

---

---

GEORGE MASON UNIVERSITY SCHOOL OF LAW  
JOURNAL OF INTERNATIONAL  
COMMERCIAL LAW

---

---



**ARTICLES**

COMMERCE MUST ADOPT A CENTRAL ROLE IN  
ADDRESSING CIRCUMVENTION OF ALL TYPES  
*Jordan C. Kahn & Nathaniel Maandig Rickard*

JUST GRIN AND BEAR IT: WHY CONSISTENT USE OF  
INDIVIDUAL BAILOUTS UNDER SECTION 13(3) OF THE  
FEDERAL RESERVE ACT IS A NECESSARY EVIL TO COMBAT  
ECONOMIC 'MASS DESTRUCTION'  
*Daniel J. Hunt*

**NOTES**

A LOSE-LOSE SCENARIO WHEN THE FEDERAL  
GOVERNMENT STARTS A THEORY WITH "TOO BIG": HOW  
THE DOJ'S AML ENFORCEMENT POLICY FORCES  
REMITTANCES UNDERGROUND  
*Bryan L. Mulcahey*

HOOPER V. LOCKHEED MARTIN CORP.: HOW AND WHY  
FRAUDULENT UNDERBIDDING SHOULD SCARE  
GOVERNMENT CONTRACTORS  
*Jason Sarfati*

**JOURNAL OF INTERNATIONAL  
COMMERCIAL LAW**

---

VOLUME 6

FALL ISSUE

NUMBER 1

---

**CONTENTS**

**ARTICLES**

COMMERCE MUST ADOPT A CENTRAL  
ROLE IN ADDRESSING CIRCUMVENTION  
OF ALL TYPES      *Jordan C. Kahn & Nathaniel Maandig Rickard*      1

JUST GRIN AND BEAR IT: WHY CONSISTENT  
USE OF INDIVIDUAL BAILOUTS UNDER SECTION  
13(3) OF THE FEDERAL RESERVE ACT IS A  
NECESSARY EVIL TO COMBAT ECONOMIC  
'MASS DESTRUCTION'      *Daniel J. Hunt*      59

**NOTES**

A LOSE-LOSE SCENARIO WHEN THE FEDERAL  
GOVERNMENT STARTS A THEORY WITH "TOO BIG":  
HOW THE DOJ'S AML ENFORCEMENT POLICY  
FORCES REMITTANCES UNDERGROUND      *Bryan L. Mulcahey*      107

HOOPER V. LOCKHEED MARTIN CORP.: HOW AND  
WHY FRAUDULENT UNDERBIDDING SHOULD  
SCARE GOVERNMENT CONTRACTORS      *Jason Sarfati*      131

**JOURNAL OF INTERNATIONAL  
COMMERCIAL LAW**

---

VOLUME 6

FALL ISSUE

NUMBER 1

---

*Editor-in-Chief*

JACQUELINE NGUYEN

*Executive Editor*

CAMERON HAMES

*Managing Editor*

BRYAN MULCAHEY

*Senior Articles Editor*

CHRISTOPHER GARDNER

*Articles Editor*

MARK HAGEDORN

*Senior Research Editor*

ALENA THOMAS

*Associate Editor*

YOOJUN LEE

*Notes Editors*

ALYSSA COFFEY

JASON SARFATI

*Research Editor*

ERIC FRICK

*Candidate Members*

BRYAN BURACK  
REBECCA EUBANK  
LUCY MECKLEY  
GABRIEL PETERS

TERRICA CARRINGTON  
ALEX JENSEN  
BRIAN MOTTI  
ARUN SHOME

CHRISTINE CONNELL  
KATHERINE MCCLASKEY  
TAYLOR HOVERMAN

*Faculty Advisor*

JAMES BYRNE

Cite as 6 GEO. MASON J. INT'L COM. L. \_\_\_\_ (2014)

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: [gmsljicl@gmail.com](mailto:gmsljicl@gmail.com). 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* (19<sup>th</sup> 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: [gmsljicl@gmail.com](mailto:gmsljicl@gmail.com).

**COMMERCE MUST ADOPT A CENTRAL ROLE IN ADDRESSING  
CIRCUMVENTION OF ALL TYPES**

Jordan C. Kahn\*  
Nathaniel Maandig Rickard\*\*

I. INTRODUCTION

Parties involved in trade impacted by antidumping and countervailing duties<sup>1</sup> – affected domestic industries, producers and exporters of subject merchandise, importers, distributors, and consumers – must increasingly confront widespread circumvention of the disciplining effects of trade remedies. For domestic industries, antidumping and countervailing duty orders may be effectively gutted by extralegal methods that facilitate the continuation of unfair trade practices. For producers, exporters, and importers, the ability to remain competitive in the U.S. market is substantially undermined by the willingness of other market participants to engage in unlawful practices. These companies are forced into the difficult choice of adopting the same practices as their competitors or risk being pushed out of the business entirely. For distributors and consumers, sourcing becomes further complicated by the infrastructure created to carry out fraudulent evasion of antidumping and countervailing duty orders.

Responsibility for enforcement of antidumping and countervailing duty orders has principally fallen on the shoulders of U.S. Customs and Border Protection (“CBP” or “Customs”), with the U.S. Department of Commerce (the “Department” or “Commerce”) primarily assuming statutory responsibility for a narrow set of circumvention concerns articulated in 19 U.S.C. § 1677j or addressing scope issues when definitions are unclear pursuant to its regulations found at 19 C.F.R. § 351.225. But any attempt to create hard and fast boundaries between the responsibility and authority of these two respective agencies to address circumvention of

---

\*Counsel, Picard Kentz & Rowe LLP; J.D., LL.M., New York University School of Law, J.D. University of Colorado School of Law; B.S., University of California at Berkeley.

\*\* Partner, Picard Kentz & Rowe LLP; J.D., New York University School of Law; B.A., Grinnell College.

<sup>1</sup> Antidumping and countervailing duties are trade remedies available to address unfair trade harming domestic industries under conditions established by Title VII of the Tariff Act of 1930, as amended. 19 U.S.C. § 1671. Antidumping duties are a remedy available to address harm caused by dumping, otherwise known as sales of imported merchandise at less than fair value. Countervailing duties are a remedy available to address harm caused by certain subsidies granted by foreign governments to producers and exporters of merchandise shipped to the U.S. market.

trade remedies results in a Maginot Line providing procedural comfort but little practical utility. The prevalence of circumvention means that the Department should not be limited to addressing such practices only when the narrow circumstances of 19 U.S.C. § 1677j or 19 C.F.R. § 351.225 are met and anti-circumvention or scope proceedings are initiated. Indeed, simplistic arguments to cabin the Department's authority to address circumvention only in the context of the mechanisms provided for in 19 U.S.C. § 1677j and 19 C.F.R. § 351.225 undermine the whole of the agency's ability to administer the antidumping duty and countervailing duty laws by allowing unscrupulous actors to dictate when the Department can take action. As the Court of Appeals for the Federal Circuit ("CAFC") recently observed in *AMS Associates*:

However, Commerce does not have to initiate a formal scope proceeding under 19 C.F.R. § 351.225 when it wishes to issue a ruling that does not clarify the scope of an unambiguous original order. Commerce must only follow the procedures outlined in § 351.225 when it wishes to clarify an order that is unclear. *To hold otherwise would permit importers to potentially avoid paying antidumping duties on past imports by asserting unmeritorious claims that their products fall outside the scope of the original order. Importers cannot circumvent antidumping orders by contending that their products are outside the scope of existing orders when such orders are clear as to their scope. Our precedent evinces this understanding.* We have not required Commerce to initiate a formal scope inquiry when the meaning and scope of an existing antidumping order is clear.<sup>2</sup>

Separately, rampant manipulation of antidumping and countervailing duty proceedings conducted by the Department means that CBP is often charged with the impossible task of barring the barn door after all the livestock have left. The collection figures on assessed antidumping and countervailing duties, as discussed further below, are shocking. Equally

---

<sup>2</sup> *AMS Assocs., Inc. v. United States*, 737 F.3d 1338, 1344 (Fed. Cir. 2013) (emphasis added) (quoting *Huaiyin Foreign Trade Corp. v. United States*, 322 F.3d 1369, 1378–79 (Fed. Cir. 2003) (recognizing that although Commerce “cannot interpret an antidumping order so as to change the scope of that order, nor can Commerce interpret an order in a manner contrary to its terms,” Commerce can issue clarifying instructions during an administrative review (internal citations omitted))).

shocking is how much is known about the reasons for the poor collection experience and the inability to significantly countermand the problem. Because the circumvention schemes that lead to massive undercollection of duties *depend* upon manipulation of Commerce's proceedings, deflecting responsibility for enforcement in this arena entirely to CBP is tantamount to an admission of defeat.

This article will seek to demonstrate that the Department must adopt a central role in addressing circumvention of all types and that the agency's recent practice supports the belief that Commerce is endowed with sufficient authority and has sufficient competence to address circumvention of all types and kinds.

#### I. CIRCUMVENTION OF ANTIDUMPING AND COUNTERVAILING DUTY ORDERS IS RAMPANT

How much of a problem is circumvention of antidumping and countervailing duty orders? If the issue is one found only at the margins of trade in goods subject to antidumping and countervailing duties, then narrowly-tailored responses are appropriate. If, however, the problem is pervasive, then the threat posed to the integrity of trade remedies demands more comprehensive responses.

A review of available information reasonably leads to the conclusion that circumvention of antidumping and countervailing duty orders is rampant and a significant part of the trade in goods subject to these trade remedies.<sup>3</sup> Anecdotal evidence paints a striking portrait of the substantial amount of money involved in circumvention schemes. For example, in June 2013, a federal grand jury returned an indictment against eight defendants in the U.S. District Court for the District of Puerto Rico alleging that these parties conspired to defraud the United States out of over \$26.7 million in lawful antidumping and countervailing duties accruing upon imports of aluminum extrusions of Chinese origin that had been transshipped through Malaysia.<sup>4</sup> In February 2013, seven defendants were charged in the U.S. District Court for the Northern District of Illinois for allegedly conspiring to defraud the United States out of over \$180 million

---

<sup>3</sup> See, e.g., U.S. Customs and Border Protection, *Antidumping Duty and Countervailing Duty Enforcement Actions and Compliance Initiatives: Fiscal Year 2010, Fiscal Year 2011 Report to Congress*, Fiscal Year 2011 Report to Congress at 2 (May 24, 2011) ("CBP Report to Congress"), available at: <http://www.pkrlp.com/wordpress/wp-content/uploads/Customs-Report.pdf>.

<sup>4</sup> Press Release, United States Attorney's Office (D.P.R.), Five Individuals Indicted and Arrested for Conspiracy to Smuggle Goods Into the United States and Money Laundering (June 21, 2013), available at: <http://www.justice.gov/usao/pr/news/2013/06212013.html>.

in lawful antidumping duties accruing upon imports of honey of Chinese origin through various forms of fraudulent artifice.<sup>5</sup> In December 2012, the U.S. Department of Justice (“DOJ”) announced that a Japanese-based company and its affiliates had agreed to a \$45 million payment to settle allegations that it had fraudulently entered imports of colorant carbazole violet pigment number 23 as products of other countries to evade antidumping and countervailing duties imposed on imports from the People’s Republic of China (“China” or the “PRC”) and India.<sup>6</sup> And in October 2012, multiple individuals and companies were charged in the Northern District of Georgia for their respective roles in allegedly conspiring to defraud the United States out of over \$20 million in lawful antidumping duties accruing upon imports of notebooks and filler paper of Chinese origin that had been transshipped through Taiwan.<sup>7</sup>

But these few anecdotes fail to present a comprehensive picture of just how prevalent circumvention of antidumping and countervailing duty orders has become. On their own, the individual examples are subject to dismissal as the few bad apples threatening to spoil the bunch. However, a review of aggregate data – stripped of the titillating detail of individual circumvention schemes – demonstrates the severity of the issue.

Two related but distinct strands of circumvention provide the framework for empirical measurement of the impact of circumvention. As discussed herein, one breed of circumvention tactics – the manipulation of Commerce’s mechanisms for obtaining cash deposit rates – has resulted in less than fifty percent of retrospectively assessed antidumping and countervailing duties being collected. Other breeds of circumvention tactics, including misclassification, transshipment, undervaluation, and smuggling, defy comprehensive estimates because of their clandestine nature. Nevertheless, CBP’s reporting of enforcement activities in this arena underscores the prevalence of such practices.

---

<sup>5</sup> Press Release, United States Attorney’s Office (N.D. Ill.), Two Companies and Five Individuals Charges With Roles in Illegal Honey Imports; Avoided \$180 Million in Antidumping Duties (Feb. 20, 2013), available at: [http://www.justice.gov/usao/iln/pr/chicago/2013/pr0220\\_02.html](http://www.justice.gov/usao/iln/pr/chicago/2013/pr0220_02.html).

<sup>6</sup> Press Release, U.S. Department of Justice, Japanese-based Toyo Ink and Affiliates in New Jersey and Illinois Settle False Claims Allegation for \$45 Million (Dec. 17, 2012), available at: <http://www.justice.gov/opa/pr/2012/December/12-civ-1504.html>.

<sup>7</sup> Press Release, United States Attorney’s Office (N.D. Ga.), Companies and CEOs Indicted in School Supply Scam (Oct. 22, 2012), available at <http://www.justice.gov/usao/gan/press/2012/10-22-12.html>.



A. *Unscrupulous Importers and the Undercollection of Antidumping and Countervailing Duties*

In testimony before the Senate Finance Committee in June 2008, the Deputy Assistant Secretary for Tax, Trade, and Tariff Policy of the U.S. Department of the Treasury (“Treasury”), Timothy E. Skud, highlighted the substantial difficulty presented to CBP and other agencies in enforcing antidumping duty orders:

Another area of concern to the Treasury Department, CBP, and other trade agencies has been problems in collecting antidumping and countervailing duties. In response to Congress’ interest in this area, the Treasury Department provided a report on this issue last year. Although CBP’s collection rate is over 99 percent for duties overall, *CBP is able to collect less than 50 percent of antidumping and countervailing duties* that have been retroactively assessed in excess of bonds or cash deposits. We concluded in the report that *the chief obstacle to ensuring collection of such duties is the difficulty of obtaining adequate security (cash deposits, bonds, or other instruments). This problem appears to have been exacerbated in some cases by unscrupulous importers* who imported knowing they were likely to incur duties not fully secured by bonds or cash deposits following retrospective duty assessment and who then absconded when payment was due.<sup>8</sup>

Two years later, appearing before the Subcommittee on Trade of the Committee on Ways and Means in the U.S. House of Representatives, the same Treasury official repeated this analysis:

One area of concern to the Treasury Department, CBP, and other trade agencies has been problems in collecting antidumping and countervailing duties. In response to Congress’ interest in this area, the Treasury Department has provided two reports on this

---

<sup>8</sup> Press Release, U.S. Department of the Treasury, Written Testimony of Timothy E. Skud, U.S. Department of the Treasury, Deputy Assistant Secretary for Tax, Trade, and Tariff Policy Before the Senate Finance Committee (June 24, 2008), *available at* <http://www.treasury.gov/press-center/press-releases/Pages/hp1051.aspx> (emphasis added).

issue in recent years. Although CBP's overall duty collection rate is over 99 percent, CBP is able to collect less than 50 percent of antidumping and countervailing duties that have been retrospectively assessed. The conclusion of our reports is that *the chief obstacle to ensuring collection of retrospectively assessed duties is the absence of adequate security, such as cash deposits or bonds. This problem has been exacerbated by unscrupulous importers who knew they were likely to incur retrospective duty assessments and absconded when payment was due.* We and CBP are also working with colleagues at the Department of Commerce to prepare a report requested by Congress on the relative advantages and disadvantages of prospective and retrospective anti-dumping and countervailing duty systems, including the extent to which the respective approaches would minimize uncollected duties and reduce incentives and opportunities for evasion of the anti-dumping and countervailing duty laws.<sup>9</sup>

Rather than act as a call to action to countermand the reported collection rate of less than 50 percent "of antidumping and countervailing duties that have been retrospectively assessed," Treasury's analysis has been used to argue for a fundamental change to how duties are assessed rather than collected. Discussion of the relative merits of abandoning the retrospective assessment system miss the more interesting observation contained within the remarks: undercollection of antidumping duties is "exacerbated" by "unscrupulous importers who knew they were likely to incur retrospective duty assessments and absconded when payment was due."

In 2011, CBP submitted a report to Congress that also traced uncollected duties to recalcitrant importers: "Some importers are unwilling or unable to pay the actual duties, and some are no longer in business when CBP issues a bill, leading to uncollected AD/CV duties."<sup>10</sup> Providing

---

<sup>9</sup> Written Testimony of Timothy E. Skud, U.S. Department of the Treasury, Deputy Assistant Secretary for Tax, Trade, and Tariff Policy Before the Subcommittee on Trade, Committee on Ways and Means (May 20, 2010), *available at* [http://waysandmeans.house.gov/media/pdf/111/2010may20\\_skud\\_testimony.pdf](http://waysandmeans.house.gov/media/pdf/111/2010may20_skud_testimony.pdf) (emphasis added).

<sup>10</sup> CBP Report to Congress at 2.

context to the over \$1 billion in assessed antidumping and countervailing duties that had not been collected between fiscal years 2001 and 2010, CBP explained in the report that:

In summary, approximately 25,000 unpaid AD/CVD bills are from FY 2001 through FY 2010, totaling \$1.04 billion for which CBP is pursuing collection. Of this amount, at the end of FY 2010, \$285 million was under protest and \$56 million involves bankrupt debtors. Further amounts are owed by importers that have disappeared or dissolved without going through the bankruptcy process. Additionally, tens of millions of dollars are owed by sureties that are in rehabilitation or receivership.<sup>11</sup>

In other words, only roughly a third of the total uncollected duties could be traced to active protests, bankrupt debtors, or sureties in rehabilitation or receivership. Consistent with this narrative, Appendix C to the report sets forth an accounting of all open antidumping and countervailing duty bills for fiscal years 2001 through 2010 indicating that the substantial majority of bills were neither subject to protests or involved debtors undergoing bankruptcy.<sup>12</sup> While CBP merely indicates that “[f]urther amounts” are owed by importers that have disappeared or dissolved, these parties are likely to have accounted for a substantial portion of (if not the majority) the remaining uncollected antidumping and countervailing duties.

### **1. What Is an Unscrupulous Importer?**

What is an “unscrupulous” importer? In this context, the term likely encompasses shell or front companies that act as importers of record on import transactions designed to evade the payment of duties. The use of shell or front company importers, both domestic and foreign entities, is an important element in strategies to avoid the payment of antidumping duties.

For example, in an ongoing False Claims Act suit involving evasion of antidumping and countervailing duties imposed on aluminum extrusions from China, the DOJ has recently filed a complaint intervening in that case which explains how importers of aluminum extrusions conspired to create a sham enterprise to act as the importer of record for falsely described

---

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

<sup>12</sup> *Id.* App. C.

merchandise.<sup>13</sup> The creation of the shell company importer was spurred by the desire to insulate the actual purchasers from liability for the false declarations. As alleged in the complaint, an employee of a freight-forwarding company used to ship aluminum extrusions from a Chinese producer was allegedly asked by the shipping agent of the Chinese producer to create a shell/front company importer of record on shipments of aluminum extrusions that would be declared to be products of Malaysia.<sup>14</sup> Throughout its importing history, the shell/front company created was never the “owner, purchaser, or consignee of the aluminum extrusions . . . .”<sup>15</sup> Instead, the merchandise was shipped directly to the real customers upon entry into the United States and the employee of the logistics company was alleged to have received \$100 per import entry, each of which falsely declared the value and country of origin of the merchandise in order to evade duty payment.<sup>16</sup>

The allegations presented in the civil aluminum extrusions case mirror fact patterns in the criminal prosecutions of individuals involved in the evasion of antidumping duties owed on imports of Chinese honey. For instance, in the criminal prosecution of Hung Ta Fan for evasion of antidumping duties on Chinese honey through transshipment, a U.S. Immigration and Customs Enforcement (“ICE”) Special Agent explained that Mr. Fan “was the registered agent of multiple California-based honey import companies, including Blue Action Enterprise, Inc. (“Blue Action”); 7 Tiger Enterprises, Inc. (“7 Tiger”); Honey World Enterprise Inc. (“Honey World”); and Kashaka USA, Inc. (“Kashaka”) . . . .”<sup>17</sup> Mr. Fan used these companies “to act as registered importers of record to import and enter Chinese-origin honey into the United States.”<sup>18</sup> The creation of multiple shell/front companies was designed to avoid CBP scrutiny:

FAN also told ICE agents that he created Honey World on the advice of ALW United States Executive 2, who told FAN that a high volume of imports by a single company would be noticed by CBP. FAN also stated that he acted upon additional advice provided to

---

<sup>13</sup> United States’ Complaint in Intervention and Demand for Jury Trial, United States, *ex rel. Valenti v. Tai Shan Golden Gain Aluminum Products, Ltd.*, No. 3:11-cv-00368 (M.D. Fla. Nov. 14, 2013).

<sup>14</sup> *Id.* at 34-38.

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

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

<sup>17</sup> Declaration of U.S. Immigration and Customs Enforcement at 1, United States v. Fan, No. 10-CR-198 (N.D. Ill. Mar. 12, 2010).

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

him by an employee of the FAN Companies, who advised FAN that he should import into the United States using multiple companies to avoid added scrutiny and attention by CBP and that this advice was seconded by ALW Executives in at least one-in-person meeting with FAN.<sup>19</sup>

Similarly, in the criminal case against Katy Lin prosecuted three years later regarding more transshipped honey, the creation of shell/front companies to act as importers of record was again a central component of the fraud. Responding to the defendant's objection to the pre-sentencing report in a recent criminal case, the U.S. Attorney observed:

KBB Express Inc. was a freight forwarding company located in South El Monte, California that provided nationwide transportation, delivery, and other logistical services for imported and entered merchandise, including Chinese-origin honey. LIN owned and operated KBB Express Inc., and also served as the U.S. agent for at least twelve importers of record that were controlled by Chinese honey producers and manufacturers. These importers of record included Bright Step (United States) Limited; Sweet Campo Co., Ltd.; Migrow Trading Inc.; Chix Trading Inc.; Rouka International Inc.; Oliv Amber Trading Co., Ltd.; Titto International Inc.; Stariver Trading Inc.; Tobest Trading Co., Ltd.; Russa International Inc.; Sunny (USA) Trading Inc.; and Silver Spoon International Inc. As the U.S. agent for these companies, LIN handled the process of importing, and coordinated with customhouse brokers to enter and bring in, Chinese-origin honey into the United States without paying antidumping duties and honey assessment fees.<sup>20</sup>

Likewise, in the criminal case brought against Jun Yang for transshipped honey, the U.S. Attorney's sentencing position paper again noted the creation of shell company importers to effectuate the fraud:

---

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

<sup>20</sup> Government's Response to Defendant's Objection to the PSR at 4-6. United States v. Lin, No. 13-CR-125 (N.D. Ill. Sept. 25, 2013).

As part of the fraudulent practice, YANG ordered honey from Chinese honey suppliers, including “Chinese Transshipper A,” knowing that the Chinese honey suppliers would send Chinese-origin honey to countries of intermediate destination, including Malaysia and India, where the honey was mislabeled as to country of origin before the honey passed through a United States customhouse as non-Chinese-origin honey. YANG and National Commodities also (a) caused the formation of at least three companies, including CCM Foods, Inc.; Kota Imports, Inc.; and Madu Jaya Inc.; and used at least one other company, Wintex Group, Inc. (collectively the “companies”), to import and enter honey supplied by Chinese Transshipper A knowing that all or some of the honey was Chinese in origin; (b) benefitted from the companies filing CBP entry forms 3461 and 7501 that falsely and fraudulently declared all the honey as originating from Malaysia and India; (c) purchased honey imported by the companies despite knowing that some or all the honey was Chinese in origin, but declared at the time of importation and entry as entirely originating from Malaysia and India; and (d) wire transferred funds to the companies as payment for the purchase of honey that fraudulently entered the United States.<sup>21</sup>

Discussions of the difficulties faced by CBP in enforcement of antidumping and countervailing orders have tended to focus on the fact that the assessment of such duties is done on a retrospective basis.<sup>22</sup> As described in more detail below, parties seeking to evade trade relief may manipulate administrative processes to obtain the ability to import merchandise subject to antidumping/countervailing duties with minimal security deposited with CBP and abscond when full duty amounts are later calculated for those entries. However, the breed of circumvention schemes at issue in the cases discussed above is agnostic as to whether antidumping

---

<sup>21</sup> The Government’s Position Paper as to Sentencing Factors at 8–9. *United States v. Yang*, No. 13-CR-139 (N.D. Ill. Nov. 8, 2013).

<sup>22</sup> *See, e.g.*, U.S. Gov’t Accountability Office, GAO-08-391, *Antidumping and Countervailing Duties: Congress and Agencies Should Take Additional Steps to Reduce Substantial Shortfalls in Duty Collection 1–4* (Mar. 2008).

duties are retrospectively or prospectively assessed. In each case, the fraud is practiced upon CBP with false declarations asserting that the merchandise was not, in fact, subject to antidumping duties upon importation. A common thread in each of these duty evasion schemes is the construct and operation of shell/front companies acting as importers of record, each lacking any financial interest in the merchandise imported. These schemes thus depend upon parties acting in concert to evade the discipline of an antidumping or countervailing duty order. The shell/front companies only exist to facilitate transactions between willing sellers and willing buyers eager to complete transactions without the encumbrance of antidumping and/or countervailing duties.

Although “unscrupulous” shell/front company importers represent only one possible vehicle for circumventing antidumping duties, the coordinated nature of such schemes have significant consequences for the federal agencies charged with administering and enforcing the antidumping duty laws.

## **2. Manipulation of Commerce Proceedings to Obtain Favorable Cash Deposit Rates**

The comments of both Treasury and CBP indicate that the avoidance of duties is an engineered activity – one in which “unscrupulous” importers design or, at a minimum, participate in import transactions in order to evade the obligation to pay duty amounts owed to the U.S. Treasury. This particular breed of circumvention scheme is entirely contingent upon the involvement of the Department. As the same Treasury official explained in a 2008 letter to the U.S. Government Accountability Office (“GAO”):

We believe the second type of risk that you identified, that new shippers can take advantage of the current system, is more significant. As the report describes, new shippers “can purposefully make one commercial shipment to the United States at a relatively high price,” which can lead to a low or zero percent AD/CV duty rate being applied to subsequent shipments by that new shipper. If it is subsequently determined through administrative review that additional duties are to be retrospectively assessed on those shipments, a collection risk is created because the retrospectively assessed duties will not be secured (by bond, cash deposit, or other means). In sum, *an*

*unscrupulous new shipper can by design obtain a low AD/CV rate and then ship at that rate until additional duties are retroactively assessed through administrative review and then abscond when billed for retrospectively assessed duties.*<sup>23</sup>

Because the goal of the “unscrupulous” actors is to obtain a low or zero cash deposit rate the problem described is not exclusive to new shipper reviews. In some cases, because of the circumstances of a given antidumping duty order, an existing shipper can obtain these low or zero rates with a small number of shipments if that shipper can obtain an individual review or take advantage of low rates calculated for other companies that were individually reviewed.<sup>24</sup> Nevertheless, new shipper reviews are a convenient vehicle for such manipulation and invite “unscrupulous” actors to attempt to commit fraud upon the Department.

---

<sup>23</sup> U.S. Government Accountability Office, GAO-08-391, Antidumping and Countervailing Duties: Congress and Agencies Should Take Additional Steps to Reduce Substantial Shortfalls in Duty Collection, 63–64 (Mar. 2008) (emphasis added).

<sup>24</sup> Achieving a low cash deposit rate while continuing sales at far less than fair value does not always require manipulating Commerce’s processes. In market economy settings, an exporter who is dumping at substantial margins can respond to a high cash deposit rate calculated by the agency by recreating itself as a new entity and shipping under the rate applicable to exporters receiving the “all others” rate. Such is the fact pattern currently playing out with respect to the antidumping duty order on polyethylene retail carrier bags from Thailand, where the primary shipper in the last completed administrative review refused to participate in Commerce’s review under ludicrous circumstances. *See, e.g.*, Decision Memorandum for Preliminary Results of the 2011/12 Antidumping Duty Administrative Review: Polyethylene Retail Carrier Bags from Thailand at 3-7, 78 Fed. Reg. 28,192 (Dep’t of Commerce May 14, 2013). The same behavior has been adopted by the respondent selected in the current ongoing administrative review, Beyond Packaging. *See* Response to Request for Information, Case No. A-549-821 (Dec. 18, 2013), <https://iaaccess.trade.gov/public/searchresults.aspx?btn=qs>.

As the Department is by now well aware from the lengthy history of this antidumping order, the *modus operandi* of the primary Thai PRCB exporter has been to either avoid service of the questionnaire or otherwise not cooperate in reviews, and then continue exporting under a new name (at the low 4.69 percent all-others rate). This began with Zip-Pak and continued with King Pac, Master Packaging, Trinity Pac and, finally, Beyond Packaging. Given these circumstances, in the context of the eighth review of Trinity Pac, the Department took the appropriate step last year of serving the questionnaire on the directors of that exporter (when service could not be accomplished at the company’s official address).

In response to a Commerce request for additional information regarding Beyond Packaging, Petitioners recently submitted bills of lading information indicating that the shell/front company exporter acted as the consignee on its shipments with a notify party first registered as a corporate entity in the state of New York in March 2012. *See* Information re Importers, Case No. A-549-821 (Jan. 31, 2014).



**a. QHD Sanhai**

For example, in an earlier criminal prosecution regarding honey imports (United States v. Alfred W. Wolff GmbH) the criminal docket included information describing how a major honey distributor concocted a fraudulent scheme to present a fake new shipper to the Department in order to obtain a low cash deposit rate for Chinese honey shipments. Specifically, an affidavit from the ICE Special Agent responsible for the investigation explained how various actors conspired to create a false entity and fraudulent transactions to form the basis of a new shipper review:

40. In an email dated October 29, 2007, Liu (ALW Beijing) wrote Belten (ALW Hong Kong) and Giesselbach (ALW USA), with a copy to Alex Wolff (ALW Germany) and Von Buddenbrock (ALW USA), regarding an “internal memo\*\*\*” dealing with the charged conspiracy to defraud the Department of Commerce (the New Shipper aspect of the fraud), attached a sales contract between ALW Beijing and codefendant Gong Jie Chen (aka George Gao), and stated:

Dear all,

This is a fake sales confirmation from George Gao [defendant Gong Jie Chen]. He is to use this to show the DOC [Department of Commerce] that he has busy [sic: business] with Wolff [ALW Food Group] also for Germany besides, USA. I will make a stamp. And he can use this to show the US DOC officer. *See* Ex. 14.

41. In an email dated December 19, 2007, Belten (ALW Hong Kong) wrote to Giesselbach (ALW USA) and Von Buddenbrock (ALW USA) at their personal email accounts, with a copy to Alex Wolff (ALW Germany), Liu (ALW Beijing), and Marten (who had returned to Germany; ALW Germany), regarding the charged New Shipper fraud on the Department of Commerce and stated:

Now we really have to do some work and get prepared for the fight of the petitioners. Just talked to CGJ [defendant Gong Jie Chen] this morning. The chance that DOC will come to your office is not very high but since Sanhai [defendant QHD

Sanhai Honey] is the only new shipper case we should get prepared. Therefore please:

- clean up your documentation for the fist [sic: first] import
- clean up your email files regarding the sale of the bears (I remember there was some back and forth with refund to [USA Customer 8] and so on, there can be no trace of this discussion)
- please make sure that the [antidumping] duty and the DNs [debit notes] (discussed yesterday) are not booked as duty but as quality or some other claim, and it should not be related to QHD Sanhai Honey

CGJ (George) [defendant Gong Jie Chen] will send an email to you soon regarding another business (I believe that was discussed in Chicago already) similar the the [sic] first import. Since the preliminary rate is 0% now, they would really like to ship this container.

I keep the fingers crossed now and hope that the final rate will be zero as well!

Thanks for your good and hard work for this new shipper case. *See* Ex. 15.

42. In an email dated April 17, 2008, Von Buddenbrock (ALW USA) emailed a customs broker, with a copy to Giesselbach (ALW USA) and Alex Wolff (ALW Germany), stating “Alex, As per your instructions, I have issued a check and sent it via UPS to [the customs broker]” in furtherance of the charged New Shipper scheme. *See* Ex. 16. On that same day and related to the same shipment, Giesselbach (ALW USA) emailed Alex Wolff (ALW Germany), with a copy to Von Buddenbrock (ALW USA) and a customs broker, asking Alex Wolff (ALW Germany) to “confirm if PO [purchase order] 1159, Acacia Honey Bears shall be stored in a warehouse nearby (Minneapolis).” On April 18, 2008, Alex Wolff (ALW

Germany) responded to the foregoing email stating “yes, pls store it for the time being.” *See* Ex. 17.

43. In another email in furtherance of the charged New Shipper scheme dated May 13, 2008, Giesselbach (ALW USA) wrote to Alex Wolff (ALW Germany), with a copy to Von Buddenbrock (ALW USA), Belten (ALW Hong Kong), and Liu (ALW Beijing), stating “Alex, As instructed by you on the phone, I will be sending out [a CBP] entry summary report to [a lawyer representing defendant QHD Sanhai Honey] today.” *See* Ex. 18.<sup>25</sup>

The Department ultimately rescinded the new shipper review of QHD Sanhai, finding the proffered sale to not be “bona fide.”<sup>26</sup> In the course of the conduct of the new shipper review, representatives of the domestic honey industry questioned the validity of the commercial transaction, alleging that the “U.S. customer aided QHD Sanhai in fabricating the single sale under review to obtain a lower” antidumping duty deposit rate, and asserted that the U.S. customer behind the transaction had “a history of manipulating Commerce’s new shipper review process.”<sup>27</sup> In response, the purported new shipper asserted that the agency was not allowed to consider the business practices of the U.S. customer in its analysis:

QHD Sanhai argues that QHD Sanhai’s U.S. customer was an experienced importer of honey that understood the Department’s antidumping duty review process, and was willing to act as the importer of record. QHD Sanhai argues that QHD Sanhai’s U.S. customer during the POR acted in a commercially reasonable manner, and the any adverse inference by the Department based on QHD Sanhai’s U.S. customer’s business practices would be in direct contravention of U.S. law and U.S. international obligations.<sup>28</sup>

---

<sup>25</sup> Affidavit of Special Agent Matthew Gauder at 21–23, *United States v. Wolff*, No. 08-CR-417 (N.D. Ill. June 17, 2011).

<sup>26</sup> *See* *Honey from the People’s Republic of China*, 73 Fed. Reg. 42,321 (Dep’t of Commerce July 21, 2008) (final results).

<sup>27</sup> *See* *Issues and Decision Memorandum for the Honey from the People’s Republic of China*, 73 Fed. Reg. 42,321 (Dep’t of Commerce July 21, 2008) (final results).

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

The Department did not need to confront the issue because it found the single sale not to be *bona fide* on other grounds, explaining that “other speculative arguments raised by petitioners . . . do not need to be reached in this review.”<sup>29</sup>

#### b. Hejia

Although ALW’s QHD Sanhai new shipper gambit was unsuccessful, the benefits of successfully navigating the new shipper review process are enormous and create substantial incentives for parties to construct schemes to abuse Commerce’s administration of the dumping laws. An example of the potential rewards – and attendant risk to collection of antidumping duties – resulting from a zero cash deposit rate obtained through a new shipper review is provided in a recent lawsuit filed at the U.S. Court of International Trade (“CIT”) by a Chinese exporter of fresh garlic, Jinxiang Hejia Co., Ltd. (“Hejia”), and its importer, Yin Xin International Trading Company, Ltd. (“Yin Xin”), against CBP.<sup>30</sup> In October 2009, Hejia was assigned a cash deposit rate of 15.37 percent in the final results of a new shipper review regarding the antidumping duty order on fresh garlic from

---

<sup>29</sup> *Id.* QHD Sanhai appealed the determination to the U.S. Court of International Trade – even filing an opening brief challenging Commerce’s decision – but counsel ultimately withdrew from representation in the appeal prior to filing a reply to the Government’s response. Motion for Leave to Withdraw as Counsel at 1–2, QHD Sanhai Co., Ltd. v. United States, No. 08-257 (Ct. Int’l Trade Apr. 21, 2009). The Court opined:

Since retention as counsel by Sanhai and following the filing by GDLSK of its case brief currently on the record before this Court, counsel was contacted by the U.S. Attorney’s office, Northern District of Illinois. The U.S. Attorney’s office advised that the U.S. Attorney and the Department of Homeland Security, Immigration and Customs Enforcement were investigating Sanhai and Mr. Gao Jie (George), the sales manager of Sanhai, for potential illegal conduct in the New Shipper Review on honey; the very same review is the subject of this civil action. Based upon advice from Andrew Boutros, the Assistant U.S. Attorney involved in the investigation, we have been requested to be witnesses in their investigation. Although we are not in a position to determine whether U.S. Attorney’s claims of illegal conduct by QHD Sanhai and/or Mr. Gao are accurate, on April 13, 2009, we advised QHD Sanhai and Mr. Gao that due to a wide range of potential conflicts, we could no longer act as counsel in the pending lawsuit given the possibility that we would be called as witnesses in connection with a criminal prosecution of the company and/or Mr. Gao. In our letter, we advised the company of its options to either abandon the lawsuit or to obtain alternate counsel to represent its interests in the litigation. We specifically advised Sanhai and Mr. Gao that due to the obvious conflict inherent in our continued representation of Sanhai in this litigation and the fact that we would likely be called as witnesses in a criminal prosecution of the company and Mr. Gao, we could no longer act as Sanhai’s counsel. In addition, we noted that Sanhai had failed to remit payment of legal fees owed in connection with the new shipper review.

<sup>30</sup> Complaint at 3, Yin Xin Int’l Trading Co. v. United States, No. 13-392 (Ct. Int’l Trade Dec. 6, 2013).

China.<sup>31</sup> Hejia challenged this final cash deposit rate through an appeal to the CIT; the suit eventually led to a redetermination of the cash deposit rate establishing a zero cash deposit rate that became effective in June 2012.<sup>32</sup>

A review of bills of lading data indicate that other than the single sale of garlic made by Hejia in 2008 that formed the basis for its new shipper review, the company made no other shipments to the U.S. market until after receipt of the zero cash deposit rate. Once the zero cash deposit rate was awarded, bills of lading indicate that Hejia began to ship large volumes of fresh garlic to the United States in November 2012. Because the administrative period of review (“POR”) for the antidumping duty order on fresh garlic from China runs from November 1 through October 31,<sup>33</sup> the delay in shipments from when the zero cash deposit rate became effective (June 2012) until November 2012 pushed off the first possible administrative review of subject merchandise exported by Hejia.<sup>34</sup> Had any shipments been made in July, August, September, or October 2012, these would have been subject to an administrative review initiated a year earlier.<sup>35</sup>

In November 2012, Hejia began shipping fresh garlic to Yin Xin – a company described by the DOJ as “a non-resident importer whose physical address is in China [and] has no known assets or operations in the United States or in China.”<sup>36</sup> However, beginning in October 2013, CBP began to

---

<sup>31</sup> See Fresh Garlic from the People’s Republic of China, 74 Fed. Reg. 50,952, 50,954 (Dep’t of Commerce Oct. 2, 2009) (final results).

<sup>32</sup> See Fresh Garlic from the People’s Republic of China, 77 Fed. Reg. 38,583 (Dep’t of Commerce June 28, 2012) (notice of decision and final results).

<sup>33</sup> See Fresh Garlic from the People’s Republic of China, 78 Fed. Reg. 77,653 (Dep’t of Commerce Dec. 24, 2013) (preliminary results).

<sup>34</sup> See Initiation of Antidumping and Countervailing Duty Administrative Reviews and Request for Revocation in Part, 78 Fed. Reg. 79,392, 79,395 (Dep’t of Commerce Dec. 30, 2013) (noting shipments made in November 2012 are subject to the administrative review initiated by Commerce on December 30, 2013).

<sup>35</sup> See Initiation of Antidumping and Countervailing Duty Administrative Reviews and Request for Revocation in Part, 77 Fed. Reg. 77,017, 77,021 (Dep’t of Commerce Dec. 31, 2012) (assigning Hejia a \$4.71 per kilogram cash deposit rate). Fresh Garlic from the People’s Republic of China, 78 Fed. Reg. 77,653, App. II (Dep’t of Commerce Dec. 24, 2013) (preliminary results and partial rescission). However, Hejia recently filed a letter with Commerce arguing that the agency had improperly failed to consider the “no shipment” certification filed by the company in January 2013 and that Hejia should not have been subject to this administrative review. See Letter from deKieffer & Horgan, PLLC to the U.S. Department of Commerce, Case No. A-570-831 (Dec. 20, 2013).

<sup>36</sup> Picard, Kentz & Rowe LLP, *Circumvention of AD/CVD Orders – What Is and What Is Not Circumvention, and Enforcement Against It* 18 [www.pkrllp.com/docs/KentzTradeUpdatePaper.pdf](http://www.pkrllp.com/docs/KentzTradeUpdatePaper.pdf) (last visited Sept. 16, 2014) (citing U.S. Dep’t of Justice, Memorandum in Support of Defendant’s Opposition to Plaintiffs’ Application for Temporary Restraining Order and Motion for Preliminary Injunction and In

examine Hejia's shipments of fresh garlic to Yin Xin.<sup>37</sup> Reviewing sales documents accompanying these entries, CBP learned that the sales were to another party "in care of Yin Xin and, therefore, questioned whether Yin Xin has any financial interest in the garlic it is attempting to enter."<sup>38</sup> CBP also questioned whether Hejia was, in fact, the producer of the fresh garlic shipments – a requirement for eligibility for the zero cash deposit rate obtained in the new shipper review.<sup>39</sup> The agency thereafter placed a requirement for single-transaction bonds ("STB") on Yin Xin's entries while the investigation was pending,<sup>40</sup> leading Hejia and Yin Xin to bring suit at the CIT challenging CBP's authority to impose a requirement for STBs on Hejia's shipments. Although significant portions of the Government's response to Hejia and Yin Xin was redacted on the public record, the DOJ's filing made clear that CBP suspected that Hejia's and Yin Xin's transactions were a further part of schemes that had already led to millions of dollars in uncollected antidumping duties:

Furthermore, [ ] is an established debtor to the United States with a troubling U.S. importation history. [ ] made hundreds of entries of Chinese garlic subject to antidumping duties between [ ] and [ ], for which more than 250 unpaid bills for additional duties remain outstanding today, totaling more than \$12 million . . . Also, [ ] at one time had received a separate antidumping duty rate as low as [ ] percent on its garlic imports but by [ ] Commerce determined that JDF should be subject to the PRC-wide rate of 376.67 percent. *Compare* 71 Fed. Reg. 26,329-01 (showing that [ ] received a [ ] antidumping duty rate) *with* 75 Fed. Reg. 34,976-02 (showing that [ ] rate was changed to the PRC-wide rate). After recognizing that [ ] "official invoices" were being presented to CBP as evidence of Hejia's garlic purchases, CBP questioned

---

Support of Defendant's Request for Security for Entries Covered by the Temporary Restraining Order Entered by the Court on December 16, 2013, *Yin Xin Int'l Trading Co. v. United States*, No. 13-00392 (Ct. Int'l Trade Dec. 23, 2013)).

<sup>37</sup> *Id.*

<sup>38</sup> *Id.*

<sup>39</sup> *Id.* at 5.

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

the authenticity of the purchase orders and further questions Yin Xin's lawful interest in the garlic.<sup>41</sup>

Hejia and Yin Xin ultimately dismissed the lawsuit,<sup>42</sup> but not before the CIT reversed its initial grant of a temporary restraining order ("TRO"): "After reviewing Defendant's response, it is apparent that the Court improvidently granted Plaintiffs' Application for a TRO."<sup>43</sup> The Court further made note of the comprehensive evidence compiled by CBP, as summarized by the DOJ, in support of the STB requirement and the questionable nature of the documents submitted in support of a TRO:

As to Plaintiffs' claim of irreparable harm, Defendant raises equally troubling concerns. First, if Hejia is not the producer of the subject garlic imports, then the purported harm to Plaintiffs flows not from Customs' decision on enhanced bonding, but from Commerce's decision that the PRC-wide rate applies to these imports. Second, Defendant challenges the declarations submitted from Lin Xin Hui, General Manager of Hejia, in that those declarations do not describe the relationship between Hejia and Yin Xin and do not reflect personal knowledge of any harm that will flow to Yin Xin from Customs' enhanced bonding requirement. Lastly, Defendant points out that Mr. Hui's declarations appear internally inconsistent, thereby calling into question his credibility.<sup>44</sup>

Further, the CIT summarized the significant risk to revenue posed by the Hejia-Yin Xin shipments of fresh garlic:

The moment prior to entry represents the only time that Customs can require additional security to protect the revenue. If Yin Xin is permitted to enter the subject imports into the United States without posting the additional security, substantial revenue may be unsecured and at risk of loss if Yin Xin defaults on the

---

<sup>41</sup> *Id.* at 10-11.

<sup>42</sup> *See* "Notice of Dismissal," Form 7A, Yin Xin Int'l Trading Co. Ltd. v. United States, No. 13-392 (Ct. Int'l Trade Dec. 27, 2013).

<sup>43</sup> *See* "Memorandum and Order," Yin Xin Int'l Trading Co. Ltd. v. United States, No. 13-392, at 2 (Ct. Int'l Trade Dec. 23, 2013).

<sup>44</sup> *Id.* at 3.

amounts owed. Absent additional security, if liquidation results in a debt to the United States, Customs will have to commence a collection action against Yin Xin to recover the unpaid duties. Yin Xin is a non-resident importer with no business address in the United States, has no known assets or operations in the United States or China, and is an entity with questionable financial standing.<sup>45</sup>

The CIT's comments accurately reflect the challenge faced by CBP in collecting any increased assessed antidumping duties on Yin Xin's entries of Hejia's fresh garlic between November 2012 and October 2013. For these entries, the potential amounts due are largely unsecured by virtue of the zero percent cash deposit rate obtained by Hejia in the new shipper review and subsequent court challenge to that review's final results. As the Court also notes, Yin Xin, the importer of record – a non-resident shell/front company importer – is an entity of questionable financial standing. Accordingly, Yin Xin fits the mold of the Treasury's concern of a company that will import substantial quantities of merchandise and then "abscond" when antidumping duty payment obligations come due. While the DOJ's response to Hejia and Yin Xin alleges some connection between Hejia's shipments and uncollected assessed antidumping duties on fresh garlic owed by another party, there is no apparent evidence of fraud or allegation of fraud in the construct of Hejia's new shipper review.

However, there is evidence that the strategy underlying Hejia's effort to obtain a low cash deposit rate as a vehicle for shipping large quantities of Chinese fresh garlic is part of a larger, repetitive effort to obtain low or zero cash deposit rates for multiple foreign exporter entities as new shippers. Specifically, in November 2009 (shortly after the publication of the final results of Hejia's new shipper review), Commerce received requests for new shipper reviews from two companies, one of which was named Jinxinag Yuanxin Imp. & Exp. Co., Ltd. ("Yuanxin").<sup>46</sup> In April 2011, the Department rescinded the new shipper review for Yuanxin finding that the company's sales were not "bona fide" and, as such, Yuanxin had failed to qualify for a new shipper review.<sup>47</sup> The reasons for Commerce's conclusion were largely based on the business' proprietary information and not

---

<sup>45</sup> *Id.* at 4.

<sup>46</sup> *See* Fresh Garlic from the People's Republic of China, 75 Fed. Reg. 343-44 (Dep't of Commerce Jan. 5, 2010) (initiation of review).

