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ARTICLES

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INDEPENDENT GUARANTEE CLAUSES IN CISG CONTRACTS

Edgardo Muñoz¹
David Obey Ament-Guemez²

“Kill him provisionally, we'll investigate later.”

-A quote attributed to Pancho Villa

I. INTRODUCTION

The independent guarantee has become a standard arrangement in international trade. The use of independent guarantees has increased significantly since the 1960s³ and their frequency has grown exponentially ever since.⁴ Such development can be attributed to various factors. First of all, independent guarantees have proven useful in connection with any kind of underlying transaction, for example, in financial dealings, sales agreements and industrial projects.⁵ Second, the amounts at stake in modern transactions have increased, making the risk factor for the parties concerned significantly greater.⁶ The parties' determination to cover the risk of a breach of contract has provided the impetus for the extraordinary development of independent guarantees.⁷ In international industrial projects,

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³ Filip DeLy, *The UN Convention on Independent Guarantees and Stand-by Letters of Credit*, 33 FOREIGN L. YEAR REV. 831, 833 (1998).

⁴ Mirjana Knezević & Aleksandar Lukić, *Bank Guarantees and Their Representation in Bank Business Activities*, 64 ECON. INSIGHTS - TRENDS & CHALLENGES 42 (2012) (“Due to its non-accessoriness, abstractness and the fact that a fast and simple act of realization provides coverage for a great amount of risk, the bank guarantee is one of the most important instruments of security payments in the trading operation.”).

⁵ R.I.V.F. BERTRAMS, *BANK GUARANTEES IN INTERNATIONAL TRADE* 1 (ICC Publishing S.A. ed., Kluwer Law International. 1996) (“The increasing wealth in the oil producing countries of the Middle East in this period enable these countries to conclude major contracts with Western firms on large scale projects, such as infrastructure improvements (roads, airports, harbors facilities), public works [...]. It is to these developments that the origins and early demand for independent bank guarantees and specially those payable on first demand can probably be traced.”).

⁶ Enrique Fernández-Masiá, *Las Garantías Bancarias en el Comercio Internacional*, 1 BOLETÍN MEXICANO DE DERECHO COMPARADO 101, 103 (2014).

⁷ Knezević et al., *supra* note 4, at 43.

for example, long-term contracts involving significant amounts are very common and the question of whether the exporter (contractor) has performed its contractual obligations often requires the determination of complex issues.⁸ Importers (owners) have resorted to independent guarantees in order to ensure that performance claims can be compensated immediately and effectively by a third party guarantor.⁹

From the outset, independent guarantees have been a creation of the practice of international trade.¹⁰ Most national systems have not enacted provisions of law dealing expressly with independent guarantees.¹¹ The validity and binding effect of an independent guarantee therefore directly rests on the general principle of freedom of contract and sanctity of contracts.¹² The terms are negotiated between the guarantor – usually a bank – and its customer (the principal) pursuant to what was agreed in the underlying contract. The contracts are then interpreted and construed by courts and arbitrators in accordance with the provisions of the applicable rules,¹³ if any, or of the proper law of the guarantee,¹⁴ usually domestic laws on agency (*mandat* in French or *mandato* in Spanish and Portuguese).¹⁵

In light of the absence of specific regulation at a national level, some international treaties seek to harmonize international practice,¹⁶ for instance, the UNCITRAL Convention on Independent Guarantees and Stand-By Letters of Credit (1995) (the “UNCITRAL Convention on Independent Guarantees”).¹⁷ In addition, uniform contract terms to which

⁸ Fernández-Masiá, *supra* note 6, at 103.

⁹ BERTRAMS, *supra* note 5, at 2.

¹⁰ *Id.* at 7.

¹¹ DeLy, *supra* note 3. With two notable exceptions: French Law Article 2321 of the Civil Code (2006) and US Law Article 5 U.C.C. with provisions on Stand-By Letters of Credit.

¹² *Id.* at 389; *see also* Fernández-Masiá, *supra* note 6.

¹³ *See* ICC UNIFORM RULES FOR DEMAND GUARANTEES 758, art. 3, containing their own rules of interpretation [hereinafter U.R.D.G. 758].

¹⁴ *See* De Ly, *supra* note 3, at 838; BERTRAMS, *supra* note 5, at 7-8. (Pursuant to Article 21 of the UNCITRAL Convention on Independent Guarantees, a guarantee is governed by the national law chosen in the guarantee or between the guarantor and the beneficiary. In the absence of such a choice, the guarantee is governed by the law of the State where the guarantor/issuer has that place of business at which the undertaking was issued pursuant to article 22 of the UNCITRAL Convention on Independent Guarantees.)

¹⁵ In spite of the fact that practice is not entirely uniform, considering the multiple fora which are available and the various systems of law which may apply in each forum, this state of affairs does not appear to have given rise to major difficulties.

¹⁶ De Ly, *supra* note 3, at 834-35; Fernández-Masiá, *supra* note 6, at 134-44.

¹⁷ United Nations Convention on Independent Guarantees and Stand-By Letters of Credit (New York, 1995) has been ratified by eight States to date (Belarus, Ecuador, El Salvador, Gabon, Kuwait, Liberia, Panama and Tunisia) and signed, but not ratified, by the U.S.A. *See* U.N. Convention on Independent Guarantees and Standby Letters of Credit, *last ratified* Sept. 16, 2005,

the parties may agree¹⁸ have flourished and enhanced the use and utility of independent guarantees. The International Chamber of Commerce (“ICC”) has undertaken major private unification efforts in this area in the form of soft law or *lex mercatoria* instruments. The ICC has issued four major texts on independent guarantees: the ICC Uniform Rules for Contract Guarantees (“URCG”) (1978),¹⁹ the ICC Uniform Rules for Demand Guarantees (“URDG 458”) (1992),²⁰ the ICC Uniform Rules for Contract Bonds (“URCB”) (1994)²¹ and the ICC Uniform Rules for Demand Guarantees (“URDG 758”) (2010).²² Finally, the American Institute of International Banking Law & Practice has issued the International Standby Practices (“ISP98”).²³

The beneficiary of an independent guarantee may be the buyer (the owner or importer) so that the buyer’s right to claim performance of a contractual or legal duty can be guaranteed, as well as the seller (or the contractor or exporter) so that the seller’s claim for payment of the purchase price can be guaranteed.²⁴ Once established, an independent guarantee creates rights and obligations between the beneficiary and the guarantor.²⁵ These rights and obligations are formally independent from the underlying contract between the seller and the buyer of which performance of certain obligations has been guaranteed.²⁶

However, a clause in the underlying contract requiring the issuance of an independent guarantee creates an obligation for the applicant to have the guarantor issue²⁷ that guarantee for the beneficiary. This obligation to

http://www.uncitral.org/uncitral/en/uncitral_texts/payments/1995Convention_guarantees_status.html. The UNCITRAL Convention contains interesting and useful provisions in spite of the fact that it has not gained widespread acceptance yet.

¹⁸ See U.R.D.G. 758 *supra* note 13, art. 1(a) (stating that the rules “apply to any demand guarantee or counter-guarantee that expressly indicates it is subject to them.” Where a guarantee issued on or after July 1, 2010 states that it is subject to the U.R.D.G. without stating whether 458 (1992) or 758 (2010) is to apply, the guarantee will be subject to 758).

¹⁹ UNIFORM RULES FOR CONTRACT GUARANTEES, ICC PUBLICATION NO. 325 (1978).

²⁰ UNIFORM RULES FOR DEMAND GUARANTEES, ICC PUBLICATION NO. 458 (1992) [hereinafter U.R.D.G. 458].

²¹ UNIFORM RULES FOR CONTRACT BONDS, ICC PUBLICATION NO. 524 (1994).

²² U.R.D.G. 758, *supra* note 13 (2010).

²³ Also published as INTERNATIONAL STANDBY PRACTICES, ICC PUBLICATION NO. 590.

²⁴ Peter S. O’Driscoll, *Performance Bonds, Bankers’ Guarantees, and the Mareva Injunction*, 7 NW. J. INT’L L. & BUS. 380, 385 (1985).

²⁵ BERTRAMS, *supra* note 5, at 9.

²⁶ *Id.*

²⁷ See U.R.D.G. 758, *supra* note 13, art. 4 (stating that a guarantee is issued when it leaves the control of the guarantor).

apply for the guarantee to the guarantor is enforceable under the law governing the underlying contract.²⁸ Questions then arise as to the enforcement and effects of the applicant's obligation under the applicable law. In particular, failure to apply for an independent guarantee or a defective provision of an independent guarantee may entitle the other party to claim certain remedies but exclude others.

In this article, the authors address these questions in the light of the provisions of the 1980 United Nations Convention on Contracts for the International Sale of Goods (the "CISG").²⁹ Section II introduces the notion and features of independent guarantees. Section III addresses a party's obligation to provide an independent guarantee in accordance with the CISG. Section IV analyzes the remedies that may follow from a party's breach of a contractual obligation to provide an independent guarantee pursuant to the CISG. Section V discusses a party's right to suspend performance of a contractual obligation to provide an independent guarantee and other interdependent obligations as well as a party's right to stop payment after provision of an independent guarantee. Section VI reminds us of the legal effect of avoiding the underlying contract over an independent guarantee.

II. NOTION AND FEATURES OF INDEPENDENT GUARANTEES

An independent guarantee³⁰ may be defined as a contract between the guarantor and the beneficiary³¹ whereby the guarantor³² undertakes to pay the beneficiary the specified amount of money upon the beneficiary's demand in writing, provided that such demand is made within the period of validity of the guarantee and complies with the terms of the guarantee.³³

²⁸ See *infra* Section III.

²⁹ The CISG is the law for contracts on the international sale of goods in force in more than 80 countries, including the US and its main trading partners. See text and status at www.uncitral.org.

³⁰ In the law and practice of international trade "bank guarantee" and "guarantee" are the terms which have come to be generally accepted in spite of the fact that they are not free from ambiguity in many languages. They may therefore be regarded as a term of art in their own right.

³¹ BERTRAMS, *supra* note 5, at 12. ("A guarantee is a contract between two parties, namely the guarantor/bank and the beneficiary."). See also Rolf Meyer-Reumann, *Rights and Obligations in the Event of Bank Guarantees Being Called in Governmental Projects*, 17 ARAB L. Q. 34 (2002).

³² U.R.D.G. 758, *supra* note 13, art. 2.

³³ ROY GOODE, *GUIDE TO THE ICC UNIFORM RULES FOR DEMAND GUARANTEES* 8 (International Chamber of Commerce, 1992). The UNCITRAL Convention defines a guarantee in article 2(1) as follows: "For the purposes of this Convention, an undertaking is an independent commitment, known in international practice as an independent guarantee or as a

The party upon whose request the guarantee has been issued, known as the principal, the applicant³⁴ or the account party, is not a party to the guarantee.³⁵ The guarantor is usually a bank,³⁶ but may be an insurance company or any other entity or person such as the parent company of the main debtor in the case of a parent company guarantee.³⁷

An independent guarantee is different from a secondary (also called accessory) guarantee. Independent guarantees give rise to a primary contract duty on the guarantor which is independent from the underlying contract between the beneficiary of the guarantee and the latter's contracting party.³⁸ The guarantor's obligation to pay the agreed amount to the beneficiary is independent from the beneficiary's right to invoke a breach of the underlying contract by its contracting party.³⁹ In other words, the guarantor's obligation is "documentary"⁴⁰ in character as it arises upon the presentation by the beneficiary of the documents or statements mentioned in the guarantee itself.⁴¹

On the contrary, a secondary or accessory guarantee⁴² makes the guarantor liable to the beneficiary of the guarantee only if, when and to the extent that, the beneficiary's contracting party in the underlying contract has

stand-by letter of credit, given by a bank or other institution or person ("guarantor/issuer") to pay to the beneficiary a certain or determinable amount upon simple demand or upon demand accompanied by other documents, in conformity with the terms and any documentary conditions of the undertaking, indicating, or from which it is to be inferred, that payment is due because of a default in the performance of an obligation, or because of another contingency, or for money borrowed or advanced, or on account of any mature indebtedness undertaken by the principal/applicant or another person." United Nations Convention on Independent Guarantees and Stand-By Letters of Credit art. 2(1), Dec. 11, 1995, U.N. Doc. A/RES/50/48 [hereinafter Convention]; Meyer-Reumann, *supra* note 31, at 34 ("According to Article 411 and Article 414 [United Arab Emirates - Commercial Transactions Law] a bank guarantee is an undertaking according to which a bank undertakes to pay a customer's debt to a third party in accordance with the conditions, upon which the agreement is concluded and which are included in the guarantee").

³⁴ See U.R.D.G. 758, *supra* note 13, art. 2.

³⁵ See BERTRAMS, *supra* note 5, at 12.

³⁶ See generally Peter O'Driscoll, *Performance Bonds, Bankers' Guarantees and the Mareva Injunction*, 7 NW. J. OF INT'L L. & BUS. 380 (1985).

³⁷ See U.R.D.G. 758, art. 2.

³⁸ U.R.D.G. 758, *supra* note 13, art. 5(a); BERTRAMS, *supra* note 5, at 56; O'Driscoll, *supra* note 36, at 385 (making reference to English case law on the legal nature of independent guarantees); De Ly, *supra* note 3, at 831-32 (1999).

³⁹ See Convention, *supra* note 33, art. 3.

⁴⁰ See U.R.D.G. *supra* note 13, art. 6, 7, 19.

⁴¹ See U.R.D.G. *supra* note 13, art. 15(a); BERTRAMS, *supra* note 5, at 9.

⁴² Also known as dependent guarantees in international trade.

been found in breach of the underlying contract.⁴³ In this sense, an accessory guarantee is similar to contracts existing in civil law and common law jurisdictions in which the guarantor assumes a liability only in cases where the principal debtor has defaulted or breached the underlying transaction.⁴⁴ In Spanish these accessory guarantees are known as “*fianzas*,”⁴⁵ in French law as “*cautionnement*” and in Anglo-American law as “suretyship.” Secondary guarantees are therefore twofold. Firstly, the guarantor’s duty to pay arises only if, when and to the extent that, the principal debtor has defaulted. Secondly, the guarantor duty to pay is limited to the liability of the principal debtor. Accordingly, the guarantor may rely on all the defenses and objections that the debtor has under the terms of the underlying contract with the creditor-beneficiary, including the right to challenge the very existence and validity of the underlying contract.⁴⁶

Because banks are generally reluctant to act as guarantors under terms that require the determination of fault or breach by a judge or arbitrator pursuant to a contract to which they are not a party (nor have they real incentive or interest to be),⁴⁷ international commercial practice produced “independent guarantees” where the guarantor’s duty to pay the beneficiary would be independent of the underlying contract’s proper performance.⁴⁸ In resemblance to the barbarian saying attributed to Mexican revolutionary leader Pancho Villa “Kill him provisionally, we’ll investigate later,”⁴⁹ the fundamental bargain to which the parties under the underlying contract agreed to may be expressed by the maxim “pay first, litigate later.”⁵⁰

For the purposes of this article, “guarantee” will indicate an independent guarantee provided by a bank or other guarantor, which is paid pursuant to its own terms upon demand by the beneficiary, independent from any fault or breach by the principal.⁵¹ Nonetheless, in international trade practice other terms are often used to refer to independent guarantees

⁴³ See BERTRAMS, *supra* note 5, at 3.

⁴⁴ Fernández-Masiá, *supra* note 6, at 126.

⁴⁵ *Id.* at 125.

⁴⁶ *Id.* at 130.

⁴⁷ U.R.D.G. 758, *supra* note 13, art. 5(a); BERTRAMS, *supra* note 5, at 2.

⁴⁸ See Fernández-Masiá, *supra* note 6, at 111; *see also* U.R.D.G. 758, *supra* note 13, art.

5.

⁴⁹ This is what Pacho Villa supposedly told a shooting squad that was about to kill a suspected cow rustler.

⁵⁰ Werner Blau & Joachim Jedzig, *Bank Guarantees to Pay upon First Written Demand in German Courts*, 23 INT’L L. 725, 725 (1989).

⁵¹ See *United Nations Convention*, *supra* note 39; Fernández-Masiá, *supra* note 6, at 127.

as well. For example, “first demand guarantee”⁵² or “on demand guarantee,” “demand guarantee,”⁵³ “performance bonds”⁵⁴ and “Stand-By Letters of Credit”⁵⁵ are all terms used to describe independent guarantees.

III. A PARTY’S OBLIGATION TO PROVIDE AN INDEPENDENT GUARANTEE

The CISG does not require the parties to have a guarantor establishing an independent guarantee in order to cover the risk of a party’s breach of contract.⁵⁶ However, this state of affairs does not preclude the parties from agreeing to do so. Article 6 CISG expresses the principle of party autonomy to tailor their contract.⁵⁷ The provisions of the CISG governing the seller’s obligations and the buyer’s obligations apply only insofar as the contract does not contain other specific provisions.⁵⁸ As a result, the parties may agree upon the additional obligation to have a guarantor issuing an independent guarantee.⁵⁹ Where the contract as a whole falls within the scope of application of the CISG,⁶⁰ such additional

⁵² This is a type of guarantee, *see infra* Part III.

⁵³ The term “Demand Guarantees” was coined by the ICC as it issued its second and third sets of uniform rules in 1992 and 2010 under the title “Uniform Rules for Demand Guarantees” (“U.R.D.G.”). U.R.D.G. 458, *supra* note 20; U.R.D.G. 758, *supra* note 13.

⁵⁴ “Performance bond” is another expression used to refer to a bank guarantee.

⁵⁵ The expression “stand-by letter of credit” adds further diversity to the terminology and essentially refers to an independent bank guarantee used to guarantee payment obligations in the US. *See De Ly, supra* note 3, at 836.

⁵⁶ Pursuant to articles 30 to 44 of the CISG, the seller’s obligations include the timely delivery of conforming goods, among other duties. United Nations Convention on Contracts for the International Sale of Goods art. 30-44, March 2, 1987, 52 Fed. Reg. 6262-02. In accordance with articles 53 to 60 of the CISG, the buyer’s obligations include the timely payment of the price and taking delivery of the goods; *Id.*, art. 53-60.

⁵⁷ Ingeborg Schwenzer et al., *GLOBAL SALES AND CONTRACT LAW* 65 (Oxford University Press 1st ed. 2011); SCHLECHTRIEM & SCHWENZER: COMMENTARY ON THE UN CONVENTION ON THE INTERNATIONAL SALE OF GOODS 106 (Ingeborg Schwenzer ed., Oxford University Press 3d ed. 2010).

⁵⁸ *See* Corinne Widmer, *Article 30 in SCHLECHTRIEM & SCHWENZER, supra* note 57, at 490; *see also* ALEJANDRO M. GARRO & ALBERTO L. ZUPPI, *COMPRAVENTA INTERNACIONAL DE MERCADERÍAS* 170 (Abeledo Perrot 2012).

⁵⁹ JAN RAMBERG, *INTERNATIONAL COMMERCIAL TRANSACTIONS* 47 (ICC Norstedts Juridik AB 4th ed. 2011).

⁶⁰ The United Nations Convention on Contracts for the International Sale of Goods (CISG) applies to contracts for the international sale of goods when the parties to the contract have their places of businesses in different Contracting States or when the rules of private international law lead to the application of the law of a contracting state. United Nations Convention on Contracts for the International Sale of Goods, art. 1(1)(a), (b), Mar. 2, 1987, 52 U.S.T. 6264-6280, 1489 U.N.T.S. 3, <http://www.cisg.law.pace.edu/cisg/text/treaty.html> [hereinafter CISG].

obligations will also be subject to the CISG's rules since they are obligations arising from that CISG contract.⁶¹

Despite the fact the CISG allows verbal agreements⁶² or the incorporation of obligations arising out of the parties' prior practices,⁶³ it is advisable for independent guarantee clauses of the underlying contract to be an express term.⁶⁴ These clauses will in principle be regarded as giving rise to a main contract duty (see Section IV below). In some instances, the conclusion of the underlying contract is made conditional *inter alia* on all agreed guarantees having been duly provided.⁶⁵ The wording of the guarantee required by the underlying contract is often set out in an appendix to that contract.

When the underlying sales contract is null and void or voidable for duress, undue influence, mistake, or any other legal grounds admissible under its applicable law,⁶⁶ that contract's independent guarantee clause will most likely follow the same fate. As such, the party who had provided the guarantee may claim that the guarantee should be handed back (see Section VI below). However, because the guarantee issued by the guarantor is independent from the underlying contract, the fact that the latter is null and void does not necessarily void the guarantee itself. The guaranty will remain valid until its own expiration event⁶⁷ or date.⁶⁸

As mentioned above, the main purpose of independent guarantees is to enable the beneficiary to obtain immediate payment without proving default or breach of the underlying contract.⁶⁹ In practice, the parties go further as to specify the type of breach or default that the independent guarantee intends to cover. In the context of international sales of goods, these typically include the following situations First, parties can contract for a tender or bid guarantee, sometimes also called "initial guarantee,"

⁶¹ Widmer, *supra* note 58, at 493.

⁶² CISG, *supra* note 60, art. 8, 11.

⁶³ *Id.*, art. 9.

⁶⁴ Bertrams, *supra* note 5, at 66.

⁶⁵ *Id.* ("When the parties to the underlying relationship have agreed that the principal debtor is to furnish an guarantee payable on certain terms and conditions, that agreement constitutes a condition precedent in the sense that the obligations of the other party are suspended until the issuance of the guarantee").

⁶⁶ The CISG will not apply to these issues as they fall outside its scope of application in accordance with article 4(a) of the CISG. CISG, *supra* note 60, art. 4.

⁶⁷ U.R.D.G. 758, *supra* note 13, art. 2.

⁶⁸ BERTRAMS, *supra* note 31, at 236-7; Dr. Filip De Ly, *Independent Guarantees and Stand-By Letters of Credit*, 33 INT'L LAWYER 831, 841 (1999); Meyer-Reumann, *supra* note 31, at 28, 29.

⁶⁹ Fernández-Masiá, *supra* note 6, at 110.

which is required for bidders taking part in a tender, especially a public tender.⁷⁰ This type of guarantee is intended to protect the beneficiary against the risk that the bidder, in spite of having tendered successfully, will fail to sign the contract or to sign it in a timely manner or fail to procure an additional performance guarantee.⁷¹ Second, the delivery guarantee (or bond), may be intended to protect the beneficiary against the risk that the seller/exporter fails to deliver the goods.⁷² This type of guarantee does not cover the whole risk relating to performance but only delivery,⁷³ and this has given rise to further types of guarantees which specifically cover the risk of defects in the goods or further risks. Alternatively, parties may contract for a performance guarantee (or bond) that is intended to protect the beneficiary against the risk that the seller/exporter fails to perform its contract duties,⁷⁴ like the delivery of conforming goods under the contract or the applicable law.⁷⁵ Such a guarantee may or may not, according to its terms, cover breaches of warranty; where it does not, a warranty guarantee may be issued as well.⁷⁶ Fourth, maintenance (or warranty) guarantee is intended to protect the beneficiary against the risk that the seller/exporter fails to perform its contract duties with respect to warranty,⁷⁷ maintenance or other activities to be performed after completion of the works or delivery of conforming goods, such as training or further activities relating to the commercial operation of a plant or machinery.⁷⁸ Fifth, the parties may contract for an advance payment (or repayment) guarantee (or bond) that purports to protect the beneficiary against the risk that the seller/exporter fails to perform its contract duties so that the advance payment made by the beneficiary is to be reimbursed by the seller/exporter.⁷⁹ Sixth, a retention guarantee aims to protect the beneficiary against the risk that the seller/exporter fails to effect full performance of its contract duties in case the beneficiary has released full payment for the works or part of the works without withholding retention monies.⁸⁰ Finally, a payment guarantee or

⁷⁰ *Id.* at 115.

⁷¹ INTERNATIONAL COMMERCIAL TRANSACTIONS, *supra* note 59; Werner Blau & Joachim Jedzig, *Bank Guarantees to Pay Upon First Written Demand in German Courts*, 23 INT'L LAWYER 725, 725 (1989); see UBS, *Bank Guarantees*, UBS (Nov. 20, 2015, 7:47PM), https://www.ubs.com/ch/en/swissbank/corporates/finance/trade_exportfinance/bankgarantie/mustertexte.html.

⁷² UBS, *supra* note 71.

⁷³ Fernández-Masiá, *supra* note 6, at 115, 116.

⁷⁴ INTERNATIONAL COMMERCIAL TRANSACTIONS, *supra* note 59.

⁷⁵ Meyer-Reumann, *supra* note 31, at 28.

⁷⁶ UBS, *supra* note 71.

⁷⁷ Blau & Jedzig, *supra* note 71.

⁷⁸ Fernández-Masiá, *supra* note 6, at 116; UBS, *supra* note 71.

⁷⁹ *Id.*

⁸⁰ UBS, *supra* note 71.

stand-by letter of credit intends to protect the seller against the risk that the buyer will fail to pay the contract price.⁸¹

Since the principle of freedom of contract operates also at the level of the independent guarantee (and not only at the level of the underlying contract), the parties are able to freely structure the payment mode of the guarantee's monies.⁸² Depending on the circumstances, the parties may choose a direct guarantee or an indirect guarantee. A direct guarantee involves three parties: the principal, the guarantor and the beneficiary.⁸³ The principal is the seller that instructs the guarantor to issue the guarantee.⁸⁴ The guarantor is the bank or other entity or person issuing the guarantee.⁸⁵ The beneficiary is the buyer for whose benefit the guarantee is issued.⁸⁶ In a CISG contract, the seller and the buyer have places of businesses in different countries. The guarantor (a bank) will usually be located in the seller's country. In such case, a second bank called the "advising bank" will usually be involved in the guarantee in the buyer's country, as the guarantor's agent.⁸⁷ The advising bank does not have a contractual relationship with the beneficiary and does not assume any contractual obligations.⁸⁸ Its task is limited to transmitting documents from and to the beneficiary, verifying that the terms of the guarantee⁸⁹ are met before any amount is made available to the beneficiary on behalf of the guarantor. In such a case, the beneficiary has a contractual relationship only with the issuing bank and can claim payment of the guarantee only from the issuing bank.⁹⁰

⁸¹ DeLy, *supra* note 3, at 833; UBS, *supra* note 71.

⁸² BERTRAMS, *supra* note 5, at 64.

⁸³ Fernández-Masiá, *supra* note 6, at 117, 118; Bertrams, *supra* note 5, at 13.

⁸⁴ BERTRAMS, *supra* note 5, at 13.

⁸⁵ *Id.*

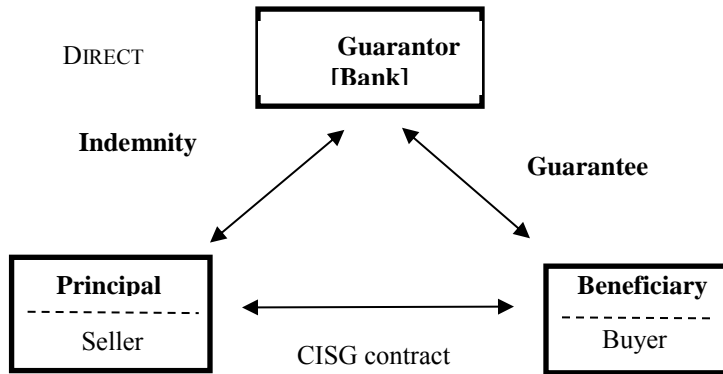
⁸⁶ *Id.*

⁸⁷ See U.R.D.G. 758, *supra* note 13, art. 10 § b (Int'l Chamber of Commerce 2010); *Id.* at 14.

⁸⁸ See U.R.D.G. 758, *supra* note 13, art. 10 § c; BERTRAMS, *supra* note 5, at 14.

⁸⁹ For example, verifying the authenticity of the beneficiary's signature on a demand. See U.R.D.G. 758, *supra* note 13, art. 10 § b.

⁹⁰ BERTRAMS, *supra* note 5, at 14.

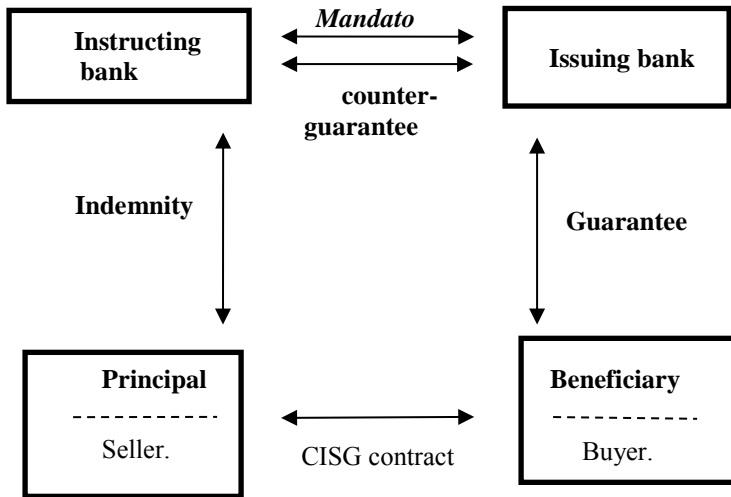


In the case of indirect guarantees, the bank in the seller's country may also instruct a bank in the buyer's country to issue the guarantee; the former bank is then said to be the "first" or "instructing bank" and the latter the "second" or "issuing bank".⁹¹ The issuing bank usually requests an undertaking by the instructing bank to be reimbursed of all costs. Such undertaking has the nature of a guarantee and is known as a counter-guarantee.⁹²

⁹¹ *Id.* at 15; Fernández-Masiá, *supra* note 8, at 118.

⁹² See U.R.D.G. 758, *supra* note 13, art. 5 § b; BERTRAMS, *supra* note 5, at 15, 16; Fernández-Masiá, *supra* note 8, at 119. See also *Direct and Indirect Guarantee*, UBS, https://www.ubs.com/ch/en/swissbank/corporates/finance/trade_exportfinance/bankgarantie/garantie/direkte_indirektegarantien.html (last visited Jan. 19, 2016).

INDIRECT



In addition, the terms of the guarantee will then determine the formal and substantive requirements to be met by the beneficiary (for payment) under the guarantee.⁹³ For instance, the so called “(on) first demand guarantees” are payable simply against presentation of a demand for payment by the beneficiary.⁹⁴ On the other hand, where the beneficiary is required under the terms of the guarantee to state that the applicant [usually the seller] is in breach under the underlying relationship (the CISG contract),⁹⁵ the guarantee in essence remains a first demand guarantee. The beneficiary is not in principle bound, absent any language to that effect, to prove that its statement is accurate, and the bank is not entitled to request such proof.⁹⁶ However, the requirement to state that the applicant (usually the seller) breached the underlying contract is believed to be adequate to

⁹³ Fernández-Masiá, *supra* note 8, at 121; *See* United Nations Convention on Independent Guarantees and Stand-by Letters of Credit, *Independent Guarantees and Stand-by Letter of Credit*, art. 15(1), U.N. Doc. A/RES/50/48 (Dec. 11, 1995); *see also* DeLy, *supra* note 3, at 842.

