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Business Law Brief

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Media Relations:

Avoiding a PR Nightmare

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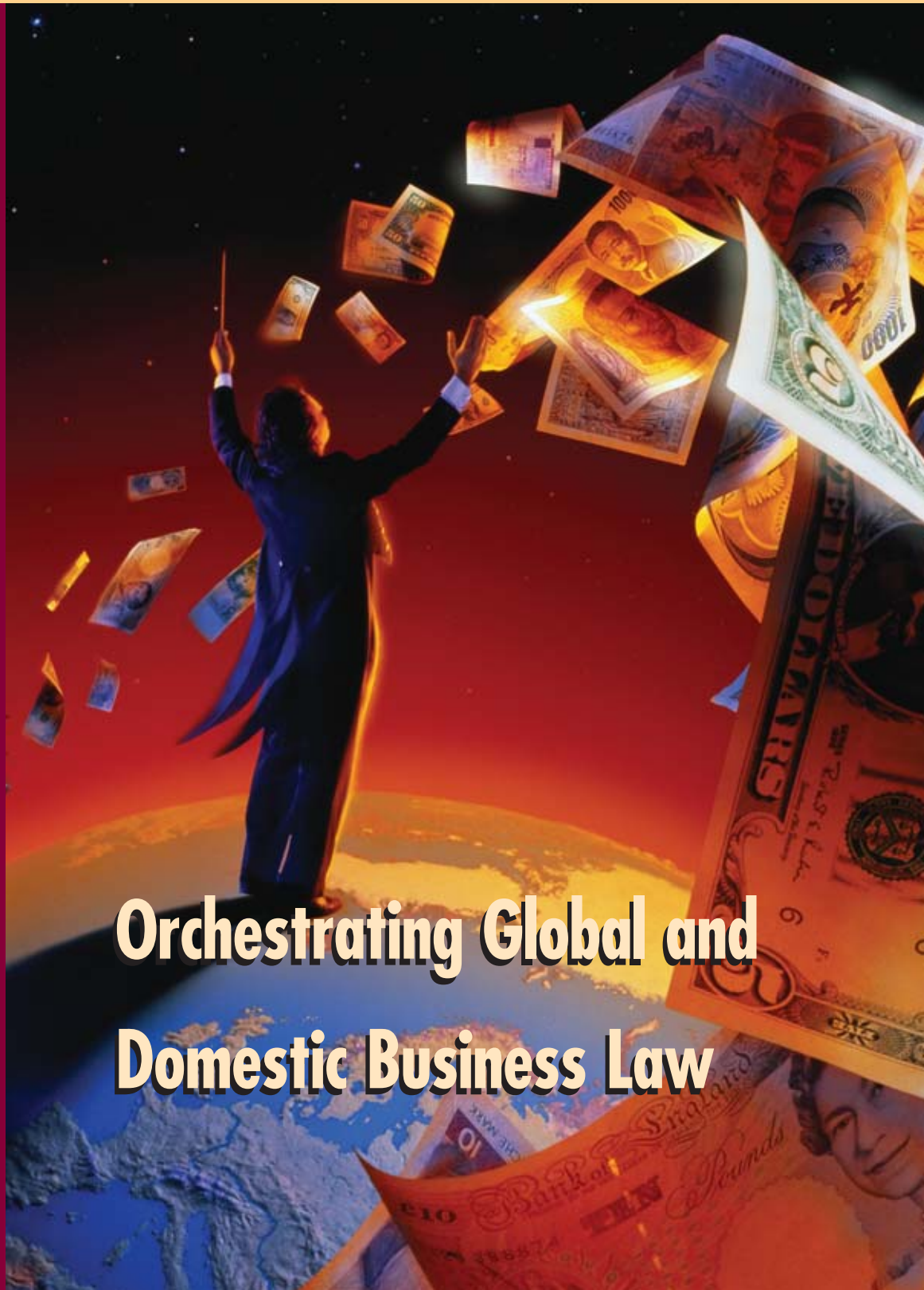
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A Clear and Present Danger:

THE GROWING COMMUNICATIONS CRISIS FOR U.S. BUSINESSES AND THEIR LAWYERS

By Richard S. Levick, Esq.



A GENERATION AGO, IT WAS CALLED the “Credibility Gap.” During the Vietnam War, a significant percentage of the American people – not just the discontent intelligentsia or urban “underclass” – simply lost faith in American authority. They didn’t believe anything they heard from government officials or military leaders.

To a certain extent, corporations got off easier than the politicians. True, the Left was castigating ITT and Dow Chemicals for alleged global conspiracies of one sort or another. But most Americans disillusioned with the Pentagon had no particular animus toward U.S. business. There were not then such pandemic threats to brand-name corporate reputations or looming investigations of internal corporate behavior. For every Lockheed tagged with a Foreign Corrupt Practices Act enforcement, a hundred other companies went their merry way.

Most important, in those days there was no so-called “litigation explosion.” Even had the American people viewed Palmolive as they viewed General Westmoreland, direct legal and financial exposure was not the inevitable consequence. ITT and Dow were much less likely to meet 12 peers in the hallowed halls of blind justice.

Today’s post-Enron Credibility Gap does, however, directly implicate corporations in a litigious environment where every new slippage in public confidence makes for an increasingly hostile jury pool.

The haunting fact is that slippage anywhere now affects the daily caseloads of American business everywhere. If the military betrays our confidence at Abu Ghraib, it contributes to a generalized distrust that has a potential impact on a product liability case in Portland, Oregon or an employment suit in Portland, Maine.

Latest Bad News

THIS FALL, DECISIONQUEST, the nation’s foremost trial consulting firm, co-sponsored a study with Reuters that measured the diminution of collective confidence in authority. The study shows precisely how such diminution is affecting business in a way that would have been unimaginable 30 years ago.

The time frame for the research was from 2000 to 2004, embracing the Florida election recount, the corporate scandals, and the Iraqi war. Of 1,100 respondents, 61% said they had lost faith in America’s leaders and institutions. It is an appalling statistic, but here is the real kicker for corporate America: Of that 61%, 90-95% said that, as a result of their disillusionment, they would likely find for individual plaintiffs in lawsuits against large organizations.

“[I]f media relations were just common sense, we wouldn’t have so many sensible people, including lawyers, who feel they get burned by reporters every time they talk to one.”

The data has a few practical hints for lawyers selecting juries. Women report greater loss of trust: 66% versus 55% for men. Eighty-four percent of African-Americans report loss of faith, compared to 57% of whites. The numbers are cold comfort, however. If counsel picks an all-white male jury, there is still a 55-57% chance that the corporate defendant will be judged by men who have practically no confidence in corporate America.

Politically, the breakdown is more dramatic, with 78% of Democrats reporting diminished trust and only 39% of Republicans doing so. Of course, lawyers do not query political affiliations during voir dire, so one supposes that during jury selection, lawyers can only try to guess what a Republican looks like. But, then they have to hope plaintiff’s counsel does not disqualify the Eisenhower look-alike.

Regional differences confound even these political hints. The so-called plaintiffs' havens in Texas, Mississippi, and Central Illinois are often Republican. However, a populist distrust of global corporations, especially if the plaintiff is small-town and working class, mitigates any party-based advantage defendants might hope for.

Fighting Back

SUCH DATA – AND THE PROSPECT OF EVEN GREATER CRISES in confidence ahead if the Iraqi war worsens – begs the question: What is corporate America to do?

The crisis depicted in the DecisionQuest/Reuters survey is a socio-cultural mega-trend. Business leaders do not control socio-cultural mega-trends. Like most of humanity, they simply respond as best they can and hope the bottom line weathers the storm.

But if the world has changed, so too must the mindset of corporate leaders. They must assume an increasingly open posture in terms of their willingness to comment on difficult matters. Many C-Suite occupants have already begun to invest the time and money to institutionalize myriad communications strategies and tactics in order to rebuild public confidence.

An important next step, directly responsive to the findings of the DecisionQuest/Reuters survey, is specifically targeting prospective jurors – to rebuild public confidence with the very definite idea that members of that public will someday sit in judgment on corporate leaders. The idea is to disseminate messages that are simultaneously efficacious in courts of law and the court of public opinion.

However, this messaging requires a step most corporations have not yet taken – get the lawyers involved.

The Lawyer as Great Communicator

BECAUSE THIS PUBLIC CRISIS DIRECTLY INVOLVES THE JURY POOL, some corporations (DaimlerChrysler is a case in point)– now insist that their legal counsel be sensitive to media and public relations issues. These corporations expect lawyers to be able to anticipate and support, not undermine, outreach predicated on public candor.

To be sure, such corporations are compelled toward greater media sensitivity because their adversaries have been many steps ahead. Plaintiffs' counsel spends six to eight times more money on marketing and communications than defense lawyers do. Their media instincts are far better as well. They understand, for example, the value of pictures, of showcasing the most sympathetic parties to a case, such as a grandmother or child. They understand that what we see always trumps what we hear.

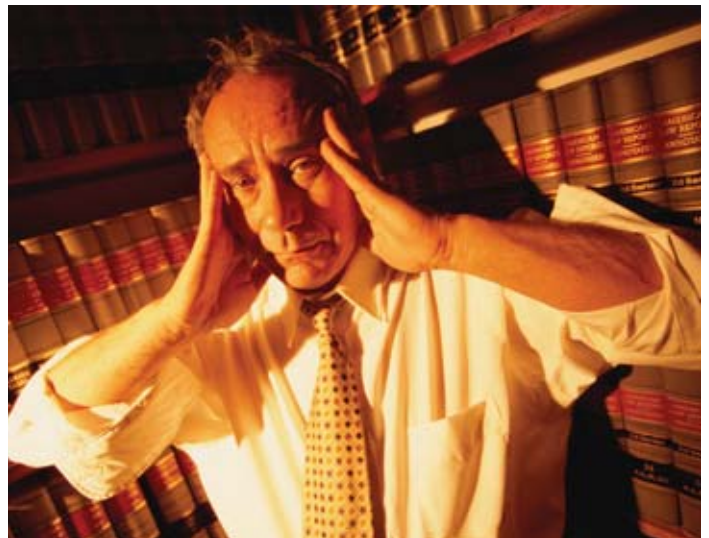
In contrast, defense lawyers often rely on corporate executives to make a business case for their side of any dispute. Not

just plaintiffs' lawyers, other adversaries, like the government, have developed advanced media skills as well. The government also has a highly sophisticated reliance on visuals – for instance, the “perp walks” timed for maximum exposure on the evening news – designed to win cases or leverage negotiating positions.

Only the defense bar has neglected to play the decisive game. That being the case, what sort of results would one logically expect the DecisionQuest/Reuters survey to produce? Why should anyone be expected to have confidence in authority figures who are, simply, media no-shows?

Today's new Credibility Gap thus requires a different mindset on the part of defense lawyers as well as their C-Suite clients. It requires training in media relations and public communications. It requires lawyers to rethink their role, and to start rethinking this role as early as law school. Lawyers need not be strategic communications experts, but they can no longer ignore this dimension of client interest.

As case managers, lawyers are often not willing to work as team members in the evolution of a communications strategy. They peremptorily veto the experience-tested advice of media professionals. The consequence is no communications program whatsoever at the very moment when one is most needed.



Contributing to this disconnect, lawyers look at media relations and assume that it's just common sense. There are no weighty tomes. No three years of graduate study dedicated to esoteric media precedent. No convoluted rulings to navigate on a daily basis. It is something everyone can do if they're just a little sensible. Of course, if media relations were just common sense, we wouldn't have so many sensible people, including lawyers, who feel they get burned by reporters every time they talk to one.

It is a lot more than press releases. It is relationships as well as skill. It is knowing the *60 Minutes* cameraman well enough

to persuade him *not* to shoot your client during an unflattering moment. It is all about resources, including enough online wherewithal to ensure that reporters conducting web searches will find your side of the story more frequently than your opponent's (and, as a result of that higher volume, invest more confidence in your position).

It is about understanding technology enough to know if the cost benefits justify beaming satellite video to America's 900 television stations so that the company's position runs on dozens of evening news programs. It is about knowing when a special video news release ("VNR") will build momentum for the client's position. Or knowing which reporter is the right reporter to get the story first.

It is not solely common sense; strategic communications touches on enough contingencies to necessitate a partnership of equals between lawyers and communications professionals.

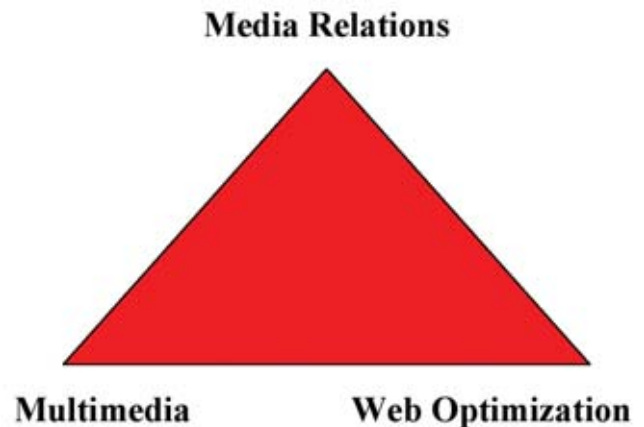
The Practical Agenda

ONCE SUCH A "REAL TEAM" IS IN PLACE, influencing the media – and in turn, other audiences – becomes, not just possible, but *likely*.

Seldom if ever, though, do defense lawyer/communications teams control the media agenda to such an extent. At best, they influence it. The maximum level of influence requires a three-part strategy:

- (1) **Media Relations.** Traditional media work is fueled by reporter relationships; a solid understanding of what must be said, by whom, and when; and story placements to disseminate key messages. Here, the communications professionals need to have the main say in identifying the publications of record. These are the media outlets likely to inspire and influence subsequent stories by other journalists. In highly sophisticated campaigns, it can also include grassroots communications where groups of activists can be used to apply pressure at key points.
- (2) **Multimedia.** Media think tanks have shown that a decisive percentage of television news stories result from interested parties providing the stories. Tobacco and automobile companies, among others, often make their own news videos – the aforementioned VNRs complete with interviews, background, and news footage. They provide the stories as ready-to-run package to all U.S. news programs, which frequently air them as part of the evening news and often do the same with radio. Why shouldn't other companies?
- (3) **Web Optimization.** Virtually all journalists use the web to research stories that have already been written on the topic they're covering. They are looking to

confirm or adjust their own conclusions, and to identify the broader trends underlying the newsy events. The more often a particular "take" on a story comes up at the top of search engines, the more it tends to become the prevailing interpretation.



It is a triple-threat media impact. Once the client controls all three legs of this triangle, the client is more likely to control the message and the story. Once the client is influencing the story, the client has a significantly better chance of influencing the outcome of a case and its own reputation – but that is only possible when lawyers recognize the role they must play in allowing and encouraging communications professionals to do their jobs. Lawyers cannot just set the limits of litigation communications. They cannot just be naysayers. They must help evolve a balanced strategy.

To be sure, no single victory, neither a dismissal in a court of law, nor the winning of public support for the business side of a particular controversy, will dispel the mistrust that the DecisionQuest/Reuters survey spells out so disturbingly. Enough has happened, in Houston and in Fallujah, at CBS and on Pennsylvania Avenue, to make a short-term recovery impossible.

Only a renewed sense of purpose, and a new appreciation for the value and power of a sophisticated, integrated media team, can reverse the tide – one message point at a time, one corporate brand at a time.

BLB

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Exchange Fund Transactions:

AN ADVANTAGEOUS INSTRUMENT FOR CORPORATE INSIDERS; A POTENTIAL NIGHTMARE FOR PUBLIC INVESTORS

By Jed Wulfekotte

Introduction

RECENT INVESTIGATIONS into America's "corporate scandalfest"¹ revealed that corporate insiders² across the country secretly dumped their stock, causing uninformed shareholders to bear the bulk of the loss as each company sank into bankruptcy. In response, the Securities and Exchange Commission (SEC) tightened disclosure rules and mandated the immediate public disclosure of insider trades. However, by transferring stock into an exchange fund, corporate insiders can still divest corporate shares without alerting investors. An exchange fund is a private company in which shareholders, who own highly appreciated, undiversified stock, contribute a portion of their shares to a common fund. In return, investors receive shares in this fund without incurring immediate taxation on capital gains.³

Although exchange funds have always been a topic of controversy due to their tax-deferral benefit, these funds have recently come under fire because they enable executives to divest shares of their companies' stock without disclosing the initial transaction to the public. In September 2004, the *Wall Street Journal* reported that the SEC was investigating dozens of corporate insiders who may have used exchange funds as mechanisms to reduce their respective economic stakes in their companies without alerting investors.⁴ Although section 16(a) of the Securities Exchange Act of 1934 requires corporate insiders to report every exchange fund transaction, neither the SEC, nor the courts, require insiders to report the exchange fund transactions as a "sale." According to section 16(a), insiders must file reports with the SEC disclosing any changes in beneficial ownership of their companies' shares. These reports, which are publicly available at SEC offices, permit insiders to label dispositions as either a "sale" or "other." While some executives elect to disclose the initial transaction as a "sale" to avoid the appearance of abuse, most corporate insiders elect to label the initial exchange fund transaction as "other," increasing the odds that analysts and public investors who monitor insider trading will not take notice of the transactions.⁵

In the post-Enron business world, attorneys should encourage, and the SEC should require, corporate insiders to report these transactions as "sales." This requirement would

facilitate full disclosure of insider trades and would prevent corporate abuse. The purpose of the disclosure requirements in section 16(a) is to keep public investors informed about purchases and sales which may indicate insiders' private opinions of their corporation's future prospects.⁶ This interpretation of SEC reporting requirements emphasizes the purpose of section 16(a), is permissible under the current definition of a "sale," and is consistent with subsequent case law interpreting this definition.

Exchange Funds as a Diversification Mechanism for Concentrated Wealth

ALTHOUGH CONGRESS REPEATEDLY TRIED to eliminate exchange funds since they emerged in the mid-1960s, corporate insiders have organized these funds to conform to the evolving regulations. In 1966, Congress effectively eliminated exchange funds by abolishing the tax-deferral benefit for individuals who transferred stock into an investment company organized as a corporation.⁷ To ensure that this prohibition included exchange

"The primary benefit of investing in an exchange fund is that it enables investors to diversify a single stock, tax-free, until they decide to redeem their share of the fund."

funds, Congress defined an "investment company" as any corporation in which more than 80 percent of its assets consisted of readily marketable stocks and securities.⁸ Following this legislation, investors attained tax-free diversification by organizing exchange funds as partnerships, which was permissible under the 1966 regulations.⁹ Congress responded by redefining the term "investment company," hoping to close the tax-free loophole.¹⁰ However, brokers countered again in the 1990s by offering exchange funds that held at least 20 percent of assets in illiquid securities, thus conforming to the existing

definition of an “investment company.”¹¹ In response, the Taxpayer Relief Act of 1997 redefined “investment company” as an entity investing at least 80 percent of its assets in stock or securities.¹² Currently, exchange fund investors organize funds by investing at least 20 percent of fund assets in non-financial investments, such as real estate.