<sup>47</sup> *See* Fresh Garlic from the People's Republic of China, 76 Fed. Reg. 19,322, 19,324 (Dep't of Commerce Apr. 7, 2011) (rescission of reviews).



disclosed publicly.<sup>48</sup> Yuanxin unsuccessfully appealed the rescission to the CIT and the Court's opinion provided additional details on the unusual circumstances of Yuanxin's sale, noting that the wholesaler involved had previously acted as the purchaser for the single sale of fresh garlic that formed the basis for Hejia's new shipper review:

Thus, the peculiar circumstances presented here could be considered by Commerce in its totality of the circumstances analysis, and it was not unreasonable for Commerce to find that the sales arrangement involved here was atypical. Indeed, Yuanxin does not attempt to explain why a sporting goods manufacturer acted as a middleman for its sale to the Wholesaler, a company that had previously purchased single-clove garlic directly from Hejia.<sup>49</sup>

Thus, Hejia and Yuanxin could be connected through a common wholesaler and, on the record of the new shipper review, Yuanxin had made no effort to explain the convoluted structure of the transaction. Further, in the Hejia new shipper review, representatives of the domestic garlic industry had questioned the validity of the purchaser of Hejia's single sale of single-clove garlic that had formed the basis for that new shipper review:

Petitioners argue that the behavior of Hejia's U.S. customer is indicative of the non-bona fide nature of the sale. Petitioners point out that Hejia's customer did not purchase any garlic from other companies either during or subsequent to the POR of this NSR. . . . Petitioners argue that this is indicative of the fact that the U.S. customer's purchase of single-clove garlic was atypical. Petitioners also contend that Hejia's U.S. customer could not have made a profit from its re-sale of the garlic since the U.S. customer had to pay antidumping duties on its initial purchase. Petitioners argue that it is unlikely for a first-time purchaser to assume the risk of having to pay antidumping duties even if it were possible for the purchaser to be refunded the antidumping duties at a

---

<sup>48</sup> *Id.* (“Significant portions of the issues involved in Yuanxin’s bona fides include BPI. Therefore, we have addressed all of the arguments in a separate memorandum as part of our full bona fides analysis.”).

<sup>49</sup> *Jinxiang Yuanxin Imp. & Exp. Co. v. United States*, No. 11-00145, slip op. at 24 (Ct. Int’l Trade June 18, 2013).

later date. Based on the aforementioned points, Petitioners conclude that it is not possible for Hejia's U.S. customer to make a profit from the re-sale of the single-clove garlic it purchased and thus the transaction with Hejia is not bona fide.<sup>50</sup>

The Department rejected the argument, finding the single sale *bona fide* and taking no issues with the U.S. customer: "Finally, we note that information on the record also indicates that Hejia sold the single clove garlic at issue to an unaffiliated U.S. importer who resold it [at] a profit."<sup>51</sup>

Whatever the merits of Hejia's and Yuanxin's request for a new shipper review or the authenticity of these companies' claims, the record materials made public in Hejia's and Yin Xin's suit against CBP make clear that the concerns voiced by the domestic garlic industry in opposition to Hejia's new shipper review have come to fruition.<sup>52</sup> Moreover, CBP's allegations regarding the nature of Hejia's fresh garlic shipments to Yin Xin necessarily raise additional questions regarding the veracity of claims made to the agency in the initial new shipper review proceeding.

There exists, however, no formal mechanism through which the Department would further review the representations made by Hejia to the agency in prior proceedings. While CBP endeavors to protect the revenue against substantial potential duty liability, Hejia maintains its zero percent cash deposit rate.

At the same time, the ramifications of the fact pattern presented by Hejia extend beyond just those shipments and the circumstances of the garlic antidumping duty order indicate that the lack of a formal mechanism (or established, consistent practice) to address potential fraud results in substantial drains on Commerce's resources regardless. The Department continues to receive requests for the initiation of new shipper reviews for additional Chinese garlic exporters.<sup>53</sup> Subsequent new shipper reviews

---

<sup>50</sup> Issues and Decision Memorandum accompanying Fresh Garlic from the People's Republic of China, 74 Fed. Reg. 50,952 (Dep't of Commerce Oct. 2, 2009) (Final Results), at 2-3.

<sup>51</sup> *Id.* at 5.

<sup>52</sup> *Id.* at 2 ("Petitioners conclude that Hejia is seeking to obtain a cash deposit rate based on its sale of single-clove garlic in order to sell the more common multi-clove garlic in the United States.")

<sup>53</sup> *See, e.g.*, Fresh Garlic from the People's Republic of China, 78 Fed. Reg. 129, 40,428 (Dep't of Commerce July 5, 2013) (initiation of review); Fresh Garlic from the People's Republic of China, 78 Fed. Reg. 88 (Dep't of Commerce Jan. 2, 2013) (initiation antidumping new shipper review).

conducted by the agency related to fresh garlic have continued to raise troubling questions regarding representations made by the parties seeking new cash deposit rates. For example, new shipper reviews initiated in January 2012<sup>54</sup> ultimately resulted in the rescission of those reviews.<sup>55</sup> The Department found that record evidence indicated that one of the purported new shippers, Maycarrier, was related to an existing Chinese shipper of fresh garlic to the United States.<sup>56</sup> For the other company subject to the new shipper review, Fuyi, Commerce found that the two sales proffered were not *bona fide* while questioning the veracity of Fuyi's representations: "Furthermore, Fuyi has not sufficiently addressed the other concerns, as discussed below, which leads us to question whether Fuyi has been entirely forthcoming in its responses to the Department."<sup>57</sup>

Under the current structure of antidumping duty administration and enforcement, substantial incentives exist for parties to seek low or zero percent cash deposit rates through artifice. The consequences of failure to achieve such a result appear to be limited only to the liquidation of the one or few number of shipments that provided the basis for the new shipper or administrative review. At the same time, if a party successfully obtains a low or zero percent cash deposit rate from the Department, there appears to be no formal mechanism preparing CBP for the risk to revenue – the difference between the ultimate assessed duties and the amount deposited at the time of entry – potentially presented by the exporter. This risk is exacerbated if front/shell company importers are used for the import transactions after a favorable cash deposit rate is obtained. The Hejia fact pattern presents circumstances wherein the sale that formed the basis for obtaining a favorable cash deposit rate appears not to have been representative of the exporter's commercial behavior. Unfortunately, the lag time between when the favorable cash deposit rate is obtained and when that cash deposit rate may be reset creates opportunities for parties to undertake activities that are likely to result in the evasion of payment of large amounts of antidumping duties. Moreover, when numerous issues *with the same parties* appear repeatedly in Commerce proceedings, there appears to be no formal mechanism by which CBP is informed of the heightened risk posed by these actors.

---

<sup>54</sup> Fresh Garlic from the People's Republic of China, 77 Fed. Reg. 2, 266 (Dep't of Commerce Jan. 4, 2012) (initiation of review).

<sup>55</sup> See Fresh Garlic from the People's Republic of China, 78 Fed. Reg. 58, 18,316 (Dep't of Commerce Mar. 26, 2013) (final rescission of review).

<sup>56</sup> See *id.*, accompanying Issues and Decision Memorandum at 4.

<sup>57</sup> *Id.* at 14.

### **B. Fraud and the Evasion of Antidumping and Countervailing Duties**

The nature of schemes to circumvent antidumping and countervailing duty orders through manipulation of cash deposit rates lends itself to quantification. In these circumstances, the Department issues liquidation instructions to CBP to assess definitive amounts of duties and the disappearance/dissolution of front/shell company importers in anticipation of such assessment leaves open bills that must be accounted for. Other circumvention schemes are not so easily quantified. Explaining the various forms of circumvention tactics employed by bad actors, the GAO explained that the nature of the activities made it difficult to estimate the amount of duties evaded by such schemes:

Importers that seek to avoid paying appropriate AD/CV duties may attempt to evade them by using a variety of techniques. These techniques include illegal transshipment to disguise a product's true country of origin, undervaluation to falsify the price of an import to reduce the amount of AD/CV duties owed, and misclassification of merchandise such that it falls outside the scope of an AD/CV duty order, among others . . . . According to CBP, importers sometimes use more than one evasion method at a time to further disguise the fact that they are importing goods subject to AD/CV duties. Because the techniques used to evade AD/CV duties are clandestine, the amount of revenue lost as a result is unknown.<sup>58</sup>

Thus, unlike manipulation of cash deposit rates, evasion of antidumping and countervailing duties through other methods only result in assessed and uncollected duties when enforcement actions are taken by CBP. Nevertheless, the enforcement activities undertaken by CBP have been significant:

From fiscal years 2007 to 2011, CBP assessed 252 civil penalties totaling about \$208 million against 237 importers that evaded AD/CV duties. Over the same

---

<sup>58</sup> U.S. Gov't Accountability Office, GAO-12-551, Antidumping and Countervailing Duties: Management Enhancements Needed to Improve Efforts to Detect and Deter Duty Evasion 6 (2012) (citation and footnote omitted).

period, CBP also made 33 seizures related to AD/CV duty evasion, with a total domestic value of nearly \$4 million. In instances where CBP suspects that criminal laws may have been violated, it can refer cases to ICE for criminal investigation. Between fiscal years 2007 and 2011, ICE investigations of AD/CV duty evasion led to 28 criminal arrests, 85 indictments, and 37 criminal convictions.<sup>59</sup>

With misclassification and transshipment schemes, the importer makes fraudulent statements to CBP upon entry. This fraud, however, also impacts Commerce's ability to administer the antidumping and countervailing duty laws by falsely concealing subject merchandise that would otherwise be lawfully subject to administrative reviews.

## II. COMMERCE'S EVOLVING PRACTICE ON CIRCUMVENTION

The substantial amount of assessed antidumping duties uncollected by virtue of "unscrupulous" importers and the increasing number of criminal prosecutions and civil actions involving unlawful evasion of antidumping duties demonstrate the prevalence of circumvention of antidumping and countervailing duty orders. However, in response to evidence of fraud in some Commerce antidumping proceedings, the agency has in the past exercised discretion to limit its responsibility for investigating allegations of certain types of circumvention. For example, in an administrative review of the antidumping duty order on activated carbon from China, the Department, although recognizing that it had the authority to make inquiries regarding allegations of transshipment to evade antidumping duty orders, declined to act upon evidence of transshipment in the context of that review:

At this time, the Department continues to find that although the Department does have the authority to investigate allegations of transshipment within the context of an administrative review, we have determined that an administrative review is not the best context for addressing the type of allegations that Petitioners have brought to the Department. Specifically, we continue to find, as we did in the Globe Metallurgical remand, that evaluating and verifying additional information relating to a

---

<sup>59</sup> *Id.* at 11 (footnotes omitted).

circumvention allegation creates an overwhelming burden in an administrative review. Therefore, as previously stated, *it is the Department's practice that where a party has placed evidence on the record of an administrative review to support allegations of transshipment involving third-country processing, a scope or anti-circumvention inquiry is the proper venue and we will not consider it within the context of an administrative review.* Furthermore, where the allegation concerns transshipment that does not involve third-country processing, such an allegation should be directed to CBP, which is the proper authority to investigate claims of mislabeling country-of-origin.<sup>60</sup>

While limited to allegations of transshipment, this language likely reflects concerns regarding the potential quagmire and resulting drain on agency resources if the Department were to actively investigate allegations of fraud under available authority within agency proceedings.

This position is not tenable in the long-term. The practical reality of Commerce's proceedings is that the agency will be repeatedly and consistently confronted with fact patterns that imply transshipment or some other variant of import fraud. The Department cannot rely only on CBP investigation in these instances because, as the CAFC observed in December, limiting Commerce's authority to investigate such fraud:

would permit importers to potentially avoid paying antidumping duties on past imports by asserting unmeritorious claims that their products fall outside the scope of the original order. Importers cannot circumvent antidumping orders by contending that their products are outside the scope of existing orders when such orders are clear as to their scope.<sup>61</sup>

Fortunately, Commerce's more recent practice has been to creatively find ways to address circumvention through a variety of tools. Indeed, while administrative review procedures do not specifically provide for the investigation of claims related to the circumvention, the nature of the

---

<sup>60</sup> Certain Activated Carbon from the People's Republic of China, 76 Fed. Reg. 83, 23,978, 23,980 (Dep't of Commerce Apr. 29, 2011) (prelim. results) (emphasis added).

<sup>61</sup> AMS Assocs., Inc. v. United States, 737 F.3d 1338, 1344 (Fed. Cir. 2013).

activities that facilitate the circumvention requires respondents to make false representations to the agency in these proceedings. Such false representations should be treated no differently than false claims made in response to conventional inquiries in antidumping and countervailing duty administrative reviews. In fact, Commerce's experience in investigating transshipment claims in the context of administrative reviews of the antidumping duty order on shrimp from China demonstrates the agency's capacity to meaningfully address circumvention while simultaneously protecting the integrity of its proceedings against fraud.

#### A. Tissue Paper and Globe Metallurgical

For those advocating for a limited Commerce role in investigating fraud and circumvention, the agency's language in a remand redetermination related to an antidumping administrative review of silicon metal from China provides comfort. In that redetermination, upheld by the CIT in *Globe Metallurgical*,<sup>62</sup> Commerce disparaged the utility of investigating transshipment allegations in the context of an administrative review:

In accordance with the Court's instructions, and after careful examination of the record and comments received from petitioner, the Department explained further its decision to rescind the review with respect to Ferro-Alliages in the *Draft Remand Results*. . . . The Department clarified that it does not intend to follow *Tissue Paper* for several reasons, including certain reasons identified in the Remand Order, such as the time constraints imposed by administrative reviews. The Department explained in the Draft Remand that its experience in *Tissue Paper* demonstrates that administrative reviews are an inadequate venue to investigate country-of-origin claims. The Department declines to follow *Tissue Paper* here because the Department does not intend to establish a practice of investigating circumvention/transshipment claims in administrative reviews. . . .

Moreover, upon reexamination of the record, we have determined the Department's statement in the *Final*

---

<sup>62</sup> *Globe Metallurgical Inc. v. United States*, 722 F. Supp. 2d 1372, 1382 (Ct. Int'l Trade 2010).

*Results* that no evidence existed on the record of the review with respect to circumvention/transshipment to be in error. We acknowledge that petitioner had placed some evidence on the record to support its allegations with respect to Ferro-Alliages. However, after further examination of our practice and statutory authority and framework, we find that *the issue of whether, and how, to address allegations that subject merchandise has been exported to the United States through a third-country is primarily a procedural question.* In that regard, *the Department has concluded that the proper venue and procedural framework to conduct inquiries regarding transshipment involving third-country processing are those providing for scope and circumvention inquiries,* as further discussed below.<sup>63</sup>

The *Tissue Paper* determination referenced by the agency related to the first administrative review of the antidumping duty order on certain tissue paper products from China. In that proceeding, the Department investigated claims made by Petitioner that an Indonesian shipper, the Sanisco Group, was shipping subject merchandise falsely claimed to be product of Indonesia.<sup>64</sup> Following investigation, the Department rejected Petitioner's claims, noting that the Sanisco Group's position "[had] consistently been that it had no shipments of subject merchandise to the United States during the POR."<sup>65</sup> Although the Department conducted a verification of the Sanisco Group's responses to the agency's inquiries, the Sanisco Group's supplier refused to allow the agency to conduct a full verification of its facility.<sup>66</sup> The Department declined to hold this refusal against the Sanisco Group and criticized the presentation of transshipment allegations in the context of an administrative review:

In addition, we also note that this inquiry was conducted pursuant to an administrative review, under

---

<sup>63</sup> U.S. Dep't of Commerce, Final Results of Redetermination Pursuant to Court Remand of *Globe Metallurgical Inc. v. United States*, No. 08-290, 7-8 (2010)(emphases added) (citations omitted); *see* Order, *Globe Metallurgical Inc. v. United States*, No. 08-290 (Ct. Int'l Trade Dec. 18, 2009).

<sup>64</sup> Issues and Decision Memorandum (cmt. 3) accompanying *Certain Tissue Paper Products from the People's Republic of China*, 72 Fed. Reg. 58,642 (Dep' of Commerce Oct. 16, 2007) (final results).

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

<sup>66</sup> *Id.*



Section 751(a)(2)(A) of the Act and not pursuant to a claim of circumvention, under Section 781 of the Act. Had petitioner requested a circumvention inquiry, and had the Department been denied access to supplier A's review-period books and records during the conduct of the circumvention inquiry, the Department would have had the authority to apply adverse facts available to the Sansico Group's supplier A sales, pursuant to sections 776(a) and (b) of the Act.<sup>67</sup>

Commerce's position in *Globe Metallurgical* was therefore premised on the agency's failure to substantiate transshipment allegations in the first administrative review of the antidumping duty order on tissue paper from China. However, subsequent developments with respect to the tissue paper antidumping duty order belie the agency's previous position regarding the "procedural" nature of transshipment investigations. Indeed, subsequent Commerce determinations specifically contemplate that the agency will make determinations regarding the appropriate country of origin of tissue paper imports in the context of administrative reviews.

### 1. Quijiang

By the time Commerce had issued its determination in the first administrative review of the antidumping duty order on Chinese tissue paper, Petitioner had already filed a request for the initiation of an anti-circumvention inquiry of Vietnam Quijiang Paper Co., Ltd. ("Quijiang") in July 2006.<sup>68</sup> After initiating a proceeding under 19 U.S.C. § 1677j(b) in September 2006,<sup>69</sup> the Department eventually returned a final affirmative determination that Quijiang was circumventing the antidumping duty order over two years later, in October 2008.<sup>70</sup>

Although the Department made an affirmative circumvention determination, the agency declined Petitioner's request to make all of Quijiang's entries subject to a cash deposit rate with liquidation suspended on each.<sup>71</sup> Commerce declared: "The Department's statutory authority is

---

<sup>67</sup> *Id.*

<sup>68</sup> Certain Tissue Paper Products from the People's Republic of China, 71 Fed. Reg. 53,662 (Dep't of Commerce Sept. 12, 2006) (notice of initiation).

<sup>69</sup> *Id.*

<sup>70</sup> Certain Tissue Paper Products from the People's Republic of China, 73 Fed. Reg. 57,591 (Dep't of Commerce Oct. 3, 2008) (final determination).

<sup>71</sup> *Id.*

not as sweeping as portrayed by the Petitioner.”<sup>72</sup> At the same time, the Department emphasized its authority to address *all* forms of circumvention of antidumping and countervailing duty orders:

We do agree with Petitioner that the Department has discretion to administer the law in a manner that prevents evasion of the order.<sup>73</sup>

As the Federal Circuit articulated in Tung Mung, “The ITA has been vested with authority to administer the antidumping laws in accordance with the legislative intent. To this end, the ITA has (a) certain amount of discretion (to act) . . . with the purpose in mind of preventing the intentional evasion or circumvention of the antidumping duty law.”<sup>74</sup>

Indeed, without such authority, the Department, despite being the administrative agency designated with the responsibility of enforcing the antidumping law, would be forced to accept information it knew to be false or inappropriate, and review sales which it knew were the result of potentially illegal or inappropriate arrangements.<sup>75</sup>

It is a staple of federal administrative law that the “inherent power of an administrative agency to protect the integrity of its own proceedings” is without question.<sup>76</sup>

---

<sup>72</sup> *Id.*

<sup>73</sup> *Id.* (citing Tung Mung Dev't v. United States, 219 F. Supp. 2d 1333, 1343 (Ct. Int'l Trade 2002) (upholding Commerce's application of middleman dumping, although such an application does not appear in the statute or in Commerce's regulations), *aff'd* Tung Mung v. United States, 354 F. 3d 1371 (Fed. Cir. 2004)).

<sup>74</sup> *Id.* (citing Mitsubishi Elec. Corp. v. United States, 700 F. Supp. 538, 555 (1988), *aff'd* 898 F. 2d 1577 (Fed. Cir. 1990) (finding Commerce's scope ruling to be supported by substantial evidence on the record)).

<sup>75</sup> *Id.* (citing Queen's Flowers De Colombia v. United States, 981 F. Supp. 617, 621 (Ct. Int'l Trade 1997) (determining that Commerce's decision to define the term “company” to include several closely related companies was a permissible application of the statute, given its “responsibility to prevent circumvention of the antidumping law.”); Hontex Enter., Inc. v. United States, 248 F. Supp. 1323, 1343 (Ct. Int'l Trade 2003) (finding that Commerce's decision to increase the scope of its analysis to include NME exporters was reasonable in light of its “responsibility to prevent circumvention of the antidumping law”)).

<sup>76</sup> Affirmative Final Determination of Circumvention of Antidumping Duty Order, *supra* note 70, at 57,591 (citing Alberta Gas Chems. Ltd. v. United States, 650 F. 2d 9 (2nd Cir. 1981)).

In the context of this circumvention finding, the Department determined that the implementation of a certification program – by which Quijiang would be required to certify the non-Chinese origin of the jumbo rolls used to produce the tissue paper shipped – was the appropriate remedy.<sup>77</sup> In response to Petitioner’s criticism of a certification program, the agency held that in the context of a certification program it was Commerce’s, not CBP’s, responsibility to determine whether the country of origin of the merchandise had been accurately declared *in an administrative review*:

Lastly, we find that Petitioner’s understanding of the role that CBP and the Department play in determining the accuracy of country-of-origin declarations pursuant to a certification program is inaccurate. It is the Department, not CBP, which determines, via the administrative review process, whether an exporter’s country-of-origin certifications are factually correct.<sup>78</sup>

Shortly before the publication of the preliminary affirmative finding of circumvention regarding Quijiang,<sup>79</sup> Petitioner filed an administrative review request regarding Quijiang’s entries between March 2007 and February 2008.<sup>80</sup> The Department exercised its discretion to expand the POR for Quijiang back to September 5, 2006, to encompass the company’s entries that were subject to the ongoing anti-circumvention inquiry.<sup>81</sup> In response, Quijiang refused to answer the agency’s questionnaires or requests for information, reporting that it had closed its factory in Vietnam.<sup>82</sup> In the final results of the administrative review, Quijiang became subject to the China-wide antidumping duty cash deposit rate (112.64%)<sup>83</sup> without the Department having to make any determination regarding the factual accuracy of country-of-origin claims made by the company in the context of an administrative review.

---

<sup>77</sup> *Id.* at 57,593.

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

<sup>79</sup> Certain Tissue Paper Products from the People’s Republic of China, 73 Fed. Reg. 21,580 (Dep’t of Commerce Apr. 22, 2008) (preliminary determination).

<sup>80</sup> Certain Tissue Paper Products from the People’s Republic of China, 74 Fed. Reg. 15,449, 15,450 (Dep’t of Commerce Apr. 6, 2009) (prelim. admin. review).

<sup>81</sup> *Id.* at 15,450 n.7.

<sup>82</sup> *Id.* at 15,452.

<sup>83</sup> Certain Tissue Paper Products from the People’s Republic of China, 74 Fed. Reg. 52,176, 52,177 (Dep’t of Commerce Oct. 9, 2009) (final admin. review).

## 2. Sunlake Décor

Shortly before the publication of the final affirmative circumvention finding regarding Quijiang, Petitioner filed a request for the initiation of an anti-circumvention inquiry of a Thai company, Sunlake Décor Co., Ltd. (“Sunlake”) in September 2008.<sup>84</sup> Once the proceeding began, Sunlake objected to the substance of Commerce’s questions, insisting that it would not answer any inquiries about past activities.<sup>85</sup> Based on its refusal to participate, the Department made an affirmative circumvention finding and ordered that all of Sunlake’s entries be subject to the China-wide antidumping duty cash deposit rate (112.64%).<sup>86</sup>

## 3. Max Fortune

In the fourth administrative review of the antidumping duty order on tissue paper from China, initiated in April 2009,<sup>87</sup> Petitioner submitted information to the Department alleging that a Chinese respondent, Max Fortune Industrial Ltd. and Max Fortune (FZ) Paper Products Company, Ltd. (collectively, “Max Fortune”), had “lied to Commerce about its use of third party suppliers and packers . . . .”<sup>88</sup> Investigating Petitioner’s claim eventually led the Department to verify the facilities of a “Chinese Informant” that provided evidence supporting Petitioner’s allegations.<sup>89</sup> The verification and review of evidence on the record of the review resulted in the Department applying total adverse facts available (“AFA”) to Max Fortune in the review and assigning an assessment rate for entries during the POR (and a new cash deposit rate going forward) of 112.64%.<sup>90</sup>

---

<sup>84</sup> Certain Tissue Paper Products from the People’s Republic of China, 74 Fed. Reg. 20,915, 20,915 (Dep’t of Commerce May 6, 2009) (prelim. determination).

<sup>85</sup> *Id.* at 20,917 (“Sunlake refused to answer questions about its production activities before August 2008, and argued that the Department should re-issue its questionnaire to focus only on Sunlake’s current operations, which it claimed incorporate only Thai-origin jumbo rolls in the production of cut-to-length tissue paper products.”).

<sup>86</sup> *See* Certain Tissue Paper Products from the People’s Republic of China, 74 Fed. Reg. 29,172, 29,172–73 (Dep’t of Commerce June 19, 2009) (final determination).

<sup>87</sup> *See* Antidumping and Countervailing Duty, 74 Fed. Reg. 19,042, 19,043 (Dep’t of Commerce Apr. 27, 2009) (admin. review initiation).

<sup>88</sup> *See* Max Fortune Indus. Ltd. v. United States (*Max Fortune I*), 853 F. Supp. 2d 1258, 1261 (Ct. Int’l Trade 2012).

<sup>89</sup> *See id.* at 1262.

<sup>90</sup> Certain Tissue Paper Products from the People’s Republic of China, 75 Fed. Reg. 63,806, 63,809 (Dep’t of Commerce Oct. 18, 2010) (final results).

Max Fortune challenged Commerce’s final results and the CIT upheld the agency.<sup>91</sup> Faced with contradictory claims and record evidence presented by Max Fortune and the Chinese Informant, the CIT deferred to the agency’s expertise observing “it is the role of the agency as the factfinder, not of this Court, to determine authenticity between contradictory sets of documents where both are supported by substantial evidence on the record.”<sup>92</sup> In upholding Commerce’s actions, the CIT noted “that this is a case of first impression in that the documents relied upon by Commerce were provided by a third party source, the Chinese Informant.”<sup>93</sup> The end result of the fourth administrative review, then, was the approval by the reviewing court for innovative actions taken by the Department to investigate claims of false representations – here, the factors of production for Max Fortune’s subject merchandise – in the context of an administrative review.

In February 2010, during the pendency of the fourth administrative review proceedings, Petitioner also filed a request that the Department initiate and conduct an anti-circumvention inquiry pursuant to 19 U.S.C. § 1677j(b) of the shipments of tissue paper claimed to be from the Socialist Republic of Vietnam (“Vietnam”) from a subsidiary of Max Fortune, Max Fortune (Vietnam) Paper Products Company Limited (“Max Fortune Vietnam” or “MFVN”).<sup>94</sup> An anti-circumvention inquiry was initiated in April 2010,<sup>95</sup> shortly before the publication of the preliminary results of the fourth administrative review.<sup>96</sup> In the course of its conduct of the inquiry, the Department conducted verification of Max Fortune Vietnam’s questionnaire responses at the respondent’s facilities in Vietnam.<sup>97</sup> At verification, contrary to Max Fortune Vietnam’s factual representations to the Department, the agency “discovered that there were, in fact, Chinese jumbo rolls in [Max Fortune Vietnam’s] inventory as late as March 2010.”<sup>98</sup> Noting that Max Fortune Vietnam had (1) conceded that it was “possible” that the respondent had made tissue paper from Chinese-origin jumbo rolls before December 31, 2007, (2) failed to provide verifiable production data for calendar year 2008, and (3) held jumbo-rolls of Chinese-origin in

---

<sup>91</sup> *Max Fortune I*, 853 F. Supp. 2d at 1267.

<sup>92</sup> *Id.* at 1265 (citation omitted).

<sup>93</sup> *Id.*

<sup>94</sup> Certain Tissue Paper Products from the People’s Republic of China, 75 Fed. Reg. 17,127, 17,127 (Dep’t of Commerce Apr. 5, 2010) (initiation notice).

<sup>95</sup> *Id.*

<sup>96</sup> Certain Tissue Paper Products from the People’s Republic of China, 75 Fed. Reg. 18,812 (Dep’t of Commerce Apr. 13, 2010) (preliminary results).

<sup>97</sup> *Max Fortune Indus. Co. v. United States (Max Fortune II)*, 2013 Ct. Intl. Trade LEXIS 57, at \*4 (Ct. Int’l Trade Apr. 15, 2013).

<sup>98</sup> *Id.*

inventory at the end of December 2008, through 2009, which were later withdrawn from in inventory in March 2010, the Department found that the company was circumventing the antidumping duty order on tissue paper from China.<sup>99</sup> In result, the Department instructed CBP “to collect cash deposits on all tissue paper produced and exported by” Max Fortune Vietnam.<sup>100</sup> The Department further observed that:

Should the Department conduct an administrative review in the future, and determine in the context of that review that [Max Fortune Vietnam] has not produced for export tissue paper using Chinese-origin jumbo rolls and/or cut sheets, the Department will consider initiating a changed circumstances review pursuant to section 751(b) of the Act to determine if the continued suspension of all tissue paper produced by MFVN is warranted.<sup>101</sup>

Max Fortune Vietnam challenged Commerce’s determination at the CIT, arguing against the application of AFA and the requirement of a cash deposit rate rather than the institution of a certification program.<sup>102</sup> In response, the CIT upheld the agency’s determination and exercise of discretion.<sup>103</sup> The CIT further specifically upheld Commerce’s authority to require cash deposits on future entries:

However, Commerce’s determination is not punitive. Commerce reasonably determined that the remedy of collecting cash deposits on MFVN’s tissue paper exports, while permitting Max Fortune to avoid the assessment of duties upon the entries of nonsubject merchandise through the conduct of an administrative review, was “in no way punitive.” . . . Commerce explained that this remedy “effectively addresses the circumvention of the [AD] Order, while at the same time allowing for adjustment to the remedy if” MFVN is able to demonstrate to Commerce “in a future segment that none of its tissue paper exported to the

---

<sup>99</sup> *Id.* at \*4–6.

<sup>100</sup> *Id.* at \*6.

<sup>101</sup> Certain Tissue Paper Products from the People’s Republic of China, 76 Fed. Reg. 47,551, 47,554 (Dep’t of Commerce Aug. 5, 2011) (final results).

<sup>102</sup> *Max Fortune II*, 2013 Ct. Intl. Trade LEXIS 57, at \*9.

<sup>103</sup> *Id.* at \*30.

United States was produced using Chinese-origin jumbo rolls and/or cut sheets.”<sup>104</sup> Commerce’s determination is remedial and not punitive. It reasonably and lawfully addresses the past circumvention of the AD order while allowing for adjustment to the remedy if Max Fortune is able to demonstrate the merchandise has not circumvented the AD order.<sup>105</sup>

The remedy adopted by the Department offered a tacit refutation of the agency’s reasoning in the first administrative review of the antidumping duty order. Although previously indicating that investigations of the country-of-origin of merchandise purported to be non-subject were inappropriate in the context of an administrative review,<sup>106</sup> Commerce’s actions with respect to Max Fortune Vietnam specifically contemplated the agency making a country-of-origin determination in an administrative review proceeding: “Should the Department conduct an administrative review in the future, and determine in the context of that review that [Max Fortune Vietnam] has not produced for export tissue paper using Chinese-origin jumbo rolls and/or cut sheets . . . .” In other words, Max Fortune Vietnam can pursue the removal of the cash deposit requirement on its shipments if it proved, in an administrative review, that the country-of-origin of its merchandise was not Chinese.

#### 4. ARPP

The procedure established in Max Fortune Vietnam related to imports that, because of the cash deposit requirements, were treated as subject merchandise upon entry. This fact pattern therefore remains distinguishable from circumstances wherein merchandise that might be subject to an administrative review was declared to be not subject to an antidumping or countervailing duty order upon entry. With respect to the latter fact pattern, the Department has adopted a position of not conducting an administrative review of a producer/exporter of subject merchandise unless it can be demonstrated that there is at least one entry of such merchandise for which liquidation has been suspended because establishing assessment rates for

---

<sup>104</sup> *Id.* at \*25 (citation omitted).

<sup>105</sup> *Id.* at \*26.

<sup>106</sup> See Certain Tissue Paper Products from the People’s Republic of China, *supra* note 101.

entries that have been liquidated would be futile.<sup>107</sup> The CIT rejected this rationale in *Hubbell Power Systems*, noting that the Department is required to review entries of subject merchandise regardless of whether such entries have been liquidated or not:

Vulcan argues that if Commerce reviewed liquidated entries, importers would have no incentive to properly classify the merchandise upon entry and this would disrupt the U.S. retrospective system. . . . . Commerce did not supply this explanation on the record, and thus, it cannot support Commerce's policy. Regardless, Commerce has chosen to address potentially unlawful conduct by referring the matter to Customs for investigation and enforcement. Commerce cannot now argue that its chosen enforcement method is ineffective. At least in theory, Custom's enforcement powers would seem effective at deterring importers from mis-classifying entries, because Customs is authorized in non-intentional conduct cases to collect as a penalty up to four times the duties that should have been paid and higher penalties in the event of fraud, in addition to collecting the duties owed.<sup>108</sup>

Moreover, once Commerce refers the entries to Customs for investigation and enforcement, assessment of duties on the entries becomes an open issue. If Customs establishes a violation of 19 U.S.C. § 1592 has occurred, the statute provides that Customs "shall require that such lawful duties, taxes, and fees be restored . . . ."<sup>109</sup>

Thus, even if the entries were prematurely liquidated without the assessment of full duties, Customs will require the delinquent importer to pay the duties owed on those entries. *It is, therefore, not futile for Commerce to calculate a rate for liquidated entries because the liquidation will not bar collection of the duties in such a case. If Customs establishes liability*

---

<sup>107</sup> See, e.g., *Hubbell Power Sys., Inc. v. United States*, 884 F. Supp. 2d 1283, 1289 (Ct. Int'l Trade 2012) (noting that "Commerce has never formally articulated this position" or provided a clear explanation for it).

<sup>108</sup> *Id.* (citations omitted).

<sup>109</sup> *Id.* (citing 19 U.S.C. § 1592(d)).



*under 19 U.S.C. § 1592, the calculated rate will be used to assess duties and determine penalties.*<sup>110</sup>

Accordingly, the result of *Hubbell Power Systems* coupled with Commerce's insistence to domestic interested parties that "[c]omplaints of deliberate misclassification of entries or fraudulent activity regarding entries to the United States should be raised with CBP as appropriate"<sup>111</sup> rather than with the Department is perverse. Foreign exporters and U.S. importers may present evidence that misclassified entries were, in fact, subject merchandise and obtain an administrative review of such entries. In contrast, allegations that an exporter has, in fact, shipped subject merchandise while misclassifying such entries upon importation are deflected to CBP and no administrative review is conducted.

Indeed, Commerce's position is contradicted by the remedy imposed following another affirmative finding of circumvention of the antidumping duty order on tissue paper from China. In March 2012, Petitioner requested that the Department initiate and conduct an anticircumvention inquiry pursuant to 19 U.S.C. § 1677j(b) of shipments of tissue paper from an Indian company, AR Printing and Packaging India Pvt. Limited ("ARPP"), that purported to be of Indian origin.<sup>112</sup> The anticircumvention proceeding was initiated in May 2012,<sup>113</sup> ultimately resulting in an affirmative finding of circumvention.<sup>114</sup> Unlike with *Max Fortune Vietnam*, however, the Department determined that it was not appropriate to impose a cash deposit requirement on all of ARPP's future entries.<sup>115</sup> Instead, the Department held that cash deposits would only be required on ARPP's future entries of *Chinese-origin* tissue paper,<sup>116</sup> leaving it to the discretion of the importer to declare entries of ARPP's merchandise as Chinese or Indian in origin. In responding to distinct challenges to the remedy brought by both ARPP and Petitioner, Commerce defended its decision by observing that ARPP was

---

<sup>110</sup> *Id.* (emphasis added).

<sup>111</sup> See Memorandum from A. Ray, Senior Int'l Trade Analyst, Office 9, Int'l Trade Admin., to J. Doyle, Dir., Office 9, Int'l Trade Admin. at 6 (May 24, 2013) (on file with U.S. Dep't of Commerce) (public version) ("The CIT upheld the Department's position that CBP has more expansive authority to investigate country-of-origin claims") (citing *Globe Metallurgical*, 722 F. Supp. 2d at 1372, 1381).

<sup>112</sup> Certain Tissue Paper Products from the People's Republic of China, 77 Fed. Reg. 27,430 (Dep't of Commerce May 10, 2012) (notice of initiation).

<sup>113</sup> *Id.*

<sup>114</sup> Certain Tissue Paper Products from the People's Republic of China, 78 Fed. Reg. 40,101, 40,102 (Dep't of Commerce July 3, 2013) (final determination).

<sup>115</sup> *Id.*, accompanying Issues and Decision Memorandum cmt. 2.

<sup>116</sup> *Id.*

potentially subject to an administrative review regardless of whether any cash deposit requirement was put in place:

Furthermore, there is nothing overly burdensome or unfair about the remedy applied in the Preliminary Determination. First, if ARPP does not export PRC-origin tissue paper to the United States, then it will pay no cash deposits. Second, irrespective of an affirmative circumvention finding, as a third-country reseller of the subject merchandise, ARPP could be subject to an administrative review if an interested party requests such review. In fact, the petitioner recently requested an administrative review of ARPP as a third-country reseller, and the Department initiated such a review. Accordingly, even if the Department did not order the collection of cash deposits on ARPP's tissue paper exports to the United States as a result of this anticircumvention determination, this would not necessarily prevent ARPP from being reviewed by the Department as ARPP appears to claim.

If a review is requested of ARPP's tissue paper exports and the Department finds that no PRC-origin jumbo rolls and/or cut sheets were used to produce the merchandise sold and entered into the United States, the Department will instruct CBP to liquidate ARPP's merchandise without regard to AD duties. On the other hand, *if the Department finds that the goods entered were produced using PRC-origin jumbo rolls and/or cut sheets, the Department will instruct CBP to liquidate those entries in accordance with the rate established in the course of the review.* Such a remedy is fully compliant with the Department's authority under section 781(b)(1)(E) of the Act and appropriately addresses ARPP's circumvention of the PRC Tissue Paper Order.<sup>117</sup>

Commerce's reasoning necessarily contemplates that the agency would make country-of-origin determinations in an administrative review. The Department specifically observes that with an administrative review it

---

<sup>117</sup> *Id.* (emphasis added).

might determine that ARPP's shipments were or were not produced from Chinese-origin jumbo rolls. Commerce's reasoning is notably not contingent upon whether such entries had been liquidated or were subject to the suspension of liquidation; *even if no cash deposit requirement was imposed, ARPP might be subject to an administrative review if requested by Petitioner.*

In sum, the examples of Max Fortune Vietnam and ARPP demonstrate that even if the Department limited its activities regarding circumvention only to the narrow circumstances provided for in 19 U.S.C. § 1677j, the agency *would still be* required to make country-of-origin and classification determinations in administrative reviews.

The CAFC's recent decision in *AMS Associates* does not change this analysis. As the CAFC repeatedly notes, the issue presented in the underlying administrative review of the antidumping duty order on laminated woven sacks from China was whether sacks made from non-Chinese fabric were within the scope of the antidumping duty order.<sup>118</sup> Noting the peculiar circumstances, the CAFC stated:

This is a case about what procedures Commerce must follow *when the scope of an existing antidumping duty order is unclear and Commerce seeks to further clarify that scope.* Commerce has the express authority to conduct a scope inquiry and to clarify the scope of an unclear order during an administrative review pursuant to 19 C.F.R. § 351.225(f)(6). However, as the trade court correctly noted, the appeal before us questions whether Commerce failed to abide by the restrictions imposed on that authority to suspend liquidation to only those entries made on or after the date of initiation of a formal scope inquiry. We conclude that it did. We agree with Shapiro and the trade court that Commerce exceeded its authority under 19 C.F.R. § 351.225(l)(2) by ordering the suspension of liquidation retroactive to the beginning of the period of review with respect to an antidumping duty order that did not clearly cover laminated woven sacks manufactured in China from imported fabrics.<sup>119</sup>

---

<sup>118</sup> See *AMS Assocs., Inc. v. United States*, 737 F.3d 1338, 1340-41, 1344 (Fed. Cir. 2013).

<sup>119</sup> *Id.* at 1343 (emphasis added).

The CAFC stressed that such concerns only existed where the scope of the original order was unclear.<sup>120</sup> Where, in contrast, the scope of the order is clear, the Department is fully authorized to evaluate (and fully capable of evaluating) importers' claims that merchandise is outside the scope.<sup>121</sup> Where the Department declines to make such determinations, the agency – in the words of the CAFC – “permit[s] importers to potentially avoid paying antidumping duties on past imports by asserting unmeritorious claims that their products fall outside the scope of the original order.”<sup>122</sup>

### **B. Commerce Can Meaningfully Address Circumvention in Administrative Reviews: A Hilltop Case Study**

Commerce's reaction to evidence of circumvention throughout administrative reviews of the antidumping duty order on frozen warmwater shrimp from China demonstrates that the agency can meaningfully address import fraud in administrative reviews. The Department initially refused to consider evidence regarding pervasive import misclassification and, after being ordered to do so by the CIT, declined to make any adjustments to its selection of mandatory respondents in response, continuing to hold to the position that CBP – not the Department – was the appropriate venue for concerns regarding import fraud.<sup>123</sup> Yet once highly incriminating evidence was placed on the record, the Department investigated the allegations and took forceful action that including increasing the dumping margin assigned to the Chinese shrimp exporter Hilltop International (“Hilltop”) from 0% to 112.81% across multiple reviews – resulting in an antidumping duty liability increase “from zero ... to likely over 100 million.”<sup>124</sup> This Department response in the China shrimp order demonstrates that Commerce can and does investigate and countermand import fraud in reviews if the evidence of circumvention is compelling.<sup>125</sup>

---

<sup>120</sup> *See id.* at 1344.

<sup>121</sup> *Id.*

<sup>122</sup> *Id.*

<sup>123</sup> *See* discussion *infra* Section III.B.1.

<sup>124</sup> *See* discussion *infra* Section III.B.2; *Strengthening Trade Enforcement to Protect American Enterprise and Grow American Jobs; Hearing Before the S. Comm. on Appropriations Subcomm. on Homeland Security*, 113th Cong. 4 (2014) (statement of Ronald Lorentzen, Deputy Assistant Sec. Enforcement & Compliance, Int'l Trade Admin., Dep't of Commerce), *available at* <http://www.appropriations.senate.gov/sites/default/files/hearings/ITA%20written%20statement%20for%20Homeland%20Security%20Approp%20hearing%20July%202016.2014.pdf>.

<sup>125</sup> *See* discussion *infra* Section III.B.3.

### 1. Commerce's Initial Response: Talk to CBP

The Ad Hoc Shrimp Trade Action Committee (“AHSTAC”), an association of domestic producers of warmwater shrimp, placed evidence of import fraud on the record of the fourth administrative review (“AR4”) of the antidumping duty order on shrimp from China covering imports between 2008 and 2009.<sup>126</sup> The evidence was presented as a challenge to Commerce’s methodology of exclusively relying on CBP data for selecting mandatory respondents.<sup>127</sup> Because the CBP data utilized depended upon importers voluntarily identifying shrimp imports as subject merchandise, evidence of pervasive misclassification, according to AHSTAC, meant that significant quantities of subject merchandise escaped the agency’s consideration. This evidence included, *inter alia*, GAO and CBP reports to Congress documenting misclassification and transshipment to evade the antidumping duty order on shrimp from China.<sup>128</sup> When the Department refused to consider this evidence, AHSTAC appealed to the CIT, where Hilltop and its affiliated U.S. importer Ocean Duke Corp (“Ocean Duke”) intervened on behalf of the United States.<sup>129</sup> In August 2011, the CIT ordered remand, finding that: “Commerce Improperly Refused to Consider AHSTAC’s Evidence.”<sup>130</sup> Upon remand, the Department considered the evidence, but declined to take any action in response.<sup>131</sup> The CIT affirmed: “Though these reports show that both misclassification and transshipment of Chinese shrimp exported to the U.S. has occurred in the past, they do not...indicate ongoing problems.”<sup>132</sup> The CIT did note that “there is a lag time between when conduct occurs and when the report detailing the investigation of that conduct becomes public.”<sup>133</sup>

Commerce’s response to AHSTAC in AR4, eventually upheld by the CIT, was that “complaints of deliberate misclassification of entries or fraudulent activity regarding entries into the United States should be

---

<sup>126</sup> See *Ad Hoc Shrimp Trade Action Comm. v. United States*, 791 F. Supp. 2d 1327, 1331 & n.8 (Ct. Int’l Trade 2011) (“*AHSTAC I*”).

<sup>127</sup> See *id.* at 1329-34 (alleging that Commerce’s reliance on “Type 03” import data – designated by the importer as subject to the antidumping duty order – was not a reliable source to select the largest exporters by volume from whom dumping margins would be calculated for the industry). See also 19 U.S.C. § 1677f-1(c)(2)(B).

<sup>128</sup> See *AHSTAC I*, 791 F. Supp. 2d at 1331 & n.8.

<sup>129</sup> *Id.* at 1327, 1331.

<sup>130</sup> *Id.* at 1332.

<sup>131</sup> See *Ad Hoc Shrimp Trade Action Comm. v. United States*, 828 F. Supp. 2d 1345, 1350 (Ct. Int’l Trade 2012) (“*AHSTAC II*”).

<sup>132</sup> *Id.* at 1353.

<sup>133</sup> *Id.* at 1334 n.12.

properly lodged with CBP.”<sup>134</sup> The Department found AHSTAC’s “argument regarding alleged circumvention of the antidumping duty order inappropriate in the context of . . . this administrative review . . . [b]ecause the Department has neither received a request to initiate an anti-circumvention inquiry nor self-initiated a separate anti-circumvention inquiry for the antidumping duty order on shrimp from the PRC.”<sup>135</sup> AHSTAC thereafter appealed the adverse CIT decision in AR4 to the CAFC, as discussed below.<sup>136</sup> AHSTAC also challenged Commerce’s refusal to act in response to the same evidence of import fraud in the subsequent, fifth administrative review (“AR5”) of the subject order covering imports between 2009 and 2010.<sup>137</sup> The CIT again denied relief in AR5 “[b]ecause AHSTAC presents no new evidence.”<sup>138</sup>

## 2. AHSTAC’s March 2012 Letter and the Consequences for Hilltop

AHSTAC placed over one thousand pages of new and highly incriminating evidence on the record late in the sixth administrative review (“AR6”) of the subject order covering imports between 2010 and 2011, prompting the Department to investigate.<sup>139</sup> Hilltop refused to cooperate and was found to have made material misrepresentations to the agency. As a result of this determination, Commerce revisited and recalculated Hilltop’s dumping margin from 0% to 112.81% across multiple reviews, denied Hilltop’s ability to obtain revocation from the order, and took related action in an antidumping duty order on shrimp from Vietnam.<sup>140</sup>

### a. AHSTAC’s March 2012 Letter and Commerce’s Investigation

In March 2012, the Department preliminarily announced that Hilltop was entitled to a 0% dumping margin in AR6 and company-specific revocation pursuant to a regulation (no longer in force) through which a

---

<sup>134</sup> Certain Frozen Warmwater Shrimp from the People’s Republic of China, 75 Fed. Reg. 49, 460 (Dep’t of Commerce Aug. 13, 2010) (final results).

<sup>135</sup> *Id.*, accompanying Issues and Decision Memorandum cmt. 1.

<sup>136</sup> *See* Ad Hoc Shrimp Trade Action Comm. v. United States, No. 12-001416, 2013 U.S. App. LEXIS 10,613 (Fed. Cir. May 24, 2013) (Fed. Cir. May 24, 2013) (“*AHSTAC I*”); discussion *infra* Section III.B.2.b(v).

<sup>137</sup> *See* Ad Hoc Shrimp Trade Action Comm. v. United States, 882 F. Supp. 2d 1366, 1369-70 (Ct. Int’l Trade 2012) (“*AHSTAC III*”).

<sup>138</sup> *Id.* at 1370-71.