⁹⁴ RAMBERG, *supra* note 59; Fernández-Masiá, *supra* note 8, at 121.

⁹⁵ This is the rule, absent any different express agreement of the parties, under the U.R.D.G. Sections 458 and 758. *See* GOODE, *supra* note 33, at 3233.

⁹⁶ Fernández-Masiá, *supra* note 8, at 121.

inhibiting unjustified demands and to strike a fair balance between a pure on-demand guarantee and a guarantee requiring evidence of breach in the form *e.g.* of a judgment or an arbitral award.⁹⁷ Moreover, an inaccurate statement on the part of the beneficiary may be relied upon by the applicant in later judicial or arbitral proceedings against the beneficiary.

IV. REMEDIES FOR BREACH OF A PARTY'S DUTY TO PROVIDE AN INDEPENDENT GUARANTEE

A party's failure to perform any of its obligations will entitle the other party to claim the legal remedies available pursuant to articles 45 and 61 CISG.⁹⁸ A breach will ensue regardless of whether the obligation at stake is a main obligation or an ancillary one, whether it arises under the CISG provisions or the sales contract. A seller's failure to have the agreed independent guarantee issued by the guarantor and delivered to the beneficiary [the buyer] constitutes a breach of contract.⁹⁹ Accordingly, the injured party will be entitled to the remedies afforded by the CISG. These remedies include a request for (a) specific performance; (b) the avoidance of the sales contract; and (c) damages.

A. *Specific Performance of an Obligation to Provide an Independent Guarantee*

The CISG gives a party the remedy to require performance by the other party of its obligations, unless the former had opted for a different remedy that is inconsistent with specific performance, such as the avoidance of the sales contract.¹⁰⁰ Possible breaches giving rise to the remedy of specific performance include the failure to deliver the goods, related documents or their defective delivery, and also other contractually accepted obligations,¹⁰¹ like the provision of an independent guarantee by the seller or the buyer.¹⁰² When the buyer has received non-conforming goods, Article 46(2) CISG grants the buyer a right to request the delivery of substitute goods only if the lack of conformity constitutes a fundamental breach. In

⁹⁷ *Id.* at 122.

⁹⁸ GARRO & ZUPPI, *supra* note 58, at 285.

⁹⁹ Markus Müller-Chen, *Article 45*, COMMENTARY ON THE UN CONVENTION ON THE INTERNATIONAL SALE OF GOODS (CISG) 519, 519-20 (Peter Schlechtriem & Ingeborg Schwenzer eds., 2d ed. 1998).

¹⁰⁰ CISG, *supra* note 60, at arts. 46, 61-62; GARRO & ZUPPI, *supra* note 58, at 287.

¹⁰¹ Markus Müller-Chen, *Article 46*, COMMENTARY ON THE UN CONVENTION ON THE INTERNATIONAL SALE OF GOODS (CISG) 535, 537 (Peter Schlechtriem & Ingeborg Schwenzer eds., 2d ed. 1998).

¹⁰² *Cf.* Shael Herman, *Specific Performance: A Comparative Analysis* (2), 7 EDINBURGH L. REV. 194, 204 (2003).

other words, a fundamental breach arises only if keeping the non-conforming goods substantially deprives the buyer of what it was entitled to expect under the contract and this deprivation was foreseen by the seller at the conclusion of the contract.¹⁰³ The rationale for requiring the high standard for a breach of substantial deprivation for the delivery of substitute goods assumes that the non-conforming goods have already been shipped and transported to the buyer's place of business or to the place where the goods are intended to be resold or used. In that case, the delivery of substitute goods is considered a *ultima ratio* remedy, which is made available only to the extent that other remedies that do not require a fundamental breach such as repair of the goods (Article 46 (3) CISG), the reduction of the price (Article 50 CISG) or/and damages (Article 74), would not fully remedy or compensate the seller's breach.¹⁰⁴

In the case of the establishment of an independent guarantee with terms that depart from the underlying sales contract's specifications, the beneficiary (the buyer for example) may require the applicant (the seller for instance) to have the guarantor issuing a substitute conforming guarantee or to amend its nonconforming terms, with the beneficiary's consent.¹⁰⁵ Since the issuance of a new bank guarantee does not implicate the hazards or expenses generally involved in the shipment and transportation of substitute goods, no reason exists to subject the buyer's claim to provide a new conforming independent guarantee to the requirements of Article 46(2) CISG, *i.e.* the existence of a fundamental breach. In this context, the basis for the beneficiary's claim is Article 46(1) CISG.¹⁰⁶

A party may nevertheless be exempted from performing its obligation to provide a bank guarantee due to an impediment beyond its own or the guarantor's control that was unforeseeable and unavoidable either by the applicant or the guarantor pursuant to article 79(1)(2)(a)(b) CISG.¹⁰⁷

¹⁰³ CISG, *supra* note 60, art. 25.

¹⁰⁴ Müller-Chen, *supra* note 101.

¹⁰⁵ See U.R.D.G. 758, *supra* note 13, art. 11, § b.

¹⁰⁶ Article 46, section 1 of CISG establishes the general right of the buyer to require performance by the seller of his obligations unless the buyer has resorted to a remedy which is inconsistent with this requirement. CISG, *supra* note 60, art. 46, § 1.

¹⁰⁷ CHRISTOPH BRUNNER, FORCE MAJEURE AND HARDSHIP UNDER GENERAL CONTRACT PRINCIPLES: EXEMPTION FOR NON-PERFORMANCE IN INTERNATIONAL ARBITRATION 187 § 18 (2008): "the obligor has basically no control over these third parties. Paragraph 2 thus only applies if the third party independently discharges a performance obligation of the obligor. Firstly, this is the case for transport companies or banks, inasmuch as they independently perform certain obligations of the seller or the buyer (e.g., to transport the

1. *Fixing an additional period of time to provide an independent guarantee*

For the sake of goodwill among the parties or for its own benefit, a buyer may fix an additional period of time for performance by the seller of any contractual or statutory obligations pursuant to article 47(1) CISG.¹⁰⁸ The setting of an additional period of time also works for a contractual obligation to provide a conforming independent guarantee. In the case of a seller's breach of the obligation to deliver the goods, article 47(1) CISG is of paramount importance because a repeated failure to deliver the goods within the additional period of time fixed by the buyer will automatically entitle the buyer to declare the avoidance of the contract pursuant to article 49(1)(b) CISG.¹⁰⁹ However, those legal consequences do not follow from the breach of other types of obligations by the seller. In particular, if the seller breached its obligation to have a guarantor issue an independent guarantee, the buyer's right to avoid the contract depends only on whether or not the breach of contract is 'fundamental' within the meaning of Article 25 (see Section B below). The fixing of an additional period of time and the repeated failure is of no consequence in that regard. However, fixing an additional period of time may become important in cases where the breach of an obligation to provide an independent guarantee represents a fundamental breach pursuant to the terms of the sales contract.¹¹⁰ For instance, when the sales contract provides that failure to provide the independent guarantee to the buyer would lead to the termination of the contract,¹¹¹ but the buyer initially chooses, after the first failure, not to request the strict performance of that obligation. The buyer's conduct would lead to a failure to declare avoidance of the contract within the time-limit required by article 49(2)(b)(i) CISG.¹¹² If the buyer then wishes to pursue the termination of the contract, he may regain the initially lost right to avoid the contract by fixing an additional period of time for the seller to provide

goods, to transfer the money to the seller's bank, to open a letter of credit or to establish a bank guarantee)".

¹⁰⁸ GARRO & ZUPPI, *supra* note 58, at 286.

¹⁰⁹ CISG, *supra* note 60, art. 49, § 1, cl. b.

¹¹⁰ Markus Müller-Chen, *Article 47*, in COMMENTARY ON THE UN CONVENTION ON THE INTERNATIONAL SALE OF GOODS (CISG) 553, 554 (Peter Schlechtriem & Ingeborg Schwenzer eds., 2d ed. 1998).

¹¹¹ BERTRAMS, *supra* note 5, at 66: "When the parties to the underlying relationship have agreed that the principal debtor is to furnish and guarantee payable on certain terms and conditions, that agreement constitutes a condition precedent in the sense that the obligations of the other party are suspended until the issuance of the guarantee."

¹¹² *Id.*

the guarantee.¹¹³ Other remedies available to the buyer (besides avoidance of the contract) never depend upon the formal step of an additional period of time, like the right to require performance (Article 46 CISG) and generally the right to claim damages (Article 45(1)(b) CISG).

In all cases, the additional period of time fixed by the buyer must be for a reasonable length of time as determined by the circumstances (Article 47(1) CISG).¹¹⁴ In the context of an obligation to have a guarantor issue an independent guarantee, the banking practices at the seller's place of business, bank holidays, the type of guarantee agreed upon and its payment structure, *i.e.* whether the guarantee is a direct or indirect guarantee must be given due regard. In this line of thought, the issuance of an indirect guarantee may need a longer additional period of time because of the involvement of the issuing bank at the buyer's place of business and the counter-guarantee in place for the instructing bank. The buyer will be bound to hold any other remedy during the additional period of time unless the seller informs the buyer that it does not intend to perform during such period (Article 47(2) CISG).¹¹⁵

2. *Possibility to request an opportunity to remedy an independent guarantee*

Pursuant to article 48 CISG, the seller may request of the buyer the opportunity to remedy a defective performance of its obligations if the seller can do so without unreasonable delay or without causing an unreasonable inconvenience or uncertainty to the buyer.¹¹⁶ There is no express corresponding buyer's right to remedy a defective performance of its obligation after the due date. However, the seller's right to remedy a defective performance constitutes a foundational principle upon which the CISG is based¹¹⁷ (Article 7(2) CISG) and thus should be extended to the buyer. The right to remedy at one's own expenses exists for every type of breach of contract.¹¹⁸ It includes a violation of any agreed obligation like the provision of an independent guarantee.¹¹⁹

¹¹³ *Id.*

¹¹⁴ CISG, *supra* note 60, art. 47, § 1.

¹¹⁵ *Id.*, art. 47, § 2.

¹¹⁶ CISG, *supra* note 60, art. 48, § 1; *see id.*, art. 48.

¹¹⁷ CISG, *supra* note 60, art. 72.

¹¹⁸ Markus Müller-Chen, *Article 48*, in COMMENTARY ON THE UN CONVENTION ON THE INTERNATIONAL SALE OF GOODS (CISG) 562, 563 (Peter Schlechtriem & Ingeborg Schwenzer eds., 2d ed. 1998).

¹¹⁹ *Id.*

Article 48(1) CISG provides that the seller's opportunity to remedy does not exist until after the due date of the delivery of the goods. Prior to this time, the curing of defects is regulated by articles 34 and 37 CISG regarding early performance of a party's obligations. However, if a seller is required to provide an independent guarantee by a particular date in order to secure punctual and proper delivery of the goods and he fails to do so by that date, or if the terms of the guarantee do not correspond to the specification in the underlying sales contract, the date for exercise of the right to remedy by subsequent performance is moved from the delivery date to the date on which the duty in question was to be performed.¹²⁰

The way a seller is to remedy his failure comes from the nature of the obligation breached. Accordingly, a defective bank guarantee can be replaced by a new guarantee.¹²¹ In so far the failure is of a nature that allows itself to be remedied.¹²² Whether the seller is able to remedy its breach without 'unreasonable delay,' 'unreasonable inconvenience,' or 'unreasonable uncertainty of reimbursement of expenses' for the buyer cannot be decided as a general principle, but shall be answered only on the basis of the circumstances of each individual case.¹²³ In the case of an obligation to provide an independent guarantee, the seller's steps to remedy its failure to comply on time will always suit the buyer. Unless the buyer has already acquired the right to avoid the contract with regard to a different obligation, it is unlikely that the buyer may argue that the provision of a new independent guarantee, after its due date, causes him any inconvenience or uncertainty. As one would say, better late than never. Consequently, a seller will usually be entitled to remedy its failure to provide a proper independent guarantee under article 48(1)(2) CISG.

B. Avoidance of the Underlying Contract Caused by Failure to Provide an Independent Guarantee

In accordance with article 49 CISG, a party may declare the sales contract avoided if the other party's failure to perform any of its obligation amounts to a fundamental breach. A breach is fundamental if it results in such a detriment to the suffering party as to substantially deprive that party of what it was entitled to expect under the contract, and such result was, or ought to be, foreseeable for the breaching party.¹²⁴ In principle, whether a CISG contract may be avoided because of a seller's failure to hand over

¹²⁰ *Id.* at 564.

¹²¹ *Id.*

¹²² *Id.*

¹²³ *Id.* at 565.

¹²⁴ CISG, *supra* note 60, art. 8.

proper documents related to the goods is to be decided according to principles similar to those applicable to delivery of non-conforming goods.¹²⁵ For instance, if the seller fails to deliver documents that entitle the buyer to dispose of the goods or documents of title such as bills of lading, load notes, warehouse warrants, etc., or if there are defects in their content, then an objectively serious defect may exist.¹²⁶ In that case, a fundamental breach may have occurred. However, in the case of a seller's failure to perform a contractual obligation to provide an independent guarantee, the question of whether there has been a fundamental breach of contract depends on the objective importance of that breach in the context of the particular contract pursuant to article 25 CISG, and on whether the defect can be remedied within a reasonable period in accordance with article 48(1)(2) CISG (see section A, 2 above).¹²⁷

The rule of fixing an additional period of time under Article 49(1)(b) applies only to the failure to deliver the goods. In all other cases, when the breach is interpreted as being of a fundamental nature, Article 49(1)(a) leads to diverse solutions that are appropriate to individual cases (see section A, 1 above).¹²⁸

In our view, a failure to provide an independent guarantee is unlikely to constitute a fundamental breach. As stated above, independent guarantees are intended to cover the risk of different types of breach of contract or default. Coverage against that risk cannot, by default, constitute a party's main expectation under a sales contract. A seller's main expectation under a sales contract is to be paid for the value of the goods it sells. A buyer's main expectation under a sales contract is to obtain and be able to dispose of or use the goods in conformity with the contract and the CISG. Parties do not enter into a sales contract to be covered against the

¹²⁵ MARTIN DAVIES, CONTRACTS FOR THE INT'L SALE OF GOODS ADVISORY COUNCIL, CISG-AC OPINION NO. 11: ISSUES RAISED BY DOCUMENTS UNDER THE CISG FOCUSING ON THE BUYER'S PAYMENT DUTY, ¶ 3.5 (CISG Advisory Council ed., 2012), <http://www.cisgac.com/UserFiles/File/CISG%20Advisory%20Council%20Opinion%20No%2011.pdf>; cf. COMMENTARY ON THE UN CONVENTION ON THE INTERNATIONAL SALE OF GOODS (CISG), art. 49, 751 [hereinafter COMMENTARY] (Peter Schlechtriem & Iñgberg Schwenzer eds., 3d. ed. 2005).

¹²⁶ See INGEBORG SCHWENZER, CONTRACTS FOR THE INT'L SALE OF GOODS ADVISORY COUNCIL, CISG-AC OPINION 5: THE BUYER'S RIGHT TO AVOID THE CONTRACT IN CASE OF NON-CONFORMING GOODS OR DOCUMENTS, ¶¶ 4.7- 4.10, (CISG Advisory Council ed., 2005), <http://www.cisgac.com/UserFiles/File/CISG%20Advisory%20Council%20Opinion%20No%2005%20PDF.pdf>

¹²⁷ COMMENTARY, *supra* at note 125, at 752; see also SCHWENZER, *supra* note 126, at ¶ 4.9, Section IV (A)(1) (discussing the buyer's right to avoid the contract in case of non-conform).

¹²⁸ COMMENTARY, *supra* note 125, at 752.

possibility of seeing their main expectations under the sales contract unfulfilled.

Of course, the parties may stipulate that, for example, the seller has an immediate right to contract avoidance should the buyer fail to provide an independent guarantee (Article 6 CISG). Indeed, there may be cases where a party would not have entered into a sales contract but for the other party's agreement to provide an independent guarantee. But that would need to be an express term or need to stem from the parties' implied intent (Article 8(2)(3) CISG), *i.e.* their prior practices or a trade practice in the industry (Article 9(1)(2) CISG). It is not a coincidence that parties who place great importance on being covered against the risk of breach or default (for instance, governments acting as private parties) will expressly subject the contract's existence to a condition precedent or subsequent, consisting of the proper issuance of an independent guarantee by a guarantor bank and its acceptance by the beneficiary.¹²⁹

When the parties agree that an independent guarantee is to be provided punctually before the performance of the obligation relevant to the guarantee, the question arises as to whether it may be concluded from the failure to provide the guarantee that the applicant will not perform the obligation guaranteed. For example, if the parties agree that the seller is to provide a "delivery guarantee" on September 4 prior to the delivery of the goods on September 28, some may argue that a fundamental breach exists if the seller fails to provide the guarantee in time and it follows that he will not deliver the goods either. In this case, however, the breach in question regards the failure to deliver the goods or its likelihood (and not the failure to provide the guarantee). The hypothetical falls into the realm of article 72 CISG, which entitles a party to declare the contract avoided if, prior to the date of performance, it is clear that one of the parties will commit a fundamental breach.

Another example is the case where the buyer is contractually obliged to provide the seller with a payment guarantee or stand-by letter of credit securing the seller for the buyer's failure to pay the price. If the buyer fails to provide the seller with such a guarantee, the seller is entitled to suspend the performance of his obligations until the buyer gives assurances (see V below). Some authors argue that if time is of the essence under the contract, the seller may be entitled to avoid the contract for fundamental

¹²⁹ See BERTRAMS, *supra* note 5, at 79 (stating that "when the parties to the underlying relationship have agreed that the principal debtor is to furnish a guarantee payable on certain terms and conditions, that agreement constitutes a condition precedent in the sense that the obligations of the other party are suspended until the issuance of the guarantee").

breach of contract by the buyer.¹³⁰ Again, in this case, the breach that eventually reaches a “fundamental” level is not the failure to provide the stand-by letter of credit or payment guarantee, but the failure to pay the price as such, or its certainty pursuant to article 72(1) CISG.

In addition, a scholar submits that “where the failure to open a letter of credit or provide a bank guarantee cannot in itself be regarded as a fundamental [breach] of contract, the seller may set an additional period of time for the buyer to open the letter of credit or provide the guarantee, failing which the seller will then be entitled to avoid the contract under Article 64(1)(b) without needing to show a fundamental breach of contract.”

¹³¹ We respectfully disagree. The scholar refers to two instruments that deserve different treatment. A bank guarantee applied by the buyer, also known as “payment guarantee” or “stand-by letters of credit”,¹³² intends to cover the seller against the risk that the buyer fails to pay. The amount of the payment guarantee or stand-by letter of credit does not necessarily match the purchase price.¹³³ Contrary to a commercial “letter of credit,” a “payment guarantee” may be considered neither part of the buyer’s obligations to pay the price under Article 53 CISG, which is the treatment given to a “letter of credit” when time is of the essence in documentary sales of commodities,¹³⁴ nor an act to enable payment under Article 54 CISG. Although some disagree with us,¹³⁵ the provision of an independent

¹³⁰ COMMENTARY, *supra* at note 125, at 898.

¹³¹ *Id.* at 898.

¹³² *See generally id.*

¹³³ *See* INTERNATIONAL CHAMBER OF COMMERCE, UNIFORM RULES FOR DEMAND GUARANTEES (U.R.D.G.), art. 13 (2010) (noting “that a guarantee may provide for the reduction or increase of its amount on specified dates or on the occurrence of a specified event which under the terms of the guarantee results in the variation of the amount”).

¹³⁴ *See* COMMENTARY, *supra* at note 125, at 431-32 (noting that a commercial “letter of credit” in a documentary sale of commodity may be “governed by the CISG”).

¹³⁵ *See* Secretariat of the United Nations Convention on Contracts for the International Sale of Goods, *Secretariat Commentary on Article 50 of the 1978 Draft* art. 69 ¶ 3, (1978) (“Since, in accordance with Article 54 CISG, the buyer’s obligation to pay the price includes taking such steps and complying with such formalities as may be required under the contract to enable payment – such as the issuance of a bank guarantee – the buyer’s failure to secure payment constituted a breach of its obligation to pay the price”); UNCITRAL, DIGEST OF CASE LAW ON THE UNITED NATIONS CONVENTION ON CONTRACTS FOR THE INTERNATIONAL SALE OF GOODS, 264, (2012); Alejandro Osuna-González, *Buyer’s Enabling Steps to Pay the Price: Article 54 of the United Nations Convention on Contracts for the International Sale of Goods* 25 J. L. & COM. 299, 303 (2006); Arbitration Court of the Chamber of Commerce and Industry of Budapest, Hungary November 17, 1995, VB/94124, (Hung.), <http://www.unilex.info/case.cfm?pid=1&do=case&id=217&step=Abstract>; *see* Oberlandesgericht München [OLG][Provincial Court of Appeal] Feb. 8, 1995, 7 U 1720/94, cisgw3.law.pace.edu/cases/950208g1.html (holding that the parties agreed to have a bank

guarantee results from a different contractual obligation (see section III above). As put by Bertrams:

A documentary credit is a means of payment of the purchase price and its utilisation occurs in the ordinary course of events, in contemplation of performance as envisaged by the parties, whereas a guarantee provides security and contemplates payment of compensation in the unexpected event of non-performance of the principal contract. From the account party's viewpoint this difference is crucial. In the case of a documentary credit, utilisation serves his interest, since he will thereby obtain the goods that he intended to obtain. In contrast, payment of the bank guarantee pursuant to a valid call under the guarantee merely results in the account party's duty to reimburse the bank without any corresponding advantage....¹³⁶

Accordingly, a failure to provide an independent guarantee will not fall into the scope of Article 64(1)(b) CISG since such failure does not amount to failing to pay the price.

C. Damages

Liability for damages arises when a seller or a buyer breaches any of his obligations under the sales contract or the CISG.¹³⁷ The breach does not have to be a "fundamental" one under article 25 CISG. The breach of any obligation by one of the parties, including the obligation to provide an independent guarantee,¹³⁸ triggers the right to damages that, under the principle of full compensation, must be equal to the financial loss suffered by the other party because of the breach.¹³⁹ Therefore, damages recoverable

guarantee fulfill payment requirements, which also was a penalty for not taking the contracted items).

¹³⁶ BERTRAMS, *supra* note 5, at 69.

¹³⁷ See CISG, *supra* note 60, art. 73-74.

¹³⁸ BERTRAMS, *supra*, note 5, at 66 (if the correct guarantee has not been issued in time, the other party is ordinarily [...] entitled to damages); HOSSAM A. EL-SAGHIR, THE INTERPRETATION OF THE CISG IN THE ARAB WORLD, (André Janssen & Olaf Meyer eds., 2008) (referring to an arbitral tribunal which awarded damages to one party in light of the other party's breach of contractual obligations by not extending a bank guarantee), reprinted in Hossam A. El-Saghir, *The Interpretation of the CISG in the Arab World*, <http://www.cisg.law.pace.edu/cisg/biblio/el-saghir.html>

¹³⁹ See Ingeborg Schwenzer & Pascal Hachem, *The Scope of the CISG Provisions on Damages*, CONTRACT DAMAGES: DOMESTIC AND INTERNATIONAL PERSPECTIVES 92-93 (Djakhongir Saidov & Ralph Cunnington eds., 2008).

are not in such cases related or limited to the amount of the guarantee. The type of financial losses recoverable under the CISG includes non-performance loss, incidental loss, and consequential loss resulting from the breach¹⁴⁰ of the obligation to provide the guarantee,¹⁴¹ which is independent from the breach of the obligation that was intended to be guaranteed. For instance, where the delivery of the goods is subject to the issuance of a payment guarantee by the buyer's bank, any extra storage cost resulting from a deferred delivery of the goods because the buyer failed to provide the payment guarantee on time shall be recoverable by the seller as damages.¹⁴²

On the other hand, damages arising out of the guarantor's temporal or definite refusal to pay the guarantee's amounts to the beneficiary are not recoverable under the sales contract against the applicant party. This case cannot be considered as a breach of the sales contract if, for example, the seller has provided the agreed guarantee and the guarantor has refused or delayed payment to the buyer for reasons that could only be described as frivolous, untenable or spurious.¹⁴³ Any damage arising in such a case is recoverable under the guarantor and beneficiary's legal relationship only.

V. RIGHT TO WITHHOLD PERFORMANCE

Article 71(1) CISG entitles a party to suspend the performance of its obligations, when it becomes apparent that the other party will not perform a substantial part of its obligations.¹⁴⁴ A party's right to suspend performance applies to concurrent performance by both parties, to agreed performance by the debtor first, and to performance by the creditor first.¹⁴⁵

It has been generally held that the right of suspension applies only to reciprocal obligations.¹⁴⁶ In other words, a creditor may only be entitled to withhold an obligation that constitutes the counterpart of the debtor's obligation that is unlikely to be fulfilled. However, the right to suspension may also be extended to interdependent obligations, for instance, obligations that a party would not have agreed up on if the performance of a

¹⁴⁰ COMMENTARY, *supra* note 125, at 1006.

¹⁴¹ BRUNO ZELLER, DAMAGES UNDER THE CONVENTION ON CONTRACTS FOR THE INTERNATIONAL SALE OF GOODS 70 (2d ed. 2009) ("a breach can occur even if it is not laid down explicitly in this Convention").

¹⁴² COMMENTARY, *supra* note 131, at 1009.

¹⁴³ BERTRAMS, *supra* note 5, at 244.

¹⁴⁴ See CISG, *supra* note 60, art. 71, § 1.

¹⁴⁵ COMMENTARY, *supra* note 131, at 951.

¹⁴⁶ *Id.* at 950.

specific (probably nonreciprocal) obligation had not been promised in return.¹⁴⁷

In the context of independent guarantees, the following questions arise. A seller may be required to provide a delivery guarantee or performance guarantee prior to or concurrently to the buyer's payment of the price. The question thus arises as to whether failing to provide the independent guarantee entitles the buyer to suspend a related counter-obligation or even the interdependent payment obligation. In such a hypothetical, a seller, who must provide the independent guarantee prior or simultaneously to the payment of the goods, may learn that the buyer will not have the financial capacity to meet its payment obligation under the contract. The question then arises as to whether the seller may suspend its independent guarantee obligation or its (reciprocal) delivery of goods obligation or both. The same applies to a buyer's contractual obligation to furnish a payment guarantee or stand-by letter of credit prior to or simultaneously to the delivery of the goods or the documents representing them. May the buyer withhold its obligation to provide such guarantee or even its interdependent payment obligation if the buyer learns that the delivery of goods will be delayed? These questions will be addressed below after a brief review of the requirements for suspension under the CISG.

Article 71 CISG requires the existence of threat of future failure to perform. This provision specifies the situations giving rise to an imminent breach of contract. A party's inability to perform must be due to "a serious deficiency in his ability to perform" or "its creditworthiness" or to its "own conduct in preparing performance".¹⁴⁸ A "serious deficiency in the ability to perform" relates to factual elements such as strikes or impossibilities due to natural events as well as to legal impediments like failures due to government laws or action.¹⁴⁹ Generally, available information about basic market conditions or market developments that could possibly endanger performance is no impediment within the meaning of Article 71(1)(a) CISG.¹⁵⁰ Serious deficiency in "creditworthiness" relates to insolvency and similar events or by cessation of payment.¹⁵¹ Whether a failure to furnish a payment guarantee by the buyer may qualify as grounds for suspension of the seller's obligation to deliver the goods will depend on the circumstances, as further explained. Finally, doubts about the debtor's ability to perform its obligations due to its "own conduct in preparing

¹⁴⁷ *Id.* at 951.

¹⁴⁸ Damien Nyer, *Withholding Performance for Breach in International Transactions: An Exercise in Equations, Proportions or Coercion?*, 18 PACE INT'L L. REV. 29, 72 (2006).

¹⁴⁹ COMMENTARY, *supra* note 131, at 955.

¹⁵⁰ *Id.* at 955.

¹⁵¹ *Id.*

performance” such as the seller’s failure to source the raw or auxiliary materials, licenses, export permits, proper package, components or the like that are needed to accomplish its obligation to deliver the goods, in conformity with the contract or the CISG.¹⁵² As further discussed in this section, the seller’s failure to furnish a delivery guarantee or performance bond may allow the buyer to withhold performance of a correlated contractual obligation like furnishing a payment guarantee. However, such failure may be insufficient to indicate that the seller will be unable to deliver conforming goods under the contract or the CISG.

A party’s failure must relate to a “substantial” part of that party’s obligations. The standard of failure is, nevertheless, lower than the “fundamental” breach standard in article 25 CISG.¹⁵³ This is due to the fact that the remedy granted by article 71 CISG is preventive. The contract’s main obligations may have not been performed yet and the suspension of a party’s obligation, *per se*, does not lead to the avoidance of the contract. What may be considered a substantial part of a party’s obligation has to be determined in light of the sales contract’s provisions as a whole and the creditor’s reasonable expectations under the contract, which were known or should have been known by the other party.¹⁵⁴

Against this background, the buyer will be entitled to suspend an agreed obligation to provide a stand-by letter of credit if the seller has already failed to perform a related counter-obligation to provide a delivery guarantee or performance guarantee. On the other hand, a buyer may be entitled to suspend its obligation to pay the price in light of a seller’s failure to perform an interdependent obligation to provide a delivery guarantee if such failure indicates a threat that the seller will not perform its main obligation to deliver conforming goods. This could be the case where the seller has failed to comply with the obligation to deliver conforming goods (which will be considered a ‘substantial’ part) in the past and the guarantee requested is precisely intended to cover the risk that such failure repeats. The buyer could also withhold its interdependent obligation to pay the price if the contract expressly provides for payment against a delivery guarantee or performance guarantee and the seller is late in performing such an obligation.

A seller’s provision of a performance guarantee or delivery guarantee against a stand-by letter of credit by the buyer can be withheld until the buyer’s provision of the stand-by letter of credit. If the seller is

¹⁵² *Id.* at 956.

¹⁵³ *Id.* at 954.

¹⁵⁴ *Id.*

required to provide the performance guarantee or delivery guarantee first, it may only suspend performance when, for instance, it obtains reliable information that the buyer's usual guarantor is in bankruptcy or has refused to issue the independent guarantee for the buyer.