Currently, exchange funds provide a highly advantageous tool for corporate insiders. The primary benefit of investing in an exchange fund is that it enables investors to diversify a single stock, tax-free, until they decide to redeem their share of the fund. Investment banks offer this option to qualified purchasers and to accredited investors, which includes investors with a net worth of at least \$5 million dollars (excluding property, furnishings, and automobiles) and with a \$200,000 annual income. Due to the benefits of tax-free diversification, most exchange funds are quite large, ranging from 50 to 499 investors who have highly appreciated shares in a single company.

Section 16(a) Disclosure Requirements

CONGRESS INTENDED SECTION 16(a) of the Exchange Act of 1934 to require complete disclosure of securities holdings and transactions of all corporate executives to discourage abuse of insider information. Recently, in response to the Enron debacle, Congress and the SEC tightened the reporting requirements of section 16(a). Prior to these amendments, the SEC required insiders to file Form 4 reports on or before the tenth day of the month following the month in which the transaction occurred. After Congress enacted, and President Bush signed, the Sarbanes-Oxley Act of 2002¹³ (Sarbanes-Oxley), insiders must report most exchange fund transactions within two business days of the transaction.¹⁴ Corporate insiders are required to file reports with the SEC that detail any changes in the ben-

eficial ownership of equity securities. Form 4 reports, which are readily available to the public, must label all dispositions that represent a change in beneficial ownership as either a “sale” or “other.”

Transactions labeled as “sales” in Form 4 reports provide public investors with a sense of how an issuer’s securities are likely to perform in the future. Many analysts and investors monitor insider “sales” because these sales are viewed as an indicator of the company’s health. The SEC publishes monthly summaries of section 16(a) reports and many major newspapers routinely publish information gathered from Form 4 reports. A number of private newsletters and services also analyze and report insider sales.

An exchange fund transaction that is reported as “other” may disguise the nature of the transaction and may provide investors with a misleading view of a corporation’s health. Exchange fund investments allow corporate insiders to reduce their economic stake in the corporation by divesting large amounts of company stock. If these transactions are labeled as “other,” as is the standard practice, the transactions will most likely go unnoticed. Subsequent reports, newsletters, and other services that monitor insider sales will not inform the public of these transactions, and thus public investors may have erroneous perceptions of executive confidence in a corporation’s future prospects.

“By investing in an exchange fund, insiders can eliminate between 70 to 90 percent of the risk that often accompanies investing in a single stock. The only remaining risk is that the market, as a whole, may fall.”

Exchange Fund Transactions Fit the SEC’s Definition of “Sale”

ONE WAY TO ENSURE THAT CORPORATE INSIDERS provide public investors with an accurate and complete picture of a corporation’s future prospects is to require insiders to disclose each exchange fund transaction as a “sale” in Form 4 reports. Section 2(a)(3) of the Securities Act of 1933 (‘33 Act) defines a “sale” as “every contract of sale or disposition of a security or interest in a security, for value.”¹⁵ The statutory definition of a “sale” clearly includes the exchange of securities for cash, but inclusion of other transactions,

such as exchange fund investments, is unclear. Despite the apparent confusion, defining an exchange fund transaction as a “sale” is permissible under the language the ‘33 Act, and is consistent with case law interpreting the definition.

When insiders relinquish shares to an exchange fund, they are actually exchanging their shares for an interest in the fund. The “disposition of a security or interest in a security” occurs when an insider invests his or her corporate shares, usually consisting of at least one million dollars of corporate stock, into the



fund. Once an insider contributes shares to the fund, the investment may not be retrieved. Exchange funds are extremely illiquid; to receive the tax-deferral benefit, insiders must remain in the fund for at least seven years. Thus, exchange fund transactions satisfy the first element of the SEC’s definition of a “sale” because investors clearly dispose of a security, or at minimum, investors dispose of their interest in a security.

Exchange fund investors receive a highly advantageous “value” in return for relinquishing their shares in the fund. Essentially, investors turn shares of a single stock into a diversified portfolio of stocks without accruing capital gains taxation on the investment until they decide to redeem their shares in the fund. By investing in an exchange fund, insiders can eliminate between 70 to 90 percent of the risk that often accompanies investing in a single stock.¹⁶ The only remaining risk is that the market, as a whole, may fall.¹⁷ Despite this risk, the investor is still able to exchange an extremely risky investment for a relatively safe investment that is not dependant upon the success of a single company.¹⁸ Therefore, insiders

clearly receive the “value” of a safer investment, satisfying the second part of the definition and leading to the appropriate classification of exchange fund investments as “sales” within the language of the ‘33 Act.

This interpretation and application of a “sale” is not only permitted by the language of the SEC rules, but also reinforced by case law. Since the ‘33 Act, courts have generally held that a securities exchange constitutes a “sale” when one investor parts with a security in exchange for another, because the investor gives up the value of the original stock in exchange for the value of the newly acquired security.¹⁹ According to the courts, any change in the rights and obligations of the securities holder, or any amendment to the security, constitutes a “sale.”²⁰

This Interpretation of a “Sale” Emphasizes the Purpose of Section 16(a)

THE CONCEPT OF A “SALE” should be interpreted broadly to prevent exchange fund investments from being used to side-step securities laws, which are intended to prevent the consequences of these investments. In fact, courts have broadly construed the term “sale” in order to accomplish the objective of certain securities laws.²¹ Congress promulgated section 16(a) to publicize insider transactions and to deter the abuse of insider information.²² Congress also sought to provide public investors with information that might indicate insiders’ private opinions of their companies’ future prospects.²³

When Congress enacted the Sarbanes-Oxley amendments, it recognized that existing reporting requirements inadequately fulfilled the purpose of section 16(a). Prior to these amendments, corporate insiders could wait more than a month before publicly disclosing insider transactions.²⁴ Because of the long delays, these reporting requirements prevented public investors from accurately gauging a corporation’s future prospects. The Sarbanes-Oxley amendments tightened disclosure rules by reducing the time corporate insiders have to file Form 4 reports, thus preventing the insiders from withholding information concerning insider sales.²⁵

Although Congress aimed to protect shareholders from corporate abuse stemming from insider trading, exchange fund transactions slipped through the cracks of the disclosure requirements. Exchange funds provide corporate insiders with a vehicle for potential abuse because corporate insiders may divest their shares without alerting public investors.²⁶ This is one of the fundamental actions that the Sarbanes-Oxley amendments sought to prevent by requiring timely reporting. Requiring corporate insiders to report exchange fund transactions as “sales” in Form 4 filings, would prevent insiders from secretly dumping corporate shares and would provide public investors with complete and accurate information.

Implications

IF THE SEC DEFINED AN EXCHANGE FUND TRANSACTION as a “sale,” investors would no longer have the option to defer capital gain taxation of their investments. A capital gain represents the difference between the present value of the total future income expected to be generated by the asset (determined at the time of purchase), and the present value of the total future income expected to be generated by the asset (determined at the time of the sale).²⁷ Currently, the initial transaction is not considered a capital gain because it occurs when an investor relinquishes shares to an exchange fund and therefore is not considered a “sale.” However, when investors redeem their share of the fund after seven years, a sale of any stock out of this new portfolio will trigger a capital gain. Therefore, if the SEC defined the initial transaction as a “sale” it would be considered a capital gain – which is immediately taxed.

Although this proposal would eliminate the tax-deferral benefit, investing in exchange funds may still be highly advantageous. Exchange funds might still serve as vehicles to diversify a highly appreciated, undiversified holding. As previously stated, this benefit alone is highly advantageous because investors may hedge a substantial amount of risk that accompanies investing in a single stock. Furthermore, exchange funds provide estate-planning benefits for investors who make gifts to others; in such cases, the gifts would remain illiquid and eventually would consist primarily of securities rather than cash. A gift may reduce the face value of an exchange fund by 15 to 40 percent for tax purposes, provided the gift is made in the first

year of the fund’s existence. Therefore, even if the tax-deferral benefits are eliminated, exchange funds may still provide investors with substantial benefits through portfolio diversification and estate planning.

Conclusion

RECENTLY, CONGRESS AND THE SEC enacted regulations requiring corporate insiders to publicly disclose purchases and sales of company shares. However, the requirements for disclosing exchange fund transactions under these regulations remains unclear. This ambiguity opens the door for insiders to partake in the very actions which Sarbanes-Oxley aims to prevent. The SEC can shut the door on potential abuse by defining an exchange fund transaction as a “sale.” This interpretation is permissible under the SEC’s definition of “sale” and is reinforced by case law interpreting the definition. Since 2001, corporate insiders have deceived public investors by disguising information about insider sales. However, investors may protect themselves by utilizing the most powerful weapon the public has against this type of corporate abuse; investors must demand the complete and immediate disclosure of exchange fund transactions.²⁸

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ENDNOTES: Jed Wulfekotte

¹ Allan Sloan, *Martha May have Jaywalked, but Kenny Boy did Worse*, WASH. POST, July 20, 2004, at E03 (stating that Kenneth Lay misled Enron’s employees by telling them he had been buying Enron stock, but in reality, he sold it heavily).

² The term corporate insider refers to a director or officer of an issuer that has a class of equity securities registered under Exchange Act of 1934 § 12, or a person who is the beneficial owner of more than ten percent of an outstanding class of § 12 registered equity securities, who is subject to reporting requirements of § 16(a). 2-8 FEDERAL SECURITIES EXCHANGE ACT OF 1934 § 8.03 n.1 (2004).

³ Richard A. Booth, *The Limited Liability Company and the Search for a Bright Line Between Corporations and Partnerships*, 32 WAKE FOREST L. REV. 79, 85 (1997). Exchange funds have a number of other benefits, including the diversification of one’s portfolio thereby reducing the risk of loss to the shareholder.

⁴ Randall Smith, *SEC Looks at How Insiders Use Exchange Funds*, WALL ST. J., Sept. 7, 2004, at A1.

⁵ See Smith, *supra* note 4.

⁶ See FEDERAL SECURITIES EXCHANGE ACT OF 1934, *supra* note 2.

⁷ Foreign Investors Tax Act of 1966, Pub. L. No. 89-809, § 203, 80 Stat. 1539, 1577 (codified as I.R.C. § 351 (1994)).

⁸ *Id.*

⁹ Catherine L. Heron, *Tax Issues for Certain Unregistered Funds and Other Nontraditional Funds*, 1112 PRAC. LAW INST., CORP. LAW AND PRAC. COURSE HANDBOOK 79, 88 (1999).

¹⁰ *Id.*

¹¹ *Id.*

¹² Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788.

¹³ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745.

¹⁴ Securities Exchange Act of 1934, Pub. L. No. 107-204, 116 Stat. 788 §16(a)(2)(C).

¹⁵ 15 U.S.C. § 77b(a)(3) (2000).

¹⁶ Booth, *supra* note 3, at 87.

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ See, e.g., *In re* No. Natural Gas Co., Exchange Act Release No. 4638 1943, WL 29768, at *3 (Oct. 25, 1943).

²⁰ See *United States v. New York, New Haven & Harford Railroad Co.*, 276 F.2d 525 (2d Cir. 1960), *cert. denied* 362 U.S. 961 (1960); see generally THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* 312 (4th ed. 2002).

²¹ See *In re* American Continental Corp. v. Keating, 49 F.3d 541 (9th Cir. 1995); see also *United States v. Rudi*, 902 F.Supp. 452 (S.D.N.Y. 1995); see generally HAZEN, *supra* note 21, at 297.

²² See H.R. REP. NO. 1381, at 13 (1934) [hereinafter HOUSE REPORT] (stating that it is difficult to draw a bright line between truly inside information and information that should be known by informed investors).

²³ *Id.*

²⁴ See FEDERAL SECURITIES EXCHANGE ACT OF 1934, *supra* note 2 (stating that corporate insiders must file Form 4 reports electronically and must publish these reports on their websites by the end of day after they filed the report).

²⁵ See *id.*

²⁶ See Smith, *supra* note 4.

²⁷ See Yoseph M. Edrey, *What Are Capital Gains and Losses Anyway?*, 24 VA. TAX REV. 10 (1995).

²⁸ See HOUSE REPORT, *supra* note 23.

The Business Lawyer's Expanding Role in Facilitating Small and Mid-Sized Merger and Acquisition Transactions

By Andrew J. Sherman, Esq.



BUYERS AND SELLERS OF COMPANIES look to their legal counsel for guidance on a wide variety of strategic, regulatory, and financial tasks beyond the obvious roles typically played in the due diligence process and in preparing and negotiating the acquisition documents. In a larger “Wall Street-style” transaction, the advisory team is often very large and the role of counsel is often narrower and more clearly defined. However, in deals involving smaller and mid-sized companies, the role of the business lawyer is often expanded to include a wide variety of responsibilities from financial advisor, to corporate strategist, to creative problem solver, to quasi-investment banker, to emotional sounding-board, to family business counselor. To be an effective advisor in one or more of these roles, a business lawyer will need to really understand the key aspects of the client’s business model and plans, as well as trends in the client’s industry. Effective advising may also require training and expertise in fields as wide-ranged as strategic planning, accounting and finance, tax, and even psychology.

It is critical to understand that for many sellers of a business that has been owned and grown over a long period of time, the sale of the company will not only be the most important financial event of their lives but also the most emotional. An effective business lawyer will help his or her client prepare for this transaction at an early-stage in the process, with a focus on a legal audit to identify potential problems and prepare for the buyer’s due diligence request, the review of the offering memorandum, the review of the projected valuation and pro forma or restated financials, and estate planning and related issues which will be relevant following the closing of the transaction. In a future article for the *Business Law Brief*, I will discuss the lawyer’s role in representing sellers of small and mid-sized companies in greater detail. The chart below provides an overview of each attorney’s role which is driven by the role of the client in a given transaction.

This article focuses on the role of the buyer’s counsel. As counsel to a company which will be acquiring other businesses, it is critical that the business lawyer ensure that the client has gone through the Acquisition Planning process in order to

Roles of Counsel:		
Merger & Acquisition Transactions		
	Seller's Counsel	Buyer's Counsel
Early Stage	<ul style="list-style-type: none"> Legal audit/preparing for the due diligence process Review of Offering Memorandum and presentation materials 	<ul style="list-style-type: none"> Assist the development of the Acquisition Plan and screening process Preliminary due diligence on wide range of targets
Letter of Intent/ Due Diligence	<ul style="list-style-type: none"> Prepare document/data room for due diligence Review and negotiate Letter of Intent 	<ul style="list-style-type: none"> Legal and strategic due diligence on target Review and negotiate the Letter of Intent
Acquisition Documents	<ul style="list-style-type: none"> Review and negotiate the definitive documents <i>Narrow</i> the representations & warranties and covenants and shift allocation of risk. 	<ul style="list-style-type: none"> Review and negotiate the definitive documents <i>Widen</i> the scope of the representations & warranties and covenants and shift allocation of risk
Post Closing	<ul style="list-style-type: none"> Enforce any post-closing compensation terms/covenants Work with seller on asset/estate protections and post-closing projects 	<ul style="list-style-type: none"> Enforce post-closing obligations of the seller Work on post-closing integration issues Work with buyer on asset transaction
	Regulatory Counsel	Third Party Counsel
	<ul style="list-style-type: none"> Works to obtain regulatory approvals to allow for the closing of the transactions Advises on post-closing regulatory issues 	<ul style="list-style-type: none"> Represents the debt and equity sources of capital that may be required to finance the transaction Represents lenders, venture investors, vendors, customers, landlords etc. that may be required to approve the proposed deal Investment bankers and other advisors may also have their own counsel

define the goals, objectives, screening processes, and selection criteria for the proposed transactions.

Acquisition Planning

ONE OF THE KEY CRITICAL TRANSACTIONAL SUCCESS DRIVERS for buyers of companies is the preparation and execution of an Acquisition Plan. The Acquisition Plan: (1) analyzes key trends in the target’s industry, (2) identifies the method for finding candidates, (3) defines the criteria which will be used to evaluate candidates, (4) sets forth the targeted budgets and timetables for accomplishing the transaction, (5) defines the price ranges to be considered, (6) articulates the amount of external

capital which will be required to accomplish the transaction, (7) identifies the internal and advisory teams for the transaction, and (8) sets forth the decision-making and approval process. One of the goals of the Acquisition Plan is to “narrow the field” of candidates as quickly as possible to avoid wasting time and resources. Other benefits of having a well-prepared Acquisition Plan include:

- providing a road map for the company’s leadership to follow;
- informing shareholders of key objectives;
- reducing professional and advisory fees;
- mitigating the risk of doing a transaction that a client will later regret;
- identifying post-closing integration challenges well in advance; and
- informing sellers of your plans for the company on a post-closing basis.

In today’s marketplace, it is especially important to the seller (particularly if an earn-out is part of the deal, *or* if the seller’s compensation will include issuance of company stock *or* if the compensation will involve any significant deferral of seller consideration as discussed below) to understand, accept, and

“[T]he Acquisition Plan should always answer the fundamental question: How will the buyer’s professional management or brand equity enhance the performance or profitability of the seller’s company?”

respect the buyer’s acquisition strategy and growth Plan for the consolidated companies on a post-closing basis. Well-prepared Acquisition Plans are valuable negotiation tools for the buyer when approaching sellers who are naturally concerned with the value and continued growth of the buyer’s stock.

The Acquisition Plan also identifies the value-added efficiencies and projected cost-savings which will result from the proposed transaction(s). Therefore, the Acquisition Plan should always answer the fundamental question: How will the buyer’s professional management or brand equity enhance the perform-

ance or profitability of the seller’s company? These objectives may vary, but generally include a desire to accelerate growth in revenues and profits, strengthen the buyer’s competitive position, broaden existing product lines, or break into new geographic markets or market segments as part of a diversification strategy. The heart of the plan will identify the “*Targeted Industries*” and the “*Criteria for Evaluating Candidates*” within the targeted industries. The Acquisition Plan will also identify:

- the targeted size of the candidates;
- the source of acquisition financing (including the logistics for obtaining the capital, where necessary, and the targeted amount and method of payment to the seller);
- the method for bringing candidates to the buyer’s attention (e.g. internal search vs. use of intermediaries vs. dealing with unsolicited offers, etc.);
- the desired financial returns and/or operating synergies to be achieved as a result of the acquisition;
- the minimum/maximum ranges and rates of revenues, growth, earnings, net worth, etc., of the seller which would be acceptable to the client and the client’s Board of Directors;
- the impact on existing shareholders of the company;
- the likely competing bidders for qualified candidates;
- the members of the acquisition team and each of their roles;
- the nature and types of risks which you are willing to assume versus those which will be unacceptable;
- the desired geographic location of the target companies;
- the desired demographics and buying habits of the seller’s customers;
- the plans to retain or replace the management team of the target company (even though this policy may vary on a target-by-target basis, it is recommended to include a section addressing the preliminary plans in the Acquisition Plan);
- the buyer’s willingness to consider turnaround or troubled companies (again, each buyer will have a different tolerance level as to what condition the seller should be in – some buyers want and prefer the “cost-savings” of buying a “fixer-upper” and others prefer matters to be pretty well intact when they “move-in”);
- the buyer’s tax and financial preference for asset vs. stock transactions;
- the buyer’s openness to full vs. partial ownership of the

seller's entity or willingness to consider a spin-off sale, such as the purchase of the assets of an operating division or the stock of a subsidiary; and

- the buyer's interest or willingness to launch an unfriendly takeover of a publicly-held company or buy the debt from the largest creditor of a privately-held company.