<sup>139</sup> *See* discussion *infra* Section III.B.2.a.

<sup>140</sup> *See* discussion *infra* Section III.B.2.b.

respondent could demonstrate eligibility for revocation, in part, on findings of no dumping in three consecutive reviews.<sup>141</sup> That same month, AHSTAC placed extensive evidence on the record that was made public in an early 2012 record in connection with the sentencing proceeding for the criminal conviction of the President of Ocean Duke for falsely labeling fish fillets.<sup>142</sup> The U.S. Attorney alleged that Ocean Duke, between May 2004 and July 2005, had imported shrimp that was transshipped through the Kingdom of Cambodia (“Cambodia”) to avoid the antidumping duty orders on both China and Vietnam.<sup>143</sup> The evidence obtained through a multi-year, multi-agency investigation included:

- July 2004 correspondence between the Ocean Duke President and the General Manager of Yelin Enterprise Co. Hong Kong (“Yelin”) – the company that Commerce had in 2007 found to be Hilltop’s predecessor-in-interest – discussing the planned incorporation of a new Cambodian company called “Ocean King (Cambodia) Co. Ltd.” (“Ocean King”).<sup>144</sup> That same month, Yelin was preliminary assigned a 98.34% dumping margin in the investigation of shrimp from China;<sup>145</sup>
- A huge discrepancy between the 15 million pounds of shrimp shown in CBP data that Ocean King purportedly imported from Cambodia, and that country’s limited capacity to produce shrimp during that timeframe, as documented by the Cambodian Fisheries Administration Director General and official United Nation statistics;<sup>146</sup>

---

<sup>141</sup> Certain Frozen Warmwater Shrimp From the People’s Republic of China, 77 Fed. Reg. 12,801, 12,802-03, 12,810 (Dep’t Commerce Mar. 2, 2012) (preliminary results); 19 C.F.R. § 351.222(e) (2012); Modification of Regulation Concerning the Revocation of Antidumping and Countervailing Duty Orders, 77 Fed. Reg. 29,875 (May 21, 2012) (“Revocation Elimination”).

<sup>142</sup> Letter from Picard Kentz & Rowe LLP to U.S. Dep’t of Commerce, Case No. A-570-893 (Mar. 12, 2012).

<sup>143</sup> *See id.* at 3-5, 19-26.

<sup>144</sup> *Id.* at 19; Certain Frozen Warmwater Shrimp from the People’s Republic of China, 72 Fed. Reg. 33, 447-01 (Dep’t of Commerce June 18, 2007) (final results).

<sup>145</sup> Certain Frozen Warmwater Shrimp from the People’s Republic of China, 69 Fed. Reg. 42, 654-01 (Dep’t of Commerce July 16, 2004) (preliminary determination).

<sup>146</sup> *See* Sentencing Report at 22-23 & n.3, Attachments 9, 10, 17, 18.

- Correspondence from the Ocean Duke General Manager discussing whether transshipped shrimp should be placed into new boxes or simply relabeled.<sup>147</sup>
- Statements made to an investigator from Commerce's National Oceanic and Atmospheric Administration when interviewing a former Ocean Duke employee, who explained that the company's General Manager had knowledge of transshipment through Cambodia to evade the antidumping duty order on shrimp from China;<sup>148</sup> and
- The findings of an ICE investigation into the transshipment of seafood products by Yelin Enterprise (Vietnam) ("Yelin (Vietnam)").<sup>149</sup>

In June 2012, the Department asked Hilltop detailed questions concerning this record evidence, including its relationship with Ocean King and Yelin (Vietnam).<sup>150</sup> Hilltop emphatically and repeatedly denied having an affiliation with Ocean King.<sup>151</sup> Hilltop nevertheless, seizing upon prior instances where Commerce during an administrative review did not investigate claims of transshipment, "declin[ed] to provide information . . . since the Department has determined that such information would not be relevant to this proceeding."<sup>152</sup> Hilltop relied on Commerce's CIT-approved determination in response to AHSTAC's evidence in AR4 and other agency proceedings as precluding any inquiry as to transshipment during an administrative review.<sup>153</sup> The Department was not persuaded and responded by clarifying that the previously requested information was

---

<sup>147</sup> See *id.* at Attachment 14 ("On second thought. . . . They must print new master cartons for Cambodia origin products. Do NOT allow them to sticker over Product of Vietnam cartons.").

<sup>148</sup> See *id.* at Attachment 21.

<sup>149</sup> See *id.* at Attachments 24, 26.

<sup>150</sup> Letter from U.S. Dep't of Commerce to Hilltop Int'l, Case No. A-570-893 (June 1, 2012).

<sup>151</sup> Letter from Grunfeld, Desiderio, Lebowitz, Silverman & Klestadt LLP to U.S. Dep't of Commerce, Case No. A-570-893, at 6 (May 31, 2012) ("Hilltop is not affiliated with any company producing shrimp in Cambodia. In other words, Hilltop is not affiliated with Ocean King. . . . Hilltop confirms that neither the company, nor its owners or officers, invested any funds in Ocean King."); Letter from Grunfeld, Desiderio, Lebowitz, Silverman & Klestadt LLP to U.S. Dep't of Commerce, Case No. A-570-893, at 12 (June 15, 2012) (Hilltop and/or Ocean Duke, and/or any individuals affiliated with Hilltop and/or Ocean Duke, had no Cambodian affiliate or Cambodian affiliates.) ("Hilltop 6th Supp. Response").

<sup>152</sup> Hilltop 6th Supp. Response, *supra* note 151, at 14.

<sup>153</sup> See *id.* at 4-6.



relevant and “providing Hilltop with another opportunity to respond to those questions that it declined to answer.”<sup>154</sup> Hilltop was specifically warned that non-cooperation could result in the application of AFA.<sup>155</sup> Yet Hilltop once again refused to answer most of the questions “because the Department’s well-established policies and court precedent confirm that such information would not be relevant to the instant proceeding.”<sup>156</sup>

In response, the Department conducted its own investigation, obtaining Ocean King’s Cambodian incorporation documents and placing them on the AR6 record.<sup>157</sup> These documents established that the Hilltop General Manager incorporated Ocean King in July 2005 – in precisely the manner discussed one year earlier with the Ocean Duke President – and remained on the Ocean King board of directors through September 2010, thereby establishing that the companies had in fact been affiliated pursuant to the statutory definition.<sup>158</sup> Hilltop thereafter conceded that its prior representation “was in error” because “an affiliation within the statutory definition . . . existed between the Hilltop Group and Ocean King until September 28, 2010.”<sup>159</sup> Hilltop further acknowledged that Ocean Duke had sold shrimp sourced from Ocean King during the AR4 POR.<sup>160</sup> However, Hilltop once again refused to answer most of Commerce’s questions concerning transshipment “because the Department’s well-established policies and court precedent confirm that such information would not be relevant to the instant proceeding.”<sup>161</sup>

#### **b. The Consequences for Hilltop and Ocean Duke**

The Department in AR6 concluded that Hilltop had committed material misrepresentation by concealing the existence of its affiliation with

---

<sup>154</sup> Letter from U.S. Dep’t of Commerce to Hilltop Int’l, Case No. A-570-893, at 1 (June 19, 2012).

<sup>155</sup> *See id.* at 2-3; 19 U.S.C. § 1677e(b) (through P.L. 113-162 (excluding P.L. 113-128, 113-146, 113-150, 113-157, and 113-159)).

<sup>156</sup> Letter from Grunfeld, Desiderio, Lebowitz, Silverman & Klestadt LLP to U.S. Dep’t of Commerce, Case No A-570-893, at 1-2 (June 26, 2013) (“Hilltop 7<sup>th</sup> Supp. Response”).

<sup>157</sup> *See* U.S. Dep’t of Commerce Memorandum from K. Archuletta to File, Case No. A-570-893, Attachment 1 (June 19, 2012).

<sup>158</sup> *See id.*; 19 U.S.C. § 1677(33)(B) (though P.L. 113-162 (excluding P.L. 113-128, 113-146, 113-150, 113-157, and 133-159)) (“The following persons shall be considered to be ‘affiliated’ . . . Any officer or director of an organization and such organization”); Sentencing Report, Attachment 19.

<sup>159</sup> Hilltop 7<sup>th</sup> Supp. Response, *supra* note 156 at 1-2.

<sup>160</sup> *See id.* at 2.

<sup>161</sup> *Id.* at 1.

Ocean King.<sup>162</sup> The Department further found that the record evidence – and Hilltop’s refusal to respond to agency inquiries – supported a determination that Hilltop likely engaged in transshipment to evade antidumping duties.<sup>163</sup> The Department thereafter assigned Hilltop a 112.81% dumping margin in AR6, the seventh administrative review (“AR7”) of the subject order, and the eighth administrative review (“AR8”) of the subject order.<sup>164</sup> The Department also reopened AR4 and AR5 to increase the dumping rate from 0% to 112.81% in those reviews, such that Hilltop’s antidumping duty liability “grew from zero ... to likely over \$100 million.”<sup>165</sup> Further, Commerce took action in proceedings involving the relationship between Hilltop and Yelin, as well as the antidumping duty order on shrimp from Vietnam.<sup>166</sup>

#### i. AR6

The Department concluded AR6 by declining to revoke the antidumping duty order as to Hilltop, as the agency had preliminarily decided, and instead applying AFA to assign Hilltop the 112.81% PRC-wide rate.<sup>167</sup> The Department concluded that, on account of the material misrepresentation as to affiliation with Ocean King, all information submitted by Hilltop lacked credibility – including the respondent’s claim to be independent from the Chinese government.<sup>168</sup> Accordingly, Hilltop is no longer eligible for company-specific revocation under the regulation that was eliminated in May 2012.<sup>169</sup> Hilltop has challenged this determination at the CIT, claiming that the Department acted improperly by both accepting AHSTAC’s March 2012 submission and applying AFA.<sup>170</sup>

---

<sup>162</sup> Certain Frozen Warmwater Shrimp from the People’s Republic of China, 77 Fed. Reg. 53,856, 53,861 (Dep’t of Commerce Sept. 4, 2012) (Final Results).

<sup>163</sup> *See id.*, accompanying Issues and Decision Memorandum (“AR6 IDM”) cmt. 1 (“Hilltop has chosen not to provide any information regarding its activities prior to AR4 and, absent any contradictory information, the evidence weighs in favor of the conclusion that Cambodia did not produce all of the shrimp imported as Cambodian country-of-origin by Ocean Duke”).

<sup>164</sup> *Infra* Section III.B.2.b(i)-(iii).

<sup>165</sup> *Infra* Section III.B.2.b(iv)-(v); Lorenzten Testimony, *supra* note 124 at 4.

<sup>166</sup> *Infra* Section III.B.2.b(vi)-(vii).

<sup>167</sup> Certain Frozen Warmwater Shrimp from the People’s Republic of China., *supra* note 162, at 53,859-61.

<sup>168</sup> *See* AR6 IDM, *supra* note 163.

<sup>169</sup> *See* Revocation Elimination, *supra* note 141.

<sup>170</sup> *See* Complaint, Hilltop Int’l v. United States, No. 12-289 (Sept. 19, 2012) (pending final resolution of its challenges in AR4 and AR5); Order, Hilltop Int’l v. United States, Consol. No. 12-289 (Apr. 23, 2014).

**ii. AR7**

Throughout the AR6 proceedings, Hilltop's U.S. sales between 2011 and 2012 were being reviewed by the Department in AR7. In October 2012, Hilltop "notif[ied] the Department that the Hilltop Group respectfully declines to respond to additional information requests in the above-referenced proceeding. The Hilltop Group has made this decision due to the Commerce's findings and conclusions in the recently published final results from the sixth administrative review . . . ."<sup>171</sup> The Department in September 2012 once again applied AFA to assign Hilltop the 112.81% PRC-wide rate in AR7.<sup>172</sup> Hilltop is challenging this rate at the CIT – but not the application of AFA.<sup>173</sup>

**iii. AR8**

In February 2013, at the outset of AR8, Hilltop requested that the Department review its U.S. sales between 2012 and 2013.<sup>174</sup> Nevertheless, Hilltop declined to respond to Commerce's initial questionnaire in the review.<sup>175</sup> The Department in September 2014 therefore applied AFA to assign Hilltop the 112.81% rate in AR8,<sup>176</sup> as it had in previous reviews.

**iv. AR5**

In addition to the consequences for Hilltop in AR6 and forward, the Department has reopened closed reviews. In response to AHSTAC's request,<sup>177</sup> the Department agreed to reconsider the AR5 proceeding that

---

<sup>171</sup> Letter from Grunfeld, Desiderio, Lebowitz, Silverman & Klestadt LLP to U.S. Dep't of Commerce, Case No. A-570-893, at 1 (Oct. 3, 2012).

<sup>172</sup> Certain Frozen Warmwater Shrimp From the People's Republic of China, 78 Fed. Reg. 56,209 (Dep't of Commerce Sept. 12, 2013) (Final Results).

<sup>173</sup> See Amended Complaint, Hilltop Int'l v. United States, No. 13-346 (July 23, 2014); Order, Hilltop Int'l v. United States, No. 13-346 (July 23, 2014) (pending resolution of Hilltop's challenges in AR4 and AR5).

<sup>174</sup> See Letter from Grunfeld, Desiderio, Lebowitz, Silverman & Klestadt LLP to U.S. Dep't of Commerce, Case No. A-570-893 (Feb. 28, 2013).

<sup>175</sup> See U.S. Dep't of Commerce Memorandum from C. Bertrand to J. Doyle, Case No. A-570-893, at 1 (June 21, 2013).

<sup>176</sup> Certain Frozen Warmwater Shrimp From the People's Republic of China, 79 Fed. Reg. 57,872, 57,873 & nn.6-7 (Dep't of Commerce Sept. 26, 2014) (Final Results). Hilltop has filed an appeal at the CIT challenging the 112.81% rate, and AHSTAC has intervened in support of that rate. See Complaint, Hilltop Int'l v. United States, No. 14-286 (Oct. 30, 2014).

<sup>177</sup> See Letter from Picard Kentz & Rowe LLP to U.S. Dep't of Commerce (Sept. 17, 2012), Case No. A-570-893, at 1, 2, <https://iaaccess.trade.gov/> ("AHSTAC Reopen Request").

was in the midst of CIT litigation.<sup>178</sup> Over Hilltop's objection, the Department sought CIT permission to voluntarily reconsider the 0% dumping margin that it assigned to Hilltop in AR5.<sup>179</sup> In January 2013, the CIT granted "Commerce's request to expand the scope of remand to permit the agency to consider new evidence concerning the question of whether Hilltop International provided false or incomplete information regarding its affiliates in the course of the fifth administrative review."<sup>180</sup> The Department thereafter placed the AR6 evidence of material misrepresentation and likely transshipment on the AR5 record.<sup>181</sup> In its April 2013 remand redetermination, the Department applied AFA to assign Hilltop the 112.81% PRC-wide rate in AR5.<sup>182</sup> In July 2013, the CIT affirmed Commerce's application of AFA to treat Hilltop as part of the PRC-wide entity as follows:

- "Commerce's finding that Hilltop repeatedly withheld and misrepresented material information regarding its affiliation with Ocean King is supported by a reasonable reading of the record here",<sup>183</sup>
- "Hilltop subsequently denied and concealed its affiliation with and investment in Ocean King until confronted with public registration documents contradicting its misrepresentations. This is sufficient to reasonably support Commerce's conclusion that *Hilltop withheld information requested of it in this review and significantly impeded this proceeding* by submitting information containing material misrepresentations and inaccuracies",<sup>184</sup>
- "Although Hilltop was afforded an opportunity to rehabilitate its impeached credibility by providing a reasonable explanation for its non-disclosure and subsequent denial of any affiliation with Ocean King, *the evidence also supports Commerce's conclusion that*

---

<sup>178</sup> See Letter from J. Doyle, U.S. Dep't of Commerce, to Ad Hoc Shrimp Trade Action Comm., Case No. A-570-893 (Nov. 29, 2012), <https://iaaccess.trade.gov> ("Commerce Reopening Memo").

<sup>179</sup> See *Ad Hoc Shrimp Trade Action Comm. v. United States*, 882 F. Supp. 2d 1377, 1378-79 (Ct. Int'l Trade 2013) ("*AHSTAC IV*").

<sup>180</sup> *Id.* at 1382.

<sup>181</sup> See U.S. Dep't of Commerce Memorandum from K. Archuletta to File, Case No. A-570-893, at 1-4 (Feb. 14, 2013), <https://iaaccess.trade.gov>.

<sup>182</sup> See *Ad Hoc Shrimp Trade Action Comm. v. United States*, 925 F. Supp. 2d 1315, 1319 (Ct. Int'l Trade 2013) ("*AHSTAC VT*").

<sup>183</sup> *Id.* at 1321.

<sup>184</sup> *Id.* at 1323 (emphasis added).

*Hilltop's explanation was unpersuasive. Far from providing a reasonable explanation, Hilltop admitted only what was unequivocally evidenced by the new documents, trivialized its prior misrepresentation as having been in error 'for whatever reason,' and continued to evade Commerce's requests for information regarding possible additional undisclosed affiliates",*<sup>185</sup>

- “Commerce reasonably determined to disregard the totality of Hilltop’s representations in this review - including those previously used to support Hilltop’s separate rate status - as *inherently unreliable* because Hilltop’s conduct ‘raises questions regarding what other information is missing that could be relevant to [Commerce]’s proceeding”,<sup>186</sup>
- “Hilltop’s unexplained contradictions in representing its corporate structure in this review concern information that is core, not tangential, to Commerce’s analysis because it goes to the heart of Hilltop’s corporate ownership and control. And as Hilltop continued to misrepresent its corporate structure - including by explicitly denying any affiliation with Ocean King or other undisclosed entities - until forced to reconcile its misrepresentations with contradictory evidence, Commerce reasonably decided that Hilltop’s remaining representations regarding its structure and ownership - particularly those concerning the role of PRC government control in its pricing decisions - may be similarly incomplete and inaccurate”,<sup>187</sup> and
- “*Commerce’s conclusion that Hilltop’s representations regarding its corporate structure, affiliations, and government control are not reliably accurate and complete is reasonable. Accordingly, because the record contains no other reliable information to rebut the presumption of government control, Commerce’s determination that Hilltop failed to demonstrate eligibility for a separate rate from the PRC-wide entity is supported by substantial evidence and is therefore sustained.*”,<sup>188</sup>

---

<sup>185</sup> *Id.* (emphasis added).

<sup>186</sup> *Id.* (emphasis added).

<sup>187</sup> *Id.*

<sup>188</sup> *Id.* at 1324 (emphasis added).

After an initial judicial setback, the 112.81% rate was eventually affirmed by the CIT. While affirming the application of AFA to Hilltop in July 2013, the CIT ordered remand because the 112.81% rate had not been corroborated in accordance with the statutory requirement.<sup>189</sup> The Department had corroborated that rate during the initial investigation using a respondent's margin that was subsequently reduced through CIT litigation.<sup>190</sup> The CIT ordered the Department to "either adequately corroborate the 112.81 percent PRC-wide rate . . . or choose a different country-wide rate."<sup>191</sup> In its November 2013 remand redetermination, the Department continued to assign Hilltop the 112.81% rate that was corroborated using additional information from the initial investigation.<sup>192</sup> The CIT affirmed this rate in May 2014, and Hilltop is appealing to the CAFC.<sup>193</sup>

#### v. AR4

In response to AHSTAC's request, the Department agreed to reconsider the 0% margin it assigned Hilltop in AR4.<sup>194</sup> That review was in the midst of appellate litigation, with AHSTAC challenging Commerce's inaction with respect to the evidence of import fraud.<sup>195</sup> The United States, over Hilltop's objection, sought and in May 2013 obtained CAFC permission to voluntarily reconsider AR4.<sup>196</sup> The Department thereafter placed the AR6 evidence of material misrepresentation and likely transshipment on the AR4 record.<sup>197</sup> In its November 2013 remand redetermination, the Department applied AFA to assign Hilltop the 112.81% PRC-wide rate that was corroborated using additional information from the initial investigation.<sup>198</sup> The CIT in May 2014 affirmed both the

---

<sup>189</sup> *AHSTAC VI*, 925 F. Supp. 2d at 1324-27.

<sup>190</sup> *See id.* at 1326 & n.48; *Allied Pac. Food (Dalian) Co. v. United States*, 716 F. Supp. 2d 1339, 1352 (Ct. Int'l Trade 2010).

<sup>191</sup> *AHSTAC VI*, 925 F. Supp. 2d at 1327.

<sup>192</sup> *See* U.S. Dep't of Commerce, "Final Results of Redetermination Pursuant to Court Remand," *Ad Hoc Shrimp Trade Action Comm. v. United States*, Case No. 11-335, at 2 (Ct. Int'l Trade Nov. 7, 2013), <https://iaaccess.trade.gov>.

<sup>193</sup> *Ad Hoc Shrimp Trade Action Comm. v. United States*, 992 F. Supp. 2d 1285, 1295-1302 (CIT 2014) ("*AHSTAC VII*").

<sup>194</sup> *See* AHSTAC Reopen Request, at 1, 2; Commerce Reopening Memo at 2.

<sup>195</sup> *See supra* Section III.B.1.

<sup>196</sup> *AHSTAC V*, 2013 U.S. App. LEXIS 10,613, \*2-5.

<sup>197</sup> *See* U.S. Dep't of Commerce Memorandum from K. Archuletta to File, Case No. A-570-893, Bar Code 3148357-01 (Aug. 5, 2013), <https://iaaccess.trade.gov>.

<sup>198</sup> *See* U.S. Dep't of Commerce, Final Results of Redetermination Pursuant to Court Remand, *Ad Hoc Shrimp Trade Action Comm. v. United States*, No. 10-275, Bar Code 3161555-01, at 71 (Ct. Int'l Trade Nov. 4, 2013), <https://iaaccess.trade.gov>.

application of AFA and the 112.81% rate, and Hilltop is appealing to the CAFC.<sup>199</sup>

#### vi. Changed Circumstances Review

At AHSTAC's request, the Department agreed to reconsider its 2007 changed circumstances review ("CCR") resulting in the determination that Hilltop was the successor-in-interest to Yelin.<sup>200</sup> Hilltop sought and received this determination during the first administrative review ("AR1") of the subject antidumping duty order. This determination became critical in April 2013 because the Department – as a means of complying with adverse rulings of the World Trade Organization ("WTO") – recalculated the investigation margins without use of the "zeroing"<sup>201</sup> methodology.<sup>202</sup> Because Yelin was found not to have been dumping, that respondent was released from the subject order.<sup>203</sup> However, Hilltop did not benefit from this action because the Department in December 2013 applied AFA to reverse its finding that Hilltop was Yelin's successor-in-interest.<sup>204</sup> The Department based its finding on the concealment of Ocean King and refusal to answer questions concerning the AR6 evidence, as well as Hilltop having falsified information to Commerce in its CCR request and during the AR1 verifications:

- "Hilltop and Ocean Duke boldly presented false information regarding its corporate structure to Department officials at two verifications",<sup>205</sup>
- "... Hilltop's corporate structure and affiliations are of primary concern in a successor-in-interest analysis. Accordingly, we find that Hilltop submitted material misrepresentations in this CCR";<sup>206</sup>

---

<sup>199</sup> *AHSTAC VII*, 992 F. Supp. 2d at 1300, 1302.

<sup>200</sup> See *AHSTAC Reopen Request*, at 1, 2; *Commerce Reopening Memo*, at 1, 2.

<sup>201</sup> Zeroing is a methodology to calculate antidumping duties through which "negative dumping margins (*i.e.*, margins of sales of merchandise sold at nondumped prices) are given a value of zero and only positive dumping margins (*i.e.*, margins of sales of merchandise sold at dumped prices) are aggregated." *Union Steel v. United States*, 713 F.3d 1101, 1104 (Fed. Cir. 2013).

<sup>202</sup> *Certain Frozen Warmwater Shrimp From the People's Republic of China and Diamond Sawblades and Parts Thereof From the People's Republic of China*, 78 Fed. Reg. 18,958 (Dep't of Commerce Mar. 28, 2013) (Implementation of Determinations).

<sup>203</sup> *Id.* at 18,958.

<sup>204</sup> *Certain Frozen Warmwater Shrimp from the People's Republic of China*, 78 Fed. Reg. 76,106 (Dep't of Commerce Dec. 16, 2013) (Final Reconsideration) ("CCR Reconsideration").

<sup>205</sup> Decision Memorandum at 14 (cmt. 1) accompanying CCR Reconsideration, 78 Fed. Reg. 76,106.

- “Hilltop in its CCR Request stated in a sworn affidavit that there had been no ‘investments or divestitures in the way of mergers, acquisitions, share purchases or sale of assets in any company since . . . the antidumping duty order was published’”,<sup>207</sup> and
- Hilltop stated that “it had no affiliation or business dealings with Yelin Enterprise (Vietnam) but refused to provide any information prior to that date. We note that this is the same response in which Hilltop denied any involvement with Ocean King and refused to provide any information regarding its purchases from that company.”<sup>208</sup>

**vii. Reconduct of AR4 for Ocean Duke’s  
Vietnamese Affiliate**

The evidence that AHSTAC placed on the record in AR6 also had consequences for the antidumping duty order on shrimp from Vietnam. In AR4 of that order, the Vietnamese shrimp exporter Grobest & I-Mei Industrial (Vietnam) Co., Ltd. (“Grobest”) affiliated with Ocean Duke was assigned the 3.92% dumping margin for those respondents not individually reviewed but eligible for a rate separate from the Vietnam-wide entity.<sup>209</sup> Dissatisfied with that margin (and its inability to obtain company-specific revocation), Grobest challenged Commerce’s determination not to grant voluntary respondent review. This resulted in two favorable CIT opinions ordering remand.<sup>210</sup> In September 2012 the CIT entered judgment in favor of Grobest obligating the Department to reconduct AR4 for that respondent.<sup>211</sup> In October 2012, the Department published notice of the

<sup>206</sup> *Id.* at 12.

<sup>207</sup> *Id.* at 9 (footnote omitted).

<sup>208</sup> *Id.* at 10 (footnote omitted).

<sup>209</sup> Certain Frozen Warmwater Shrimp From the Socialist Republic of Vietnam, 72 Fed. Reg. 10,689, 10,693 n.13 (Dep’t of Commerce Mar. 9, 2007) (preliminary results); Certain Frozen Warmwater Shrimp From the Socialist Republic of Vietnam, 75 Fed. Reg. 61,122, 61,124 (Dep’t of Commerce Oct. 4, 2010) (amended final results).

<sup>210</sup> *Grobest & I-Mei Indus. Co. v. United States*, 815 F. Supp. 2d 1342, 1360-64 (Ct. Int’l Trade 2012); *Grobest & I-Mei Indus. (Vietnam) Co. v. United States*, 853 F. Supp. 2d 1352, 1365 (Ct. Int’l Trade 2012).

<sup>211</sup> *Id.*



initiation of this reconducted AR4 for Grobest.<sup>212</sup> Yet Grobest requested that the Department rescind the court-ordered review that December, claiming that it no longer wished to devote resources towards individual review in AR4.<sup>213</sup> The Department continued with the review and, after Grobest repeatedly refused to cooperate, applied AFA to assign Grobest the 25.76 Vietnam-wide rate in March 2014.<sup>214</sup> Grobest has challenged this action at the CIT.<sup>215</sup>

Grobest's request to rescind the court-ordered review suggests that it may have preferred to avoid answering questions regarding undisclosed affiliates and the indicia of transshipment through Vietnam. Indeed, Grobest refused to answer Commerce's January 2013 request to "provide a chart beginning with the period of investigation, and for each period of review through the present review, provide a list of Grobest's affiliates (with the relevant address for each), whether or not such affiliates are located in Vietnam."<sup>216</sup> After incurring the expense of qualifying for voluntary respondent treatment and years of successful CIT litigation, the respondent abruptly changed its position. Its subsequent failure to cooperate resulted in a nearly seven-fold margin increase.

### 3. *Hilltop* Demonstrates That Commerce Can Investigate and Countermand Circumvention in Administrative Reviews

Commerce's contrasting approaches towards evidence of circumvention of the antidumping order on shrimp from China indicate that the agency can and will investigate such impropriety in administrative reviews. *Hilltop* featured the Department exercising its authority to investigate circumvention in administrative reviews. Commerce's statutory mandate to conduct administrative reviews for "each entry of the subject merchandise" is frustrated by documented efforts to conceal subject

---

<sup>212</sup> Certain Frozen Warmwater Shrimp From the Socialist Republic of Vietnam, 77 Fed. Reg. 63,786 (Dep't of Commerce Oct. 17, 2012) (final results).

<sup>213</sup> Letter from Thompson Hine to U.S. Dep't of Commerce, Case No. A-552-802 (Dec. 18, 2012).

<sup>214</sup> Certain Frozen Warmwater Shrimp from the Socialist Republic of Vietnam, 79 Fed. Reg. 15,309 (Dep't of Commerce Mar. 19, 2013) (final results).

<sup>215</sup> Complaint, at 3, Viet I-Mei Frozen Foods Co. v. United States, Case No.14-092 (Ct. Int'l Trade Apr. 11, 2014)(AHSTAC has intervened in support of Commerce and briefing is expected to conclude in February 2015).

<sup>216</sup> Letter from S. Fullerton, U.S. Dep't of Commerce, to Grobest & I-Mei Industrial Co., Ltd., Case No. A-552-802, at ¶ 14 (Jan. 15, 2013).

merchandise.<sup>217</sup> The Department therefore has every right to assess whether the review-specific calculated dumping margins are based on accurate information. While the Department has declined to investigate circumvention in certain administrative reviews, those instances do not reflect either a statutory prohibition or a binding agency practice. Because Hilltop concealed its Ocean King affiliation and refused to answer questions concerning the indicia of transshipment, the Department was unable to find that subject merchandise had been accurately reported: “Hilltop’s failure to report at least one undisclosed affiliate and its refusal to provide information regarding allegations of transshipment make it impossible for the Department to be confident that its submissions do not contain additional material misrepresentations or, consequently, calculate normal value or U.S. price.”<sup>218</sup>

The Department correctly rejected Hilltop’s position that the agency was prevented from inquiring as to transshipment in administrative reviews. While Hilltop relied upon Commerce’s CIT-affirmed response to the GAO and CBP reports in AR4,<sup>219</sup> that agency response cannot authorize respondents to refuse agency inquiries based on record evidence. This position would in essence require that Commerce in all circumstances accept information provided by respondents regardless of evidence casting doubt on the veracity of those submissions. The CIT in *Hilltop* endorsed Commerce’s ability to investigate circumvention in administrative reviews by affirming the application of AFA based on the agency having obtained the Ocean King incorporation documents.<sup>220</sup>

The breadth and forcefulness of Commerce’s reaction in *Hilltop* reveal that the agency is able to countermand circumvention through import fraud in administrative reviews when appropriate. The Department applied AFA to assign the 112.81% rate in no less than five reviews and closed both opportunities available for Hilltop to obtain company-specific revocation.<sup>221</sup> While Hilltop only conceded to selling Ocean King merchandise in the AR4 POR,<sup>222</sup> the Department found that all reviews “may have been severely tainted by incomplete and false information.”<sup>223</sup> The Department conducted

---

<sup>217</sup> 19 U.S.C. § 1675(a)(2)(A). *See* *Consol. Bearings Co. v. United States*, 348 F.3d 997, 1004-05 (Fed. Cir. 2003).

<sup>218</sup> *See* AR6 IDM at 22.

<sup>219</sup> *See* Hilltop 6<sup>th</sup> Supp. Resp. at 4-6.

<sup>220</sup> *AHSTAC VI*, 925 F. Supp. 2d at 1319.

<sup>221</sup> *Id.* at 1324.

<sup>222</sup> *See* Hilltop 7<sup>th</sup> Supp. Resp. at 2.

<sup>223</sup> *See* AR6 IDM cmt. 1.

an analysis based on import patterns to conclude that the likely transshipment in 2004 and 2005 benefitted Hilltop well beyond that timeframe:

Hilltop's failure to disclose its Cambodian affiliate in AR1 allowed it to ship massive amounts of shrimp, which record evidence demonstrates was *highly unlikely to be of Cambodian origin*, to the United States while avoiding the Department's scrutiny and antidumping duties. This *enabled Hilltop to maintain its U.S. customer base* until the final results of AR1 were published, when it received a *de minimis* margin based on relatively few entries and was able to resume its shipments from the PRC with a zero cash deposit rate. . . . Thus, the validity of the cash deposit rate under which Hilltop began, and continued, to enter subject merchandise throughout the periods under consideration for revocation, is called into question by the evidence on the record, the allegations that Hilltop refused to address and the certification of material misrepresentations that persist on the record. Because Hilltop refused to disclose its Cambodian affiliate in AR1 and beyond, and Hilltop continued to make sales of shrimp imported through Cambodia into AR4, we are unable to determine what the effects of an accurately calculated margin in AR1 would have had on the sales made during the periods of AR4 through AR6. However, we find the record evidence sufficient to suggest that it *would have been unlikely for Hilltop to make sales in the quantities and at the prices it was able to during the periods under consideration for revocation had they been subjected to a higher cash deposit rate*. Thus, we find that the reported quantities and gross unit prices for Hilltop's sales made during the periods under consideration are invalidated, and the record of AR4 through AR6 does not contain the information necessary to calculate an accurate margin for Hilltop and must be filled by facts otherwise available.<sup>224</sup>

---

<sup>224</sup> *Id.* at 14-15 (emphases added).

The Department applied AFA in *Hilltop* after carefully reviewing AHSTAC's evidence and other record evidence and conducting its own investigation. With the CIT affirming the rationale for AFA application, it is clear that the Department has this authority in administrative reviews. Moreover, the *Hilltop* line of cases represents that inquiries by the Department into alleged circumvention through import fraud can result in meaningful consequences sufficient to deter against future schemes. This message is being communicated; as a senior Commerce official testified before the Senate Appropriations Committee in July 2014:

In 2012, while conducting an administrative review of the AD order on frozen warmwater shrimp from China, Commerce received information that one of the Chinese exporters, Hilltop International, had been supplying false information to Commerce over a multiyear period. Commerce rapidly assimilated vast amounts of information in order to directly investigate the matter. Ultimately, Commerce concluded that Hilltop made false statements in response to Commerce's first probe and, given the seriousness of the matter, Commerce reopened prior administrative review results regarding Hilltop. Upon re-examination of the information, Commerce found that Hilltop engaged in the same pattern of behavior in the prior reviews. As a result, *the AD duties due from Hilltop grew from zero, a finding which had been supported by false information, to likely over \$100 million.*<sup>225</sup>

### III. CONCLUSION

Circumvention of antidumping and countervailing duty orders is a significant and growing problem. Schemes that result in parties avoiding payment of lawfully-due duties not only have a meaningful impact on the federal budget, as has been recognized by Treasury, GAO, and other government agencies, leading to lost revenue in excess of a billion dollars, they also undermine the effectiveness of our WTO-sanctioned trade laws. These strategies further disadvantage domestic producers and their workers who have already demonstrated that they have been injured by unfairly

---

<sup>225</sup> *Strengthening Trade Enforcement to Protect American Enterprise and Grow American Jobs*, Hearing in Comm. On Appropriations Subcom. On Homeland Sec. Sen., at 4 (2014) (Testimony of Lorentzen) (emphasis added).

traded imports. The damage is not theoretical; producers, their employees and consumers, who in many cases are unable to determine the country of origin of the products they are purchasing, all are harmed. Further, the utter magnitude of the amount of money and imports involved in circumvention shakes confidence in the U.S. trade laws and in the ability of the U.S. government to properly police its borders.

Circumvention practices often are complex, subtle, and carefully planned. At their worst they are sophisticated conspiracies specifically designed to defraud the U.S. government and to create massive economic gain at the expense of both the government and U.S. producers and their workers. As this article illustrates, these schemes can involve sham importers who appear to be established solely for the purpose of accruing large amounts of owed antidumping and countervailing duties before disappearing and reemerging in new corporate form effectively cleansed of the obligation to pay the properly-applied duties. They also involve manipulation of Commerce proceedings and, in some instances include, material misrepresentations submitted in such proceedings that are designed to hide the true identity of a foreign producer or importer and to mask the actual country of origin of an imported product. The plans described in this article are those that have been uncovered through serious and time-consuming investigations by many government officials. Nevertheless, there is no reason to believe that they capture even a meaningful portion of existing circumvention or the full range of such strategies.

Some may seek to interpret current law to restrict the ability of Commerce, CBP, and other federal government agencies to investigate and respond to trade law circumvention only under limited and precise circumstances. The fact is that the problem has grown so severe that simple good government principles argue for exactly the opposite approach. Most recently, both CBP and Commerce have taken important steps to address glaring instances of circumvention. These are welcome actions but do not constitute the limit of appropriate measures that these agencies can and must implement. While no doubt there exists ample room for improvement in the laws to counter trade law circumvention, Commerce and CBP already have means available under current law and the courts have affirmed that these measures, fairly and forcefully applied, are appropriate and proper when confronting unlawful circumvention of antidumping and countervailing duty orders.



**JUST GRIN AND BEAR IT: WHY CONSISTENT USE OF INDIVIDUAL  
BAILOUTS UNDER SECTION 13(3) OF THE FEDERAL RESERVE ACT IS A  
NECESSARY EVIL TO COMBAT ECONOMIC ‘MASS DESTRUCTION’<sup>1</sup>**

Daniel J. Hunt\*

“Trust is built with consistency”<sup>2</sup>

**Introduction**

On the eve of Lehman Brother’s collapse, the Federal Reserve and other government leaders believed they were doing everything they could to save the failing financial giant.<sup>3</sup> They placed calls to international financial institutions, soliciting potential suitors.<sup>4</sup> They attempted to pool private funds to facilitate any acquisition.<sup>5</sup> They even agreed to broker any deal involving Lehman.<sup>6</sup> In the end, no deal reached fruition;<sup>7</sup> Lehman failed.<sup>8</sup> The financial system broke.<sup>9</sup> The shockwaves crippled both domestic and global economies.<sup>10</sup>

---

<sup>1</sup> Warren Buffet, Warren Buffet on Derivatives, available at <http://www.fintools.com/docs/Warren%20Buffet%20on%20Derivatives.pdf>

\* Corporate & Securities lawyer; J.D., *magna cum laude*, Villanova University School of Law. The author would like to thank Professor Jennifer O’Hare at Villanova University School of Law for her helpful guidance and Ashley Curran for her unwavering support. He would also like to thank the entire staff of the GEORGE MASON JOURNAL OF INTERNATIONAL COMMERCIAL LAW for their hard work and diligence.

<sup>2</sup> Lincoln Chafee, Q&A: Lincoln Chafee, Mother Jones (2008), <http://www.motherjones.com/politics/2008/09/qa-lincoln-chafee>.

<sup>3</sup> See Alan S. Blinder, *After the Music Stopped: The Financial Crisis, the Response, and the Work Ahead* 119-24 (2013) (describing government’s actions just before Lehman’s failure).

<sup>4</sup> See *id.*

<sup>5</sup> See *id.*

<sup>6</sup> See *id.*

<sup>7</sup> See *id.*

<sup>8</sup> See *id.* at 122-24 (narrating Lehman’s entering bankruptcy).

<sup>9</sup> See Blinder, *supra* note 3 (discussing consequences of Lehman entering bankruptcy, including credit markets freezing, stock market plunge, and run on money market mutual fund). For a further discussion of the consequences of Lehman’s failure, see *infra* note 120-23 and accompanying text.

<sup>10</sup> See Richard Wachman, *The Lehman Brothers Collapse: The Global Fallout*, THE GUARDIAN (Sept. 4, 2009), available at <http://www.theguardian.com/business/2009/sep/04/lehman-collapse-global-impact> (analyzing effect of Lehman’s failure on global economy and emerging markets); *How Lehman Shook The Global Economy*, NEWSWEEK (Sept. 13, 2009) available at <http://www.newsweek.com/how-lehman-shook-global-economy-79633> (noting Lehman’s failure sparked series of global economic consequences). See also Blinder, *supra* note 3, at 428 (“In 2008 a financial panic in the United States quickly infected Europe and the rest of the world.”).

But, did the Federal Reserve really do all that it could? While Ben Bernanke, then Chairman of the Federal Reserve, claimed that the Fed was “helpless because [Lehman Brother] was essentially an insolvent firm,” the Federal Reserve possesses several tools to carry out its responsibilities as the central bank of the United States.<sup>11</sup> Among its many responsibilities, the Fed is tasked with preventing systemic risk.<sup>12</sup> Systemic risk is characterized as risk to the entire financial system through the inherent interconnectivity of financial institutions.<sup>13</sup> One of the Fed’s most potent weapons for combating systemic risk is Section 13(3) of the Federal Reserve Act.<sup>14</sup> Indeed, the Fed invoked Section 13(3) to save Bear Stearns, an investment bank that faced the same financial predicament as Lehman six months earlier.<sup>15</sup> This begs the question: how could the Fed use Section 13(3) to save Bear Stearns but was “helpless” to save Lehman Brothers?

The Fed has posited several explanations to justify its disparate responses to the two investment banks.<sup>16</sup> First, the Fed has indicated that it

---

<sup>11</sup> See generally, Board of Governors of the Federal Reserve System, *The Federal Reserve System: Purposes and Functions*, THE FEDERAL RESERVE, [http://www.federalreserve.gov/pf/pdf/pf\\_complete.pdf](http://www.federalreserve.gov/pf/pdf/pf_complete.pdf); Board of Governors of the Federal Reserve System, *Mission*, THE FEDERAL RESERVE, <http://www.federalreserve.gov/aboutthefed/mission.htm> (listing current duties of Federal Reserve, including conducting monetary policy, regulating banks, maintaining stability, containing systemic risk, and providing financial services).

<sup>12</sup> See *id.*

<sup>13</sup> See Alexander Mehra, *Legal Authority in Unusual and Exigent Circumstances: The Federal Reserve and the Financial Crisis*, 13 U. PA. J. BUS. L. 221, 262 (2010) (defining systemic risk as both “chain reaction problem” of one firm’s failure affected others and “exogenous shock” of impact of multiple financial firms due to one event). See also *Systemic Risk*, INVOSTOPEDIA, <http://www.investopedia.com/terms/s/systematicrisk.asp>.

<sup>14</sup> See *id.*; See Federal Reserve Act § 13(3), 12 U.S.C. § 343 (2006) (“In unusual and exigent circumstances, the Board of Governors of the Federal Reserve System, by the affirmative vote of not less than five members, may authorize any Federal reserve bank, during such periods as the said board may determine, at rates established in accordance with the provisions of section 357 of this title, to discount for any individual, partnership, or corporation, notes, drafts, and bills of exchange when such notes, drafts, and bills of exchange are indorsed or otherwise secured to the satisfaction of the Federal reserve bank: Provided, that before discounting any such note, draft, or bill of exchange for an individual or a partnership or corporation the Federal reserve bank shall obtain evidence that such individual, partnership, or corporation is unable to secure adequate credit accommodations from other banking institutions. All such discounts for individuals, partnerships, or corporations shall be subject to such limitations, restrictions, and regulations as the Board of Governors of the Federal Reserve System may prescribe.”).

<sup>15</sup> See Blinder, *supra* note 3, at 100-14 (describing Fed’s use of Section 13(3) to prevent Bear Stearns from collapsing).

<sup>16</sup> See *id.* at 127 (detailing Fed’s reasons for letting Lehman fail). For a further discussion of the Fed’s purported reasons for not aiding Lehman Brothers, see *infra* notes 115-17 and accompanying text.



believed the market had time to prepare for Lehman's failure after witnessing Bear's near collapse.<sup>17</sup> Second, the Fed claimed that it did not have the legal power because Lehman was insolvent and could not post satisfactory collateral to trigger Section 13(3); Lehman possessed lower-grade collateral than Bear.<sup>18</sup>

Almost immediately after Lehman collapsed, the Fed faced criticism for both its use of Section 13(3) to save Bear and its decision not to use Section 13(3) to aid Lehman.<sup>19</sup> On one hand, some commentators argue that the Fed possessed legal authority to save Lehman, but chose to let it fail.<sup>20</sup> The Fed's inconsistency between the Bear and Lehman situations led to a greater financial fallout after Lehman's collapse because the market did not expect Lehman to fail.<sup>21</sup> Others argue that Bear's rescue was improper in the first place because it promoted moral hazard.<sup>22</sup> Moral hazard is a theory that risk-taking behavior is encouraged when the government "saves" a company because it reduces accountability for risky behavior thereby incentivizing a game of "heads I win, tails you lose."<sup>23</sup> Thus, condemned for both perpetuating moral hazard with Bear's rescue and for exacerbating the Financial Crisis by letting Lehman fail, the Fed had few friends in the public.<sup>24</sup> Indeed, the Fed had fewer friends in Congress. The Dodd-Frank Act, passed by the Congress and signed into law in 2010, overhauled many of the laws governing the financial sector including amendments to Section 13(3).<sup>25</sup> Specifically, it removed the Fed's ability to

---

<sup>17</sup> See *id.* at 125 ("They first enunciated the belief that because six months had elapsed since Bear Stearns, the markets had ample time to prepare . . . for the possible demise of Lehman Brothers."). For a more detailed discussion of the Fed's reasons for letting Lehman fail, see *infra* notes 115-17 and accompanying text.

<sup>18</sup> See *id.* (citing Ben Bernanke's statement that Lehman's collateral "fell short" compared to Bears). For a further discussion of the Fed's conclusion that it could not legally lend to Lehman Brothers, see *infra* note 117 and accompanying text.

<sup>19</sup> For a detailed discussion of the criticism the Fed faced, see *infra* notes 150-166 and accompanying text.

<sup>20</sup> For a detailed discussion of the supposed inconsistency between the Fed's treatment of Bear Stearns and Lehman Brothers, see *infra* notes 161-66 and accompanying text.

<sup>21</sup> For a discussion of why the inconsistency between Bear and Lehman's situation may have contributed to the Financial Crisis, see *infra* notes 161-64 and accompanying text.

<sup>22</sup> See Rick Newman, *Best Move of 2008: Letting Lehman Fail*, U.S. NEWS (Dec. 30, 2008), available at <http://money.usnews.com/money/blogs/flowchart/2008/12/30/best-move-of-2008-letting-lehman-fail> (arguing bailout of Bear Stearns increased moral hazard and contributed to risky behavior that led to Financial Crisis).

<sup>23</sup> See Blinder, *supra* note 3 and accompanying text (describing theory of moral hazard).

<sup>24</sup> See Mark Thoma, *Letting Lehman Fail "Was a Genuine Error"*, ECONOMIST'S VIEW (Oct. 23, 2008), <http://economistsview.typepad.com/economistsview/2008/10/letting-lehman.html> (arguing that Lehman should have been saved); Newman *supra* note 21 (arguing that Bear should not have been saved).

<sup>25</sup> *Id.*; Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1101, 124 Stat. 1376, 2114 (2010) (amending Section 13(3) by removing "individual,

provide emergency loans to individual companies by limiting emergency loans to “broad-based eligibility”.<sup>26</sup> Further, the amendments require the Fed to adhere to several procedures designed to increase transparency and consistency in Section 13(3)’s use.<sup>27</sup> In December 2013, the Fed released proposed regulations implementing Dodd-Frank’s mandates.<sup>28</sup>

This paper argues that while Dodd-Frank’s amendments to increase transparency and consistency of the Fed’s use of Section 13(3) powers are needed, Dodd-Frank’s prohibition of the Fed’s ability to make emergency loans to individual companies undercuts the Fed’s flexibility to respond to liquidity needs to fulfill its role as the lender of last resort. Individual “bailouts” provide a flexible, viable, and particularized response to unforeseen market developments in an increasingly complex and interconnected financial system. This paper argues for the return of bailout power but with increased consistency and transparency. If bailout power cannot be returned, this paper also advocates that the Federal Reserve implement regulations that broadly define “broad-based eligibility” to reclaim some of the power sapped by Dodd-Frank.