Where the buyer has already provided a stand-by letter of credit correlated to the seller's performance guarantee, the seller is unlikely to have grounds to suspend its obligation to provide the performance guarantee based on a threat that the buyer will not pay the purchase price. In that scenario, the seller could eventually demand the payment guarantee in case the buyer also calls the performance guarantee. Depending on the value of the respective guarantees, both parties could be said to be temporarily set off. In case no stand-by letter of credit is required from the buyer, the seller will not be entitled to withhold the provision of a contractual independent guarantee if the payment of the purchase price is conditioned to the provision of the seller's independent guarantee. The seller may only withhold the provision of an independent guarantee based on the future threat of never receiving the interdependent obligation of payment, if the buyer has become insolvent or bankrupt or if the transaction required the buyer's bank or parent or government approval to finance the transaction and the seller learns from reliable sources that the buyer has not obtained such approval. The seller could also suspend its interdependent obligation to deliver the goods if the buyer fails to provide a valid payment guarantee prior to delivery of the goods as agreed by the parties.¹⁵⁵

Similarly, the buyer may withhold its contractual obligation to provide a stand-by letter of credit if the seller breaches its obligation to furnish a delivery or performance guarantee first. Where the buyer is contractually bound to provide a stand-by letter of credit first, only a real threat that the seller will not furnish a correlated delivery guarantee or

¹⁵⁵ See UNCITRAL, *supra* note 135, at 333; Arbitration Court of the Chamber of Commerce and Industry of Budapest, Hungary, *supra* note 135, available at <http://www.unilex.info/case.cfm?pid=1&do=case&id=217&step=Abstract> ("A Hungarian seller and an Austrian buyer that had a longstanding business relationship concluded a contract according to which the seller had to make several deliveries of mushrooms to the buyer. The buyer would secure payment for deliveries by a bank guarantee in favor of the seller which should be valid until a certain date. The said guarantee, however, was neither given by the buyer nor requested by the seller before that date. The seller started to deliver the goods, but as the buyer failed to make payment, stopped further deliveries and declared the contract avoided. On a later date, the parties agreed that the seller would resume delivery on condition that the buyer provide the required guarantee. The buyer finally sent a guarantee which however bore the expiry date originally agreed upon and therefore was no longer valid. The Court held that the seller was entitled to suspend performance of its obligation as the buyer had not given adequate assurance of payment of the price through a valid bank guarantee (Article 71(1)(b) CISG)").

performance guarantee may entitle the buyer to withhold the provision of a stand-by letter of credit. A real threat may emerge when the financing bank has cut the seller's credit line or when the parent company that usually acts as the guarantor has announced its liquidation or insolvency.

The buyer could also suspend a contractual obligation to furnish a stand-by letter of credit, as well as its main obligation to pay the price if it learns from reliable sources that the seller will not perform its obligation to deliver the goods. This may be the case when the goods in question have been destroyed before delivery and the seller is definitely prevented from performing its obligation to deliver the goods.

A party's imminent failure to perform a substantial part of its obligation due to *force majeure* or impossibility under article 79 CISG, does not preclude the other party's right to suspend performance if the requirements of article 71 CISG are met.¹⁵⁶ A question of major practical relevance is whether a party who has already performed its contractual obligation to provide an independent guarantee may order the guarantor to stop payment when it learns that the other party will not perform a correlated or an interdependent obligation. In other words, whether a party is entitled to stop performance after performance under article 71(2) CISG in the context of independent guarantees.

Some scholars submit that the right to stop performance after performance operates only on the seller's benefit and in relation to the delivery of goods since during the Vienna Conference the buyer's right to stop payment after being ordered was discussed but not included.¹⁵⁷ We submit, on the contrary, that the right of a party to stop the guarantor from paying the guarantee may be possible under the contract between the principal and the guarantor and that such possibility cannot have any negative effects under the CISG. If the terms of the guarantee allow the principal to withdraw the guarantee or at least to stop payment of its monies in light of the beneficiary's imminent threat of failure to perform the underlying contract, the principal may rely on the exoneration afforded by article 71(2) CISG. In that case the principal will not breach any obligation under the underlying sales contract. In principle, the guarantor undertakes a duty to deliver a guarantee to the beneficiary in accordance with the instructions received from the principal. The guarantor has a duty to follow the instructions received from the principal and to advise him on limited and special aspects. The guarantor is bound to inform the principal immediately when it becomes aware that the beneficiary intends to make a

¹⁵⁶ BRUNNER, *supra* note 107, at 376; Fountoulakis, *supra* note 137, at 955.

¹⁵⁷ Fountoulakis, *supra* note 137, at 961.

demand,¹⁵⁸ and always has a duty to do so before making payment. But a guarantor is not required to hold payment until the principal has been made aware of the demand or its reasons.¹⁵⁹ Under the terms of the contract with the principal, the guarantor is bound to pay the guarantee only where the demand is in accordance with the terms of the guarantee, or is complying in URDG 758 parlance.¹⁶⁰

But that hypothetical guarantee, whose terms could allow the principal to withdraw the guarantee or at least to stop payment of its monies in light of the beneficiary's imminent threat of failure to perform the underlying contract, may not be called an independent guarantee. Those terms would work against the very nature of an independent guarantee. Under most independent guarantees the guarantor has a duty to pay the guarantee upon the beneficiary's demand from the time the guarantee has entered into force until the expiry date or event.¹⁶¹ The express terms of the guarantee generally describe the case(s) in which the beneficiary is entitled to payment and any documents that may have to be provided.¹⁶² Not infrequently the guarantee contains ambiguous terms, especially terms which appear to refer to the main commercial contract, by conditions such as "if the seller has failed to perform his delivery obligation"; in such case, the guarantor may request the beneficiary to sign a statement declaring that the condition or requirement expressed by such clause is met.¹⁶³

Where the demand is noncompliant, the guarantor has a duty to the principal to refuse to pay.¹⁶⁴ But where the demand is compliant and there are no circumstances from which an inference of irregularity¹⁶⁵ or fraud may be drawn, the guarantor has a duty to pay in accordance with the terms

¹⁵⁸ U.R.D.G. 758, *supra* note 13, art. 16; U.R.D.G. 458, *supra* note 20, art. 17; *see also* DeLy, *supra* note 3, at 835.

¹⁵⁹ *Id.* at 836.

¹⁶⁰ U.R.D.G. 758, *supra* note 13, art. 2 ("Complying presentation under a guarantee means a presentation that is in accordance with, first, the terms and conditions of the guarantee, second, these rules so far as consistent with those terms and conditions and, third, in the absence of a relevant provision in the guarantee or these rules, international standard demand practice.").

¹⁶¹ Blau & Jedzig, *supra* note 50, at 726; O'Driscoll, *supra* note 24, at 382.

¹⁶² *See* U.R.D.G. 758, *supra* note 13, art. 19.

¹⁶³ *See* U.R.D.G. 758, *supra* note 13, art. 15 § b; Ramberg, *supra* note 59, at 47, 48.

¹⁶⁴ Blau & Jedzig, *supra* note 50 ("[u]nder German law, the contract between the contractor and the bank by which the bank was instructed to give the Guarantee is deemed to impose an obligation on the bank to protect the contractor against damage. Certainly, in case of an abuse, the contractor is damaged when the bank pays to the beneficiary and the contractor has to reimburse the bank promptly thereafter. Therefore, it is argued that the bank not only has a right to refuse payment in cases of abuse but, in regard to the contractor, has the obligation to do so.").

¹⁶⁵ U.R.D.G. 758, *supra* note 13, art. 25 §§ a, b.

of the guarantee.¹⁶⁶ In the case of demand guarantees, the beneficiary's demand will be sufficient to trigger the guarantor's obligation to pay the guarantee and at that point, it is impossible for the principal to stop the guarantor from paying.¹⁶⁷ The guarantor has a duty to pay even if the beneficiary is in breach under the terms of its contract with the principal.

In most scenarios, a principal will only be able to request a state court or arbitral tribunal to make an injunction ordering the guarantor to stop payment of the guarantee if the beneficiary's demand is fraudulent.¹⁶⁸ The guarantor is entitled, indeed bound under its relationship with the principal, to refuse payment when a demand is fraudulent. National courts and tribunals interpret the notion of fraudulent demand in accordance with the law applicable to the guarantee¹⁶⁹ and thus the concepts are not uniform.¹⁷⁰ Generally, there is a fraudulent demand when such is manifestly contrary to the prohibition against abuse of legal and contractual

¹⁶⁶ U.R.D.G. 758, *supra* note 13, art. 20 § b; O'Driscoll, *supra* note 24, at 387, 388 (“Commenting the leading English case in the field of performance bonds *Edward Owen Engineering Ltd. v. Barclays Bank International Ltd.* [1978] 1 Q.B. 159, where Lord Denning from the Court of Appeals held that ‘[a] bank which gives a performance guarantee must honour that guarantee according to its terms. It is not concerned in the least with the relations between the supplier and the customer; nor with the question whether the supplier has performed his contracted obligation or not; nor with the question whether the supplier is in default or not. The bank must pay according to its guarantee, on demand if so stipulated, without proof or conditions. The only exception is when there is a clear fraud of which the bank has notice.’”).

¹⁶⁷ U.R.D.G. 758, *supra* note 13, art. 20 § b; Blau & Jedzig, *supra* note 50, at 726; Meyer-Reumann, *supra* note 31, at 32-33.

¹⁶⁸ GOODE, *supra* note 33, at 23; O'Driscoll, *supra* note 24, at 384.

¹⁶⁹ Austria Supreme Court Decision of July 28, 1999 [7 Ob 204/99x] [hereinafter *Pipe case*], *translation available at* <http://cisgw3.law.pace.edu/cases/990728a3.html> (“[T]he Court of First Instance and the Court of Appeal only ignored that the guarantee document itself recites a choice-of-law. It is stated in this document that ‘Austrian law is applicable to this bank guarantee’ [...] on which the Court of Appeal based its decision, it is argued, in accord with the preceding considerations, that the right to withdraw a bank guarantee has to conform with the law which is decisive for the contractual relationship.”).

¹⁷⁰ For jurisprudential overview of what constitutes a fraudulent demand in various jurisdictions, see BERTRAMS, *supra* note 5, at 260; GOODE, *supra* note 33, at 23. For jurisprudential overview of what constitutes a fraudulent demand in the United States, United Kingdom, Canada and Australia, and under the United Nations Convention on Independent Guarantees and Standby Letters of Credit, see Goa Xiang & Ross P. Buckley, *A Comparative Analysis of the Standard of Fraud Required Under the Fraud Rule in Letter of Credit Law*, 13 DUKE J. OF INT'L & COMP. L. 293 (2003). For jurisprudential overview of what constitutes a fraudulent demand in Germany, see Blau & Jedzig, *supra* note 50, at 727 (“German courts refuse to issue preliminary injunctions in cases where the call of the Guarantee is only ‘unjustified.’ Apart from these cases, they are prepared to grant injunctive relief only in the rare cases of a ‘manifest abuse,’ which in practice seems to be very similar to the concept of ‘fraud.’ Such a manifest abuse is established only if the absence of any entitlement on the basis of the underlying contract is irrefutably prove.”).

rights and thus represents a gross and qualified breach of the rules of good faith.¹⁷¹ But a demand that is in contradiction with the parties' respective rights and duties under the sales contract is not *per se* fraudulent.¹⁷² Accordingly, the right to stop payment of the guarantee in light of article 71(2) CISG could not be automatic even if the other party has failed to perform a correlated or interdependent obligation. Remember that the fundamental bargain to which the parties under that sales contract have agreed is expressed by the maxim "pay first, litigate later",¹⁷³ and such term is also part of the contract between the principal and the bank.

Pursuant to Article 19 (1)(c) UNCITRAL Convention on Independent Guarantees a demand is fraudulent when, for example, it is made to cover one risk whereas the guarantee covers another.¹⁷⁴ Accordingly, situations that may entitle the principal to request stoppage of payment by the guarantor could include the buyer's demand to pay a delivery guarantee where the buyer actually intends immediate compensation for some defects discovered in the goods at the time of taking delivery. It is similarly fraudulent when a *force majeure* event exempts the principal from liability or the beneficiary's conduct is the cause of the damage complained of.¹⁷⁵ A seller could request its guarantor to stop payment of a delivery guarantee to the buyer if an impediment under article 79 CISG prevents the seller from performing its obligation to deliver. In a tender bond, the demand is fraudulent when the beneficiary has awarded the tender to a bidder other than the principal on whose instructions the guarantee was issued. Fraud does not require intention to cause harm or malice, because that is not a requirement of unconscionable conduct under most laws.¹⁷⁶

¹⁷¹ BERTRAMS, *supra* note 5, at 273-74; GOODE, *supra* note 33, at 23.

¹⁷² O'Driscoll, *supra* note 24, at 389, 390. Commenting on the English case of *Bolivinter Oil S.A. v. Chase Manhattan Bank* [1984] 1 Lloyd's L.R. 251 (1983), where the English Court of Appeals held that it was "clearly debatable whether Horns [...] acted fraudulently in making their claim on the CBS guarantee or whether they[...] merely acted in breach of their release agreement with Bolivinter. Such knowledge is quite insufficient to justify a Court in preventing Chase and CBS complying with their contractual obligations"; *Pipe case*, *supra* note 161, translation available at <http://cisgw3.law.pace.edu/cases/990728a3.html> ("The recipient could not be accused of acting fraudulently or in abuse of law as long as it was not definitely proven that it was not entitled to claim the purchase price. The affirmation or the negation of the clearness of the evidence to be brought by [Buyer] to prove an abuse of law was in any case an act of consideration of evidence carried out by a judge although the clearness of the guarantee's abuse could not be assessed entirely without legal considerations"); Blau & Jedzig, *supra* note 50, at 727.

¹⁷³ Blau & Jedzig, *supra* note 50, at 727.

¹⁷⁴ DeLy, *supra* note 3, at 842; see also Meyer-Reumann, *supra* note 31, at 33.

¹⁷⁵ UNCITRAL Convention on Independent Guarantees art. 19 § 2d.

¹⁷⁶ BERTRAMS, *supra* note 5, at 273.

Under Article 71(3) CISG, the right of suspension or stoppage ceases to apply as soon as the debtor provides adequate assurances that it will perform. For example, if the buyer fails to provide the seller with a payment guarantee, the seller is entitled to suspend the performance of his obligations until the buyer gives assurances.¹⁷⁷ Assurances may consist of other types of means to secure the underlying transaction such as mortgages, liens, chattel mortgage, assignments, etc.¹⁷⁸

VI. RESTITUTION

In case of avoidance of the underlying contract, article 81(2) entitles a party who has performed its obligation to provide an independent bank guarantee to claim its return from the other party. If the guarantee's monies have already been paid without legal grounds at the time of avoidance, the reimbursement of such monies may be claimed in accordance with the rules of unjust enrichment of the proper law.¹⁷⁹

VII. CONCLUSION

A party's obligation to have a guarantor issue an independent guarantee will be subject to the CISG's rules where the underlying contract as whole falls within the CISG's scope of application. Accordingly, a party's failure to provide the agreed independent guarantee to the beneficiary will constitute a breach of contract. The injured party will be entitled to the remedies afforded by the CISG.

As demonstrated above, the CISG offers an effective legal framework for the enforcement of a party's obligation to provide an independent guarantee under an international sale of goods contract. The CISG's system of remedies strikes a balance between a party's right to obtain coverage against the risk that the other party fails to perform its contractual obligations and the economic benefit of keeping the international sales contract alive in spite of the occurrence of a breach. In this line of thought, the beneficiary will always be entitled to request the

¹⁷⁷ Mohs, *supra* note 130, at 898.

¹⁷⁸ Fountoulakis, *supra* note 145, at 964.

¹⁷⁹ Appellate Court München Germany, Decision of Feb. 8, 1995 [7 U 1720/94], *supra* note 127, *abstract available at* <http://www.cisg.law.pace.edu/cisg/wais/db/cases2/950208g1.html> ("It was held that, although the CISG will normally apply to German-Italian sales, it does not regulate the seller's rights concerning bank guaranties. The court, applying its rules of private international law, determined that German law was applicable. The court found the [seller] to have been unjustifiedly enriched according to 812(1) 1 German Civil Code since the [seller] obtained the payment of the bank guarantee without legal grounds.")

applicant to have the guarantor issuing a substitute conforming guarantee or to amend its nonconforming terms. On the other hand, the fixing of an additional period of time to provide an independent guarantee and the repeated failure will not lead to the automatic avoidance of the sales contract: A party's right to avoid the contract will depend only on whether or not the breach of contract is 'fundamental' within the meaning of article 25 or pursuant to the contract terms. In addition, a seller will be generally entitled to remedy its failure to provide a proper independent guarantee under article 48(1)(2) CISG since it is unlikely that a late provision can cause the buyer any inconvenience or uncertainty.

Similarly, it is unlikely that a failure to provide an independent guarantee may constitute a fundamental breach because parties do not enter into a sales contract with the aim to be covered against the possibility of seeing their main expectations under the sales contract unfulfilled. The latter is part of the normal business' risk taken by traders. That being said, the parties may stipulate that, for example, a party has an immediate right to contract avoidance should the other party fail to provide the independent guarantee agreed.

The failure to comply with a contractual obligation to provide a guarantee may anticipate that the applicant will not perform the obligation guaranteed. This may entitle the beneficiary of the guarantee to declare the contract avoided if it becomes clear that the applicant will commit a fundamental breach with respect to the obligation guaranteed pursuant to article 72 CISG. In those instances, however, the breach whose fundamentality is analysed regards the failure to comply with the obligation that was intended to be guaranteed or its likelihood (and not the failure to provide the guarantee).

The breach of an obligation to provide an independent guarantee triggers the right to damages that shall be equal to the financial loss suffered by the other party because of the breach. The amount of damages recoverable is not limited to the amount of the guarantee and is independent from the damages resulting from the breach of the obligation that was intended to be guaranteed.

Depending on whether the threat of a future breach meets the requirements of article 71 CISG, a party's failure to provide the independent guarantee will entitle the other party to suspend a related counter-obligation or even an interdependent obligation. Similarly, a party required to provide an independent guarantee prior or simultaneously to the obligation guaranteed may suspend performance if there is a clear threat that the other party will not perform a correlated obligation.

The very nature of independent guarantees makes it almost impossible for a party to stop performance after performance under article 71(2) CISG. The principal will only be able to request a State Court or Arbitral Tribunal to make an injunction ordering the guarantor to stop

payment of the guarantee if the beneficiary's demand is fraudulent. But a demand that is in contradiction with the parties' respective rights and duties under the sales contract is not *per se* fraudulent. Accordingly, the right to stop payment of the guarantee in light of article 71(2) CISG cannot be automatic even if the other party has failed to perform a correlated or interdependent obligation.

In summary, the CISG's provisions contribute to the effective enforcement of the fundamental bargain to which the parties under an international sales contract agreed to with the incorporation of an independent guarantee clause: "pay first, litigate later."

RALLS IMPLICATIONS FOR THE NATIONAL SECURITY REVIEW*Dr. Qingxiu Bu*

INTRODUCTION

Globalization provides China with financial capital and advanced technologies to expand its geopolitical clout, as well as overseas commercial accesses.¹ Merger and acquisitions (M&As) are the predominant form of entry of foreign direct investment (FDI) worldwide. Chinese multinational companies (MNCs), some of which are state-owned enterprises, attempt to acquire American firms that deal with strategic assets or critical infrastructures.² For example, Sany Electric is a Chinese-based global manufacturing company that produces wind turbines. Ralls, a Delaware company owned by two Chinese nationals who are also senior executives of Sany, sought to acquire four wind farm projects in Oregon. The assets are near restricted Navy airspace. Ralls was ordered by the U.S. President to disinvest its acquisition of the target projects. Ralls then filed suit, alleging that the administration exceeded its authority under the Administrative Procedure Act.³ Although the grounds of the Appeal of Court's reversal are narrow, the decision represents a sharp rebuke to the opaque procedures used to conduct national security reviews (NSR) of foreign investments in the U.S. There is a particularly notable lack of consensus on how to treat transnational M&As that raise questions of national security. It remains challenging to balance two plausible values, i.e. promoting an open market and protecting national security.⁴ This paper takes a comparative look at the enforcement agencies' review of foreign M&As on the grounds of national security.

The paper proceeds in five parts. Part I introduces the Committee on Foreign Investment in the U.S. (CFIUS), which is designed to scrutinize the national security implications that may emerge from foreign takeovers

¹ Matthew Sweeney, *Foreign Direct Investment in India and China: The Creation of a Balanced Regime in a Globalized Economy*, 43 CORNELL INT'L L. J. 207, 214-15 (2010).

² Souvik Saha, *CFIUS Now Made in China: Dueling National Security Review Frameworks as a Countermeasure to Economic Espionage in the Age of Globalization*, 33 NW. J. INT'L L. & BUS. 199, 205 (2012).

³ Amy Josselyn, *National Security at All Costs: Why the CFIUS Review Process May Have Overreached Its Purpose*, 21 GEO. MASON L. REV. 1347, 1379 (2014).

⁴ Joanna Rubin Travalini, *Foreign Direct Investment in the United States: Achieving a Balance between National Economic Benefits and National Security Interests*, 29 NW. J. INT'L L. & BUS. 779, 783 (2009).

of U.S. firms.⁵ The current mechanism leaves the CFIUS and President's interpretation of the NSR unchallenged prior to the *Ralls* case. Part II looks into Ralls' argument that the President exceeded his statutory authority by ordering the plaintiff to unwind its operations in Oregon, and that it was deprived of due process. The court did not challenge the national security merits of the President's decision, but rather the way in which it was implemented. Part III addresses challenges *Ralls* poses to the national security through a depoliticized regulatory process, with a particular focus on national critical infrastructure (NCI). A rigorous analysis of the perceived discrimination based on nationalities is developed in this part. It appears that acquisitions by companies from China receive more intense scrutiny than acquisitions by those from the U.S.'s close allies.⁶ The rules and regulations should be transparent, consistent and applied equally, regardless of where foreign investors are from. Part IV discusses the implications arising from the U.S.'s paradoxical protections measures, which may deter foreign investment and precipitate retaliation. Part V sets forth some suggestions highlighting that an efficient compliance governance represents a most practical resolution to the *status quo* of the stalemate. The voluntary filing to CFIUS is highly advocated, due largely to the fact that any failure to do so remains subject indefinitely to divestment or other sanctions. A tentative conclusion is provided in the final part, reaffirming that it is vital to strike a balance, safeguarding national security without stifling free trade and innovation.

A. *The Committee on Foreign Investment in the United States (CFIUS)*

The Committee on Foreign Investment in the United States ("CFIUS") is an inter-agency group charged with reviewing whether a proposed foreign acquisition would compromise U.S. national security.⁷ Its scrutiny encompasses not only defence sectors and dual-use technologies, but also critical infrastructure. Furthermore, the Act grants the President authority to block mergers, acquisitions or takeovers involving foreign entities if they threaten national security.⁸ As the Circuit Court held: "[t]he

⁵ Theodore Moran, *Chinese Investment and CFIUS: Time for an Updated (and Revised) Perspective*, PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS, (Sept. 2015), available at <https://www.piie.com/publications/pb/pb15-17.pdf>.

⁶ *Id.*

⁷ Stephen Heifetz & Michael Gershberg, *Why Are Foreign Investments in Domestic Energy Projects Now Under CFIUS Scrutiny?*, 3 HARV. BUS. L. REV. ONLINE 203 (2013).

⁸ 50 U.S.C. § 4565(d); Jeremy Zucker & Hrishikesh Hari, *Gone with the Wind: The Ralls Transaction and Implications for Foreign Investment in the United States*, 8 GLOBAL TRADE & CUSTOMS J. 182, 185 (2013).

President acts only after reviewing the record compiled by CFIUS and CFIUS's recommendation.”⁹

1. The Establishment of the CFIUS under the Exon-Florio Amendment

The CFIUS was established under the Defence Production Act of 1950, also known as the “Exon-Florio Amendment.”¹⁰ The CFIUS vets foreign takeovers of U.S. assets, and is tasked with reviewing foreign nationals' acquisitions to determine whether the transactions would affect U.S. national security.¹¹ Congress granted CFIUS the authority to “negotiate, enter into or impose, and enforce any agreement or condition...in order to mitigate any threat to the national security...that arises as a result of the covered transaction”.¹² After notification, the CFIUS has 30 days to conduct an initial review, and if it deems that a statutory investigation is necessary, it has another 45 days to investigate, after which it decides to either permit the acquisition or recommend that the President block the transaction.¹³ In accordance with Exon-Florio, the President delegates his authority to review such transactions to the CFIUS.¹⁴ The President only has the authority to act if CFIUS determines that proposed mitigation measures would not neutralize the threat.¹⁵ If recommended for prohibition, the President has another 15 days to make a final decision.¹⁶ Such action is considered a last resort, only enforceable after the President has concluded that no other alternative remedies are adequate to protect national security.

CFIUS was significantly amended by the Foreign Investment and National Security Act of 2007 (FISIA), which increased congressional oversight, broadened the scope of factors for CFIUS to consider, and formalized CFIUS's practice of negotiating remedies with the parties.¹⁷ The statute contains a finality clause, which states:

⁹ *Ralls Corp. v. Comm. on Foreign Inv. in the U.S.*, 758 F.3d 296, 320 (2014) (quoting 31 C.F.R. § 800.506(b), (c)).

¹⁰ Defence Production Act of 1950 §721, now 50 U.S.C. § 4565 (2012).

¹¹ CFIUS operates pursuant to § 721 of the Defence Production Act of 1950, as amended by the Foreign Investment and National Security Act of 2007 (FISIA) (§ 721) and as implemented by Executive Order 11858, as amended, and regulations at 31 C.F.R. Part 800.

¹² 50 U.S.C.A. app. § 2170 (l)(1)(A) (current version at 50 U.S.C.A. § 4565 (l)(1)(A)).

¹³ Foreign Investment and National Security Act § 2(b)(1)(E); §2(b)(2)

¹⁴ 50 U.S.C. § 4565(b)(1)(A).

¹⁵ 50 U.S.C. §§ 4565(b)(2)(B)(i)(I), (d)(2).

¹⁶ 50 U.S.C. § 4565(d)(2).

¹⁷ Foreign Investment and National Security Act of 2007, Pub. L. No. 110-49, 121 Stat. 246 (2007).

[t]he actions of the President under paragraph (1) of subsection (d) of this section and the findings of the President under paragraph (4) of subsection (d) of this section shall not be subject to judicial review.¹⁸

Only once has a President actually invoked his authority to block a transaction.¹⁹ In practice, a significant portion of CFIUS activity is conducted through informal mechanisms, where the transacting parties engage in discussions with the CFIUS even before the formal 30-day review period and often modify terms to obtain clearance. If modification is unattainable, parties normally withdraw the deal.²⁰

2. *The Widened Definition of National Security*

The term “national security” is not defined in the statute and is construed broadly by CFIUS to include all circumstances that have potential national security implications.²¹ There remains no clear indication when a foreign acquisition constitutes a national security threat and what type of transactions are likely to be rejected on national security grounds. CFIUS has explicitly rejected the concept of “economic security” in the definition of national security, although as a practical matter CFIUS does consider economic issues if they affect national security.²² FINSA has significantly broadened the U.S.’s definition to include many sectors of the economy previously beyond CFIUS’s purview. Notably, it seems that FINSA still deliberately avoids referring to “national economic security”.²³ The changes in law make it evident that the definition of national security has substantively expanded with the effects of FINSA and the Department of Homeland Security’s (DHS) involvement has broadened CFIUS’s mandate.²⁴ It is worth examining whether CFIUS is adequately equipped to

¹⁸ 50 U.S.C. § 4565(e).

¹⁹ Christopher Yu, *Wind Farms and the CFIUS: Protectionism?*, COLUM. BUS. L. REV. ONLINE (Nov. 6, 2012).

²⁰ *Id.*

²¹ James Jackson, *CRS Report for Congress: Exon-Florio Foreign Investment Provision: Comparison of H.R. 556 and S. 1610* (July 13, 2007),

<https://www.fas.org/sgp/crs/natsec/RL34082.pdf>; 31 C.F.R. § 800 (2008); Anne Salladin & Amelia Schmidt, *CFIUS Post-Ralls: Ramifications for Sovereign Wealth Funds*, 4 INT’L REV. OF LAW 1, 23 (2015).

²² Christopher Tipler, *Defining ‘National Security’: Resolving Ambiguity in the CFIUS Regulations*, 35 U. OF PA. J. OF INT’L L. 1223, 1284 (2014).

²³ Christopher M. Weimer, *Foreign Direct Investment and National Security Post-FINSA 2007*, 87(3) TEX. L. REV. 663 (2009).

²⁴ Foreign Investment and National Security Act of 2007, Pub. L. No. 110-49, 121 Stat. 246 (2007); Homeland Security Act of 2002, Pub. L. No. 107-296, 116 Stat. 2135 (2002); Each

take measures to mitigate that risk, or even block the investment in case of any national security issues.²⁵

Ralls acquired four wind farms from Terna Energy U.S. Holding Corporation (Terna) in March 2012. Ralls is owned by two Chinese senior executives of the Sany Group China (Sany).²⁶ The wind farms are all within or in the vicinity of restricted air space at the Naval Weapons Systems Training Facility Boardman in Oregon.²⁷ Companies involved in transactions likely to be reviewed can file a voluntary notice seeking review under the Act.²⁸ However, Ralls neither voluntarily notified CFIUS of the transaction nor sought its approval prior to closing their deal.²⁹ Before the end of the first 30-day review, CFIUS determined that there existed credible evidence to show the transaction posed national security risks on the critical infrastructure.³⁰ The President, as recommended by CFIUS,³¹ issued an order to divest Ralls' ownership in the target project on September 28, 2012.³² The order was based on "credible evidence" indicating that the parties, "through exercising control of the [companies,] might take action that threatens to impair the national security of the United States."³³ This decision reaffirms the President's broad authority under the Exon-Florio Amendment to block foreign acquisitions on the basis of national security concerns. Arguably, The President did not provide the rationale on which

CFIUS member has its own mandates, such as DHS's broad mandate to protect 'critical infrastructure.' Homeland Security Act § 3531(5).

²⁵ *The Need For CFIUS To Address Homeland Security Concerns: Hearing Before the H. Comm. on Homeland Sec.*, 109th Cong. 34 (2006) (statement of Stuart Eizenstat).

²⁶ *Ralls Corp.*, 758 F.3d at 304 ; Daniel B. Pickard et al., *Ralls Case Affirms President's Broad CFIUS Authority* (Mar. 14, 2013), <http://www.lexology.com/library/detail.aspx?g=88a64620-57f8-4b0d-bcd3-300d4d236551>.

²⁷ Damian Paletta, *Treasury: Obama's China Decision Can't Be Reviewed*, THE WALL ST. J., (Oct. 1, 2012).

²⁸ 50 U.S.C. app. § 2170 (b)(1)(C), (D).

²⁹ *Ralls Corp.*, 758 F.3d at 305.

³⁰ *Id.*

³¹ See 31 C.F.R. § 800.506(b).

³² Order Regarding the Acquisition of Four U.S. Wind Farm Project Companies by Ralls Corporation, 77 Fed. Reg. 60,281 (Sept. 28, 2012) [hereinafter Order]; see also *Ralls Corp. v. Terna Energy USA Holding Corp.*, 920 F. Supp. 2d 27 (D.D.C. 2013).

