1)(i)-(iii) (2013).

[158] Press Release, Department of Justice – Opinions of the Office of Legal Counsel, Whether Proposals By Illinois And New York to Use the Internet and Out-Of-State Transaction Processors to Sell Lottery Tickets to In-State Adults Violate The Wire Act (Sept. 20, 2011), *available at* http://www.justice.gov/olc/2011/state-lotteries-opinion.pdf.

transmitting business, shall be fined in accordance with this title or imprisoned not more than 5 years, or both."[159] So, assuming online poker companies can get licensed in the states that allow online poker,[160] the statute at least facially appears easy to comply with. Assessing all of these statutes makes it clear that the one thing an online poker company must be certain to do is only provide access to Americans living in states in which online poker is legal. The subsections below discuss some ways in which online state poker laws apply.

1. State Online Poker Laws

Poker is viewed differently in different areas of the United States and, thus, is subject to differing regulations.[161] "Most states prohibit any gambling that they do not expressly permit."[162] However, because gambling laws—and, in turn, what would be considered poker laws—are not consistent across the country, it is sometimes difficult to determine which games are illegal and where they are illegal. "All states except Hawaii and Utah authorize some form of gambling by their residents, such as lotteries, bingo, card games, slot machines, or casinos. Seven states (Illinois, Indiana, Louisiana, Montana, Oregon, South Dakota, and Washington) expressly outlaw Internet gambling."[163] This means that, if poker is gambling under the UIGEA, online poker companies cannot legally provide access to Americans that live in those seven states because the UIGEA relies on state law to determine what is "unlawful internet gambling."[164] Because state laws regulating online poker are subject to change,[165] a foreign-run online poker company would need to keep up with state laws to determine when and if they can allow players from such states to play. "However, in light of growing state budget deficits and state legislators' desire to find ways of raising revenue without increasing taxes, several states are considering measures that would legalize, license, and tax Internet gambling within their borders."[166] State-run online poker would take advantage of the UIGEA intrastate exception.[167] Assessing the status of online poker for every single state is beyond the scope of this Comment.

---

[159] 18 U.S.C. § 1960(a) (effective 2013).

[160] Answering this question is beyond the research and scope of this comment and is only assumed for purposes of continuing with the analysis – there may be practical difficulties with getting a license.

[161] *Compare* 18 PA. CONS.STAT. ANN. §§ 5513(a)(2) (2013) *and* *N.C. GEN. STAT.* § 14-292 (2013).

[162] Yeh & Doyle, *supra* note 4.

[163] *Id.*

[164] 31 U.S.C. §5362(10)(A) (2013).

[165] *See, e.g., Emery, supra note 74.*

[166] Yeh & Doyle, *supra* note 4.

[167] 31 U.S.C. §5362(10)(B)(i) (2013).

Instead, it will provide a framework for reading and assessing a state statute as to how the UIGEA applies.

One issue is whether distinction between poker and online poker exists in the text of state statutes. If table poker is statutorily distinguished from online poker, it might lead to a scenario in which residents of a state could play poker legally at a local casino but would not be able to play online poker because of the specific wording in their state statutes. Because the UIGEA operates as another layer of legislation on top of already existing state laws, if casino poker is legal in a state, there would likely need to be evidence that online poker is explicitly illegal to charge a UIGEA violation using the state law.

To make online poker legality even more difficult to determine, some state law statutes are written to outlaw "games of chance,"[168] which leads to a further analysis of whether or not poker is a game of chance or skill. Two recent cases illustrate this issue.

2. Joker Club – The Case for Poker as a Game of Chance

In 2007, the Court of Appeals of North Carolina held that poker was a game of chance.[169] The court noted that the key determination was not simply whether skill existed in a game, but rather the more predominant presence between skill and luck.[170] The court concluded that there was more luck than skill in a hand of poker, poker is in fact a game of chance, and thus is in violation of the specific North Carolina statute,[171] in this case outlawing games of chance.[172] The statute in question reads: "[A]ny person or organization that operates any game of chance or any person who plays at or bets on any game of chance at which any money, property or other thing of value is bet, whether the same be in stake or not, shall be guilty."[173] As it applies for our purposes, poker is a game of chance in North Carolina. Games of chance for money are illegal under the North Carolina statute, which (applying the five UIGEA elements) makes accepting a bet for real money, online, knowingly, from a North Carolina resident illegal and punishable under the Act.