The Narrowing of Acquisition Criteria

BUYERS OF COMPANIES ARE MORE SPECIALIZED and more focused than ever. From the buyer's perspective, developing a set of defined acquisition criteria and having the discipline to stick to the criteria is the real art of M&A. Open-ended requests for deal flow seem to be a thing of the past because buyers are increasingly better focused on what they really want, which leads to higher quality deals. Provided that the Acquisition Plan addresses all of the issues listed above, it should be relatively easy to define the criteria and screen the candidates. It is typical for the criteria to include a combination of the following:

- history of stable financial and growth performance during different market cycles and conditions;
- market leader in industry niches and geographic regions (recognized brand names with established market-share);
- products with life cycles that are not too short-term or susceptible to obsolescence or rapid technological change;
- strong management team with research and development capability and technological know-how;
- stable and economically favorable relationships with customers, vendors, lenders, and lessors;
- room for growth (or excess) capacity in manufacturing or production;
- range of current or potential claims or litigation in the \$ _____ to \$ _____ range;
- sales range in the \$ _____ to \$ _____ million level with minimum earnings before income and taxes at \$ _____ million, with an aggregate set of post-closing obligations (e.g. liabilities, union contracts, etc.) not to exceed \$ _____;
- purchase price range from \$ _____ to \$ _____ and seller must be willing to accept up to _____% of its consideration in buyer's stock and an additional _____% of the consideration will be contingent on the performance of the seller's company on a post-closing basis (exact method, such as earn-out, to be determined);

- geographical location is desired in the states of _____, _____, and _____ or within a _____ mile range of the buyer's principal headquarters; and
- existing management team must agree to remain in place for up to _____ years.

Naturally, the buyer and its team are not likely to find *all* of these criteria in *each* candidate. Rather, the buyer and its team must be ready to mix and match and accept some compromise in the rigid criteria. However, the buyer must also be careful not to overlook "too many warts" which will result in a deal that will be regretted later.

Again, the goal is to compare the acquisition objectives described in the Acquisition Plan with the strengths and weaknesses of each seller to ensure that the acquisition team



has a clear idea as to *how* the targeted companies will complement the buyer's strengths and/or mitigate the buyer's weaknesses. The specific qualitative and quantitative screening criteria help the buyer and its team ensure that the right candidates are selected. The screening criteria are intended to "filter out" the wrong deals and mitigate the chances of post-closing regrets and problems.

Keys To Preparing an Effective Acquisition Agreement

FOLLOWING THE NEGOTIATION AND EXECUTION of the Letter of Intent and concurrent with the due diligence process, the buyer's lawyer will typically begin preparing the definitive Acquisition Agreement and related documents. Preparing an effective Acquisition Agreement starts with the business lawyer for the buyer understanding the key issues and challenges to the closing of the transaction, the key factors motivating the transaction, and the special issues and risks that need to be dealt with in the documents based upon the results of the due diligence process. The motivation for the deal to occur and the underlying goals and objectives for the



transaction on a post-closing basis will often affect the structure of the transaction (e.g., stock vs. asset acquisitions), pricing and valuation issues, and the ability to obtain necessary third party or governmental approvals.

Structuring the Deal

THERE ARE VIRTUALLY AN INFINITE NUMBER of ways in which a corporate merger or acquisition may be structured. There are probably as many potential deal structures as there are qualified and creative transactional lawyers and investment bankers. The goal is not to create the most complex structure, but rather to create a structure which fairly reflects the goals and objectives of the buyer and seller. Naturally, not all of the objectives of each party will be met each time — there will almost always be some degree of negotiation and compromise. Virtually all structures, even the most complex, are basically either mergers or acquisitions at their roots, including the purchase or consolidation of either stock or assets.

The creativity often comes in structuring the deal to achieve a particular tax or strategic result, or to accommodate a multi-step or multi-party transaction.

At the heart of each transaction are the following key issues which will affect the structure of the deal and the terms of the Acquisition Agreement:

- How will tangible and intangible assets be transferred to the purchaser from the seller? At what price and according to what terms?
- What issues, discovered during due diligence, may affect the structure of the deal?
- What liabilities will the purchaser assume? How will risks be allocated among the parties?
- What are the tax implications to the buyer and seller?
- What are the long-term objectives of the buyer?
- What role will the seller have in the management and growth of the underlying business after closing?
- To what extent will third party consents or governmental filings/approvals be necessary?
- What arrangements will be made for the key management team of the seller (which may not necessarily be among the selling owners of the company)?
- Does the buyer currently have access to all of the consideration to be paid to the seller or will some of these funds need to be raised from debt or equity markets?

There are a wide variety of corporate, tax, and securities law issues which affect the final decision as to the structure of any given transaction. Each issue must be carefully considered from a legal and accounting perspective. However, at the heart of each structural alternative are the following basic questions:

- Will the buyer be acquiring stock or assets of the target?
- In what form will the buyer's consideration to the seller be made (e.g., cash, notes, securities, etc.)?
- Will the purchase price be fixed, contingent, or payable over time on an installment basis?
- What are the tax consequences of the proposed acquisition structure?

Once the deal structure has been determined, due diligence has been completed, valuations and appraisals conducted, terms and price initially negotiated, and financing arranged, the acquisition team must work carefully with legal counsel to structure and begin the preparation of the definitive legal documentation which will memorialize the transaction. The drafting and negotiation of these documents usually focuses on the

past history of the seller, the present condition of the business, and a description of the rules of the game for the future. The documents also describe the nature and scope of the seller's representations and warranties, the terms of the seller's indemnification of the buyer, the conditions precedent to closing of the transaction, the responsibilities of the parties during the time period between execution of the purchase agreement and actual closing, the terms and structure of payment, the scope of post-closing covenants of competition, the deferred or contingent compensation components, and any predetermined remedies for breach of the contract.

The heart and soul of the Acquisition Agreement is, in many ways, merely a tool for *allocating risk*. The buyer will want to hold the seller accountable for any post-closing claim or liability which arose in relation to a set of facts which occurred while the seller owned the company or which occurred as a result of a misrepresentation or material omission by the seller. The seller, on the other hand, wants to bring as much finality to the transaction as possible to allow some degree of sleep at night. When both parties are represented by skilled negotiators, a middle ground is reached both on general as well as on specific issues of actual or potential liability. The buyer's counsel will want to draft changes, covenants, and representations and warranties that are strong and absolute. The seller's counsel will seek to insert phrases like "... except insignificant defaults or losses which have not, or are not likely to, at any time before or after the closing, result in a material loss or liability to or against the buyer..." that leave some wiggle room for insignificant or non-material claims. The battleground will be the indemnification provisions and any exceptions, carve-outs, or baskets that are created to dilute these provisions.

The following chart is designed to be a diagnostic tool to ensure that all parties to the transaction understand the acquisition documents, and to ensure that all key categories of issues have been addressed, and that the definitive documents are reflective of the business points reached between the parties.

<u>Consideration</u>	<u>Mechanics</u>	<u>Allocation Of Risk</u>
<ul style="list-style-type: none"> • Structure • Scope of purchase • Price • How/when paid • Deferred consideration/security • Earn-outs and contingent payments • Other ongoing financial relationships between buyer & seller • Employment/consultant agreements • Post-closing adjustments 	<ul style="list-style-type: none"> • Conditions to closing • Timetable • Covenants (including covenants not to compete) • Third party and regulatory approvals • Schedules (exceptions/substantiation) • Opinions • Dispute resolution 	<ul style="list-style-type: none"> • Representations and warranties ("R&W's") two-way street (due diligence driven) • Indemnification • Holdbacks and baskets • If seller is taking buyer's stock or notes, then R&W's are a two-way street • Collars • R&W insurance • Methods for dealing with surprises

Keeping Merger & Acquisition Deals on Track: Managing the Deal Killers

ANOTHER KEY ROLE OF BUYER'S COUNSEL – in fact, the role of *all* lawyers to the transaction – is to work hard to keep the deal on track. The first step in keeping a transaction heading in the right direction and toward closing (and greatly increasing the chance of deal killer avoidance) is to have strong communication and leadership by and among all parties and key players to the transaction. As in football, each team (e.g., buyer, seller, source of capital, etc.) should appoint a quarterback who will be the point person for communication and

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coordination. Too many lines of communication, like too many chefs in one kitchen, will create confusion and misunderstanding — which are fertile conditions that allow a deal killer to pollinate. The more that the quarterbacks coordinate, communicate and anticipate problems with the various members of their team, and promptly discuss key issues with the quarterbacks of the other teams, the greater the chances that the transaction can and will close.

Some of the key tasks of the buyers counsel as the “transactional quarterback” to keep the transaction on track towards closing include:

- formulate a master game plan/timetable (with realistic expectations regarding financial and post-closing objectives)
- build the right internal and advisory teams
- communication and teamwork
- orchestration and leadership
- momentum and timetable accord
- avoid emotion (“don’t call my baby ugly syndrome”), buyers (and sellers) must avoid falling in love with a given transaction
- start early on governmental and third party approvals
- creative problem solving
- cooperation and support from financing sources

Diagnosing the Source of the Problem

WHEN A POTENTIAL DEAL KILLER DOES ARISE, each quarterback should first diagnose the source of the problem. Where is the issue coming from and what can be done to fix it? A deal killer for one party may not be a deal killer for another party. Take a look at the chart below. The old adage “where you stand often depends on where you sit” clearly applies here. For example, a loan with a higher lending rate than anticipated may significantly alter the attractiveness of the transaction from the buyer’s perspective but may be viewed as a non-issue for the seller.

The Source of the Problem Will Dictate the Solution			
Seller	<u>Stakeholders</u> <ul style="list-style-type: none"> Minority shareholders Key employees VC investors Family members 	<u>Third party Approaches</u> <ul style="list-style-type: none"> Regulatory Lenders Lessors Unions 	A L L P A R T I E S
Buyer	<u>Sources of Capital</u> <ul style="list-style-type: none"> Debt Equity Mezzanine 	<u>Professional Advisors</u> <ul style="list-style-type: none"> Lawyers CPA’s Investment bankers Consultants 	

Once the source of the deal killer has been analyzed, the respective quarterbacks should focus on the specific type of deal killer involved. Most deal killers can, and should be, resolved — either with creative restructuring, effective counseling, or precision document redrafting. Some deal killers cannot be resolved (they are just too sizeable) and other deal killers should not be resolved (like trying to squeeze a square peg into a round hole).

Curing the Transactional Patient

ALTHOUGH A DETAILED DISCUSSION OF THE TOOLS available to “kill a deal killer” is beyond the scope of the article — and is probably as broad as the number of tools available to the Orkin® man to kill the hundreds of different insects and rodents — some of the more common tools are listed below. For the quarterback of the buyer and seller, the first step is to ensure that the transaction *can* and *should* be fixed. If so, these tools can be very valuable in mending a broken deal:

- earn-outs/deferred and contingent post-closing consideration
- representations, warranties, and indemnities may be used to adjust allocation and assumption of risk (weighting of priorities issues)
- adjusting the post-closing survival period of R&W’s
- holdbacks and security interests
- closing date audits

- third party performance guaranties/performance bonds/escrows
- M&A insurance policies
- restrictions on sales by the seller of the buyer’s securities issued as part of the overall consideration
- recasting of financial projections and retooling post-closing business plans

Business lawyers for both buyers and sellers should understand that bad deals deserve to die a peaceful death and hopefully without the need for litigation. Not all transactions are meant to be closed: (a) at this time; (b) at this valuation; (c) between these parties; or (d) under these terms and conditions. But if a transaction can be saved, then it should be saved. The quarterback on each team must have the transactional experience, the business acumen, and the communication skills that are necessary to diagnose the source and nature of the problem, as well as enough familiarity with all of the available tools to get the transaction back on track toward closing.

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The Aetna v. Davila Decision:

IMPLICATIONS FOR HMOs, CONSUMERS, AND STATES

By Christine Naglieri

I. Introduction

FOR THE FOURTH TIME IN FOUR YEARS, the United States Supreme Court analyzed the extent to which the Employment Retirement Income Security Act of 1974 (ERISA) preempts state laws regulating health insurance.¹ On June 21, 2004, in a unanimous decision, the Supreme Court issued its opinion in the consolidated cases of *Aetna Health Inc. v. Davila* and *CIGNA HealthCare of Texas, Inc. v. Calad* (collectively, “*Aetna*”). The Court held that ERISA completely preempts state law claims of wrongful denial of healthcare benefits by ERISA-governed employee health plans.²

The *Aetna* decision has important implications for HMOs, consumers, and states that may not be obvious from the Court’s opinion. Despite being a positive development for HMOs, the decision does not foreclose plaintiffs from suing HMOs, and it does not destroy states’ authority to draft healthcare regulation. In fact, plaintiffs may still sue HMOs under various liability theories, and have several alternatives to bringing a benefits claim in federal court under ERISA. Also, state laws permitting patients to sue HMOs for medical malpractice are not entirely preempted after *Aetna*.

The *Aetna* decision sets forth ERISA standards and clarifies preceding ERISA jurisprudence for the healthcare community. *Aetna* also has significant implications for the healthcare industry, leaves doctrinal questions unanswered, and sets the stage for future ERISA litigation.

II. ERISA Preemption and Jurisprudence

A. What is ERISA?

ERISA is federal legislation that sets minimum standards for most voluntarily established employee health and pension plans. Congress enacted ERISA in order to promote commerce and protect employees by federalizing employee retirement programs.³ Specifically, Congress sought a balance between ensuring fair and prompt enforcement of rights under a health or pension plan and encouraging the creation of such plans.

ERISA (1) requires that health and pension plans provide participants with plan information, (2) establishes fiduciary responsibilities for those who manage and control plan assets, (3) establishes a grievance and appeals process for participants to petition for the proper benefits, and (4) gives participants a

right to sue for benefits and breach of fiduciary duty. ERISA does not cover all group health plans. Examples of those plans not covered by ERISA are: plans established or maintained by government entities or churches for their employees; plans maintained solely to comply with applicable workers compensation, unemployment, or disability laws; and plans maintained outside of the United States primarily for the benefit of nonresident aliens or unfunded excess benefit plans.

B. ERISA Preemption

In *Aetna*, the Court explicitly states Congress’ purpose and intent in enacting ERISA legislation and creating ERISA’s preemptive provisions.

Congress enacted ERISA to ‘protect . . . the interests of participants in employee benefit plans and their beneficiaries’ by setting out substantive regulatory requirements for employee benefit plans and to ‘provid[e] for appropriate remedies, sanctions, and ready access to the Federal courts. The purpose of ERISA is to provide a uniform regulatory regime over employee benefit plans. To this end,



ERISA includes expansive preemption provisions . . . which are intended to ensure that employee benefit plan regulation would be exclusively a federal concern.⁴

ERISA's broad preemption clause supersedes "any and all State law insofar as they may now or hereafter relate to any employee benefit plan."⁵ This preemption provision determines when federal courts have subject matter jurisdiction over certain state law claims brought by employee health plan beneficiaries in state court.

The preemption provision is divided into two sections, §502(a) and §514(a).⁶ ERISA §502(a) provides for "complete" preemption, and allows ERISA participants or beneficiaries to bring causes of actions against ERISA plans. ERISA §514(a) applies to state laws that are "conflict" preempted, and provides that "ERISA supersedes any and all States laws insofar as they may now or hereafter relate to any employee benefit plan described in section 1003(a) of this title."⁷

III. The Davila Decision

A. Juan Davila and Ruby Calad

The facts of *Aetna* focus on two Texas plaintiffs, Juan Davila ("Davila") and Ruby Calad ("Calad"), who brought separate cases against their HMOs in the U.S. District Court for the Northern District of Texas. Both Davila and Calad alleged that their HMOs' denial of benefits constituted a failure "to exercise ordinary care" required under the Texas Health Care Liability Act ("THCLA"),⁸ and that this failure proximately caused their injuries. They also alleged that the HMOs' systems made substandard care more likely, and the HMOs acted negligently in making decisions of medical necessity.

The first plaintiff, Davila, suffers from long-term effects of polio. He is a participant in Aetna, the HMO that provides coverage for his employer's health plan. Davila's physician prescribed Vioxx, an anti-inflammatory medication, for his arthritis and inflammation based on studies showing that Vioxx causes fewer gastrointestinal problems than other pain medications on Aetna's formulary. Aetna refused to cover the Vioxx prescription, instead covering a drug called Naprosyn. Aetna insisted that Davila first try two less expensive medications, and would only cover Vioxx if Davila had an adverse reaction to the less expensive medications.⁹ Davila did not appeal Aetna's decision denying Vioxx.

After taking Naprosyn for three weeks, Davila suffered bleeding stomach ulcers, was hospitalized for five days, required transfusion of seven units of blood, and nearly suffered a heart attack. Currently, he can no longer take pain medication that is absorbed through the stomach. Davila alleged that Aetna's adherence to its policies on the use of Vioxx constituted a violation of the THCLA, and Aetna was liable for

punitive damages because it knew its policy involved a risk of serious injury or death.

The second plaintiff, Calad, is a beneficiary of CIGNA Healthcare of Texas, a Texas HMO, through her husband's employer. She underwent a hysterectomy performed by a CIGNA physician and was discharged from the hospital earlier than the physician recommended. CIGNA stated that Calad did not meet the plan's criteria for approving a longer hospital stay, that the standard one-day hospital stay was sufficient, and that it would not pay for additional inpatient treatment. Similar to Davila, Calad did not appeal the CIGNA decision. She left the hospital and returned a few days later for additional treatment after becoming seriously ill. Calad alleged that CIGNA's conduct violated the THCLA since her illness was a result of CIGNA's decision to deny her a longer initial hospital stay.

B. The Arguments

When the consolidated case was filed in district court, Aetna and CIGNA requested to remove the case to federal court. The HMOs argued that because the plaintiffs' health coverage existed under employer-sponsored ERISA plans, the case was completely preempted by ERISA and could only be litigated in federal court. In addition, the HMOs argued that Davila and Calad could have sought alternative remedies, such as paying for treatment and seeking reimbursement or obtaining a preliminary injunction.

Davila and Calad argued against the case being removed to federal court because they would have to argue their case under federal law.¹⁰ They claimed that the HMOs violated legal duties that arise independently of ERISA and the terms of the employee benefit plans. In particular, they argued that the duty of "ordinary care" imposed by the THCLA was an independent legal duty that should allow the case to proceed in state court. This duty arose independently of any duty imposed by ERISA and the plan terms, and any civil action to enforce this duty was not within the scope of ERISA civil enforcement.