³³ 50 U.S.C. app. § 2170(d)(1); The Exon-Florio Amendment to the Defense Production Act of 1950 authorized the President, when acting based on "credible evidence", "to suspend or prohibit acquisitions that are deemed a threat to national security." 50 U.S.C. app. §2170(d)(1), (4) (2000); Order *supra* note 32, available at <http://www.whitehouse.gov/the-press-office/2012/09/28/order-signed-president-regarding-acquisition-four-us-wind-farm-project-c>.

his decision was based, and neither did the CFIUS.³⁴ The core issues before the court were to determine whether the presidential actions taken on national security grounds shall be subject to judicial review, and whether the restriction should extend to constitutional issues raised by CFIUS transactions.³⁵

3. *The Landmark Lawsuit Against the CFIUS & the President of the United States*

Ralls launched an unprecedented challenge on the authority of the CFIUS and the President regarding the thwarting of the acquisition on September 12, 2012.³⁶ The firm allegedly claimed that it had been deprived without constitutional due process of a protected interest, which constituted a violation of the Exon-Florio Amendment and the Administrative Procedures Act (APA).³⁷ As Josselyn commented, based on the finding of the District Court, Ralls was not deprived of any protected property rights due largely to the fact that the dubious acquisition was “subject to the known risk of a Presidential veto”.³⁸ Arguably, there have been sufficient opportunities for Ralls to interact with CFIUS in respect of the latter’s assessment of the national security concern.³⁹ On February 26, 2013, the court declined to review the President’s findings on the merits, and dismissed Ralls’ claims of violations of the Exon-Florio Amendment and the APA as beyond the scope of judicial review.⁴⁰

As head of the executive branch, the President is traditionally given wide latitude to decide matters related to national security. He has the

³⁴ *Ralls Corp.*, 758 F.3d 296; Scott M. Flicker & Dana M. Stepnowsky, *A Look Behind the Curtain: D.C. Circuit Orders Obama Administration to Provide Chinese Company with Explanation for CFIUS Challenge to Wind Farm Investment* (July 18, 2014), <http://www.paulhastings.com/publications-items/details/?id=ee9de169-2334-6428-811c-ff00004cbded>.

³⁵ *Id.*

³⁶ *Landmark CFIUS Ruling in Ralls Case - D.C. Circuit Reverses District Court* (July 15, 2014), <http://www.wileyrein.com/newsroom-articles-3230.html>.

³⁷ Robert Schlossberg & Christine Laciak, *Chinese Corporation Loses Court Battle Over National Security Rejection of Wind Farm Acquisition* (Oct. 28, 2013), http://www.freshfields.com/en/insights/Chinese_Corporation_Loses_Court_Battle_Over_National_Security_Rejection_of_Wind_Farm_Acquisition/?LangId=2057.

³⁸ *Ralls Corp.*, 758 F.3d at 306-07; Amy Josselyn, *National Security at All Costs: Why the CFIUS Review Process May Have Overreached Its Purpose*, 21 GEO. MASON L. REV. 1347, 1371-72 (2014).

³⁹ *Ralls Corp. v. Comm. on Foreign Inv. in the U.S.*, No.1:12-cv-01513, Mem. Op. (D.D.C. Feb. 22, 2013) at 20; Timothy Keeler et al., *US Government Produces Unclassified Documents in Litigation Regarding CFIUS Review of Chinese Investment*, MAYER BROWN (Dec. 5, 2014), <https://www.mayerbrown.com/de/publications/detailprint.aspx?publication=10886>.

⁴⁰ *Ralls Corp. v. Barack H. Obama*, No. 12-cv-01513 (D.D.C. Feb. 26, 2013).

authority to review and block an investment if “there is credible evidence that leads the President to believe . . . [the investment] threatens to impair the national security.”⁴¹ The President’s exercise of his discretion is unreviewable by the courts, particularly in matters of national security.⁴² As the District Court found, “[j]udicial review of such a claim would deprive Congress’ finality clause of its true effect.”⁴³ In response to Ralls’s request for a right to judicial review, it was noted that the APA does not confer jurisdiction on Article III courts to review actions of the President.⁴⁴ It is not within the role of the courts to second-guess executive judgments made in furtherance of the executive branch’s role of protecting national security.⁴⁵ The executive’s decision remains final and cannot be overturned by the courts.⁴⁶ As such, the court has been traditionally reluctant to exercise judicial review when a plaintiff seeks an order of the court that will respond directly on the Presidential actions.⁴⁷ The court will effectively never or hardly ever review presidential determinations.

4. *Appeal: Unconstitutional Deprivation of Property without Due Process*

Given the setback, Ralls brought a due process claim that raised purely legal questions about the process that was followed in applying the statute in this case. On February 7, 2014, Ralls filed an appeal of the District Court’s ruling that:

Count IV alleges that the CFIUS Order and the Presidential Order violate the Due Process Clause of the Fifth Amendment to the United States Constitution as unconstitutional deprivations of property without due process of law.⁴⁸

The D.C. Circuit held that the government had virtually deprived of Ralls’s vested property since Ralls had not been able to access and possibly rebut the evidence, i.e. the unclassified information on which the

⁴¹ Foreign Investment and National Security Act of 2007, Pub. L. No. 110-49, §6, 121 Stat. 256 (2007).

⁴² *Ralls Corp. v. Comm. on Foreign Inv. in the U.S.*, 738 F.3d 296 (D.C. Cir. 2014); *Dalton v. Specter*, 511 U.S. 462, 474-75 (1994).

⁴³ *Ralls Corp.*, No. 1:12-cv-01513, Mem. Op. at 25 (D.D.C. Feb. 22, 2013).

⁴⁴ *Dalton*, 511 U.S. at 469; *Franklin v. Mass.*, 505 U.S. 788, 801 (1992).

⁴⁵ *Ralls Corp.*, No. 1:12-cv-01513 Mem. Op. (D.D.C. Feb. 22, 2013).

⁴⁶ 50 U.S.C. § 2170(e).

⁴⁷ *Mississippi v. Johnson*, 71 U.S. 475, 501 (1967).

⁴⁸ *Ralls Corp.*, No. 1:12-cv-01513 Am. Mem. Op. (D.D.C. Feb. 22, 2013) .

President based his decision.⁴⁹ On July 15, 2014, the Circuit Court reversed the District Court's decision on the ground that President Obama's order deprived Ralls of its right to due process under the law.⁵⁰ Due to the procedural defects, it was held that due process required "at the least" that the parties be afforded: "(1) notice of the official action; (2) access to the unclassified information "on which the official actor relied," and (3) an opportunity to rebut that evidence."⁵¹ While the President has an unreviewable right "to suspend or prohibit any covered transaction that threatens to impair the national security of the United States, the reviewability of a constitutional claim challenging the process preceding such presidential action" is not precluded.⁵² The Fifth Amendment provides that no person shall be "deprived of life, liberty, or property, without due process of law."⁵³

Without ruling on the merits of Ralls's challenge, the Court confirmed its jurisdiction to ascertain whether the Presidential Order had deprived Ralls of property with due process of law.⁵⁴ The Court of Appeals remanded the case to the District Court, requiring that Ralls be provided with access to requisite information with adequate due process.⁵⁵

Despite Ralls' due process claim, it still remains inherently difficult for firms under scrutiny to assess the decision-making process given that the CFIUS deals with risk assessment pertaining to classified

⁴⁹ Zucker & Hari, *supra* note 8, at 190; *Landmark CFIUS Ruling in Ralls Case - D.C. Circuit Reverses District Court*, WILEY REIN (July 15, 2014), <http://www.wileyrein.com/newsroom-articles-3230.html>.

⁵⁰ *Ralls Corp. v. Comm. on Foreign Inv. in the U.S.*, 758 F.3d 296, 302 (D.C. Cir. 2014); *Ralls v. CFIUS: D.C. Circuit Explains Constitutional Due Process Requirements During CFIUS Review*, SULLIVAN & CROMWELL (July 17, 2014), https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Ralls_v_CFIUS_DC_Circuit_Explains_Constitutional_Due_Process_Requirements.pdf.

⁵¹ *Id.* at 319.

⁵² *Id.* at 314.

⁵³ U.S. CONST. amend. V.

⁵⁴ *Ralls Corp.*, 758 F.3d 311, 314, 319; Andrew Kent, *Disappearing Legal Black Holes and Converging Domains: Changing Individual Rights Protection in National Security and Foreign Affairs*, 115 COLUM. L. REV., 1029, 1084 (2015); *Ralls Case Affirms President's Broad CFIUS Authority*, WILEY REIN (Mar. 14, 2013), <http://www.wileyrein.com/newsroom-articles-2647.html>.

⁵⁵ William Mauldin & Brent Kendall, *Appeals Court Faults Government Order Prohibiting Ralls Corp. Wind Farm Deal*, THE WALL ST. J. (July 15, 2014), <http://www.wsj.com/articles/appeals-court-faults-government-order-prohibiting-ralls-corp-wind-farm-deal-1405439077>; Stephen McHale et al, *Ralls vs. CFIUS*, SQUIRE PATTON BOGGS (July 16, 2014), <http://www.squirepattonboggs.com/insights/publications/2014/07/ralls-v-cfius>.

information, which is not disclosed to the public.⁵⁶ The executive branch is obliged to reveal only unclassified information used to block the acquisition. Certain “capability” and “intent” assessments of transactions are completed by the non-voting intelligence agencies in a CFIUS review, such as the National Security Agency (NSA) and Central Intelligence Agency (CIA).⁵⁷ One of the rationales for keeping the assessments secret is to avoid revealing “sources and methods” used in their investigations.⁵⁸ Therefore, the President may not be permitted to divulge the evidence and reasoning on which his divestiture order was based. Secrecy is essential to protect the national security interests, but risks devolving into unprincipled protectionism.⁵⁹ Between valuable investment and security interests, it is hard to neutralise one value over another, which raises a question of the extent to which the NSR mechanism may be transparent and subject to public scrutiny. It remains uncertain how the administration could provide to Ralls an explanation of the divestiture decision in respect of the classified nature of the CFIUS process.⁶⁰ Ralls and the government have reached an undisclosed settlement during November 2015, before the court ruled on the ultimate legal issues.⁶¹ The reconciliation between the two parties serves as a landmark precedent for Chinese firms pursuing strategic acquisitions, with particular regard to investment protection. Nevertheless, the settlement will unlikely affect the CFIUS’s review of the impact on national security substantially. As such, the *Ralls* case will not open the floodgate of challenges on the CFIUS’s process. The *Ralls* case prompts the judiciary to develop jurisprudence on a fundamental question, that is, how much due process should be owed to foreign acquirers undergoing CFIUS reviews.⁶²

⁵⁶ See 31 C.F.R. § 800 (2008); Daniel Pickard et al., *Ralls Case Affirms President’s Broad CFIUS Authority*, LEXOLOGY (Mar. 14, 2013),

<http://www.lexology.com/library/detail.aspx?g=88a64620-57f8-4b0d-bcd3-300d4d236551>.

⁵⁷ Moran, *supra* note 5, at 4.

⁵⁸ *Id.*

⁵⁹ *Trends and Implications of Chinese Investment in the United States, Hearing before the U.S.-China Economic and Security Review Commission: 113th Cong. 87 (2013)* (statement of Mark E. Plotkin, Partner, Covington & Burling, LLP) [hereinafter Plotkin],

<http://origin.www.uscc.gov/sites/default/files/transcripts/USCC%20Hearing%20Transcript%20-%20May%209%202013.pdf>.

⁶⁰ Hunter Deeley, *Expanding Reach of the Executive in Foreign Direct Investment: How Ralls v. CFIUS Will Alter the FDI Landscape in the United States*, 4 (1) AM. U. BUS. L. REV. 125, 152 (2014); Daniel Pickard, *Ralls Case Affirms President’s Broad CFIUS Authority*, WILEY REIN LLP (Mar. 14, 2013), <http://www.wileyrein.com/newsroom-articles-2647.html>.

⁶¹ Paul Welitzkin, *Lawsuit Settlement Seen as Unlikely to Affect CFIUS*, CHINA DAILY 1 (Nov. 6, 2015).

⁶² Zucker & Hari, *supra* note 8, at 191.

B. *The Ralls' Far-Reaching Repercussions*

Ralls' challenge to the CFIUS process in court raises a legitimate question about how the CFIUS process operates. This case was the first time that a President invoked his authority to block an investment under Section 721 of Defence Production Act of 1950 in nearly 25 years.⁶³ It was also the first time the judiciary was called upon to review the administration's decision.⁶⁴ The ruling represents a plausible win for *Ralls*. The case shows how essential it is to notify CFIUS voluntarily prior to an acquisition. Had *Ralls* done so, it might have been possible to negotiate a mitigation arrangement that would have allowed at least some part of the transaction to go through.

1. *The Interpretation of National Critical Infrastructure (NCI)*

There must be effective procedures in place to assess risks arising from potential investment in the critical national infrastructure (CNI). The focus on protection of CNI is an evolving national security objective, and may have different implications in various regulatory contexts.⁶⁵ Intrinsically, allowing more than one agency to apply their own definitions ensures that a broad range of interests are represented, weighed and balanced as part of the integral review process.⁶⁶ FINSA defines the term as "systems and assets, whether physical or virtual, so vital to the United States that the incapacity or destruction of such systems or assets would have a debilitating impact on national security."⁶⁷ However, the statutory definition used by DHS is "systems and assets, whether physical or virtual, so vital to the United States that the incapacity or destruction of such systems and assets would have a debilitating impact on security, national

⁶³ Keith Johnson & Damian Paletta, *Chinese-Owned Firm Sues Obama over Wind-Farm Project*, WALL ST. J. (Oct. 2, 2012, 7:04 PM),

<http://www.wsj.com/articles/SB10000872396390444712904578024590739979984>.

The last transaction blocked on CFIUS grounds was by then-president George H.W. Bush in 1990 in the proposed acquisition of MAMCO Manufacturing Inc., a maker of motors and generators based in Washington State, by China national Aero-Technology and Export Corporation. In 1990, President George H.W. Bush ordered China Aviation Technology Import–Export Corporation (CATIC) to divest its interest in MAMCO, a manufacturer of civilian airplane parts, primarily for Boeing. CATIC was at the time the import & Export arm of the Ministry of Aerospace Industry of the People's Republic of China.

⁶⁴ David McLaughlin, *Chinese-Owned Ralls Can Question U.S. on Project Denial*, BLOOMBERG (July 14, 2014, 4:16 PM), <http://www.bloomberg.com/news/articles/2014-07-15/chinese-owned-firm-can-question-u-s-on-project-denial>.

⁶⁵ James Lewis, *New Objectives for CFIUS: Foreign Ownership, Critical Infrastructure, and Communications Interception*, 57 (3) FED. COMM. L. J. 457, 478 (2005).

⁶⁶ Plotkin, *supra* note 59, at 3.

⁶⁷ 50 U.S.C. App. § 2170(a)(6).

economic security, national public health or safety, or any combination of those matters.”⁶⁸ The two definitions, which do not match exactly, are subject to the enforcement agencies’ interpretation and discretion. Although FINSA includes NCI in the definition of national security, the CFIUS regulations specifically reject defining classes of systems or assets as “critical infrastructure.”⁶⁹ CFIUS’s mandate does not include national economic security, creating a significantly narrower definition than DHS’s focus and a definition that is vague in its application. CFIUS only has the power to determine the effects of the transaction on the US national security.⁷⁰

The U.S. government is particularly concerned with protecting its defence apparatus from espionage. This approach has rendered the Ralls’s acquisition under closer scrutiny given the proximity of the acquired property to a U.S. naval training facility.

CFIUS reviews particularly those investments that involve facilities in proximity to sensitive installations.⁷¹ CFIUS had effectively blocked a previous transaction in which a Chinese state-controlled firm sought to acquire a gold mine near military assets.⁷² Due to the proximity of the target project to the military installation, CFIUS found that the transaction at issue threatened to impair national security.⁷³ On the one hand, the flexibility of the language in the definition of “national security” is critical to the CFIUS’s proper functioning. However, the lack of a

⁶⁸ USA PATRIOT ACT OF 2001, Pub. L. No. 107-56, § 1016(e), 115 Stat. 272 (2001); 42 U.S.C. § 5195c (e).

⁶⁹ James Jackson, CONG. RESEARCH SERV., RL33312, *The Exon-Florio National Security Test for Foreign Investment* 12 (2012).

⁷⁰ FOREIGN INVESTMENT AND NATIONAL SECURITY ACT OF 2012, 50 U.S.C. App. § 2170 (b)(1)(A)(i) (2012).

⁷¹ See, e.g., Sara Forden & Rebecca Penty, *Nexen Rigs Near U.S. Military Base May Be Issue in CNOOC Review*, FIN. POST (Dec. 6, 2012), <http://business.financialpost.com/news/energy/nexen-rigs-near-u-s-military-base-may-be-issue-in-cnooc-review>.

⁷² In December 2009, CFIUS rejected the plans of a Chinese government-controlled company, Northwest Ferrous International Investment Company, to acquire a 51% interest in a Nevada gold mining business, Firstgold Corp. See, e.g., Eric Lipton, *Questions on Security Mar Foreign Investments*, N.Y. TIMES (Dec. 17, 2009), http://www.nytimes.com/2009/12/18/business/18invest.html?_r=0. In May 2012, CFIUS forced Far East Golden Resources Group Ltd. (Far East), a subsidiary of Chinese firm Hybrid Kinetic, to divest its majority interest in US mining company Nevada Gold Holdings, Inc. The interest was acquired in October 2010 without a voluntary CFIUS filing, but the Committee subsequently proceeded to initiate a review on its own in March 2012 and ultimately compelled the rescission of the acquisition 18 months after its completion. See, e.g., Forden & Penty, *supra* note 71.

⁷³ Josselyn, *supra* note 3, at 1362.

specific, limited definition arguably subjects foreign investments to an arbitrary and capricious review process.⁷⁴

2. *The Perceived Nationality Discrimination*

The broad definition of national security may enable the CFIUS to politicize foreign investment by disfavoring countries, such as China, which might represent a threat to U.S. economic hegemony.⁷⁵ The prospective purchaser's nationality and whether it is controlled by a foreign government are important factors in determining whether a CFIUS review is necessary.⁷⁶ Transactions involving Chinese acquirers, perceived as a "non-alliance" partner, are likely subjected to greater scrutiny than acquirers within an "alliance" partner, such as the EU. Notably, there are other wind farms owned by foreign companies in the proximity of the airbase, but the Ralls wind farms were singled out.⁷⁷ Companies from countries that are perceived as having weak corporate governance or a history of espionage will be subject to higher scrutiny.⁷⁸ CFIUS seems to be more suspicious of some ostensibly private Chinese firms as indistinct from those owned or controlled by the Chinese government.⁷⁹ This normally results in heightened scrutiny of companies irrespective of whether they are officially state owned enterprises (SOEs).⁸⁰

The possible discrimination could lead to retaliatory measures to the detriment of American investors attempting to enter into the Chinese markets.⁸¹ Nevertheless, an empirical analysis of public data for discriminatory application has shown no evidence that indicates NSRs are

⁷⁴ Saha, *supra* note 2, at 215; see also George Stephanov Georgiev, *The Reformed CFIUS Regulatory Framework: Mediating Between Continued Openness to Foreign Investment and National Security*, 25 YALE J. ON REG. 125, 131 (2008).

⁷⁵ Cf. Christopher Fenton, *U.S. Policy Towards Foreign Direct Investment Post-September 11: Exon-Florio in the Age of Transnational Security*, 41 COLUM. J. TRANSNAT'L L. 195, 211 (2002).

⁷⁶ Exec. Order No. 11,858, 3 C.F.R. § 990 (1971-1975); C.J. Voss & Alexandra Mertens, *Energy Law Alert: CFIUS Intervenes in Chinese-Owned Wind Project*, STOEL RIVES LLP (Sept. 24, 2012), <http://www.stoel.com/energy-law-alert-cfius-intervenes-in-chinese-owned>.

⁷⁷ See *Ralls Corp. v. Comm. on Foreign Inv. in the U.S.*, 926 F. Supp. 2d 71, 78 (D.D.C. 2013), *rev'd*, 758 F.3d 296 (D.C. Cir. 2014).

⁷⁸ Yu, *supra* note 19.

⁷⁹ See Daniel C.K. Chow, *Why China Wants a Bilateral Investment Treaty with the United States*, 33 B. U. INT'L L.J. 421, 441-42 (2015).

⁸⁰ Emily Rauhala, *Huawei: The Chinese Company that Scares Washington*, TIME (Apr. 4, 2013), <http://world.time.com/2013/04/04/huawei-the-chinese-company-that-scaries-washington/>.

⁸¹ See Gaurav Sud, *From Fretting Takeovers to Vetting CFIUS: Finding a Balance in U.S. Policy Regarding Foreign Acquisitions of Domestic Assets*, 39 VAND. J. TRANSNAT'L L. 1303, 1325 (2006).

being undertaken in a discriminatory manner.⁸² This can be used to rebut the perceived country-based discrimination for which China may seek to establish retaliation detrimental to U.S. investors. Indirectly, the empirical data serves as counterevidence, refuting the claim that CFIUS impedes trade liberalisation in an arbitrary and capricious manner. It seems that CFIUS was not so much concerned about foreign ownership of wind farm assets, but rather the installation of Ralls's project so close to military assets.⁸³ The facts of the case provide valuable insight in the CFIUS review process and lessons for Chinese companies seeking to invest in assets geographically close to sensitive defence instalments in the U.S.⁸⁴ In a world of geopolitical tensions, acquisitions by firms from potential adversary countries, like China, will inevitably receive disproportionately intense scrutiny.⁸⁵ Given the political sensitivity surrounding inbound investment, for the foreseeable future, Chinese investment in strategic American sectors will likely continue to be scrutinized.⁸⁶

3. *The Far-Reaching Implications*

The *Ralls* case will have a substantial impact on foreign companies' M&As in certain sensitive industry sectors, but could also reshape long-standing procedures at CFIUS. It is considered a milestone since the court has held that the parties before CFIUS are entitled to procedural due process.⁸⁷ The decision could give foreign firms more leverage and greater legal protections as they seek to expand in the U.S., which may open the door to potential legal challenges provided that parties are denied due process. A setback for the CFIUS,⁸⁸ the landmark decision arguably weakened President's ability to block foreign firms' acquisition on national security grounds.⁸⁹ The ruling will help create some transparency in the CFIUS process. Prior to the *Ralls* case, foreign companies had virtually no say in the review process, but the ruling could result in

⁸² Paul Connell & Tian Huang, *An Empirical Analysis of CFIUS: Examining Foreign Investment Regulation in the United States*, 39 YALE J. INTERN'L L. 131, 154-55 (2014).

⁸³ See *Ralls Corp. v. Comm. on Foreign Inv. in the U.S.*, 926 F. Supp. 2d 71, 78 (D.D.C. 2013), *rev'd*, 758 F.3d 296 (D.C. Cir. 2014).

⁸⁴ Dustin Tingley et al., *The Political Economy of Inward FDI: Opposition to Chinese Mergers and Acquisitions*, 8 CHINESE J. INTERN'L POL. 27, 57 (2015).

⁸⁵ Moran, *supra* note 5.

⁸⁶ Stewart Baker & Stephen Heifetz, *Addressing National Security Concerns*, INSIGHT 21, 23 (Sept. 2010), <http://www.steptoe.com/assets/attachments/4149.pdf>.

⁸⁷ See *Ralls Corp. v. Comm. on Foreign Inv. in the U.S.*, 758 F.3d 296, 318 (D.C. Cir. 2014).

⁸⁸ Mauldin & Kendall, *supra* note 55.

⁸⁹ Shengzhi Wang, *Committee, President, and Congress: A Triangular Model to Explore the Inter-department Relationship in the CFIUS Scheme and the Viability of Judicial Review of Committee Actions*, VT. L. REV. (Apr. 24, 2015), <http://lawreview.vermontlaw.edu/archives/2237>.

requiring the CFIUS to disclose the unclassified evidence upon which it relies in making decisions.⁹⁰ In addition, the challenge may increase the burdens on parties and result in lengthier and more rigorous investigations. Furthermore, *under any scenario*, the authority of CFIUS to review acquisitions remains intact and its ability to call in unfiled transactions remains undisturbed. Finally, the divestiture order may precipitate a possible tit-for-tat retaliation from the CFIUS's counterpart. In 2011, China established its own national security review regime that mirrors the operation of CFIUS.⁹¹ Given the *de facto* discriminatory consequences arising from such precedents as *Huawei* and *Ralls*, it is worth exploring whether the Chinese NSR regime could politicize potential American businesses in China.

C. *The National Security Review Regimes in China*

There has been a trend of heightened scrutiny of foreign investment into China in potentially sensitive sectors. If a transaction is determined to pose significant concern to national security, parties may be required either to withdraw the transaction or to implement the mandatory remedies to address the concern. Some concerns have arisen as to whether the U.S. action to tighten restrictions on foreign investment in the U.S. has provoked similar countermeasures in China, arguably limiting opportunities for outward investment by American companies. It remains uncertain whether national security could be used as a pretext for protectionism. It is worth examining the extent to which the Chinese NSR process is similar to, or distinct from the CFIUS.

1. *The National Security Review (NSR) Framework*

The definition of “national security” has substantial impact on which cross-border mergers receive clearance. Both the U.S. and China use a deliberately open-ended definition of national security in their regulatory regimes.⁹² Given the lack of sufficient parameters, a further effort needs to be made to circumscribe as clearly as possible what the concept of national security means in order to avoid possible protectionism or discrimination. The new definition under FINSAs makes the U.S. practice more appealing to

⁹⁰ Mauldin & Kendall, *supra* note 55.

⁹¹ Guowuyuan Bangong Ting Guanyu Jianli Waiguo Touzi Zhe Binggou lingnei Qiye Anquan Shencha Zhidu De Tongzhi (国务院办公厅关于建立外国投资者并购境内企业安全审查制度的通知) [National Security Review Mechanism for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors] (promulgated by the Gen. Off. St. Council, Feb. 3, 2011, effective Mar. 5, 2011) Guo Ban Fa [2011] No. 6 [hereinafter NSR Notice].

⁹² See Tipler, *supra* note 22, at 1239.

Chinese Antimonopoly Enforcement Agencies (AMEAs), which is likely to influence the emerging Chinese NSR committee. China defines "national security" much more broadly than CFIUS does.⁹³ For instance, defence and high-technology industries are not the only sectors that potentially fall under the national security arena.

The PRC Antimonopoly Law (AML 2008) provides for a review in cases where a foreigners' proposed transaction will have any adverse effect on national security, in addition to the anti-monopoly review.⁹⁴ The statute paves the way for legitimate establishment of a framework for an NSR regime.⁹⁵ Under the supervision of the State Council, the NSR is conducted by a joint inter-ministerial committee (the NSR Committee) led by Ministry of Commerce of the People's Republic of China (MOFCOM).⁹⁶ The NSR Committee is empowered to ensure that there are effective institutions in place, and clear lines of responsibility in reviewing inbound investment in China.⁹⁷ It undertakes a sophisticated assessment based on the following elements: national defence, national economic stability, basic social order and key technological R&D capability in connection with national security.⁹⁸ More specifically, the NSR Committee will assess the transaction's impact on:

- (i) national defence and security, including its impact on the production capacity of defence-related domestic products, capacity of provision of defence-related domestic services, and equipment and facilities that are required for national defence;
- (ii) national economic stability;
- (iii) the basic order of life in society; and
- (iv) research and development capabilities related to key technologies associated with national security.⁹⁹

⁹³ Peter J. Wang et al., *China's New National Security Review Will Examine Foreign Investment in Chinese Companies*, JONES DAY PUBLICATIONS (Feb. 2011), http://www.jonesday.com/china_new_national_security_review/.

⁹⁴ AML 2008, Article 31 provides for additional review of transactions between foreign buyers and domestic firms if "national security" is implicated. Fanlongduan Fa (反垄断法)[Anti-Monopoly Law] (promulgated by the Standing Comm. Nat'l People's Cong., Aug. 30, 2007, effective Aug. 1, 2008) 2007 Standing Comm. Nat'l People's Cong. Gaz. 517-23, art. 31 [hereinafter AML].

⁹⁵ See Stephen Sothmann, *Let He Who is Without Sin Cast the First Stone: Foreign Direct Investment and National Security Regulation in China*, 19 IND. INT'L & COMP. L. REV. 203, 231 (2009).

⁹⁶ Wang, *supra* note 93.

⁹⁷ *Id.*

⁹⁸ NSR Notice, *supra* note 91, at art. 2.

⁹⁹ *Id.*

While China's emerging NSR procedures bear some resemblance to the CFIUS process, there are significant differences. Overall, both have the same basic goal: to review foreign investments' implications on national security. However, as Plotkin testified before the U.S.-China Economic and Security Review Commission, the above list of factors is neither intended to be an exhaustive definition of the scope of national security nor is it meant to be treated as such in practice.¹⁰⁰ The statutory inclusion of "national economic stability" is broad and hints at economic, rather than national security.¹⁰¹ The NSR system has been tainted by concerns about what China calls 'economic security,' which could provoke protectionism when applied by the AMEAs.

2. *The NSR Notice*

China's State Council adopted an interdepartmental national security review system for foreign M&As. For better coordination and efficiency, China's State Council issued the "*Notice on Establishment of a Security Review System for the Merger and Acquisition of Domestic Enterprises by Foreign Investors*" (NSR Notice) on February 3, 2011.¹⁰² It serves as a legal basis for the M&As security review system, and further refines China's procedures for reviewing certain foreign acquisitions of control over Chinese domestic enteritis. The issuance of *NSR Notice* represents a significant step forward in an effort to enhance transparency and formalize the NSR procedures in China. The *NSR Notice* goes far beyond traditional national security issues, encompassing the "economic stability" and "the fundamental order of the society."¹⁰³ It leaves the terms "national economic stability" and "basic order of life in society" undefined, which will likely establish a scope of review that is broader than the CFIUS review.¹⁰⁴ Furthermore, the definition of "actual control"¹⁰⁵ in the *NSR Notice* covers a broad array of foreign investment scenarios. It is defined to include situations where any foreign investor or combination of foreign

¹⁰⁰ Plotkin, *supra* note 59, at 2-3.

¹⁰¹ PRINCETON TASK FORCE ON CHINESE INV. IN THE US, RESPONDING TO CHINESE FOREIGN DIRECT INVESTMENT IN THE UNITED STATES (2013), <http://scholar.princeton.edu/sites/default/files/smeunier/files/Owned%20by%20China%20Class%20Report.pdf>.

¹⁰² General Office of the State Council's Notice on Establishment of a Security Review System for the Merger and Acquisition of Domestic Enterprises by Foreign Investors [hereinafter NSR Notice], Feb. 3, 2011, Guo Ban Fa Guowuyuan Bangong Ting Guanyu Jianli Waiguo Touzi zhe Binggou Jingnei Qiye Anquan Shencha Zhidu de Tongzhi.

¹⁰³ *Id.* at art. I (III)(II)(4)(II-III).

¹⁰⁴ See Saha, *supra* note 2, at 219 (noting that the scope of review under the Chinese model is broader than the U.S. model).