Joker Club is supported by a 2010 Pennsylvania Superior Court case.[174] The court held poker, specifically Texas Hold 'Em, to be gambling because "it is predominantly a game of chance."[175] The applicable Pennsylvania statute

---

[168] Joker Club, L.L.C. v. Hardin, 643 S.E.2d 626, 630–31 (N.C. Ct. App. 2007).
[169] *Id.*
[170] *Id.* at 629.
[171] N.C. GEN. STAT. § 14-292 (2013).
[172] *Joker Club*, 183 S.E.2d at 630–31.
[173] N.C. GEN. STAT. § 14-292 (2013).
[174] Commonwealth v. Dent, 992 A.2d 190, 195–96 (Pa. Super. Ct. 2010).
[175] *Id* at 196.

reads: "A person is guilty of a misdemeanor of the first degree if he: . . . (2) allows persons to collect and assemble for the purpose of unlawful gambling at any place under his control;".[176] The statute facially does not clarify whether or not poker is considered unlawful gambling.[177] "Neither a statute nor case law specifically addresses the legality of Texas Hold 'Em Poker. To resolve this appeal, we must first determine whether Texas Hold 'Em Poker is gambling. If so, then we must decide whether it is 'unlawful' as that term is used in § 5513."[178] The court eventually applied what they referred to as a "predominate-factor test": Texas Hold 'Em Poker is "gambling" because, while the outcome may be dependent on skill to some degree, it is *predominantly* a game of chance.[179] Under this holding, an online poker company would violate the UIGEA by allowing bets made by anyone located in Pennsylvania.[180] If courts nationwide interpreted poker as a game of chance, online poker would be illegal under statutes similar to those of North Carolina and Pennsylvania. If all courts interpreted their state statutes to ban online poker, assuming they have a state statute addressing some form of gambling, an online poker company would have its field of players heavily reduced. Courts, however, do not always interpret state gambling statutes to include poker.

---

[176] 18 PA. CONS. STAT. ANN. §§ 5513(a)(2) (2013).
[177] *Id.*
[178] *Dent*, 992 A.2d at 192 (Pa. Super. Ct. 2010).
[179] *Id.* at 196.
[180] 31 U.S.C. §5362(10)(A) (2006).

3. Dicristina – The Case for Poker as a Game of Skill

The Eastern District of New York dealt with the Illegal Gambling Business Act in *United States v. Dicristina*.[181] Recall that the Illegal Gambling Business Act reads:

> (a) Whoever conducts, finances, manages, supervises, directs, or owns all or part of an illegal gambling business shall be fined under this title or imprisoned not more than five years, or both.
> (b) As used in this section—
> (1) "illegal gambling business" means a gambling business which—
> (i) *is a violation of the law of a State* or political subdivision in which it is conducted;[182]

The Eastern District wrote: "Close reading of the [Illegal Gambling Business Act] reveals that it requires both a violation of an applicable state law and proof of additional federal elements."[183] The court then assessed whether poker should fall under the Illegal Gambling Business Act at all by first breaking down the statute and then questioning whether Congress would have explicitly included poker if it intended for the statute to cover it. "Poker is, for the purposes of this case, an elephant—or perhaps an eight hundred pound gorilla—that Congress would have been unlikely to ignore."[184] The court reasoned that poker's popularity may explain the reasoning behind the text: "The fact that card games like poker, pinochle, gin rummy, and bridge were so widely played by law-abiding individuals in noncriminal settings may explain its omission from the [Illegal Gambling Business Act]."[185] The court concluded: "As a matter of statutory construction, poker must fall under the general definition of gambling and be sufficiently similar to those games listed in the statute to fall within its prohibition. It does not."[186] With this statutory construction holding, the Eastern District of New York opened up a window of opportunity for the legality of both poker and online poker. However, the court noted that the window applied to the Illegal Gambling Business Act, due to its ambiguity, but not to the UIGEA: "Unlike other provisions of the Unites

---

[181] 886 F.Supp.2d 164 (E.D.N.Y. 2012) *rev'd*, 726 F.3d 92 (2d Cir. 2013).
[182] 18 U.S.C. § 1955(a)(b)(1)(i)(2012) (emphasis added).
[183] *Dicristina*, 886 F.Supp.2d at 200.
[184] *Id.* at 225.
[185] *Id.*
[186] *Id.*

States Code dealing with gambling, the [Illegal Gambling Business Act] does not provide explicit criteria for what constitutes gambling"[187].[188] It is unclear exactly what the Eastern District meant with this statement, as both the Illegal Gambling Business Act and UIGEA are ambiguous when it comes to defining gambling.