C. The Supreme Court's Ruling

The U.S. Supreme Court unanimously held that states may not provide ERISA health plan beneficiaries or participants with non-equitable remedies under state law claims for erroneous plan benefit determinations. In particular, the Court concluded that state law causes of action under the THCLA were completely preempted and thus, removable to federal court under ERISA.

Writing for the court, Justice Clarence Thomas explained that ERISA's purpose is to "provide a uniform regulatory regime" with broad preemption provisions that are "intended to ensure that employee benefit plan regulation" is "exclusively a federal concern."¹¹ Justice Thomas further added that ERISA §502(a) is "essential to accomplish Congress' purpose of creating a com-

prehensive statute for the regulation of employee benefit plans.” In quoting *Pilot Life Ins. Co. v. Dedeaux*,¹² he stated:

[T]he detailed provisions of §502(a) set forth a comprehensive civil enforcement scheme that represents a careful balancing of the need for prompt and fair claims settlement procedures against the public interest in encouraging the formation of employee benefit plans. The policy choices reflected in the inclusion of certain remedies and the exclusion of others under the federal scheme would be completely undermined if ERISA-plan participants and beneficiaries were free to obtain remedies under state law that Congress rejected in ERISA.¹³

IV. Implications for the Healthcare Industry

The Supreme Court’s ruling in *Aetna* displays an aggressive protection of federal interests under ERISA and has significant implications for HMOs, consumers, and states. In particular, the decision presents several issues: (1) what options are left for consumers who are faced with a denial of benefits, (2) whether HMOs remain liable for consumer grievances, and (3) whether state laws that provide remedies for citizens who receive medical treatment below state standards are valid. Although the Court’s central holding may seem clear, its implications for the healthcare industry are not so obvious.

A. Implications for HMOs

The Supreme Court’s decision is a positive development for HMOs and provides new guidelines for ERISA civil enforcement. The decision quickly reverses a decade of deci-

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sions promoting a decline in ERISA preemption.

1. A POSITIVE DEVELOPMENT FOR HMOs

Following the decision in *Aetna*, an HMO should not be subject to a state tort claim for a benefit denial unless the plan actually employs the treating physician. HMOs contracting with treating physicians who do not make benefits determina-

tions, and whose medical directors are not treating physicians, may obtain removal to federal court and subsequent dismissal of state law claims. Therefore, HMOs will routinely be allowed to remove benefit litigation to federal court.

In *Aetna*, the Supreme Court ruled that HMOs act as ERISA fiduciaries when they make eligibility determinations. Thus, the Court’s holding limits an HMO’s liability because an ERISA fiduciary owes his duty to the ERISA plan as a whole, not to individual ERISA beneficiaries.¹⁴ As long as HMO administrative personnel act in accordance with ERISA plan terms in a manner that serves the interests of the plan, they should not be liable for harm caused by denials of coverage for treatment.

2. EFFECTS OF A CONTRARY DECISION

In *Aetna*, the Supreme Court could have allowed the plaintiffs to bring their claims under state law. Such a decision, however, would be contrary to legislative intent under ERISA. Congress intended for ERISA to provide uniform regulation of group health plans and to avoid a patchwork of state remedies that would expand liability. If the Court held for the plaintiffs, a claim of fiduciary breach by an HMO physician making a mixed decision could be categorized as a malpractice claim. As a result, ERISA’s fiduciary standard would amount to nothing more than the malpractice standard traditionally applied in actions against physicians.

3. ARE HMOs LIABLE AFTER AETNA?

After *Aetna*, if a plaintiff is successful in bringing an ERISA claim against an HMO, the HMO may be subject to a variety of civil penalties. Under ERISA’s “carefully integrated civil enforcement provisions,” a plaintiff may recover damages for the cost of the benefit and reasonable attorneys’ fees. In addition, ERISA authorizes lawsuits against HMOs for breach of fiduciary duty, disgorgement of profits, imposition of constructive trust on ill-gotten profits, interest on delayed benefit payments, restitution, and injunctions.

Although a treating physician may not be an employee of an HMO, plaintiffs may attempt to pursue vicarious liability theories against an HMO such as agency and ostensible agency. An HMO may also be liable for a physician’s conduct under a respondent superior theory or for negligently selecting and/or retaining the physician on staff. Accordingly, counsel for HMOs should be sure that their clients implement appropriate policies and procedures for making benefit determinations and follow efficient credentialing and peer review procedures.

ERISA regulations also expressly provide that state independent review laws are not preempted.¹⁵ State independent review laws are binding on an HMO, and a plaintiff can file suit against an HMO for violation of such laws. In addition, plaintiffs may bring suits alleging that an HMO acted in bad faith. For example, a plaintiff may bring a bad faith cause of action

when an HMO discriminates between ERISA and non-ERISA members in examining claims.

In *Aetna*, the Supreme Court pointed out that a cause of action will be deemed “independent” of ERISA only if it is “entirely independent of the federally regulated contract itself.”¹⁶ Thus, duties outside of ERISA may be imposed on an HMO that are not “related to” an ERISA plan. Nevertheless, the Court did not give much guidance on what is “independent” of ERISA, and has left this issue open for future ERISA litigation.

B. Implications for Consumers

If the *Aetna* decision is a positive result for HMOs, what are the anticipated effects on consumers? After *Aetna*, consumers can still bring suit against their HMOs, and have alternatives to ERISA litigation.

1. CAN CONSUMERS SUE HMOs AFTER AETNA?

The Supreme Court decision does not mean that consumers can't sue their HMOs. Instead, it is about whether a state law that requires HMOs to exercise a duty of care is preempted by ERISA. If a state law is preempted by ERISA, consumers can

“[A]fter *Aetna*, alternatives to suits against HMOs for denial of benefits or services will become more important than ever for consumers.”

still recover the value of benefits denied to them, and may be able to sue their HMOs in certain factual situations.¹⁷

Consumers can still sue non-ERISA plans, such as government or church plans. The decision does not apply to Medicaid managed care products, Medicare HMOs, Medigap policies, health benefits plans for federal employees, or discount health plans. Also, medical malpractice claims against staff-model HMOs based upon an agency theory would not be preempted by ERISA because it would not be an eligibility claim, but a negligent hiring or supervision claim. In addition, vicarious liability claims against HMOs and insurers may survive the decision.

After *Aetna*, consumers, under certain circumstances, may bring claims against ERISA-governed health plans in state court. The Supreme Court stated that consumers may sue in state court when the facts of their case resemble the facts of *Pegram v. Herdrich*.¹⁸ In *Pegram*, the plaintiff's treating physician was administering the plan benefits, and the Supreme Court explained that “the physician's eligibility decision and the treatment of the decision were inextricably mixed.”¹⁹

The *Aetna* Court held that treating physicians or their employers are not acting as fiduciaries when making mixed treatment and eligibility decisions; HMOs, insurers, and plan administrators are acting as fiduciaries and are covered and protected by ERISA when making benefit determinations. The Court did not consider under what conditions HMOs directly employing treating physicians are liable to ERISA beneficiaries for physician conduct. This is because the coverage decisions in Davila and Calad's cases were not made by treating physicians. Thus, whether ERISA preempts such claims is unclear and is another question left open for future ERISA litigation.

2. CONSUMER ALTERNATIVES TO ERISA

In its opinion, the Supreme Court points out that Davila and Calad could have pursued alternative remedies upon their denial of benefits.

It is clear, then, that respondents complain only about denials of coverage promised under the terms of ERISA-regulated employee benefit plans. Upon the denial of benefits, respondents could have paid for the treatment themselves and then sought reimbursement through a §502(a)(1)(B) action, or sought a preliminary injunction . . .²⁰

Consumers claiming wrongful denial of ERISA benefits have alternatives to bringing an ERISA claim against their HMO. For instance, a consumer may pay for denied benefits out of pocket and seek reimbursement under the HMO's internal appeals process, required by ERISA. If this appeal is denied, consumers may then sue under ERISA.

If consumers cannot pay for their benefits out of pocket, and the benefits are needed urgently, they can seek an injunction or seek a temporary restraining order from a state or federal court against the HMO. This would force the HMO to make a decision or to cover the service for that period of time. If the HMO is recommending discharge or will not keep the patient in the hospital without coverage, consumers may also ask a state court for an injunction. However, this approach requires that both the consumer come up with the money and the provider give the services without insurance approval or authorization. If the HMO alone is the problem, consumers may first complain to a hospital administrator or compliance officer.

Some of these alternatives could have been used by Davila and Calad. Davila could have purchased Vioxx and then sued Aetna for the cost, or sought a declaratory judgment requiring Aetna to pay for Vioxx. Similarly, Calad could have stayed in the hospital, paid the hospital bill, and then sued CIGNA. In addition, Davila and Calad could have appealed their denial of benefits through their HMOs' appeals process, or instead sued a doctor or hospital. HMO internal grievance processes were available to both plaintiffs.

In Calad's case, however, by the time the HMO heard the appeal, she would have been out of the hospital. Calad needed the decision immediately and an appeal would have been futile. Nevertheless, she could have asked for an injunction. Consumers may go to state or federal court to ask for an injunction and request the court to hear their complaint immediately. They may represent themselves or have counsel present, and if the situation is urgent, the court will hear their request the same day. However, this assumes that consumers are aware of injunctions and if they cannot represent themselves, can afford counsel to represent them. This may not be a realistic option for most consumers.

The Supreme Court's ruling in *Aetna* means that there are fewer options for consumers who seek to recover from a denial of benefits and do not obtain the benefits on their own. Thus, after *Aetna*, alternatives to suits against HMOs for denial of benefits or services will become more important than ever for consumers.

3. CONSUMER RELIEF UNDER ERISA

Although consumers may perceive their grievances as unremedied, the *Aetna* decision may create greater relief under future ERISA enforcement. In her concurring opinion, Justice Ginsburg recommends that a form of "make whole" relief might be appropriate equitable relief under ERISA. She suggests that the Court's broad interpretation of ERISA's preemptive provisions, along with its construction of equitable relief under §502(a)(3), creates a "regulatory vacuum" in which a majority of state law remedies will be preempted, but few federal substitutes will be available for plaintiffs. She urges the judicial and legislative branches to "revisit what is an unjust and increasingly tangled ERISA regime" and assist those "persons adversely affected by ERISA-proscribed wrongdoing."²¹

The Supreme Court notes that Davila and Calad failed to amend their complaints to bring a claim under §502(a), and therefore waived the opportunity for the Court to address the "make-whole" issue. Justice Ginsburg's appeal for such relief may suggest that plaintiffs should consider pursuing an action under §502(a)(3) for monetary damages resulting from harm caused by erroneous medical necessity decisions made by HMOs. Whether such a difficult case would be fruitful may be the next step in ERISA preemption analysis.

C. Implications for States

A state's role is to protect the health, safety, and welfare of its citizens. The regulation of healthcare is an integral part of that role. One implication of the *Aetna* decision is the erosion of states' authority through invalidation of state laws providing remedies for citizens who receive medical treatment below state standards. However, are state statutes concerning HMO liability actually invalidated as a result of *Aetna*?

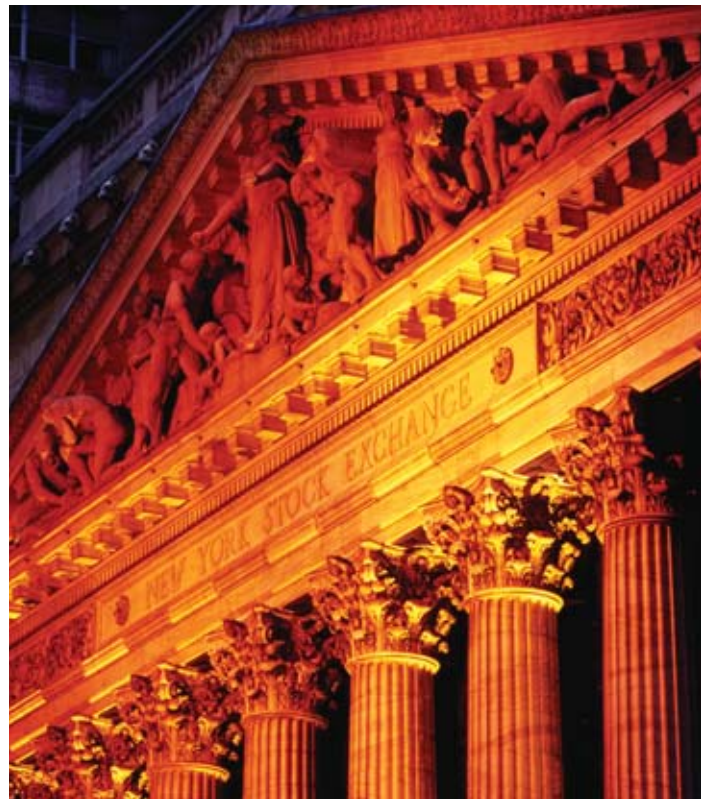
State laws concerning HMO liability may be invalid with respect to liability for denials of benefits. However, the *Aetna*

decision does not mean that all state laws are preempted. For example, the THCLA is not entirely invalidated. Only those portions of the THCLA with remedies "in addition to" ERISA's remedies are preempted, and those portions of the THCLA that do not relate to civil cases are not preempted. Furthermore, the THCLA still protects consumers with non-ERISA HMO plans.

State independent right to review laws are also not preempted by ERISA.²² Forty-three states and the District of Columbia have right to review laws which enable consumers to challenge coverage decisions.

1. "INDEPENDENT" OF ERISA

The THCLA requires the interpretation of plan benefit terms in order to determine liability under its provisions. Thus, the legal duties imposed by the THCLA do not arise independently of ERISA or the terms of the HMO plan, and the Court did not need to consider what might constitute an "independent duty" owed by an HMO to an individual ERISA beneficiary.



States may attempt to enact managed care liability laws, which would create an independent legal duty, in order to permit actions against HMOs based on an alleged breach of those duties. However, it is difficult to ascertain what those duties might be. Arguably, any state cause of action by an ERISA beneficiary against an HMO that is acting as a fiduciary either seeks remedies alternative to ERISA's exclusive remedies under §502(a), and/or "relates to" an ERISA plan under §514. Thus, it is uncertain how the *Aetna* ruling will play out in future ERISA cases.

2. STATE INSURANCE LAWS

The *Aetna* decision also raises the issue of whether state insurance laws that create liability for bad faith are affected by ERISA's enforcement provisions. The Court addressed this issue when it reaffirmed its holding in *Pilot Life Ins. Co. v. Dedeaux*.²³ The Court reiterated that *Pilot Life* requires preemption of even saved state insurance laws if such laws would provide "a separate vehicle to assert a claim for benefits outside of, or in addition to, ERISA's remedial scheme."²⁴ Therefore, even where state statutes meet ERISA's test under the savings clause,²⁵ if the statutes replace ERISA remedies, they are preempted. Consequently, it appears that states must create laws that do not replace the ERISA remedial scheme in order to provide remedies for citizens.

V. Conclusion

The *Aetna* decision has many anticipated implications for HMOs, consumers, and states. While the decision is a positive development for HMOs, it does not entirely foreclose consumers from gaining relief under ERISA and does not erode states' authority in healthcare regulation. Although seemingly supported by the decision, HMOs may still be liable for their conduct and for the conduct of physicians, and remain subject to ERISA's exclusive remedies. HMOs also face the prospect of litigation on issues such as what is appropriate make-whole

relief for plaintiffs, and what constitutes a violation of federal or state legal duties independent of ERISA and benefit plan terms.

The decision does not preclude consumers from having their potential grievances remedied. Consumers may still sue non-ERISA HMOs and government-sponsored plans, and medical malpractice claims against doctors and hospitals remain as options. Consumers also have alternatives to ERISA litigation such as appeals processes and court-ordered injunctions.

The *Aetna* decision does not erode state authority in healthcare regulation. Only those provisions that are "in addition" to ERISA's remedial provisions are preempted. After *Aetna*, states must create laws that constitute an independent legal duty of ERISA in order to avoid preemption. However, creation of an independent duty may be a difficult task because what is "independent" of ERISA enforcement remains unanswered.

Given its many unresolved issues and open-questions, *Aetna* will likely become another decision in a long line of court decisions on the role of ERISA in an increasingly complex healthcare setting.²⁶

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ENDNOTES: Christine Naglieri

¹ Kentucky Assn. of Health Plans, Inc., et al. v. Miller, 123 S.Ct. 1471 (2003) (upholding a Kentucky "any willing provider" law); Rush Prudential HMO, Inc. v. Moran, 536 U.S. 355 (2002) (upholding an Illinois external review law); Pegram v. Herdrich, 530 U.S. 211 (2000) (holding that HMOs could not be sued over the use of physician financial incentives to limit care).

² *Aetna Health, Inc. v. Davila*, 124 S.Ct. 2488 (2004).

³ Commerce is promoted by allowing companies to operate on a national basis and not have to worry about each individual state law that regulates employee benefits. Health coverage is considered an employee benefit.

⁴ *Aetna Health, Inc.*, 124 S.Ct. at 2495. (citing *Alessi v. Raybestos-Manhattan, Inc.*, 451 U.S. 504, 525 (1981)).

⁵ 29 U.S.C.A. § 1144(a) (2000).

⁶ 29 U.S.C. § 1132(a) (2000); 29 U.S.C. § 1144(a).

⁷ 29 U.S.C. § 1144(a).

⁸ Tex. Civ. Prac. & Rem. Code §§ 88.001-88.003. The THCLA is a Texas state law that allows Texas patients to sue their HMOs directly for medical malpractice. It expressly provides that an HMO can be sued in state court for breaching its "duty to exercise ordinary care when making health care treatment decisions and is liable for damages for harm to an insured or enrollee proximately caused by its failure to exercise such ordinary care." Ten states have enacted legislation similar to the THCLA. They are: Georgia, California, Washington, Arizona, Maine, Oklahoma, West Virginia, Oregon, New Jersey and North Carolina.

⁹ *Aetna* covered Naprosyn as part of a step program in which patients receive less expensive medication before trying more expensive forms of similar medications.

¹⁰ Under ERISA, there would be nothing for *Davila* and *Calad* to recover because they were asking only for monetary damages for pain and suffering and ERISA does not provide monetary relief.

¹¹ *Aetna Health, Inc.*, 124 S.Ct. at 2495 (citing *Alessi v. Raybestos-Manhattan, Inc.*, 451 U.S. 504 (1981)).

¹² 481 U.S. 41 (1987).

¹³ *Aetna Health, Inc.*, 124 S.Ct. at 2495.

¹⁴ *Massachusetts Mut. Life Ins. Co. v. Russell*, 473 U.S. 134, 141-143, 140-148 (1985).

¹⁷ See 29 CFR § 2560.503-1 (k)(2)(i); See also, *Rush Prudential HMO, Inc. v. Moran*, 536 U.S. 355 (2002) (holding that an Illinois statute providing for outside review of plan coverage determinations did not conflict with ERISA).

¹⁸ *Aetna Health Inc.*, 124 S.Ct. at 2497.