¹⁰⁵ NSR Notice, *supra* note 91, at art. I (I).

investors will hold more than 50 percent of an enterprise's equity, or where voting rights give a foreign investor significant influence over shareholder meetings or board meetings.¹⁰⁶ It remains to be seen what would constitute "significant influence," which results in a foreign investor being deemed to have acquired actual control.¹⁰⁷ Finally, the institutional void due to the overlap between the AMEAs may create bureaucratic delays and impede NSR Committee's ability to efficiently implement the Article 31 under AML 2008.¹⁰⁸

It seems challenging for foreign investors to navigate the interplay of the NSR regime with the antitrust process,¹⁰⁹ particularly when inconsistent outcomes arise from the two investigations respectively. On July 1, 2015, the National People's Congress passed the People's Republic of China National Security Law ("NSL").¹¹⁰ The NSL provides that certain types of foreign investments will be subject to NSR requirements based on national security concerns.¹¹¹ On the one hand, the NSL has established China's NSR on a statutory basis. On the other hand, the broad definition of national security embedded in the NSL could further complicate the M&As' review. The NSR injects uncertainty and complexity into cross-border deals.¹¹² It is critical to consider the NSR's impact on the timing and

¹⁰⁶ *Id.* at art. I(III)(1-3).

¹⁰⁷ Stephen Heifetz & Michael Gershberg, *Why Are Foreign Investments in Domestic Energy Projects Now Under CFIUS Scrutiny?* 3 HARV. BUS. L. REV. 204 (2013) (noting that "CFIUS now actively reviews and sometimes alters transactions that result in foreign control of U.S. energy companies"); *Id.* at n.8.

¹⁰⁸ See Angela Huyue Zhang, *Bureaucratic Politics and China's Anti-Monopoly Law* 47 CORNELL INT'L L. J. 671, 707 (2014) (noting that "the enforcement of the AML is therefore another example of the predicament that the Chinese leadership faces in governing and reforming the country").

¹⁰⁹ Saha, *supra* note 2, at 235 (noting that "the U.S. national security review process has featured an intricate balance in protecting U.S. national security while promoting national economic interests").

¹¹⁰ The National Security Law was adopted at the 15th Session of the Standing Committee of the 12th National People's Congress of the People's Republic of China on July 1, 2015. The NSL came into effect from the date of promulgation; Chun Han Wong, *China Adopts Sweeping National-Security Law*, WALL ST. J. (July 1, 2015), <http://www.wsj.com/articles/china-adopts-sweeping-national-security-law-1435757589>; *Top Legislature Concludes Bi-Monthly Session*, XINHUANET (July 1, 2015, 7:36 PM), http://news.xinhuanet.com/english/2015-07/01/c_134373276.htm.

¹¹¹ *Zhonghua Renmin Gongheguo Guojia Anquan Fa* (中华人民共和国国家安全法) [National Security Act People's Republic of China [hereinafter NSL]] (promulgated by the Standing Comm. of the Nat'l People's Cong., July 1, 2015, effective July 1, 2015), art. 59 (China), http://www.chinadaily.com.cn/hqcg/zgj/2015-07-01/content_13912103.html.

¹¹² See generally Andreas Heinemann, *Government Control of Cross-Border M&A: Legitimate Regulation or Protectionism?* 15 J. INT'L ECON. L. 843, 865 (2012).

ultimate success of the transaction.¹¹³ The longer a deal takes to approve, the more it costs and the more variables can affect the underlying transaction.¹¹⁴ It remains to be seen whether the NSR regime will result in economic protectionism constituting a serious obstacle for foreign multinational companies (MNCs). To a greater extent, it depends upon how it will be applied in practice given that the NSR leaves substantial discretion to the enforcement agencies.¹¹⁵

3. *Implications: Protectionism and Tit-for-Tat*

The *Ralls* decision has a tangible and material impact on the relations between the U.S. and China. Politicized NSRs result in uncertainty for businesses and can harm diplomatic relations between the two economic giants. The U.S. approach to dealing with the national security is highly regarded by the Chinese AMEAs, although they never openly admit this for the sake of ideologies and propaganda. Such a delicate balance encourages institutional evolution in Chinese executive and judicial structures, which has substantially helped to level the playing field in the future. The *Ralls* decision has, to a greater extent, shaken the AMEAs' trust in the perceived high-quality implementation of an NSR practice. A critical issue arises as to under what circumstances a blockage of foreign acquisitions constitutes protectionism. This will depend largely upon whether there is genuine national security rationale for blocking a proposed acquisition. It seems unclear whether national attempts to block foreign acquisitions will become a new protectionist trend that interferes with the free flow of capital and technology across borders.¹¹⁶ Without a proper resolution, this would trigger reciprocal retaliation and undoubtedly hurt both countries' foreign investments.

The Chinese NSR regime could have a broad impact on prospective M&As by U.S. investors in China. More specifically, any improper processing of the Chinese investment in the U.S. may risk subjecting U.S. businesses to similar sufferings when they invest in China. This is because the scope of NSR is ambiguous and could be an option of

¹¹³ Christopher Tipler, *Defining 'National Security': Resolving Ambiguity in the CFIUS Regulations* 35 U. PENN. J. INT'L L. 1223, 1266 (2014).

¹¹⁴ *The Need For CFIUS To Address Homeland Security Concerns: Hearing Before the H. Comm. On. Homeland Sec.*, 109th Cong. 32 (2006) (statement of Stuart Eizenstat, Partner, Covington and Burling, Former Deputy Secretary of the Treasury) (noting that "time is money"), <http://www.gpo.gov/fdsys/pkg/CHRG-109hrg37216/pdf/CHRG-109hrg37216.pdf>.

¹¹⁵ Vivienne Bath, *Foreign Investment, the National Interest and National Security-Foreign Direct Investment in Australia and China* 34 SYDNEY L. R. 5, 33 (2012).

¹¹⁶ Destiny Duron Deas, *The Costs of Perceived Hypocrisy: The Impact of U.S. Treatment of Foreign Acquisitions of Domestic Enterprises* 57 DUKE L. J. 1795, 1803 (2008).

last resort for the Chinese authorities to block a transaction at its discretion.¹¹⁷ The NSR provision under the AML 2008 reflects the resurgence of protectionist sentiments following the increase in foreign acquisitions of Chinese companies.¹¹⁸ The NSR could be used as a shield to protect domestic industry in the context of strategic industrial policy,¹¹⁹ and to challenge foreign MNCs that increasingly control the Chinese economy. Notably, the *NSR Notice* followed several high-profile rejections of Chinese firms' acquisitions on national security grounds. For instance, the creation of the new NSR coincided with CFIUS' high-profile ruling against an acquisition in the U.S. by Huawei.¹²⁰ The new NSR may have potentially opened a door to retaliation by those who perceive the U.S.'s CFIUS process as protectionist. It remains highly datable as to whether the *NSR Notice* will bring greater transparency to an opaque process or, consistent with Chinese perceptions of the CFIUS process, will serve mainly to establish a highly politicized forum for protectionist interests.

Neither statutes nor institutions provide objective criteria to help prospective acquirers become well informed as to what kind of transaction is likely to be rejected on national security grounds. The NSR mechanism adds to the regulatory restrictions on foreign acquirers, as well as additional costs and unpredictability to a proposed acquisition. Whether these rules will constitute serious obstacles will depend upon how the NSR regime is applied. In the interests of a level competitive playing field, as well as, regulatory symmetry, a more transparent and predictable NSR regime is necessary in the long term. Both the U.S. and China will benefit greatly from eliminating politicized treatment of investments, which would strengthen the reciprocal effect if one party demands similar treatment from another when its MNCs invest in overseas markets.¹²¹

¹¹⁷ Tipler, *supra* note 22, at 1261.

¹¹⁸ Anu Bradford, *Chinese Antitrust Law: The New Face of Protectionism*, HUFFINGTON POST (Aug. 1, 2008), http://www.huffingtonpost.com/anu-bradford/chinese-antitrust-law-the_b_116422.html.

¹¹⁹ See Vivienne Bath, *National Security and Chinese Investment Policy* 3 HARV. BUS. L. REV. 81, 91 (2013) (noting that “[t]he final determination whether a transaction may have an impact on national security or would be contrary to the national interest is fundamentally political in both systems”).

¹²⁰ Daniel C.K. Chow, *Why China Wants a Bilateral Investment Treaty with the United States* 33 B.U. INT'L. L. J. 422, 435 (noting the argument that Huawei's acquisition of U.S. technology would pose a threat to U.S. national security interest and Huawei's subsequent withdrew its offer presumably due to pressure from CFIUS).

¹²¹ Paul Rose, *Sovereign Investing and Corporate Governance* 18 FORDHAM J. OF CORP. & FIN. L. 913, 958 (2013).

D. *Stalemate between National Security and Economic Competitiveness*

The CFIUS process carries with it a significant amount of unpredictability.¹²² The difficulty of balancing economic competitiveness and national security seems to have resulted in a stalemate.¹²³ Such an issue has been further plagued by mutual suspicion and distrust between the U.S. and China.¹²⁴ Separating plausible national security threats from implausible claims that a foreign acquisition will threaten national security is vital to strike a balance between proving a predictable investment environment and ensuring national security.¹²⁵ Disconcertingly, both CFIUS and the Chinese NSR system are considered a trade barrier dressed up as a national security tool, signalling a deep lack of trust between the two countries. FDI and national security need not be a zero sum in combination.¹²⁶

1. *Safeguard National Security without Stifling Free Trade*

Given the global nature of supply chains, the potential risk of foreign investment to national security cannot be eliminated. It is therefore critical to develop a processing procedure that can strategically mitigate risks.¹²⁷ When screening foreign acquisitions for potential threats to national security, CFIUS needs the flexibility to focus its scarce resources on those investments that pose real risks.¹²⁸ Otherwise, CFIUS's ability to deal with those transactions that genuinely matter will be compromised considerably. The NSR policies in the U.S. should be clarified so that the benchmarks and hurdles facing Chinese investors are understood relatively well, which will lead to a win-win outcome in achieving sustainable growth for the two

¹²² See Brandt Pasco, *United States National Security Reviews of Foreign Direct Investment: From Classified Programmes to Critical Infrastructure, This is What the Committee on Foreign Investment in the United States Cares About* 29 INT'L CTR. FOR SETTLEMENT OF INV. DISP. REV. – FOREIGN INV. L. J. 350, 367 (2014) (noting that Congress “appears to have recognized that the inclusion of Critical Infrastructure in the definition of national security could lead to unpredictable results”).

¹²³ GOVERNMENT RESPONSE TO THE INTELLIGENCE AND SECURITY COMMITTEE'S REPORT OF SESSION 2013-14: FOREIGN INVOLVEMENT IN THE CRITICAL NATIONAL INFRASTRUCTURE, cm. 8662, at 3 (UK).

¹²⁴ Jane Perlez, *In China and U.S., Mutual Distrust Grows*, N.Y. TIMES (July 18, 2015), http://www.nytimes.com/2013/07/18/world/asia/in-china-and-us-mutual-distrust-grows-study-finds.html?_r=0.

¹²⁵ Georgiev, *supra* note 74, at 125, 131.

¹²⁶ Plotkin, *supra* note 59.

¹²⁷ See Malcolm Rifkind, *Foreign Involvement in the Critical National Infrastructure: The Implications for National Security*, INTELLIGENCE & SECURITY COMMITTEE (June 2013).

¹²⁸ EIZENSTAT, *supra* note 25, at 37.

economies. More predictable NSRs would likely attract more Chinese investment in the U.S.¹²⁹ It is essential for NSR reviews to be undertaken in an objective manner, so as to avoid precipitating protectionist and retaliatory influence.¹³⁰ As Rose observed:

Clarification would help inoculate CFIUS against claims that its decisions are susceptible to political manipulation, and that increased frictions for certain deals, particularly from political and economic rivals, are not ‘by design.’¹³¹

More disclosure of the justifications for divestiture orders in cases like *Ralls* would make CFIUS reviews more predictable and provide foreign investors with a better sense of the types of investments that are likely to create national security concerns.¹³²

2. *Compliance with CFIUS Procedures: Make Efficient Use of the Voluntary Filing*

The resort to judicial recourse *ex post* will necessarily increase uncertainty for all parties in a transaction.¹³³ However, the use of appropriate CFIUS mitigation procedures can minimise the effects of litigation. The current voluntary notification system allows the parties to learn CFIUS’s decision with relative certainty prior to closing the transaction. The main benefit is that a company can take advantage of a regulatory “safe harbour” that protects it from further scrutiny or executive action.¹³⁴ This enables the parties to avoid substantial damage to the transaction. Moreover, the system of confidentiality enables parties to avoid negative publicity typically associated with a CFIUS investigation. If the parties intend to sidestep such a procedure,¹³⁵ CFIUS may initiate review *sua sponte* at any time and impose measures to mitigate a security risk, including possible divestiture following the acquisition.¹³⁶ As such, transactions that are not voluntarily filed and are later reviewed begin at a

¹²⁹ Wayne Morrison & Marc Labonte, *China’s Holdings of U.S. Securities: Implications for the U.S. Economy*, CONG. RES. SERV. (Aug. 19, 2013), <https://www.fas.org/sgp/crs/row/RL34314.pdf>.

¹³⁰ Josselyn, *supra* note 3.

¹³¹ Rose, *supra* note 121.

¹³² Stephen Paul Mahinka & Sean Duffy, *CFIUS Review Needs Greater Transparency*, INT’L FIN. L. REV. (2012).

¹³³ Yu, *supra* note 19.

¹³⁴ 31 C.F.R. § 800.601(d) (2006).

¹³⁵ See 31 C.F.R. § 800 (2008) (stating that parties are not required to notify their transactions to the committee, but may notify CFIUS voluntarily).

¹³⁶ 50 U.S.C. app. § 2170(b)(1)(D).

distinct disadvantage.¹³⁷ Acquisitions that sidestep CFIUS review proceeded at the investor's peril, as was clearly demonstrated by the President's decision in 2012 to unwind the Ralls' acquisition.¹³⁸ Had Ralls filed a notice and had CFIUS cleared it, the deal would have been insulated from subsequent rigorous review. It is helpful to engage in informal pre-notification consultation with CFIUS to discuss the transaction, filing documentation and discussing possible remedies. Otherwise, a proposed transaction potentially remains subject to divestment or other action in the future. Therefore, it is prudent to voluntarily seek CFIUS review when there is even a remote possibility of national security concerns,¹³⁹ which not only builds credibility with CFIUS, but also helps mitigate potential risks arising from the NSR.¹⁴⁰ Ralls should have taken as broad as possible a view of what the CFIUS might deem to be of national security concern so as to avoid potential judicial deadlock. Even where that is not possible, Ralls might have avoided the costs and adverse press of an acquisition and forced divestiture as a result of not engaging in pre-notification consultations.

3. *Are There Genuinely Well-Justified Grounds?*

As a common practice, legitimate competitive and national security concerns need to be addressed.¹⁴¹ Under the world's most prominent international trade regimes, a nation has the right to deny foreign investment in areas of its economy deemed integral to its national security interests.¹⁴² Certain prospective acquisitions of U.S. assets present legitimate security risks that may warrant intervention.¹⁴³ It remains uncertain, however, whether the process is completely apolitical.¹⁴⁴ Although the CFIUS regulations specifically disavow economic protectionism and reiterate the U.S. government's policy of encouraging foreign direct investment, an overly intrusive CFIUS would be an unintended protectionist barrier and risk undermining the U.S.'s goal of

¹³⁷ Joshua Zive, *Unreasonable Delays: CFIUS Reviews of Energy Transactions*, 3 HARV. BUS. L. REV. 169 (2013).

¹³⁸ Raymond Barrett & Joy Shaw, *Ralls CFIUS Block Alters Sany's Future Investment Strategy in US*, FIN. TIMES (Mar. 1, 2013).

¹³⁹ 50 U.S.C. § 2170(b)(1)(C)(i).

¹⁴⁰ Zucker & Hari, *supra* note 8.

¹⁴¹ Jonathan Masters, *Foreign Investment and U.S. National Security*, COUNCIL ON FOREIGN REL. (Sept. 27, 2013), <http://www.cfr.org/foreign-direct-investment/foreign-investment-us-national-security/p31477>.

¹⁴² Sothmann, *supra* note 95.

¹⁴³ Samuel Porteous, *The National Security Threat to Free Trade*, WALL ST. J. (Jan. 17, 2006).

¹⁴⁴ Daniel Ikenson, *Despite Huawei's Experience, America Is Open to Chinese Investment*, FORBES (Feb. 23, 2011).

greater investment.¹⁴⁵ The U.S. has adequate controls in place to review and block those prospective M&As with national security risks. Rigorous assessments deter those acquisitions with any potential threat to national security from entering into the U.S. market. Such sophisticated institutional and regulatory mechanisms have been successful in balancing the need for foreign investment against the threat of national security.¹⁴⁶

To mitigate the issue of a potential stalemate depends upon regulatory transparency and improved external perceptions. The requirement of transparency contradicts the legal mandate of the non-disclosure of the assessment methods and criteria by the intelligence agencies on behalf of CFIUS. Given the absence of well-defined criteria in the CFIUS legal regime, it is hard to evaluate the extent to which the *Ralls* case will change the transparency of CFIUS assessments. Without such details, it is difficult to undertake an objective evaluation of the legitimacy and justification for CFIUS's approaches. Without objective criteria, Chinese investors will not find more predictable or transparent treatment. There is a long way to go toward treating all investors in a fair and equitable manner under the law. The conflict on the national security grounds could be addressed through a bilateral investment treaty between the US and China as a possible solution.¹⁴⁷

CONCLUSION

Given the global nature of supply chains and M&As, there is the potential for commercial and national security interests to conflict, hence the increase in government scrutiny of cross-border acquisitions. The screening process represents an integral part of the existing foreign investment approval procedures. An NSR regime could make transactions involving foreign acquirers more challenging to navigate, increasing the level of uncertainty in the foreign investment approval process. The *Ralls* case demonstrates that the U.S. harbours deep national security concerns with foreign acquisitions. *Ralls*'s failure to notify CFIUS *ex ante* rendered it impossible for the plaintiff to modify the terms of the acquisition before the President's divestiture order. However, it should have done so to avoid the uncertainty of CFIUS interfering in the deal after consummation. After all, despite a judicial victory, CFIUS's risk assessment for the *Ralls* transaction was based on classified information that is generally not available for public

¹⁴⁵ Derek Scissors, *A Better Committee on Foreign Investment in the United States*, HERITAGE FOUND. ISSUE BRIEF NO. 3844 (Jan. 28, 2013).

¹⁴⁶ Eric Jensen, *Balancing Security and Growth: Defining National Security Review of Foreign Investment in China*, 19 PAC. RIM L. & POL. J. 161, 186 (2010).

¹⁴⁷ Sander Denecker, *The US-China BIT-Opportunities and Challenges*, INSIGHT (July 8, 2015).

disclosure. Any potential foreign acquirers should seek approval of CFIUS prior to closing a deal. Plausibly as CFIUS's decision may be, the result is a *de facto* politicized process. Such protectionist and discriminatory scrutiny may precipitate retaliation, to the detriment of the global economic recovery. The NSR institutions in both the U.S. and China need to adapt to a constantly evolving national security landscape and evaluate each transaction on a case-by-case basis. It will be beneficial for the world economy if both the CFIUS and Chinese NSR systems seek to balance protecting national security while promoting national economic interests.

GRUMPY CAT¹ OR COPY CAT? MEMETIC MARKETING IN THE DIGITAL AGE

Terrica Carrington*

INTRODUCTION

Can a “selfie”² feature more than one person? Is it still a “selfie” if the photograph is taken with a tripod? These were the questions posed by articles from two leading media outlets in 2014.³ In the last two years, the word “selfie” has increased in use by 17,000% and was even named Oxford Dictionaries’ Word of the Year in 2013.⁴ Yet prior to 2012, the term was practically non-existent.⁵ That is the nature of a successful Internet meme: an overnight celebrity. As Internet memes become more popular, companies are beginning to incorporate them into marketing campaigns, leading some to question the potential for copyright infringement.⁶

The Copyright Act of 1976 (the “Act”) governs copyright law in the United States and protects “original works of authorship fixed in any tangible medium of expression, now known or later developed.”⁷ In order to successfully bring a claim for copyright infringement, one must demonstrate both ownership of a valid copyright over the material in question, and that the accused copied that same protected material without permission.⁸ Codified in Section 107 of the Act, the Fair Use doctrine provides a defense

¹ “Grumpy Cat” refers to a meme incorporating a photograph of a cat. Kate Knibbs, *Are Memes the Pop Culture Art of Our Era?*, DIGITAL TRENDS (June 23, 2013), <http://www.digitaltrends.com/social-media/when-does-a-meme-become-art/>.

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² *Selfie Definition*, MERRIAM-WEBSTER, <http://www.merriam-webster.com/dictionary/selfie> (last visited Nov. 2, 2015) (defining “selfie” as “an image of oneself taken by oneself using a digital camera especially for posting on social networks”).

³ Caitlin Dewey, *Stop Abusing the Word ‘Selfie,’ Please*, WASH. POST (June 18, 2014), <http://www.washingtonpost.com/news/the-intersect/wp/2014/06/18/stop-abusing-the-word-selfie-please/>; Adrienne LaFrance, *When Did Group Pictures Become ‘Selfies’?*, THE ATLANTIC (Mar. 25, 2014), <http://www.theatlantic.com/technology/archive/2014/03/when-did-group-pictures-become-selfies/359556/>.

⁴ Ben Brumfield, *Selfie Named Word of the Year for 2013*, CNN (Nov. 20, 2013), <http://www.cnn.com/2013/11/19/living/selfie-word-of-the-year/>.

⁵ Shea Bennett, *A Brief History Of The #Selfie (1839-2014)*, MEDIABISTRO (July 10, 2014), http://www.mediabistro.com/alltwitte/first-ever-selfie-history_b58436.

⁶ E.g., Scott J. Slavick, *I Can Haz Copyright Infringement? Internet Memes and Intellectual Property Risks*, CORP. COUNSEL (Nov. 14, 2012), http://www.brinksgilson.com/files/article_nov_14_corp_counsel_slavick_internet_memes_2012.pdf.

⁷ 17 U.S.C. § 102(a) (1976).

⁸ *Kelly v. Arriba Soft Corp.*, 336 F.3d 811, 817 (9th Cir. 2003).

for those accused of copyright infringement.⁹ When evaluating this defense, courts are to consider the following four factors:

(1) the purpose and character of the use, including whether such use is of a commercial nature or is for nonprofit educational purposes; (2) the nature of the copyrighted work; (3) the amount and substantiality of the portion used in relation to the copyrighted work as a whole; and (4) the effect of the use upon the potential market for or value of the copyrighted work.¹⁰

Internet memes and the use of those memes in advertisements are new territories both commercially and legally, but major companies, like Virgin Media, are beginning to expand the realm of advertising by incorporating Internet memes into commercials.¹¹ This comment seeks to create a legal discourse about memetic marketing as it relates to copyright law and defending memetic marketing as a Fair Use.

This article will focus primarily on the two Fair Use factors most implicated by memetic marketing: (1) the purpose and character of the use and (4) the effect of the use upon the potential market for or value of the copyrighted work.¹² Part I will provide the background and context from which memetic marketing, i.e. the use of Internet memes in commercial advertising,¹³ has developed and its cultural relevance. It will begin by highlighting the development of the term “meme” and how memes function. Next, it will discuss how social media has contributed to the rise in popularity of Internet memes. Finally, it will explain the purpose of copyright law and the implications of the Commercial Speech doctrine on copyright protection. Part II will explore how the Fair Use doctrine should be applied to cases in which companies face copyright litigation as a result of memetic marketing. It will briefly discuss factors two and three and how they are likely to be dealt with in memetic marketing litigation and will then provide a detailed analysis of factors one and four.

⁹ 17 U.S.C. § 107 (1976).

¹⁰ § 107.

¹¹ Jason England, *Virgin Media Using 'Success Kid' Meme For Marketing*, NEW RISING MEDIA (Feb. 14, 2012), <http://newrisingmedia.com/all/2012/2/14/virgin-media-using-success-kid-meme-for-marketing.html>.

¹² § 107.

¹³ Jordan Markowski, *The Best Examples of Meme Marketing*, SPARKSHEET (Apr. 10, 2013), <http://sparksheet.com/the-best-examples-of-meme-marketing/>.

I. BACKGROUND AND CONTEXT OF MEMETIC MARKETING AND ITS RELATIONSHIP TO COPYRIGHT LAW

Internet memes, while entertaining, possess cultural significance that far surpasses their comedic value. Before analyzing memetic marketing under the Fair Use defense, it is important to understand the context from which both memetic marketing and copyright law developed and how those contexts affect the cultural and legal significance of memetic marketing.

a. *What is a Meme?*

In 1976, Richard Dawkins coined the term “meme” in his book *The Selfish Gene*, defining it as “a unit of cultural information passed between people.”¹⁴ Internet memes, a subcategory of memes, are usually photos, images, quotes, videos, and the like that pass from person to person via the internet in such a way that they acquire their own meanings and identities.¹⁵ While there are several categories of Internet memes, some memes, such as “Selfie” or “We are the 99%,”¹⁶ are not copyrightable material, as “catchwords, catchphrases, mottoes, slogans, or short advertising expressions” do not meet the minimum requirements for authorship.¹⁷ However, image memes consisting of text superimposed over a familiar image contain photos and other graphics, which are copyrightable.¹⁸ Therefore, this article will specifically focus on how the Fair Use defense should be applied to image memes used by companies. It is important to note, however, that image memes are not *just* photos and images enhanced with text. Memes are recognizable, the subject of social commentary and scrutiny, and “develop through the production of additional copies.”¹⁹

¹⁴ Cheryl Conner, *Three Tips For Marketing Better With Memes*, FORBES (July 2, 2013), <http://www.forbes.com/sites/cherylsnappconner/2013/07/02/three-tips-for-marketing-better-with-memes>.

¹⁵ *Id.*

¹⁶ Nick Carbone, *Top 10 Memes: 1. We are the 99 Percent*, TIME (Dec. 7, 2011), http://content.time.com/time/specials/packages/article/0,28804,2101344_2100875_2100915,00.html.

¹⁷ *Copyright Protection Not Available for Names, Titles, or Short Phrases*, U.S. COPYRIGHT OFF. (Jan. 2012), <http://copyright.gov/circs/circ34.pdf>.

¹⁸ Jana Quinn, *7 Things Marketers Should Know About Memes (The Ultimate Meme FAQ)*, QUALITY LOGO PRODUCTS (Mar. 29, 2013), <http://www.qualitylogoproducts.com/blog/7-things-marketers-should-know-memes-faq/>; § 102(a).

¹⁹ Ronak Patel, *First World Problems: A Fair Use Analysis of Internet memes*, 20 UCLA ENT. L. REV. 235, 248 (2013).

b. *The Development and Function of Memes*

Internet memes are a useful marketing tool for companies such as Vitamin Water, Virgin Media, and Wonderful Pistachios because of how quickly they spread online.²⁰ In his book, *The Selfish Gene*, Richard Dawkins explains the phenomenon by which memes “go viral” by analogizing memes with genes and memetics with genetics:²¹

One of Dawkins' more intriguing ideas was that any entity that can make copies of itself will evolve by natural selection, as long as three conditions are present in the right proportions. The first condition, referred to as replicability or heritability, is that the entity must reproduce with sufficient fidelity, fecundity, and longevity to pass on copies of itself to "offspring." The second condition, variability, is that the entity sometimes replicates imperfectly, typically through mutation. The third condition, fitness or selection, is that some of the mutations provide the entity with a replicatory advantage within a given environment. As long as the environment remains relatively stable, mutations that give rise to replicatory advantages will become more prevalent within the population over time.²²

Like genes, memes replicate, online and within society, by natural selection – Charles Darwin's theory within the context of evolution that the more advantageous a given trait, the greater its chances for survival from one generation to the next.²³ Similarly, anyone can create a meme and put it online, but only those with a certain *je ne sais quoi* will go viral.²⁴

²⁰ *Internet Memes: Copyright Licensing in an IP Minefield*, WORLD INTELL. PROP. REV. (Jan. 3, 2013), <http://www.worldipreview.com/article/internet-memes-copyright-licensing-in-an-ip-minefield>; Pamela Vaughn, *10 Popular Memes Masquerading as Marketing Campaigns*, HUBSPOT (June 7, 2012), <http://blog.hubspot.com/blog/tabid/6307/bid/33197/10-Popular-Memes-Masquerading-as-Marketing-Campaigns.aspx>.

²¹ See generally RICHARD DAWKINS, *THE SELFISH GENE* (1976).

²² Thomas F. Cotter, *Memes and Copyright*, 80 TUL. L. REV. 331, 337 (2005).

²³ See generally DAWKINS, *supra* note 21.

²⁴ Paula Steen, *How to Make a Meme Go Viral*, MEMECRUSHER (Oct. 28, 2012), <http://www.memecrusher.com/how-to-make-a-meme-go-viral/>.

Some marketing professionals suggest that companies should create their own memes to avoid the chances of legal trouble,²⁵ but this suggestion undermines the goal of memetic marketing. A successful meme is a recognizable meme and a meme to which people can relate and identify.²⁶ Internet memes separate the “in” group from the “out” group.²⁷ Sharing a meme that is already popular or that is closely related to an already popular meme is “in” group behavior that demonstrates to others an understanding of the content.²⁸ Through memetic marketing, companies seek to reach consumers by joining the “in” group and actively contributing to the conversation.²⁹ Success in this realm is not simply vested in creating a marketable meme; without an “in” group contributing to the meme’s promulgation and replication, the “marketable meme” is a meme merely by nomenclature and appearance, not function. So while it may appear a simple feat for a company to create a completely original meme and garner instant success, that formula is more wishful thinking than science because it is difficult to project how popular such an original creation will become.³⁰

c. Social Media and Communication via Memetics

Social media sites like Facebook, Twitter, and Instagram thrive on the ability of users to interact by sharing short messages, videos, and photos, including memes.³¹ On average, Facebook has about 1.5 billion active users per month.³² In 2015, the social network reached a record-breaking 1 billion users in a single day:³³ this is more than three times the total population of the United States.³⁴ Social media platforms also allow information to be

²⁵ Deborah Sweeney, *The Copyright Conundrum of Memes in Social Advertising*, SOC. MEDIA TODAY (Oct. 28, 2013), <http://www.socialmediatoday.com/content/copyright-conundrum-memes-social-advertising>.

²⁶ *How Memes Have Become Social Media Marketing Tools*, ENGELBRECHT ADVERT., <http://engelads.com/how-memes-have-become-social-media-marketing-tools/> (last visited Oct. 1, 2014).

²⁷ *See id.*

²⁸ *Id.*

²⁹ *Id.*

³⁰ *See Sweeney, supra* note 25; *see also Patel, supra* note 19, at 250-51.

³¹ Mor Naaman et al., *Hip and Trendy: Characterizing Emerging Trends on Twitter*, 62(5) J. OF THE AM. SOC’Y FOR INFO. SCI. AND TECH. 902, 902 (2011).