Part II of this paper traces the background of the Federal Reserve and Section 13(3) by examining the Section’s genesis, original purpose, use, and development.<sup>29</sup> Part III summarizes the Fed’s use of Section 13(3) prior to

---

partnership, or corporation” and replacing with “broad-based eligibility”). Section 1101 amends Section 13(3) as follows:

The third undesignated paragraph of section 13 of the Federal Reserve Act (12 U.S.C. 343) . . . is amended . . . by striking “individual, partnership, or corporation” . . . inserting the following: “participant in any program or facility with broad-based eligibility” . . . . Such policies and procedures shall be designed to ensure that any emergency lending program or facilities is for the purpose of providing liquidity to the financial system, and not to aid a failing financial company, and that the security for emergency loans is sufficient to protect taxpayers from losses and that any such program is terminated in a timely and orderly fashion.

<sup>26</sup> *See id.*

<sup>27</sup> *See id.* (requiring Secretary of Treasury review and assignment of lendable value to collateral used for loan under Section 13(3)). For a detailed discussion of the added procedural aspects of Section 13(3) after Dodd-Frank, see *infra* notes 199-202 and accompanying text.

<sup>28</sup> *See generally* Extensions of Credit by Federal Reserve Banks, 79 Fed. Reg. 615 (proposed Jan. 6, 2014) (to be codified at 40 C.F.R. pt. 201), *available at* <http://www.gpo.gov/fdsys/pkg/FR-2014-01-06/pdf/2013-31025.pdf> (incorporating Dodd-Frank’s conditions).

<sup>29</sup> For a detailed discussion of the creation and evolution of Section 13(3), see *infra* notes 35-84 and accompanying text.

and during the Financial Crisis.<sup>30</sup> This section further explores the Fed's inconsistent application of 13(3) by illustrating the decision-making process of the Fed during Bear Stearns' rescue and Lehman Brother's collapse.<sup>31</sup> Part IV details the regulatory response to the Fed's inconsistent use of Section 13(3) by examining The Dodd-Frank Act's Section 1101 and the Fed's proposed regulations implementing Section 1101's mandates.<sup>32</sup> Part V analyzes the efficacy of Dodd-Frank's Section 1101 with a focus on the prohibition of individual bailouts.<sup>33</sup> Part VI explains the benefits of consistent and transparent bailouts.<sup>34</sup> This section also advocates for a broad interpretation of the definition of broad-based eligibility.<sup>35</sup> Finally, Part VII concludes by suggesting that under the proposed regulations the Fed may still wield vast emergency powers but with greater transparency and much needed consistency.<sup>36</sup>

### I. The Background of a Battle-Tested Paragraph

Initially created to protect against banking panics, the Federal Reserve serves as the central bank of the United States.<sup>37</sup> As part of its duties, the Federal Reserve stabilizes the financial system through monetary policy and reduction of systemic risk.<sup>38</sup> To carry out these responsibilities, the Fed embraces the role of the lender of last resort, making loans to illiquid companies in an attempt to contain systemic risk.<sup>39</sup> Section 13(3) originated as an emergency weapon for the Fed to use in its role as lender of last resort.<sup>40</sup>

---

<sup>30</sup> For a summary narration of the Fed's use of Section 13(3) during the Financial Crisis to aid ailing companies, see *infra* notes 85-145 and accompanying text.

<sup>31</sup> For a discussion of the disparate treatment of Bear Stearns and Lehman Brothers, see *infra* notes 91-123 and accompanying text.

<sup>32</sup> For a discussion of the regulatory response to the Fed's use of Section 13(3) through the Dodd-Frank Act, see *infra* notes 169-202 and accompanying text.

<sup>33</sup> For an analysis of Dodd-Frank 1101 and its proposed regulations, see *infra* notes 228-313 and accompanying text.

<sup>34</sup> For recommendation for re-implementing Federal Reserve bailout power, see *infra* notes 333-49 and accompanying text.

<sup>35</sup> For recommendations for more a more appropriate regulatory definition of broad-based eligibility under 13(3), see *infra* 335-46 notes and accompanying text.

<sup>36</sup> For a conclusion, see *infra* notes 353-55 and accompanying text.

<sup>37</sup> For a discussion of the Fed's creation and original purpose, see *infra* notes 35-53 and accompanying text.

<sup>38</sup> For a discussion of the Fed's responsibilities, see *infra* notes 39-41 and accompanying text.

<sup>39</sup> For a discussion of the Fed's role as lender of last resort, see *infra* notes 42-53 and accompanying text.

<sup>40</sup> For a discussion of Section 13(3) and its original purpose, see *infra* 54-68 notes and accompanying text.

a. The Creation of the Federal Reserve, the Lender of Last Resort, and the Discount Window

The Federal Reserve Act created the Federal Reserve in response to an epidemic of banking panics at the turn of the twentieth century.<sup>41</sup> Originally conceived as a way to regulate the banking industry and implement monetary policy through the buying and selling of treasury securities (open market transactions), the Federal Reserve Act also contains measures by which the Federal Reserve banks can provide discounted loans to its member banks.<sup>42</sup> The former function, known as the discount window, provided the Federal Reserve the ability to carry out its role as lender of last resort.<sup>43</sup>

The role of lender of last resort can be summarily described as lending “for good collateral . . . to solvent institutions.”<sup>44</sup> For instance, if a borrower suffers liquidity shortages and cannot quickly obtain sufficient loans from other institutions, the Fed, as lender of last resort, can choose to lend to the cash-strapped institution to provide the necessary liquidity.<sup>45</sup>

---

<sup>41</sup> See generally The Federal Reserve Act, Pub. L. 63-43, 38 Stat. 251(1913) (codified as amended in scattered section of 12 U.S.C.). See also *Purposes and Functions*, supra note 11, at 1-2 (providing overview of Federal Reserve system and describing development of Federal Reserve system in 1913 as response to financial panics and bank failures “to prevent and contain financial disruptions”).

<sup>42</sup> See *Purposes and Functions*, supra note 11 at 45 (describing discount window lending as “backup source of liquidity for individual depository institutions”). See also Colleen Baker, *The Federal Reserve as Last Resort*, 46 U. MICH. J.L. REFORM 69, 83-87 (discussing Federal Reserve’s traditional ability to make loans in order to provide liquidity for commercial banks “to act as the lender of last resort to the commercial banking system”); Thomas O. Porter, *The Federal Reserve’s Catch-22: A Legal Analysis of the Federal Reserve’s Emergency Power*, 13 N.C. BANKING INST. 483, 501 (2009) (“In times of extraordinary stress, the Fed uses a second tool ‘secured lending at the discount window’ to affect monetary policy . . . [h]istorically, the discount window is the tool by which the Fed fulfills its role as ‘lender of last resort’ in times of financial stress.”).

<sup>43</sup> See Baker, supra note 42, at 85 (noting Fed’s ability to supply discounted loans to member banks “enabled the Federal Reserve to act as the lender of last resort to the commercial banking system”).

<sup>44</sup> See Jose Gabilondo, *Evolving Legal Standards for Liquidity Stabilization by the Central Bank: The Fed’s Financial Hospital as a Case Study*, 32 NO. 6 BANKING & FIN. SERVICES POL’Y REP. 8, 8 (June 2013) (“[D]uring a market-wide liquidity crisis the central bank should act as lender of last resort to solvent banks by lending to them at a penalty rate against good collateral. Formulated as a rule for central banks by Walter Bagehot in 1873 for the Bank of England, the notion has become the policy norm.”) (citing WALTER BAGEHOT, *LOMBARD STREET: A DESCRIPTION OF THE MONEY MARKET* (1873)).

<sup>45</sup> See Baker, supra note 42, at 85-86 (“In a bank run or panic, an otherwise solvent depository institution suddenly requires additional emergency ‘funding liquidity’ . . . [t]he [] lender of last resort [] provide[s] this funding when a solvent bank finds itself unable to borrow funds from other banks or market participants.”).

Lending to alleviate liquidity shortages may also indirectly shield against insolvency issues because the borrower will not be forced to sell its assets at reduced value to achieve its liquidity goals.<sup>46</sup> To fulfill its role as lender of last resort, the Federal Reserve uses the discount window.<sup>47</sup>

At the discount window, institutions in need of liquidity can post adequate collateral to obtain a discounted loan from the Federal Reserve.<sup>48</sup> A discounted loan means that the value of the Fed's loan is lower than the value of the collateral that secures the loan, ensuring the Fed receives "an interest payment in advance."<sup>49</sup> The original discount window, however, was initially restricted to "member banks"—investment banks could not use the discount window.<sup>50</sup>

Further, the collateral requirements to take advantage of the discount window were stringent.<sup>51</sup> First, the collateral could not have a maturity date greater than ninety days.<sup>52</sup> Second, the collateral could not include financial instruments "issued or drawn" for the purpose of trading in securities other than United States securities.<sup>53</sup> Consequently, the Federal Reserve was fairly restricted in its role as lender of last resort because it could only aid

<sup>46</sup> *See id.* at 86 ("Without a lender of last resort to supply emergency 'funding liquidity,' liquidity concerns could quickly become solvency issues, because a bank could be forced to conduct a fire sale of its assets.'").

<sup>47</sup> *See id.* at 84 (describing traditional discount window). *See also* Mehra, *supra* note 13, at 231 (detailing Federal Reserve's discount window to loan to depository institutions).

<sup>48</sup> *See* Mehra, *supra* note 13, at 231 (noting at discount window, Fed accepts collateral in form of "notes, drafts, and bills of exchange"); Baker, *supra* note 42, at 84-85 (quoting Jose Gabilondo, *Leveraged Liquidity: Bear Raids and Junk Loans in the New Credit Market*, 34 J. CORP. L. 447, 448 (2009) (describing discount window as "Fed's pawnshop for commercial banks facing short-term liquidity problems . . .")) (internal quotation marks omitted).

<sup>49</sup> *See* Mehra, *supra* note 13, at 225-26 (describing discount loan as accepting collateral and lending money for "less than the face value of the instrument").

<sup>50</sup> *See id.* at 231-32, ("Lending to member banks takes place at a Reserve Bank's discount window."). The original discount window was limited to member banks; Federal Reserve Act § 13(2), 12 U.S.C. § 343 (1916) (limiting discount window to "member banks"). The only way for non-member banks to receive loans was indirectly; Mehra, *supra* note 13, at 231, n. 31 (citing Federal Reserve Act § 19(e), 12 U.S.C. § 463 (1913) (limiting discount window to member banks)).

<sup>51</sup> *See* 12 U.S.C. § 343 (implementing restrictions on collateral for access to discount window). *See also* Mehra, *supra* note 13, at 231 ("Such instruments must have a maturity period of no more than ninety days. Furthermore, instruments 'issued or drawn for the purpose of carrying or trading in stock, bonds or other securities,' other than Treasury securities, are expressly ineligible.'").

<sup>52</sup> *See* 12 U.S.C. § 343 ("Notes, drafts, and bills admitted to discount under this paragraph must have a maturity at the time of discount of not more than 90 days . . .").

<sup>53</sup> *See id.* (excluding "Notes, drafts, or bills covering merely investments or issued or drawn for purposes of carrying or trading in stocks, bonds or other investment securities, except bonds and notes of the government of the United States.'").

illiquid member banks that possessed eligible collateral.<sup>54</sup> In 1932, however, Congress increased the Fed's responsibilities as lender of last resort by amending the Federal Reserve Act to include Section 13(3).<sup>55</sup>

b. The Development of Section 13(3)

Congress enacted the Emergency Relief and Construction Act in 1932, amending Section 13(3) and granting the Federal Reserve additional power to fend off liquidity concerns.<sup>56</sup> Initially a modest expansion of power of the Federal Reserve, Section 13(3) lay dormant for more than three quarters of a century before eventually exploding on the scene in 2008 by supplying the Federal Reserve with vast authority and discretion during the Financial Crisis.<sup>57</sup>

i. Forged During the Great Depression

Congress devised Section 13(3) to provide the Federal Reserve with emergency powers to combat further damage to the economic state after the Stock Market Crash of 1929.<sup>58</sup> Section 13(3) expanded the Fed's power to make discounted loans to "any individual, partnership, or corporation."<sup>59</sup> This power extended the reach of the Fed to make emergency loans as lender of last resort beyond the original discount window, which was

---

<sup>54</sup> See Baker, *supra* note 42, at 83-84 ("The requirement of quality collateral is to ensure that a bank needs assistance because it is illiquid, not because it is insolvent due to a balance sheet filled with worthless assets." Nevertheless, on occasion, the discount window has been used to aid insolvent member banks: "In practice, however, it can be difficult for both market participants and financial regulators to distinguish between liquidity and insolvency in a financial crisis. Not surprisingly, therefore, the discount window has sometimes been used to assist insolvent banking institutions."); Because it is difficult to tell when a bank is insolvent or merely illiquid, the Fed, through the discount window, has often made loans to bank's "with a high probability of insolvency in the near term . . . ." See Anna J. Schwartz, *The Misuse of the Fed's Discount Window*, Homer Jones Memorial Lecture (1992) available at, [https://research.stlouisfed.org/publications/review/92/09/Misuse\\_Sep\\_Oct1992.pdf](https://research.stlouisfed.org/publications/review/92/09/Misuse_Sep_Oct1992.pdf) (detailing statistics and examples of Fed's use of discount window to loan to technically insolvent firms).

<sup>55</sup> See Baker, *supra* note 42, at 87 (discussing Fed's expanded power under Section 13(3)). For a discussion of the development of Section 13(3), see *infra* notes 55-84 and accompanying text.

<sup>56</sup> See Emergency Relief and Construction Act of 1932 § 210, ch. 520, 47 Stat. 709, 714 (1932) (amending Section 13 to add paragraph 3). See also Mehra, *supra* note 13, at 230 (describing history of Section 13(3) and Emergency Relief and Construction Act).

<sup>57</sup> For a further discussion of Section 13(3)'s evolution, see *infra* notes 56-86 and accompanying text.

<sup>58</sup> See §210, 47 Stat. at 715 (amending Section 13(3) of the Federal Reserve Act).

<sup>59</sup> *Id.*

limited to member banks.<sup>60</sup> Thus, investment banks and other institutions gained eligibility to receive emergency loans from the Fed to resolve liquidity concerns.<sup>61</sup>

Nevertheless, Congress placed several shackles on the Fed's ability to make Section 13(3) loans.<sup>62</sup> Section 13(3) incorporated the stringent collateral requirements of the original discount window.<sup>63</sup> Thus, use of Section 13(3) was limited to collateral with a maturity date of no more than ninety days and was not used for trading purposes.<sup>64</sup> The purpose of this requirement was to ensure that the borrower bears the risk of its behavior by posting collateral that had an ascertainable and not speculative value, limiting the availability of Section 13(3) to firms with good collateral in need of a liquidity boost due to external market factors.<sup>65</sup> Investment banks, however, dealt primarily in securities used in trading.<sup>66</sup> Thus, even though investment banks could now receive loans, the banks were saddled with ineligible collateral, preventing them from taking full advantage of Section 13(3).<sup>67</sup>

The collateral requirement constraint may have proved an impediment when the Fed first used its newly created 13(3) powers during the Great Depression.<sup>68</sup> Indeed, as originally conceived and with its collateral restrictions, Section 13(3) was not meant to empower the Fed to bailout failing individual institutions but rather to allow the Fed to inject liquidity when external market obstacles arose.<sup>69</sup> Notwithstanding its original

---

<sup>60</sup> See *id.* (granting Fed ability to make discounted loans to individuals, partnerships, and corporations that were not member banks, which was not possible under discount window).

<sup>61</sup> See *id.*

<sup>62</sup> See 47 Stat. at 714 (limiting collateral to "the kinds and maturity made eligibility for discount for member banks"). See also Mehra, *supra* note 13, at 230-32 (describing initial restrictions on Fed's use of Section 13(3)).

<sup>63</sup> See Mehra, *supra* note 13, at 230-32 (describing initial limitations of Section 13(3)).

<sup>64</sup> *Id.* at 231.

<sup>65</sup> Mehra, *supra* note 13, at ("Section 13(3) as enacted sought only to contain systemic liquidity risks."). See Adam J. Levitin, *In Defense of Bailouts*, 99 GEO. L.J. 435, 498 (2011).

<sup>66</sup> See Mehra, *supra* note 13, at 231 ("By specifying the collateral eligible for discount, the legislation . . . limited the Fed's ability to extend credit to investment banks . . . [because] the majority of their assets consist of investment instruments, against which no loans could then be made.").

<sup>67</sup> See *id.*

<sup>68</sup> For a discussion of the limited use of Section 13(3) before it was amended in 1991, see *infra* notes 71-79 and accompanying text.

<sup>69</sup> See Levitin, *supra* note 65, at 496 ("Section 13(3) was probably never intended as a source of bailout authority. Neither its language nor its circumstances of its adoption lend themselves to such an interpretation . . . The language refers to firms being unable to find financing elsewhere, but assumes that the firms can post sufficient collateral for discounting. That is section 13(3) was designed to address liquidity problems, not solvency problems.")

purpose, however, Section 13(3) slowly grew over three quarters of a century from a limited liquidity tool to a source of broad bailout power.<sup>70</sup>

ii. The Fed's Swelling Arsenal: Section 13(3)'s from 1932 until 2008

Although Section 13(3) provided the Fed with a new, albeit limited, weapon to fight financial problems, the Fed rarely used Section 13(3) in the immediate years following its inception.<sup>71</sup> From 1932 until 1937, the Fed utilized Section 13(3) to make 1.5 million dollars in aggregate loans.<sup>72</sup> Even adjusting for inflation, the aggregate amount would only be the equivalent of 25 million dollars today.<sup>73</sup> The Fed's use of Section 13(3) did not generate loans as aggressively as it would in the future.<sup>74</sup>

Indeed, after 1937, the Federal Reserve did not use Section 13(3) until 2008.<sup>75</sup> On several occasions, however, the Fed contemplated using Section 13(3) and went as far as to authorize regional Federal Reserve banks to use 13(3), but it did not actually make any 13(3) loans.<sup>76</sup> The closest the Fed came to using Section 13(3) arose during the tail end of the savings and loan crisis in 1991.<sup>77</sup> The Federal Deposit Insurance Corporation (the "FDIC") requested a 25 billion dollar loan under Section 13(3).<sup>78</sup> The Fed, then led by Alan Greenspan, rejected the request.<sup>79</sup>

---

<sup>70</sup> For a discussion of the Section 13(3)'s development, see *infra* notes 71-89 and accompanying text.

<sup>71</sup> Mehra, *supra* note 13, at 233 (noting that during 1932-1936, Section 13(3) lending "was limited" due in part to "collateral constraints"). See Levitin, *supra* note 65, at 496 ("The Fed has used its section 13(3) powers 'sparingly'; between 1932 and 1936, the Fed made 123 direct loans under section 13(3), totaling about \$1.5 million. It is not clear whether any of these loans were bailouts per se.") (internal citations omitted).

<sup>72</sup> See Mehra, *supra* note 13, at 233 (noting aggregate amount of Section 13(3) was \$1.5 million, or \$23 million adjusted for inflation).

<sup>73</sup> BUREAU OF LABOR STATISTICS, CPI Inflation Calculator, *available at* [http://www.bls.gov/data/inflation\\_calculator.htm](http://www.bls.gov/data/inflation_calculator.htm) (last visited Oct. 17, 2014).

<sup>74</sup> See *infra* notes 87-93.

<sup>75</sup> David Fetting, *The History of a Powerful Paragraph*, THE FEDERAL RESERVE BANK OF MINNEAPOLIS (June 1, 2008), [http://www.minneapolisfed.org/publications\\_papers/pub\\_display.cfm?id=3485](http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=3485) (tracing history of Section 13(3), its use, and its near use).

<sup>76</sup> See *id.*; Mehra, *supra* note 13, at 234 (detailing Fed's authorization to make 13(3) loans to Penn Central Railroad in 1970, to non-member bank in 1980, and FDIC in 1991).

<sup>77</sup> See Fetting, *supra* note 75 ("The Federal Reserve discount window was invoked to dispense \$25 billion as a direct loan to the Federal Deposit Insurance Corporation's Bank Insurance Fund.").

<sup>78</sup> See *id.* (noting that FDIC chairman request Fed loan and Fed Chair, Alan Greenspan, testified against the request).



Soon after the Fed's refusal to loan to the FDIC, Congress amended Section 13(3).<sup>80</sup> The Federal Deposit Insurance Corporation Improvement Act of 1991 eliminated the strict collateral requirements of Section 13(3) by removing the cross-reference to "member banks" in defining what constitutes adequate collateral.<sup>81</sup> Collateral under 13(3) no longer needed to mirror the stringent collateral requirements for member banks under the original discount window.<sup>82</sup> Consequently, to be satisfactory, collateral under Section 13(3) no longer needed a maturity date of less than ninety days and the collateral could have trading purposes.<sup>83</sup> Thus, to meet the threshold for adequate Section 13(3) collateral, the collateral only needed to be "endorsed or secured to the satisfaction of the Federal Reserve Bank."<sup>84</sup> By shedding its main constraint, Section 13(3) opened up its availability, especially to investment banks that deal primarily in non-government securities.<sup>85</sup> Moreover, supplying the Fed with increased discretion to make loans under 13(3) improved Section 13(3)'s potency as a weapon in combating economic disaster through individual bailouts—a powerful and controversial weapon that dropped during the Financial Crisis of 2008.<sup>86</sup>

## II. The Fed's Use of Section 13(3) During the Financial Crisis

The Federal Reserve relied on Section 13(3) as its primary tool to mitigate the damage caused by the mortgage collapse and the subsequent

---

<sup>79</sup> See Mehra, *supra* note 13, at 234 ("[I]n 1991, the Fed refused to make a \$25 billion loan to the Bank Insurance Fund of the Federal Deposit Insurance Company, despite requests by the Treasury and the Chairman of the Corporation).

<sup>80</sup> See Federal Deposit Insurance Corporation Improvement Act of 1991 § 473, 12 U.S.C. §1811 (1991) (amending Section 13(3) by removing collateral requirements).

<sup>81</sup> See *id.* (amending Section 13(3)). See also Mehra, *supra* note 13, at 231-32 ("[Section 473 of the Federal Deposit Insurance Corporation Improvement Act] removed the phrase 'of the kinds and maturities made eligible for discount for member banks under other provisions of this Act'").

<sup>82</sup> See Mehra, *supra* note 13, at 231-32 (describing effect of removing cross-reference to member banks in 13(3) collateral requirements, by allowing all "notes, drafts and bills of exchange" to be eligible collateral "as long as they were endorsed and secured to the satisfaction of the Federal Reserve Bank").

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

<sup>84</sup> See *id.* (noting remaining constraint on collateral under Section 13(3)).

<sup>85</sup> See *id.* at 232 (stating that investment banks could now access Section 13(3)'s lending).

<sup>86</sup> See Mehra, *supra* note 13, at 263 (noting that although Section 13(3) was adopted to protect against systemic liquidity risk, "during the crisis [of 2008], the Fed in fact used section 13(3) to respond to systemic insolvency risks."). For a further discussion of the Fed's use of Section 13(3) during the Financial Crisis, see *infra* notes 87-151 and accompanying text.

Financial Crisis.<sup>87</sup> The Fed invoked Section 13(3) to make direct loans to failing companies.<sup>88</sup> Moreover, the Fed utilized Section 13(3) to develop large-scale lending facilities that provided liquidity to multiple institutions in an attempt to stabilize the financial system.<sup>89</sup>

a. Taking Aim: The Fed Targets Individual Companies During the Financial Crisis

After storing away Section 13(3) in its arsenal for over half a century, the Fed unloaded Section 13(3) in new and unprecedented ways during the Financial Crisis, including using it to “rescue” seemingly failing companies.<sup>90</sup> First, the Fed invoked Section 13(3) to facilitate JP Morgan’s acquisition of Bear Stearns.<sup>91</sup> Then, the Fed, in an abrupt about-face, refused to use Section 13(3) to save Lehman Brothers from bankruptcy.<sup>92</sup> Nevertheless, the Fed used 13(3) to aid AIG.<sup>93</sup>

i. The Shot Heard Around the Financial World: The Fed “Bails Out” Bear Stearns

After the housing bubble burst, investors in mortgage-related financial instruments had a major credit problem.<sup>94</sup> Once thought to be unparalleled investments, mortgage loans and mortgage-backed securities quickly became considered poor assets.<sup>95</sup> Thus, investment banks with large collections of mortgage-related assets found themselves in a liquidity crisis because they were unable to obtain credit and unable to liquidate their

---

<sup>87</sup> For a detailed discussion of the Fed’s use of Section 13(3) in responding to the effects of the mortgage crisis and the subsequent Financial Crisis, see *infra* notes 87-151 and accompanying text.

<sup>88</sup> For an exploration of the Fed’s use of Section 13(3) to make loans to individual companies, see *infra* notes 94-138 and accompanying text.

<sup>89</sup> For a look at the Fed’s use of broad-based lending facilities during the Financial Crisis, see *infra* notes 139-151 and accompanying text.

<sup>90</sup> For a further discussion of the Fed’s use of Section 13(3) bailout individual companies, see *infra* notes 87-138 and accompanying text.

<sup>91</sup> For a discussion of the Fed’s use of Section 13(3) to aid Bear Stearns, see *infra* notes 94-113 and accompanying text.

<sup>92</sup> For the Fed’s response to Lehman Brothers’ failure, see *infra* notes 114-129 and accompanying text.

<sup>93</sup> For a discussion of the Fed’s use of Section 13(3) to aid AIG, see *infra* notes 130-138 and accompanying text.

<sup>94</sup> See Blinder, *supra* note 3, at 101-02 (detailing affect of housing bubble burst on financial system).

<sup>95</sup> See *id.*

mortgage-related assets; they were cash poor.<sup>96</sup> Additionally, after the bubble burst, ascertaining the value of mortgage-backed securities and other mortgage-related financial instruments was nearly impossible.<sup>97</sup> Indeed, the value of these assets may have been (and likely were) considerably less than what companies carried the assets at on their financial statements.<sup>98</sup>

In 2007, Bear Stearns (“Bear”) suffered this fate because it was a major player in the mortgage-backed securities market.<sup>99</sup> Confidence in Bear waned, and counterparties disengaged.<sup>100</sup> Consequently, the investment bank was unable to procure overnight credit to fund its enterprise.<sup>101</sup> Without overnight credit, Bear was not only illiquid; it was also perhaps effectively insolvent—even if its financials said otherwise.<sup>102</sup>

With Bear on the brink of failure, the Federal Reserve decided to step in and facilitate Bear’s acquisition by JP Morgan Chase because it believed Bear’s failure would wreak havoc on the financial world.<sup>103</sup> To do so, the Fed, through JP Morgan, loaned Bear 13 billion dollars through the discount

---

<sup>96</sup> See Blinder, *supra* note 3, at 87 (analogizing the financial system to a house of cards, “By 2006 the United States had built an intricate financial house of cards—a concoction of great complexity, but also of great fragility . . . [a]ll that was necessary to trigger the collapse was the removal of one of its main supporting props . . . when house prices ended their long ascent . . . the rest of the crumbling followed logically.”). For example, Bear Stearns credit rating plummeted after the mortgage collapse because it held mounds of mortgage-related assets. *Id.* at 102. Mortgage-related assets included mortgage loans, mortgage-backed securities, collateralized debt obligations, and credit default swaps. *Id.* With mortgage loans as the foundation, the rest of these assets built on top of each other like a Jenga tower; by removing the bottom blocks, the rest of the structure crumbles. *Id.* at 87. Following the nationwide mortgage collapse, many originating mortgages foreclosed. *Id.* The securities built on top of the originating mortgages, then, had no underlying assets to provide value. *Id.* In essence, the bottom blocks disappeared; the top blocks had nothing on which to exist. *Id.*

<sup>97</sup> See Porter, *supra* note 42 at 490-93 (describing how housing bubble burst created downward pressure on mortgage-related assets).

<sup>98</sup> See Blinder, *supra* note 3, at 104 (“A company facing a severe cash squeeze . . . may be forced into fire sales of its less liquid assets. Which may mean selling them at exceptionally low prices . . . [w]hich reduces net worth.”).

<sup>99</sup> See Porter, *supra* note 42, at 493 (“In the summer of 2007, one of Bear’s two proprietary hedge funds, focused on bets in the subprime mortgage market, collapsed as the value of mortgage-backed securities quickly declined with rising borrower defaults.”).

<sup>100</sup> *Id.* at 493-94 (“Concerns spread quickly that Bear’s liquidity position was compromised . . . hedge funds began exiting Bear’s prime brokerage business . . .”).

<sup>101</sup> See Blinder, *supra* note 3, at 103 (“Bear’s access to the repo market was withering away”); Porter, *supra* note 42, at 294 (noting Bear was cut off from repo market on March 13, 2008).

<sup>102</sup> See Blinder, *supra* note 3, at 104 (explaining difference between illiquidity and insolvency and noting that Bear Stearns’ illiquidity could be characterized as insolvency because value of assets carried on its balance sheet were likely much lower in reality).

<sup>103</sup> See Porter, *supra* note 42, at 495-98 (narrating Fed’s action to facilitate JP Morgan’s acquisition of Bear Stearns).

window.<sup>104</sup> Then, through a holding company, Maiden Lane, the Fed acquired 29 billion dollars of Bear's assets that JP Morgan refused to assume.<sup>105</sup>

To accomplish this task, the Fed invoked the dormant Section 13(3) of the Federal Reserve Act.<sup>106</sup> As discussed above, Section 13(3) permitted the Fed to make loans in emergency situations to individual companies for satisfactory collateral.<sup>107</sup> Thus, even though JP Morgan did not want Bear's riskiest assets, the Fed deemed the assets satisfactory and loaned under Section 13(3), inducing JP Morgan to complete its acquisition of Bear Stearns.<sup>108</sup>

The Fed announced several reasons to justify its unprecedented use of Section 13(3).<sup>109</sup> First, the Fed believed that Bear Stearns failure would wreak havoc on global financial markets because Bear was closely involved with many financial companies.<sup>110</sup> Second, the Fed feared that Bear's many counterparties would suffer direct financial consequences.<sup>111</sup> Thus, the Fed deemed Bear Stearns "too interconnected to fail" because its failure would negatively impact many other financial institutions and markets, which

---

<sup>104</sup> See *id.* at 495 (describing Fed's initial loan to JP Morgan through discount window to indirectly loan to Bear Stearns).

<sup>105</sup> See *id.* at 496 (describing Fed's acquisition of Bear Stearns's assets to facilitate acquisition).

<sup>106</sup> See Blinder, *supra* note 3, at 105 (stating Fed invoked dormant Section 13(3) to accomplish its lending to Bear Stearns).

<sup>107</sup> See Federal Reserve Act § 13(3), 12 U.S.C. § 343 (2006) (permitted Fed to make discounted loans to individuals in time of emergency).

<sup>108</sup> See Porter, *supra* note 42, at 496-97 (narrating JP Morgan's acquisition of Bear through aid of Fed). JPMorgan was hesitant to acquire Bear because it represented huge risk. *Id.* (noting JPMorgan was "alarmed by the risk in the transaction given the overall fragility of the markets and economic climate, the riskiness of their own balance sheet, and the lack of time to conduct due diligence and value Bear's illiquid assets."). Nevertheless, with the Fed's aid through Section 13(3), JPMorgan agreed to acquire Bear and guaranteed the first \$1 billion dollars of the assets acquired by Maiden Lane. *Id.* (describing details of Bear's acquisition).

<sup>109</sup> See generally THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT TO THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES 290-291 (Jan. 2011) (documenting Henry Paulson's and Ben Bernanke's justifications for saving Bear Stearns).

<sup>110</sup> See FINANCIAL CRISIS INQUIRY COMM'N, FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES 291 (2011) ("Our view on why it was important to save [Bear Stearns] . . . was that because it was so essentially involved in this critical repo financing market, that its failure would have brought down that market, which would have had implications for other firms.").

<sup>111</sup> See *id.* (quoting Henry Paulson's testimony, "[i]f Bear had gone, there were hundreds, maybe thousands of counterparties that all would have grabbed their collateral, would have started trying to sell their collateral, drove down prices, create even bigger losses").

would affect the global market.<sup>112</sup> The Fed’s “rescue” of Bear signaled to the market that the government would “bail out” failing financial institutions that were too interconnected to fail.<sup>113</sup>

ii. Out of Ammunition, The Fed “Lets Lehman Fail”

Six months after Bear’s rescue, however, the Fed faced almost the exact same decision when Lehman Brothers, another notable investment bank, suffered a liquidity crisis.<sup>114</sup> Like Bear, Lehman invested heavily in mortgage-related assets, and after the mortgage collapse, Lehman was stuck with enormous amounts of illiquid assets.<sup>115</sup> Unable to obtain adequate credit, Lehman’s financials, like Bear’s, straddled the line between illiquidity and insolvency.<sup>116</sup>

As was the case with Bear and JP Morgan, a potential acquisition between Lehman and Barclay Capital, a British financial institution, reached near fruition.<sup>117</sup> Unlike the case with Bear and JP Morgan, however, the government, led by then Secretary of Treasury Hank Paulson and Chairman of the Federal Reserve Ben Bernanke, refused to devote any public money to facilitate the acquisition.<sup>118</sup> The Fed believed the market had ample time to prepare for Lehman’s failure, unlike the situation with Bear, which was unanticipated.<sup>119</sup> Moreover, the Fed, citing the text of

<sup>112</sup> See Blinder, *supra* note 3, at 112-113 (“The primary reason [the Fed saved Bear] was fear that Bear was *too interconnected to fail*—in several respects.”). Mr. Blinder described the ways in which Bear was too interconnected to fail, including that it “was too closely linked to many other financial companies,” that “Bear was counterparty to what were probably hundreds of thousands of derivatives transactions, that its failure would cripple the repo market, and that “Bear’s failure would call into question the fate of other financial institutions that might share Bear’s predicament. *Id.* See also Porter, *supra* note 42, at 497-98 (“[The Regulators] evaluated the economic stability of the financial system and concluded Bear as too interconnected and the financial system too disorderly to absorb the bankruptcy fluidly.”).

<sup>113</sup> See Blinder, *supra* note 3, at 113 (“Saving Bear implied a tacit commitment to save Lehman Brothers, Merrill Lynch, Morgan Stanley, and Goldman Sachs if necessary.”).

<sup>114</sup> See Porter, *supra* note 42, at 511 (“[S]ubsequent events in the unfolding crisis presented regulators with a strikingly similar situation [to Bear Stearns] when Lehman Brothers . . . faced a parallel collapse in September 2008.”).

<sup>115</sup> See Blinder, *supra* note 3, at 120-23 (chronicling Lehman’s collapse).

<sup>116</sup> See *id.*

<sup>117</sup> See *id.* (narrating Fed and Treasury’s role in trying to facilitate acquisition of Lehman Brothers by Barclay Capital).

<sup>118</sup> See *id.* (describing Fed’s refusal); Porter, *supra* note 42, at 511 (“The Fed refused to Bailout Lehman and the firm filed for bankruptcy protection on September 15, 2008 in the largest Chapter 11 filing in U.S. history.”).

<sup>119</sup> See The Financial Crisis Inquiry Report, *supra* note 109, at 340 (statement of Ben Bernanke) (“We judged that investors and counterparties had had time to take precautionary measures.”). Thus, Mr. Bernanke believed the market had ample time and opportunity to

Section 13(3), subsequently explained that it could not legally loan to Lehman because Lehman had unsatisfactory collateral.<sup>120</sup> Ultimately, without any government money, the deal between Lehman and Barclays fell through.<sup>121</sup> Lehman Brothers entered bankruptcy.<sup>122</sup> What the Fed feared would happen if Bear had failed happened—Lehman was too-interconnected-to fail.<sup>123</sup> On top of that, the Fed's refusal to aid Lehman aggravated the consequences of Lehman's failure because the market had expected the Fed to save Lehman in light of its actions toward Bear Stearns.<sup>124</sup> Because the market believed Lehman would be saved, it was ill prepared for Lehman's abrupt bankruptcy, unlike what the Fed had hoped.<sup>125</sup> Consequently, Lehman's failure had devastating effects on the global financial system: the stock market plunged, credit froze, funds incurred runs (the money market mutual fund broke the buck), and, most directly, Lehman's many counterparties, including Freddie Mac, were hung out to dry.<sup>126</sup> The United States economy entered the worst recession since the Great Depression.<sup>127</sup> Additionally, due to Lehman's interconnectivity,

---

prepare for Lehman's failure because it had recently witnessed Bear's near failure. *Id.* See also Blinder, *supra* note 3, at 125 (narrating decision to let Lehman fail).

<sup>120</sup> See The Financial Crisis Inquiry Report, *supra* note 109, at 340-41 (noting that Ben Bernanke only claimed Fed lacked legal authority to lend to Lehman days after decision not to lend was made). *But see* James B. Stewart, *Eight Days: The Battle to Save the American Financial System*, THE NEW YORKER (Sept. 12, 2009), available at [http://www.newyorker.com/reporting/2009/09/21/090921fa\\_fact\\_stewart?currentPage=all](http://www.newyorker.com/reporting/2009/09/21/090921fa_fact_stewart?currentPage=all) (“Lehman clearly had some solid collateral . . . [t]he very day Lehman failed, the assets from its broker-dealer operations were deemed acceptable as collateral for a series of short-term multibillion-dollar loans for the Fed . . . to insure an orderly winding down . . . [i]t seems likely that such collateral might also have been adequate to support a rescue on the Bear Stearns model.”).

<sup>121</sup> See Blinder, *supra* note 3, at 124 (describing Fed's refusal and Lehman's bankruptcy).

<sup>122</sup> See *id.*

<sup>123</sup> See *id.* at 127 (characterizing consequences of Lehman's failure as “more severe than probably anyone imagined”).

<sup>124</sup> See *id.* at 128 (“[T]he market had acquired the view that the government was not going to let any financial giant fail messily . . . [t]he Lehman decision abruptly and surprisingly tore the perceived rulebook into pieces . . .”).

<sup>125</sup> See *id.*

<sup>126</sup> See generally *id.* at 129-145 (listing effects of Lehman's failure on financial market, including effect on counterparties, asset price decline, run on money market fund due to funds investment in Lehman's commercial paper, and spread to global markets); Stewart, *supra* note 120, at 74-81 (Sept. 21, 2009) (describing days immediately following Lehman's bankruptcy and drop in U.S. stock market, run on money market fund, capital shortages, and credit freeze).

<sup>127</sup> See Blinder, *supra* note 3 at 171 (documenting economic effects after Lehman's failure, including “sharp deterioration in U.S. macroeconomic performance,” credit freeze, contraction of GDP, drop in employment rate, and “speculation about Great Depression 2.0”); Stewart,

the effects of Lehman's failure extended internationally: global superpowers suffered immediate and drastic reduction in exportation, foreign stock markets plummeted, and many Europe economies entered severe and protracted recessions.<sup>128</sup> The Financial Crisis of 2008 formally began.<sup>129</sup>

### iii. The Fed Provides Cover for AIG

Immediately after Lehman's failure and the global economic fallout it helped precipitate, the Fed did use Section 13(3) to aid AIG.<sup>130</sup> AIG, an international insurance company, owned a subsidiary, AIG Financial, which actively participated in the mortgage industry by writing large amounts of credit default swaps (CDS) on collateralized debt obligations (CDO).<sup>131</sup> In essence, AIG Financial bet heavily on the continued growth of the mortgage market.<sup>132</sup> It lost.<sup>133</sup>

To prevent the global markets from further suffering, the Fed, in collaboration with the U.S. Treasury Department, intervened to loan to AIG, the parent company.<sup>134</sup> Initially structured as a treasury loan totaling

*supra* note 120 ("The economic crisis, the worst since the Depression, destroyed household and retirement savings, pensions, insurance funds, and endowments.").

<sup>128</sup> See Blinder, *supra* note 3, at 409-12 (attributing European economic recession in part to U.S. financial crisis, leading to European debt crisis). See also *How Lehman Shook the Global Economy*, *supra* note 10 (noting "volume of world trade began to plummet sharply" after Lehman's failure in September 2008, including "sharp contraction in exports" in Germany, China, and Japan); Stewart, *supra* note 120 (reporting that "Asian and European stock markets had dropped sharply, and trading was halted in Russia" after Lehman's failure).

<sup>129</sup> See Blinder *supra* note 3 at 128 (describing Lehman's failure as "watershed" event of Financial Crisis).

<sup>130</sup> See generally *id.* at 130-140 (chronicling AIG's pre-Financial Crisis investment activities, including substantial use of CDSs, its risky behavior, its massive losses, and the government's bailout). See also Matthew Karnitschnig, *U.S. to Take Over AIG in \$85 Billion Bailout: Central Banks Inject Cash as Credit Dries Up*, THE WALL ST. J. (Sept. 16, 2008) available at, <http://online.wsj.com/news/articles/SB122156561931242905> (narrating AIG bailout as it occurred).

<sup>131</sup> See Blinder, *supra* note 3, at 131 ("By the time AIG stopped selling CDS early in 2006, the insurance behemoth was in the unenviable position of being the dominant seller in a market that was destined to collapse.").

<sup>132</sup> See *id.* at 133 (noting AIG negligently believed its CDS were safe).

<sup>133</sup> See *id.* at 134 ("AIG was woefully unprepared to post more collateral against its massive volume of outstanding CDS.").

<sup>134</sup> See *American International Group (AIG), Maiden Lane II and III*, BD. OF GOVERNORS OF THE FED. RESERVE SYS., [http://www.federalreserve.gov/newsevents/reform\\_aig.htm](http://www.federalreserve.gov/newsevents/reform_aig.htm) (providing background of AIG's financial struggles, the government's aid, and use of Maiden Lane to facilitate aid). See also Stewart, *supra* note 120 (noting financial leaders believed AIG's failure would "have sparked a global banking panic").

\$85 billion dollars, the government restructured the loan to fit under Section 13(3).<sup>135</sup> To provide the necessary liquidity to AIG, the Fed once again relied on Maiden Lane transactions.<sup>136</sup> The Fed created Maiden Lane II to acquire mortgage-related assets from AIG and Maiden Lane III to acquire CDOs from AIG's counterparties on which AIG wrote CDS.<sup>137</sup> The Fed managed AIG's assets and eventually disposed of them, turning a profit for the taxpayer.<sup>138</sup>

b. Scatter Shots: The Fed's Use of Broad-Based Eligible Lending Facilities during the Financial Crisis

Prior to and during the Financial Crisis, the Fed also crafted lending facilities through its 13(3) powers.<sup>139</sup> Lending facilities differ from bailouts because they provide broad-based eligibility.<sup>140</sup> Broad-based eligibility provides access to Federal Reserve loans to any company that meets the lending facility's conditions and requirements.<sup>141</sup> Thus, lending facilities spread the wealth of the Federal Reserve among similarly situated and likely ailing institutions.<sup>142</sup>

The first of the Section 13(3)-empowered lending facilities was the Term Securities Lending Facility (TSLF) and the Primary Dealer Credit Facility (PDCF), established immediately after Bear's rescue.<sup>143</sup> Both

<sup>135</sup> See BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 134 (describing government's restructuring of AIG's loan after TARP passed).

<sup>136</sup> *See id.*

<sup>137</sup> *Id.*; *Maiden Lane Transactions*, FED. RESERVE BANK OF N.Y., <http://www.newyorkfed.org/markets/maidenlane.html> (providing overview of Fed's use of Maiden Lane, including when repaid loans to Fed and net gain to taxpayer).

<sup>138</sup> *See Maiden Lane Transactions*, *supra* note 137 (detailing gain to taxpayer of \$2.8 billion from Maiden Lane II and \$6.6 billion from Maiden Lane III).

<sup>139</sup> *Credit and Liquidity Programs and the Balance Sheet*, BD. OF GOVERNORS OF THE FED. RESERVE SYS., [http://www.federalreserve.gov/monetarypolicy/bst\\_lendingother.htm](http://www.federalreserve.gov/monetarypolicy/bst_lendingother.htm) (describing lending facilities to primary dealers and other lending facilities created under Section 13(3) power).

<sup>140</sup> *See id.* (describing operations of Section 13(3) lending facilities). *See also* Gabilondo, *supra* note 44, at 15 (describing lending facilities as "out patient" facilities that let "firms swap bad collateral for good collateral" to "stabilize" specific sectors of financial system).

<sup>141</sup> *See, e.g., Credit and Liquidity Programs and the Balance Sheet*, *supra* note 139 (describing conditions of Primary Dealer Credit Facility, which was limited to primary dealers with eligible investment-grade securities).

<sup>142</sup> *See id.*

<sup>143</sup> *See* Arthur E. Wilmarth, Jr., *Narrow Banking: An Overdue Reform that Could Solve the Too-Big-to-Fail Problem and Align US and UK Financial Regulation of Financial Conglomerates (Part 1)*, 31 No. 3 BANKING & FIN. SERVICES POL'Y REP. 1, 22 n.93 (2012) (describing PDCF). The PDCF provided the Fed's primary dealers "to make secured borrowings from the FRB on a basis similar to the FRB's discount window for banks." *Id.*



facilities provided recourse loans to primary dealers for eligible collateral in order to inject liquidity.<sup>144</sup> Primary dealers are direct counterparties to the Federal Reserve Banks in open market transactions through which the Fed implements monetary policy.<sup>145</sup> Primary dealers include the major investment banks, as well as several large banking entities such as Barclays Capital, Citigroup, JPMorgan, and Credit Suisse, among others.<sup>146</sup> Following TFLS and PCDF, the Fed began creating lending facilities to provide liquidity to specific financial markets, including asset-backed securities, commercial paper, and money market mutual funds.<sup>147</sup> Through the lending facilities, eligible borrowers could receive loans, easing liquidity concerns.<sup>148</sup> The eligibility requirements open the door to a broad base of borrowers, permitting widespread participation.<sup>149</sup> Nevertheless, the eligibility requirements also preclude participation by institutions that do not have the requisite collateral.<sup>150</sup> Most of the 13(3)-lending facilities have closed, making back their money.<sup>151</sup>

### III. The Dodd-Frank Disarmament

Although it may be unfair to categorize the Fed's refusal to loan to Lehman as a cause of the Financial Crisis, many believe that the Fed's actions amplified the financial reverberations of the mortgage collapse.<sup>152</sup> Government bailouts have been attacked for both encouraging moral hazard and also for lacking discernable consistency and transparency.<sup>153</sup> In

---

<sup>144</sup> See *Credit and Liquidity Programs and the Balance Sheet*, *supra* note 139, [http://www.federalreserve.gov/monetarypolicy/bst\\_riskmanagement.htm](http://www.federalreserve.gov/monetarypolicy/bst_riskmanagement.htm) (last updated Oct. 16, 2014) (detailing purpose and operations of PDCF and TSLF).

<sup>145</sup> See *Primary Dealers List*, FED. RESERVE BANK OF N.Y., [http://www.ny.frb.org/markets/pridealers\\_current.html](http://www.ny.frb.org/markets/pridealers_current.html) (last visited Oct. 17, 2014) (“Primary dealers serve as trading counterparties of the New York Fed in its implementation of monetary policy.”).

<sup>146</sup> See *id.* (listing primary dealers of New York Fed).

<sup>147</sup> See *Credit and Liquidity Programs and the Balance Sheet*, *supra* note 139 (describing “other facilities” enacted by Fed under Section 13(3) to provide liquidity to “investors in key credit markets,” including asset-backed securities, commercial paper, and money market mutual funds). See also Levitin, *supra* note 64, at 498 (“[T]hrough these programs, the Fed was substituting itself for the shadow banking system ‘one market at a time.’”).

<sup>148</sup> See *Credit and Liquidity Programs and the Balance Sheet*, *supra* note 139 (detailing operations of lending facilities).

<sup>149</sup> See *id.*

<sup>150</sup> See *id.*

<sup>151</sup> See *id.*

<sup>152</sup> For a further discussion of the criticism of the Fed for its use of Section 13(3), see *infra* notes 156-74 and accompanying text.