¹⁹ The major advantage to bringing a state law tort cause of action rather than an ERISA claim against an HMO is the broader spectrum of relief available under state tort law. In a state tort law cause of action against an HMO, a successful plaintiff can recover monetary damages which are unavailable under ERISA. For example, a plaintiff may seek compensatory damages for past and future physical, mental, and emotional pain and suffering, as well as medical expenses and lost wages. In contrast, ERISA does not permit individual claims for compensatory or punitive damages.

²⁰ 530 U.S. 211 (2000).

²¹ *Aetna Health Inc.*, 124 S.Ct. at 2501, quoting *Pegram*, 530 U.S. at 228.

²² *Id.* at 2497.

²³ *Id.* at 2503.

²⁴ The *Aetna* opinion does not affect the Supreme Court's holding in *Rush Prudential v. Moran*, 536 U.S. 355 (2002) (holding that state external review laws are saved from ERISA preemption, as "garden variety insurance regulation.").

²⁵ 481 U.S. 41 (1987) (holding that all state insurance remedies that are in addition to ERISA's remedies are preempted, even for non-compliance with saved insurance laws).

²⁶ *Aetna Health Inc.*, 124 S.Ct. at 2489.

²⁷ *Id.*

²⁸ After the Supreme Court issued its decision, a group of more than 50 House Democrats, led by representative John Dingell (D-MI), the ranking member of the House Committee on Energy and Commerce, introduced H.R. 4628, legislation proposing a wide range of health plan mandates and a major expansion of liability for health plans, insurers, and employers. The bill, based on a "Patients' Bill of Rights," guarantees patients certain rights under their health plans such as the right to appeal claim denials to an independent board of review, the right to sue HMOs for damages if claim denials result in injury to the patient, and final medical necessity determinations made by doctors, not insurance administrators. See Press Release, Dingell to Introduce Patients' Rights Bill After Supreme Court Sides with HMOs (June 21, 2004), at www.house.gov/commerce_democrats/press/108nr38.htm.

Flying On Empty?

AIRLINES, PENSIONS, AND DISAPPOINTMENTS

By Professor Nancy S. Abramowitz

SINCE ITS DEREGULATION IN 1978, the airline industry has provided our bankruptcy courts with a fair amount of business. United Airlines (UAL) has continued operating in bankruptcy since initially filing for chapter 11 protection in December 2002. US Airways is a repeat player having reentered bankruptcy this year - shortly following its emergence from an earlier bankruptcy two years ago. At the time of this article, having just announced a recent agreement with its pilots union for labor cost savings, Delta seems uncertain about whether or not it has narrowly escaped a threatened filing. Other “legacy” carriers, as opposed to the newer, barebones, low-cost carriers, have dissolved in bankruptcy, been absorbed by others in bankruptcy, or merely flirted off and on with bankruptcy as the industry struggles with its new highly price-competitive identity.¹

The old guard domestic airline industry, like the domestic steel industry, has often struggled under the weight of labor costs – especially enormous pension obligations. The bankruptcy forum has become the vehicle with which employers may shed these obligations and move forward in reorganized, leaner form. The weighty pension obligations arise from bargaining table promises (often made as “IOUs” in lieu of cash wages) to provide retirement plans that offer workers defined benefit pension annuities at retirement. Until the passage of the Employee Retirement Income Security Act of 1974 (ERISA), such plans with their promises of future benefits were under lightly regulated and certainly were not subject to requirements that employers set aside funds to cover the benefits promised to employees.

ERISA first imposed certain minimum funding standards on employer promises of this type, although the legal obligation did not involve playing a quick “catch-up” for outstanding obligations nor the immediate funding of new promises for prior years’ work. ERISA also created a federal insurance program through the Pension Benefit Guaranty Corporation (PBGC) to insure some portion of promised

benefits in the event of a plan termination where the plan assets are unable to satisfy the promised benefits. The PBGC’s assets used for the payment of guaranteed benefits are derived from several sources: first, the PBGC collects insurance premiums from sponsors of insured plans; second, the PBGC succeeds to both the assets *and* liabilities of terminated plans insufficient to cover promised benefits; and, third, in the case of bankrupt employers with terminated plans, the PBGC stands as creditor generally with a host of claims in its own right and as a successor to the plan entity.

The history of PBGC’s financial health might be described as a roller coaster. After some major corporate defaults in the PBGC’s formative years, it was in critical negative territory. After some legislative tinkering with the insurance program and changes in the economic climate, PBGC moved unmistakably to an estimated \$9 billion profit several years ago. But fortunes and circumstances changed. With



reduced interest rates, a softer stock market, and a new swell of corporate bankruptcies giving rise to large plan terminations, the PBGC is back in the negative column. Because the PBGC’s deficit or surplus is measured on a present valuation of assets and liabilities, the present deficit does not suggest the PBGC is unable to meet its pay as you go liabilities for insured benefits on a current or near-future basis. But, given the cur-

rent deficit and the specter of possible terminations of covered plans maintained by UAL, US Air, and Delta, the Executive Director of the PBGC has recently advised Congress:

Considerable attention has been - and must be - paid to the PBGC's financial position. The Corporation's single-employer insurance fund had a record deficit at the end of the 2003 fiscal year of \$11.2 billion, and we will be reporting a significantly increased deficit for the 2004 fiscal year. As you know, United Airlines has said publicly that it will not make any further contributions to its pension plans during bankruptcy and that it "likely" will have to terminate them. Those plans are now underfunded by an estimated \$8.3 billion on a termination basis, \$6.4 billion of which is guaranteed by the PBGC.

Likewise, US Airways, which recently re-entered bankruptcy, announced that it is suspending contributions to pension plans that are already underfunded by an estimated \$2.3 billion on a termination basis, almost all of which - \$2.1 billion - would be guaranteed by the PBGC. In addition, Delta has publicly indicated that the company may have to file under Chapter 11 in the near future. We estimate that the total exposure of plan participants and the pension insurance program to the airline industry was \$31 billion on a termination basis as of the end of 2003.²

The PBGC's prior experience with the airline industry included terminations of plans maintained by Pan Am, Eastern, and TWA, whose plans were funded merely 31 percent, 65 percent, and 39 percent respectively, at termination. Based upon past experience and the prospect of imminent plan terminations, the PBGC has made - and continues to make - its case before Congress about shoring up the system. Specifically, the PBGC has requested stronger funding standards, a more rational and risk-based premium system, better information on participating employers' financial health, and more and better options for the PBGC when a corporate plan sponsor is in bankruptcy.³

Especially irksome to the PBGC is the deliberate and announced policy of bankrupt debtors defaulting on funding obligations without terminating plans. UAL recently announced that it would not meet its required annual funding obligations of some \$500 million this year for its defined benefit plans. US Air, for the defined benefit plans it still maintains, followed suit announcing it would not be making \$100 million in contributions this year because such payments would not benefit the bankrupt estate. In so doing, the

airlines are extending a warm invitation to the PBGC to exercise its statutory authority to terminate the plans, and step in and take over - without the employers having to face unions and employees by taking the termination step on their own.

US Air took the issue head on and minced no words when it announced in its bankruptcy filing that it would be "irrational" to make its required pension contributions as the payments furnish no added value to the debtor's estate.⁴ PBGC Executive Director Bradley Belt called the US Air



statement "remarkable," adding "[t]he company is saying it's irrational to keep your pension promises and to comply with federal pension law. Bankruptcy should not be the path of least resistance to deal with your pension obligations."⁵

Given the interplay of plan funding status, the differential between promised and guaranteed benefits, and the operation of current bankruptcy law, the airlines' position is not so remarkable. Bold headlines about the default suggest that employees stand to lose. The reality may be that the participating employees have already lost. To the extent funded benefits are not only below the promised level but also below the PBGC guaranteed level, the additional contributions to a plan that will assuredly be terminated may provide no added benefit to participant-employees. From the debtor's perspec-

tive, there is no incentive to make payments to the plan. Broadly speaking, the PBGC benefit guarantees are determined without regard to the plan's funding status. Accordingly, United and US Air are simply observing that additional funding contributions will only provide PBGC additional assets with which it must pay fixed benefits in any event. The additional plan contributions are unlikely to improve benefit payments over these guaranteed levels.

While pension law requires periodic contributions despite the pendency of bankruptcy proceedings, the bankrupt company, operating as a debtor-in-possession on behalf of the bankrupt estate, might conclude the additional pension funds deplete the estate without adding value to the estate. Because the debtor stands as a fiduciary on behalf of the bankrupt estate, the debtor's disregard of funding rules is neither remarkable nor irrational.

For employees and their union representatives, the failure to fund may not translate into any enhanced benefits on a termination basis, but it may have significance as a trigger or a reason to terminate a plan sooner rather than later. PBGC can initiate an involuntary termination in appropriate circumstances to reduce any increase in its own exposure to long-term loss.⁶ Each day by which a termination is postponed tends to result in more individual employees and participants qualifying for more benefits on a termination basis. So, while the employees and participants may not reap a direct monetary benefit from a missed contribution in the face of an inevitable termination, the potential that the failure to contribute may accelerate or make more real the fact of termination is problematic.

The PBGC is the real beneficiary of funding under these circumstances. However, the failure of Congress to make the bankrupt company's choice to fund such benefits prior to termination more "rational" ultimately threatens to endanger the pension insurance program and the future of defined benefit plans generally. Congress might choose to respond now or to put matters off until such time as options are limited to a taxpayer rescue.

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ENDNOTES: Nancy S. Abramowitz

¹ See Micheline Maynard, *Survival of the Fittest and Leanest Becomes Strategy for the Airlines*, N.Y. TIMES, Oct. 30, 2004, at A1.

² See *The Effect of Federal Bankruptcy and Pension Policy on the Financial Situation of the Airlines: Hearing Before the Committee on Commerce, Science, and Transportation*, 108th Cong. (2004) (testimony of Bradley D. Belt, Executive Director, Pension Benefit Guaranty Corporation).

³ See *id.*

⁴ **Editor's Note:** In mid-December of 2004, the PBGC urged the bankruptcy court to mandate United's pension contributions; as of December 31, 2004, the PBGC assumed trusteeship of the United pilots' plan (following an agreement between the union and the employer), thereby assuming some \$1.4 billion in unfunded. On Feb. 2, 2005, the PBGC assumed responsibility for the pensions of 51,000 US Air employees at an approximate cost of \$2.3 billion. At the time of this publication, the PBGC estimated the total claim for US Air's pension to be \$3 billion, the second largest claim in the company's history, after Bethlehem Steel at \$3.7 billion. See Elizabeth Souder, *PBGC Takes Over Some US Airways Pension Plans*, Dow Jones Newswires, Feb. 2, 2005.

⁵ See Albert B. Crenshaw, *Pension Agency Seeks More Power: Federal Insurer Wants to Put Liens on Companies in Bankruptcy*, WASH. POST, Sept. 15, 2004, at E03.

⁶ See Employee Retirement Income Security Act of 1974, tit. IV, 29 U.S.C. §1001 (1974) (amended 1997).

Registration of Clinical Trials for Pharmaceuticals

By Danielle Bradus

VIOXX WAS REMOVED FROM THE MARKET because its use was linked to an increased risk of heart attack and stroke. Paxil may be associated with an increased risk of suicide in children. These are only two examples of many similar stories publicized recently by the media. In light of reports and public disclosure of information, pharmaceutical companies have come under attack for failing to disclose information about the side effects of their drugs. The negative exposure has resulted in numerous lawsuits, an American Medical Association (AMA) study, Congressional Hearings, and a recent ruling by the International Committee of Medical Journal Editors (ICMJE) mandating the registration of clinical trials in a public database before member journals may publish the results of those trials. Pharmaceutical companies have not registered their studies in a timely manner, impacting the scientific community, the medical community, and the public at large. With the recent publicity of problems associated with different medications there is an increased push for the registration of clinical trials. However, registration will have a great impact on the pharmaceutical industry and will not solve all problems related to clinical trials.

Initial Registration and the Law

TO UNDERSTAND THE EFFECTS OF REGISTRATION and the ICMJE ruling, it is important to have a basic knowledge of the regulation of clinical trials. The Food and Drug Administration (FDA) governs new drug applications and trials under the Food Drug and Cosmetic Act (FDCA). The FDCA originally contained no requirements for the registration of clinical studies. The first proposal for mandatory clinical trial registration arose in the 1970s during President Nixon's "War on Cancer;"¹ however, this push for a registration requirement was unsuccessful.

Congress amended the FDCA in an effort to increase the use of registries. The FDA Modernization Act of 1997 ("Modernization Act") required the registration of clinical trials for serious or life-threatening diseases.² The Modernization Act included the following requirements:

A registry of clinical trials (whether federally or privately funded) of experimental treatments for serious or life-threatening diseases and conditions . . . which provides a

description of the purpose of each experimental drug[,] . . . eligibility criteria for participation in the clinical trials, a description of the location of trial sites, and a point of contact for those wanting to enroll in the trial, and shall be in a form readily understood by members of the public.³

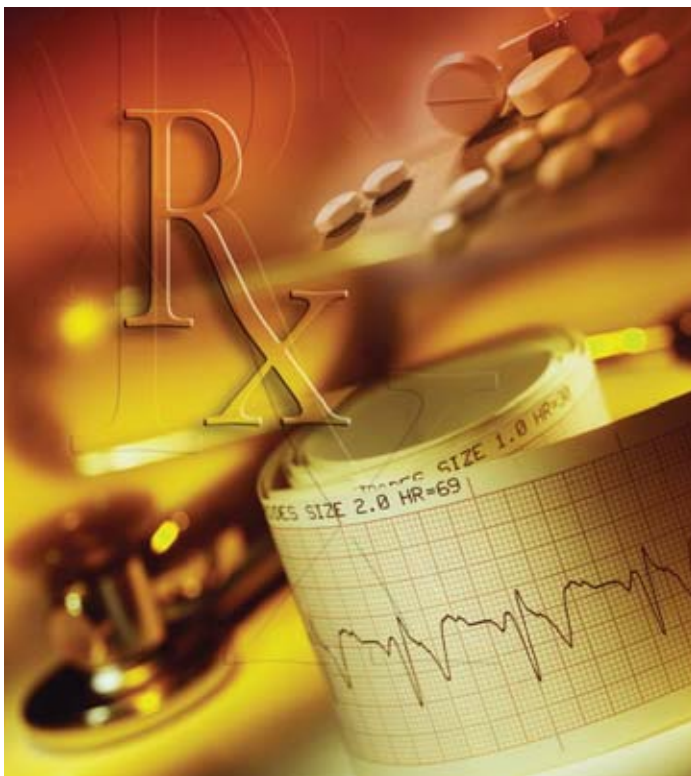
By applying these guidelines to trials involving life-threatening diseases and conditions, the Modernization Act was Congress' attempt to produce a register of trials for the most critical diseases. The Act led the FDA and National Institute of Health (NIH) to create a national register maintained by the United States National Library of Medicine.⁴ This registration system became operational in 2000 and contained 10,906 registered trials by June of 2004.⁵ Although the register was created for studies involving serious or life-threatening diseases, the database also accepts other listings, such as government-funded clinical trials.⁶

The pharmaceutical industry did not fully comply with the new regulations. From its point of view, the economic cost of compliance, discussed in detail below, outweighed the benefits. Therefore, the Modernization Act did not compel the industry to change its practices drastically. In addition, pharmaceutical companies likely realized that the Modernization Act did not grant the FDA funding or an enforcement mechanism. Therefore, although adhering to FDA regulations might help the industry gain the required FDA approval for new medicines, pharmaceutical companies realized that failure to comply with the mandate was unlikely to result in adverse consequences.⁷ The lack of public and media awareness of the benefits and existence of the clinical trial registries may also have contributed to the pharmaceutical companies' failure to comply.⁸

Awareness Levels

THE LACK OF PUBLIC AWARENESS about the benefits of registration may be due to minimal press coverage about the existence of bias in clinical studies. Without media coverage to alert the public to the possibility that clinical trials are skewed toward a positive outcome, there is no public outcry to change the system. Nevertheless, scientists have known of the lack of registration for years, resulting in large part to problems during the publication of study results. In

fact, for decades, scientists complained about publication bias in medical research, particularly the issue of more frequent reporting of positive results.⁹ Publication bias is often attributed to decisions made by the author, investigator, or editor, but may also be present throughout the entire trial, eventually leading to outcome bias.¹⁰ By providing the scientific and medical communities with access to initial information about studies, practitioners may better understand the objectives of each study, the comparative benefits of different study methods, and the markers for success within the studies. This information would help practitioners recognize the impact of various criteria within the published results and enable them to more accurately evaluate the data when deciding whether to use or prescribe a product.



In addition to the publication bias, studies show that an association exists between pharmaceutical industry sponsorship of clinical research and positive results favoring a company's products.¹¹ This bias, however, may be exacerbated by the fact that many clinical trials are performed to obtain FDA approval, rather than to test new hypotheses or compare efficacy among products.

Reasons for Selective Registration

AS CLINICAL TRIALS HAVE BECOME MORE SOPHISTICATED, the number of untreated diseases has decreased while the cost of drug development has substantially increased.¹² This cost increase can largely be attributed to the scientific community's attempts to understand and cure more complex diseases - such as Parkin-

son's and Alzheimer's. Today, the average cost of introducing one new drug into the U.S. market is about \$500 million.¹³ As a result, pharmaceutical companies running clinical trials actively seek ways to keep costs down.

One method used by pharmaceutical companies to decrease costs is to hire contract research organizations (CROs) to perform trials. CROs are able to perform trials at a lower cost and with fewer hassles than academic researchers. The increased use of CROs has generated competition among CROs and academic researchers which enables pharmaceutical companies to bargain for increased control over all aspects of a study, including trial design, who will have access to the data, and who will have permission to publish the results.¹⁴ With such control, pharmaceutical companies may plan and publish studies focusing on the companies' respective goals without making information available that is in the best interest of patients or scientific advancement.

Pharmaceutical companies have much to gain by maintaining complete control over their trials and refusing to register them. Some of the monetary and proprietary benefits include: (1) protection of information about products under development, (2) potential patent acquisitions, (3) concealment of information about recruiting, and (4) avoiding consumer information requests.¹⁵ By keeping studies unregistered, competitors are unable to gain access to information about the drugs involved in the trials.

Failure to register trials often affords pharmaceutical companies with significant financial returns. The recall of Vioxx illustrates how allowing pharmaceutical companies too much control and enabling them to restrict access to pertinent information about a drug may adversely affect consumers. If Merck was aware that Vioxx may cause increased risk of heart attack or stroke,¹⁶ then why did it fail to alert doctors or the public? The answer to this question is simple: the company sponsoring the trial, Merck in this case, often owns the study database and thus may control the release of data,¹⁷ allowing a company to control the publication of information relating to new products. Trials and published study results may be used to market drugs in ways that overstate the drugs' efficacy, producing financial gain for the sponsoring company.¹⁸

The Effect of Selective Registration

ALTHOUGH PHARMACEUTICAL COMPANIES have much to gain by taking advantage of selective registration, the consequences of such action within the scientific community and the public are often quite problematic. To uncover the truth about a product the scientific community faces the daunting task of wading through propaganda wasting time and energy that could be used to for medical advancement.