³² Jackie Wattles, *Facebook Hits One Billion Users in a Single Day*, CNNMONEY (Aug. 28, 2015, 8:26 AM), <http://money.cnn.com/2015/08/27/technology/facebook-one-billion-users-single-day/>.

³³ *Id.*

³⁴ *As of November 2015, the Total Population of the United States is Approximately 322 Million*. U.S. and World Population Clock, U.S. CENSUS BUREAU, <http://www.census.gov/popclock/> (last visited Nov. 14, 2015).

shared at a speed of up to 10 hours worth of content per minute.³⁵ The sheer speed with which information travels online, combined with the pervasive culture of sharing on social media websites, means that if a meme catches on, it catches on quickly and replicates even faster.³⁶

Memes are tools for communication within a large, ongoing cultural conversation in which ideas are shared and developed.³⁷ The process begins with an image or photograph that need not be particularly special or intrinsically meaningful because the image itself is not a meme. The image's journey toward becoming a meme requires "remixing" and modifying the original content by implementing creative editing decisions.³⁸ For example, a popular meme known as "Success Kid" began with a photograph depicting an 11-month old boy at the beach with a fist full of sand and a slightly smug facial expression.³⁹ His mother, the photographer, knew that the photograph was special, but the photograph itself was not symbolic or intrinsically meaningful.⁴⁰ Now, this photograph has gone viral over the Internet and is believed to be embedded in at least 66,000 memes.⁴¹ While there are sometimes slight aesthetic variations from one version to the next, each variation contains words superimposed on the photograph to illustrate a sense of achievement or feeling of success that others can relate to.

Meme culture is about more than just reposting a popular meme. In addition to replication, Internet memes thrive via growth and mutation, as social network users comment on and imitate the original.⁴² Social media also provides a unique opportunity for companies to create and become a part of important sets of dialogue with their consumers in ways they were previously unable to. Before social media, large-scale advertising was limited mostly to one-way communication.⁴³ Popular forms of advertising

³⁵ Andreas M. Kaplan & Michael Haenlein, *Users of the World, Unite! The Challenges and Opportunities of Social Media*, 53 BUS. HORIZONS 59, 59 (2010).

³⁶ See Bennett, *supra* note 5 ("The first recorded use of the hashtag #selfie took place on Flickr in 2004, but the word didn't really enter the public lexicon until 2012. Since then, the use of selfie across social media platforms such as Facebook, Twitter and Instagram has skyrocketed by 17,000 percent").

³⁷ *Internet Memes*, *supra* note 20.

³⁸ *Id.*

³⁹ Christine Erickson, *What to Expect When Your Kid Becomes a Meme*, MASHABLE (May 10, 2012), <http://mashable.com/2012/05/10/child-memes/>.

⁴⁰ *Id.*

⁴¹ Jeremy Taylor, *You Can Chat With the Real Life 'Success Kid'*, THE FW (Sept. 6, 2012), <http://thefw.com/chat-with-success-kid/>.

⁴² *Internet Memes*, *supra* note 20.

⁴³ See Gary E. Mullins, *The Nature of Two Way Communications in a Social Media Presence*, SOCIALLY BUZZING (Mar. 15, 2013), <http://sociallybuzzing.com/the-nature-of-two-way-communications-in-a-social-media-presence/>.

such as television commercials and magazine spreads do not allow for immediate responses from consumers.⁴⁴ Sites like Twitter and Facebook, however, invite users to engage in dialogue with the companies whose products they invest in and provide companies the opportunity to listen and respond effectively.⁴⁵ As the use of memes online has become an integral part of the social media experience, memetic marketing is an important way for companies to remain a part of this ongoing dialogue with consumers.

Recently, however, companies like Warner Brothers have incorporated memes into advertising schemes, resulting in lawsuits filed by copyright holders.⁴⁶ In this case, copyright holders of the popular Internet memes “Nyan Cat” and “Play Him Off, Keyboard Cat” sued Warner Brothers and 5th Cell for copyright infringement.⁴⁷ Both Internet memes were extremely popular online; Nyan Cat was the 5th most watched video on YouTube in 2011 and won “Meme of the Year” in 2012, while Play Him Off, Keyboard Cat, one of the first memes to go viral, was listed among the top 50 greatest viral videos.⁴⁸ This case is unique because the creator of the meme, Brad O’Farrell, obtained permission from the owner of the original video before creating and posting the meme.⁴⁹ Although the parties in this and other similar cases settled out of court,⁵⁰ the novelty and popularity of Internet memes means that this is likely just the beginning of litigation on this matter. Therefore, it is important to distinguish that although it may be suggested otherwise,⁵¹ memetic marketing is not categorically excluded from an implication of Fair Use by virtue of its commercial nature.

⁴⁴ Kathrik S, *Can Advertising Become a Two-Way Communication?*, BEAST OF TRAIL (Nov. 23, 2009), <http://itwofos.com/beastoftrail/2009/11/23/can-advertising-become-a-two-way-communication/>.

⁴⁵ *How A Small Business Can Use Twitter and Facebook to Talk to Their Customers*, WHEN CUSTOMERS TALK, <http://www.whencustomerstalk.com/>.

⁴⁶ *Keyboard Cat Wins a Settlement With Maker of the Game “Scribblenauts”*, THE SPOKESMAN-REV. (Oct. 1, 2013), <http://www.spokesman.com/blogs/officehours/2013/oct/01/keyboard-cat-wins-settlement-maker-game-scribblenauts/>.

⁴⁷ Complaint at 2, Schmidt et al. v. Warner Bros. Entm’t Inc. et al, 2:13-cv-02824 (C.D. Cal. Apr. 22, 2013).

⁴⁸ *Id.* at 2.

⁴⁹ Jake Coyle, *‘Keyboard Cat’ Phenomenon Spreads on Web, TV*, USA TODAY (Feb. 16, 2013), <http://archive.today/6I70r>.

⁵⁰ *Keyboard Cat Wins a Settlement with Maker of the Game “Scribblenauts”*, *supra* note 46.

⁵¹ Kate Knibbs, *Warner Brothers Used Memes to Advertise – and Now They’re Getting Sued by Mr. Nyan Cat*, DIGITAL TRENDS (May 7, 2013), <http://www.digitaltrends.com/social-media/warner-brothers-used-memes-to-advertise-and-now-theyre-getting-sued-by-mr-nyan-cat/> (“Don’t mess with cat memes – especially if your idea of ‘messaging with’ is an attempt to profit off their popularity without giving the creators a heads up.”).

d. Means vs. Ends: The True Purpose of Copyright Law

Intellectual property rights, including copyrights, are provided for in the United States Constitution.⁵² Unlike many other provisions of the Constitution, this particular provision spells out its exact purpose.⁵³ While many people believe that intellectual property rights exist specifically to protect a creator's piece of work,⁵⁴ the Constitution states otherwise.⁵⁵ Article I, Section 8, Clause 8, commonly known as the Intellectual Property Clause, states that "the Congress shall have power... *to promote the progress of science and useful arts*, by securing for limited times to authors and inventors the exclusive right to their respective writings and discoveries."⁵⁶ Securing intellectual property rights is merely a *means* by which Congress can help achieve the goal of promoting the progress of science and the arts.⁵⁷ For this reason, copyrights are not completely exclusive and must yield to certain uses that are deemed "fair."⁵⁸

Beyond entertainment value, memes are useful socially because they are the product of collective contribution of social commentary and critique, and commercially because they allow commercial advertising to advance along with technology and keep up with the needs of the consumer.

II. A FAIR USE ANALYSIS OF MEMETIC MARKETING

Under a Fair Use analysis of memetic marketing, considering the totality of the factors,⁵⁹ memetic marketing constitutes a Fair Use because although it involves a commercial use and often incorporates a significant portion of the original work, the level of transformation memes must undergo

⁵² U.S. CONST. art. I, § 8, cl. 8.

⁵³ *Id.*

⁵⁴ *E.g. Purpose of Copyright: Protecting the Creator Against Infringement*, NOVAGRAAF, <http://www.novagraaf.com/en/services/copyright-covers-a-wide-area/purpose-of-copyright-protecting-the-creator-against-infringement> (last visited Oct. 1, 2014) ("The purpose of copyright law is to protect the creator of a work against infringement, to guarantee commercial exploitation and to stimulate new ideas").

⁵⁵ U.S. CONST. art. I, § 8, cl. 8.

⁵⁶ *Id.* (emphasis added).

⁵⁷ *Id.*

⁵⁸ Pierre N. Leval, *Toward a Fair Use Standard*, 103 HARV. L.REV. 1105, 1107 (1990) ("The copyright is not an inevitable, divine, or natural right that confers on authors the absolute ownership of their creations. It is designed rather to stimulate activity and progress in the arts for the intellectual enrichment of the public.")

⁵⁹ 17 U.S.C. § 107 (1976) ("(1) the purpose and character of the use, including whether such use is of a commercial nature or is for nonprofit educational purposes; (2) the nature of the copyrighted work; (3) the amount and substantiality of the portion used in relation to the copyrighted work as a whole; and (4) the effect of the use upon the potential market for or value of the copyrighted work.")

paired with the fact that memetic marketing creates and improves upon the market for the original work outweighs the factors weighing against it.

a. Applying Factors Two & Three of Fair Use to Memetics

The second and third factors of Fair Use require less indulgence with regard to memetic marketing and therefore will only be dealt with briefly. Factor Two – the nature of the copyrighted work – is likely to weigh in favor of the copyright holder.⁶⁰ Courts first determine “whether the work is expressive or creative” and give preference toward protection of those rights as opposed to works that are “factual or informational.”⁶¹ Next, courts consider whether the work is published or unpublished, applying a more limited scope for Fair Use in relation to unpublished works.⁶² Although the original photograph of Sammy, the basis for Success Kid, was published online, its’ creative nature⁶³ would likely cause factor two to be resolved in favor of the copyright holder.⁶⁴

Factor three addresses the amount and substantiality of the portion used in relation to the copyrighted work as a whole, examining the quantity and quality of the portion used.⁶⁵ Some image memes, like Futurama, are based on still frames taken from videos, television shows, and cartoons,⁶⁶ while others, like Success Kid, are based on photographs.⁶⁷ In the first scenario, there is likely to be a finding in favor of Fair Use because only a small portion of the copyrighted work is used in the secondary work.⁶⁸ However, in the latter scenario, courts would likely find in favor of the copyright holder because the secondary work would encompass most, if not all, of the original work.⁶⁹ Success Kid, in particular, would likely lose this factor because the meme uses the “heart” of the original photograph, and the “part most likely to be newsworthy and important in licensing

⁶⁰ Patel, *supra* note 19, at 252.

⁶¹ *Cariou v. Prince*, 714 F.3d 694, 709-10 (2nd Cir. 2014).

⁶² *Id.* at 709-10; *Harper & Row Publishers, Inc. v. Nation Express*, 471 U.S. 539, 552-53 (1985).

⁶³ *Kelly v. Arriba Soft Corp.*, 336 F.3d 811, 820 (9th Cir. 2003) (“Photographs that are meant to be viewed by the public for informative and aesthetic purposes... are generally creative in nature”).

⁶⁴ *Cariou*, 714 F.3d at 709-10; *see also* Patel, *supra* note 19, at 252.

⁶⁵ *Campbell v. Acuff-Rose Music, Inc.*, 510 U.S. 569, 586-87 (1994).

⁶⁶ Patel, *supra* note 19, at 238.

⁶⁷ *E.g. id.*, at 252.

⁶⁸ *Id.*

⁶⁹ *Id.*

serialization.”⁷⁰ However, more leeway would be given to memes that act as parodies.⁷¹

b. Factor One: Purpose & Character

While commerciality tends to weigh against a finding of Fair Use under factor one, “nearly all of the illustrative uses listed in the preamble paragraph of § 107 [of the Act], including news reporting, comment, criticism, teaching, scholarship, and research ... are generally conducted for profit.”⁷² The Commercial Speech doctrine helps illustrate why categorically excluding commercial use from the Fair Use defense would be problematic with regard to the First Amendment.⁷³ When evaluating the purpose and character of memetic marketing, the highly transformative nature of memes outweighs their commercial nature.

i. Commercial Speech Doctrine and Factor One

The first factor looks at “the purpose and character of the use, including whether such use is of a commercial nature or is for nonprofit educational purposes.”⁷⁴ Historically, some courts have interpreted this to mean that non-profit educational use is a fair one, while commercial uses are not.⁷⁵ The problem with this interpretation, however, is that it would highly limit the freedom of commercial speech, which is protected by the First Amendment.⁷⁶ In the Supreme Court case *Virginia State Board of Pharmacy v. Virginia Citizens Consumer Council, Inc.*, the Court established the Commercial Speech doctrine, stating that even an advertiser’s purely financial motive does not disqualify it from protection under the First Amendment.⁷⁷ The Court ruled that while there are limitations, commercial speech does not fall outside of the realm of First Amendment protection, stating “a State may [not] completely suppress the dissemination of concededly truthful information about entirely lawful activity” merely because that speech is commercial in nature.⁷⁸

⁷⁰ See *Campbell*, 510 U.S. at 587.

⁷¹ *Id.* at 588-89.

⁷² *Cariou v. Prince*, 714 F.3d 694, 709 (2nd Cir. 2014) (quoting *Campbell*, 510 U.S. at 584).

⁷³ See *Virginia State Bd. Of Pharmacy v. Virginia Citizens Consumer Council, Inc.*, 425 U.S. 748, 762 (1976).

⁷⁴ 17 U.S.C. § 107 (1976).

⁷⁵ Manal Z. Khalil, *The Applicability of the Fair Use Defense to Commercial Advertising: Eliminating Unfounded Limitations*, 61 *FORDHAM L. REV.* 661, 663, 669-70 (1992).

⁷⁶ *Id.* at 663, 673.

⁷⁷ *Virginia State Bd. of Pharmacy*, 425 U.S. at 762.

⁷⁸ *Id.* at 773.

After twenty years of placing limitations on this doctrine,⁷⁹ the Court stated in *44 Liquormart, Inc. v. Rhode Island* that, “when a State entirely prohibits the dissemination of truthful, non-misleading commercial messages for reasons unrelated to the preservation of a fair bargaining process, there is far less reason to depart from the rigorous review that the First Amendment generally demands.”⁸⁰ Therefore, based on the Commercial Speech doctrine, the first factor of the Fair Use defense cannot be read to categorically disqualify truthful, non-misleading commercial speech from applying the defense based solely on its commercial nature.

This premise is bolstered by the Supreme Court’s statement in *Campbell v. Acuff-Rose Music, Inc.* that commercial use is not a dispositive factor in determining Fair Use, but rather, a consideration weighed as a part of the first factor.⁸¹ The Court further explains that the most important consideration under the first factor lies in how much the new work transforms the original, stating:

Under the first of the four § 107 factors, “the purpose and character of the use, including whether such use is of a commercial nature ...,” the [inquiry] focuses on whether the new work merely supersedes the objects of the original creation, or whether and to what extent it is “transformative,” altering the original with new expression, meaning, or message. The more transformative the new work, the less will be the significance of other factors, like commercialism, that may weigh against a finding of Fair Use.⁸²

The Court further explains that while this “transformative” standard is not necessarily requisite for a finding of Fair Use, “the goal of copyright, to promote science and the arts, is generally furthered by the creation of transformative works. Such works thus lie at the heart of the Fair Use doctrine’s guarantee of breathing space within the confines of copyright.”⁸³

⁷⁹ In *Central Hudson Gas & Elec. Corp. v. Public Service Commission of New York*, Justice Blackmun’s concurrence states that “[s]ince the Court, without citing empirical data or other authority, finds a “direct link” between advertising and energy consumption, it leaves open the possibility that the State may suppress advertising of electricity in order to lessen demand for electricity.” He further states that while “energy conservation is a goal of paramount national and local importance” he disagrees with the Court’s assertion that “suppression of speech may be a permissible means to achieve that goal.” 447 U.S. 557, 573-74 (1980).

⁸⁰ *44 Liquormart, Inc. v. Rhode Island*, 517 U.S. 484, 501 (1996).

⁸¹ *Campbell v. Acuff-Rose Music, Inc.*, 510 U.S. 569, 584 (1994).

⁸² *Id.* at 569 (citing 17 U.S.C. § 107 (1976)).

⁸³ *Id.* at 579.

ii. Memes Require a Transformation

Since most copyright infringement cases involving memetic marketing have ended at the settlement stage, it is necessary to examine how courts have evaluated the first factor in similar circumstances.⁸⁴ In *Leibovitz v. Paramount Pictures Corp.*, the Federal District Court for the Southern District of New York found that an advertisement (“Nielsen ad”), which parodied another piece of work, was a Fair Use of that original piece.⁸⁵ The original piece, a cover shot for *Vanity Fair*, featured a pregnant and nude Demi Moore (“Moore photo”).⁸⁶ The Nielsen ad was an advertisement for the movie *Naked Gun: The Final Insult 33⅓*, featuring the body of an eight-month pregnant woman against a similar backdrop, edited “to duplicate the skin tone and body configuration” of the Moore photo.⁸⁷ The Nielsen ad, however, featured the head of a man smirking, rather than that of Demi Moore with her more serious facial expression, or that of the pregnant woman whose body was photographed.⁸⁸

The District Court explained that the Nielsen ad was sufficiently transformative as a parody because it set out to mock the Moore photo, which had become a cultural icon, and relied on contrasting the Moore photograph for comedic effect.⁸⁹ Citing the Supreme Court precedence established by *Campbell*, the District Court discussed how the nature of a parody requires the secondary work to use the original work in order to comment on it.⁹⁰ The District Court further held that the contradiction between the underlying message in the Nielsen ad and the Moore photograph contributed to its nature as a parody, saying:

The Moore photograph thus came to represent a particular view of pregnancy as a source of pride and a particular form of beauty. By contrast, Leslie Nielsen's character in the film is subject to pressure from his wife to start a family and views pregnancy and fatherhood with at best ambivalence, at worst stereotypical dread... The contradiction between these views is captured in the Nielsen ad by the

⁸⁴ Sara Boboltz, *Getty Is Quietly Charging Bloggers For ‘Socially Awkward Penguin’ Meme*, HUFFINGTON POST (Sept. 5, 2015, 11:34 AM), http://www.huffingtonpost.com/cpenguin_55e9d8e4b03784e275e935.

⁸⁵ *Leibovitz v. Paramount Pictures Corp.*, 948 F. Supp. 1214, 1226 (S.D.N.Y. 1996).

⁸⁶ *Id.* at 1215.

⁸⁷ *Id.* at 1216.

⁸⁸ *Id.*

⁸⁹ *Id.* at 1221-22.

⁹⁰ *Id.* at 1220.

contrast between Leslie Nielsen's guilty smirk and the copying of Demi Moore's forthright pose. This contradiction is part of what makes the Nielsen ad a parody.⁹¹

While this was a District Court opinion, and therefore not dispositive of the issue, it does provide a strong logical and legal argument with which to parallel memetic marketing. Internet memes, specifically image memes, follow a format almost identical to the one adopted in the Nielsen ad. A copyrightable image is used as the foundation of the meme, and creative modifications are made to express a message.

For example, a meme was created which parodies the movie *12 Years a Slave* by playing off of current events associated with racist remarks made by former NBA basketball team owner, Donald Sterling.⁹² The meme uses the same layout of the movie's advertisement. In the movie ad, the enslaved main character is running – likely away from slavery and toward freedom.⁹³ In the meme, the actor's head is replaced by that of NBA player Chris Paul, who is chasing a basketball, and the title is changed to “12 Years a Clipper.”⁹⁴ Like the editing choices made for the Nielsen ad, these choices are designed as a commentary about and contradiction of the original work's underlyingly message.⁹⁵ An official summary of the movie states:

“[12 Years a Slave is] based on an incredible true story of one man's fight for survival and freedom. In the pre-Civil War United States, Solomon Northup,... a free black man from upstate New York, is abducted and sold into slavery. Facing cruelty (personified by a malevolent slave owner...), ...Solomon struggles not only to stay alive, but to retain his dignity.”⁹⁶

While the movie *12 Years a Slave* puts a lens on *historic* racial tensions, the meme contrasts this context with reference to *current* events highlighting racial tensions and modern “plantation mentality.”⁹⁷ Without

⁹¹ *Id.* at 1222.

⁹² Andrew F. Williams, *OP-ED: 12 Years a Clipper*, POST NEWS GROUP (Apr. 24, 2014, 11:54 AM), <http://postnewsgroup.com/blog/2014/04/28/op-ed-12-years-clipper/>.

⁹³ *Id.*

⁹⁴ *Id.*

⁹⁵ *Id.*

⁹⁶ 12 YEARS A SLAVE, <http://www.12yearsaslave.com/> (last visited Oct. 23, 2015).

⁹⁷ *Celebs React to Donald Sterling Ban, Then The Memes Started Rolling In*, UPTOWN (Apr. 29, 2014), <http://uptownmagazine.com/2014/04/celebs-react-to-adam-silver-donald-sterling-ban-memes/3/>.

reference to the original work, the meme would have no comedic value, nor would the message behind it make sense.

Not all memes are parodies, so it is necessary to address where non-parody image memes stand in reference to the transformative standard. In 2012, Virgin Media implemented “Success Kid” into a billboard advertisement.⁹⁸ In the advertisement, the image is an inversion of the original photograph, the color of his shirt is different, and he is placed in front of a white background rather than the beach in the original photo.⁹⁹ The text accompanying the image reads, “Tim just reali[z]ed his parents get HD channels at no extra cost.”¹⁰⁰ While Virgin Media purchased the rights to use the original photo, this advertisement can be used as the basis for analyzing how the Fair Use defense would apply in a similar situation where rights were not obtained.

In a recent Second Circuit case, *Cariou v. Prince*, an appropriation artist sold a series of paintings, which featured copyrighted photographs of Rastafarians.¹⁰¹ The photographer sued for copyright infringement, but the artist claimed the Fair Use defense.¹⁰² The court explains how appropriation art often comments on the original piece, stating, “[m]uch of Andy Warhol's work, including work incorporating appropriated images of Campbell's soup cans or of Marilyn Monroe, comments on consumer culture and explores the relationship between celebrity culture and advertising.”¹⁰³

The Second Circuit conceded, however, that there is “no requirement that a work comment on the original or its author in order to be considered transformative, and a secondary work may constitute a Fair Use even if it serves some purpose other than those (criticism, comment, news reporting, teaching, scholarship, and research) identified in the preamble to the statute.”¹⁰⁴ In determining that the artist's appropriations of the photographs were indeed a Fair Use, the court emphasized that the artist did more than merely repackage the original photos; instead, he “‘add[ed] something new’ and presented images with a fundamentally different aesthetic.”¹⁰⁵ The key message here is that the appropriations gave the

⁹⁸ England, *supra* note 11.

⁹⁹ *Id.*

¹⁰⁰ *Id.*

¹⁰¹ *Cariou v. Prince*, 714 F.3d 694, 698 (2d Cir. 2013).

¹⁰² *Id.*

¹⁰³ *Id.* at 706.

¹⁰⁴ *Id.* at 706 (citing *Campbell v. Acuff-Rose Music, Inc.*, 510 U.S. 569, 577 (1994); *Harper & Row Publishers, Inc. v. Nation Express*, 471 U.S. 539, 561 (1985)).

¹⁰⁵ *Cariou*, 714 F.3d at 708 (quoting *Leibovitz v. Paramount Pictures Corp.*, 137 F.3d 109, 114 (2d Cir. 1998)).

photographs a totally different character and expression.¹⁰⁶ The appropriation presents the set of photographs in a new medium – a collage rather than a book – adds color to the original black and white photographs, incorporates distorted human forms, and presents the images in a “crude and jarring” manner that distinctly contrasts the “natural beauty” evoked in the original photographs.¹⁰⁷

While Virgin Media’s use of Success Kid implements aesthetic changes to the original photograph – altering the color of the shirt, inverting the image, and adding text – the question is whether or not the original photograph is sufficiently altered to create a new expression, aesthetic, and meaning.¹⁰⁸ The Second Circuit in *Cariou* compares the images side-by-side.¹⁰⁹ Using this form of analysis, it is important to remember that the original photograph *is not* “Success Kid” as it is known today. Appearance-wise, it is; but as far as what the photograph represents, it is not. The original photograph depicts nothing more than a small boy playing in the sand whose mother was lucky enough to catch a once-in-a-lifetime photo. Sammy, the child depicted in the photo, is not Success Kid. Success Kid is a character created by the public via the Internet. Success Kid is a meme. The fact that something does not become a meme until it reaches a significant level of recognition and saturation over the internet helps differentiate Sammy and Success Kid.¹¹⁰

What is particularly interesting about memes in general is that the process of becoming a meme involves a large transformation. Creativity is the means by which memes replicate and, therefore, thrive.¹¹¹ There are said to be at least 66,000 versions of Success Kid on the Internet,¹¹² and each one of those memes has contributed to the fictional Success Kid character. A website devoted to the creation of memes describes the character Success Kid as “hilarious and witty, saying many of the things we wish we could say but don’t have the guts to.”¹¹³ Without having passed from person to person over the Internet and having “different episodes of successful events” attributed to him “through the use of the photograph and accompanying text,” Success Kid would not exist.¹¹⁴ To deny this would be to assert that the

¹⁰⁶ *Id.* at 706.

¹⁰⁷ *Id.*

¹⁰⁸ *Id.*

¹⁰⁹ *Id.* at 707-08.

¹¹⁰ See Patel, *supra* note 19.

¹¹¹ David A. Simon, *Culture, Creativity, and Copyright*, 29 CARDOZO ARTS & ENT. L.J. 279, 294 (2011).

¹¹² Taylor, *supra* note 41.

¹¹³ *Success Kid*, MEME GENERATOR, <http://www.memegenerator.net/Success-Kid> (last visited Oct. 1, 2014).

¹¹⁴ *Id.*

photograph taken of Sammy on the beach with a fist full of sand would itself have enticed Virgin Media to invest in using it as an advertisement.

With this background in mind, Virgin Media's billboard advertisement is more than a mere repackaging of the original photo. There is a distinctly new meaning associated with Sammy as he appears on the billboard as opposed to in his appearance in the original photograph. In addition to the aesthetic changes, there is a new context, and Virgin Media presents an original "episode" in which Success Kid, not Sammy, is met with the unexpected surprise that he and his parents have access to all of the HD channels with no added cost.

iii. The Commercial Nature of Memetic Marketing

Both *Cariou* and *Leibovitz* represent scenarios in which the use of copyrighted material was deemed a Fair Use despite the commercial nature of the piece.¹¹⁵ Similarly in *Campbell*, the Supreme Court debunked the previously held notion that there was a presumption of unfairness associated with commercial use of copyrighted material.¹¹⁶ The *Campbell* court supports this statement by explaining how such a presumption "would swallow nearly all of the illustrative uses listed in the preamble paragraph of § 107, including news reporting, comment, criticism, teaching, scholarship, and research, since these activities 'are generally conducted for profit in this country.'"¹¹⁷

In *Cariou*, the court did not place much weight on the fact that the secondary work was commercial because of its transformative nature.¹¹⁸ In *Liebovitz*, the court recognized that commerciality tends to weigh against a finding of Fair Use, but is not dispositive.¹¹⁹ However, the court also determined the parody to be sufficiently transformative and thus, needed to reconcile these opposing assertions.¹²⁰ In doing so, the court turned to the purpose of copyright law: "to foster the creation and dissemination of the greatest number of creative works."¹²¹ The court held that, "the purposes of copyright are best served by a finding that the highly transformative character of the Nielsen ad trumps its admittedly commercial purpose."¹²² It

¹¹⁵ See *Cariou v. Prince*, 714 F.3d 694 (2nd Cir. 2014); see also *Leibovitz v. Paramount Pictures Corp.*, 948 F. Supp. 1214 (S.D.N.Y. 1996).

¹¹⁶ *Campbell v. Acuff-Rose Music, Inc.*, 510 U.S. 569, 584 (1994).

¹¹⁷ *Id.* (citing *Harper & Row Publishers, Inc. v. Nation Express*, 471 U.S. 539, 590 (1985)).

¹¹⁸ *Cariou*, 714 F.3d at 708.

¹¹⁹ *Leibovitz*, 948 F.Supp. 1214, at 1222-23.

¹²⁰ *Id.* at 1223.

¹²¹ *Id.*

¹²² *Id.*

is important to remember that “highly transformative” in this scenario speaks not only to the physical appearance of the advertisement, but also to its message and context as compared to the original photograph.¹²³

As mentioned above, photographs and images endure a highly transformative process in order to become popular, recognizable memes. However, the commercial aspect of memetic marketing tends to weigh against a finding of Fair Use, although not conclusively.¹²⁴ Following the approach taken by the *Liebovitz* court and looking to the purpose of copyright law, Internet memes in general *are* the creation and dissemination of a large number of creative works. The central objective of copyright law is not to vest “inevitable, divine, or natural right[s]” in authors of original works, but rather “to stimulate activity and progress in the arts for the intellectual enrichment of the public.”¹²⁵ Believe it or not, Internet memes are influential in the realm of mainstream art. As a recent discussion on PBS suggested, “[p]eople are creating images and sharing them with strangers to communicate their personal experiences... That, my friends, is art.”¹²⁶ Much like Andy Warhol’s work, Internet memes allow creators to transform “everyday” things into art.¹²⁷

Even more directly, some popular Internet memes have made their way into mainstream art.¹²⁸ One example of this phenomenon is the meme “Grumpy Cat,” which inspired thirty studio artists to host an art exhibit in which they created and sold “Grumpy Cat-themed” artwork.¹²⁹ A separate art exhibit, entitled “Memes,” also features artwork inspired by Internet memes. An artist by the name of Lauren Kaelin has an entire portfolio of meme-related paintings.¹³⁰ She draws inspiration from memes’ “reproducible, shareable, and recognizable” nature and explains that by using Internet memes in her work, the art “creates an aura where none previously existed.”¹³¹ The democratic nature of Internet memes also invites social

¹²³ *Id.* at 1220 (“As to the first fair use factor, the Court held that the critical inquiry entailed whether the second work ‘adds something new, with a further purpose or different character, altering the first with new expression, meaning, or message’”) (quoting *Campbell*, 510 U.S. at 579).

¹²⁴ *Id.* at 1219 (“The Court noted that any hard evidentiary presumption would run counter to the long common-law tradition of fair use adjudication and would contradict the statute’s clear indication that a work’s commercial nature is only one element of the first factor inquiry into its character and purpose.”).

¹²⁵ Leval, *supra* note 58, at 1107.

¹²⁶ Knibbs, *supra* note 51.