<sup>153</sup> For a further discussion of the different types of criticism of the Fed, see *infra* notes 156-74 and accompanying text.

response, Congress promulgated Dodd-Frank in an attempt to eliminate the government's ability to bailout and to combat systemic risk at an earlier stage.<sup>154</sup> Several years later, the Fed finally embraced Dodd-Frank by publishing proposed regulations incorporating Dodd-Frank's mandates.<sup>155</sup>

a. The Backlash Against Bailouts

The Fed's use of bailouts during the Financial Crisis has been besieged from several divergent viewpoints.<sup>156</sup> On the one hand, the use of a bailout to rescue Bear Stearns was seen as promoting moral hazard through an implied commitment by the government that it will save failing institutions.<sup>157</sup> Thus, the true egregious conduct on the Fed's part was saving Bear Stearns in the first place. To function efficiently, the market needs to rid itself of inferior participants to make room for superior replacements.<sup>158</sup> If the government perpetually bails out these inferior participants who take unnecessary risk, it incentivizes the exact behavior that led to the failure in the first place because the companies and individuals remain in the market without any motive to change.<sup>159</sup>

Some even argue that Bear's bailout was beyond the legal power of the Fed because the traditional role of lender of last resort is limited to loans

---

<sup>154</sup> For a further discussion of Dodd-Frank, specifically Dodd-Frank Section 1101 that limits the Fed's use of Section 13(3), *see infra* notes 175-198, 234-322 and accompanying text.

<sup>155</sup> For a detailed discussion of the proposed rule incorporating Dodd-Frank's limits of Section 13(3), *see infra* notes 209-25, 322-40 and accompanying text.

<sup>156</sup> For a discussion of the disparate criticism, *see infra* notes 157-74 and accompanying text.

<sup>157</sup> *See, e.g., Newman, supra* note 21 ("Bear Stearns was the real mistake . . . [i]f the government had let Bear fail completely, there might have been a credit freeze and market plunge in the spring instead of the fall. But it probably would have been less severe . . . . Lehman came to embody the risks of 'moral hazard'—the notion that decision makers will behave recklessly if they don't believe they have to bear responsibility for their own actions.").

<sup>158</sup> *See id.* ("[T]he failure of unsuccessful firms used to be capitalism's way of clearing the decks for smarter entrepreneurs with fresher ideas and better products."). *See also* Lawrence H. White, *The Federal Reserve and the Rule of Law*, CATO INST. (Sept. 12, 2013), <http://www.cato.org/publications/testimony/federal-reserve-rule-law> ("Consistently enforcing the rules that require insolvent firms to exit the market promptly would remove the kind of uncertainty that followed the Lehman collapse and provide greater clarity to financial markets.").

<sup>159</sup> *See* Porter, *supra* note 42, at 510 (describing theory that "mere presence of [Section] 13(3) may help produce the very circumstances that require its use" because financial companies know the government will not let them fail, which promotes "greater risk-taking and increased leverage"). *See also* Blinder, *supra* note 3, at 101-02 (describing moral hazard concerns of bailouts such as Bear Stearns).

to solvent companies for good collateral.<sup>160</sup> Thus, the Fed overstepped its bounds by lending to arguably insolvent institutions for less-than-good collateral.<sup>161</sup> Instead of acting as lender of last resort, the Fed was functioning as “market maker of last resort.”<sup>162</sup> A market maker “uses its own capital . . . to buy when the customer wants to sell and to sell when the customer wants to buy . . . [allowing] issuers of a security and its investors . . . to get in and out of an investment position easily.”<sup>163</sup> The Fed’s bailouts during the Financial Crisis positioned it as a market maker of last resort instead of lender of last resort because it was basically purchasing unmovable assets, which was beyond the intent of Section 13(3), instead of making loans against collateral, which Section 13(3) was enacted to do.<sup>164</sup>

Similarly, critics questioned how the Fed, a politically independent entity, unilaterally purchased assets through Section 13(3) without Congressional approval.<sup>165</sup> By purchasing assets to bailout individual companies, the Fed was illegally encroaching into political territory.<sup>166</sup>

On the other hand, commentators, who may have supported bailouts, decried the Fed’s inconsistent use of bailouts as a reason why Lehman’s

---

<sup>160</sup> See White, *supra* note 158 (stating Fed’s use of Section 13(3) during Financial Crisis violates its legal mandates); Chad Emerson, *The Illegal Actions of the Federal Reserve: An Analysis of How the Nation’s Central Bank Has Acted Outside the Law in Responding to the Current Financial Crisis*, 1 WM. & MARY BUS. L. REV. 109, 128 (2010) (arguing Fed acted outside its legal authority under Section 13(3) through loans and asset purchases during Financial Crisis); Mehra, *supra* note 13, at 261 (“[T]he Fed not only reached the bounds of its legislative powers, but [] it exceeded them.”).

<sup>161</sup> See White, *supra* note 158 (arguing rule of law for role of lender of last resort only entails providing cash to the market and not to specific firms and use of 13(3) to make individual bailouts violates this rule of law).

<sup>162</sup> See Gabilondo, *supra* note 44, at 11 (“[I]t is clear that the Fed was beginning to discover its role as market maker.”).

<sup>163</sup> *Id.*

<sup>164</sup> See Mehra, *supra* note 13, at 261-63 (tracing legislative purpose of Section 13(3) and concluding “[s]ection 13(3) as enacted sought only to contain systemic liquidity risks . . . [b]ut during the crisis, the Fed in fact used [Section] 13(3) to respond to systemic insolvency risks,” by purchasing assets to make failing companies solvent). Thus, the Fed was not actually making loans because it was obtaining ownership of the collateral rather than just a security interest. See *id.* at 226 (describing difference between secured loan and asset purchase).

<sup>165</sup> See Emerson, *supra* note 160, at 135 (questioning how “federal government finds itself obligated on purchases for which Congress did not provide any budgetary appropriation.”).

<sup>166</sup> See *id.* at 137 (arguing federal government should have ability to audit Fed because Fed’s asset purchases during Financial Crisis went beyond its legal activities). See also Ron Paul, *Ron Paul: Transparency and Accountability for the Federal Reserve!*, RONPAUL.COM (Jan 9, 2011), <http://www.ronpaul.com/2011-01-09/ron-paul-transparency-and-accountability-for-the-federal-reserve/> (arguing against Fed’s independence because it limits accountability and oversight to an agency with “ability to greatly impact the economy” through “purchasing power” which led to Great Recession).

failure inflicted so much damage.<sup>167</sup> The signal emitted by Bear's rescue was suddenly and surprisingly snapped when the government refused to save Lehman.<sup>168</sup> The market was completely unprepared for Lehman's failures, and its counterparties and creditors suffered first hand.<sup>169</sup> The financial system imploded.<sup>170</sup>

Moreover, the reasons behind the Fed's inconsistent conduct remained opaque because Fed leaders refused to pinpoint the exact criteria behind their decisions.<sup>171</sup> The Fed declared that it did not have the legal authority to loan to Lehman because Lehman had unsatisfactory collateral, but the Fed never explained the actual difference in collateral between Bear and Lehman or between AIG and Lehman.<sup>172</sup>

Ultimately, the Fed's use of individual bailouts received harsh criticism from both possible supporters of bailouts for its inconsistency and lack of transparency and non-supporters of bailouts for its rescue of Bear because it violated the traditional role of central banks and promoted moral hazard.<sup>173</sup> Indeed, the severe backlash spilled over into the political arena. In 2010, taking into account the harsh criticism directed at the Fed's use of

---

<sup>167</sup> See Allan H. Meltzer, *What Happened to the 'Depression'?*, WALL ST. J. (Aug. 31, 2009),

<http://online.wsj.com/news/articles/SB10001424052970204251404574342931435353734>.

("Allowing Lehman to fail *without warning* is one of the worst blunders in Federal Reserve history") (emphasis added).

<sup>168</sup> See Porter, *supra* note 42, at 512 ("On first blush, the Lehman collapse reveals an ad hoc policy that developed once the emergency powers were invoked—Lehman faced remarkably similar circumstances to those faced by Bear . . . yet the Fed responded in exactly opposite ways.")

<sup>169</sup> See *supra* notes 123-28 (detailing discussion of the consequences, anticipated and unanticipated, of Lehman's collapse).

<sup>170</sup> *Id.*

<sup>171</sup> See Mehra, *supra* note 13, at 260 (finding that while it may be within Fed's discretion to determine whether collateral is satisfactory, "we might question whether Lehman's assets would have remained insufficient even after the private consortium had acquired its assets . . . [but] we lack the information necessary to assess the quality of Lehman's assets as against those of Bear Stearns, or those of AIG . . .").

<sup>172</sup> See Joe Nocera & Edmund L. Andrews, *Struggling to Keep Up as the Crisis Raced On*, N.Y. TIMES (Oct. 22, 2008),

[http://www.nytimes.com/2008/10/23/business/economy/23paulson.html?pagewanted=all&\\_r=0](http://www.nytimes.com/2008/10/23/business/economy/23paulson.html?pagewanted=all&_r=0) ("When pressed about why it was legal for the Fed to lend billions of dollars to Bear Stearns and A.I.G. but not Lehman Brothers, Mr. Paulson emphasized that Lehman's bad assets created "a huge hole" on its balance sheet. By contrast, he said, Bear Stearns and A.I.G. had more trustworthy collateral."). See also Blinder, *supra* note 3, at 127 (quoting the Fed that Bear's collateral was partially secured by JP Morgan and AIG's collateral was adequate, but Lehman's "fell well short of the amount needed to secure a Federal Reserve Loan.")

<sup>173</sup> See *supra* notes 152-66 (describing criticism of the Fed's Section 13(3) use during the Financial Crisis).

13(3), Congress struck a bargain that would limit the Fed’s Section 13(3) powers and provide measures for increased consistency and transparency.<sup>174</sup>

b. Dodd-Frank Deactivates Individual Bailouts

In direct response to the Federal Reserve’s use of bailouts and in tune with the public backlash against bailouts, Congress enacted Dodd-Frank to reduce the Fed’s power to conduct individual bailouts through Section 13(3).<sup>175</sup> Dodd-Frank Section 1101 removed the phrase “individual, partnership, or corporation” from the language of Section 13(3).<sup>176</sup> Thus, Section 1101 expressly limits emergency loans under Section 13(3) to broad-based eligibility for liquidity purposes.<sup>177</sup> Moreover, Section 1101 places procedural hurdles on the Fed’s use of Section 13(3) to increase consistency and transparency.<sup>178</sup>

i. Legislative History of Dodd-Frank 1101

Due to the wide-ranging criticism of Section 13(3), it received significant attention by both houses of Congress during passage of Dodd-Frank.<sup>179</sup> In the House, the proposed bill would have prohibited only pure individual bailouts.<sup>180</sup> The House bill, however, would have heightened the collateral requirements to expressly preclude “substandard” assets.<sup>181</sup>

---

<sup>174</sup> See *infra* notes 179-208 and accompanying text.

<sup>175</sup> See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 § 1101, 124 Stat. 1376, 2113-15 (codified as amended in scattered sections of 12 U.S.C.) (amending Section 13(3)).

<sup>176</sup> *Id.* at (a)(2).

<sup>177</sup> See *id.* (amending Section 13(3)); see generally *infra* notes 189-203 (detailing discussion of Dodd-Frank Section 1101’s amendments to Section 13(3)).

<sup>178</sup> See *id.* (mandating procedural and transparency requirements into Section 13(3)); see generally *infra* notes 204-08 (detailing discussion of these procedural and transparency requirements).

<sup>179</sup> See Jeremy C. Kress, *Credit Default Swaps, Clearinghouses, and Systemic Risk: Why Centralized Counterparties Must have Access to Central Bank Liquidity*, 48 HARV. J. ON LEGIS. 49, 84-91 (2011) (discussing the legislative history of Dodd-Frank’s amendments to Section 13(3)).

<sup>180</sup> See H.R. 4173, 111th Cong. § 1701 (2009) (enacted) (documenting House proposals to amend Section 13(3)). See also Kress, *supra* note 179, at 86 (“The house bill would have prohibited the Federal Reserve from authorizing § 13(3) loans ‘for only a single and specific individual, partnership or corporation . . . .’”).

<sup>181</sup> See H.R. 4173, 111th Cong. § 701 (2009) (enacted) (documenting House proposals to amend collateral requirements of Section 13(3)). See also Kress, *supra* note 179, at 86 (“The house bill also specified that the Federal Reserve could not discount or accept as security any asset that would be classified as ‘substandard,’ ‘doubtful,’ or ‘loss’ by a federal or state banking regulator . . . .”).

Further, the House bill would have prevented the Fed from using Section 13(3) unless “repayment” of the loan had a “99 percent likelihood.”<sup>182</sup> Finally, the House bill sought to subject the Fed’s use of Section 13(3) to consent by the Treasury.<sup>183</sup> Thus, the House bill represented a severe restriction on Section 13(3).<sup>184</sup>

The Senate opted for an even broader restriction on Section 13(3) by allowing only loans under a lending facility “with broad-based eligibility.”<sup>185</sup> Like the House bill, the Senate bill also required Secretary of Treasury approval.<sup>186</sup> Unlike the House bill, however, the Senate bill did not contain the repayment or collateral restrictions.<sup>187</sup> Ultimately, Dodd-Frank Section 1101 closely resembles the Senate bill.<sup>188</sup>

## ii. Purpose and Substantive Changes

Section 1101 of Dodd-Frank amended Section 13(3) to include an express purpose paragraph.<sup>189</sup> The stated purpose of the amended Section 13(3) is, “to ensure that any emergency lending program or facility is for the purpose of providing liquidity to the financial system, and not to aid a failing financial company. Additionally the section provides that the security for emergency loans is sufficient to protect taxpayers from losses and that any such program is terminated in a timely and orderly fashion.”<sup>190</sup>

<sup>182</sup> See H.R. 4173, 111th Cong. § 1701 (2009) (enacted). See also Kress, *supra* note 179, at 87 (“[T]he House bill would have clarified that an extension of emergency credit is not ‘secured to the satisfaction of the Federal Reserve bank’—and therefore cannot be made—unless there is ‘at least a 99 percent likelihood’ that all dispersed funds will be repaid, with interest.”).

<sup>183</sup> See H.R. 4173, 111th Cong. § 1701 (2009) (enacted); see also Kress, *supra* note 179, at 86-87 (noting that House bill would have required risk council to determine whether too-big-to-fail event required Section 13(3) Fed to utilize Section 13(3) power and for “certification by the President and consent from Secretary of the Treasury” before Section 13(3) could be used).

<sup>184</sup> See Kress, *supra* note 179, at 91 (characterizing House bill restrictions on Section 13(3) as “draconian”).

<sup>185</sup> See S. 3217, 111th Cong. § 1151(2) (2010) (enacted) (documenting Senate bills proposed amendments to Section 13(3)); see also Kress, *supra* note 179, at 89 (stating that the Senate bill “would have limited the mechanism for emergency Federal Reserve loans to “a program or facility with broad-based eligibility”).

<sup>186</sup> See S. 3217, 111th Cong. § 1151(2) (2010) (enacted).

<sup>187</sup> See *id.* (requiring transparency in accepted collateral but not expressly restricting collateral or requiring strict repayment assurance).

<sup>188</sup> See *infra* notes 189-203 (discussing further the amendments to Section 13(3) by Dodd-Frank Section 1101).

<sup>189</sup> See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 § 1101, 124 Stat. 1376, 2113-14 (codified as amended in scattered sections of 12 U.S.C.) (stating purpose of amendments to Section 13(3)).

<sup>190</sup> *Id.* at (a)(6)(B)(i).

With this purpose in mind, the amendments to Section 13(3) expressly prohibit bailouts and heighten the collateral needed to trigger Section 13(3).<sup>191</sup>

First, Dodd-Frank amends Section 13(3) by “striking ‘individual, partnership, or corporation’ and replacing it with ‘participant in any program or facility with broad-based eligibility.’”<sup>192</sup> The consequence of this new language is a direct prohibition of Section 13(3) loans to individual companies.<sup>193</sup> Thus, the loan to Bear Stearns and AIG would be a violation of the Federal Reserve Act, as amended by Dodd-Frank.<sup>194</sup>

Second, Dodd-Frank 1101 also contains an express prohibition against any lending program to an insolvent borrower.<sup>195</sup> Traditionally, a prohibition on lending to an insolvent borrower is an axiom of central banking that does not need to be expressly stated.<sup>196</sup> As the Financial Crisis taught us, however, the line between illiquidity and insolvency has blurred.<sup>197</sup> Thus, Dodd-Frank 1101 expressly prohibits lending to formally insolvent borrowers but tasks the Fed with establishing the procedures to implement the prohibition.<sup>198</sup>

Finally, Section 13(3)’s increased the collateral requirements of Section 13(3).<sup>199</sup> First, acceptable collateral must be “consistent with sound risk management practices . . . to ensure protection for the taxpayer.”<sup>200</sup>

---

<sup>191</sup> See *id.* at 2113-15 (proscribing the Fed’s power under Section 13(3)).

<sup>192</sup> See *id.* at 2113(a)(2)-(5) (removing all references to “individual, partnership, or corporation” from Section 13(3) of Federal Reserve Act).

<sup>193</sup> See *id.* at 2113-15 (limiting bailouts to individual companies); see also Mehra, *supra* note 13, at 264 (“[T]he Fed can no longer make loans to individual entities.”).

<sup>194</sup> See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 § 1101, 124 Stat. 1376, 2113-14 (codified as amended in scattered sections of 12 U.S.C.); see also Gabilondo, *supra* note 44, at 12 (noting the Fed would not have been able to loan to Bear Stearns under Dodd-Frank’s conditions).

<sup>195</sup> See *id.* at 2114 (prohibiting any lending under Section 13(3) to insolvent borrowers).

<sup>196</sup> See Walter Bagehot, *Lombard Street: A Description of the Money Market 1873-98* (1873) (stating that central banks should let banks fail when they become insolvent); see also Fabio Castiglionesi & Wolf Wagner, *Turning Bagehot on His Head: Lending at Penalty Rates When Banks Can Become Insolvent*, 44 *J. Money, Credit & Banking* 201, 202 (2012) (“Institutions without sufficient collateral were assumed to be insolvent and should, in Bagehot’s view, be allowed to fail.”).

<sup>197</sup> See Blinder, *supra* note 3, at 103-04 (describing the fine line between illiquidity and insolvency); Baker, *supra* note 42, at 85 (noting that while strong collateral for access to lender of last resort ensures borrower is merely illiquid and not insolvent, “[i]n practice, however, it can be difficult for both market participants and financial regulators to distinguish between liquidity and insolvency in a financial crisis”).

<sup>198</sup> See Dodd-Frank Wall Street Reform and Consumer Protection Act Pub. L. 111-203 § 1101, 124 Stat. at 2114 (“The Board shall establish procedures to prohibit borrowing from programs and facilities by borrowers that are insolvent.”).

<sup>199</sup> See *id.* at 2113 (discussing changes to collateral used for loan under Section 13(3)).

<sup>200</sup> *Id.*

This increases the collateral requirement because it expressly prohibited loans that present too much risk.<sup>201</sup> Second, the collateral requirement becomes more transparent because the Fed must assign a “lendable value to all collateral for a loan executed by a Federal reserve bank under [Section 13(3)]” to determine “whether the loan is secured satisfactorily...”<sup>202</sup> To ensure further compliance and increased transparency, Dodd-Frank 1101 also requires the Fed to submit to several procedural hurdles before using its newly diluted Section 13(3) powers.<sup>203</sup>

### iii. Procedural Changes

Prior to the Dodd-Frank amendments, the Fed could unilaterally activate Section 13(3).<sup>204</sup> After the amendments, the Fed must gain approval of the Secretary of Treasury before creating any 13(3) lending program.<sup>205</sup> Further, under Dodd-Frank Section 1102, the Comptroller General can review the Fed and its lending facilities.<sup>206</sup> Under this authority, the Comptroller General can check the financials of the any facility, the effectiveness of the collateral, the risk to the Fed bank and the taxpayer, and whether the facility “inappropriately favors one or more specific participants over other institutions eligible to utilize the facility...”<sup>207</sup> Thus, even if it wanted to, the Fed could not circumvent Dodd-Frank’s mandates because both the Secretary of Treasury and the

---

<sup>201</sup> See *id.* (prohibiting collateral that would put too much risk on taxpayer).

<sup>202</sup> *Id.*

<sup>203</sup> See *id.* at 2114 (detailing procedural requirements); § 1102, 124 Stat. at 2116-17 (subjecting Fed’s use of Section 13(3) to Comptroller Review). For a further discussion of the procedural changes to Section 13(3), see *infra* notes 204-08 and accompanying text.

<sup>204</sup> See Federal Reserve Act § 13(3), 12 U.S.C. § 343 (2006).

<sup>205</sup> See Dodd-Frank Wall Street Reform and Consumer Protection Act Pub. L. 111-203 § 1101, 124 Stat. at 2114 (“The Board may not establish any program or facility under this paragraph without prior approval of the Secretary of the Treasury.”).

<sup>206</sup> See § 1102, 124 Stat. at 2116-17: The Comptroller General of the United States may conduct audits, including onsite examinations, of the Board of Governors, a Federal Reserve bank, or a credit facility, if the Comptroller General determines that such audits are appropriate, solely for the purposes of assessing, with respect to a credit facility or a covered transaction—(A) the operational integrity, accounting, financial reporting, and internal controls governing the credit facility or covered transaction; (B) the effectiveness of the security and collateral policies established for the facility or covered transaction in mitigating risk to the relevant Federal reserve bank and taxpayers; (C) whether the credit facility or the conduct of a covered transaction inappropriately favors one or more specific participants over other institutions eligible to utilize the facility; and (D) the policies governing the use, selection or payment of third-party contractors by or for any credit facility or to conduct any covered transaction.

<sup>207</sup> See *id.*



Comptroller General oversee the Fed's actions to ensure compliance, consistency, and transparency.<sup>208</sup>

iv. Proposed Regulations

Dodd-Frank Section 1101 requires the Fed, in consultation with the Secretary of Treasury, to devise regulations and policies to implement the mandates of the amendments to Section 13(3).<sup>209</sup> In December 2013, the Fed finally released proposed regulations incorporating Dodd-Frank Section 1101.<sup>210</sup> While the proposed rules comport with Dodd-Frank Section 1101, the rules go no further than Dodd-Frank Section 1101's restrictions, reserving broad discretion in the Fed to use Section 13(3).<sup>211</sup>

In the proposed rules, the Fed defines Section 13(3)'s broad-based eligibility requirement as "designed to provide liquidity to a market or sector of the financial system."<sup>212</sup> Moreover, the proposed rules specifically state "that a program or facility must not be for the purpose of aiding a failing financial company and must not be structured to remove assets from the balance sheet of a *single and specific company*."<sup>213</sup> Thus, the definition of broad-based eligibility only precludes loans to individual companies.

Similarly, the Fed narrowly defines the term insolvency, adding no more restrictions than Dodd-Frank requires.<sup>214</sup> Specifically, the Fed borrows its definition directly from Dodd-Frank and defines an insolvent borrower as "any person or entity that is in bankruptcy, resolution under

---

<sup>208</sup> See *id.* (increasing oversight of Section 13(3)'s use); see also Mehra, *supra* note 13, at 267 ("Congress's main concern may have been about the distinction that the Fed drew between Bear Stearns, AIG, and issuers of commercial paper on the one hand and Lehman on the other. Hence the thrust of the newly amended legislation may be to proscribe arbitrary decision making rather than asset purchasing as such.").

<sup>209</sup> See § 1101, 124 Stat. at 2113 ("As soon as is practicable after the date of enactment of this subparagraph, the Board shall establish, by regulation, in consultation with the Secretary of the Treasury, the policies and procedures governing emergency lending under this paragraph.").

<sup>210</sup> See Extensions of Credit by Federal Reserve Banks, 79 Fed. Reg. 615 (proposed Jan. 6, 2014) (to be codified at 40 C.F.R. pt. 201), available at <https://www.federalregister.gov/articles/2014/01/06/2013-31025/extensions-of-credit-by-federal-reserve-banks> (incorporating Dodd-Frank's conditions).

<sup>211</sup> See *infra* notes 322-40 and accompanying text (analyzing the broad retention of discretion by the proposed rules),

<sup>212</sup> Extensions of Credit by Federal Reserve Banks, 79 Fed. Reg. at 616.

<sup>213</sup> *Id.*

<sup>214</sup> See *id.* at 617 (incorporating Dodd-Frank's insolvency definition "that a Reserve Bank must not extend credit through a program or facility established under Section 13(3) of the FRA to any person or entity that is in bankruptcy, resolution under Title II of the Dodd-Frank Act, or any other Federal or State insolvency proceeding.").

Title II of the Dodd-Frank Act, or any other Federal or State insolvency proceeding.<sup>215</sup> Ultimately, the proposed rules definition of insolvency mirrors Dodd-Frank's formal definition of insolvency.<sup>216</sup>

Moreover, the proposed rules incorporate the transparency and procedural mandates of Dodd-Frank.<sup>217</sup> First, the proposed rules permit the Fed to rely on a written certification solvency "from the person, the chief executive officer of the entity or another authorized officer of the entity . . . that the person or entity is not in bankruptcy or in a resolution or other insolvency proceeding."<sup>218</sup> Second, the proposed rules address the assignment of lendable value to collateral.<sup>219</sup> The proposed rules reiterate Dodd-Frank's requirement that the Federal Reserve Banks "must, prior to or at the time the credit is initially extended, assign a lendable value to all collateral for the program or facility, consistent with sound risk management practices and to ensure protection for the taxpayer."<sup>220</sup> Thus, while the proposed rules commit the Fed to the increased consistency and transparency measures of the lendable value assignment, the rules do not specifically address the details of the assignment of lendable values.<sup>221</sup>

Finally, the proposed rules ensure the Fed will submit its Section 13(3) authority for approval by the Secretary of Treasury.<sup>222</sup> The rules also require the Fed to periodically review 13(3) programs to ascertain "whether each emergency lending program should be terminated."<sup>223</sup> To ensure the Fed is stationing itself as lender of last resort, the rules require the Fed to "obtain evidence of the inability of participants to secure adequate credit accommodations. . ."<sup>224</sup> Ultimately, the proposed rules mirror Dodd-Frank's amendments without further restricting the Fed's 13(3) power; rather, the rules likely retain broad discretion in the Fed as discussed in the sections below.<sup>225</sup>

---

<sup>215</sup> *Id.*

<sup>216</sup> *See id.*

<sup>217</sup> *See id.* at 617-19 (incorporating Treasury approval and lendable value requirements of Dodd-Frank).

<sup>218</sup> Extensions of Credit by Federal Reserve Banks, 79 Fed. Reg. at 617.

<sup>219</sup> *See id.* at 619.

<sup>220</sup> *Id.*

<sup>221</sup> *See id.* at 617 (stating Fed Reserve Banks will assign lendable value without detailing procedures of lendable value system.).

<sup>222</sup> *See id.* at 616 (incorporating Secretary of Treasury prior approval condition).

<sup>223</sup> *Id.* at 617.

<sup>224</sup> Extensions of Credit by Federal Reserve Banks, 79 Fed. Reg. at 617.

<sup>225</sup> For an analysis of the broad retention of discretion by the proposed rules, see *infra* notes 314-32 and accompanying text.

c. The FSOC

Dodd-Frank also created a new government entity, The Financial Stability Oversight Council (FSOC), to regulate systemic risk.<sup>226</sup> The purpose of the FSOC is to “identify risks to the financial stability of the United States” due to too-big-to-fail companies, “to promote market discipline, by eliminating expectations ... that the Government will shield them from losses,” and “to respond to emerging threats to the stability of the United States financial system.”<sup>227</sup> Composed of high-level government leaders including the Secretary of Treasury and the Chairman of the Fed, the FSOC incorporates Congress’s “preference for ex ante solutions to systemic risk concerns,” rather than bailouts.<sup>228</sup> Among its “ex ante” solutions, the FSOC researches financial risk factors and can subject risky too-big-to-fail companies to Federal Reserve oversight.<sup>229</sup> Further, the FSOC can authorize the Fed to limit a financial company’s ability to combine with another company and reduce its financial services, activities, and conduct.<sup>230</sup> If oversight and restrictions fail, the FSOC can authorize the Fed to order a company to liquidate “in a manner that mitigates such risk and minimizes moral hazard,” in order to prevent messy failures.<sup>231</sup> Ultimately, the FSOC aims to establish “ex ante” approaches to preventing and containing systemic risk in order to eliminate the need for bailouts by attacking too-big-to-fail before it gets to the point that a bailout is needed.<sup>232</sup> As discussed in the section below, however, even with ex ante measures, bailouts may still be needed to combat systemic risk.<sup>233</sup>

---

<sup>226</sup> See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 111(a), 124 Stat. 1376, 1393 (codified at 12 U.S.C. §§ 5321, 5322 (2010)) (establishing Financial Stability Oversight Council).

<sup>227</sup> See *id.* at § 112(a)(1)(A)-(C), 124 Stat. at 1394 (describing purpose and duties of Financial Stability Oversight Council).

<sup>228</sup> Mehra, *supra* note 13, at 271. See also *id.* at § 111(a)(1), 124 Stat. at 1393 (stating voting members of FSOC include Secretary of the Treasury, Chairman of the Board of Governors, Comptroller of the Currency, among several others).

<sup>229</sup> See *id.* at § 113(a)-(b), 124 Stat. at 1398 (authorizing FSOC to require supervision of financial companies by Federal Reserve Board of Governors).

<sup>230</sup> See *id.* at § 121(a), 124 Stat. at 1410 (describing “mitigatory actions” of Federal Reserve once given supervisory control by FSOC).

<sup>231</sup> See *id.* at § 204(a), 124 Stat. at 1454 (empowering FSOC to authorize orderly liquidation of “failing financial companies”).

<sup>232</sup> See Mehra, *supra* note 13, at 271 (describing role of FSOC as “new systemic risk regulator” that can incorporate Congress’ “preference for ex ante solutions to systemic risk concerns.”).

<sup>233</sup> For a further discussion of why bailouts can be helpful even if ex ante procedures are implemented, see *supra* notes 228-32, *infra* notes 234-97 and accompanying text.

#### IV. Assessment

Dodd-Frank Section 1101 limits the Federal Reserve's ability to make emergency bailouts under Section 13(3).<sup>234</sup> These limitations may handicap the Fed and the government from responding to future financial crises.<sup>235</sup> Nevertheless, the Fed's proposed regulations retain broad discretion in the Fed to legally utilize Section 13(3) in flexible ways.<sup>236</sup>

##### a. A Critical Analysis of Dodd-Frank Section 1101

Section 13(3) originated as a minimal extension to the Fed's role as lender of last resort.<sup>237</sup> Indeed, the original Section 13(3) merely empowered the Fed to loan to alleviate liquidity issues due to frozen markets.<sup>238</sup> In other words, the entity drawing loans from the Fed could not obtain liquidity elsewhere due to external market forces beyond the borrower's control despite the borrower possessing ample credit and high-grade collateral.<sup>239</sup> Thus, as originally adopted, Section 13(3) merely permitted the Fed—in line with its role as lender of last resort—to address liquidity concerns, not to fend off systemic risk through insolvency issues.<sup>240</sup> Over time, however, Section 13(3) evolved because its collateral requirements were reduced to the point where the Fed had absolute discretion to decide whether collateral was satisfactory, allowing it to loan more freely.<sup>241</sup> During the Financial Crisis, the Fed used 13(3)'s generous discretion to loan to institutions whose issues went well beyond liquidity concerns and bordered on insolvency.<sup>242</sup> Preventing systemic risk, however, is a responsibility of the Federal Reserve.<sup>243</sup> Its use of emergency

---

<sup>234</sup> See § 1101, 124 Stat. 1376, 2113-15 (removing the Fed's ability to loan to "individual, partnerships, or corporations"). *see also supra* notes 183-202 and accompanying text for a detailed discussion of Dodd-Frank's restrictions of §13(3).

<sup>235</sup> For an analysis on why individual loans under § 13(3) may be needed, *see infra* notes 241-97 and accompanying text.

<sup>236</sup> For an analysis of the Fed's proposed rules incorporating § 1101, 124 Stat. 1376, 2113-15, *see infra* notes 314-32 and accompanying text.

<sup>237</sup> For a detailed discussion of the role of lender of last resort, *see supra* notes 32-52 and accompanying text.

<sup>238</sup> *See supra* notes 42-46 (describing purpose of lender of last resort).

<sup>239</sup> *See id.*

<sup>240</sup> *See id.*

<sup>241</sup> For a discussion of the 1991 amendment to Section 13(3), *see supra* notes 80-85 and accompanying text.

<sup>242</sup> For a discussion of the Fed's use of Section 13(3) during the Financial Crisis, *see supra* notes 86-145 and accompanying text.

<sup>243</sup> *See generally*, Board of Governors of the Federal Reserve System, *The Federal Reserve System: Purposes and Functions*, (June 2005), available at

individual bailouts helps satisfy that responsibility because individual bailouts provide the Fed with the flexibility to quickly respond to specific, unanticipated market developments.<sup>244</sup> Nevertheless, the Fed's use and decision-making during the Financial Crisis remained opaque.<sup>245</sup> Dodd-Frank's measures to increase consistency and transparency would help prevent the disparate outcomes of the Bear Stearns and Lehman Brothers situations.<sup>246</sup>

i. The Benefits of Bailouts

The Fed should retain the power to make individual bailouts because individual bailouts, when used consistently, offer ways to combat financial turmoil and economic disaster that broad-based eligibility programs and traditional monetary policy cannot.<sup>247</sup> While Section 1101's prohibition rests on the valid idea that individual bailouts promote moral hazard and encourage risky behavior, it presumes that the too-big-to-fail doctrine and its problems can be cured without the need to resort to bailouts.<sup>248</sup> Ideally, too-big-to-fail can be cured through ex ante measures such as increased banking regulations, financial reform, and increased oversight, but too-big-to-fail may be enmeshed in our financial system.<sup>249</sup> Dismantling too-big-to-fail is a process that will not happen overnight.<sup>250</sup> As long as too-big-to-fail

---

[http://www.federalreserve.gov/pf/pdf/pf\\_complete.pdf](http://www.federalreserve.gov/pf/pdf/pf_complete.pdf) (detailing duties and responsibilities of Federal Reserve); Board of Governors of the Federal Reserve System, *Mission*, <http://www.federalreserve.gov/aboutthefed/mission.htm> (last updated Nov. 6, 2009) (listing current duties of Federal Reserve, including conducting monetary policy, regulating banks, maintaining stability, containing systemic risk, and providing financial services).

<sup>244</sup> For an analysis of the benefits of bailouts, see *infra* notes 241-43, *supra* notes 245-297 and accompanying text.

<sup>245</sup> For a discussion of how the Fed's use of Section 13(3) lacked consistency and transparency, see *supra* notes 298-301 and accompanying text.

<sup>246</sup> For an analysis of how the transparency and consistency requirements of Dodd-Frank will help the Fed properly use Section 13(3), see *infra* notes 302-13 and accompanying text.

<sup>247</sup> See Gabilondo, *supra* note 43, at 8 ("When the financial crisis of 2007 occurred, the Fed followed Bagehot's advice because it had been statutorily charged by Congress to act as the lender of last resort. It was not enough, though, to stem the crisis. Instead, the Fed had to experiment with new ways of injecting stabilizing liquidity into the financial sector.") (emphasis added).

<sup>248</sup> See § 1101, 124 Stat. at 2113-14 (stating Section 13(3) is not to aid failing financial company); see also § 112, 124 Stat. at 1394 (establishing FSOC to dismantle too-big-to-fail doctrine through ex ante solutions rather than post-hoc bailouts).

<sup>249</sup> See Levitin, *supra* note 64, at 490 ("Absent vigorous ex ante regulation, some firms will be regarded as TBTF . . . [t]he need for bailouts cannot be entirely eliminated.")

<sup>250</sup> See *id.*

exists, bailout authority provides flexibility in responding to uncertain market developments and agility in implementing the response.<sup>251</sup> Further, as evidenced by the Fed's use of bailouts during the Financial Crisis, taxpayer money is not necessarily forfeited because the Fed has proven it can manage illiquid assets and dispose of them for gain.<sup>252</sup> Finally, bailouts provide the Fed with the ability to target specific institutions in need of aid, whereas broad-based eligible lending facilities may be overbroad, wasting the Fed's resources.<sup>253</sup>

### 1. Flexibility and Agility

Individual bailouts provide necessary flexibility because the financial system has evolved to the point where it cannot be adequately regulated through traditionally means.<sup>254</sup> For example, the shadow banking system has grown to rival the commercial banks.<sup>255</sup> As a result, the two systems have become intertwined, with commercial banks opting to lend through the shadow banking system to increase their market presence.<sup>256</sup>

One banking commentator has noted that this "inter-market" funding "phenomenon" raised several new issues regarding the Fed's role in stabilizing the evolving market.<sup>257</sup> First, a majority of bank funding occurred outside the purview of the Fed.<sup>258</sup> Thus, the Fed could not rely on its traditional tools to provide liquidity in this system.<sup>259</sup> Second, the new

---

<sup>251</sup> For a discussion bailout's flexibility in responding to market developments, *see infra* notes 247-69 and accompanying text.

<sup>252</sup> For a further analysis of the reliability of individual bailouts to turn a profit under Section 13(3), *see infra* notes 270-82 and accompanying text.

<sup>253</sup> For a comparison of individual loans to broad-based lending facilities, *see infra* notes 286-97 and accompanying text.

<sup>254</sup> *See Gabilondo, supra* note 44 at 8 ("When the financial crisis of 2007 occurred, the Fed followed Bagehot's advice because it had been statutorily charged by Congress to act as the lender of last resort. It was not enough, though, to stem the crisis. Instead, the Fed had to *experiment with new ways* of injecting stabilizing liquidity into the financial sector.") (emphasis added).

<sup>255</sup> *See id.* at 12-13 ("[B]anks had began to face competition from nonbank lenders in the 'shadow banking' sector, including securities firms, hedge funds, money market mutual funds, and special-purpose vehicles.").

<sup>256</sup> *See id.* at 13 ("[H]ow banks financed their lending operations changed . . . customers moved their funds into other types of financial institutions . . . [as a result] depository institutions adopted a new funding model . . . funding had really become an 'inter-market' phenomenon.").

<sup>257</sup> *See id.* at 12-13 (noting new issues presented by evolving funding market).

<sup>258</sup> *See id.* at 13 ("The new forms of inter-bank funding had weakened the Fed's grip on the money supply because funding was taking place in markets beyond the Fed's reach.").

<sup>259</sup> *See id.*

funding system relied on a “secondary loan market,” including the repurchase market.<sup>260</sup>

The repurchase market—an overnight funding system—relies on credit, which requires confidence in the borrower.<sup>261</sup> Because funding is based on investment securities—including mortgage-related assets that have inherently transient and unsecure value—as collateral, confidence in a borrower can quickly disappear as the value of the borrower’s assets decline.<sup>262</sup> Once confidence in a borrower is lost, the borrower is unable to secure overnight funding, rendering the borrower immediately illiquid and threatening near-future insolvency because the borrower no longer has adequate cash flow or sufficient assets to keep the business going.<sup>263</sup> Thus, the boundary between illiquidity and insolvency has dissipated with the evolution of the financial system because overnight funding—a major source of funding—and asset values have become nearly interdependent.<sup>264</sup> Indeed, this exact situation happened to both Bear Stearns and Lehman Brothers.<sup>265</sup> Consequently, the Fed had to devise a way to respond to the new “inter-market” funding system and the complex and imminent concerns it created.<sup>266</sup>

Because the Fed was unencumbered by politics and Congressional approval, the Fed quickly and decisively devised a way to respond to the issues of the inter-market funding system through its use of individual

---

<sup>260</sup> See *id.* (describing secondary market for credit as changing way banks funded their lending operations because “banks looking for financing had to turn to others wholesale lenders (such as banks themselves) and other financial markets.”).

<sup>261</sup> See Gabilondo, *supra* note 44 at 13 (“One wholesale’s lender’s risk assessment of a borrower could cause a panic if other lenders followed suit . . . the secondary market for credit made it easy for price signals to travel anonymously and quickly.”); Blinder, *supra* note 3 at 102-103 (noting that lack of confidence in Bear Stearns disrupted Bear’s access to overnight loans).

<sup>262</sup> See Blinder, *supra* note 3 at 102 (describing faltering confidence in Bear Stearns due to Bear’s “heavy concentration in mortgage finance”); see also Gabilondo, *supra* note 44, at 14 (noting that in 2007 “a French bank stopped redeeming some of its funds after concluding that it could not value some securities backed by U.S. subprime mortgages”).

<sup>263</sup> See Gabilondo, *supra* note 44 at 13 (“[T]he imminence of funding transactions made them important as liquidity signals: if a firm could not pay its overnight debt, its long-term solvency was in peril.”).

<sup>264</sup> See *id.* (describing relationship between illiquidity and insolvency); Blinder, *supra* note 3 at 104 (describing reduction in net worth when companies cannot obtain liquidity because they have to sell assets at low price which “severe percentage declines in net worth” due to high leverage).

<sup>265</sup> See Blinder, *supra* note 3 at 104 (describing Bear Stearns as illiquid and perhaps technically insolvent).

<sup>266</sup> See Gabilondo, *supra* note 44 at 13 (“Because . . . dynamics in the interbank market could signal systemic risk, . . . it was natural that the Fed would take an interest in the new ways through which banks were funding themselves.”).

bailouts.<sup>267</sup> Indeed, the swift response—in less than a weekend—mitigated the consequences of Bear’s failure because it allowed the Fed to keep pace with the rate in which Bear was “bleeding cash.”<sup>268</sup> Moreover, the quick response also collaterally saved the new “inter-market” funding system from a potential collapse as well.<sup>269</sup> In fact, Mr. Bernanke has stated as much, “our view was that because [Bear] was so essentially involved in this critical repo financial market, that its failure would have brought down that market, which would have had implications for other firms.”<sup>270</sup> If Bear had failed outright, other firms might have lost access to the repo market from lack of confidence as well, especially given the state of the financial market at the time.<sup>271</sup> The repo market, which these companies critically relied on, would no longer exist as a source of funding for them.<sup>272</sup> Then, the liquidity and insolvency issues that plagued Bear and Lehman would spread to these other firms, increasing systemic risk and endangering the global markets.<sup>273</sup>

So, while perhaps acting beyond its traditional role as lender of last resort, the Fed’s use of Section 13(3) to respond to Bear Stearns’ situation showcased the necessary speed and flexibility of individual bailouts in responding to a financial system that continuously develops in more complex and interconnected ways, creating new ways to spread systemic risk.<sup>274</sup> Although the inter-market funding system will likely be more heavily regulated in the future, at the time, the Fed’s use of individual

---

<sup>267</sup> See Levitin, *supra* note 65 at 507 (“the Fed was able to act nearly instantaneously . . . .”); Blinder, *supra* note 3 at 107 (noting that Fed tried to get Treasury to respond, “but that would have required an act of Congress, which was plainly impossible on such short notice . . . .”).

<sup>268</sup> See Blinder, *supra* note 3 at 103-104 (describing Bear’s loss of liquidity in less than four days and Fed’s immediate response).

<sup>269</sup> See Gabilondo, *supra* note 44 at 14 (noting Fed’s use of Section 13(3) “stabilize[d] credit markets” with “its theater of operations [becoming] the interbank liquidity cycle.”).

<sup>270</sup> Bernake, *supra* note 109.

<sup>271</sup> See Blinder, *supra* note 3 at 112 (stating “the market would look for the next wounded deer, then the next, and the whole system would be at serious risk.”); see also Heidi N. Moore, *Can What Happened to Bear Happen to Other Banks*, *The Wall St. J.* (Mar. 18, 2008), available at <http://blogs.wsj.com/deals/2008/03/18/repos-just-where-do-the-other-banks-stand/> (describing repo market and exposure of other investment banks to its volatility which leads to illiquidity).

<sup>272</sup> See Moore, *supra* note 271 (stating “repos led to the downfall of [Bear]” and posed threat to other similarly-situated investment banks); see also Blinder, *supra* note 3 at 53 (analogizing repo market to “playing with fire” because borrower could lose access to funding in matter of days, which “killed both Bear Stearns and Lehman Brothers . . . and almost killed Merrill Lynch, Morgan Stanley, and Goldman Sachs.”).

<sup>273</sup> See Blinder, *supra* note 3 at 112-113 (noting “Bear’s risk profile was far unique. If Bear fell, other firms might not be far behind.”).

<sup>274</sup> See Gabilondo, *supra* note 44 at 13-14 (describing evolving funding system and issues it presents).



bailouts was the quickest way to ensure Bear's fate did not gravely affect the rest of the financial market.<sup>275</sup> No one can predict what transformations or convolutions the financial system will undergo in the future. Therefore, the Fed should embrace the role of market maker of last resort and retain the ability to bailout individual firms because it provides a swift and flexibility tool to quickly respond—in emergency situations—to a financial system that will experience unpredictable changes.<sup>276</sup>

## 2. Reliability and Viability

Further, the use of individual bailouts during the Financial Crisis proved to be reliable because each time the Fed made individual loans, it made its (the taxpayers') money back with interest.<sup>277</sup> During the Financial Crisis, in the bailouts to Bear and AIG, the Fed created holding companies to manage the collateral provided for the loan.<sup>278</sup> The holding companies received the Fed's loan and purchased the assets from either Bear or AIG.<sup>279</sup>

In Bear's case, Maiden Lane acquired 30 billion dollars in mortgage-backed securities, mortgage loans, and credit default swaps.<sup>280</sup> Through Maiden Lane, Bear's assets remained viable, "obviating the need for Bear's collateralized lenders to sell their collateral."<sup>281</sup> By smartly managing Bear's assets, Maiden Lane repaid the Fed's loan in full with interest.<sup>282</sup>

In the case of AIG, the Fed created two separate holding companies, Maiden Lane II and Maiden Lane III, to acquire and manage AIG's assets.<sup>283</sup> For Maiden Lane II, the assets included mortgage-backed

---

<sup>275</sup> See Levitin, *supra* note 65 at 507.

<sup>276</sup> See Gabilondo, *supra* note 44 at 17 (finding "it would be better to have some flexibility in the future to respond to uncertain market developments.").

<sup>277</sup> See *Maiden Lane Transactions*, Fed. Reserve Bank of N.Y., <http://www.newyorkfed.org/markets/maidenlane.html> (providing overview of Fed's use of Maiden Lane, including when repaid loans to Fed and net gain to taxpayer).

<sup>278</sup> See *id.*

<sup>279</sup> See *id.*

<sup>280</sup> See *Regulatory Reform: Bear Stearns, JPMorgan, and Maiden Lane LLC*, Bd. of Governors of the Fed. Reserve Sys., [http://www.federalreserve.gov/newsevents/reform\\_bearstearns.htm](http://www.federalreserve.gov/newsevents/reform_bearstearns.htm) (detailing Fed's use of Section 13(3) to create Maiden Lane to acquire assets of Bear that JPMorgan refused to assume).

<sup>281</sup> Gabilondo, *supra* note 43, at 15.

<sup>282</sup> See *Maiden Lane Transactions*, The Federal Reserve Bank of New York, <http://www.newyorkfed.org/markets/maidenlane.html> (providing overview of Fed's use of Maiden Lane, including when repaid loans to Fed and net gain to taxpayer).