Without full access to information about on-going trials, scientists and medical practitioners are unable to determine what medical research has and has not already been performed. This causes a variety of problems for scientific advancement and patient health. Scientists are limited in their ability to plan future studies when they are unable to build upon current research. Lack of registration may cause the loss or distortion of trial results, waste and duplication of trials, and a chaotic system



from which few pharmaceutical companies benefit.¹⁹ When pharmaceutical companies take advantage of the system for economic benefit, it deters medical advancement and limits the ability of medical professionals to make informed decisions about patient care.

Unfortunately, the public does not learn of the dangers of selective registration until after the harm occurs. In *New York v. GlaxoSmithKline*, the plaintiff alleged that although GlaxoSmithKline (GSK) was aware of the link between use of Paxil by children and suicidal tendencies, this information was withheld from both the medical community and the general public.²⁰ Unaware of this potentially fatal link, medical professionals continued prescribing the drug to children.²¹ As a result of GSK's absolute control over Paxil studies and trials, doctors lacked vital information when they wrote prescriptions for Paxil.

ICMJE Policy Requirements

IN LIGHT OF CURRENT EVENTS, ICMJE, which includes all the major medical journals, issued a statement that it would not publish the results of unregistered clinical trials. Specifically, the policy requires “as a condition for publication, registration in a public trials registry. Trials must register at or before the onset of patient enrollment.”²² Additionally, “the registry must be accessible to the public at no charge. It must be open to all prospective registrants and managed by a not-for-profit organization. There must be a mechanism to ensure the validity of the registration data, and the registry should be electronically searchable.”²³

Currently, <http://www.clinicaltrials.gov> is the only database in existence that meets the ICMJE requirements of (1) a unique identifying number, (2) a statement of purpose of the study, (3) the study's hypothesis, (4) defined primary and secondary outcome measures, (5) eligibility criteria, (6) key trial dates, (7) a target number of subjects, (8) a funding source, and (9) contact information for the principle investigator.²⁴

The ICMJE policy forces pharmaceutical companies to act where the law does not. Individual companies must be proactive in registering studies, otherwise, the results will not be published. There is no room for retroactive registration.

Industry Gains and Losses

With the ongoing wave of negative publicity, the pharmaceutical industry is reacting to the ICMJE policy. Through individual and collective action, the industry has taken steps to ameliorate the harmful impact of past events. For example, the Pharmaceutical Research and Manufacturers Association (PhRMA), the leading pharmaceutical industry group, announced a recommitment to its own programs. Among these programs is a new plan, announced in September of 2004, to create a public database of published and unpublished summaries of clinical trial results.²⁵

Individual companies have gone even further to create information transparency. In its settlement with New York Attorney General Eliot Spitzer, GSK agreed to become “the first major drug manufacturer to publicly disclose information on clinical studies of its drugs.”²⁶ The agreement stipulates that GSK will create an online “Clinical Trials Register” that will contain summaries of all study results for GSK-sponsored studies conducted after December 27, 2000.²⁷ Other leading pharmaceutical companies reacted to the GSK settlement with their own promises of disclosure. For instance, Forest Laboratories announced a plan similar to GSK's just two weeks after the GSK settlement.²⁸ Soon after, Merck announced that it will support a government-run register that includes late-stage clinical trials or trials after approval. On August 3, 2004, Eli Lilly

and Company (Eli Lilly) announced a more ambitious program by implementing an independent third party system that verifies Eli Lilly's adherence to its own standards of disclosure.²⁹

Despite promises by pharmaceutical companies to disclose clinical trial information, the ICMJE policy is still needed to hold the companies to their word. In the past, companies claimed that they would register their trials, but no permanent, useful, unbiased register resulted.³⁰ The ICMJE requirement creates an excellent incentive for companies to register. Additionally, under the policy, pharmaceutical companies lose little of their competitive edge in their respective markets since the requirements apply uniformly to all companies. In fact, with the negative publicity surrounding the lack of disclosure, individual companies gain credibility by honoring their word and reporting their trials. If registries and disclosure requirements were in place years ago, as recently as the late 1990s, information about the dangers of drugs such as Vioxx and Paxil would probably have been available to medical professionals and the public. This information may have saved lives.

Conclusion

WHILE REGISTRATION MAY CAUSE PHARMACEUTICAL companies to lose some control over clinical trials, the medical community would have greater access to clinical trial information, leading to better and safer treatment for patients. Mandatory registration, however, cannot fix all of the problems of selective reporting. Government policy must compel pharmaceutical companies to comply by requiring the registration, monitoring, and enforcement of trials. The ICMJE policy, in addition to the current individual pharmaceutical company policies, presents the best opportunity for improved transparency of clinical trials.

BLB

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ENDNOTES: Danielle Bradus

¹ Robert Steinbrook, *Public Registration of Clinical Trials*, 351 N. ENGL. J. MED. 4, 315, 316 (July 22, 2004).

² Kay Dickersin and Drummond Rennie, *Registering Clinical Trials*, 290 J.A.M.A. 4, 516, 520 (July 23, 2003).

³ FDA Modernization Act of 1997, 111 Stat. 2311 § 113(j)(3)(A) (amending section 402 of the Public Health Service Act, 42 U.S.C. § 282).

⁴ available at <http://www.clinicaltrials.gov>

⁵ Steinbrook, *supra* note 1.

⁶ *Id.*; Dickersin, *supra* note 2, at 518.

⁷ *Id.* at 520.

⁸ *Id.* at 521.

⁹ *Id.* at 517.

¹⁰ American Medical Association, *Featured C.S.A. Report: Influence of Funding Source on Outcome, Validity, and Reliability of Pharmaceutical Research 2* (June 2004).

¹¹ *Id.*

¹² Frank Davidoff, *Sponsorship, Authorship, and Accountability*, 345 N. ENGL. J. MED. 11, 825 (Sept. 13, 2001).

¹³ *Id.*

¹⁴ *Id.*

¹⁵ Dickersin, *supra* note 2, at 519.

¹⁶ Marcia Angell, *Merck Downplayed the Risks of its Vioxx*, WALL ST. J., Oct. 7, 2004, at A19.

¹⁷ Steinbrook, *supra* note 1, at 315.

¹⁸ Davidoff, *supra* note 12.

¹⁹ Dickersin, *supra* note 2, at 517.

²⁰ *New York v. GlaxoSmithKline*, (Compl. at 5-8). Case was settled out of Court.

²¹ *Id.* at 4. While Paxil was not specifically approved for children, many states allow medical professionals to expand the use of pharmaceuticals beyond FDA approval based on the physician's professional judgment.

²² *Clinical Trial Registration: A Statement from the International Committee of Medical Journal Editors*, 292 J.A.M.A. 11, 1363 (Sept. 15, 2004).

²³ *Id.* at 1364.

²⁴ *Id.*

²⁵ Press Release, PhRMA, *New Database Provides Doctors and Patients Unprecedented Access to Clinical Study Information for Marketed Medicines* (Sept. 7, 2004).

²⁶ Press Release, Office of New York Attorney General Eliot Spitzer, *Major Pharmaceutical Firm Concealed Drug Information: GlaxoSmithKline Misled Doctors About the Safety of Drug Used to Treat Depression in Children* (June 2, 2004) (available at http://www.oag.state.ny.us/press/2004/jun/jun2b_04.html) (last visited on November 2, 2004).

²⁷ *Id.*

²⁸ Press Release, Office of New York Attorney General Eliot Spitzer, *Forest Labs To Establish Clinical Trials Registry* (September 7, 2004) (available at http://www.oag.state.ny.us/press/2004/sep/sep7b_04.html) (last visited on November 2, 2004).

²⁹ Drummond Rennie, *Trial Registration: A Great Idea Switches From Ignored to Irresistible*, 292 J.A.M.A. 11, 1359, 1360 (Sept. 15, 2004).

³⁰ *Id.*

Congress Misfires on SUV Loophole

By Professor Andrew Pike

THE INTERNAL REVENUE CODE (IRC) provides special tax treatment for purchasers of gas-guzzling, jumbo Sports Utility Vehicles (SUVs). Congress had the opportunity to remedy this situation when it considered tax legislation in 2004, but it did not do so. Instead, it enacted a limited measure that retains excessive, (albeit reduced) tax benefits for the affluent few who feel the need to acquire a Hummer-class vehicle.

Why would Congress create an incentive that is limited to some of the most luxurious, high-cost, and least fuel-efficient vehicles on the road? The simple answer is that Congress never enacted an IRC provision that either requires, or explicitly encourages, taxpayers to purchase these gas-guzzlers. Rather, it has enacted several sensible provisions which, when considered together, produce a seemingly incongruous set of incentives due to the complexities of the IRC and the interplay of unrelated provisions.

This article discusses the creation of the SUV tax break and examines: (1) the special tax benefits available for motor vehicle purchasers, (2) the IRC's cost recovery provisions that govern the tax treatment of new equipment that is purchased for business use, (3) the limitations that Congress enacted to prevent what it perceived as excessive tax benefits claimed with respect to luxury automobiles, (4) the incentives that Congress created in 2003 to encourage small businesses to invest in new business equipment, (5) how the interaction of these provisions created the unanticipated SUV tax break, and (6) how Congress responded to the SUV loophole in the American Jobs Creation Act of 2004.¹

Special Tax Benefits Available for Motor Vehicle Purchasers

PRIOR TO THE ENACTMENT of the American Jobs Creation Act of 2004, purchasers of the least fuel-efficient SUVs could receive a tax deduction. However, this deduction was not available to all who purchased an SUV. Rather, only those who purchased a Hummer-class behemoth for use in a business could benefit. Thus, this tax benefit was available primarily to doctors, lawyers and small businesses owners –folks who receive a salary need not apply.

Unlike the \$2,000 deduction available to those who purchase hybrids,² the tax break for an SUV purchase may have equalled the full cost of the vehicle, up to a maximum of \$100,000. The tax deduction for SUV purchasers is not explic-

itly stated; rather, it results from the interplay of several statutory provisions governing the tax treatment of equipment purchased for use in a business.

Tax Treatment of Equipment Purchased for Use in a Business

One of the cornerstone principles of the U.S. income tax system is that taxpayers must report their income on an annual basis.³ The IRC incorporates three broadly applicable principles that are fundamental to measuring income on an annual basis.

First, a business' income for any given year should reflect all income generated during the year as well as the costs incurred in producing this income. This "matching principle" is reflected in numerous statutory provisions. For example, taxpayers must use a specific "method of accounting" that governs

"Why would Congress create an incentive that is limited to some of the most luxurious, high-cost, and least fuel-efficient vehicles on the road?"

the timing of income and deductions.⁴ In addition, taxpayers are permitted to deduct an expense only in the year in which the expense is "paid or incurred."⁵

Second, the IRC generally provides that a business may not deduct any capital expenditure in the year in which the expenditure incurs. A capital expenditure represents the cost of acquiring an asset that will last substantially beyond the end of the taxable year.⁶ The capitalization requirement was created to prevent serious distortions in the calculation of a taxpayer's annual income. Absent this requirement, the cost of an asset would be treated as a cost of producing income in the year in which the taxpayer acquires an asset. A mismatching of income and costs results to the extent that the asset generates income in future years.

Third, consistent with the matching principle, taxpayers are allowed depreciation deductions.⁷ Depreciation represents the decline in value of a business asset that takes place in any given year. This economic cost represents one of the costs that the taxpayer incurs to generate his income for that year.

Although the depreciation deduction is an essential feature of an income tax, Congress has used the depreciation provisions of the IRC to provide economic subsidies for businesses. For many years, taxpayers have been allowed to claim depreciation on an accelerated basis. This acceleration generates a “time value of money” benefit for a business: the larger deductions in the first years in which an asset is owned reduces the business’ tax liability in those years. Although this is offset by the effect of smaller depreciation deductions allowed in later years, the “time value of money” benefit is significant.

There are several distinct factors that contribute to the acceleration of depreciation deductions:

- Taxpayers may use short “useful lives” for purposes of depreciation. For example, the cost of a business asset that remains productive in a business for nine years may be fully deducted over a five-year period rather than over its nine-year economic lifespan.⁸
- Depreciation deductions are “front-loaded.” Under the depreciation rules in effect since 1981, taxpayers may utilize accelerated methods of depreciation for assets other than real property.⁹ As a result, more than half of the cost of a business asset may be deducted as depreciation during the first half of the asset’s useful life.¹⁰
- Congress enacted explicit front-loading provisions: In 2002 and 2003, Congress increased the extent to which depreciation deductions are front-loaded. For assets acquired after September 10, 2001, taxpayers were allowed to deduct 30 percent of an asset’s cost in the year in which it was first used in business. In 2003, Congress increased the additional first-year depreciation deduction to 50 percent of an asset’s cost.¹¹ An asset’s remaining cost is depreciated under the general accelerated depreciation rules. The 50 percent first-year deduction applies to most tangible personal property acquired after May 5, 2003, and before January 1, 2005.
- Congress allowed “small businesses” to deduct the full cost of business assets. In 1981, Congress enacted IRC section 179. This provision allows taxpayers to deduct the cost of certain types of business assets in the year in which the asset is acquired. Initially, taxpayers could deduct up to \$5,000 pursuant to this section, but Congress repeatedly increased the maximum deduction, thereby scheduling the increase to reach \$25,000

in 2003. In 2003, Congress again increased the maximum deduction to \$100,000.¹²

Limitations on Tax Benefits Claimed with Respect to Automobiles

THE BUSINESS USE OF AUTOMOBILES raises several tax policy concerns that are not applicable to other types of business assets. First, an automobile provides a driver with a certain amount of personal satisfaction. Particularly when the car is exceptionally luxurious (e.g., a Rolls Royce, Bentley or high-end Mercedes Benz) or unusually sporty (e.g., a Ferrari or Lamborghini), the personal rewards are likely to exceed the business benefits from the car’s operation.

Second, a driver may use an automobile to satisfy both business and personal needs. To the extent that an asset is used for non-business purposes, no depreciation deduction is allowed. For example, consider a situation in which an automobile is used 60 percent for business with the remaining 40



percent attributable to personal use. In this case, the taxpayer must reduce his or her otherwise allowable depreciation deductions by 40 percent.¹³

It is difficult to determine the extent to which use of a luxury or sports car satisfies the personal needs of the employee/driver, as opposed to satisfying the business needs of the employer. It is also difficult for the Internal Revenue Service to determine the extent of a taxpayer’s non-business use of an automobile since it is virtually impossible to verify how a car is used during an entire year.

In response to these concerns, Congress enacted IRC section 280F, which limits the amount of depreciation deductions a taxpayer may claim with respect to automobiles used for business purposes. Section 280F contains explicit dollar limits on the amount of depreciation deductions allowed in any given year.¹⁴

In addition to the limitations on the magnitude of depreciation deductions contained in section 280F, taxpayers were

able to take advantage of the additional first-year depreciation deductions. As mentioned above, Congress increased the front-loading of depreciation deductions. Through the end of 2004, taxpayers were able to deduct 50 percent of an asset's cost in the year in which the taxpayer first uses the asset in his or her business. For passenger vehicles subject to section 280F, however, Congress limited the amount of additional first-year depreciation that taxpayers may claim.¹⁵ When combined with the section 280F limitations on depreciation deductions, a business' first-year depreciation was limited to \$10,610. During the first

“Any taxpayer who claims to have used one of these SUVs entirely for business may deduct 60 percent of his or her cost during the first calendar year of ownership.”

three years of ownership, the aggregate depreciation deductions could not exceed \$18,260 and subsequent annual depreciation deductions are limited to \$1,675 per year thereafter.¹⁶

The following example demonstrates the effect of the section 280F limitations. A business paid \$60,000 in 2004 for an automobile. Assuming that the taxpayer uses the automobile solely for business, he or she would be entitled to the additional first-year deduction of \$30,000 if the section 280F limitations were not applicable. Under the general depreciation provisions, the taxpayer would be allowed to deduct \$6,000 in that year, with deductions of \$9,600 and \$5,760 in the following two years.¹⁷ For the first three years of business use, the aggregate deductions would total \$51,360. Under section 280F, the taxpayer's deductions are limited to \$18,260 during that three-year period.

It is important to note that section 280F applies only to passenger automobiles. Congress defined a “passenger automobile” as any four-wheeled vehicle manufactured primarily for use on public streets, and which is rated at 6,000 pounds gross vehicle weight or less.¹⁸ At the time section 280F was enacted, few, if any, automobiles manufactured primarily for routine passenger use had a rated gross vehicle weight of more than 6,000 pounds. This definition effectively distinguished passenger vehicles, which are subject to these limitations, and delivery vans and other trucks, which are used in business and by farmers.

In subsequent years, the permissible depreciation allowed

with respect to automobiles did not change. Rather, the market for automobiles underwent a transformation. Specifically, Americans developed a love affair with the SUV. Initially, the largest and best selling SUV was the “mid-sized” Ford Explorer. Although the 2005 model has a gross vehicle weight of 5,880 pounds, the Explorer is still characterized as a passenger vehicle.

For many Americans, the mid-sized SUV was not large enough. The automobile manufacturers developed larger, and substantially heavier, SUVs that surpassed 6,000 pounds and thereby avoid classification as a passenger vehicle. American consumers came to love the Cadillac Escalade, the Lexus LX-470, and that armored personnel carrier in civilian clothing, the Hummer H1. The Lexus tips the scales at 6,860 pounds, the Escalade weighs in at 7,000 pounds, and the Hummer H1 is 10,300 pounds.¹⁹ The owners of these super-sized vehicles avoided the depreciation limits in section 280F because their SUV's weight exceeded the 6,000-pound limit.

Then Congress Created the SUV Tax Break

AT THIS POINT, IT IS APPARENT that different depreciation regimes applied to cars and SUVs. Section 280F classifies most cars, minivans, pick-up trucks, and small to medium sized SUVs as “passenger vehicles.” Taxpayers who use these vehicles in their businesses were able to claim, at most, \$18,260 in depreciation during the first three calendar years of the vehicle's use in business.

The ultra-large SUVs, however, are not “passenger vehicles,” and taxpayers who acquire them may claim depreciation deductions under the generally applicable depreciation rules. Any taxpayer who used one of these SUVs entirely for business was allowed to deduct 60 percent of his or her cost during the first calendar year of ownership. Clearly, owners of these SUVs enjoy preferential tax treatment compared to the owners of smaller passenger vehicles, who may claim depreciation only to the extent permitted under section 280F.

Moreover, section 179 permits certain small and moderate size businesses to deduct the cost of depreciable equipment and machinery, rather than capitalize those costs. As discussed above, the maximum deduction permitted under this section was scheduled to reach \$25,000 in 2003.