¹²⁷ *Id.*

¹²⁸ *Id.*

¹²⁹ *Id.*

¹³⁰ *Id.*

¹³¹ *Id.*

media users to contribute to the creative process by creating their own memes, commenting on those created by others, and sharing them.¹³² This results in a “commons-based peer production” in which multiple people collaborate to create something new.¹³³ Collaborative efforts like these produce the “most democratic manifestation of user generated content.”¹³⁴ It is hard to imagine how this process could more efficiently “stimulate activity and progress in the arts for the intellectual enrichment of the public.”¹³⁵ Memetic marketing, more specifically, takes this to another level by sharing the creativity of memes with a larger, more broad, and diverse audience.

c. Fourth Factor: The Market for the Original Work

The *Campbell* court states that “[t]he use, for example, of a copyrighted work to advertise a product... will be entitled to less indulgence under the first factor of the Fair Use enquiry than the sale of a parody for its own sake,” but offers insufficient reasoning as to why the use of copyrighted material, including parody, in an advertisement is presumptively less fair than the outright sale of a piece that parodies another.¹³⁶ This contention seems to undermine the purpose of the Fourth Factor, which asks to what extent the new work restrains the marketability of the original work.¹³⁷ In the Ninth Circuit, in *Fisher v. Dees*, the Court explains that the presumption against commercial use may be rebutted by showing that the secondary work does not unfairly diminish the value of the original piece.¹³⁸ The nature of an advertisement, as compared to direct sales, makes the chance of competition between the two pieces less likely because, unlike with direct sales, an advertisement is not a substitute for the original work. If anything, it is much more likely that because a piece is featured in an advertisement, it would gain more exposure and potentially increase in marketability.

Meme placement can be interpreted as an inverted form of product placement – “the purposeful incorporation of commercial content into non-commercial settings” for the purpose of advertisement¹³⁹ – as it places a non-commercial, yet highly recognizable, work into an advertisement. An actor in

¹³² Carolyn Gregoire, *Are Internet Memes A Form Of Art? Viral Video Weighs In*, HUFFINGTON POST (Apr. 17, 2012, 3:36 PM), http://www.huffingtonpost.com/2012/04/17/are-internet-memes-a-form_n_1432076.html.

¹³³ Simon, *supra* note 111, at 320.

¹³⁴ Kaplan & Haenlein, *supra* note 35, at 62.

¹³⁵ Leval, *supra* note 58, at 1107.

¹³⁶ *Campbell v. Acuff-Rose Music, Inc.*, 510 U.S. 569, 585 (1994).

¹³⁷ 17 U.S.C. § 107 (1976).

¹³⁸ *Fisher v. Dees*, 794 F.2d 432, 437 (9th Cir. 1986).

¹³⁹ Kaylene Williams et al., *Product Placement Effectiveness: Revisited and Renewed*, J. OF MGMT. AND MKTG. RES. (2011) at 1, 2, <http://www.aabri.com/manuscripts/10712.pdf>.

a movie or sitcom drinking Pepsi, a powerful executive using a MacBook Pro, or a scene in which characters stop to eat at Burger King are all examples of product placement.¹⁴⁰ Just as product placement helps increase exposure and visibility, consumer recognition, and recall of the product, meme placements can increase general awareness of the original work and help develop a market for that work, assuming the work is itself valuable enough for such a market.¹⁴¹ Product placement advertising schemes can result in a return five times that of the original investment.¹⁴² Additionally, product placement increases rates of sale, sometimes up to 1,400 percent.¹⁴³ The major difference between product placement and meme placement is that with product placement, companies usually pay to have their products incorporated into a television show or movie. However, if memetic marketing fails to constitute a Fair Use, an advertiser would need to pay the copyright owner to use the image. The most apparent problem with this scenario is that advertisers would then be paying copyright holders in order to promote the copyright holder's work, in exchange for the right to make use of an expression that *is not* original to that author. Nonetheless, this scenario presumes that the copyright holder to some extent intends to sell or license the photograph; in most cases, this does not occur with the photographs used in Internet memes.

In *Campbell*, the court states that the likelihood of harm to the potential market may be assumed when the "intended use is for commercial gain."¹⁴⁴ However, when the secondary work is sufficiently transformative, "market substitution is at least less certain and market harm may not be so readily inferred" because "it is more likely that the new work will not affect the market for the original... by acting as a substitute for it."¹⁴⁵ As previously explained, since consumers do not purchase advertisements, memetic marketing does not pose such a threat. Additionally, since image memes are often based on images that are created for recreational rather than commercial purposes, there is little likelihood that these images would have been commercially valuable but for their incorporation into memes. The

¹⁴⁰ See, e.g., Pola B. Gupta & Kenneth R. Lord, *Product Placement in Movies: The Effect of Prominence and Mode on Audience Recall*, 20 J. OF CURRENT ISSUES AND RES. IN ADVERTISING, 47, 47 (1998).

¹⁴¹ Williams et al., *supra* note 139, at 5.

¹⁴² Daniel Farey-Jones, *First TV Product Placement Returns 5:1 Media Value*, MKTG. MAGAZINE (Mar. 18, 2011), <http://www.marketingmagazine.co.uk/article/1060352/first-tv-product-placement-returns-51-media-value>.

¹⁴³ E.g. Michael Byers, *Getting Value from Product Placement*, MKTG. MAG. (Mar. 26, 2013), <http://www.marketingmag.com.au/blogs/getting-value-from-product-placement-38035/#.VDe7YecdWeQ>.

¹⁴⁴ *Campbell v. Acuff-Rose Music, Inc.*, 510 U.S. 569, 590-91 (1994).

¹⁴⁵ *Id.* at 591.

concern is not whether “the secondary use suppresses or even destroys the market for the original work... but whether the secondary use *usurps* the market of the original work.”¹⁴⁶ Since the original photographs would have very little market demand but for their appearance in memes, memetic marketing neither suppresses nor usurps the potential market. With regard to image memes that incorporate still shots from television shows, videos, cartoons, etc., this factor will likely weigh against a finding of Fair Use because there are instances in which companies seek to license the use of a cartoon character or the like to use in an advertisement.¹⁴⁷

Due to the highly transformative nature inherent to popular Internet memes and the fact that memes often help create a market for the original work, an Internet meme that incorporates previously published but commercially undesirable photos and images warrants an exception under Fair Use.

CONCLUSION

The foregoing argument fails to answer one important question: if the Fair Use doctrine prevents the copyright holder of the original photograph from asserting her rights in court based on the transformative nature of the work, does that mean that the original creator of the *meme* has a copyrightable work that she can protect against infringement? This presents an interesting conundrum with respect to Internet memes and copyright law. This Comment addresses the applicability of Fair Use in the context of a company that uses a *popular meme* in advertising. This Comment does not address whether or not the *original* creator of the meme infringes upon the rights of the original photograph’s copyright holder. A large part of the analysis associated with Fair Use and memetic marketing relies on the transformative nature of the process of going from a photograph to a meme. Ironically, the original version of a meme is not truly a meme yet: it has not yet gone through the requisite degrees of replication and mutation that a meme must undergo. The very first time a Success Kid meme was created, there arguably was no “Success Kid” character. In fact, the first memetic representations of Sammy’s beach photograph presented a meaning substantially different from the meaning associated with the meme today. The early ancestors of Success Kid represented feelings of anger rather than accomplishment or success, with messages like “I hate sandcastles”

¹⁴⁶ *Blanch v. Koons*, 467 F.3d 244, 258 (2d Cir. 2006).

¹⁴⁷ *Snoopy as a Brand Icon*, METLIFE (July 2010),

https://www.metlife.com/assets/cao/gbms/brandcenter/visual/snoopy/brand-icon/09020651_Snoopy_Brand_con_v3.pdf (“Since 1985 Snoopy has served as an ambassador for MetLife, enhancing the warm, approachable quality that is important to the MetLife brand”).

juxtaposed on the photo,¹⁴⁸ but in time, “it naturally evolved into Success Kid.”¹⁴⁹

It is unlikely that early ancestors of popular memes exhibit the necessary originality or transformation to merit legal protection. At this stage, a would-be meme has yet to truly transform. Therein lies the conundrum: memes are original to no one because they are the product of a mass, collaborative effort, and therefore, no single, identifiable person can claim copyright ownership over a meme.

It is hard to tell how long something will remain a part of popular culture. Whether Internet memes are a passing trend or an emerging staple is impossible to know. However, Internet memes are a part of popular culture *now* and as a result, companies and consumers alike enjoy participating in the creation and dissemination of those memes. As companies continue to use social media and memes, questions of copyright infringement will continue to be raised. However, much like parody and appropriation art are allowed under the Fair Use defense, memetic marketing, sharing many of the same material qualities, merits the same consideration. The essence of copyright law is to promote and progress the development of science and art. It would substantially undermine this purpose to take from the public that which the public, collectively, created. As a cultural phenomenon and the product of a communal effort to transform and attribute new meaning to an image, Internet memes promote creative expression on a large scale, and memetic marketing will only increase the reach and scope of this influence.

¹⁴⁸ *Success Kid/I Hate Sandcastles*, KNOW YOUR MEME, <http://knowyourmeme.com/memes/success-kid-i-hate-sandcastles> (last visited Oct. 1, 2014).

¹⁴⁹ Erickson, *supra* note 39.

HAZY JURISDICTION: CHALLENGES OF APPLYING THE STORED COMMUNICATIONS ACT TO INFORMATION STORED IN THE CLOUD

*Rebecca Eubank**

INTRODUCTION

While the model of the Internet operating in the cloud¹ appears to defy national boundaries, governments are increasingly asserting jurisdiction over the users, providers, and physical infrastructure of cloud-based services that exist in their territory. A fear of user privacy violations has put pressure on central governments to implement policies assuring, to the extent such assurance may be provided, they can adequately control the flow of data out of the country and protect the citizens' private information and communications.²

In this context, the Southern District of New York upheld a bench order issuing a warrant that would require Microsoft, one of the largest U.S. Internet Service Providers (ISPs), to turn over data that is stored on a server in Ireland to the U.S. government.³ The order asserts the U.S. government has access to the information based on the location of Microsoft, a company incorporated in the U.S.⁴ The order does not directly address Microsoft's assertions that such a warrant cannot be applied to extraterritorially stored

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¹ 'Cloud computing' has been defined by the National Institute of Standards and Technology as: "ubiquitous, convenient, on-demand network access to a shared pool of configurable computing resources ... that can be rapidly provisioned and released with minimal management effort or service provider interaction." PETER MELL & TIMOTHY GRANCE, NAT'L INST. OF STANDARDS AND TECH., DEP'T OF COMMERCE, *The NIST Definition of Cloud Computing*, special pub. 800-145, 1-2 (2011). The NIST definition includes five essential characteristics, (1) on demand self-service, (2) broad network access, (3) resource pooling, (4) rapid elasticity, (5) measured service. *See id.* at 2. While there are many technological differences between the "cloud" and the Internet, the relevant difference to the instant discussion is the extensive availability of storage in the cloud that is unavailable on the Internet. Essentially, the Internet provides services to users while the cloud allows users to occupy space by means of inexpensively storing information from something as basic as emails to something as extensive as an application or operating system. *See generally* Lisa Angelo, *Exploring Legal Issues at High Altitudes: The Law in the Cloud*, 20 CURRENTS INT'L TRADE L.J. 39, 40 (2011).

² *See generally* Jonah Force Hill, *The Growth of Data Localization Post Snowden*, 2 LAWFARE RES. PAPER SERIES 3 (2014).

³ *In re* Warrant to Search a Certain E-Mail Account Controlled & Maintained by Microsoft Corp., 15 F. Supp. 3d 466, 467 (S.D.N.Y. 2014), *adopted by* No. 1:13-mj-02814 (S.D.N.Y. Aug. 29, 2014).

⁴ *Id.* at 468, 476.

data.⁵ The order's justification rests on a tenuous assumption that the Stored Communications Act (SCA), the U.S. law governing such information, creates a warrant that applies extraterritorially when the ISP storing the data is a U.S. company.⁶ This case raises a fundamental challenge for those determining whether the nationality of (1) the company providing access and/or storage over the Internet, (2) the user of these services, or (3) the country where the data is physically stored is the correct basis for applying the SCA to data. Basing jurisdiction on any of these – location of the company providing storage, of the user, or of the stored data – has advantages and disadvantages. Even if the courts were to settle on one of the three, the potential for a conflict of laws would likely remain.

Courts have differing interpretations of whether the SCA is appropriately applied based on the location of the IPS, user or data, and how the government obtains access to data through the SCA. The Microsoft warrant case demonstrates that application of the SCA based on the location of the ISP can lead to conflicts with the data laws of other nations. Legislation recently introduced in the U.S. Senate would clarify to whom the SCA applies by basing jurisdiction on the location of the user and in doing so attempt to resolve conflicts of law raised in the Microsoft warrant case by requiring a court to modify warrant orders if such conflicts arise.

Part one of this note evaluates the opinion in *The Matter of a Warrant to Search a Certain E-mail Account Controlled and Maintained by Microsoft Corporation* (the “Microsoft warrant case”) and the questions that the opinion leaves unanswered. Part two addresses the structure of the SCA and application of the SCA to the developing cloud. Part three evaluates the various bases for jurisdiction: the location of (1) the company providing access and/or storage over the Internet – the ISP, (2) the user of these services, or (3) the country where the data is physically stored. Part four discusses a legislative proposal directed at resolving the conflicts in the Microsoft warrant case.

⁵ *Id.* at 467.

⁶ *Id.* at 466-67. This note limits its consideration to a private user's data stored on a secured server. There is a broad and equally complex discussion ongoing regarding information made publicly available over the Internet and what jurisdictional basis governments may have for litigating alleged harms such information may cause within their borders. See generally David G. Post, *Governing Cyberspace: Law*, 24 SANTA CLARA HIGH TECH. L. J. 883, 885-88 (2007) (discussing the challenges of asserting jurisdiction over information a government finds offensive, dangerous, or illegal posted on a public website).

I. THE MICROSOFT WARRANT CASE AND THE LEGAL QUESTIONS LEFT BY THE COURT

On April 24, 2014, the Southern District of New York delivered a magistrate opinion, *In re Warrant to Search a Certain E-Mail Account Controlled & Maintained by Microsoft Corp* (the “Microsoft warrant case”) issuing a search warrant for a Microsoft e-mail account.⁷ Microsoft complied with the warrant, producing the content requested that was stored in the United States.⁸ However, Microsoft refused to turn over data requested by the warrant that was stored on servers overseas.⁹ The court determined that the Stored Communications Act (SCA) creates a hybrid subpoena-warrant that required Microsoft to produce all requested data regardless of location.¹⁰ This opinion creates several problems.

The court assumes jurisdiction over all data in Microsoft’s control related to this case based on the fact that Microsoft is headquartered in the United States.¹¹ This is not necessarily an incorrect assumption but in making this assertion of jurisdiction over the ISP, the court created a conflict of laws in applying the SCA extraterritorially.¹² The court justified this assertion and extension of the SCA because, according to the opinion, to hold otherwise would encourage evasion of U.S. law.¹³ Additionally, the court asserted the formal process of gathering information stored abroad, primarily through Mutual Legal Assistance Treaties (MLATs), is too cumbersome for application in these types of criminal investigations.¹⁴

1. *The Microsoft Warrant Case*

The contention following the Southern District of New York’s opinion in the Microsoft warrant case is that some of the data required by the warrant is stored in a data center in Dublin, Ireland, beyond the territorial reach of the SCA under which the U.S. Government makes its case for access to the data.¹⁵ Thus far, Microsoft has refused to turn over the data stored in Ireland but has complied by producing data stored within the United States.¹⁶

⁷ *In re Warrant to Search*, 15 F. Supp. 3d 466, 476 (S.D.N.Y. 2014).

⁸ *Id.* at 468.

⁹ *Id.*

¹⁰ *Id.* at 471, 477.

¹¹ *Id.* at 467-68.

¹² *See infra*. Part III for discussion of bases for jurisdiction over Internet data.

¹³ *In re Warrant to Search*, 15 F. Supp. 3d at 467.

¹⁴ *Id.* at 475.

¹⁵ *Id.* at 467.

¹⁶ *Id.* at 468.

According to the April 24, 2014 opinion, Microsoft's counter argument was that a warrant permits government search and seizure and such a warrant cannot be applied extraterritorially.¹⁷ Search and seizure of property cannot take place outside the territory of the United States pursuant to a U.S. warrant.¹⁸ Microsoft argued that because the data was stored outside the United States, the warrant obtained under the SCA could not reach extraterritorially stored data.¹⁹ The opinion rebuts this argument saying there is no clear indication that the SCA warrant was intended to be limited to the territorial jurisdiction of the United States,²⁰ though the SCA refers to the rules and procedures for obtaining a warrant under the Federal Rules of Criminal Procedure, which do include a limit on territoriality.²¹

The opinion addresses this limitation by determining that the SCA creates a hybrid warrant-subpoena.²² Though the statute expressly uses the term "warrant," the court reasoned the request for information is served like a subpoena on the ISP creating a "hybrid" warrant-subpoena:

the resulting order is not a conventional warrant; rather, the order is a hybrid: part search warrant and part subpoena. It is obtained like a search warrant when an application is made to a neutral magistrate who issues the order only upon a showing of probable cause. On the other hand, it is executed like a subpoena in that it is served on the ISP in possession of the information and does not involve government agents entering the premises of the ISP to search its servers and seize the e-mail account in question.²³

Under the court's reasoning, this hybrid retains the characteristics of a subpoena's request for information, which has not been limited to territorial boundaries, but also requires the third party to produce information in their possession.²⁴

¹⁷ *Id.*

¹⁸ *Id.* at 476. This comment will discuss the order and law pertaining to the government's ability to access the content and does not address the Constitutional concerns regarding extraterritorial search and seizure.

¹⁹ *In re Warrant to Search*, 15 F. Supp. 3d at 468.

²⁰ *Id.* at 471.

²¹ 18 U.S.C. § 2703(a) (2009); FED. RULES OF CRIM. PROC., SEARCH AND SEIZURE, Rule 41(a) (2015).

²² *In re Warrant to Search*, 15 F. Supp. 3d at 471.

²³ *Id.*

²⁴ *Id.* at 472.

The text of the SCA does not refer to the location of the data covered by the law, whether in the United States or not. The opinion justifies applying the SCA to extraterritorially stored data from the Senate bill report and the White House report issued with the passage of the law.²⁵ The Senate report indicates Congress only recognized that the procedures under the act would not result in searches conducted directly on data held by the user but on data held by a third party, in this case the ISP, who actually stored and maintained the data.²⁶ The White House report on the other hand specifically states that the act is not intended to have extraterritorial effect.²⁷ The opinion in the Microsoft warrant case concludes that the White House report remains ambiguous for two reasons. First, the Senate report references a case in which the court found information intercepted in Canada by Canadian authorities could be admitted into a United States court proceeding, though the Canadian authorities' actions could not have been carried out in the U.S. because those actions were illegal under U.S. law.²⁸ The opinion suggests this court's holding indicates the SCA was intended to address individual rights affected by the SCA and not the reach of the government.²⁹ Second, the SCA never makes clear whether government access refers to the location of the actual raw data or the location of the ISP in possession of the data.³⁰ The opinion concludes the SCA can be applied based solely on the location of the ISP.³¹

The opinion also notes that the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 – the Patriot Act – specifically provides for nationwide service of search warrants for electronic evidence.³² The House of Representatives' report accompanying the Patriot Act explains this provision is intended to “address delays caused by the cross-jurisdictional nature of the Internet.”³³ The report states “Section 108 amends § 2703 [of the Stored Communications Act] to authorize the court with jurisdiction over the investigation to issue the warrant directly, without requiring the intervention of its counterpart in the district where the ISP is located.”³⁴ The Microsoft warrant opinion deduces from this explanation that the location

²⁵ *Id.* at 472-73.

²⁶ S. REP. NO. 99-541, at 3 (1986).

²⁷ *In re* Warrant to Search, 15 F. Supp. 3d at 473.

²⁸ *Id.* (citing *Stowe v. Devoy*, 588 F.2d 336 (2d Cir. 1978)).

²⁹ *Id.*

³⁰ *Id.*

³¹ *Id.* at 474.

³² *Id.* at 473.

³³ H.R. REP. NO. 107-236(I), at 57 (2001).

³⁴ *Id.*

of the property, in this case the data, is associated with the location of the ISP, not the location of the server where the data is actually located.³⁵

The opinion extrapolates out of the national cross-jurisdiction service of warrants under the Patriot Act that Congress intended SCA warrants to reach beyond the United States' borders.³⁶ The order postulates that, if jurisdictional control were based on the location of the data, then users could manipulate the system to avoid the reach of US law.³⁷ This concern arises as Microsoft determines the location of the user and where to store data in part based on the country code provided when a user sets up a service, such as e-mail or document storage, with the ISP.³⁸ The opinion theorizes that a user could enter a different country code to avoid the application of U.S. law.³⁹

The opinion raises a concern that if the reach of an SCA warrant were limited to the territory of the United States, the government would need to undergo a complex process to access data stored on servers overseas. Currently, cooperation between governments on criminal cases and sharing information related to such cases is governed by Mutual Legal Assistance Treaties (MLATs).⁴⁰ The opinion notes that obtaining data or other information through an MLAT remains a laborious process,⁴¹ and working through an MLAT would impede the government's access to the data because the search would have to be made in accordance with the policy concerns and laws of the requested country.⁴² Finally, MLATs have been negotiated with a finite number of countries, and, where no such treaty is in place, the government would have limited recourse to access such data in those countries.⁴³

According to the opinion in the Microsoft warrant case, the SCA creates a hybrid warrant-subpoena that permits application of the law extraterritorially. The court supports this application of the law based on the national warrant authority provided under the Patriot Act. The opinion finds the extraterritorial application of the law necessary, lest users and ISPs actively attempt to avoid American jurisprudence.

³⁵ *In re Warrant to Search*, 15 F. Supp. 3d at 474.

³⁶ *Id.*

³⁷ *Id.*

³⁸ *Id.*

³⁹ *Id.*

⁴⁰ *In re Warrant to Search*, 15 F. Supp. 3d at 474.

⁴¹ *Id.* at 475.

⁴² *Id.* at 474-75.

⁴³ *Id.* at 475.

2. *Questions Left by the Microsoft Warrant Case*

The opinion in the Microsoft warrant case leaves open several questions about the extraterritorial reach of the SCA. The court presumes that jurisdiction over the Internet Service Provider (ISP) necessarily gives the court access to data in the ISP's control.⁴⁴ This assumption raises two of three jurisdictional bases that have been employed by governments to exercise control over cloud data: the location of the ISP and the location of the data itself. Governments have also proposed to exercise jurisdiction based on the location of the user.⁴⁵

The court makes something of a logical leap in the discussion of cross-jurisdictional warrants provided for under the Patriot Act.⁴⁶ Essentially, the Patriot Act allows for a warrant to be issued by a court in jurisdiction "A" on an ISP located in jurisdiction "B" without working through the local court system in jurisdiction "B."⁴⁷ The impetus for this provision, in part, was to speed up the process of obtaining a search warrant.⁴⁸ Another explanation is the provision was a product of Congressional recognition that the majority of U.S. ISPs are based in either California or Virginia. Requiring courts in those jurisdictions to process every warrant request for information from an ISP could result in a significant system backlog in the California and Virginia courts.⁴⁹ While the court in the Microsoft warrant case takes the provision as indication that Congress expected the SCA to reach beyond the United States' borders, it appears the provision was aimed at alleviating procedural barriers in the United States' judicial system. Furthermore, there is no indication in the text of the SCA that Congress intended it to have extraterritorial application.⁵⁰

The court bases its conclusion of applying the SCA warrant extraterritorially on bill reports written in the process of passing the act into law. The court does not consider that the ISPs and the Internet that Congress intended to regulate was the Internet of 1986, a time when the Internet was in its infancy, comprised of a network created by United States based ISPs working through United States servers and primarily used by

⁴⁴ *Id.* at 468.

⁴⁵ See discussion *infra* Part III.

⁴⁶ *In re Warrant to Search*, 15 F. Supp. 3d at 473-74.

⁴⁷ H.R. REP. NO. 107-236(I), at 57 (2001).

⁴⁸ *Id.*

⁴⁹ Patricia L. Bellia, *Surveillance Law Through Cyberlaw's Lens*, 72 GEO. WASH. L. REV. 1375, 1454 n. 402 (2004).

⁵⁰ See *Zheng v. Yahoo! Inc.*, No. C-08-1068, 2009 WL 4430297, at 2-3 (N.D. Cal. Sept. 18, 2010) (finding the SCA does not apply extraterritorially).

U.S. citizens.⁵¹ While this computer network was rapidly growing and would soon reach past the U.S.'s borders, Congress's focus was most likely on the existing U.S. network. Therefore, it seems unlikely that Congress intended or even contemplated international jurisdictional battles over Internet data that might arise from extraterritorial application of the law.

There is an overarching principal left unaddressed by the Microsoft warrant opinion; that the court presumes a U.S. law has no extraterritorial application unless clearly stated otherwise.⁵² This "commonsense" notion⁵³ prevents a clash of laws of the kind the Microsoft warrant case creates.⁵⁴ If the presumption against applying the SCA extraterritorially is not taken into account, then the SCA potentially creates a conflict of laws as American ISPs comply with U.S. government warrants for data stored abroad.⁵⁵ Blind application of the SCA extraterritorially puts these providers in the position of having to navigate potential conflicts when the U.S. government is likely the better agent to enter into a dialogue with foreign governments to resolve requests conflicting with their data policies.⁵⁶ This is true because, regardless of the court's conclusions on whether or not the United States government may properly access the data under the SCA, the foreign jurisdictions where the data is stored may nonetheless feel that such an application of U.S. law violates their own sovereignty.⁵⁷

The potential repercussions of such a conflict are not considered in the opinion on the Microsoft warrant case. The ISPs who addressed their concerns to the court through *amicus* briefs, including Cisco and Apple, raised concerns that an indelicate handling of international law conflicts could result in retaliatory or reciprocal action.⁵⁸ Reciprocal actions by foreign governments may include demanding information stored on servers in the United States or otherwise in possession of an American ISP.⁵⁹ Retaliatory actions could include any number of steps by foreign

⁵¹ Orin S. Kerr, *Next Generation Communications Privacy Act*, 162 U. PA. L. REV. 376, 395 (2013).

⁵² *EEOC v. Arabian Am. Oil Co.*, 499 U.S. 244, 248 (1991).

⁵³ *Smith v. United States*, 507 U.S. 197, 204 n. 5 (1993).

⁵⁴ *EEOC v. Arabian Am. Oil Co.*, 499 U.S. at 261 (Marshall, J., dissenting).

⁵⁵ Brief for Apple Inc. and Cisco Systems, Inc. as Amicus Curiae Supporting Respondents at 6, *In re Warrant to Search a Certain E-Mail Account Controlled & Maintained by Microsoft Corp.*, 15 F. Supp. 3d 466, 475 (S.D.N.Y. 2014) (No. 1:13-mj-02814).

⁵⁶ *Id.* at 1.

⁵⁷ *Id.* at 3.

⁵⁸ *Id.* at 1.

⁵⁹ *Id.* at 1-2 (discussing a foreign government obtaining data from a U.S. ISP based on the presence of a subsidiary of that ISP in the sovereign borders of the foreign country).

governments to either control the flow of data across their borders or bar US ISPs all together for broad policy concerns about privacy.⁶⁰

In contrast to concerns raised by ISPs, there are examples of non-digital disputes that have resulted in the laws of one country spilling over into the territory of another.⁶¹ In the context of such non-digital disputes where a company based in the United States is prosecuted under a foreign nation's laws, that company has a choice to either comply with local law or to remove themselves from the market.⁶² The second option seems somewhat unrealistic, especially when the European Union represents a significant market. The first option, complying with the law, where laws in two countries are dissimilar may require different compliance strategies. Requiring a company to conform to the laws of every country where they operate seems reasonable, if bothersome. However, this scenario leads back to the original problem where compliance with one law leads to noncompliance with another.

The conflict of laws problem is unique in the area of cloud computing because the nature of the cloud computing model takes advantage of "scalability."⁶³ Scalability necessitates using infrastructure placed in a wide variety of legal jurisdictions.⁶⁴ The cloud model, as it functions now, is predicated on a concept of freely moving data. While the ISP has control over the location of their infrastructure, an increasing trend toward restricting the actual data may begin to limit an ISP's choices for locating infrastructure or will give rise to increased conflicts between new data specific legal regimes.

Finally, in its opinion, the court rejects the MLAT process as an appropriate mechanism for the United States government to obtain data in another country.⁶⁵ The ISPs filing *amicus* briefs raised concerns that this will encourage foreign governments to do the same, opting for a more direct demand for data.⁶⁶ The briefs urge that, while admittedly laborious, the MLAT process has the advantage of heading off conflicts of law that may

⁶⁰ See discussion *infra*. Part III (4).

⁶¹ See e.g., JACK GOLDSMITH & TIM WU, *Who Controls the Internet? Illusions of a Borderless World* 154-56 (Oxford Univ. Press 2008) (discussing government enforcement actions over Internet intermediaries) (noting environmental and U.S. Federal Trade Commission cases that have had extraterritorial effects).

⁶² *Id.* (discussing government enforcement actions over Internet intermediaries).

⁶³ See discussion *infra*. Part III (4).

⁶⁴ Damon C. Andrews & John M. Newman, *Personal Jurisdiction and Choice of Law in the Cloud*, 73 MD. L. REV. 313, 325 (2013).

⁶⁵ *In re Warrant to Search*, 15 F. Supp. 3d at 474-75.

⁶⁶ Brief in Support of Motion, *supra* note 55, at 4.

arise from SCA warrants.⁶⁷ Frustrations with the MLAT process go both ways. Foreign law enforcement bodies have raised concerns that the U.S. Justice Department is too slow to respond, and the process is too cumbersome.⁶⁸ But the fact that governments found it necessary to create MLATs indicates that there is a need for a formal process for law enforcement cooperation.⁶⁹ If the MLATs no longer satisfactorily serve their purpose, then an analogues cooperation mechanism should be created.⁷⁰

MLATs are negotiated primarily on a bilateral basis, though some have been negotiated regionally, and provide a process by which one government may request information from another government.⁷¹ Traditionally, MLATs were limited to activities such as transmitting evidence and documents or even extradition in criminal cases.⁷² The U.S. currently has MLATs in place with 60 foreign countries.⁷³ The scope of these treaties varies, generally on the basis of the larger relationship between the sovereign governments, which speaks to the mutual level of trust.⁷⁴ In the instant case, the U.S. has an MLAT with Ireland. The Irish government, in the appellate phase of the Microsoft warrant case, submitted an *amicus* brief stressing both the importance of this agreement and indicating willingness to work through the formal legal channels to provide the requested information.⁷⁵

The questions left by the court in the Microsoft warrant case opinion demonstrate the challenge of applying the SCA to the more technologically complex modern era. The proper entity over which the court may assert jurisdiction under the law – the ISP, the user and the data – is not clearly addressed. While the court makes the case that the law is intended to apply extraterritorially, contrary evidence unaddressed by the court's opinion undercuts the rationale for issuing the warrant. Though the court

⁶⁷ *Id.* at 7.

⁶⁸ Hill, *supra* note 2, at 26.

⁶⁹ Brief in Support of Motion, *supra* note 55, at 11.