<sup>283</sup> See *American International Group (AIG), Maiden Lane II and III*, Board of Governors of the Federal Reserve System, [http://www.federalreserve.gov/newsevents/reform\\_aig.htm](http://www.federalreserve.gov/newsevents/reform_aig.htm) (providing background of AIG's financial struggles, the government's aid, and use of Maiden Lane to facilitate aid).

securities; for III, the primary assets were CDOs on which AIG had written CDS.<sup>284</sup> Despite acquiring these seemingly risky assets, both Maiden Lane I and II managed the assets and provided net gain to the U.S. taxpayer.<sup>285</sup>

These results indicate that the Fed's use of individual loans have not actually cost the taxpayer anything, despite critics claiming that they represent substantial risk to taxpayers.<sup>286</sup> In fact, the U.S. public has benefited because the Fed was able to acquire the assets at a depressed price and resold them at a gain.<sup>287</sup> While the Fed did assume risk in acquiring these assets as collateral, we cannot discount the fact that the Fed understood it would succeed in managing the assets to profit because they acquired the assets at an extremely depressed price.<sup>288</sup> Thus, the use of individual loans is reliable because the Fed has proven it can assess risk appropriately, manage risky assets, and avoid taxpayer losses.<sup>289</sup>

Further, the Fed's acquisitions of the assets affected not just the assets acquired but also similar mortgage-related assets that had unascertainable value because the Fed's valuation of its acquisitions created a baseline for valuing these assets in the market.<sup>290</sup> During the Financial Crisis, the value of mortgage-related assets declined, but no one knew that actual value, rendering the assets unusable.<sup>291</sup> Thus, individual bailouts are also a viable valuation device because they help ascertain the price of risky assets, increasing market liquidity by allowing firms to pencil in prices on their balance sheet for previously uncertain assets, such as mortgage-backed

---

<sup>284</sup> *See id.*

<sup>285</sup> *See Maiden Lane Transactions, supra* note 283.

<sup>286</sup> *See, e.g.,* Craig Torres, Bob Ivry, and Scott Lanman, *Fed Reveals Bear Stearns Assets Swallowed to Get JPMorgan to Rescue Firm*, Bloomberg (Apr. 1, 2010) (stating taxpayer money put at risk by acquiring Bear's assets); Jim Puzzanghera, *AIG bailout is 'poisonous'; taxpayers risk 'severe losses,' panel says*, L.A. Times (June 11, 2010) (documenting Congressional Overnight Panel's attack on AIG bailout due to risk to taxpayer money).

<sup>287</sup> *See id.*

<sup>288</sup> *See* Rick Newman, *What Taxpayers Get From the Bear Stearns 'Bailout'*, U.S. News (Mar. 25, 2008), available at <http://money.usnews.com/money/blogs/flowchart/2008/03/25/what-taxpayers-get-from-the-bear-stearns-bailout> (noting Fed's acquisition of Bear's assets at depressed price could minimize losses incurred).

<sup>289</sup> *See* Gabilondo, *supra* note 43, at 16-17 (noting that Fed's use of Maiden Lane transactions added stability to the market, increased assets price, ascertained similarly-situated assets' prices, and injected liquidity throughout the market, and not just into Bear or AIG).

<sup>290</sup> *See id.* at 17 ("Once the Fed had 'discovered' the real value of these assets, other investors holding them could free ride using these valuation markets to adjust their balance sheet.").

<sup>291</sup> *See id.* at 16 (noting market participants "were afraid of being stuck with rapidly wasting assets").

security, which allows them to put the assets to use.<sup>292</sup> Therefore, individual bailouts provide a reliable and viable means to aid not only specific failing firms, but also the entire financial industry.

### 3. Particularity and Specificity

Finally, individual bailouts enable the Fed to pinpoint exactly where the financial system is weakest, allowing the Fed to quarantine the contagion.<sup>293</sup> For example, when Bear was the “slowest antelope,” the Fed targeted Bear and assisted JP Morgan’s acquisition.<sup>294</sup> If Bear went bankrupt, the post-Lehman financial fallout may still have occurred—just six months earlier.<sup>295</sup> The Fed used its Section 13(3) power because it identified Bear’s weaknesses and the impact of Bear’s failure.<sup>296</sup> An individual bailout, then, was likely the best response because at the time only Bear needed aid.<sup>297</sup> Bear’s bailout worked prophylactically to shore up the financial system before it completely fell apart.

In the wake of Bear’s rescue, the Fed began experimenting with broad-based lending facilities such as the TSLF to provide widespread liquidity to the market.<sup>298</sup> These lending facilities helped stabilize the shaky market, but they could not prevent the effects of Lehman’s failure.<sup>299</sup> After Lehman’s failure, lending facilities continued to provide liquidity, slowly recovering the market.<sup>300</sup> Indeed, the lending facilities “served a progressively larger set of liquidity clients” and “stabilized the financial

---

<sup>292</sup> See *id.* at 15-16; see also Porter, *supra* note 42, at 498 (noting selling prices of assets at depressed prices would “form the market by which institutions must value similar assets on their books . . . these institutions would write down assets and . . . attendant losses on the income statement”).

<sup>293</sup> For an analysis of how bailouts provide a targeted response to specific threats, see *infra* notes 296-297 and accompanying text.

<sup>294</sup> See Blinder, *supra* note 3, at 102 (narrating Bear’s troubles and Fed’s targeted AIG).

<sup>295</sup> See Newman, *supra* note 22 (noting there would have been “credit freeze and market plunge” if Bear went bankrupt, “but it probably would have been less severe.”).

<sup>296</sup> See Blinder, *supra* note 3, at 105-07 (describing Fed’s decision to use Section 13(3) to aid Bear and facilitate JPMorgan’s acquisition).

<sup>297</sup> Cf. Mehra, *supra* note 13, at 271 (“Let us imagine that we are faced with a chain reaction problem. Only one entity is illiquid and so requires a loan. However, if it fails, many others will also fail. Here, providing credit to that entity alone would be precisely the right step to take. But § 13(3) as amended precludes the Fed from taking such a step.”).

<sup>298</sup> See *supra* notes 134-145 (describing Fed’s Section 13(3) lending facilities).

<sup>299</sup> See Gabilondo, *supra* note 43, at 16 (noting Fed’s pre-Lehman lending facilities “temporarily stabilized” the markets but were “not enough . . . to mitigate the effects of Lehman’s collapse.”).

<sup>300</sup> See Credit and Liquidity Programs and the Balance Sheet, *supra* note 139 (describing lending facilities and affect on markets).

turbulence that peaked after Lehman's bankruptcy.<sup>301</sup> Nonetheless, the facilities acted remedially rather than prophylactically to combat systemic risk by supplying aid to markets and sectors already weakened.<sup>302</sup> Thus, no matter their efficacy, facilities may not have the same preventative capabilities as bailouts.

Moreover, bailouts provide specific aid without overextending the Federal Reserve. With lending facilities, the Fed opens up its doors for any institution that meets the facilities' conditions; some institutions that have no need for aid will be eligible.<sup>303</sup> Consequently, lending facilities run the risk of being over inclusive, which may waste the Fed's resources.<sup>304</sup> Bailouts, on the other hand, provide assistance to only specific companies, allowing the Fed to adjust its aid accordingly and appropriately.<sup>305</sup> Moreover, due to the inherent interconnectivity of the financial system, a well-used bailout can guard against the devastating global economic consequences of a sudden bankruptcy of a too-big-to-fail firm to prevent another Lehman situation. Therefore, bailouts have a unique role in preventing systemic risk from spreading by targeting specific weaknesses in the financial system, which broad-based lending facilities may not possess.

## ii. Consistency and Transparency

While individual bailouts provide the Fed with the necessary tool to combat systemic risk in emergency situations, Dodd-Frank's increased consistency and transparency will help protect against another Lehman situation.<sup>306</sup> As discussed above, the consequences of Lehman's collapse may be partially attributed to the Fed's inconsistent response to Bear and Lehman's failure.<sup>307</sup> The market expected the Fed to bailout Lehman because Lehman and Bear's situation were nearly identical; few would have guessed the Fed would reject Lehman's collateral when it accepted

---

<sup>301</sup> Gabilondo, *supra* note 43, at 16.

<sup>302</sup> *See id.*

<sup>303</sup> *Cf.* Levitin, *supra* note 65, at 499 (describing type 1 errors as "a risk that too many firms will be treated as TBTF . . .").

<sup>304</sup> *See id.*

<sup>305</sup> *See generally*, Gabilondo, *supra* note 43, at 17 (questioning whether Dodd-Frank's limitation of Section 13(3) to broad-based eligibility can provide same results as individual loans).

<sup>306</sup> For a discussion of how the consistency and transparency requirements could increase efficacy of individual bailouts under Section 13(3), see *infra* notes 298-313 and accompanying text.

<sup>307</sup> *See supra* notes 120-23 (describing how Fed's inconsistency aggravated financial fallout post-Lehman).

Bear's.<sup>308</sup> Dodd-Frank Section 1101's increased procedural requirements diminishes the concern over whether the Fed can make a Section 13(3) loan because it reduces the subjectivity in the Fed's decisions and improves both consistency and transparency through the lendable value requirement and the oversight and approval measures.<sup>309</sup>

### 1. Lendable Values

Transparent lendable values would increase consistency because it will help create a more definite boundary between what is satisfactory and what is not by quantifying the value of acceptable collateral. Critics of bailouts argue that bailouts incentivize risky behavior because the investment banks and other financial firms know they have a government safety net to cushion their fall.<sup>310</sup> With increased market certainty in the collateral requirement, however, the moral hazard concerns may diminish.<sup>311</sup> For example, if a borrower knows the lendable value of satisfactory collateral, the borrower will have to ensure that it possesses similar or better collateral to receive any Section 13(3) loans.<sup>312</sup> To ensure it possesses necessary collateral, the borrower will have to minimize its risky behavior or suffer its fate without a bailout.<sup>313</sup>

Moreover, a transparent cutoff for lendable value may signal to the market that a firm is bound for failure. For example, if Lehman knew it did not possess satisfactory collateral because its collateral had a low lendable value, the market would have known the Fed would not save it. Then, Bernanke and Paulson's theory that the market had time to prepare for Lehman's failure would have credence.

---

<sup>308</sup> See Porter, *supra* note 41, at 512 ("On first blush, the Lehman collapse reveals an ad hoc policy that developed once the emergency powers were invoked—Lehman faced remarkably similar circumstances to those faced by Bear . . . yet the Fed responded in exactly opposite ways."); Allan H. Meltzer, *What Happened to the 'Depression'?*, *The Wall St. J.* (Aug. 31, 2009), available at <http://online.wsj.com/news/articles/SB10001424052970204251404574342931435353734> ("Allowing Lehman to fail *without warning* is one of the worst blunders in Federal Reserve history") (emphasis added).

<sup>309</sup> For a discussion of how the lendable value and oversight requirements can prevent inconsistent application of Section 13(3), see *infra* notes 310-21, and accompanying text.

<sup>310</sup> E.g., Newman, *supra* note 22 (arguing saving Bear was a mistake because it promoted moral hazard). For a further discussion of moral hazard implications promoted by bailouts, see *supra* notes 156-159 and accompanying text.

<sup>311</sup> Cf. Mehra, *supra* note 13, at 263 (arguing that original iteration of Section 13(3) protected against moral hazard because strict collateral requirements ensured "the borrower, and not the Fed, would still bear the main effects of its own risk-taking behavior").

<sup>312</sup> *Id.* at 265.

<sup>313</sup> See *id.* ("Insolvent borrowers are expressly prohibited from borrowing...").

## 2. Oversight and Approval

Second, the transparency and accountability requirements—such as the Comptroller review and the Secretary of Treasury approval—may safeguard against arbitrary or subjective decisions by the Fed.<sup>314</sup> The Comptroller review will help ensure the Fed adheres to a strict lendable value system because it may prevent the Fed from deviating from its historical use of lendable value.<sup>315</sup> This may prevent the Fed from using different lendable value systems for different borrowers at different times, which may have led to the disparate treatment of Bear and Lehman's collateral. Although it may be hard to precisely quantify collateral such as mortgage-related assets that have uncertain value, the Comptroller's review may limit unnecessary subjective deviations to provide both increased consistency and transparency.<sup>316</sup>

Finally, the Secretary of Treasury approval will also increase transparency through the addition of political accountability.<sup>317</sup> While commentators have argued that the Treasury approval will unnecessarily slow the Fed's ability to react to market needs because the approval will be hamstrung by political interference, the Fed relies on the Treasury's implicit approval before conducting its more aggressive monetary measures.<sup>318</sup> Indeed, during the Financial Crisis, Bernanke and Paulson and Bernanke and Geithner worked closely together, coordinating their response.<sup>319</sup> Thus, the Secretary of Treasury approval formalizes what may have been common practice.<sup>320</sup> Nevertheless, the formality gains efficacy because it may

---

<sup>314</sup> *C.f.* Emerson, *supra* note 160, at 133-36 (advocating for increased oversight of Fed to prevent Fed from exercising too much discretion in its aid).

<sup>315</sup> *C.f. id.* (advocating for increased oversight of Fed).

<sup>316</sup> *C.f. id.* at 136 (“[A]n audit would force the Fed to more stridently act to conform to the law--appropriate behavior for an entity created by Congress with the ability to bind the federal government and United States citizens to a wide array of near unlimited financial obligations.”).

<sup>317</sup> *See* Levitin, *supra* note 65, at 514 (“Bailouts . . . are the proper response to systemic crises, but they must be conducted in transparent, politically accountable ways to ensure public legitimacy, which is essential for the ultimate efficacy.”).

<sup>318</sup> Gabilondo, *supra* note 44, at 17 (“[Treasury approval] is a bad idea, because it further politicizes central bank liquidity support . . . [and] may substantially limit the Fed's ability to respond in an agile and efficient way . . .”).

<sup>319</sup> *See* Blinder, *supra* note 3, at 105-107, 110, 127 (describing coordinated response to Bear, Lehman, and other financial issues by Bernanke, Paulson, and Geithner, who was at time president of Federal Reserve Bank of New York).

<sup>320</sup> *See id.* (describing coordinated response). *But see* Fetting, *supra* note 75 (describing FDIC's request for loan by Fed under Section 13(3), support by Secretary of Treasury, and opposition by the Fed). Despite this disagreement, the recent Financial Crisis highlighted the interaction and coordination between the Fed and the Treasury. *See* Blinder, *supra* note 3, at 105-107, 110, 127.

assuage the critics that claim the Fed's bailout power should not be used by a politically unaccountable entity.<sup>321</sup> Therefore, the Secretary of Treasury's approval may increase positive perception of Fed bailouts use without necessarily slowing the process down.

b. Proposed Regulations

While the Fed's proposed rules comport with Dodd-Frank Section 1101, the rules go no further than Dodd-Frank.<sup>322</sup> Indeed, the Fed does not proscribe its Section 13(3) powers any more than what Dodd-Frank requires, leaving many terms broadly defined.<sup>323</sup>

The rules define "broad-based eligibility" nearly as broadly as possible.<sup>324</sup> While the rules state that Section 13(3) can only be used to aid a sector of the financial system, the rules do define what constitutes a sector.<sup>325</sup> The rules only prevent aid to single companies.<sup>326</sup> Thus, under the proposed rules, the Fed is free to use its discretion to determine what constitutes aid to a sector.<sup>327</sup> As discussed in the recommendation section below, aid to a sector may be accomplished narrowly through assistance to as few as two companies.<sup>328</sup>

Similarly, the Fed incorporates a formal and narrow definition of insolvency.<sup>329</sup> The rules eschew a broad, functional approach to insolvency by avoiding any definitions that relate to the balance sheet issues surrounding mortgage-related assets as in the case of Bear, where the borrower was bordering the boundary between illiquidity and insolvency.<sup>330</sup> Therefore, the proposed rules also retain broad discretion in the Fed to lend

---

<sup>321</sup> *Cf.* Emerson, *supra* note 160, at 137 ("At the very least, elected members of Congress should be afforded the power to see the full details of the Fed's transactions.").

<sup>322</sup> *See* Extensions of Credit by Federal Reserve Banks, *supra* note 28, at 615-620 (incorporating Dodd-Frank Section 1101's amendments to Section 13(3)).

<sup>323</sup> *See id.* at 619 (Section 201.4(d)(1)(i), "In unusual and exigent circumstances, the Board, by the affirmative vote of not less than five members, may authorize any Federal Reserve Bank, subject to such conditions and during such periods as the Board may determine, to extend credit...").

<sup>324</sup> *See id.* (Section 201.4(d)(2)(i), defining broad-based eligibility).

<sup>325</sup> *See id.* (Section 201.4(d)(2)(i)(A)).

<sup>326</sup> *Id.* (Section 201.4(d)(2)(i)).

<sup>327</sup> *See id.* (Section 201.4(d)(2)(i)(A)).

<sup>328</sup> *See id.* (Section 201.4(d)(2)(i)). For an analysis of the impact of the proposed rule's broad definitions, see *infra* notes 345-57 and accompanying text.

<sup>329</sup> *See* Extensions of Credit by Federal Reserve Banks, *supra* note 28, at 619 (Section 201.4(d)(2)(iii)(A)).

<sup>330</sup> *See id.*

to failing companies that are technically insolvent because it defines insolvency narrowly to mean only formally insolvent institutions.<sup>331</sup>

Moreover, the procedural requirements do little to limit the Fed.<sup>332</sup> The certification of solvency process attempts to increase transparency in the Fed's decision-making process by supporting the Fed's decision to lend with a legally binding certification from the borrower.<sup>333</sup> Because the certification comes from an interested party—the borrower—however, the efficacy of the certification may be questioned.<sup>334</sup>

Further, the Fed expressly avoids designing a lendable value system within the rules.<sup>335</sup> Instead, the Fed merely states that a lendable value must be assigned to protect the taxpayer.<sup>336</sup> This retains discretion in the Fed to implement lendable value system on an ad hoc basis; the Fed has stated that it has “long assigned a lendable value to collateral . . . [to] determine . . . the financial strength of the borrower . . . [and] whether the credit is satisfactorily secured.”<sup>337</sup> Nevertheless, even without a fully developed lendable value system in the rules, the Comptroller oversight may ensure that the lendable value system is applied more consistently than its historical antecedent by enforcing a strict lendable value system adhering to Dodd-Frank's mandates.<sup>338</sup> Ultimately, the proposed rules reserve broad discretion in the Fed's use of Section 13(3).<sup>339</sup> As discussed below, this broad discretion enables the Fed to legally reclaim some of the power sapped by Dodd-Frank.<sup>340</sup>

## V. Recommendations to Reactivate Bailouts

The benefits of possessing a tool as flexible and useful as individual bailouts outweigh its theoretical costs such as promoting moral hazard, especially when the costs can be mitigating by other means such as the consistency and transparency procedures. Thus, the prohibition of individual bailouts should be removed. If it cannot be removed, the Fed should promulgate rules that permit bailouts that affect two or more institutions. Similarly, the Fed's current proposed rules should be

---

<sup>331</sup> *See id.*

<sup>332</sup> *See id.* (Section 201.4(d)(2)(iii)(B)).

<sup>333</sup> *See id.*

<sup>334</sup> *See id.*

<sup>335</sup> *See id.* at 619-620. (defining insolvent borrowers).

<sup>336</sup> *See id.* at 619 (Section 201.4(d)(3)(ii)).

<sup>337</sup> *Id.*

<sup>338</sup> Emerson, *supra* note 160, at 137.

<sup>339</sup> *See supra* notes 314-32.

<sup>340</sup> *See infra* notes 335-346.



interpreted as broadly as possible to ensure the Fed can effectively respond to market needs. Conversely, if the Fed's power to bailout specific institutions is indeed eliminated, the FSOC should inherit the pre-Dodd-Frank Section 13(3) power but with the new consistency and transparency requirements.

a. Abolish the Ban on Individual Bailouts while Keeping or Increasing the Consistency and Transparency Provisions

The most direct way to re-arm the Fed with the power of individual bailouts is to remove the prohibition of emergency individual bailouts from Dodd-Frank Section 1101. The express prohibition contained in Dodd-Frank is premised on the theory that government bailouts encourage risky behavior because they provide a perceived safety net for companies. As discussed in the section above, however, moral hazard may be mitigated by Dodd-Frank Section 1101's consistency and transparency requirements because the lendable value system and the increased oversight established by Dodd-Frank Section 1101 would effectively heighten the level of collateral needed to secure a Section 13(3) loan by creating a transparent and consistent lendable value cutoff.<sup>341</sup> To further ensure transparency, however, the Fed should disclose the metrics used in its lendable value system so borrowers and the market can assess collateral themselves to better anticipate the Fed's response.

Moreover, if Congress wants to expressly heighten the collateral requirements of Section 13(3), it can install language that prohibits certain trading securities from acting as collateral under Section 13(3), similar to the pre-1991 iteration of Section 13(3) or the Dodd-Frank House bill discussed above.<sup>342</sup> For example, Congress can specifically preclude assets such as CDOs, CDS, or other asset-backed securities that cannot be quickly liquidated. This would eliminate the riskiest collateral, preventing firms with only junk collateral from obtaining Section 13(3) aid, while still permitting bailouts if necessary.

Nevertheless, even if Congress leaves Dodd-Frank Section 1101 as is, the collateral requirements are effectively heightened by the consistency and transparency measures of Section 1101.<sup>343</sup> Thus, the concern of moral hazard wanes as companies will understand they cannot expect the Fed's

---

<sup>341</sup> See *supra* notes 298-313.

<sup>342</sup> See Emergency Relief and Construction Act of 1932 § 210, ch. 520, 47 Stat. 709, 714 (1932) (limiting collateral under Section 13(3) to securities not drawn or issued for trading purposes other than government securities); H.R. 4173 § 1701 (documenting House proposals to amend collateral requirements of Section 13(3)); See also Kress, *supra* note 179, at 86.

<sup>343</sup> See *supra* notes 305-08.

assistance without “good” collateral.<sup>344</sup> Therefore, Dodd-Frank’s ban on individual bailouts is at best premature and possibly unnecessary given that moral hazard can be combated in other ways. The benefits of emergency individual bailouts outweigh the costs. Dodd-Frank’s prohibition should be abolished.

b. Define Broad-Based Eligibility as loans to two or more institutions or loans that will affect more than one institution

Because Dodd-Frank is not likely to be amended or repealed anytime soon, the Fed should adopt rules defining broad-based eligibility broadly. Dodd-Frank delegates the power to define broad-based eligibility to the Fed.<sup>345</sup> Consequently, the Fed can define broad-based eligibility as broadly as possible as long as it does not conflict with Dodd-Frank. Dodd-Frank, however, merely states that broad-based eligibility does not include assistance to a “single and specific company.”<sup>346</sup> One commentator has noted the lack of rigidity in Dodd-Frank’s definition of broad-based eligibility and has suggested, “[Dodd-Frank’s restrictions] could be satisfied...by any program established to help at least *two* firms....”<sup>347</sup> Taking this proposition one step further, the Fed should adopt rules that define broad-based eligibility as, for example: a program or facility that is structured to remove assets from two or more companies or that is established for the purpose of assisting two or more companies avoid bankruptcy. By specifically delineating the type of program permitted, the Fed will comport with Dodd-Frank’s ban on “single and specific” aid while also expanding its discretion to use Section 13(3) as broadly as possible.<sup>348</sup> While the Fed cannot remove assets from any single and specific firm under Dodd-Frank, under the “two or more” definition, it will not be limited to traditional programs of broad-based eligibility lending facility that were used during the Financial Crisis.<sup>349</sup> Instead, the Fed would maintain flexibility—although not to the extent of true individual loans—to create programs that would respond quickly to market crises.

---

<sup>344</sup> See *infra* notes 305-08.

<sup>345</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1101, 124 Stat. 1376, 2114 (2010).

<sup>346</sup> *Id.*

<sup>347</sup> Thomas W. Joo, *A Comparison of Liquidation Regimes: Dodd-Frank’s Orderly Liquidation Authority and the Securities Investor Protection Act*, 6 Brook. J. CORP. FIND. & COM. L. 47, 62 (Fall, 2011).

<sup>348</sup> *Id.*

<sup>349</sup> See *id.*

c. Interpret the Proposed Regulations Broadly

If the current proposed rules are adopted, the proposed rules' definition of broad-based eligibility should be interpreted broadly. As discussed above, the rules define broad-based eligibility as "a program or facility...designed to provide liquidity to an identifiable market or sector of the financial system..."<sup>350</sup> Moreover, the rules only expressly prohibit aiding a failing financial company, removing assets from a single and specific company, or assisting a single and specific company avoid bankruptcy.<sup>351</sup> Essentially, the definition incorporates the requirements of Dodd-Frank by prohibiting programs targeted at a "single and specific" company or a failing financial firm.<sup>352</sup> In either case, the language of the rules only limits individualized programs. Thus, even without the express definition of "two or more," the current proposed rules can be interpreted to mean any program that assists "two or more" companies, including two or more failing companies.<sup>353</sup> Further, aid to only two companies would fall within the rules' market liquidity requirement because specific aid to certain failing companies may prevent other companies within the same sector from failing as well given the increasing interconnectivity of financial institutions.<sup>354</sup> Thus, the current proposed rules, if interpreted broadly, are functionally equivalent to the "two or more" definition by retaining broad discretion in the Fed to create programs that target specific firms.

Indeed, reading the entire proposed rules indicates that the Fed chose to incorporate Dodd-Frank without proscribing its discretion any further.<sup>355</sup> In each definition, the Fed merely restates Dodd-Frank's mandates without further limitations or explanations.<sup>356</sup> Thus, the rules reserve broad discretion in the Fed to utilize Section 13(3) as the need arises while still operating within the legal bounds of Dodd-Frank. As such, interpreting the proposed rules' definition of broad-based eligibility broadly likely fits the purpose of the proposed rules. Therefore, the proposed rules definition of

---

<sup>350</sup> *Extensions of Credit by Federal Reserve Banks*, 79 Fed. Reg. 615 (proposed Jan. 6, 2014) (to be codified at 40 C.F.R. pt. 201), available at <https://www.federalregister.gov/articles/2014/01/06/2013-31025/extensions-of-credit-by-federal-reserve-banks> (incorporating Dodd-Frank's conditions).

<sup>351</sup> *See id.*

<sup>352</sup> *See id.*

<sup>353</sup> *See Joo*, *supra* note 347, at 62.

<sup>354</sup> *See id.*

<sup>355</sup> *See supra* notes 314-32.

<sup>356</sup> *See Extensions of Credit by Federal Reserve Banks*, 79 Fed. Reg. 615 (proposed Jan. 6, 2014) (to be codified at 40 C.F.R. pt. 201), available at <https://www.federalregister.gov/articles/2014/01/06/2013-31025/extensions-of-credit-by-federal-reserve-banks> (reserving discretion in Fed to apply Section 13(3) by broadly defining broad-based eligibility).

broad-based eligibility should be interpreted broadly to mean anything that does not assist a “specific and single” company.

d. Permit The FSOC to Inherit Bailout Authority

If the Fed does not adopt rules that broadly define broad-based eligibility, and the Fed does indeed lose its ability to bailout narrow groupings of companies, the FSOC should inherit the express bailout authority. Ideally, the FSOC can eliminate the need to use bailouts through ex-ante prevention of systemic risk; indeed the FSOC’s goal is to eliminate the need for bailouts.<sup>357</sup> Nevertheless, as discussed above, the ability to bailout a specific or narrow group of failing companies may still be necessary in certain circumstances.<sup>358</sup> If the Fed’s authority to bailout is truly eviscerated by Dodd-Frank Section 1101, FSOC should inherit the authority. With an amalgam of financial leaders heading it, the FSOC would have the political accountability, transparency, and resources to authorize individual bailouts under the appropriate circumstances. Of course, the increased consistency and transparency measures should also be inherited, but expressed bailout authority would arm the FSOC, through the Fed, with a bailout ability that can be used if all else fails. Hopefully, the FSOC can reduce too-big-to fail and regulate systemic risk at an earlier stage, but if not, it should have express bailout authority.<sup>359</sup> Transferring emergency bailout authority to FSOC would ensure individual bailouts remain a last-resort option if the new tools of systemic risk regulation prove unsuccessful.

### Conclusion

Emergency bailout power under Section 13(3) is not a weapon to be wielded improperly or clumsily. Rather, it is a tool that requires finesse and limited use. Section 13(3) was misused during the Financial Crisis because the Fed did not disclose the collateral cutoff.<sup>360</sup> The market did not understand who could be saved and who could not, and Lehman’s unexpected failure exacerbated the effects of the financial fallout leading to

---

<sup>357</sup> See Mehra, *supra* note 13, at 271.; *But see* Levitin, *supra* note 65 at 513.

<sup>358</sup> See *supra* notes 241-297.

<sup>359</sup> See generally Levitin, *supra* note 65, at 513; Peter J. Wallison, *Too big to ignore: The future of bailouts and Dodd-Frank after the 2012 Election*, American Enterprise Institute, (Oct. 24, 2012), <http://www.aei.org/outlook/economics/financial-services/banking/too-big-to-ignore-the-future-of-bailouts-and-dodd-frank-after-the-2012-election/> (arguing the FSOC may not completely dispose of bailouts).

<sup>360</sup> See *supra* notes 165-66.

the financial crisis that not only crippled the domestic economy and global markets but also affected the entire international economic landscape.<sup>361</sup> With the financial and economic stakes as high as they are, individual bailouts can be a potent tool in the fight against future financial crises if used properly and with care by increasing the consistency and transparency of the collateral.<sup>362</sup> Dodd-Frank Section 1101 expressly increases the consistency and transparency of the Fed's use of Section 13(3).<sup>363</sup> Moreover, the Fed's proposed rules manage to retain broad discretion in the Federal Reserve's use of Section 13(3).<sup>364</sup> Although not as powerful as individual bailouts, Section 13(3) can still be an effective last-resort tool to prevent systemic risk from crippling the global financial market.

---

<sup>361</sup> *See supra* notes 161-64.

<sup>362</sup> *See supra* notes 231-349.

<sup>363</sup> *See supra* notes 301-16.

<sup>364</sup> *See supra* notes 317-35.



**A LOSE-LOSE SCENARIO WHEN THE FEDERAL GOVERNMENT STARTS A  
THEORY WITH “TOO BIG”: HOW THE DOJ’S AML ENFORCEMENT  
POLICY FORCES REMITTANCES UNDERGROUND**

Bryan Mulcahey\*

“I am concerned that the size of some of these institutions (Mega Banks) becomes so large that it does become difficult to prosecute them ... When we are hit with indications that if you do prosecute, if you do bring a criminal charge it will have a negative impact on the national economy, perhaps world economy, that is a function of the fact that some of these institutions have become too large.”<sup>1</sup>

The above quote from U.S. Attorney General Eric Holder outlines a principle that intelligent people can disagree on. However, history and the demise of Arthur Andersen LLP, formerly one of the “big five” accounting firms, demonstrates that criminally charging a corporation is bad policy and can cause devastating effects. Nonetheless, the Department of Justice (DOJ), in pursuit of a non-criminal remedial policy for violations of anti-money laundering laws, implemented an unfettered and heavy-handed sanction based regime that is crippling business and pushing dangerous money transfers underground.

**I. Introduction:**

Mo Farah moved from Dibouti, Somalia to Great Britain at the age of eight to join his father, a British citizen.<sup>2</sup> Twenty-one years later, Mo Farah won two gold medals in track and field events at the 2012 Olympics held in his adopted country of Great Britain.<sup>3</sup> He earned endorsement deals with a number of international companies such as Nike, Lucozade, and Virgin

---

\*George Mason University School of Law, J.D. Candidate 2015; Cortland State University B.S. Business Economics, Financial Management Concentration, *summa cum*

<sup>1</sup> Jason Breslow, *Eric Holder Backtracks Remarks on “Too Big To Jail,”* PBS FRONTLINE (May 16, 2013), <http://www.pbs.org/wgbh/pages/frontline/business-economy-financial-crisis/untouchables/eric-holder-backtracks-remarks-on-too-big-to-jail/>.

<sup>2</sup> Tom Fordyce, *Ennis, Farah and Rutherford give GB athletics its finest hour,* YAHOO (Aug. 5, 2012), <http://uk.eurosport.yahoo.com/28072010/58/farah-seals-historic-gold-britain.html>; Simon Osborne, *Mo Farah: Young man in a hurry,* THE INDEPENDENT (Aug. 4, 2012), <http://www.independent.co.uk/sport/olympics/athletics/mo-farah-young-man-in-a-hurry-8007127.html>.

<sup>3</sup> Tom Fordyce, *Mo Farah Wins Men's 5,000m to Claim Second Olympic Gold,* BBC (Aug. 11, 2012), <http://www.bbc.com/sport/0/olympics/18912882>.

Media.<sup>4</sup> Mo and one million other British and American Somali's send small sums of money a few times each month to their families— usually no greater than a few hundred dollars.<sup>5</sup> The money ensures that their family members can afford food, medicine and other necessities.<sup>6</sup> The sponsorships also enabled Mo to set up the Mo Farah Foundation that seeks to help feed the starving population in Somalia.<sup>7</sup>

The Mo Farah Foundation and some of the world's largest international charities and organizations, such as the United Nations,<sup>8</sup> regularly send money to their local staff in Somalia.<sup>9</sup> These organizations and migrant workers both rely on the same money transfer companies to channel funds back to Somalia.<sup>10</sup>

The transactions performed by money transfer companies are especially crucial to both the families of migrant workers, their respective communities, and to the economy of developing nations. In Somalia, as in many developing countries, bank-to-bank transfers are not possible due to a non-existent banking system.<sup>11</sup> It is estimated that Somalia receives between \$750 million and \$1 billion U.S. dollars in remittances each year.<sup>12</sup> This constitutes approximately 50% of the country's GDP.<sup>13</sup> The funds are crucial resources necessary for the survival and well-being of families and communities in Somalia, as well as, some of the poorest countries in the world.<sup>14</sup>

In Somalia and other post conflict countries, the main goals are to sustain economic growth and reduce poverty.<sup>15</sup> Foreign investment is

---

<sup>4</sup> Usborne, *supra* note 2.

<sup>5</sup> Abdirahman Warsame, *Money Remittance a lifeline for Somali civilians and Political issue for others*, SOMALI CURRENT (Oct. 7, 2013), <http://www.somalicurrent.com/2013/10/07/money-remittance-a-lifeline-for-somali-civilians-and-political-issue-for-others/> (stating that the average remittance to Somalia is around \$200).

<sup>6</sup> Hugh Muir, *Mo Farah pleads with Barclays not to end remittances to Somalia* (July 26, 2013), <http://www.theguardian.com/sport/2013/jul/26/mo-farah-barclays-remittance-market>.

<sup>7</sup> Usborne, *supra* note 2; *Mo Farah campaigning against global hunger*, OPERATION BLACK VOTE (Aug. 22, 2012), <http://www.obv.org.uk/node/6051>.

<sup>8</sup> *Id.*

<sup>9</sup> Hugh, *supra* note 6.

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

<sup>11</sup> Caitlin Chalmers & Mohamed Aden Hassan, *UK Somali Remittance Survey*, DIASPORA CENTRE (May 2008), [http://www.diaspora-centre.org/DOCS/UK\\_Somali\\_Remittan.pdf](http://www.diaspora-centre.org/DOCS/UK_Somali_Remittan.pdf).

<sup>12</sup> *Id.*

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

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

<sup>15</sup> Raymond Natter, *Dodd-Frank Act and Remittances to Post-Conflict Countries: The Law of Unintended Consequences Strikes Again*, 25 LOY. CONSUMER L. REV. 403, 405-06 (2013).



deterred by the absence of a formal banking infrastructure, economic instability, and the fear of a country's inability to sustain peace.<sup>16</sup> The one source of an economic stimulus is migrant workers sending remittances to their home village, where the funds are often distributed to their families. Many of these families reside in areas that are neglected by other forms of aid.<sup>17</sup> The funds are spent on housing and a variety of goods that create a trickle effect throughout the rest of the village.<sup>18</sup> Therefore, post-conflict countries rely heavily on remittances to boost economic development and improve the quality of life for many citizens.<sup>19</sup>

Due to increased pressure by American authorities and regulators, banks are ending their business lines that service money transfer firms. If these firms are effectively shut down they will cut off migrant workers' abilities to send the small amounts of money that their families need to survive.

“The impact of this will be felt by ordinary people, families and communities who are already in poverty and are now finding an essential lifeline being cut off. There will be suffering as a result. Not only that but aid agencies and charities will be left to plug that gap when people in countries like Somalia are cut off from financial support coming from families abroad.”<sup>20</sup>

Migrant worker remittances to developing countries are likely to hit an all-time high of \$414 billion dollars by the year-end of 2013.<sup>21</sup> This includes \$215 billion transferred from America to Somalia.<sup>22</sup> It is also important to note that Somalia is not the only country effected by this move.

---

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

<sup>17</sup> *Id.* at 406.

<sup>18</sup> Natter, *supra* note 15 at 406.

<sup>19</sup> K. M. Abdul Azeez & M. Begum, *International Remittances: A Source of Development Finance*, 4 INT'L NGO J. 299, 301-04 (2009).

<sup>20</sup> Tracy McVeigh, *Mo Farah piles pressure on Barclays to cancel ban on money-transfer firms*, THE GUARDIAN (Aug. 3, 2013), <http://www.theguardian.com/global-development/2013/aug/04/mo-farah-pressure-barclays-money-transfer-firms>.

<sup>21</sup> *Migrants from developing countries to send home \$414 billion in earnings in 2013*, THE WORLD BANK (Oct. 2, 2013), <http://www.worldbank.org/en/news/feature/2013/10/02/Migrants-from-developing-countries-to-send-home-414-billion-in-earnings-in-2013>.

<sup>22</sup> Ibrahim Hirsi, *New Study: Somali-Americans send estimated annual \$215 million in remittances*, TWIN CITIES DAILY PLANET (Sept. 4, 2013), <http://www.tcdailyplanet.net/news/2013/09/04/new-study-somali-americans-send-estimated-annual-215-million-remittances>.

The constant fighting and civil war in many countries keeps formal money transfer companies such as Western Union and MoneyGram out.<sup>23</sup> However, foreign nationals still need a way to transfer part of their earnings (“remittances”) home to family members in their native country.<sup>24</sup> For example, the over one million Somali’s that live and work abroad rely on specialized Somali money transfer companies.<sup>25</sup> There are at least 100 such Somalian specialized firms, including the largest and most well-known of them all, Dahabshill.<sup>26</sup> In the past, these small companies were provided with banking services by large banks such as, HSBC, RBS, and Barclays.<sup>27</sup> These large banks provide infrastructure, satellites, and technology to help facilitate the transmissions between money transfer companies.

Last year, HSBC, RBS and others pulled out of the business of providing services for money transfer companies.<sup>28</sup> The banks withdrew from the business after a string of fines from U.S. authorities, including a record setting \$1.9 billion dollar fine levied on HSBC from the U.S. Department of Justice over allegations of money-laundering violations.<sup>29</sup> These moves left Barclays with 75% of the market share in Somalia.<sup>30</sup> However, in May of 2013 Barclays announced their plan to terminate banking services for 250 out of 275 money transfer companies, none of the remaining clients service Somalia.<sup>31</sup> As international money laundering rules tighten and DOJ enforcement actions loom, Barclays is moving to mitigate their risk of a heavy fine.<sup>32</sup> Not surprisingly, the moves made by Barclays parallel the remedial actions that were previously forced upon other banks as part of the enforcement action.<sup>33</sup>

---

<sup>23</sup> *Id.*; see also Sophie McBain, *Barclays vs Dahabshill: when a Somali money transfer company takes on a banking giant*, NEWSTATSMAN (Nov. 6, 2013), <http://www.newstatesman.com/africa/2013/11/barclays-vs-dahabshill-when-somali-money-transfer-company-takes-banking-giant>.

<sup>24</sup> Natter, *supra* note 15.

<sup>25</sup> Hassan, *supra* note 11, at 11-12.

<sup>26</sup> DAHABSHILL, <http://www.dahabshill.com/> (last visited Sept. 10, 2014). See also Nadifa Mohamed, *Somalis rely on Money Transfers. Barclays, don't sever this lifeline*, THE GUARDIAN (Aug. 7, 2013), <http://www.theguardian.com/commentisfree/2013/aug/07/somalis-money-transfers-barclays-lifeline>.

<sup>27</sup> Mohamed, *supra* note 26.

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

<sup>29</sup> Tim Worstall, *HSBC's \$1.9 Billion Money Laundering Fine and the Somalian Cost of Bank Regulation*, FORBES (Aug. 9, 2013), <http://www.forbes.com/sites/timworstall/2013/08/08/hsbcs-1-9-billion-money-laundering-fine-and-the-somalian-cost-of-bank-regulation/>.

<sup>30</sup> Mohamed, *supra* note 26.

<sup>31</sup> Worstall, *supra* note 29.

<sup>32</sup> *Id.*

<sup>33</sup> *Id.*

In November of 2013, A London court granted an injunction preventing Barclays from cutting off services to money transfer companies servicing Somalia.<sup>34</sup> The Court feared the move by Barclays could result in a “death sentence” for the many people relying on remittances.<sup>35</sup> However, this is only a short-term solution, as Barclays reached a deal that allows the bank to shut down services to Somalia in 2015.<sup>36</sup> Without another option in place, the likely consequence is that all funds are channeled back to Somalia through underground and unregulated black market channels.<sup>37</sup>

Terrorist or criminal organizations often operate the unregulated black market channels that will be used for transferring the funds. The preexisting infrastructure is already in place for transferring the criminal organization's funds and the new remittance funds will simply be thrown into the mix. For U.S. authorities, this mingling of funds increases the complexity involved in tracking black market funds and it ultimately makes preventing terrorism more difficult.<sup>38</sup> Terrorist and criminal organizations who control the underground channels will also experience increased revenue by charging for their laundering services.<sup>39</sup>

The philosophy behind U.S. Anti-Money Laundering laws (“AML”) is that financial institutions are in the best position to detect money laundering.<sup>40</sup> The current regulatory scheme requires the banks to regulate and monitor the transactions to detect patterns of illegal money laundering.<sup>41</sup> However, this philosophy and regulatory scheme is completely thwarted when all transfers move underground.<sup>42</sup> When Barclays exits the market in 2015, transactions to Somalia (a high-risk country) will no longer travel through formal bank channels.<sup>43</sup> The transactions will no longer be monitored as AML laws are not able to regulate underground money transfer organizations.<sup>44</sup>

This comment will discuss how the AML issue is twofold. First, U.S. authorities must force transactions into formal channels and not into

---

<sup>34</sup> Edwin Lane, *Somali remittances granted reprieve*, BBC NEWS (Nov. 5, 2013), <http://www.bbc.co.uk/news/business-24553148>.

<sup>35</sup> Muir, *supra* note 8.

<sup>36</sup> Lane, *supra* note 34.

<sup>37</sup> Christopher Harris, *Barclays ordered to keep Somali money transfer service Dahabshill open despite risk of money laundering and funding terrorism*, INTERNATIONAL BUSINESS TIMES (Nov., 5 2013), <http://www.ibtimes.com/barclays-ordered-keep-somali-money-transfer-service-dahabshill-open-despite-risk-money-laundering>.

<sup>38</sup> *Id.*

<sup>39</sup> *Id.*

<sup>40</sup> Collin Watterson, Note, *More Flies With Honey: Encouraging Formal Channel Remittances To Combat Money Laundering*, 91 TEX. L. REV. 711, 712-13 (2013).

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

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

<sup>43</sup> Harress, *supra* note 37.

<sup>44</sup> Watterson, *supra* note 40.

unregulated underground markets. Next, when formal channels handle the financial transactions, the DOJ must prudently compel compliance with AML laws. In compelling compliance in the past, heavy-handed DOJ sanctions and deferred prosecution agreements forced large banks to end business lines that traditionally serviced money transfer companies. The problems created by such DOJ actions include crippling the effectiveness of AML laws while stimulating terrorism, thwarting the growth of businesses, and cutting off lifelines to developing nations. The U.S. authorities must turn back the unintended consequences that the DOJ actions created. Furthermore, the addition of an AML sanction board to review future enforcement actions and fines will compel more responsible prosecution.

U.S. authorities including the DOJ ensure future bank compliance with AML laws through criminal sanctions and civil penalties. However, criminal sanctions are highly disfavored, due to their devastating impact on businesses and markets. Therefore, the DOJ must act prudently in employing future civil penalties so that they do not scare banks away from the market.

Three recommendations could benefit the DOJ's enforcement efforts without crippling the banks. First, grants of amnesty for Barclays and other banks are necessary to prevent them from ending the remittance service business line. The risk of fines for past compliance issues simply outweighs the benefits of staying in the business (i.e. the bank's ability to make a profit from the business line). Second, the DOJ and enforcement agencies nationwide need the supervision of an AML sanction board because they are showing an unwillingness to take into account the economic impact of imposing large civil penalties. Third, the HSBC deferred prosecution agreement set a precedent for the DOJ requiring banks to end business lines engaged in servicing money transfer companies. Neither the DOJ nor any U.S. authority should be engaged in making or requiring such a business decision.

## **II. Examples of how black market transfer organizations work**

The issue surrounding money laundering is that “a significant portion of remittance transfers flow through unregulated channels and the use of such informal channels hamper efforts to prevent funds from flowing to entities that engage in criminal or terrorist activities.”<sup>45</sup> Migrant workers

---

<sup>45</sup> Natter, *supra* note 24, at 407, n.25 (noting informal and “unregulated transfer systems are open to abuse- ranging from money laundering to support for terrorist activity - is well documented” and it not be necessary to analyze that issue in this comment. (Citing PATRICIA WEISS FAGEN & MICAH N. BUMP, REMITTANCES IN CONFLICT AND CRISES: HOW

often choose underground banking or “informal value transfer systems” (IVTS) due to their low financial literacy and widespread distrust of government and financial institutions.<sup>46</sup> Also, IVTS provide excellent services that are cheaper, quicker, and provide greater anonymity than formal channels.<sup>47</sup> Migrant workers are also more likely to use IVTS if their native country is one with a weak government, unreliable financial infrastructure, and high criminal activity.<sup>48</sup> Despite the apparent amiability of the IVTS, the anonymity they provide makes them vulnerable to abuse by criminals, who often operate drug and terrorist enterprises.<sup>49</sup> Forcing remittances out of IVTS and into formal channels is crucial to AML laws being effective in keeping money out of the hands of criminals.<sup>50</sup>

The most famous example of an IVTS is hawala, a money-transfer mechanism that originated in India hundreds of years ago.<sup>51</sup> Despite being illegal in most countries, the hawala system is still widely used to transfer money from industrialized countries to developing countries throughout the Middle East and South Asia.<sup>52</sup> Throughout the many years of operation the hawala system became extremely efficient in its speed, cost, reliability, convenience, and anonymity.<sup>53</sup> A typical hawala transaction is secretive by nature and operates with little or no records in order to avoid IRS auditors and law enforcement.<sup>54</sup> The hawala system can handle extremely

---

REMITTANCES SUSTAIN LIVELIHOODS IN WAR, CRISIS AND TRANSITIONS TO PEACE 11 (2005 Int'l Peace Acad. and Georgetown Univ.).

<sup>46</sup> *Id.* at 408-09.

<sup>47</sup> Watterson, *supra* note 40, at 712 (citing Barry Johnston, *Work of the IMF in Informal Funds Transfer Systems*, in *Regulatory Frameworks for Hawala and Other Remittance Systems* 1, 2 (IMF 2005) (discussing the anonymity that is a characteristic of IVTS)); Adil Anwar Daudi, Note, *The Invisible Bank: Regulating the Hawala System in India, Pakistan and the United Arab Emirates*, 15 *IND. INT'L & COMP. L. REV.* 619, 627-29 (2005) (characterizing hawala systems as providing higher quality service and charging lower fees than traditional banks).

<sup>48</sup> See Stuart Brown, *Can Remittances Spur Development? A Critical Survey*, 8 *INT'L STUD. REV.* 55, 68 (2006).

<sup>49</sup> Watterson, *supra* note 40, at 712.

<sup>50</sup> See generally Watterson, *supra* note 40, at 712 (discussing balance between a weak response to informal transfer systems and over burdensome regulation that increases demand such systems in certain markets).

<sup>51</sup> Joseph Wheatley, Comment, *Ancient Banking, Modern Crimes: How Hawala Secretly Transfers the Finances of Criminals and Thwarts Existing Laws*, 26 *U. PA. J. INT'L ECON. L.* 347, 347 (2005).