In 2003, Congress created the ultimate SUV tax break when it increased the maximum amount that taxpayers could deduct under section 179 from \$25,000 to \$100,000.²⁰ Again, Congress made no explicit reference to SUVs when it enacted this change.²¹ Rather, it focused on the fact that section 179 “lowered the cost of capital,” which it believed would lead small businesses to “invest in more equipment and employ more workers,” and would “reduce depreciation recordkeeping requirements with respect to expensed property.”²²

Notwithstanding Congress' intent, the change had an unanticipated consequence. At last, a small business that pur-

chased a heavyweight, luxurious, and high-priced SUV could deduct the full cost of the vehicle if it was used entirely for business purposes. A small business that used an ultra-large SUV could deduct up to \$100,000 of the vehicle's cost immediately, pursuant to section 179, with the remainder of the cost deductible under the generally applicable accelerated depreciation provision discussed above.²³

Daily newspapers and the financial press reported, with outrage, about the "three-ton SUV loophole,"²⁴ and hundreds of articles appeared from coast-to-coast. In October, Congress responded to this outrage as part of the American Jobs Creation Act of 2004 ("the Act"). Prior to the Act, the \$100,000 limitation in section 179 was to expire at the end of 2005. In section 201 of the Act, Congress created a two-year extension of the provision. To deal with the SUV loophole, section 910 of the Act provides: "The cost of any sport utility vehicle for any taxable year which may be taken into account under this section shall not exceed \$25,000."²⁵



Evaluation of Congressional Action

AFTER READING CONGRESSIONAL COMMITTEE REPORTS and the popular press, one might conclude that Congress has closed the SUV loophole. For example, a recent story in the *Wall Street Journal* carried the headline, "SUV Tax Break for Business Is Likely to End," and reported that Congress would either "scrap the tax break, or limit it so that it applies only to people who have legitimate business uses for these vehicles."²⁶ This is wrong.

The 2004 Act's amendment to section 179 creates a \$25,000 limit to the amount that a small business may deduct when it purchases a vehicle with a gross weight of between 6,000 and 14,000 pounds.²⁷ This provision is applicable to any SUV placed in service after October 22, 2004. The effect of the revised section 179 limitation is illustrated in the following examples. First, assume that a taxpayer acquires a super-sized SUV that costs \$70,000 prior to January 1, 2005. Assume further that the SUV meets the requirements of section 179 and is used solely for business purposes. The taxpayer then may deduct:

- \$25,000 under section 179
- \$22,500 of additional first-year depreciation deduction
- the remaining cost of \$22,500 as depreciation. In the first year of business use, the taxpayer may deduct \$4,500 with the remaining \$18,000 deductible over the next five years.

This example demonstrates that Congress created a year-end window for taxpayers seeking to obtain substantial tax benefits from the purchase of jumbo SUVs in 2004. The purchaser in this example may deduct \$52,000 in the year that the SUV is acquired.

As mentioned above, the additional first year depreciation allowance contained in section 168(k) expired at the end of 2004. Unless Congress reinstates this provision, beginning in 2005, small business owners who acquire jumbo SUVs will be allowed smaller, but still substantial, tax benefits. Assume that a taxpayer acquires a super-sized SUV that costs \$70,000 in 2005, that the SUV meets the requirements of section 179 and that it is used solely for business purposes. The taxpayer then may deduct:

- \$25,000 under section 179
- the remaining cost of \$45,000 as depreciation. In the first year of business use, the taxpayer may deduct \$9,000 with the remaining \$36,000 deductible over the next five years.

Although the first-year tax deductions are reduced to \$36,000, they remain substantial, and much greater than would be obtained if the SUV were classified as a passenger vehicle for purposes of section 280F.

These examples demonstrate that Congress has not eliminated the SUV tax break. It has merely reduced the magnitude of the unjustified tax benefits. Business taxpayers were able to deduct more than 70 percent of the cost of an SUV purchased before the end of 2004 and more than approximately 50 percent of the cost for purchases occurring thereafter.

Conclusion

THE ORIGINAL SUV TAX BREAK resulted from the interaction of the following seemingly unrelated tax provisions:

- Congress attempted to draw a line between motor vehicles commonly used for personal use and those used overwhelmingly for business when it enacted section 280F. This provision draws the line at 6,000 pounds. Although accurate during the mid-1980s, the line became inadequate to serve its intended purpose because the market for automobiles changed.
- Congress decided to provide some tax relief for small businesses. When Congress increased the amount that small businesses could deduct under section 179, it created the SUV tax break, and when Congress increased the limit to \$100,000, the SUV loophole became a subject of popular outrage.

The complexity of the IRC makes it likely that unintended consequences will arise. These consequences are more likely to occur when Congress uses the tax law to provide economic

incentives for investment rather than provide an accurate measure of income. In the case of the SUV tax break, many professionals and small business owners claimed excessive tax deductions when they improperly overstated the extent of their business use of these vehicles.

Congress's failure to close the SUV loophole is inexcusable. The loophole was widely known and the solution was simple. Congress should have amended section 280F and changed the definition of the term "passenger vehicle" to cover Hummer-class SUVs. The failure to enact this change **BLB** reinforces the notion that Congress is unwilling to remove any tax break – no matter how meritless the tax break may be.

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ENDNOTES: Andrew Pike

¹ H.R. 4520, 108th Cong. (2004) (enacted).

² See I.R.C. § 179A (2004) (providing a special deduction for taxpayers who purchase an automobile that employs hybrid technology. Purchasers may deduct up to \$2,000. Typically, these hybrid vehicles incorporate innovative technology that results in superior fuel economy and extremely low levels of pollutants).

³ I.R.C. § 441 (2004).

⁴ I.R.C. § 446 (2004); Treas. Reg. §1.446-1 (2004).

⁵ I.R.C. § 162 (2004).

⁶ I.R.C. § 263 (2004); Treas. Reg. § 1.263(a)-2(a) (2004).

⁷ I.R.C. §§ 168 (for tangible property), 197 (for certain intangible assets) (2004) (Assets such as land are not depreciable because they are deemed to have an unlimited economic life).

⁸ I.R.C. § 168(e)(1).

⁹ I.R.C. §§ 168(b)(1) and (2).

¹⁰ Rev. Proc. 87-56, 1987-2 C.B. 674, Table 1.

¹¹ I.R.C. § 168(k)(1)(4) and (4) (2004).

¹² I.R.C. § 179(b) (2004) (Pub L. No. 108-27, Sec. 202(a)-(e) amended this section in 2003 by reducing the benefit if the taxpayer's investment in business assets in the year exceeds specified levels. For 2003, the benefits were eliminated if a taxpayer's investment exceeded \$500,000).

¹³ BORIS I. BITTKER, ET AL., *FEDERAL INCOME TAXATION OF INDIVIDUALS* 14-9 (2d ed. 1995) at 14-9. See also Treas. Reg. 1.179-1(d) (1992).

¹⁴ In 1984, Congress also enacted a requirement that taxpayers maintain contemporaneous records of their business and non-business use of automobiles. Pub. L. 98-369, § 179(b)(1). Following a public outcry against these provisions, this requirement was repealed retroactively.

¹⁵ H.R. REP. NO. 108-94 (2003). This amount is not increased to reflect inflation.

¹⁶ See Rev. Proc. 2004-20, 2004-13 I.R.B. 642. § 280F(a)(1)(C)(ii) provides that the generally applicable depreciation limitations are tripled for passenger vehicles propelled primarily by electricity.

¹⁷ See I.R.C. § 168, Rev. Proc. 87-57, 1987-2 C.B. 687. This example assumes that the taxpayer uses the automobile solely for business.

¹⁸ I.R.C. § 280F(d)(5). For automobiles, the weight limit is based upon the vehicle's unloaded gross vehicle weight. The statutory definition utilizes "gross vehicle

weight" with respect to trucks and vans. Unlike the weight used for passenger automobiles, the gross weight for trucks and vans includes the weight of vehicle options, passengers, cargo and gas. 2004-5 Fed. Tax Rep. (CCH) ¶ 15,108.022.

¹⁹ All vehicle weights are obtained for 2005 vehicles from www.edmunds.com. For a list of the super-sized SUVs that avoid the "passenger vehicle" designation, see 2004-5 Fed. Tax Rep. (CCH) ¶ 15,108.022.

²⁰ Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, sec. 202 117 Stat. 752.

²¹ Although the committee reports discussing this provision do not discuss the treatment of SUVs, some members of Congress were aware of, and objected to, the differential treatment of the ultra-large SUVs and other passenger vehicles. On January 30, 2003, Senator Boxer introduced S.265, which would have amended section 280F. This proposed legislation would have expanded the definition of "passenger vehicle" to include SUVs weighing up to 14,000 pounds. Excluded from this definition, however, were vehicles incorporating features that made it unlikely that the vehicle would be used for significant non-business purposes.

²² H.R. REP. NO. 108-94 at 25 (2003).

²³ To the extent that the cost of machinery and equipment exceeds this limit, the taxpayer is allowed to deduct the remaining cost through the allowance for depreciation. See IRS Publication 946, *How To Depreciate Property* at 17 available at www.irs.gov/publications/p946/chol.html#d0e1587. If the business purchased other equipment during the year, the taxpayer might not be able to deduct the entire cost in the year of purchase.

²⁴ See, e.g., Mark K. Solheim, *Heavy Metal*, 57 *KIPLINGER'S PERSONAL FINANCE* 107 (2003) available at 2003 WL 2058001; Al Kamen, Editorial, *A Hummerdinger of a Tax Loophole*, WASH. POST, Sept. 26, 2003 at A25, available at 2003 WL 62218281.

²⁵ American Jobs Creation Act of 2004, § 910.

²⁶ Neal E. Boudette and Karen Lundegaard, *SUV Tax Break For Businesses Is Likely to End*, THE WALL ST. J., Oct. 7, 2004 at D6. available at 2003 WL 62218281.

²⁷ American Jobs Creation Act of 2004, § 910. This amendment does not apply to vehicles with: (1) seating for more than nine passengers, (2) with a cargo bed of at least six feet in interior length, or (3) which is structured as a delivery van. See § 179(b)(6)(B)(ii), as amended by American Jobs Creation Act of 2004.

The Hidden Risks of Outsourcing:

Is Your IP Safe Abroad?

By Christopher L. Sorey

The outsourcing debate has focused on the exportation of well-paying jobs to foreign countries. Close attention to job losses is justified when one considers that by the year 2015, the U.S. will have exported an estimated 3.3 million jobs to countries such as India, Russia, and the Philippines to the detriment of American workers.¹ A recent poll of U.S. corporate executives revealed that companies are ignoring the possibility of political backlash resulting from outsourcing and plan to send more jobs overseas in the coming months. Currently, only 30 percent of these companies indicated that they are moving forward in a cautious manner due to public outcry.² In previous years, outsourcing accounted for \$100 billion in revenue; projections for 2005 estimate that figure will grow to \$200 billion.³ The savings generated by outsourcing cannot be ignored, but neither should the risks.

Besides the loss of jobs, intellectual property (IP) theft is another insidious threat to the American economy and its edge in the world markets. Companies looking to take advantage of the enormous savings produced in outsourcing arrangements have often ignored the risks to IP. These companies must be cautious because theft and devaluation of a company's IP have far-reaching consequences. Most companies do not adequately address the risk of exportation of intellectual property. Thus, these companies risk loss of competitive advantage and overall market share.

Outsourcing: Why do Companies do it?

IN THE 1990'S, COMPANIES UTILIZED OUTSOURCING to gain expertise and to provide access to scarce information technology (IT) resources in a booming economic market.⁴ Instead of starting an in-house IT division, an employer could contract with a third party to provide IT expertise. Common forms of this third party expertise included support for maintaining computer hardware and software systems, support operations, and telecommunications.⁵ While the IT work may not have been in-house, at least it was in country.

Sending work abroad was once labeled "offshoring," and is still known by this term in some circles. Offshoring occurs when one company hires a foreign company to perform some business function. The definition of "outsourcing" has evolved to mean sending jobs and work overseas, and thus, these words have become interchangeable. As a result, when most people hear the word "outsourcing" they automatically assume it

means work going abroad.

In a world driven by profit, the cost savings aspect of outsourcing is the primary motivation for U.S. companies. For example, a company could acquire engineering services from three Indians, four Chinese, or five Russian workers for the same salary as one U.S. engineer.⁶ However, American firms do cite other reasons for outsourcing. Companies claim that outsourcing gives their firm access to a larger skill set and cuts down on production time by freeing up domestic personnel to concentrate on more time sensitive projects.⁷

An Illustration of the Risk

IN THE INFORMATION AGE, a company's edge over its competition is frequently embodied in either trade secrets or copyrighted source codes. Unfortunately, if stolen, a company is then hard pressed to regain a competitive advantage in its marketplace. A look at historical IP misappropriation best illustrates the risks involved with outsourcing.

"In a world driven by profit, the cost savings aspect of outsourcing is the primary motivation for U.S. companies."

The year is 1876, and Alexander Graham Bell's telephone is sweeping the globe. It is the "must-have" technological advancement of its time. In Sweden, a company starts repairing the devices and, in that effort, is able to reverse engineer the product and start producing its own telephone. Ericsson, the Swedish phone company we know today, is born.⁸ Ericsson's fortune is built on Bell's misfortune. Bell failed to file for patent protection in Sweden,⁹ and this oversight resulted in the birth of an industrial empire. Bell was partially foreclosed from further exploitation of the Swedish market and the second comer was enriched by Bell's innovation.

A 2004 example illustrates the current dilemma. An employee at an Indian outsourcing firm was confronted by her

supervisors for suspicious activity taking place at her workstation. Allegedly, the employee was caught uploading source codes along with design documents and sending them to her Yahoo! e-mail account. When confronted, the employee excused herself from work and vanished.¹⁰ Since this incident, Jolly Technologies, Inc. (“Jolly”), the American company that outsourced the work to India, has pleaded to no avail with Indian authorities to arrest the alleged thief and enforce India’s law. Likewise, Jolly has met resistance from the Indian IT industry group that represents outsourcing firms in India. Jolly also alleges that the Indian police asked for what amounted to a bribe before they would seek the criminal suspect. The situation has forced Jolly to file suit in India accusing the police of negligence, claiming that they refused to investigate the case.¹¹ This story is just the tip of the IP iceberg. Many of these crimes go undetected or unreported – just as individuals are reluctant to report crimes



where one has been duped, companies may also be reluctant to report IP theft because of the repercussions at home.

Stories such as these illustrate reasons why companies should be cautious when outsourcing IP. Source code (i.e., the uncompiled code of a computer program) is the backbone of many companies’ business. To get computers to do the wonderful things they do, the computer must be provided with instructions. The instructions are written in source code, which then translates in the form of binary object code that is readable to the computer. These codes are often times very long and intricate. In one case, a source code for a simple alarm clock was roughly

11,000 pages long. For many companies, source code is much more than propriety information. Source code is the “secret sauce,” so to speak, and once it is out of a company’s control, the company loses its competitive edge in the market. Source code and other intellectual properties are easily susceptible to theft and misappropriation when placed in the wrong hands.

As illustrated by the Jolly Technologies case, stealing source code may consist of four simple steps: (1) “Select all,” (2) “Copy,” (3) “Paste,” and (4) “Send.” The ease and speed with which one can steal source code is surprising; a company’s edge in the marketplace may be erased in a matter of seconds.

Companies that outsource should not be surprised when their IP is misappropriated, particularly when their outsourcing involves information technology. India, which is one of the leading outsourcing destinations, is a hotbed of software piracy. In fact, the International Intellectual Property Association found that Indian piracy levels for business software applications were 69 percent in 2003.¹² China, another outsourcing hotspot, posted a piracy level of 92 percent.¹³ The Philippines and Russia, which are developing reputations as outsourcing destinations, had piracy levels of 60 percent and 93 percent respectively.¹⁴ Nonetheless, U.S. companies continue to ship critical and sensitive work to outsourcing vendors in these countries. The piracy numbers either reflect a public disrespect for intellectual property rights or a lack of enforcement by the respective governments.

The outsourcing trend does not appear to be slowing despite political backlash in the United States. Instead, the political rhetoric on the campaign trail has drawn more attention to the benefits of outsourcing, such as the low cost and high level of expertise found in places like India.¹⁵ As one expert noted “Indians are doing for information technology processes what the Japanese did to manufacturing processes in the 1970’s.”¹⁶ Well-respected companies like Accenture, Unisys, and Google are planning to expand outsourcing operations in India. Apparently, the risk of IP portfolio theft is outweighed by the hope of saving a dollar.¹⁷

A 1998 study by the Brookings Institution reported that 85 percent of Standard and Poor’s 500 (S&P 500) companies’ market value consisted of intangible assets.¹⁸ The bulk of these intangible assets were intellectual properties such as copyrights, patents, trademarks, and trade secrets. Federal Reserve Chairman Alan Greenspan noted “the economic product of the United States has become so predominantly conceptual”¹⁹ and that “intellectual property can be stolen by an act as simple as broadcasting an idea without the permission of the originator.”²⁰ When a company’s intellectual property is misappropriated or stolen, the value of the IP assets decrease and the company’s market value decreases. This devaluation can be devastating and account for losses stretching into billions of dollars.

For instance, if 85 percent of the market value of the S&P 500 is composed of intangible assets and that number is diminished by even 1 percent, the value of U.S. corporations would be substantially deflated.²¹

Protections Already in Place

AT HOME, AMERICAN COMPANIES ENJOY THE BENEFIT of a very strict IP regime. Of course, we have all heard the stories of 12 years old children nefariously circumventing copyright law with Napster and cd burners. However, when it comes to software, the U.S. has the lowest piracy rate in the world.²² Software makers attribute this low rate to strict enforcement policies.²³ U.S. IP enjoys protection by the U.S. Patent and Trademark Office, the Copyright Office, the Customs Agency, the Justice Department, and complex internet laws. While most people are acquainted with the civil aspects of these protections, there are also criminal protections for IP theft. Both copyright law and trade secret law allow for the criminal prosecution of violators. However, IP protections outside of U.S. borders are not so broad.

What level of IP protection can American companies rely on when conducting business abroad? Although protection for both software and source-code is available under U.S. copyright laws, international protection of software is a bit trickier. Copyright protection abroad consists of a series of treaties patched together. Currently, a truly global copyright

“Although protection for both software and source-code is available under U.S. copyright laws, international protection of software is a bit trickier.”

protection scheme does not exist. Essentially, treaties and agreements tie the copyright regimes of many countries, including the U.S., together.

The most important of these arrangements resulted from the formation of the World Trade Organization (WTO). With the birth of the WTO came the Agreement on Trade-Related Aspects of Intellectual Property, the so-called “TRIPS” Agreement. The TRIPS Agreement subjects WTO member nations to substantive copyright obligations laid-out in the earlier Berne Convention. Under TRIPS, member nations must meet minimum standards of IP protection and must comply with Articles 1 through 21 of the Berne Convention (except

Art. 6).²⁴ Specifically, all member nations are required to protect computer programs under copyright law.²⁵ The requirements laid out in TRIPS appear to provide assurances on a global scale, but some member countries’ approach to IP law enforcement remains a problem.²⁶

The U.S. government’s frustration with many multilateral IP agreements’ enforcement has led to the creation of bilateral agreements, which attempt to provide better IP protection for American companies.²⁷ The economic interests of American companies have also prompted the U.S. government to go a step further and unilaterally monitor and sanction countries that fail to enforce IP protections.