The court further determined the context in which poker should be viewed: "The fundamental question is not whether *some* chance or skill is involved in poker, but what element *predominates*. To predominate, skill must account for a greater percentage of the outcome than chance—i.e., more than fifty percent."[189] In regards to the case, the holding meant only that the defendant did not violate the Illegal Gambling Business Act, but in terms of statutory interpretation of state gambling laws, the holding could prove to be enormous.

4. Joker Club, Dicristina, and the UIGEA

If state courts interpret their "gambling" or "game of chance" statutes the way the *Joker Club* courts did, poker will be considered a game of chance and a form of gambling. After such an interpretation, providing online poker to residents of such states will be a violation of the UIGEA, as it will be considered knowingly accepting a bet online in a state where poker has been interpreted as illegal (without a UIGEA exception). On the other hand, if state courts take the *Dicristina* approach and consider poker to be a game of skill rather than a game of chance, state statutes outlawing games of chance or gambling will not apply to poker. Essentially, this means that online poker companies can accept bets made from residents of any state that has applied a *Dicristina* interpretation to their state statutes.

G. "Knowingly" (UIGEA Element 2)

Lastly, the exact meaning of "knowingly" under the UIGEA must be considered. The UIGEA reads: "…or otherwise knowingly transmit a bet or wager by any means."[190] Recall, *supra*, ways in which banks can ensure that they have shown due diligence in dealing with possible illegal gambling operators: "Participants may comply by adopting the policies and procedures of their payments system or by adopting their own."[191] This covers the "knowingly" element in regards to a bank receiving a transaction from a

---

[187] *Compare* 31 U.S.C. § 5362(1)(A) (2006) which is the UIGEA section defining gambling.
[188] *Dicristina*, 886 F.Supp.2d at 200.
[189] *Id.* at 231.
[190] 31 U.S.C. § 5362(10) (A) (2006).
[191] Yeh & Doyle, *supra* note 4.

gambling company. However, it does not explain what online poker companies need to do in order to comply with "knowingly." The UIGEA does not explicitly state what the word "knowingly" means.[192] For example, one could interpret "knowingly" to mean that poker companies cannot accept bets from players that they are certain play in a state in which poker is illegal.[193] This interpretation would allow online poker companies to turn a blind eye and allow anyone to deposit money and simply not require poker players to provide their location when signing up to make a deposit. However, there would be two problems with this approach. First, the DOJ could simply say that as long as online poker companies are aware of the IP addresses[194] of the users playing on their site, they have knowledge (and thus fulfill the knowingly element) of the state in which the person is playing from. Second, a third party, such as the bank, will be unable to receive transfers from the online poker company because they will be unable to show "a third-party certification that the commercial customer's systems for engaging in the Internet gambling business are reasonably designed to ensure … within the licensed or otherwise lawful limits."[195] This means that online poker companies would likely avoid the risk of interpreting "knowingly" in such a loose way because they would not be able to provide the proper documentation to banks that they are complying with the UIGEA.

Online poker companies would likely give themselves the best chance of both avoiding DOJ prosecution and allowing banks to transact with them if they interpreted knowing in the strictest sense. Online poker companies could do everything in their power to find out as much as they can about a person attempting to deposit and bet in real money games.

The first two inquiries online poker companies would want to make would concern the age and location of the players using the website.[196] These are important considerations because they are specifically laid out as two checks a third-party would have to make to provide a certification when running their due diligence analysis,[197] as discussed, *supra*, in the UIGEA

---

[192] 31 U.S.C. § 5362 (2006).

[193] One could reach this interpretation under a very exact definition of the word "knowing" such as: A person acts "knowingly" or "willfully" with respect to conduct or to a circumstance described by a statute defining an offense when he is aware that his conduct is of such nature or that such circumstance exists. A person acts "knowingly" or "willfully," with respect to a result of his conduct, when he is aware that his conduct is practically certain to cause the result. COL. REV. STAT. ANN. § 18-1-501 (West, Westlaw through first regular session of 2013).