⁷⁰ While reform efforts have been discussed, the deficiencies of the MLAT process and merits of reform proposals will not be discussed here.

⁷¹ Michael A. Rosenhouse, *Validity, Construction, and Application of Mutual Legal Assistance Treaties (MLATs)*, 79 A.L.R. Fed. 2d 375, 5 (2013).

⁷² TIM RENE SALOMON, MAX PLANCK ENCYCLOPEDIA OF PUBLIC INTERNATIONAL LAW ¶3 (2013).

⁷³ United States Department of State, *Treaties in Force* (Jan. 1, 2013), available at <http://www.state.gov/documents/organization/218912.pdf>.

⁷⁴ Salomon, *supra* note 72, at ¶16.

⁷⁵ Brief for Ireland as Amici Curiae in Support of Motion at 2; see generally *In re Warrant to*, 15 F. Supp. 3d 466 (14-2985-CV).

rejects formal channels for obtaining data through the MLAT process, this process provides the best means for navigating differential laws on data.

II. THE STORED COMMUNICATIONS ACT AND APPLICATION TO THE CLOUD

In the Microsoft warrant opinion, the court relies on the SCA to assert authority over the data stored on Microsoft's servers.⁷⁶ The SCA is one of the central laws governing stored data in the United States, though the legislation was passed by Congress over twenty-five years ago. This section discusses the pertinent provisions of the SCA and the deficiencies of applying the law to modern cloud computing.

1. *The Stored Communications Act*

The Stored Communications Act (SCA) was passed in 1986 as part of the Electronic Communications Privacy Act (ECPA).⁷⁷ The act developed from federal laws prohibiting wiretapping, which date back as far as the First World War.⁷⁸ The SCA provides protection and a framework for the government to access data that is at rest – or “in storage” – while other titles of ECPA protect information in motion, for example wiretapping.⁷⁹

Section 2702 of the SCA identifies two groups of service providers handling stored data: (1) those providing public electronic communications services (ECS), - think of web-based e-mail services such as Gmail - and (2) those providing public remote computing services (RCS) - think of document production tools available over the web such as Google Docs.⁸⁰ Section 2702 defines the contexts in which service providers may *voluntarily* disclose data to government or law enforcement agencies.⁸¹ Similarly, Section 2703 of the law outlines a framework under which ECS and RCS providers are *required* to disclose data. Section 2703 is particularly important to this discussion.

Section 2703 of the SCA refers to two groups of stored communication and related data: (1) recent or intermediate data stored for

⁷⁶ See *infra* Part I for discussion of the United States Court for the Southern District of New York's application of the SCA to the Microsoft warrant case.

⁷⁷ S. REP. NO. 99-541 at 8 (1986).

⁷⁸ *Id.* at 1-2.

⁷⁹ 18 U.S.C. § 2510 (17) (2012) (defining “electronic storage” as “(A) any temporary, intermediate storage of a wire or electronic communication incidental to the electronic transmission thereof; and (B) any storage of such communication by an electronic communication service for purposes of backup protection of such communication.”).

⁸⁰ 18 U.S.C. § 2702(a)(1)-(2).

⁸¹ 18 U.S.C. § 2702(b)-(c).

ease of access and (2) data stored for more than 180 days.⁸² A search warrant is required for government entities to compel access to data in the first category, stored for less than 180 days; while a warrant, subpoena, or court order may suffice for a government entity seeking access to data stored for more than 180 days.⁸³

2. *Applying the SCA to the Cloud*

Comparing the Internet of 1986 to the modern Internet assists in understanding the distinctions drawn in the SCA. The law breaks down based on the business model of the 1986 Internet where providers of electronic communications services (ECS) were separate entities from those providing remote computing services (RCS).⁸⁴ The SCA imparts higher protections on intermediate data when, in 1986, the high costs of data storage meant there was little data stored for more than 180 days that would qualify for the lower protections afforded to backup data.⁸⁵

Notably, the U.S. had predominant, if not exclusive, control over the infrastructure of the Internet in the decades leading up to the passage of the SCA.⁸⁶ The Internet Congress sought to regulate in 1986 was largely a U.S.-based service provided by U.S. companies and used by U.S. citizens.⁸⁷ To emphasize the predominance of the U.S. in the digital sphere, in the late 1980s, 80 percent of the information available on the Internet was in English.⁸⁸ This number fell dramatically in the years following – in 2005, less than one third of Internet users were English speakers, and the content on the Internet reflected this.⁸⁹

There are gaps in the judicial frameworks established under the SCA when the law is applied to cloud computing. Because the law contemplates ISPs providing communications services and remote computing services as separate entities, it is unclear how to apply the law in a context where one ISP provides both services. Because the costs of data storage were so high in 1986, little data was stored for an extended period.⁹⁰ If the impetus behind a heightened protection standard for intermediate data

⁸² 18 U.S.C. § 2703(a) (2009).

⁸³ *Id.*

⁸⁴ Kerr, *supra* note 51, at 395-96.

⁸⁵ *Id.* at 391.

⁸⁶ See generally Goldsmith & Wu, *supra* note 61, at 33-36 (discussing the naming protocols for new Internet sites and computes joining the Internet as a function carried out in the United States).

⁸⁷ Kerr, *supra* note 51, at 405.

⁸⁸ Goldsmith & Wu, *supra* note 61, at 51.

⁸⁹ *Id.*

⁹⁰ Kerr, *supra* note 51, at 391.

was that such data would provide more granular information than stored, then it is reasonable to infer a heightened standard of protection ought to be afforded to stored data today because this data is much more information rich than in 1986.⁹¹ Because the SCA's framework does not easily translate to the modern infrastructure of the Internet, applications of the statute lead to differences in the correct standard of protection afforded to data in the scope of the law.

Some courts have addressed the dissimilar approaches to data in the SCA by holding that where one company provides both these services, the government need only meet the lower standard of acquiring a subpoena for access to the data because the data is not covered under the higher threshold required for stored data.⁹² Other courts have interpreted the shifting structure of the Internet in the context of cloud computing to mean that an ISP providing both the intermediate and long-term storage is subject to the heightened showing required by a warrant before it must turn data over.⁹³ This split in the courts is problematic because it points to the undetermined application of the law to data.

To date, there have been few cases considering the extraterritorial application of the SCA. In *Zheng v. Yahoo!*, the Northern District of California court ruled that the SCA had no effect on *activity* outside the United States and therefore a foreign citizen could not bring a claim under the law.⁹⁴ Conversely, in *Suzlon Energy Ltd. v. Microsoft Corp.*, the 9th Circuit ruled the SCA does apply to *persons* outside the United States when their data is stored in the United States.⁹⁵ None of the jurisprudence on the extraterritorial application of the SCA addresses whether the law applies to *data* stored abroad. Short of either a Supreme Court ruling on the application of the law or a statutory clarification, this issue will likely remain open to debate.

These gaps are significant as Constitutional objections have been raised to the dissimilar frameworks set forth for some kinds of data under the SCA. Courts have gone as far as to hold the SCA unconstitutional for failing to provide adequate protection to all personal data.⁹⁶ Constitutional

⁹¹ See S. REP. No. 99-541, at 8, 38 (1986) (describing the process of storing mail until a user has downloaded the message and suggesting that the only information stored after the download would be information regarding the user).

⁹² See *United States v. Weaver*, 636 F. Supp. 2d 769, 773 (C.D. Ill. 2009).

⁹³ See *Theofel v. Farey-Jones*, 359 F.3d 1066, 1075, 1077 (9th Cir. 2004).

⁹⁴ *Zheng v. Yahoo! Inc.*, No. C-08-1068 MMC, 2009 WL 4430297, 7 (N.D. Cal. Dec. 2, 2009).

⁹⁵ *Suzlon Energy Ltd. v. Microsoft Corp.*, 671 F.3d 726, 730 (9th Cir. 2011).

⁹⁶ See *United States v. Davies*, 754 F.3d 1205 (11th Cir. 2014) (finding that SCA permitting government access to cell site location information without demonstrating probable

issues will not be addressed in this discussion, though they play a role in the reasoning of the Court order in the Microsoft warrant case.⁹⁷

The basic structure of the SCA appears inconsistent with the cloud computing model. These inconsistencies make the application of the law to modern data questions difficult, if not impossible. A broad update to the law that addresses the modern structure and concerns surrounding the Internet and data storage is likely the best solution. In the interim, a solution that addresses conflicts, like those raised in the Microsoft warrant case, may be more practical.

III. JURISDICTION OVER THE CLOUD

The SCA's structure and provisions are designed to regulate infrastructure, providers and users that were largely in the United States.⁹⁸ As the Internet has grown more diverse, it has expanded the SCA, leaving gaps and inconsistent application in the United States court system.⁹⁹ As the Internet reaches an increasingly international user base, it has generated an international body of law – law that overlaps and often contradicts. For such an international and amorphous entity, the question is posed: how can one country assert jurisdiction over any part of the Internet or over what parts might a country assert jurisdiction? Countries have asserted jurisdiction over Internet data based on the location of Internet users, the providers of Internet services, the location of raw data, or some combination of these three. In applying the SCA, U.S. courts have based jurisdiction on one or more of these bases.

1. *Jurisdiction in the United States Court System*

In the United States Court system, jurisdiction over legal actions has developed from Constitutional protections of Due Process.¹⁰⁰ The Supreme Court announced in *International Shoe Co. v. State of Washington* that a court may exercise jurisdiction over a matter where the offending

cause violates Fourth Amendment protections), *vacated and reh'g granted*, 573 F. App'x. 925, *and rev'd*, 785 F.3d 498 (2015) (en banc).

⁹⁷ *In re Warrant to Search*, 15 F. Supp. 3d at 471-77 (discussing the attempt by the SCA to extend traditional Fourth Amendment protections to in the internet).

⁹⁸ Kerr, *supra* note 51, at 405.

⁹⁹ *See supra* Part II for discussion of challenges in applying the SCA to current questions regarding stored data.

¹⁰⁰ *See* U.S. CONST. amend XIV, §1 (prohibiting “depriv[ing] any person of life, liberty, or property, without due process of law”).

party has certain minimum contacts with the forum jurisdiction.¹⁰¹ In that case, while the company defending itself had no brick and mortar stores in the state of Washington, selling wares through a salesman was “continuous and systematic” enough to substantiate bringing a claim against the company in Washington courts.¹⁰²

Necessary minimum contacts have been further defined by the Supreme Court in *Calder v. Jones* as intentional harm aimed at the forum that produces injury in that forum.¹⁰³ Intentional harms aimed at a forum in the *Calder* case included a news article with damaging effects to a public figure’s reputation.¹⁰⁴ The article author and editor knew the article would cause the majority of its damage in California where the public figure’s social and professional contacts were concentrated.¹⁰⁵ In other words, even though the defendants never entered a California jurisdiction in committing the acts which gave rise to the action, the intentional harm caused in California was sufficient for jurisdictional purposes.

Application of these jurisdictional concepts to the Internet has relied in part on the harms caused in the forum, but has also tied assertions of jurisdiction to the Internet users, the location of Internet infrastructure - such as servers, or both. For example, in *Aitken v. Communications Workers of America*, the United States court for the Eastern District of Virginia asserted its jurisdiction over the action was proper because, among other factors, the servers which the e-mails passed through were stored in Virginia.¹⁰⁶ The United States Court for the Eastern District of Ohio in *Ferron v. E360Insight, LLC* found that jurisdiction was proper where the Internet user and the Internet service provider were located in Ohio.¹⁰⁷ In *Ferron*, the court also noted the harm must be in the same forum.¹⁰⁸

The harms based test for jurisdiction may be the standard going forward for adjudicating conflicts that relate to the Internet. However, applications of the SCA have focused on the location of either the ISP, user or the data, in addition to the harm. Assertions of jurisdiction under any of these bases are unlikely to entirely resolve potential conflicts of law.

¹⁰¹ *Int’l Shoe Co. v. State of Washington*, 326 U.S. 310, 316 (1945).

¹⁰² *Id.* at 317.

¹⁰³ *Calder v. Jones*, 465 U.S. 783, 788-89 (1984).

¹⁰⁴ *Id.* at 789-90.

¹⁰⁵ *Id.*

¹⁰⁶ *Aitken v. Commc’ns Workers of Am.*, 496 F. Supp. 2d 653, 659-60 (E.D. Va. 2007).

¹⁰⁷ *Ferron v. E360Insight, LLC*, No. 2:07-CV-1193, 2008 WL 4411516, at *3 (S.D. Ohio Sept. 29, 2008).

¹⁰⁸ *Id.*

2. *Asserting Jurisdiction Based on the Location of the Internet Service Provider*

Asserting jurisdiction over data based on the location of the Internet Service Provider (ISP) appears relatively straightforward. The contract laws, laws of incorporation, tax laws, even labor law and building codes of the country in which an ISP is located will govern the ISP in each of these areas. Courts basing jurisdiction over data on the location of the ISP might emphasize that their authority over the company in any of these areas is no different than asserting jurisdictional control over the company's data.

The 9th Circuit has proposed to extend SCA protections on the basis of the location of the ISP. In *Suzlon Energy Ltd. v. Microsoft*, the court read the SCA's protections of "any person's" data to include foreign citizens.¹⁰⁹ Because the ISP in question, Microsoft again, was a U.S. company, the court assumed it had jurisdiction over the company.¹¹⁰ The court did not specifically address the SCA's application to the location of the data but assumed that to the extent data exists in the United States and is controlled by an American ISP, the SCA applies to any Internet user, and the law can be applied extraterritorially.¹¹¹ This assumption that the SCA may be applied extraterritorially assumes that the U.S. standard of government access and standard of protection is a standard which international users, or their governments, would accept. Rather, the trend appears to be that other nations prefer to enact their own data protection standards and are generally distrustful of American ISPs, which foreign governments fear may be subject to overly broad readings of statutes like the SCA.¹¹²

3. *Asserting Jurisdiction Based on the Internet User*

Basing jurisdiction on the nationality of the Internet user also appears to be a straightforward proposition, as all users are citizens of one nation or another. Users will generally access the Internet from their country of origin, and their ISP will assign them an IP address based on this location.¹¹³ Moreover, the user's expectations of data security and what information can be turned over to their government are formed by the

¹⁰⁹ *Suzlon Energy Ltd. v. Microsoft Corp.*, 671 F.3d 726, 730 (9th Cir. 2011).

¹¹⁰ *Id.*

¹¹¹ *Id.*

¹¹² Hill, *supra* note 2, at 5.

¹¹³ Kerr, *supra* note 51, at 416.

norms of that country.¹¹⁴ This approach would provide some framework of expectations to users about the kinds of information that can be turned over to their government or to a foreign government.

While there are advantages to basing jurisdiction over data on the location of the user, similar challenges to basing jurisdiction on the location of the ISP arise. In a scenario where an American user is in contact with someone in Ireland, any access to the American user's data would potentially mean that the Irish's user's communications such as responses to the American user's e-mails could be reached by the United States government and could raise similar international concerns to those following the decision in the Microsoft warrant case. Moreover, ISPs have internationally diverse customers.¹¹⁵ Basing jurisdiction on the Internet user would likely mean that ISPs would spend a copious amount of time complying with requests from their users' home countries, assuming the ISP could reliably determine which country housed the user.

Again, in *Suzlon Energy LTD. V. Microsoft Corp.*, the 9th Circuit read the SCA to apply to *any* Internet user, regardless of their location.¹¹⁶ The court rejected a reading of the act as a Congressional attempt to "shore up" Internet user's constitutional rights and therefore was intended only to cover U.S. users.¹¹⁷ The court postulated that the ISP would have a hard time determining if the user was a U.S. citizen at all times and therefore covered by the SCA.¹¹⁸ The SCA, the court notes, does not include an exception for foreign citizens. Rather, the law only contemplates the scenarios under which the ISP must divulge information following the law's procedures.¹¹⁹ The 9th Circuit ruled that the location of the user ultimately has no bearing on application of the SCA, and the law can apply to foreign Internet users.¹²⁰ However, the court seems to limit this application to communications stored in the U.S. and does not consider whether the SCA similarly applies to communications stored on foreign data servers.¹²¹ This approach does not implicate the conflict of laws at issue in the Microsoft warrant case. It also may not produce the information a U.S. investigation is

¹¹⁴ Goldsmith & Wu, *supra* note 61, at 51.

¹¹⁵ Kerr, *supra* note 51, at 407 (noting less than 30% of Gmail's users are in the United States. About 16% percent of Facebook's users are in the United States while the other approximately 84% are abroad).

¹¹⁶ 671 F.3d 726, 729 (9th Cir. 2011).

¹¹⁷ *Id.* at 730.

¹¹⁸ *Id.*

¹¹⁹ *Id.* at 729.

¹²⁰ *Id.* at 730.

¹²¹ *Id.* ("[I]t's clear that the ECPA at least applies whenever the requested documents are stored in the United States. The Court does not address here whether the ECPA applies to documents stored or acts occurring outside of the United States.").

seeking because data stored on the cloud can bounce from server to server, limiting application to data in the U.S. and creating problems for U.S. law enforcement.

Applying the SCA based on the location of the user will likely be unsuccessful because of the interconnected nature of the Internet operating on a cloud system where a user's e-mails or other data may implicate the information of another user who might be in a different country. U.S. courts, specifically the 9th Circuit, have rejected the user's location as a basis for applying the SCA and asserting jurisdiction over data.

4. *Asserting Jurisdiction Based on the Location of the Data*

Basing jurisdiction on the location of the data seems to be increasingly pursued by more governments, but it is the most tenuous and arbitrary of the three bases discussed. A misconception of cloud computing is that the actual processing of data and storing that data exists someplace in the ether – in the clouds if you will.¹²² In reality, the data exists and processing takes place on an actual server warehoused within the sovereign borders of a country.¹²³ Governments seeking a clear basis for asserting jurisdiction look at the location of the data as a clear cut question: if the data center exists in a country, then that data is under the control of the government exercising its power in that location.

However, the location of data in a cloud computing model is necessarily arbitrary. The value of the cloud to Internet users is the ability of the ISP to provide a service that takes advantage of the “scalability” of the Internet.¹²⁴ Essentially, this means that ISPs can shift data in storage or data being processed quickly from server to server based on the workload demand on a particular server.¹²⁵ Shifting data from one server to another might mean shifting one server over in a data center or shifting data to a data center in another country, depending on demand and availability.¹²⁶ Without this flexibility, the value of the cloud computing for ISPs is undercut, and the users will lose out.¹²⁷ The rapid, arbitrary, and sometimes

¹²² See generally Zach Walton, *Americans Think Cloud Computing Comes from Actual Clouds*, WEBPRONNEWS (Aug. 29, 2012), <http://www.webpronews.com/americans-think-cloudcomputing-comes-from-actual-clouds-2012-08> (reporting in a survey that a number of Americans believed the Cloud infrastructure of the Internet has something to do with weather clouds).

¹²³ Paul T. Jaeger et. al., *Where is the Cloud? Geography, Economics, Environment and Jurisdiction in Cloud Computing*, 14 FIRST MONDAY 5 (2009).

¹²⁴ Andrews & Newman, *supra* note 64, at 325.

¹²⁵ *Id.*

¹²⁶ *Id.*

¹²⁷ *Id.* at 328.

difficult to track movement of data means that arguing for basing jurisdiction on the location of data is a tenuous claim.

Regardless, the location of data is increasingly the jurisdictional basis pursued by foreign governments. Policy proposals in the European Union (“EU”) exemplify the methods by which governments may assert control over the location of data and also highlight the challenges of such proposals. In 1995, the EU passed a comprehensive data privacy law called the “European Union Directive on the Protection of Individuals with regard to the Processing of Personal Data and on the Free Movement of Such Data” (the “Directive”).¹²⁸ As a Directive from the European Commission, the member states of the EU have some flexibility in implementing the Directive, but it supplies a framework with which the laws of the member states must comply.¹²⁹ Among these provisions is a requirement that data with personally identifiable information cannot be transferred out of the EU to a country that does not have “adequate” data protection laws.¹³⁰ This means that an ISP cannot move data to servers located in a country the EU Commission does not consider able to process data with the appropriate levels of protection.¹³¹

To date, the EU Commission has formally designated only 12 countries as having “adequate” data protections.¹³² The United States has not been recognized as having adequate protection, primarily because the U.S. has not passed an omnibus law on data protection that defines what data laws apply to every sector of the economy.¹³³ Rather, U.S. protection laws vary. For example, there are certain requirements for medical records and other requirements for credit information.¹³⁴ To maintain the flow of data, the U.S. and EU negotiated a “Safe Harbor” agreement in 2000 to allow companies who self-certify that they are meeting the data protection requirements of the EU directive, to move data across European borders.¹³⁵

¹²⁸ Donald C. Dowling, *International Data Protection and Privacy Law* 3 WHITE & CASE 3 (Aug. 2009).

¹²⁹ *Id.*

¹³⁰ Hill, *supra* note 2, at 13.

¹³¹ Dowling, *supra* note 128, at 9.

¹³² *Commission Decisions on the Adequacy of the Protection of Personal Data in Third Countries*, EUROPEAN UNION, http://ec.europa.eu/justice/data-protection/document/international-transfers/adequacy/index_en.htm.

¹³³ U.S. INT’L TRADE COMM’N, PUB. NO. 4415, DIGITAL TRADE IN THE U.S. AND GLOBAL ECONOMIES, Part 1 5-12 (July 2013).

¹³⁴ Dowling, *supra* note 128, at 4.

¹³⁵ Hill, *supra* note 2, at 26; On October 6, 2015, the European Court of Justice, the highest court in the EU, threw the validity of the “Safe Harbor” Agreement into question when they declared such data-transfer agreements invalid. It remains to be seen how this decision will affect the framework ISPs have developed to maintain data flows between the U.S. and EU. Mark Scott, *Data Transfer Pact Between U.S. and Europe is ruled Invalid*, N.Y. TIMES

Essentially, the Safe Harbor agreement allows U.S. ISPs to self-certify that, if data is migrated out of the EU, the data will still be treated as though it is in the EU and subject to EU data protection law.¹³⁶ To self-certify, the U.S. ISP must commit to seven privacy principals in the areas of notice, choice, onward transfer, data integrity, security, access, and enforcement.¹³⁷

Despite special agreements to maintain the flow of data, the EU's approach has led to restrictions on data flows, which undercut the value of the cloud computing model.¹³⁸ EU member states interpret the requirements of the Directive differently.¹³⁹ This uncertainty increases costs for not only U.S. ISPs but also European providers, as these providers attempt to comply with differing standards of protection.¹⁴⁰ For example, social media sites are subject to the high protections under the Directive, which requires them to minimize data collection.¹⁴¹ However, data collection, treated differently by the EU member states, is necessary for how a social media site may suggest contacts or groups for a user.¹⁴² These restrictions and requirements then undercut the business model these companies have developed.¹⁴³

Asserting jurisdiction solely based on the nationality of the Internet user, ISP or the location of the data is problematic. The legal trend seems to indicate that U.S. courts will still rely on the injury in the forum test for asserting jurisdiction. However, the trend in policy making spheres leans towards asserting jurisdiction over the user, the ISP, or the data. While the location of the data appears to be the most tenuous basis for jurisdiction, it appears to be favored by policy makers. Because the cloud-based model of the Internet assumes a certain amount of mobility in data, assertions of jurisdiction over data are likely to create conflicts where data mobility is restricted.

(Oct. 6, 2015), <http://www.nytimes.com/2015/10/07/technology/european-union-us-data-collection.html>.

¹³⁶ Dowling, *supra* note 128, at 12.

¹³⁷ U.S. INT'L TRADE COMM'N, *supra* note 133, at 5-13.

¹³⁸ Hill, *supra* note 2, at 15.

¹³⁹ U.S. INT'L TRADE COMM'N, *supra* note 133, at 5-12.

¹⁴⁰ *Id.*

¹⁴¹ *Id.* at 5-13.

¹⁴² *Id.*

¹⁴³ *Id.*

IV. A LEGISLATIVE SOLUTION

At the end of the 113th Congress, legislation was introduced in the U.S. Senate that addresses the conflicts in the Microsoft warrant case and the territorial reach of SCA warrants. While S. 2871, the Law Enforcement Access to Data Stored Abroad Act (the “LEADS Act”), provides solutions to some of the challenges raised in the Microsoft warrant case, the draft bill does not resolve all the questions raised by various courts’ interpretations of the SCA. The bill addresses these issues in three ways: first, by electing to base jurisdiction over data on the location of the user; second, by removing the outdated distinctions between ISP’s services; and third, by directing courts to the MLAT process to resolve international conflicts.

In the findings section, the LEADS Act limits the application of the SCA to U.S. citizens by authorizing the government to secure a warrant only for “the contents of electronic communications belonging to a United States person.”¹⁴⁴ The proposed legislation would also grant the government access, via a warrant, to any information stored in the United States.¹⁴⁵ In this section, the bill rejects jurisdiction based on the location of the data and favors jurisdiction based on the location of the user, extending the reach of the SCA warrants to any data connected to a United States user.¹⁴⁶ This limitation of the SCA to U.S. citizen calls into question previous judicial interpretations of the SCA, rejecting the court’s ruling in *Suzlon Energy LTD. v. Microsoft Corp.*¹⁴⁷ However, because the draft bill would extend to a U.S. user’s data regardless of location, the LEADS Act resolves some of the problems with the *Suzlon* decision only applying to data in the U.S.¹⁴⁸

The LEADS Act would further amend the SCA by dropping the distinction between remote computing service providers and electronic communications service providers, as well as strike the differential requirements for government access to information stored for more or less than 180 days.¹⁴⁹ In place of these differential standards and distinctions between providers, the proposed legislation applies the same standard to all stored information regardless of who stored it or for how long, as well as requiring the government obtain a warrant for access to the information.¹⁵⁰ The court in the Microsoft warrant case asserted that the SCA creates a hybrid warrant-subpoena, requiring a process similar to a warrant but

¹⁴⁴ S. 2871, 113th Cong. §2(4) (2014).

¹⁴⁵ *Id.* at §3(2)(A).

¹⁴⁶ *Id.*

¹⁴⁷ See *In re Warrant to Search*, 15 F. Supp. 3d at 472.

¹⁴⁸ *Suzlon Energy Ltd. v. Microsoft Corp.*, 671 F.3d 726, 730 (9th Cir. 2011).

¹⁴⁹ See S. 2871, *supra* note 144, at §3(2)(A); see also 18 U.S.C. § 2703 (2015).

¹⁵⁰ S. 2871, 113th Cong. §3(2)(A) (2014).

requiring a third party to produce the information rather than the authorizing search and seizure by the government.¹⁵¹ The LEADS Act, in classifying the request for information as a warrant, implies that the government would have to take appropriate steps for gathering information via warrant. This would include working through the MLAT process, rather than obliging a third party to turn over information as required under a subpoena.

Section 4 of the proposed legislation addresses the processing of MLAT requests in the U.S.¹⁵² This section seeks to streamline the MLAT process through several different measures. The section includes requirements creating a standard MLAT request form and online docketing system.¹⁵³ It also requires regular reports on the processing time for MLAT requests, both coming into the U.S. Department of Justice and sent to other governments.¹⁵⁴ The opinion in the Microsoft warrant case dismisses the MLAT process as too laborious and too slow for the processing of such important requests for information.¹⁵⁵ However, this legislation indicates that Congress still places value on this formal mechanism for gaining access to data stored overseas.¹⁵⁶ The proposed legislation recognizes the equal frustrations of foreign countries with the MLAT process and includes language encouraging transparency and expediency in processing requests.¹⁵⁷ While the bill does recognize these as appropriate channels for accessing information, it does not perform an extensive overhaul of the MLAT process, leaving open the concerns about the delay and frustration with the MLAT process.¹⁵⁸ Amending the MLAT process may still be necessary for efficient access to data stored extraterritorially.

The LEADS Act includes measures that address the conflict of laws issue raised by the Microsoft warrant case. The bill would require the court to either modify or vacate the warrant where the court finds the warrant would require the ISP to violate the laws of another country in order to comply with the warrant.¹⁵⁹ While this seems like it may resolve the issues created by the Microsoft warrant case, there may still be conflict. The data protections in foreign countries may be quite stringent and have entirely different jurisdictional basis than those in U.S. law.¹⁶⁰ The EU

¹⁵¹ *In re Warrant to Search*, 15 F. Supp. 3d at 471.

¹⁵² S. 2871, *supra* note 144, at §4.

¹⁵³ *Id.* at §4(a)(1)(A).

¹⁵⁴ *Id.* at §4(a)(2)(2014).

¹⁵⁵ 15 F. Supp. 3d at 475.

¹⁵⁶ *See* S. 2871, *supra* note 144, at §2(4).

¹⁵⁷ *See id.* at §4(a).

¹⁵⁸ *Id.*

¹⁵⁹ *Id.* at §3(2)(A).

¹⁶⁰ For discussion of the EU's data protection laws, see Part III, 4.

Directive on data protection, which applies in the Microsoft warrant case, does not allow transfer of data to countries that do not have adequate data protection laws – including the United States.¹⁶¹ Under the Safe Harbor agreement, American ISPs self-certify that, if data is migrated out of the EU, the data will still be treated as though it is in the EU and subject to EU data protection law.¹⁶² This would mean that if data stored on an EU data server was migrated to a U.S. data server, the SCA warrant would still be unable to reach the data because that data must be afforded the same protections as it would enjoy in the EU.¹⁶³ Where an ISP has stored data on an EU server, any action to turn that data over to the U.S. government would violate the terms of the Safe Harbor agreement and create the conflict of laws the LEADS Act seeks to neutralize.¹⁶⁴ The courts will likely be required to modify or vacate warrants seeking data migrated by U.S. ISPs under the terms of the Safe Harbor agreement often.¹⁶⁵

The LEADS Act does not provide a comprehensive solution for how the courts may assert jurisdiction over data under the SCA. The application of the SCA based on the location of the user still raises issues where data is stored on foreign servers. While the act provides flexibilities to the court where access to foreign data would create a conflict, these conflicts are perhaps more likely than the bill contemplates, and the bill does not resolve complaints with the MLAT process. However, the legislation would provide direction for a court in applying the SCA to cloud data and could serve as a useful first step in modernizing U.S. data laws.

V. CONCLUSION

The Microsoft warrant case opinion represents a misunderstanding of the territorial application of the SCA and has the potential to put ISPs in the difficult position of having to choose between complying with U.S. law or violating the laws of a foreign country. Recent legislation provides a framework by which courts may handle requests for data that lies outside the territory of the United States. While this framework may provide a solution for the fact pattern implied in the Microsoft warrant case, it does not resolve the fundamental question of what a sovereign nation's jurisdictional basis over Internet data should be. However, the bill is a positive incremental step toward updating the United State's Internet policy.

¹⁶¹ Dowling, *supra* note 128, at 4.

¹⁶² *Id.* at 12.

¹⁶³ *Id.*

¹⁶⁴ See S. 2871, *supra* note 144, at §3(2)(A).

¹⁶⁵ *Id.*