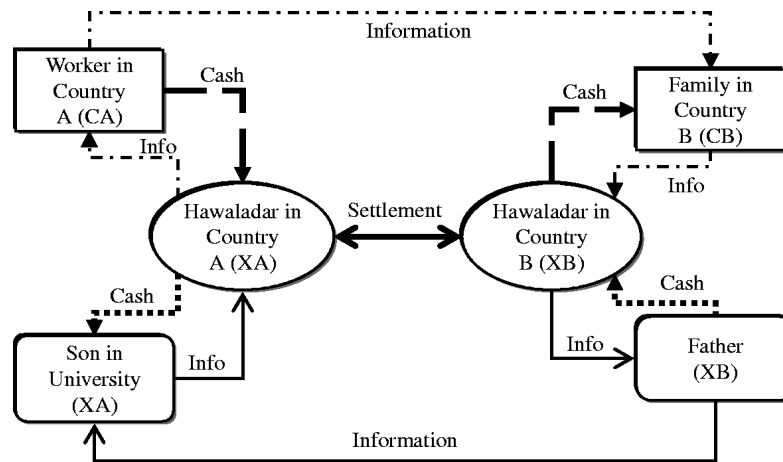
<sup>52</sup> See *id.* at 352, 356.

<sup>53</sup> *Id.* at 347.

<sup>54</sup> *Id.* at 356.

complicated transactions, yet a typical hawala transaction is simple and no money is actually transferred overseas.<sup>55</sup>

The graph below depicts the basic hawala principles.



Source: Adapted from El-Qorchi (2002)

56

As the diagram illustrates, the individuals operating the hawala (hawaladers) are used to transfer both money and information.<sup>57</sup> While focusing on the top half of the diagram concerning money transfers, the diagram is actually quite simple. The hawalader takes cash from the worker in country A, say the U.S. The worker in the United States will request that the money, or its equivalent in a foreign currency, is delivered to a family member in their native country.<sup>58</sup> The hawalader in the U.S. will signal to the hawalader in the foreign country via phone, email or fax and instruct them to deliver money to the worker's family.<sup>59</sup> The charges are typically a modest two percent and delivery is free.<sup>60</sup> The commission is often worked into the highly favorable exchange rate so that the worker in the United States doesn't need to come up with any more money.<sup>61</sup> The hawalader

<sup>55</sup> *Id.* at 351.

<sup>56</sup> Abirashid A. Ismail, *Lawlessness and economic governance: the case of hawala system in Somalia*, 6 INT'L J. DEV. ISSUES 168, 171 (2007) (this diagram can also be found at [http://www.emeraldinsight.com/content\\_images/fig/3710060205009.png](http://www.emeraldinsight.com/content_images/fig/3710060205009.png)).

<sup>57</sup> *Id.*

<sup>58</sup> *Id.* at 171.

<sup>59</sup> *Id.* at 172.

<sup>60</sup> Wheatley, *supra* note 51 at 349.

<sup>61</sup> *Id.* (citing Wheatley, *supra* note 43 at 349).

often keeps a pool of cash that enables the transferee to obtain money as soon as the instructions arrive, often within seconds.<sup>62</sup> The money was just exchanged and there is no record of the two parties who were involved in the transaction.<sup>63</sup>

The debt owed between the hawalader in the United States and the hawalader in the foreign country is handled between themselves, sometimes in large amounts after they accrue.<sup>64</sup> The hawaladers are often business partners who can settle the debts through exchanging goods, such as jewelry to satisfy their debts.<sup>65</sup> Sometimes they are family members, such as the Bariek family hawala that served 200 to 300 customers in Northern Virginia and Pakistan.<sup>66</sup> The funds sent back to Pakistan ranged from \$20 to \$5,000 and was purposed to help only families that the Barieks personally knew.<sup>67</sup> However, the elimination of the paper trail and reliability makes the IVTS or hawala especially enticing to those looking to avoid tax collectors and auditors.<sup>68</sup>

Hawala is only one example of an IVTS, but the basic underlying principles are used to transfer money to every country around the world.<sup>69</sup> Unlike a hawala, a bank would make the transferor set up a bank account, require a minimum transfer amount, charge an unfavorable exchange rate and a high transfer fee.<sup>70</sup> The transfer might take a few weeks to clear.<sup>71</sup> The family members in the native countries would then travel to a bank branch and set up an account to collect the money.<sup>72</sup> Not only is this burdensome and time-consuming, “some recipients are illiterate, and do not know how to cash a check, operate a bank account, or sign for legitimately wired money.”<sup>73</sup>

---

<sup>62</sup> *Id.* (citing Wheatley, *supra* note 43 at 349).

<sup>63</sup> See Matthew J. Rosenbaum, *A Paper Chase in A Paperless World: Regulating Informal Value Transfer Systems* Shearman & Sterling Student Writing Prize in Comparative and International Law, Best Note Award, 50 COLUM. J. TRANSNAT'L L. 169, 178 (2011).

<sup>64</sup> See Wheatley, *supra* note 51, at 350–51.

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

<sup>66</sup> *Hawala and Underground Terrorist Financing Mechanisms: Hearing Before the Subcomm. on Int'l Trade & Fin. of the S. Comm. on Banking, Hous., & Urban Affairs*, 107th Cong. 42 (2001) (statement of Rahim Bariek, Bariek Money Transfer).

<sup>67</sup> *Id.* at 42-43.

<sup>68</sup> See Rosenbaum, *supra* note 63.

<sup>69</sup> Rachana Pathak, *The Obstacles to Regulating the Hawala: A Cultural Norm or a Terrorist Hotbed?*, 27 FORDHAM INT'L L.J. 2007, 2009 (2004) (citing Mohammed El Qorchi et al., *Informal Funds Transfer Systems: An Analysis of the Informal Hawala System*, Int'l Monetary Fund Occasional Paper No. 222, at 6–9 (2003) (describing logistics of hawala networks)).

<sup>70</sup> See Wheatley, *supra* note 51, at 349.

<sup>71</sup> *Id.*

<sup>72</sup> See *id.*

<sup>73</sup> Pathak, *supra* note 69, at 2015.

Additionally, in Somalia there is only one bank and it is located in the capital of Mogadishu.<sup>74</sup> The journey is often too far for many Somalians making money transfer companies and IVTS the only viable option.<sup>75</sup>

### III. The need for AML regulation

Since the 9/11 terrorist attacks, IVTS receive special attention because policy makers believe that terrorists use IVTS to covertly move funds that finance their activities around the globe.<sup>76</sup> Specifically, much of the \$500,000 cost of executing the 9/11 attacks was sent via hawala channels.<sup>77</sup> In response, the PATRIOT Act redefined the Bank Secrecy Act of 1970's (BSA) definition of a financial institution to include

“any person that engages as a business in the transmission of funds, including any person who engages as a business through an informal money transfer system or any network of people who engage as a business in facilitating the transfer of money domestically or internationally outside of the conventional financial institutions system.”<sup>78</sup>

The PATRIOT Act further addresses illegal money laundering and terrorist financing by recognizing that “money laundering, and the defects in financial transparency on which money launderers rely, are critical to the financing of global terrorism and the provision of funds for terrorist attacks.”<sup>79</sup>

The PATRIOT Act sought to force transfers into formal channels and then tighten requirements on banks to monitor those transfers.<sup>80</sup> This move came after several of the 9/11 Hijackers received a total of \$110,000 through formal financial transactions sent to a Florida Sun Trust Bank from a bank based in the United Arab Emirates.<sup>81</sup> The largest of the transactions (\$69,000) was flagged as suspicious by the bank's anti-money laundering

---

<sup>74</sup> Harress, *supra* note 43.

<sup>75</sup> *See id.*

<sup>76</sup> *See Rosenbaum, supra* note 63, at 172.

<sup>77</sup> *See Pathak, supra* note 69, at 2027-28.

<sup>78</sup> *Id.* at 2030 (quoting USA Patriot Act § 359(a), 31 U.S.C. § 5312(a)(2)(R) (2001)).

<sup>79</sup> *Id.* at 2029 (quoting USA PATRIOT Act § 302 (a)(2)).

<sup>80</sup> *See id.* at 2030.

<sup>81</sup> *Id.* at 2026-27.



controls, and a suspicious activity report (“SAR”) was generated.<sup>82</sup> However, the report was lost in the countless number of reports that were generated by U.S. banks leading up to 9/11.<sup>83</sup>

In the wake of 9/11, the main goal of anti-terrorism legislation was to track and prevent transactions before the money could make it into the hands of terrorists or other criminals.<sup>84</sup> However, to do so the government needed to encourage the use of formal transfer channels, where the transactions are monitored.<sup>85</sup> This is accomplished through effective legislation and a thoughtful enforcement policy.<sup>86</sup> Burdensome regulation makes the services that banks or money transfer companies provide less competitive than those provided by hawalas.<sup>87</sup> Moreover, careless enforcement policies and techniques can cause negative externalities including the extinction of formal channels.

Strict enforcement policies and heavy fines make the banks' compliance with the law important but it can slow down the process and efficiency of the services provided.<sup>88</sup> Furthermore, as we can see from the result in the DOJ's case against HSBC, applying heavy penalties can dissuade the banks from keeping the business line and attempting to comply with AML laws.<sup>89</sup> The result is banks, both large and small, exiting the money transfer servicing industry.<sup>90</sup> Since the philosophy behind U.S. AML laws is that financial institutions are in the best position to detect money laundering, the government needs to encourage, not dissuade financial institutions from servicing money transfer companies. The detection and prosecution of the IVTS is extremely difficult and scholars argue making

---

<sup>82</sup> Pathak, *supra* note 69, at 207 n.100 (citing David Olinger, The Bucks Stop, Start Here: Open Climate in Arab Emirates Made Transfers Easy for Terrorists, DENVER POST, Feb. 24, 2002, at 8).

<sup>83</sup> *Id.*

<sup>84</sup> See Watterson, *supra* note 40, at 722-23 (noting that U.S. policy makers have singled out the informal banking channels as vulnerable to use and exploitation by “terrorists, drug dealers, tax evaders, arms dealers, and other criminals”); see also *Examining Treasury's Role in Combating Terrorist Financing Five Years after 9/11: Hearings Before the S. Comm. on Banking, Hous., & Urban Affairs*, 109th Cong. 1 (2006) (opening statement of Sen. Richard Shelby, Chairman, S. Comm. on Banking, Hous., & Urban Affairs) (explaining that one of the most important aspects of the national anti-terrorism strategy is constricting “the means by which terrorist organizations and their supporters raised and moved the money required to carry out their attacks”).

<sup>85</sup> Watterson, *supra* note 40, at 713.

<sup>86</sup> See *id.* at 744-48.

<sup>87</sup> *Id.* at 734.

<sup>88</sup> See *id.* at 712-13.

<sup>89</sup> See Worstall, *supra* note 29.

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

formal bank channels more competitive, through a simplified AML regulatory scheme, can solve the issue.<sup>91</sup>

Making formal channels a more competitive option is, or is soon to be, a moot argument as U.S. authorities are causing formal channels to become extinct.<sup>92</sup> Despite injunctions,<sup>93</sup> and Mo Farah leading the campaign to stop Barclays from ending affiliations with money transfer companies,<sup>94</sup> Barclays held strong with their position.<sup>95</sup> Barclays stated:

As a global bank, we must comply with the rules and regulations in all the jurisdictions in which we operate. The risk of financial crime is an important regulatory concern and we take our responsibilities in relation to this very seriously... Some money-service businesses don't have the necessary checks in place to spot criminal activity with the degree of confidence required by the regulatory environment under which Barclays operates. Abuse of their services can have significant negative consequences for society and for us as their bank.<sup>96</sup>

Therefore, the predominant issue is that the DOJ created a situation where formal and legal channels are nonexistent and all transfers are made through the illegal IVTS.

#### IV. Current AML Framework

Following 9/11, the PATRIOT Act<sup>97</sup> granted U.S. authorities the power to impose significant fines on banks that do not meet the stringent

---

<sup>91</sup> See generally Watterson, *supra* note 40 (stating that a national scheme to make formal channels more competitive is the way to go not enforcement, "Other commentators have rejected enforcement as a viable long-term solution to underground firms"). For proposals that argue for greater use of microfinance, see Charles B. Bowers, *Hawala, Money Laundering, and Terrorism Finance: Micro-Lending as an End to Illicit Remittance*, 37 DENV. J. INT'L L. & POL'Y 379 (2009); Darren Keyes, *Protecting the Peace While Profiting the Poor: Microfinance and Terrorist Financing Regulation*, 12 LAW & BUS. REV. AMS. 545 (2006).

<sup>92</sup> Mohamed, *supra* note 26.

<sup>93</sup> Lane, *supra* note 34.

<sup>94</sup> Hassan, *supra* note 11.

<sup>95</sup> McVeigh, *supra* note 20.

<sup>96</sup> *Id.*

<sup>97</sup> Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA Patriot ACT) Act of 2001, Pub. L. No. 107-56, 115 Stat. 272 (codified in scattered sections of 5, 8, 12, 15, 18, 20, 21, 22, 28, 31, 42, 47, 49, 50 U.S.C.) ("PATRIOT Act").

standards of AML laws.<sup>98</sup> The PATRIOT Act added new reporting and monitoring provisions to strengthen the Department of the Treasury (“Treasury”) and the Financial Crimes Enforcement Network (“FinCEN”).<sup>99</sup> The point of strengthening the Treasury was to enhance anti-money laundering control mechanisms that were already in place.<sup>100</sup> The pre-existing mechanisms were set forth under the Bank Secrecy Act (“BSA”).<sup>101</sup> The BSA allowed the Treasury to control certain transactions and imposed reporting requirements on the banks.<sup>102</sup> The PATRIOT Act increased bank reporting requirements and placed on the banks a burden of due diligence to protect against money laundering.<sup>103</sup> The BSA's record keeping and reporting requirements now relate to a list of activities for which such records and reporting are of a “high degree of usefulness.”<sup>104</sup> Furthermore, the Secretary of the Treasury was granted the ability to amend the list.<sup>105</sup> The additions include criminal, tax and regulatory investigations or proceedings, and conducting intelligence or counterintelligence activities to protect against international terrorism.<sup>106</sup>

A significant change under the PATRIOT Act was the addition of the due diligence requirement. In accordance with the updated BSA codified as 31 USC § 5318 (H)(1) & (I)(1) (2006), financial institutions must combat money-laundering activity at a minimum under Section (h)(1) by developing an AML program that includes internal policies, procedures, and controls, a compliance officer, an ongoing employee-training program, and

---

<sup>98</sup> Chris Skinner, *More on Africa, Somalia, remittances, Barclays and HSBC*, THE FIN. SERV. CLUB BLOG (August 15, 2013), [http://thefinanser.co.uk/fsclub/2013/08/more\\_on\\_africa\\_somalia\\_remittances\\_barclays\\_and\\_hsbc.html](http://thefinanser.co.uk/fsclub/2013/08/more_on_africa_somalia_remittances_barclays_and_hsbc.html).

<sup>99</sup> Cynthia J. Larose, *International Money Laundering Abatement and Anti-Terrorism Financing Act of 2001*, 30 J.C. & U.L. 417, 418 (2004) (“The FinCEN was created by administrative order in 1990 to provide other government agencies with an “intelligence and analytical network in support of the detection, investigation, and prosecution on domestic and international money laundering and other crimes. The USA PATRIOT Act gives FinCEN statutory life as a bureau within the Department of the Treasury. USA PATRIOT Act § 361(a)(2)(a), 115 Stat. at 329 (codified at 31 U.S.C.A. § 310 (2003))”). See also *Organization, Functions, and Authority Delegations: FinCEN*, 55 Fed. Reg. 18,433 (May 2, 1990).

<sup>100</sup> See Larose, *supra* note 99, at 418.

<sup>101</sup> Currency and Foreign Transactions Act of 1970, Pub. L. No. 91-508, 84 Stat. 1114 (codified as amended in scattered sections of 31 U.S.C.) (“Bank Secrecy Act”).

<sup>102</sup> *Id.*

<sup>103</sup> 31 U.S.C.A. §§ 5311, 5318 (2014).

<sup>104</sup> Larose, *supra* note 99 at 418. See also 31 U.S.C.A. § 5311 note (2003) (“The statute sets forth a list of the types of institutions, activities, or transactions that may be susceptible to money laundering and also gives the Secretary the ability to designate other activities as such.”).

<sup>105</sup> 31 U.S.C.A. § 5318 (2003).

<sup>106</sup> *Id.*

an independent audit function to test programs.<sup>107</sup> Furthermore, FinCEN cites in their deferred prosecution agreements that under section (I)(1):

[each] financial institution that establishes, maintains, administers, or manages a private banking account or a correspondent account in the United States for a non-United States person, including a foreign individual visiting the United States, or a representative of a non-United States person shall establish appropriate, specific, and, where necessary, enhanced, due diligence policies, procedures, and controls that are reasonably designed to detect and report instances of money laundering through those accounts.<sup>108</sup>

The BSA makes it a criminal violation under Title 31, United States Code, Section 5318 (h) and regulations issued thereunder to willfully fail to conduct and maintain due diligence on correspondent bank accounts held on behalf of foreign persons.<sup>109</sup>

The Government was wary of correspondent accounts because they are generally considered high risk.<sup>110</sup> This is due to the U.S. bank not having a direct relationship with, nor information on the foreign financial institution's customers who initiated the wire transfer.<sup>111</sup> To mitigate this risk, the BSA requires financial institutions to conduct due diligence on all non-U.S. entities (i.e., the foreign financial institution) for which it maintains correspondent accounts.<sup>112</sup> A way for financial institutions to mitigate the risks is by monitoring wire transfers to and from the correspondent accounts.<sup>113</sup>

Since 2006, financial institutions monitor wire transfers using an automated system to detect suspicious activity.<sup>114</sup> The system detects

---

<sup>107</sup>FINRA, *NASD Provides Guidance To Member Firms Concerning Anti-Money Laundering Compliance Programs Required By Federal Law* in Special NASD Notice to Members 02-21 (Apr. 2002), available at [http://finra.complinet.com/en/display/display\\_main.html?rbid=2403&element\\_id=2660&print=1](http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=2660&print=1).

<sup>108</sup> SEC, *Deferred Prosecution Agreement* (Dec. 10, 2012), available at <http://www.sec.gov/Archives/edgar/data/83246/000119312512499980/d453978dex101.htm>. See also 31 U.S.C.A. § 5318 (2003).

<sup>109</sup> See 31 U.S.C.A. § 5318 (2003).

<sup>110</sup> See SEC, *Deferred Prosecution Agreement*, supra note 108, at 8-9. See also *id.*

<sup>111</sup> See 31 U.S.C.A. § 5318(H)(3)(c).

<sup>112</sup> See SEC, *Deferred Prosecution Agreement Attachment A*, available at <http://www.justice.gov/opa/documents/hsbc/dpa-attachment-a.pdf>.

<sup>113</sup> *Id.*

<sup>114</sup> *Id.*

suspicious wire transfers based on parameters set by the financial institutions.<sup>115</sup> Financial institutions retain discretion to set the parameters and triggering factors including the type of transaction, amount, and location of the customer.<sup>116</sup> Each customer is given a risk category based primarily on the country in which they are located.<sup>117</sup> Transactions that meet certain thresholds, such as a high value, are flagged for additional review by the bank's AML department. They were referred to as "alerts."<sup>118</sup> If following a review the institution confirms unusual activity, it must submit a Suspicious Activity Report (SAR) to the Financial Crimes Enforcement Network (FinCEN).<sup>119</sup> The entire process including SAR reporting is structured to give law enforcement officials a paper trail to follow.<sup>120</sup>

#### V. Does the Current AML framework work?

The Current AML laws and transaction monitoring systems are working to catch terrorist money launderers.<sup>121</sup> As a former HSBC employee pointed out, there were thousands of backlogged alerts that the HSBC systems caught.<sup>122</sup> The alerts show HSBC was servicing exchange companies wiring large sums of money to untraceable destinations in the Middle East.<sup>123</sup> Other alerts include a Saudi fruit company sending millions to a "high-ranking figure in the Yemeni wing of the Muslim Brotherhood."<sup>124</sup> HSBC was also allowing millions of dollars to move "from the Karaiba chain of supermarkets in Africa to a firm called Tajco, run by the Tajideen brothers, who had been singled out by the Treasury as major financiers of Hezbollah."<sup>125</sup> These types of alerts would not clear a competent AML compliance division, and should be forwarded to the Treasury in the form of a SAR. However, the alerts were backlogged and never reviewed.<sup>126</sup>

After fines were levied against the HSBC, CEO Stuart Gulliver stated that from 2004 to 2010, the bank was expecting their AML controls to

---

<sup>115</sup> *Id.*

<sup>116</sup> *Id.*

<sup>117</sup> *Id.*

<sup>118</sup> See SEC, *Deferred Prosecution Agreement Attachment A*, supra note 112, at 5-6.

<sup>119</sup> Watterson, supra note 40 at 724.

<sup>120</sup> *Id.*

<sup>121</sup> Matt Taibbi, *Gangster Bankers: Too Big to Jail*, Politics, ROLLING STONE (Feb. 14, 2013), <http://www.rollingstone.com/politics/news/gangster-bankers-too-big-to-jail-20130214>.

<sup>122</sup> Taibbi, supra note 121.

<sup>123</sup> *Id.*

<sup>124</sup> *Id.*

<sup>125</sup> *Id.*

<sup>126</sup> *Id.*

become more effective under the new BSA requirements.<sup>127</sup> Mr. Gulliver also implied that the banks wrongdoings would come to an end by following the necessary anti-money laundering requirements.<sup>128</sup> Under looming fines, HSBC indicated compliance was possible and agreed to improve their AML systems in 2010.<sup>129</sup>

In response to several major AML enforcement actions, banks began hiring AML compliance officers at a rapid pace.<sup>130</sup> These officers work on implementing sufficient monitoring systems and handle the backlogged alerts and SAR's.<sup>131</sup> Financial institutions are hoping their newly formed AML departments will prevent them from violating the stringent BSA regulatory requirements.<sup>132</sup> Therefore, the AML laws are effective when backed by an appropriate sanction. However, effective AML compliance can only come with careful sanctions that do not scare banks out of the market. Pushing HSBC out of the market and scaring Barclays out leaves the business for smaller banks who are more risk averse and will not undertake costly compliance measures required by the BSA and AML laws.<sup>133</sup> When there are no banks to service the Somalian Money Transfer Market, AML laws are not effective.

## VI. Violations of AML Laws and Sanction Based Penalties

Small money transfer companies do not possess the necessary checks and anti-financial crime controls to spot criminal activity with the degree of confidence required by the AML laws.<sup>134</sup> Since large banks such as HSBC provided services to these specialized channels, they became subject to vast fines by U.S. authorities. Last year, the DOJ fined MoneyGram \$100

---

<sup>127</sup> Carrick Mollenkamp & Brett Wolf, *Special Report: HSBC's Money Laundering Crackdown Riddled with Lapses*, REUTERS (July 13, 2013), <http://www.reuters.com/article/2012/07/14/us-hsbc-compliance-delay>

are-idUSBRE86C18H20120714.

<sup>128</sup> *Id.*

<sup>129</sup> CARL LEVIN & TOM COBURN, U.S. SENATE PERMANENT SUBCOMM. ON INVESTIGATIONS, U.S. VULNERABILITIES TO MONEY LAUNDERING, DRUGS, AND TERRORIST FINANCING: HSBC CASE HISTORY 20 (2012).

<sup>130</sup> Aruna Viswanatha & Brett Wolf, *Wall Street's Hot Hire: Anti-Money Laundering Compliance Officers*, REUTERS (Oct. 14, 2013), <http://blogs.reuters.com/financial-regulatory-forum/2013/10/14/wall-streets-hot-hire-anti-money-laundering-compliance-officers/>.

<sup>131</sup> *Id.*

<sup>132</sup> *Id.*

<sup>133</sup> *Id.*

<sup>134</sup> McVeigh, *supra* note 20.

million for failing to terminate corrupt agents.<sup>135</sup> The DOJ then fined HSBC \$1.9 billion for poor money laundering controls.<sup>136</sup>

The DOJ accused HSBC of setting their automated monitoring program to only alert and automatically monitor the transaction if it came from a customer from a “high risk” country.<sup>137</sup> In doing so, HSBC provided services for over 100 million wire transfers totaling over \$300 trillion dollars and at least 1/3 of them were allowed to go unmonitored because they were customers in standard to medium risk countries.<sup>138</sup> The DOJ concluded that when HSBC set the standards to only monitor high-risk country transactions, they willfully failed to maintain due diligence on millions of correspondent bank transfers.

Throughout HSBC's deferred prosecution agreement and allegations described in the Information and Facts of Attachment A, the Justice Department fails to specify any instance of criminal money laundering that slipped through. This resulted in speculation by many that HSBC didn't intentionally allow money laundering, but instead that HSBC's internal documentation processes were inadequate to show that it had not been doing so.<sup>139</sup> As stated in the Wall Street Journal “[i]t was not a \$1.9 billion fine for allowing criminal money laundering to slip through unmonitored: it was a \$1.9 billion fine for not following the regulations about how to monitor and or prevent money laundering.”<sup>140</sup>

The distinction matters because the DOJ should not make an example out of HSBC to scare other banks into complying with AML regulations. Unfortunately, many believe that is exactly what the DOJ was trying to do.<sup>141</sup> If the DOJ does not believe they can prove beyond a reasonable doubt that HSBC intentionally allowed money laundering for profit then the DOJ should not charge HSBC with criminal violations under the BSA.<sup>142</sup> The one action taken by the DOJ that is most pervasive is the deferred prosecution of HSBC and prompting the bank to end affiliations with companies that had less than satisfactory anti money laundering checks in place.

As part of the HSBC deferred prosecution agreement, HSBC is forced to shut down its activities in the money-service sector.<sup>143</sup> The following

---

<sup>135</sup> Press Release, U.S. DOJ Criminal Division, *MoneyGram Int'l Inc. Admits Anti-Money Laundering and Wire Fraud Violations, Forfeits \$100 Million in Deferred Prosecution* (Nov. 9, 2012), <http://www.justice.gov/opa/pr/2012/November/12-crm-1336.html>.

<sup>136</sup> McVeigh, *supra* note 20.

<sup>137</sup> SEC, *Deferred Prosecution Agreement Attachment A*, *supra* note 112, at 6.

<sup>138</sup> *Id.*

<sup>139</sup> Worstall, *supra* note 29.

<sup>140</sup> *Id.*

<sup>141</sup> *Id.*

<sup>142</sup> See Breslow, *supra* note 1.

<sup>143</sup> Muir, *supra* note 9.

section was included by the DOJ in its deferred prosecution agreement with HSBC:

“The HSBC Parties have taken, will take, and/or shall continue to adhere to, the following remedial measures:

h) HSBC Bank USA has exited 109 correspondent relationships for risk reasons.”<sup>144</sup>

The DOJ is endorsing the move by HSBC to end correspondent affiliations. The language in the deferred prosecution agreement prevents HSBC from re-entering into those relationships, without regard as to their level of AML compliance. In order to regulate and monitor these transactions, the banks must service these correspondent accounts. Therefore, it makes good policy sense to allow HSBC to keep them. Moreover, if failing to follow regulation is the true reason for the fines, the DOJ should work with the bank to bring these affiliations and accounts into compliance. It is likely that HSBC knew the profit derived from servicing these affiliations does not cover the cost of fines or to implement and monitor every standard to medium risk transaction. Therefore, DOJ should know that hitting HSBC with such a large fine and including this provision in the deferred prosecution agreement would push HSBC out of the market. Moreover, the DOJ must know that similar banks wouldn't take on those affiliations and would close their existing affiliations in response to the settlement HSBC received.

This theory is further supported by the fact that in May 2013, before any fines were levied, Barclays was inclined to terminate banking services for 250 money transfer companies amid fears over DOJ sanctions against them.<sup>145</sup> Barclays plans to discontinue all affiliations in the same high-risk countries that HSBC stopped servicing, such as those in Somalia.<sup>146</sup> Wall Street Journal analysts stated:

If they were worried about money laundering Barclays would pull out of Cayman, the BVI, Jersey and other locations where tax evasion and high level avoidance is rampant – all of it only possible because of the presence of the world's major banks and the availability of corporate and trust secrecy that facilitates the movement

---

<sup>144</sup> SEC, *supra* note 108 at 5.

<sup>145</sup> Skinner, *supra* note 98.

<sup>146</sup> McVeigh, *supra* note 20; Worstall, *supra* note 29.



of billions and even trillions of funds behind a veil of respectability.<sup>147</sup>

This shows that the banks ended affiliations in foreign countries because they were in fact less profitable and the DOJ just wanted some affiliations closed down “for show.” This goes in the face of the regulatory scheme of the AML laws, because certain countries affiliations are high-risk affiliations and banks must service and monitor them to track terrorism and criminal activity.

The harsh penalties imposed by the DOJ and the deferred prosecution agreements eliminated formal and banking services for specialized remittance firms. Therefore, the AML laws and DOJ prosecution policy will lead to the proliferation not the reduction of underground banking and IVTS.

#### **VII. When remittances and transactions are pushed underground, terrorism is facilitated.**

The irony of mitigating fines by allowing banks to stop providing services is that when specialized money transfer firms are shut down, money will flow down illegal remittance channels.<sup>148</sup> The funds are then more likely to end up in the hands of terrorists and drug cartels.<sup>149</sup> In such a situation, the ‘good’ money can easily mix with ‘bad’ money that is used to fund illegal activities.<sup>150</sup> The government should proceed with caution, because IVTS tracking is already difficult.<sup>151</sup> In prosecuting individuals operating an illegal IVTS channel, it is more difficult to sort out the remittances that were made for an honest purpose from the transfers for an illegitimate purpose.<sup>152</sup> The organizations and individuals operating IVTS rarely keep records that will be helpful to a criminal investigation. The lack of records and informality leads to the commingling of legitimate and illegitimate funds, making criminally derived funds harder to track.<sup>153</sup>

Because of a fear of crime and terrorist funding going undetected, the DOJ crippled the entire remittance business, the vast majority of which serves a legitimate purpose.<sup>154</sup> The government and regulators acted with

---

<sup>147</sup> *Id.*

<sup>148</sup> Skinner, *supra* note 98.

<sup>149</sup> *Id.*

<sup>150</sup> *Id.*

<sup>151</sup> *Id.*

<sup>152</sup> *Id.*

<sup>153</sup> Watterson, *supra* note 40 at 713.

<sup>154</sup> Skinner, *supra* note 98.

myopia and focused on one issue, and in the process they facilitated terrorists and devastated the lifelines of countless communities.<sup>155</sup>

### VIII. DOJ Prosecution Policy and The Role of Megabanks' Too Big Too Fail Status

At a hearing before the Senate Judiciary Committee in March 2013, United States Attorney General Eric Holder testified that the banks were not only the all too familiar “too big too fail”, but also “too big too jail.”<sup>156</sup> Stating that the economic impact of prosecuting large banks and preventing their access to the United States market would cause negative global effects, and that a criminal action would inhibit the ability to bring more appropriate resolutions.<sup>157</sup> Eric Holder did attempt to backtrack on the statements saying, that if “a financial institution that has done something wrong, if we can prove it beyond a reasonable doubt, those (criminal) cases will be brought.”<sup>158</sup>

In a letter sent by U.S. Senators Sherrod Brown (D-OH) and Chuck Grassley (R-IA) to Eric Holder on January 29, 2013, the Senators question whether the “too big to fail” status of megabanks precludes the ability of prosecutors to seek jail time.<sup>159</sup> In debating the policy of the DOJ, the Senators added, “[t]he best deterrent to crime is to put people in prison... [and] [t]hat includes those at powerful banks and corporations. Unfortunately, we’ve seen little willingness to charge these individuals criminally. The public deserves an explanation of how the Justice Department arrives at these decisions.”<sup>160</sup>

Lenny Brauer, former head of the DOJ Criminal Division, stated a company or bank might fail if the DOJ criminally indicted them. Innocent employees could lose their jobs, the entire industry could struggle and global markets could be negatively affected.<sup>161</sup> The collapse of Arthur Andersen illustrates this concern. At the time of Enron’s collapse, Arthur

---

<sup>155</sup> *Id.*

<sup>156</sup> Breslow, *supra* note 1, at 1.

<sup>157</sup> *Id.*

<sup>158</sup> *Id.*

<sup>159</sup> *Sens. Brown, Grassley Press Justice Department on “Too Big To Jail”*, SEN. SHERROD BROWN NEWSROOM (Jan. 29, 2013), <http://www.brown.senate.gov/newsroom/press/release/sens-brown-grassley-press-justice-department-on-too-big-to-jail>.

<sup>160</sup> *Id.*

<sup>161</sup> See Ted Kaufman, *Why DOJ Deemed Bank Execs Too Big To Jail*, FORBES (July 29, 2013), <http://www.forbes.com/sites/tedkaufman/2013/07/29/why-doj-deemed-bank-execs-too-big-to-jail/>.

Andersen was one of the “big five” accounting firms.<sup>162</sup> Within months after a criminal indictment and prosecution by the DOJ, the accounting firm was out of business. Over 28,000 employees lost jobs as their 1,200 public-company audit clients took their business from the one-time model of ethical accounting turned outlaw to one of their competitors, now known as the “big four.”<sup>163</sup> Since then the “Justice Department... has brought thousands of financially-based cases over the course of the last four-and-a-half years. To date... the government has largely focused on a strategy of securing multi-billion settlements from financial firms...”<sup>164</sup>

A comprehensive list of monetary penalties assessed by FinCEN against financial institutions for deficiencies in BSA/AML programs shows that since 2004, hundreds of hawaladers and banks were fined in excess of several billion dollars.<sup>165</sup> According to the Association of Certified Anti Money Laundering Specialists, sanctions for AML violation totaled 3.5 billion in 2012, up from \$26.6 million in 2011.<sup>166</sup> The list doesn't include some of the largest fines such as that of HSBC, which were handed down by the DOJ.<sup>167</sup> In 2012, the U.S. Department of Justice (not FinCEN) issued more than 100 actions against banks, broker-dealers, and other financial institutions or their employees for AML violations.<sup>168</sup> Despite extensive fines and a cease and desist order in 2013, violations of the BSA have not been deterred.<sup>169</sup>

A modified sanction-based regime is the best option despite many members of Congress explicit dissatisfaction with the DOJ's use of deferred prosecution agreements in lieu of criminal prosecutions.<sup>170</sup> The DOJ incentivized banks to exit correspondent relationships to avoid and mitigate current and future fines that they may face. However, because the DOJ is so heavy handed with its fines it is likely that no major banks are willing to service these foreign transactions in the future. This will continue to push more remittances and money transfers to the dangerous world of IVTS. In

---

<sup>162</sup> *Arthur Anderson Goes Out of Business*, ABC NEWS (Aug. 31, 2002), <http://abcnews.go.com/Business/Decade/arthur-andersen-business/story?id=9279255>.

<sup>163</sup> *Id.*

<sup>164</sup> Breslow, *supra* note 1, at 1-2.

<sup>165</sup> *BSA/AML Penalties List*, BANKERSONLINE.COM, <http://www.bankersonline.com/security/bsapenaltylist.html#mizrahi> (last visited Sept 9, 2014).

<sup>166</sup> Viswanatha and Wolf, *supra* note 124, at 2.

<sup>167</sup> See generally *BSA/AML Penalties List*, *supra* note 165, at 1-2.

<sup>168</sup> Russell J. Bruemmer & Elijah M. Alper, *Aml: A Corporate Governance Issue*, 130 BANKING L.J. 867, 870 (2013).

<sup>169</sup> *Id.* at 876.

<sup>170</sup> *Id.* (citing Report by United States Senate Caucus on Int'l Narcotics Control, THE BUCK STOPS HERE: IMPROVING US. ANTI-MONEY LAUNDERING PRACTICES, CMP-2013-NCC-001, at 30).

such a case, it is increasingly easier for criminals to hide and disperse their money transfers in a growing world of underground banking.

What the DOJ should do is incentivize banks with amnesty for all past failures of the due diligence requirements of the BSA. The recent fines already had their effect and spurred a run to enhance AML compliance. If banks follow the AML laws and mechanisms, illegal money laundering is prevented. This is the first step in the right direction because the DOJ must do something to keep all of the transactions from soon entering the black market.

If Barclays is granted amnesty the bank may continue to monitor transactions to high-risk countries, while at the same time improving their AML compliance. If not, smaller banks whose correspondent banking services business line are a larger part of the company's business will fill the void left by the large banks. The smaller banks would also need incentives such as incentivized amnesty and as the FinCEN list shows, they are already less likely to receive crippling penalties. Furthermore, an AML sanction board would grant additional protection against draconian fines.

An AML sanction board, established under the control of FinCEN and applicable to DOJ sanctions should review all fines for AML violations. The board should use factors, similar to those found in the Securities and Exchange Commission (SEC) Seaboard Report for mitigating fines.<sup>171</sup> The factors proposed are as follows:

1. Self-policing: how well are the current AML policies within the corporation working? Why did the policies and procedure fail? Did the violations come from willful misconduct or honest mistake/negligence? What is the impact of the mistake and/or harm done?
2. Self-reporting: how long did the misconduct go for before it was ended and reported? Who uncovered it?
3. Cooperation: did the company identify any additional misconduct that could occur without being requested for such information? Was there complete cooperation with the law enforcement bodies?
4. Remediation: without ending the business line, what assurances were taken to ensure that the conduct is unlikely to recur? Are the actions taken going to make the enforcement and monitoring climate worse off?

---

<sup>171</sup>H.R. Rep. No. 1470, at 2 (2001), *available at* <http://www.sec.gov/litigation/investreport/34-44969.htm>.

5. The effects on the company: will the fines force the company to close a business line? Do the fines make the costs of operating the business line outweigh the benefits? Will the fine force compliance and not become excessively punitive? Does the gravity of the offense compel the harshness of the penalty? Are the fines in line with fines on other companies for similar misconduct? Were there negative externalities stemming from fines on similar companies with similar penalties?

In the future, more reasonable fines could keep banks in the business of servicing these companies and at the same time enforce AML compliance. The DOJ should promote companies taking steps to promote an efficient outcome, not for actions that leave the system worse off. The list of monetary penalties assessed by FinCEN includes many moderate fines that forced AML compliance without pushing the banks out of the market. Such a process that promotes more moderate fines would encourage banks to work with the specialized remittance firms to set up the appropriate checks and anti-financial crime controls. This will allow the banks and companies to spot criminal activity with the degree of confidence required by the U.S. Anti-Money Laundering Laws.

The DOJ should never again mitigate fines for the banks ending correspondent relationships. The calculation of fines is a very delicate process because banks cannot escape their duty to perform due diligence under the current AML laws. Yet, without the banks servicing the specialized remittance firms, FinCEN cannot monitor any transactions with the high-risk countries.

#### **Conclusion:**

This comment addresses problems with the DOJ's enforcement policy. Particularly, the DOJ's actions forced large banks out of the business of servicing money transfer companies. Mitigating fines against banks if they end affiliations with specialized remittance firms, and the threat of record setting fines is pushing all remittances and transactions into IVTS, where it is no longer monitored. Issuing amnesty and implementing a system to moderate civil penalties is the most reasonable way to proceed. The fines must force compliance with existing laws but not scare banks out of the market. Without the recommendations prescribed, a scary reality is forthcoming for regulators and enforcement agencies. Simply put, this DOJ policy sets back IVTS remittance and transaction monitoring for terrorism to the stone ages of pre- 9/11 and the PATRIOT Act.



**HOOPER V. LOCKHEED MARTIN CORP.: HOW AND WHY FRAUDULENT  
UNDERBIDDING SHOULD SCARE GOVERNMENT CONTRACTORS**

*Jason Sarfati*

## INTRODUCTION

It is easy to picture the following.<sup>1</sup> Contractor X enters into an extensive cost-reimbursement contract with the Department of Defense (“DOD”). The contract is highly technical, designed to be performed in a foreign war-torn country, and susceptible to limitless forces that will cause fluctuations in the cost of performance. Comforted by the fog of war, Contractor X decides to surreptitiously overestimate the actual cost required to perform the contract. The executives of Contractor X are betting that the auditors from the Defense Contract Audit Agency (“DCAA”) will be unable to notice the hidden fees, and that profits under the contract will increase more than previously expected.<sup>2</sup> Unaware of the overbid, Contractor X fraudulently induces the DOD to accept its inflated contract proposal, and without notice the U.S. Government has been defrauded in the sum of millions of dollars.

Fortunately, the False Claims Act (“FCA”) has a long history of successfully addressing fraudulent overbids on cost-reimbursement contracts.<sup>3</sup> In addition to finding that a traditional contract overbid sufficiently establishes FCA liability, courts have similarly recognized that the FCA will also apply to any fraudulently-induced contract.<sup>4</sup> Given this well-developed past precedent, it appears that the crooked defense contractor described above would be unlikely to avoid FCA liability once discovered.

But now suppose that instead of fraudulently overbidding the contract, Contractor X decides to fraudulently *underbid* the contract. Until

---

\*. George Mason University School of Law, Juris Doctor Candidate, May 2015; Notes Editor, George Mason University School of Law Journal of International Commercial Law, 2014-2015. I would like to thank my family and friends for their steadfast support throughout my legal studies.

<sup>1</sup> The facts in the introduction are hypothetical, although loosely based on *Hooper v. Lockheed Martin Corp.*, 688 F.3d 1037 (9<sup>th</sup> Cir. 2012). The facts of *Hooper* are discussed *infra* Part II. A.

<sup>2</sup> See generally 32 C.F.R. Pt. 290, App. A (discussing regulatory and administrative responsibilities of the Defense Contract Audit Agency).

<sup>3</sup> *Wrenn v. Md.*, 819 F.2d 1139 (4<sup>th</sup> Cir. 1987); *United States v. General Dynamics Corp.*, 19 F.3d 770 (2<sup>nd</sup> Cir. 1994).

<sup>4</sup> *Harrison v. Westinghouse Savannah River Co.*, 176 F.3d 766, 787 (4<sup>th</sup> Cir. 1999) (citing *United States ex rel. Schwedt v. Planning Research Corp.*, 59F.3d 196, 199 (D.C. Cir. 1995)).

recently, the FCA was incapable of keeping contractors liable for making fraudulent underbids, even if the contractor steadily increased costs during performance.<sup>5</sup> This precedent was completely upended when the Ninth Circuit became the first circuit to extend FCA liability to fraudulent underbids on a cost-reimbursement contract.<sup>6</sup> Specifically, the Ninth Circuit held that, “false estimates, defined to include fraudulent underbidding in which the bid is not what the defendant actually intends to charge, can be a source of liability under the FCA, assuming that the other elements of an FCA claim are met.”<sup>7</sup> This 2012 ruling by the Ninth Circuit represents a significant departure from previous understandings of the outer-reaches of FCA liability.<sup>8</sup>

Part I of this Comment will discuss the background of the FCA, as well as the extent that FCA liability applied to Government contractors pre-*Hooper*. Part II will examine the *Hooper* decision by analyzing how the Ninth Circuit concluded that FCA liability should be applied to both fraudulent overbids and underbids of a cost-reimbursement contract. Part III will advocate in favor of the theories advanced in the *Hooper* decision, and similarly highlight the public policy justifications for why the remaining circuits should adopt a similar extension of liability under the FCA.

## I. Background of the FCA

One cannot assess the credibility of court decisions that examine the extent of FCA liability under a cost-reimbursement contract without first understanding the purpose of the FCA as a whole. Accordingly, Part I of this casenote will provide a brief historical synopsis of the purpose behind the FCA’s passage, the current status of the FCA, and finally how the FCA was applied to cost-reimbursement contracts pre-*Hooper*.

---

<sup>5</sup> Andy Liu, Jonathan Cone, & Robert Sneckenberg, *The Top 10 FCA Decisions for Government Contractors*, The Government Contractor –Thomson Reuters (Jan. 9, 2013).

<sup>6</sup> See generally *United States ex rel. Hooper v. Lockheed Martin Corp.*, 688 F.3d 1037 (9<sup>th</sup> Cir. 2012).

<sup>7</sup> *United States ex rel. Hooper.*, 688 F.3d at 1049.

<sup>8</sup> Roger C. Haerr, *When Underbidding Below Cost to Win a Public or Government-Funded Contract May Violate the False Claims Act*, 33 WTR Construction Law. 17 (2013) (discussing the Ninth Circuit’s recent opinion that held that a fraud-in-the-inducement theory of FCA liability may attach from fraudulent underbidding below cost in an effort to win the contract).



### a. Brief history of the FCA

The United States has been afflicted by fraud against the Federal Government since its inception.<sup>9</sup> Despite a well-observed history of fraudulent conduct during the United States' adolescence, Congress failed to create any regulatory scheme to combat against Government fraud until the Civil War.<sup>10</sup>

As the Civil War raged across the countryside, both President Lincoln and Congress received alarming reports of fraudulent activity by defense contractors who were providing goods and services to the Union Army.<sup>11</sup> Such reports included gunpowder barrels filled with sawdust,<sup>12</sup> rotted ship hulls that had been painted over to appear as brand new,<sup>13</sup> and the same mules being sold over and over again to the Union Army.<sup>14</sup> After hearing of these incidents, Senator Henry Wilson of Massachusetts introduced a bill to help curb this fraud. When doing so, Senator Wilson captured the prevailing sentiment of the nation's leaders by declaring on the Senate Floor, "It is one of the crying evils of the period...that our Treasury is plundered from day to day by bands of conspirators."<sup>15</sup> Within a month's time, President Lincoln, who was equally frustrated by those defrauding the Union, signed Senator Wilson's bill into law as the False Claims Act.<sup>16</sup> Although first initiated by Senator Wilson, the FCA would come to be known as "Lincoln's Law," and to this day stands as one of the Government's most effective ways of combating fraud against the U.S. Treasury.<sup>17</sup>

### b. The FCA today

Today, the FCA imposes civil liability upon any person or entity that knowingly uses a "false record or statement to get a false or fraudulent

---

<sup>9</sup> JAMES B. HELMER JR., *FALSE CLAIMS ACT: WHISTLEBLOWER LITIGATION* 39 (Mathew Bender & Company, Inc., 3<sup>rd</sup> ed. 2002).

<sup>10</sup> JOHN T. BOESE, *CIVIL FALSE CLAIMS AND QUI TAM ACTIONS* (Wolters Kluwer Vol. 1, 4<sup>th</sup> ed. 2013).

<sup>11</sup> James B. Helmer Jr., *Incentivizing Integrity for 150 Years for Rogues, Privateers, Parasites, and Patriots*, 81 U. CIN. L. REV. 1261 (2013).

<sup>12</sup> *Id.* (citing Cong. Globe, 37th Cong., 3d Sess. 955 (1863)).

<sup>13</sup> *Id.* (citing Wayne Andrews, *The Vanderbilt Legend* 77-84 (1941)).

<sup>14</sup> *Id.* (citing 132 Cong. Rec. H6482 (daily ed. Sept. 9, 1986)) (statement of Rep. Berman).

<sup>15</sup> *Id.* (citing Cong. Globe, 37th Cong., 3d Sess. 955 (1863)).

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

<sup>17</sup> Brett Joshpe, *Celebrating The 150<sup>th</sup> 'Lincoln's Law': Privatized Fraud Fighting*, FORBES (Mar. 6, 2013), <http://www.forbes.com/sites/realspin/2013/03/06/celebrating-the-150th-birthday-of-lincolns-law-privatized-fraud-fighting/>.

claim paid or approved by the Government,” and/or any person who “conspires to defraud the Government by getting a false or fraudulent claim allowed or paid.”<sup>18</sup> Instead of simply relying upon the Federal Government to independently pursue wrongdoers, a private person, known as a “relator” can also bring a false claim on behalf the United States Government.<sup>19</sup> When a relator steps forward to report a fraud, the Government has a right of first refusal to intervene and prosecute any FCA claims included in the relator’s complaint.<sup>20</sup> Should the Government decline to intervene in the case, the relator has the right to independently “prosecute” the alleged violation of the FCA in exchange for a later determined percentage of any settlement or judgment.<sup>21</sup>

In order to dissuade potential wrongdoers, the FCA provides that any person who causes a false claim to be submitted to the Government is liable for a civil penalty of between \$5,500 and \$11,000 per claim, plus three times the amount of damages the Government sustained.<sup>22</sup> In other words, if a Government contractor defrauds the Government for \$20,000 in January, and \$20,000 in February, then the Government contractor will be liable under the FCA for \$120,000  $(\$20,000 + \$20,000) \times 3$ , in addition to a maximum civil penalty of \$22,000  $(\$11,000 \times 2 \text{ claims})$ .