[194] Which all online poker companies track as protection from players trying to cheat by having multiple accounts on the same IP address. *See e.g.*, *How Online Gamblers Unmasked Cheaters*, CBS NEWS (June 28, 2009, 9:27 PM) (http://www.cbsnews.com/8301-18560_162-4633254.html).

[195] Yeh & Doyle, *supra* note 4.

[196] The required age for online poker is generally 18 but some sites require players to be 21.

[197] Yeh & Doyle, *supra* note 4.

compliance section. Online poker companies would also want to be sure that (1) players report any change to their location, and (2) only one player was playing per account. These measures would ensure that both age and location could not be changed in each account.

If online poker companies could show they were taking these steps, they would likely be able to show they did not "knowingly" accept an illegal wager, even if someone were to slip through the account checking system and make a bet that was not of proper age or location.

III. CONCLUSION

As of this writing, several online poker companies allow American participation. Going forward, however, it is unclear how the DOJ will deal with such companies.[198] Based on the wording of the UIGEA; the PokerStars, Full Tilt Poker, and Absolute Poker indictment; state laws regarding online poker; and the underlying federal law that the UIGEA relies on, online poker—in the right form—is still legal in the United States. To comply with the UIGEA, an online poker site needs to only accept bets from players of the right age living in states in which online poker is explicitly legal or, if it not explicitly illegal, in states in which the courts interpret poker to be a game of skill and not chance.[199]

FINAL NOTES

Part of the DOJ settlement with PokerStars included: "PokerStars is prohibited from offering online poker in the U.S. for real money unless and until it is legal to do so under U.S. law."[200] This means that for PokerStars and Full Tilt Poker—now owned by PokerStars[201]—there is a larger hurdle than simply showing that online poker is legal in the U.S., they must also show that they have not broken the terms of the settlement. Those companies cannot provide Americans with real money games unless they can show that (1) it is legal to provide online poker in the U.S. under U.S. law, and (2) the terms of the settlement read strictly still allow them to do that. This is a tall order, but a test case to lay a basis for all online poker companies would be hugely helpful to clear up the law.

Regardless, there are many poker sites besides PokerStars and Full Tilt, and if the UIGEA does not get changed, companies will find other ways of

---

[198] The Bovada company (formerly known as BoDog Poker) continues to operate real money games to American players. *See* http://www.bovada.lv/.

[199] Assuming the statute is written with the "game of chance" wording.

[200] Press Release, S.D.N.Y., *supra* note 80.

[201] (Winter, *supra* note 95.

involving Americans. Due to the profitability and lucrative market associated with American online poker, this issue is unlikely to go away soon.

It should be noted that there may have been inter-workings and communications between the DOJ and the online poker companies before the indictment took place. Obviously, a lawsuit leading to a $731 million dollar settlement takes time to put together. If there is more information regarding the exact UIGEA violations, it does not appear to be available to the public, at least at this time. Because the case was settled, we do not get the benefit of reading the arguments of the judges assigned to the case. This leads to the following disclaimer: if the DOJ thinks something is illegal, it may not matter what the proper or technical legal interpretation of a statute is from a business perspective. As the Comment has argued, based on the UIGEA text, indictment, and state and federal laws, there does not appear to be a categorical ban on online poker – but that may not matter to an investor if the DOJ simply does not want foreign online poker companies to exist in the United States and is going to interpret the UIGEA to be that categorical ban. In short, although an online poker company in the U.S. could operate legally, such involvement could still represent a huge risk. A company looking to run an online poker site that offered real money games to Americans would have to consider both the potential profitability of their website weighed against possible UIGEA ramifications they could face.[202] In other words, they would have to risk a lot to potentially make millions.

Thus, a potential online poker company would have to face the conundrum that every poker player has experienced: -"You can't lose what you don't put in the middle, but you can't win much either." [203]

---

[202] One way to deal with this might be to simply request the position of the DOJ. However, an online poker company who was not averse to risk might be better off simply running an online poker company complying with the UIGEA as it would likely be tougher for the DOJ to show a UIGEA violation in court than it would for them to release a statement that the PokerStars settlement should be viewed as a categorical ban on online poker.

[203] ROUNDERS (Miramax Films 1998).