### **c. How cost-reimbursement contracts differ from fixed-price contracts**

The U.S. Government primarily negotiates for goods and services through fixed-price contracts and cost-reimbursement contracts.<sup>23</sup> Unlike fixed-price contracts, which are not subject to an adjustment based on the contractor’s actual cost during performance, cost-reimbursement contracts allow a contractor to be reimbursed for all costs reasonably incurred during the performance of a contract.<sup>24</sup> By reimbursing the contractor for all costs reasonably incurred during contract performance, the risk of fluctuating performance costs are shifted from the contractor over to the Government. Due to the added burden to the Government, the procurement of goods and

---

<sup>18</sup> See *Allison Engine Co. v. United States ex rel. Sanders*, 553 U.S. 662, 665 (2008).

<sup>19</sup> *Id.* at 665.

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

<sup>21</sup> 31 U.S.C. § 3730(b) (2010).

<sup>22</sup> 31 U.S.C. § 3729(a) (2010).

<sup>23</sup> GREGORY A. GARRETT, *GOVERNMENT CONTRACT COST ACCOUNTING* 20 (Wolters Kluwer eds., 2010).

<sup>24</sup> See generally Far 16.202-1; FAR 16.301-1; Edward R. Brown, *Not a Tecom Party: There’s “Very Little Likelihood” Green v. Tecom will Promote Sound Government Contracting Practices*, 18 GEO. MASON L. REV. 193, 195-99 (2010).

services through fixed-price contracting is preferred unless the specific circumstances surrounding a contract require that a cost-reimbursement contract be utilized.<sup>25</sup> Today, most cost-reimbursement contracts are reserved for complex contracts where it is difficult for both the Government and the contractor to accurately predict the eventual cost of performance.<sup>26</sup>

**d. FCA liability applies to cost-reimbursement contract overbids**

The FCA applies to any contractor that enters into a contract with the Government.<sup>27</sup> Given that a contractor is reimbursed for all costs incurred under a cost-reimbursement contract, contractors can expect to earn a greater than expected profit by inflating the costs they report to the Government.<sup>28</sup> As the potential for fraud under this billing mechanism is ripe, courts are quick to apply FCA liability to contractors that fraudulently overstate the cost of performance under a cost-reimbursement contract.<sup>29</sup>

Although military contracts have historically dominated cost-reimbursement contracts facing FCA liability, the use of the Act has recently grown well outside the realm of military procurement.<sup>30</sup> Today, many FCA actions stem from various non-military agencies, with those contracts relating to the health care industry dominating all other FCA actions, including those with the DOD.<sup>31</sup> The application of FCA liability on cost-reimbursement contracts is a relatively new concept for many non-military contractors.<sup>32</sup> As such, contractors should be aware that courts will routinely extend FCA liability to contractors that abusively overstate their performance costs, regardless of their line of work.<sup>33</sup>

**e. FCA liability similarly extends to fraud-in-the-inducement cases**

Aside from determining whether traditional fraudulent invoices under a cost-reimbursement contract are subject to FCA liability, courts have also had to separately determine whether the FCA extends liability to

---

<sup>25</sup> *Id.* at 196.

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

<sup>27</sup> See 31 U.S.C. 3729(a)(1).

<sup>28</sup> Rachel Grace Stabler, *Adding Insult to Injury: Opportunities for Fraud in the Katrina-Related Government Contracts Under the False Claims Act*, 58 ALA. L. REV. 631, 645 (2007).

<sup>29</sup> See generally *Kellogg Brown & Root Services, Inc. v. U.S.*, 99 Fed. Cl. 488 (Fed. Cir. 2011).

<sup>30</sup> Boese, *supra* note 10, at 141.

<sup>31</sup> *Id.*

<sup>32</sup> *Id.*

<sup>33</sup> See generally *U.S. ex rel. Fine v. MK-Ferguson Co.*, 99 F.3d 1538, (10<sup>th</sup> Cir. 1996).

claims arising under a fraudulently induced contract.<sup>34</sup> The Supreme Court has held that the FCA extends liability to a Government contractor for each claim when either the contract, or extension of government benefit, was obtained originally through false statements or fraudulent conduct.<sup>35</sup> In *United States ex. rel. Marcus v. Hess*, the case that serves as the cornerstone of fraud-in-the-inducement liability under the FCA, the trial court determined that Respondent Hess, among others, had taken a leading role in a conspiracy of collusive bidding with other contractors to perform public work projects in the Pittsburgh area.<sup>36</sup> Upon review at the Supreme Court, the court held that the collusive bidding scheme was sufficient to consider the Hess contract “fraudulently-induced.”<sup>37</sup> Consequently, even though the claims filed by Hess were not in-and-of-themselves fraudulent, the fact that the overarching contract was fraudulently induced had a tainting effect on each claim that the Respondent subsequently filed for payment.<sup>38</sup> Given Respondent Hess’s fraudulent pre-award conduct, the Supreme Court found it appropriate to expand the traditional understanding of FCA liability and hold the Respondent liable for its conduct.<sup>39</sup> The ‘fraud-in-the-inducement’ theory of FCA liability was born.<sup>40</sup>

Following *Marcus*, courts openly accepted that a fraud-in-the-inducement cause of action exists under the FCA.<sup>41</sup> A notable example of the fraud-in-the inducement theory being applied to the FCA includes *United States v. General Dynamics Corp.*, where a contractor was held liable under the FCA for submitting inflated cost estimates.<sup>42</sup> In *United States v. General Dynamics Corp.*, the primary contractor (hereafter referred to as “General Dynamics”) was aware that a subcontractor was submitting falsely inflated cost estimates, and that General Dynamic’s bid naturally contained inflated cost-estimates as well.<sup>43</sup> In light of the subcontractor’s falsely inflated cost estimates, the Second Circuit found both General Dynamic’s and the subcontractor’s pre-award activities to sufficiently constitute a form of bid-rigging similar in spirit to that found in

---

<sup>34</sup> Michael Holt, *Implied Certification under the False Claims Act*, 41 PUB. CONT. L.J. 1, 17 (2011).

<sup>35</sup> See generally *United States ex rel. Marcus v. Hess*, 317 U.S. 537 (1943).

<sup>36</sup> *Id.* at 539.

<sup>37</sup> *Id.* at 542.

<sup>38</sup> Boese, *supra* note 10, at 146.

<sup>39</sup> Holt, *supra* note 34, at 17.

<sup>40</sup> *Id.* at 17-18.

<sup>41</sup> *Harrison v. Westinghouse Savannah River Co.*, 176 F.3d 766, 787 (4<sup>th</sup> Cir. 1999) (citing *United States ex rel. Schwedt. v. Planning Research Corp.*, 59F.3d 196, 199 (D.C. Cir. 1995)).

<sup>42</sup> *Id.* at 788 (citing *United States v. General Dynamics Corp.*, 19 F.3d 770, 772 -75 (2d Cir.1994)).

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

*Marcus*.<sup>44</sup> Consequently, the Second Circuit applied FCA liability to both the contractors pursuant to the fraud-in-the-inducement theory found in *Marcus* as well as for the main contractor's fraudulent cost inflation.<sup>45</sup>

*United States v. General Dynamics Corp.* does not stand alone as the only case post-*Marcus* to uphold a fraud-in-the-inducement theory for FCA cases. In *United States ex rel. Schwedt v. Planning Research Corp.*, the U.S. District Court for the District of Columbia ("DDC")<sup>46</sup> held a contractor liable for grossly exaggerating its ability to perform a contract.<sup>47</sup> Although the contractor had submitted genuine claims, the relator alleged that the contractor's fraudulent exaggeration of its ability to perform the contract constituted another form of fraud-in-the-inducement.<sup>48</sup> The contractor's exaggerations were sufficiently consistent with the tainting effect first noted in *Marcus*, and even though the relator ultimately declined to pursue a fraud-in-the-inducement theory, the DDC noted it would have upheld such a theory if the relator had properly presented it.<sup>49</sup>

Both *United States v. General Dynamics Corp.* and *United States ex rel. Schwedt v. Planning Research Corp.*, among other notable cases,<sup>50</sup> provided the Fourth Circuit with sufficient grounds to re-affirm the fraud-in-the-inducement theory in *Harrison v. Westinghouse Savannah River Co.* In *Harrison*, the relator brought an FCA action against the Westinghouse Savannah River Corporation ("WSRC") alleging that WSRC had deliberately misrepresented the cost and duration of the proposed subcontract in order to induce the Department of Energy's approval of its bid.<sup>51</sup> Given the contractor's exaggeration for both the need and price of the subcontractors' work, the Fourth Circuit saw sufficient similarity with the Defendants' conduct in *United States v. General Dynamics Corp.* and *United States ex rel. Schwedt v. Planning Research Corp.* to re-apply fraud-in-the-inducement theory of liability under the FCA to WSRC.<sup>52</sup> In doing

---

<sup>44</sup> *Id.* at 775.

<sup>45</sup> *Id.*

<sup>46</sup> United States District Court for the District of Columbia, <http://www.dcd.uscourts.gov/dcd/> (last visited October 31, 2014) (noting that a significant number of False Claims Act cases are filed in this jurisdiction).

<sup>47</sup> *Harrison*, 176 F.3d 788 (citing *United States ex rel. Schwedt v. Planning Research Corp.*, 59 F.3d 196, 199 (D.C.Cir. 1995) (court suggested it would have upheld a theory of fraud-in-the-inducement theory of liability under the FCA had it been properly presented)).

<sup>48</sup> *Schwedt*, 59 F.3d at 199.

<sup>49</sup> *Harrison* 176 F.3d at 788 (citing *Schwedt* 59 F.3d at 199 (D.C.Cir. 1995) (court suggested it would have upheld a theory of fraud-in-the-inducement theory of liability under the FCA had it been properly presented)).

<sup>50</sup> *Harrison*, 176 F.3d 787-88 (citing *United States ex rel. Windsor v. DynCorp, Inc.*, 19 F.3d 770 (E.D.Va. 1995)); *United States ex rel. Hagood v. Sonoma County Water Agency*, 929 F.2d 1416 (9<sup>th</sup> Cir. 1991).

<sup>51</sup> *Harrison* 176 F.3d at 780.

<sup>52</sup> *Id.* at 787.

so, the Fourth Circuit concluded that FCA liability is appropriately attached where “fraud surrounds the efforts to obtain the contract or benefit status, or the payments thereunder.”<sup>53</sup> This line of thought, in part based upon the cases preceding *Harrison*, ultimately serves as the cornerstone for the fraud-in-the-inducement theory of liability eventually adopted in *Hooper*.<sup>54</sup>

It is important to note that the claims in the cases described above were not intrinsically false.<sup>55</sup> As an example, the Defendant in *United States v. General Dynamics Corp.* exclusively billed the government for services the contractor actually performed.<sup>56</sup> This notwithstanding, General Dynamics relied upon inflated cost estimates created during the procurement phase to form the basis of invoices submitted to the Government once performance began.<sup>57</sup> Accordingly, the Second Circuit found General Dynamics’ pre-award conduct sufficiently fraudulent to negate the argument that General Dynamics had only charged the Government for costs actually incurred.<sup>58</sup> WSRC raised a similar defense in *Harrison*, but it too failed to escape liability under the FCA.<sup>59</sup>

**f. On the eve of *Hooper v. Lockheed Martin Corp.***

In light of the foregoing, on the eve of *Hooper* a contractor could only be held liable under the FCA for either 1) fraudulently invoicing the Government for either a product or service that the Government never receives, or in the alternative, invoicing the Government for a higher-priced product or service than actually provided,<sup>60</sup> 2) misrepresenting its ability to perform the contract,<sup>61</sup> or 3) fraudulently-inducing a contract award.<sup>62</sup> Despite *Hess*’s extension of fraud-in-the-inducement liability to the FCA, subsequent court decisions would limit this theory exclusively to circumstances where the fraud resulted in a financial loss to the Government.<sup>63</sup> In light of this precedent, the Ninth Circuit found itself in

---

<sup>53</sup> *Hooper v. Lockheed Martin Corp.*, 688 F.3d 1037, 1048 (2012) (citing *Harrison*, 176 F.3d at 788).

<sup>54</sup> Liu, *supra* note 5.

<sup>55</sup> *Harrison* 176 F.3d at 787, n.10 & 11.

<sup>56</sup> *United States v. Gen. Dynamics Corp.*, 19 F.3d 770, 771 (2d Cir. 1994).

<sup>57</sup> *Id.*

<sup>58</sup> *See generally id.*

<sup>59</sup> *See Harrison*, 176 F.3d at 776.

<sup>60</sup> Boese, *supra* note 10.

<sup>61</sup> *United States ex rel. Schwedt v. Planning Research Corp.*, 59 F.3d 196 (D.C. Cir. 1995).

<sup>62</sup> *United States ex rel. Marcus v. Hess*, 317 U.S. 537 (1943).

<sup>63</sup> *Harrison*, 176 F.3d at 788.

uncharted waters when it was presented with a fraud-in-the-inducement case that emanated from an underbid instead of an overbid.

## II. Analysis

### a. Factual background of *Hooper*

The FCA permits a private individual, known as a “relator,” to file a *qui tam*<sup>64</sup> suit by stepping into the shoes of the U.S. Government and recouping damages from individuals who submit a false claim.<sup>65</sup> A later determined portion of the damages will be retained by the individual bring suit, while the remainder will go back to the U.S. Government. Using this provision, Nyle J. Hooper (“Hooper”), a Research Operations Engineer employed at Lockheed Martin Corp. (“Lockheed”), individually brought suit against Lockheed alleging that his employer had violated the FCA.<sup>66</sup>

In 1995, one year prior to Hooper beginning his employment at Lockheed, the United States Air Force (referred to hereafter as the “Air Force”) awarded Lockheed a contract for the Range Standardization and Automation “RSA IIA” program (referred to hereafter as the “RSA Contract”).<sup>67</sup> The RSA Contract was a lucrative cost-reimbursement contract (similar to that awarded to General Dynamics Corp.), wherein Lockheed was responsible for supporting software and hardware systems used to support space launch operations at Vandenberg Air Force Base.<sup>68</sup> As a cost-reimbursement contract, Lockheed had the benefit of being reimbursed for its actual costs during contract performance, regardless of the initial cost-estimates Lockheed had originally provided the Government.<sup>69</sup>

During the original contract proposal phase, the Air Force issued a Request for Proposal (“RFP”), which outlined the program specifications that a contractor would be expected to meet, and similarly the reimbursement scheme that the contractor could expect to receive if awarded the contract.<sup>70</sup> The RFP outlined the six factors the Air Force would consider in determining which contractor would be awarded the RSA Contract.<sup>71</sup> The first four factors, (management, systems engineering,

---

<sup>64</sup> Latin for “On behalf of another.”

<sup>65</sup> See 31 USC § 3730(b)(2010).

<sup>66</sup> Hooper v. Lockheed Martin Corp., 688 F.3d 1037, 1041 (2012).

<sup>67</sup> *Id.* at 1041 n. 2.

<sup>68</sup> *Id.* at 1041.

<sup>69</sup> JOHN CIBINIC, JR. & RALPH C. NASH, JR. COST-REIMBURSEMENT CONTRACTING 1-2 (Wolters Kluwer Law & Business, 3rd ed. 2004).

<sup>70</sup> Hooper, 688 F.3d at 1042.

<sup>71</sup> *Id.*

systems integration, and product development) were all of equal importance to the Air Force.<sup>72</sup> Cost was second in importance to the first four factors outlined above, but was still considered a significant consideration in the contract award process.<sup>73</sup> Given that cost was not the solely-determinative factor, the Air Force informed Lockheed and its competitors that the Air Force retained the right to forgo the lowest-priced acceptable offer, in exchange for the contractor who presented the Air Force with the “best valued” offer.<sup>74</sup>

Two other contractors alongside Lockheed responded to the RFP.<sup>75</sup> Despite the Air Force’s assurances that cost would not be solely determinative, Lockheed demanded that all of its employees involved in cost preparation keep cost estimates as low as possible.<sup>76</sup> Of particular consequence, Mike Allen, one of Hooper’s colleagues that had played an important role during the bid preparation, testified at trial that Lockheed instructed its employees to lower their cost estimates for the RSA Contract in some instances without regard to actual costs.<sup>77</sup>

Relator Hooper worked at Lockheed under the RSA Contract for six years prior to filing an FCA claim against his employer.<sup>78</sup> Frustrated by Lockheed’s underbid, Hooper brought forth several concerns to his management regarding the RSA Contract.<sup>79</sup> Primary among these, Hooper alleged that Lockheed had knowingly and fraudulently underbid the RSA Contract in order to ensure that the Air Force would award Lockheed the space launch contract.<sup>80</sup> On July 19, 2002, Lockheed involuntarily terminated Hooper for investigating the fraud surrounding Lockheed’s underbid of the RSA IIA program.<sup>81</sup> In response, Hooper filed a complaint in the U.S. District Court of Maryland under the FCA, alleging that Lockheed had violated the false claims provisions found in 31 U.S.C. § 3729(a) *et seq.*, in addition to the anti-retaliatory provisions found in 31 U.S.C. § 3730(h).<sup>82</sup>

#### **b. Procedural history**

---

<sup>72</sup> *Id.*

<sup>73</sup> *Id.*

<sup>74</sup> *Id.*

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

<sup>76</sup> *Hooper*, 688 F.3d at 1042.

<sup>77</sup> *Id.* at 1041.

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

<sup>79</sup> *Id.*

<sup>80</sup> *Id.*

<sup>81</sup> *Id.*

<sup>82</sup> *Hooper*, 688 F.3d at 1041.



Lockheed Martin is headquartered in Bethesda, Maryland.<sup>83</sup> Accordingly, on July 18, 2005, Hooper filed an FCA complaint against Lockheed in the District Court for the District of Maryland on the grounds of federal subject-matter jurisdiction.<sup>84</sup> Given the location of Lockheed's headquarters, said filing was initially determined to be venue-appropriate.<sup>85</sup> While the case was pending in the District Court for the District of Maryland, the United States declined to intervene in the case pursuant to section 3730(b), thus permitting Hooper to pursue his false claims against Lockheed independently.<sup>86</sup>

In light of Vandenberg Air Force Base's location on the Central Coast of California,<sup>87</sup> and upon Lockheed's request, the District Court for the District of Maryland transferred Hooper's complaint to the Central District of California on the grounds of forum non-conveniens.<sup>88</sup> Upon transfer of the case to the Central District of California, the district court granted Lockheed's motion to dismiss Hooper's anti-retaliation § 3730(h) claims, holding that such a claim was barred by California's two-year statute of limitations.<sup>89</sup>

Following the district court's dismissal of Hooper's § 3730(h) anti-retaliation claims, Hooper filed an amended complaint re-alleging that Lockheed had violated the FCA by knowingly underbidding the RSA Contract.<sup>90</sup> At the termination of discovery, Lockheed filed a motion for summary judgment claiming that Hooper had failed to provide sufficient evidence of fraudulent underbidding.<sup>91</sup> The district court agreed, and granted Lockheed's motion for summary judgment.<sup>92</sup>

In coming to its holding, the district court declined to review whether fraudulent underbidding and/or false estimates can create liability under the FCA.<sup>93</sup> Consequently, Hooper appealed to the Ninth Circuit Court of Appeals, claiming that fraudulent underbids, (as opposed to the traditional over-bid scenario), could sufficiently create liability under the

---

<sup>83</sup> LOCKHEED MARTIN WHO WE ARE, <http://www.lockheedmartin.com/us/who-we-are.html> (last visited Oct. 29, 2013).

<sup>84</sup> *Hooper*, 688 F.3d at 1041.

<sup>85</sup> *Id.* at 1045.

<sup>86</sup> *Id.* at 1044.

<sup>87</sup> DEPARTMENT OF THE AIR FORCE OF THE UNITED STATES OF AMERICA, [http://www.vandenberg.af.mil/library/factsheets/factsheet\\_print.asp?fsID=4606](http://www.vandenberg.af.mil/library/factsheets/factsheet_print.asp?fsID=4606) (last visited Oct. 29, 2013).

<sup>88</sup> *Hooper*, 688 F.3d at 1044.

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

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

<sup>91</sup> *Id.* at 1041.

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

<sup>93</sup> *Id.* at 1044.

FCA.<sup>94</sup> The Ninth Circuit granted review, and oral arguments were heard on May 10, 2012.<sup>95</sup>

### c. Legal Analysis

The Ninth Circuit was asked to determine whether fraudulent underbids during the procurement phase of a contract sufficiently extend liability to the contractor under the FCA.<sup>96</sup> Unable to rely upon the well-established application of FCA liability to fraudulent *overbids*, the Ninth Circuit first noted that the FCA should create liability for any person who, *inter alia*, “(A) knowingly presents, or causes to be presented, a false or fraudulent claim for payment or approval; [or] (B) knowingly makes, uses, or causes to be made or used, a false record or statement material to a false or fraudulent claim.”<sup>97</sup> By deduction, the Ninth Circuit preliminarily concluded that in order for a claim to be actionable under the FCA, either the relator or the United States must show that the contractor has satisfied the following four elements: (1) submitted a false or fraudulent claim, (2) that was material to the decision-making process, (3) which defendant presented, or caused to be presented, to the United States for payment or approval, and (4) with knowledge that the claim was fraudulent.<sup>98</sup>

The Ninth Circuit next turned to whether FCA liability could be premised on knowingly false statements made by the contractor pre-award (i.e. during the procurement phase).<sup>99</sup> In analyzing this issue, the Ninth Circuit looked back to the Supreme Court’s holding in *Marcus*.<sup>100</sup> As previously stated, using a fraud-in-the-inducement theory, the *Marcus* court found the Defendant contractor liable under the FCA for claims that stemmed from a contract awarded as a result of collusive bidding.<sup>101</sup> In *Marcus*, the Supreme Court viewed collusive bidding as sufficiently deceitful conduct in order to render the entire contract subject to the FCA’s provisions, regardless of the trustworthiness of each individual invoice.<sup>102</sup> Relying upon this holding, the Ninth Circuit agreed that FCA liability can

---

<sup>94</sup> *Hooper*, 688 F.3d at 1049.

<sup>95</sup> *Id.* at 1037.

<sup>96</sup> James J. Gallagher, Susan A. Mitchell, Jason N. Workmaster, *Ninth Circuit Issues Troubling False Claims Act Decision*, McKenna Long & Aldridge LLP, Publications Advisories (Aug. 6, 2012), <http://www.mckennalong.com/publications-advisories-3044.html>.

<sup>97</sup> *Hooper*, 688 F.3d at 1047 (citing 31 U.S.C. § 3729(a)).

<sup>98</sup> *Id.* (citing *United States v. Bourseau*, 531 F.3d 1159, 1171 (9<sup>th</sup> Cir. 2008)); *United States ex rel. Cafasso v. Gen. Dynamics C4 Sys., Inc.*, 637 F.3d 1047, 1056 (9<sup>th</sup> Cir. 2011).

<sup>99</sup> *Hooper*, 688 F.3d at 1048.

<sup>100</sup> *Id.*

<sup>101</sup> *See United States ex rel. Marcus v. Hess*, 317 U.S. 537 (1943).

<sup>102</sup> *Id.*

attach to fraud-in-the-inducement conduct, so long as the deceitful pre-award conduct has a similarly tainting effect on the contract as a whole.<sup>103</sup>

The Ninth Circuit similarly approved of the Fourth Circuit's holding in *Harrison*.<sup>104</sup> In *Harrison*, a relator had alleged that the Defendant was liable under the FCA for knowingly submitting several false estimates while seeking government approval for a subcontract.<sup>105</sup> The Fourth Circuit took particular exception with the Defendant's conduct in *Harrison* by holding that, "an opinion or estimate carries with it 'an implied assertion, not only that the speaker knows no facts which preclude such an opinion, but that he does know facts which justify it.'"<sup>106</sup> The Ninth Circuit agreed with the Fourth Circuit's view on the implied veracity of pre-award statements, noting that submitting false estimates while seeking government approval has a similarly tainting effect on the contract as that seen in *Marcus*.<sup>107</sup> In light of the Fourth Circuit's fluid application of the fraud-in-the-inducement theory to the FCA, the Ninth Circuit sought to apply the same analysis to determine whether FCA liability should extend in *Hooper*.<sup>108</sup>

Following its review of the Supreme Court's holding in *Marcus*, in addition to the Fourth Circuit's reliance upon the *Marcus* decision in *Harrison*, the Ninth Circuit concluded that false estimates, including underbids where the cost estimate is not what the defendant actually intends to charge, can be a source of liability under the FCA.<sup>109</sup> Consequentially, the Ninth Circuit expanded the Fourth Circuit's, and indeed the Supreme Court's, outer limits of liability under the FCA by holding that a false estimate alone, whether an underbid or an overbid, satisfies § 3729(a)'s requirement for a false or fraudulent claim for payment or approval.<sup>110</sup>

Relying upon this theory of liability, the Ninth Circuit reversed and remanded the Central District of California's dismissal of Relator Hooper's claims.<sup>111</sup> Given that FCA liability can be exclusively predicated by false estimates a contractor knows are inconsistent with rates the contractor ultimately intended to charge, the Ninth Circuit instructed the trial court to re-evaluate whether Lockheed's estimates were inconsistent

---

<sup>103</sup> *Hooper*, 688 F.3d at 1048.

<sup>104</sup> *Id.*

<sup>105</sup> *Id.* (citing *Harrison v. Westinghouse Savannah River Co.*, 176 F.3d 766, 785-86 (4<sup>th</sup> Cir. 1999)).

<sup>106</sup> *Harrison*, 176 F.3d at 791.

<sup>107</sup> *Hooper*, 688 F.3d at 1048 (citing *Harrison*, 176 F.3d at 785-86).

<sup>108</sup> *Id.*

<sup>109</sup> *Id.* at 1049.

<sup>110</sup> *Id.* at 1048 (citing *Harrison*, 176 F.3d at 785-86).

<sup>111</sup> *Id.* at 1041.

with what Lockheed knew it would eventually charge the Air Force for the RSA II Program.<sup>112</sup>

Should the trial court conclude that the underbid contained false estimates, the Ninth Circuit's holding that false estimates independently constitute a false claim under a fraud-in-the-inducement theory will be sufficient to make Lockheed liable under the FCA. As of this writing, the Ninth Circuit's holding in *Hooper* represents the greatest extension of FCA liability throughout the entire judiciary system.<sup>113</sup> The Central District of California has yet to re-examine the facts in *Hooper*, but will be doing so shortly in the future.<sup>114</sup>

### III. Argument: Justifications for circuit-wide adoption of the *Hooper* theory of FCA liability

#### a. Others weigh-in

*Hooper* has drastically altered the way government contractors must now produce cost estimates under a cost-reimbursement contract. Not surprisingly, the government contracting community has been abuzz about the practical implications of the *Hooper* decision, and how best to abide by the Ninth Circuit's holding. The profound interest in this case notwithstanding, as of this writing, this casenote remains the only scholastic or professional law review article dedicated exclusively to the case.

Within days of the Ninth Circuit Court handing down its decision, attorneys working in the government contracting and *qui tam* whistleblower litigation communities began posting blog articles warning others of the practical implications stemming from the court's decision. Reena Dutta, an attorney specializing in FCA litigation, made one such posting.<sup>115</sup>

In her article, Ms. Dutta appropriately noted that an important distinction must be made between inaccurate cost-estimates, and *false* estimates.<sup>116</sup> As noted by the Ninth Circuit, when a government contractor submits a cost-estimate, a contractor can only provide their best prediction of what the cost of performance will ultimately become.<sup>117</sup> Traditionally,

---

<sup>112</sup> *Id.* at 1050.

<sup>113</sup> See generally Liu et al., *supra* note 5.

<sup>114</sup> Minute Order in Chambers Nyle J. Hooper et Al v. Lockheed Martin Corp., No. 2:08-cv-00561 (C.D. Cal. Jan. 29, 2013), ECF No. 225.

<sup>115</sup> Reena Dutta, *Ninth Circuit Decision Is, Oddly, Good News for Both Relators and Defendants*, The Whistleblower Blog – Hodgson Russ LLP (Aug. 14, 2012), <http://blog.thewhistleblowerattorney.com/2012/08/14/ninth-circuit-decision-is-oddly-good-news-for-both-relators-and-defendants>.

<sup>116</sup> *Id.*

<sup>117</sup> *Id.*

contractors could avoid cost-estimate based liability under the FCA, because they were viewed as merely an opinion or prediction.<sup>118</sup> Tradition notwithstanding, the Ninth Circuit drew an exception to the rule that false estimates are immune to FCA liability, after *Hooper* alleged that Lockheed's cost-estimates contained no basis of fact to support them.<sup>119</sup> Appropriately, Dutta drew the same distinction in her article, by agreeing that Lockheed's instruction to lower bid costs without regard to actual costs is a violation of the previously understood definition of cost estimates.<sup>120</sup> Should a contractor wish to avoid FCA liability, Dutta advised contractors do their best to avoid submitting deflated estimates that disregard actual cost data.<sup>121</sup>

Despite the distinction *Hooper* attempts to draw between inaccurate cost-estimates and *false* estimates, the reaction within the government contracting community has not been exclusively positive. One of the primary concerns following *Hooper* is that relators will have an enhanced capacity to second-guess the motives of contractors.<sup>122</sup> Joe West, a noted attorney employed in Gibson Dunn & Crutcher LLP's Government Contracts practice, is one of the voices expressing concern over the practical implications of the *Hooper* decision.<sup>123</sup>

As noted in Mr. West's reaction to *Hooper*, many Government contractors conduct business in an uncertain and unpredictable pre-award environment.<sup>124</sup> Although *Hooper* limits FCA liability exclusively to false estimates contractors are aware are false, actual performance costs frequently exceed cost estimates for a variety of legitimate reasons.<sup>125</sup> This limitation notwithstanding, the precedent established by *Hooper* may increase the number of FCA actions in the future as contractors are forced to distinguish between legitimate and illegitimate cost overruns.<sup>126</sup> Such an environment may lead to unnecessary litigation costs, and thus have a previously unforeseen negative impact upon the Government contracting community.<sup>127</sup>

---

<sup>118</sup> *Id.*

<sup>119</sup> *See generally* Hooper v. Lockheed Martin Corp., 688 F.3d 1037 (2012).

<sup>120</sup> Dutta, *supra* note 115.

<sup>121</sup> *Id.*

<sup>122</sup> Joe West, Drew Tulumello & Jessica Sanderson, *Government Contractors Beware; Recent Federal Appellate Decisions Are Sure to Fuel Increased FCA Litigation*, 54 NO. 31 Gov't Contractor ¶ 257 (Aug. 22, 2012).

<sup>123</sup> *Id.*

<sup>124</sup> *Id.*

<sup>125</sup> *Id.*

<sup>126</sup> *Id.*

<sup>127</sup> *See id.*

**b. The Truth In Negotiations Act's inability to address competitively awarded contracts necessitates the adoption of the *Hooper* theory of liability**

At first glance, it may appear as though the Truth In Negotiations Act (TINA) sufficiently addresses the legal issues faced in *Hooper*, thus extinguishing the need for any extension of liability under the FCA. TINA's powers notwithstanding, TINA only applies in a limited number of circumstances, thus rendering it incapable of addressing forms of defective pricing that are similar to those exhibited in *Hooper*.

TINA requires that all offerors, contractors, and subcontractors submit accurate cost and pricing data to the Government during the procurement process.<sup>128</sup> In this vein, contractors must disclose the cost or pricing data that was used in building up the final value of the bid proposal.<sup>129</sup> If a contractor is found to have submitted knowingly inaccurate cost estimates that result in an overpayment, TINA dictates that a contractor reimburse the Government twice the amount of the original overpayment, plus interest.<sup>130</sup>

Despite TINA's strong ramifications for a contractor's inability to submit accurate pricing data, TINA is incapable of addressing the false estimates presented in *Hooper*. Pursuant to § 2306(b)(1)(A)(i), TINA does not apply to negotiations where adequate price competition is present (i.e. two or more responsible potential contractors have bid on a contract).<sup>131</sup> In other words, TINA can only address the false estimates exhibited in *Hooper*'s when there has been only one contractor which has responded to an RFP.<sup>132</sup> Given that Lockheed was one of three contractors to bid on the RSA Contract, TINA's provisions are inapplicable to the false estimates Hooper noticed during the course of his employment.

Today's Government contract bidding mechanisms place a strong premium on the value of competition. The general theory of government procurement is that adequate price competition during the bidding process will eviscerate any potential fraudulent over-pricing by a contractor.<sup>133</sup> TINA advances the theory that when contractors are forced to compete against one another, each will actively seek out the most favorable prices from supply and service providers to deliver the most competitive final bid

---

<sup>128</sup> See 10 U.S.C. § 2306(a) (2011) *et seq.*

<sup>129</sup> See *id.*

<sup>130</sup> 10 U.S.C. § 2306a(f) (2011).

<sup>131</sup> See 10 U.S.C. § 2306a(b)(1)(A)(i).

<sup>132</sup> See *id.*

<sup>133</sup> See generally *FAR Council Seeks to Clarify "Adequate Price Competition" Exception*, 36 No. 13 Gov't Contractor 182 (Mar. 30, 1994).

price possible.<sup>134</sup> Incorporating fraudulent pricing data into a final bid (as the theory goes) threatens a contractor's ability to adequately compete with its competitors.<sup>135</sup> TINA's provisions are specifically drafted to address only those contracts that lack sufficient competition, and explicitly avoids bids that were competitively submitted.<sup>136</sup>

TINA's inability to appropriately address false estimates on competitively awarded cost-reimbursement contracts presents a strong illustration for the necessity for circuit-wide adoption of the *Hooper* theory of liability under the FCA. By including a competitive price exception to TINA, Congress has eviscerated a statutory means to curb competitively-submitted inaccurate pricing data. An inherent problem arises when the Government inaccurately assumes fraud will be extinguished by competition. As seen in *Hooper*, the presence of two other contractors was allegedly insufficient to dissuade Lockheed from submitting false estimates during the procurement phase.<sup>137</sup> The facts of Lockheed show that an alternate regulatory structure is required to fill the competitive price exception Congress created in § 2306(b)(1)(A)(i) of TINA. The *Hooper* theory of FCA liability is the answer.

**c. The Ninth Circuit correctly applied the facts presented in *Hooper vs. Lockheed Martin Corp.* by extending liability under the FCA for false estimates under competitively awarded cost-reimbursement contracts that result in an underbid.**

**i. The Ninth Circuit appropriately identified and satisfied the FCA's original intent**

When passing the FCA in 1863, Congress sought to provide the Government with a means of protecting itself against those who wish to defraud the American people.<sup>138</sup> Although originally limited exclusively to *prima facie* false claims, the FCA has a well-documented history of being applicable to contractors under a fraud-in-the-inducement theory of liability.<sup>139</sup> First established under *Marcus* as a result of collusive bidding,

---

<sup>134</sup> *Largest Aerospace Firms in Internet Venture to Broker Supplies and Services* 42 No. 13 Gov't Contractor ¶ 118 (Mar. 29, 2000).

<sup>135</sup> *Id.*

<sup>136</sup> *Id.*

<sup>137</sup> See generally *Hooper v. Lockheed Martin Corp.*, 688 F.3d 1037 (2012).

<sup>138</sup> Patricia Meador, Elizabeth S. Warren, *The False Claims Act: A Civil War Relic Evolves into a Modern Weapon*, 65 TENN. L. REV. 455, 458-61 (Winter, 1998).

<sup>139</sup> See generally *United States ex rel. Marcus v. Hess*, 317 U.S. 537 (1943).

the fraud-in-the-inducement theory of liability under the FCA has since grown under a variety of circumstances.

The Fourth Circuit's *Harrison* decision represented a significant expansion of the fraud-in-the-inducement theory of liability.<sup>140</sup> In *Harrison*, the Fourth Circuit found that a contractor was liable under the FCA for artificially inflating cost-estimates on a cost-reimbursement contract.<sup>141</sup> The *Hooper* court relies upon the same theory of liability advanced in *Harrison*.<sup>142</sup> Contrary to critiques of the *Hooper* court, extending liability to inaccurate cost estimates that result in an underbid on a cost-reimbursement contract does not represent a sizable departure from the theory first found in *Harrison*.

In both *Harrison* and *Hooper*, the contractor engaged in defective pricing by knowingly submitting inaccurate pricing data during the procurement phase of a contract.<sup>143</sup> The only practical distinction that can be made between *Harrison* and *Hooper* is that the Defendant in *Harrison* artificially inflated cost-estimates, while Lockheed in *Hooper* artificially deflated cost-estimates. The small factual distinction between *Harrison* and *Hooper* becomes even less significant when one considers the practical side-effects of an overbid versus an underbid. In *Harrison*, the Defendant inflated cost estimates in order to submit artificially inflated invoices to the Government after contract award.<sup>144</sup> In this circumstance, artificially inflated invoices represent the type of false claims that the FCA aims to preclude. The contractor has simply submitted fraudulent information to the government ahead of time. By contrast, instead of providing artificially inflated cost pricing data, Lockheed provided artificially deflated cost pricing data.<sup>145</sup> In other words, in order to ensure that it would win the contract, Lockheed falsely certified to the Air Force that execution of the RSA Contract would cost less than Lockheed was aware it intended to ultimately invoice.

If one compares the amount of damages Lockheed inflicted upon the Government by artificially deflating cost estimates, to the amount of damages Lockheed would have inflicted had it artificially inflated cost estimates in the manner seen in *Harrison*, the total damages in both scenarios are the same. In *Hooper*, after submitting artificially deflated costs to the Government, Lockheed used the veil of cost-reimbursement

---

<sup>140</sup> See generally *Harrison v. Westinghouse Savannah River Co.*, 176 F.3d 766 (4<sup>th</sup> Cir. 1999).

<sup>141</sup> *Id.* at 787.

<sup>142</sup> Liu, *supra* note 5.

<sup>143</sup> See generally *Harrison*, 176 F.3d 776; See generally *Hooper*, 688 F.3d 1037.

<sup>144</sup> *Harrison*, 176 F.3d at 776.

<sup>145</sup> See generally *Hooper*, 688 F.3d 1037.



accounting to recoup the difference between the deflated cost estimates and the actual cost of performance.<sup>146</sup> In *Harrison*, the contractor similarly used the veil of cost-reimbursement accounting to recoup its actual cost of performance, albeit the actual cost of performance contained an artificial increase. In both scenarios the contractor has submitted an invoice for its cost of performance, both of which were fraudulently calculated. This business practice abuses the role of cost-reimbursement accounting, and thus exhibits the need for the *Hooper* theory of liability under the FCA.

As previously noted, cost-reimbursement contracts are reserved exclusively for contracts where the final cost of performance is difficult to accurately calculate prior to actual performance.<sup>147</sup> In *Hooper*, Lockheed abused this system by falsely deflating cost-estimates in order to gain an unfair advantage over its competitors.<sup>148</sup> Once contract performance began, Lockheed submitted invoices for the actual costs of performance, which, not surprisingly, were more consistent with the cost estimates that were originally submitted by Lockheed's competitors. By submitting false estimates, Lockheed gained an unacceptable advantage over its competitors whom, to their credit, offered the Government genuine cost estimates.

Contractors must be dissuaded from submitting false estimates to the Government. Lockheed's false estimates acted as a means of fraudulently inducing the Government to award Lockheed the RSA Contract. By artificially deflating cost estimates, Lockheed created a means of invoicing sums to the Government that Lockheed had specifically certified would never occur. Given the FCA's original purpose to eliminate fraud against the Government, the Ninth Circuit appropriately applied FCA liability to Lockheed for conjunctively submitting false estimates and subsequently relying upon cost-reimbursement accounting to self-correct its inaccurate pricing data.

## ii. Public policy considerations

The Ninth Circuit correctly applied past precedent in the Fourth Circuit to extend FCA liability to Lockheed's deliberate submission of false estimates. Notwithstanding the Ninth Circuit's sound legal reasoning for extending liability, public policy considerations similarly dictate that Government contractors knowingly submitting false estimates be held liable under the FCA for deliberately submitting incorrect pricing data.

Since fiscal year (FY) 2000, the Federal Government's discretionary spending has increased from \$219 billion per year to more

---

<sup>146</sup> *Id.*

<sup>147</sup> Brown, *supra* note 24, at 196.

<sup>148</sup> *Hooper*, 688 F.3d at 1041.

than \$600 billion per year in FY 2009.<sup>149</sup> Additionally, the number of contract awards disbursed by U.S. Government agencies has swelled from 500,000 transactions in FY 2000, to over 10 million transactions in FY 2009.<sup>150</sup> This tremendous increase in Federal Government spending highlights the necessity for Government contractors to provide the Government with accurate pricing data prior to contract performance.

As a result of the significant increases in government spending observed during the last decade, contemporary politicians have refocused their political energy on making the Federal Government run more efficiently.<sup>151</sup> Not surprisingly, curtailing Government spending has become one of the primary means of achieving such savings.<sup>152</sup> By extending FCA liability to Government contractors who knowingly provide false estimates, the Ninth Circuit has provided the Federal Government with an extra tool to accurately predict the final price of certain projects. This increased sense of certainty provides the Government the ability to make informed decisions regarding public policy initiatives, particularly in light of the current emphasis on cuts to Federal spending. Prior to the Ninth Circuit's holding in *Hooper*, the Federal Government lacked the ability to accurately determine the future costs of cost-reimbursement contracts. In light of the Ninth Circuit's decision, although the Federal Government is still subject to genuine inflations of cost performance on cost-reimbursement contracts, the Government now has the added benefit of knowing that extra taxpayer money spent as a consequence of fraudulent underbids can now be recouped via the False Claims Act thanks to *Hooper*. This new paradigm will inevitably lead to cost-savings for the Federal Government in the future.

**d. Questions of venue preclude government contractors from predicting which precedent to follow:**

Regardless of how members of the legal community view the merits of *Hooper*, most seem to agree that the effects of the Ninth Circuit's decision will be felt far beyond its jurisdiction. As noted above, the *Hooper* theory of liability under the FCA represents a significant departure from current precedent in the other federal circuits. Although false estimates

---

<sup>149</sup> GARRETT, *supra* note 23, at 3.

<sup>150</sup> *Id.* at 4.

<sup>151</sup> See, Jonathan Weisman, *Spending Dispute Leaves a Senate Deal Elusive*, N. Y. TIMES (Oct. 13, 2013), [http://www.nytimes.com/2013/10/14/us/politics/budget-and-debt-limit-debate.html?\\_r=0](http://www.nytimes.com/2013/10/14/us/politics/budget-and-debt-limit-debate.html?_r=0).

<sup>152</sup> Jon Cohen and Sean Sullivan, *Cut Government Spending? Sure...in theory*, WASHINGTON POST (Mar. 6, 2013), <http://www.washingtonpost.com/blogs/the-fix/wp/2013/03/06/cut-government-spending-sure-cut-the-military-no-way/>.

resulting in an overbid generate FCA liability circuit-wide, false estimates resulting in an *underbid* only generate FCA liability in the Ninth Circuit.<sup>153</sup> Accordingly, claims emanating from false estimates designed to produce an *underbid* on a cost-reimbursement contract will only generate FCA liability if a relator or Assistant U.S. Attorney can justify venue in a federal district court in Alaska, Arizona, California, Hawaii, Idaho, Montana, Nevada, Oregon, Washington, Guam, and the Northern Mariana Islands.<sup>154</sup>

As previously noted, the *Hooper* decision applies exclusively to false estimates on a cost-reimbursement contract.<sup>155</sup> Given the added risk that is placed upon the Government under a cost-reimbursement contract, procurement regulations dictate that such contracts only be awarded under circumstances that make fixed-price contracts impracticable.<sup>156</sup> Consequentially, cost-reimbursement accounting protocols are now reserved exclusively for contracts that carry with them unpredictable performance costs.<sup>157</sup> These include extensive DOD service contracts, cutting-edge weaponry development, and large-scale construction projects.<sup>158</sup>

One of the great pitfalls for those offering Government contractors legal advice in the wake of *Hooper* is that large-scale cost-reimbursement contracts are capable of establishing ‘systematic contracts,’ with multiple circuits.<sup>159</sup> Today, a great number of cost-reimbursement contracts are reserved for Government contractors providing services on behalf of the U.S. Military, most notably in Europe, the Middle East, and East Asia.<sup>160</sup> Although contract performance clearly occurs outside the 12 circuits, a significant amount of support activity occurs within the Ninth Circuit.<sup>161</sup> Home to various Naval installations throughout the Pacific, the precedent established by the Ninth Circuit is likely to affect a disproportionate number of Government contractors who accept cost-reimbursement contracts.<sup>162</sup>

---

<sup>153</sup> Husch Blackwell, *Underbidding and Faulty Estimates May Carry FCA Liability*, CONTRACTOR’S PERSPECTIVE, (Aug. 8, 2012), <http://www.contractorsperspective.com/false-claims-act/underbidding-and-faulty-estimates-may-carry-fca-liability/>.

<sup>154</sup> See, Ninth Circuit Court of Appeals, [http://www.ca9.uscourts.gov/content/view.php?pk\\_id=0000000135](http://www.ca9.uscourts.gov/content/view.php?pk_id=0000000135) (last visited Nov. 5, 2014).

<sup>155</sup> *Hooper v. Lockheed Martin Corp.*, 688 F.3d 1037, 1042 (2012).

<sup>156</sup> Brown, *supra* note 24, at 196.

<sup>157</sup> *Id.*

<sup>158</sup> *Id.*

<sup>159</sup> See generally *Int’l Shoe Co. v. State of Washington*, 326 U.S. 310 (1945).

<sup>160</sup> See, Jim McElhatton, *KBR vs. Army: On Largest Services Contract*, ‘Things Have Gotten Very Nasty’, FED. TIMES, (May 5, 2013), <http://www.federaltimes.com/article/20130505/ACQUISITION03/305050005/>.

<sup>161</sup> Loren Thompson, *U.S. Navy’s Shift to Pacific a Boon for Marine Corps’ Mission*, FORBES, (June 4, 2012), <http://www.forbes.com/sites/lorenthompson/2012/06/04/shift-to-pacific-bolsters-importance-of-marine-amphibious-skills/>.

<sup>162</sup> See *Id.*

The ensuing circuit-split created by *Hooper* requires immediate attention. Unlike other circuit-splits throughout the judiciary system, the circuit-split created by *Hooper* directly affects parties that maintain systematic contacts within a multitude of jurisdictions. Although this article continues to maintain that the Ninth Circuit correctly determined the outer reaches of FCA liability, the current situation requires that any argument for or against the merits of *Hooper* carry with it a consistent interpretation circuit-wide. In light of the analytical merits of *Hooper* outlined above, the Ninth Circuit's interpretation should be immediately adopted across every circuit to avoid any unnecessary confusion.

## CONCLUSION

In keeping with the original intent of the FCA, past precedent has correctly determined that a fraudulently induced Government contract has been sufficiently tainted to render all subsequent invoices violative of the FCA. Before *Hooper*, Government contractors were liable under the FCA for fraudulently overbidding a contract. The application of FCA liability to a fraudulently over-bided contract correctly echoes the tainting theory that should be applied when a Government contractor wins a contract by fraudulent means.

This theory is no less applicable when Government contractors fraudulently underbid a contract as well. In light of a contractor's ability to recoup all performance costs under a cost-reimbursement contract, the Ninth Circuit has appropriately bridged the gap between the *Marcus* 'tainted invoice' theory of FCA liability and the fiscal risks the Government incurs when accepting a fraudulently under-bided cost-reimbursement contract. When facing similar questions of FCA liability, other circuits should look to the *Hooper* court when determining how and when drawing a similar analytical bridge is appropriate.

---