In an attempt to protect American interests abroad, the U.S. reserves the right to monitor IP piracy and impose sanctions against countries that fail to enforce obligations arising under WTO membership and TRIPS. This monitoring and sanctioning is mandated by Congress under the Omnibus Trade and Competitiveness Act of 1988. Under 19 U.S.C. § 2216, Congress authorized the United States Trade Representative (USTR) to monitor the implementation of trade agreements between the U.S. and foreign nations.²⁸ If the USTR determines a foreign nation is not implementing or satisfactorily enforcing IP protection, then the USTR may levy sanctions against that country.²⁹ In addition, the USTR releases an annual report, the “Special 301” Annual Review that groups nations into three categories based on the nations’ respective enforcement of IP rights.³⁰

Special 301 reports examine approximately 70 countries. Countries with the most egregious reputations for protecting IP rights are placed on the Priority Foreign Country's list.³¹ In the 2004 report, 16 countries were placed on the Priority Watch List. India, the Philippines, and Russia, all outsourcing destinations, were on the Priority Watch List, designating those nations that have the most adverse impact on U.S. IP owners.³² Casting a blind eye to this information is dangerous, but companies looking to expand their profit margins have done just that.

Outsourcing as the Mechanism of Change

As nations increase dependence on the revenue generated by outsourcing agreements, some are taking steps to improve their enforcement of IP rights. Although revenue is likely the single greatest motivator, some nations are motivated by the prospect of removal from the Priority Watch List of the Special 301 reports.

While money has been cited as the root of all evil, the almighty dollar could also be cited as the root of change. In one year, India's IT sector exported \$10 billion worth of products and expects to double that figure in the coming years.³³ Like it or not, India will have to make its business climate friendly to prospective companies if it wishes to see this trend continue. India is fully aware that the one way to attract and keep business is to enforce and strengthen its existing IP regime. To its credit, the Indian government has intensified enforcement and implementation of IP laws.³⁴ The effect that outsourcing has had in India could be replayed across the globe. Logically, other countries will want to compete for outsourcing dollars and will likely tout their own IP enforcement programs as incentive for American companies to send work their way.

Nevertheless, many countries have yet to institute measures protecting foreign IP rights. With many American companies competing with their outsourcing brethren, it is unlikely that a "wait and see" approach is viable or affordable. So what can the cautious American company looking to outsource do to insure that it does not lose its secret sauce in the process?

Ways to Safeguard IP

First, companies interested in outsourcing should take advantage of the resources available to American companies. Companies should investigate whether a potential outsourcing

destination is on the Priority Watch List of the USTR – companies should be cautious or simply avoid countries listed. These Priority countries will have incentives to implement and enforce IP laws if the work stops coming in. Until that time, companies are best served by refusing to send work to these IP scofflaws.

Second, when in Rome do as the Romans do, or at least know the Romans. Companies should consider filing for local IP protection in the host country. To accomplish this, the company should make a concerted effort to learn the laws of the host country. One option is retaining counsel in the host country to address any IP issues that may arise. Before shipping IP, companies should investigate the protections available and the host countries' methods of enforcement.³⁵

Finally, companies should ensure that any company with which they enter into an outsourcing agreement with has a U.S. office or subsidiary. This suggestion directly relates to jurisdiction. If something happens in the outsourcing arrangement that would lead to a cause of action against the vendor, then the company would likely have recourse in a U.S. court. Having an outsourcing arrangement with a foreign company that has a U.S. office or subsidiary may be useless unless the American company gets guarantees from the U.S. affiliate. If jurisdiction is a concern, another way of insuring future remedies is to have the parties agree to settle all disputes in arbitration.³⁶

It is not likely that outsourcing will slow down in the near future. Globalization has directly led to this development and the problems we face now are merely growing pains. One positive development of outsourcing is that countries' desire to attract more business leads to the increased implementation and enforcement of IP laws. It is extremely important for any company to protect its IP and to take the precautions necessary to insure it does not lose its edge in the marketplace. For now, however, outsourcing is best ruled by the advice "*caveat emptor*."

BLB

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ENDNOTES: Christopher L. Sorey

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²³ *Id.*

²⁴ General Agreement on Tariffs and Trade – Multilateral Trade Negotiations (The Uruguay Round): Agreement on Trade-Related Aspects of Intellectual Property Rights, Including Trade in Counterfeit Goods, Dec. 15, 1993, art. 9(1), 33 I.L.M. 81 [hereinafter TRIPS Agreement].

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Empagran:

THE FIRST STEP IN AVOIDING A U.S. MONOPOLY ON ANTITRUST ENFORCEMENT

By Joseph DiPietro

[O]ur courts have long held that application of our antitrust laws to foreign anticompetitive conduct is . . . reasonable, and hence consistent with the principles of prescriptive comity¹

Background

ECONOMIC GLOBALIZATION brings with it the question of whether domestic regulations should follow businesses abroad. When U.S. laws apply extraterritorially, meaning outside of its borders, issues are raised regarding the appropriateness of applying U.S. jurisdiction over foreign conduct in light of other nations' interests in the method of resolution and the eventual outcome of the matter. This dilemma is especially pressing in the antitrust arena due to the frequency with which foreign plaintiffs are seeking redress in U.S. courts for injuries suffered abroad.

The issue of extraterritorial application of the Sherman Antitrust Act has come before the U.S. Supreme Court several times, most recently in the *Empagran* case. *Empagran* was an international price-fixing antitrust suit against several foreign and domestic vitamin manufacturers and distributors.² For analytic purposes, the Court assumed that the injury alleged by the plaintiffs (from Australia, Ecuador, the Ukraine, and Panama) was *entirely* independent of any domestic injury.³ In an 8 to 0 ruling (Justice O'Connor abstained), the Court held that when a foreign plaintiff solely alleges a wholly foreign injury, U.S. courts lack jurisdiction over the foreign claim.

The Court, however, remanded to the D.C. Circuit the determination of whether the plaintiffs preserved an alternative argument alleging that the adverse domestic effects exacerbated their foreign injury and therefore, should be justiciable in U.S. courts.⁴ In this alternative argument, the *Empagran* plaintiffs

claimed that a positive correlation exists in the pricing of foreign and U.S. vitamin markets, and that the correlation links the foreign injury to the domestic effects. That link, according to plaintiffs, suffices for jurisdiction over their foreign claim, despite the fact that the specific conduct and injury giving rise to the claim occurred overseas.⁵

Extraterritorial Application of U.S. Antitrust Law Prior to 1982

The Sherman Act, which applies to conduct that adversely affects commerce, was first interpreted in the international context in *American Banana v. United Fruit*.⁶ In this case, the Supreme Court determined that the Sherman Act did not apply to conduct occurring in foreign nations, even if the alleged antitrust conduct adversely effected U.S. commerce.

In 1927, the Supreme Court permitted jurisdiction over conduct occurring outside of the U.S. which adversely effected domestic commerce.⁷ The "effects test," formulated by the Second Circuit in *United States v. Aluminum Company of America*, stated that U.S. jurisdiction over foreign conduct exists if the conduct was intended to effect, and subsequently did effect domestic commerce.⁸ The "effects test" shifted the focus from an examination of the territory in which the conduct occurred to an examination of the conduct's effects.

Later, in *Timberlane Lumber v. Bank of America*, the Ninth Circuit expanded the "effects test" by creating a three-prong test for analyzing whether jurisdiction was merited over foreign antitrust claims.⁹ The *Timberlane* Court's consideration of foreign interests exemplified a growing trend in recognizing international comity. The circuit courts continued to develop different analyses regarding foreign interests in the antitrust context, leading to the passage of the Foreign Trade Antitrust Improvements Act (FTAIA).

"[T]he *Empagran* decision permits foreign plaintiffs to argue that U.S. courts have jurisdiction over every plausible nexus between their injury and the domestic injury."

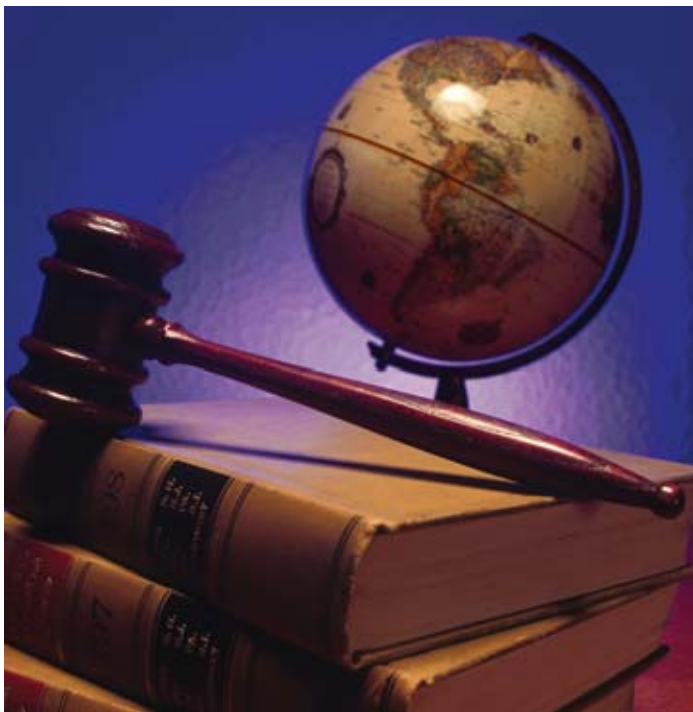
FTAIA

In 1982, Congress amended the Sherman Act with the passage of the FTAIA. The FTAIA permits a broad range of anticompetitive conduct under U.S. jurisdiction, including all conduct not involving imports. The FTAIA also creates an exception for certain types of conduct that adversely affect U.S. commerce provided that there is a “direct, substantial, and reasonably foreseeable effect”¹⁰ on export, trade, or domestic commerce. The *Empagran* Court determined that Congressional intent would also include wholly foreign conduct, with the same effects mentioned in the Act’s exception.¹¹

Circuit Split Prior To Empagran

DEN NORSKE STATS OLJESELSKAP V. HEEREMAC VOF (“STATOIL”)¹²

In *Statoil*, the Fifth Circuit held that foreign plaintiffs alleging a cause of action consisting of a wholly foreign injury lack jurisdiction in U.S. courts. *Statoil* involved a Norwegian oil company seeking damages based on an alleged price-fixing conspiracy orchestrated by British and Dutch companies in the



North Sea.¹³ The British and Dutch companies provided heavy-lift barge services, and there were only seven heavy-lift barges in existence at the time.¹⁴ Heavy-lift services also existed in Asia and an American company provided the services in the Gulf of Mexico. The conspiracy theory alleged that the British, Dutch, and American providers divided the markets and subsequently set price above the competitive level.¹⁵

The plaintiff claimed injuries suffered in the North Sea and based its claim for U.S. jurisdiction on the domestic

injuries in the Gulf of Mexico.¹⁶ The plaintiff contended that the domestic injury suffered gave rise to its cause of action, notwithstanding the injuries occurring in separate markets, because the conduct originated from the same conspiracy.¹⁷

No dispute existed over whether a domestic plaintiff had jurisdiction based on an injury suffered in the Gulf of Mexico. However, the Fifth Circuit refused to infer a connection from the domestic injury to the injury in the North Sea.¹⁸ The court rejected the concept of one plaintiff’s jurisdiction giving rise to another and held that a foreign plaintiff injured in a transaction with no domestic effect may not seek redress in U.S. courts.¹⁹

KRUMAN V. CHRISTIE’S INTERNATIONAL²⁰

In a contrary decision, the Second Circuit granted jurisdiction to a class of foreign plaintiffs claiming wholly foreign injuries. The *Kruman* court theorized a nexus between the domestic and foreign effects of anticompetitive conduct.²¹ The court held the FTAIA and the Sherman Act provided jurisdiction over the foreign plaintiffs’ claims despite all transactions occurring outside of the U.S.²²

The Second Circuit declared that its ruling deters price-fixing cartels operating in two markets from maintaining domestic price-fixing arrangements,²³ and facilitates global competition.²⁴ The court reasoned that not granting foreign

“[T]he issue of whether a domestic injury permits jurisdiction over a foreign claim remains unclear.”

plaintiffs jurisdiction may harm domestic consumers because the overall, the negative effect of the price-fixing increases.²⁵ However, the court did not consider the harm of its decisions on amnesty programs for international cartel members.²⁶

F. HOFFMAN-LA ROCHE V. EMPAGRAN

In *Empagran*, the D.C. Circuit granted jurisdiction over foreign plaintiffs’ claims based on a domestic consumer’s cognizable injury.²⁷ Thereafter, the Supreme Court granted certiorari,²⁸ and held that the FTAIA exception was inapplicable to a foreign plaintiff seeking jurisdiction in U.S. courts for a wholly foreign injury that had no effect on U.S. commerce.²⁹ The Court, however, remanded the case on the issue of whether the inflated price the plaintiffs paid necessarily depended on inflated prices in the U.S., due to the difficulty of keeping prices higher in one market than in another.³⁰ The plaintiffs argued that the U.S. market served as a benchmark for their industry’s prices set around the globe.³¹

The *Empagran* Holding

THE SUPREME COURT'S HOLDING in *Empagran* seemingly resolved the issue of extraterritorial application of the Sherman Act. The Court created a simple rule; if a foreign plaintiff sues in a U.S. court for an injury suffered abroad and the effects causing such injury arise independently of domestic effects, there is no jurisdiction.³² This ruling eliminates many suits by foreign plaintiffs, however, it does not address the amount of linkage to domestic effects that would be required to obtain jurisdiction. For analytical purposes, the Court assumed the injuries alleged were independent.³³ Thus, the *Empagran* decision permits foreign plaintiffs to argue that U.S. courts have jurisdiction over every plausible nexus between their injury and the domestic injury. What remains to be seen is the standard by which U.S. courts will determine whether that nexus is sufficient to establish jurisdiction.

Foreign plaintiffs who are attracted by treble damages,³⁴ recoverable attorney fees, the expertise of U.S. judges, and sophistication of the U.S. legal system, try to circumvent their legal systems and their available remedies by attempting to bring wholly foreign claims into U.S. courts. Therefore, the analysis of jurisdiction over foreign claims must consider the detrimental effects of U.S. jurisdiction on foreign antitrust enforcement systems.

Comity & Cooperation Programs

“Congress designed the FTAIA to clarify, perhaps to limit, but not to *expand* in any significant way, the Sherman Act's scope as applied to foreign commerce.”³⁵ Moreover, the “[Supreme] Court ordinarily construes ambiguous statutes to avoid unreasonable interference with the sovereign authorities of other nations.”³⁶ Foreign plaintiffs choose U.S. forums because successful actions provide generous damage awards. They are not restrained by principles of comity, and do not consider the harmful effects of their actions on the international antitrust enforcement system.

Cooperation programs are an essential part of U.S. and international antitrust enforcement systems. In an amicus brief filed in *Empagran*, the U.S. Department of Justice (DOJ) noted that catching international cartels requires cooperation among all nations.³⁷ It explained that the cooperation program in the U.S. alone, “crack[ed] more international cartels than all of the Division's search warrants, secret audio or videotapes, and FBI interrogations combined.”³⁸ Australia, France, Germany,

Hungary, Ireland, South Korea, New Zealand, Norway, Sweden, Switzerland, the United Kingdom, and the European Union, to name a few, have all initiated cooperation programs. This demonstrates the potential geographic reach of the adverse effects on cooperation programs.³⁹

Actions by foreign plaintiffs are usually brought after government or enforcement agency action, and government actions heavily depend on the success of cooperation programs. For example, in *Empagran*, 855 million (nearly one billion U.S. dollars at the time) in fines were levied by the European Union against the vitamin cartel prior to the civil action.⁴⁰

Many countries, including the U.S., have entered into agreements that limit the overreaching application of antitrust laws in order to facilitate the success of cooperation programs.⁴¹ An example of a foreign government's action in opposition to U.S. overreaching is the U.K.'s enactment of a statute preventing its courts from enforcing judgments resulting in “multiple dam-

ages.” This statute signifies the U.K.'s disapproval and rejection of the Sherman Act's transatlantic reach.⁴²

Jurisdiction in U.S. courts must be reserved for participants in U.S. commerce. Although the modern economy transcends geographic borders, it contains sovereign participants with their own governmental plan for antitrust enforcement

Does an Injury Truly Depend on Domestic Effects?

IF A FOREIGN PLAINTIFF SUED IN A U.S. COURT, how large must the domestic effect be to allow a foreign plaintiff to bring a claim linked to those effects? In its amicus brief in *Empagran*, the DOJ provided the following example: “[A]n international price-fixing cartel . . . had annual foreign sales of \$2 billion to 50 foreign customers, and annual sales in the United States of \$1 million to one customer.”⁴³ Thus, after *Empagran*, a plaintiff could file a similar suit and allege that the domestic effects gave rise to an injury. However, the issue of whether a domestic injury permits jurisdiction over a foreign claim remains unclear. A court must also determine whether an injury's effect on domestic commerce must be substantial or whether the entire injury itself is substantial.⁴⁴

Another question is whether a foreign plaintiff's cause of action is moot if the domestic injury has already been litigated. Allowing a foreign plaintiff to bring such an action makes little sense. It would flood the courts with determinations of standing even before the issue of antitrust injury is addressed.

“Foreign plaintiffs must seek redress in courts where their injury occurred because they submitted to those jurisdictions when they chose to conduct business there.”

Moreover, courts would be inundated with calculated lawsuits filed by plaintiffs who merely follow government enforcement.

Looking Forward

ANY COURT COULD UNDERTAKE THE BURDENSOME and time-consuming task of answering these questions and entertaining claims by foreign plaintiffs in U.S. courts. However, courts are not equipped to make such determinations, and these suits do not facilitate competition in either domestic or foreign markets. Foreign plaintiffs must seek redress in courts where their injury occurred because they submitted to those jurisdictions when they chose to conduct business there.

The jurisdiction of U.S. courts over foreign conduct allows for forum-shopping by foreign plaintiffs, and creates an opportunity to circumvent antitrust enforcement systems in foreign countries. A corporation operating within a foreign

country is bound by that country's laws, and therefore, should be limited the remedies available under those laws.

The Court's ruling eliminates matters that do not belong in U.S. courts. The issue of whether to grant jurisdiction when there is an appropriate connection between domestic effects and wholly foreign injuries remains undecided. All wholly foreign injuries should be litigated in legal systems where the parties transacted their business because this allows the continued growth and success of worldwide antitrust enforcement systems. **BLB**

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ENDNOTES: Joseph DiPietro

¹ F. Hoffman-La Roche, Ltd. v. Empagran, 124 S.Ct. 2359 (2004) (quoting United States v. Aluminum Co., 148 F.2d 416, 443-44 (2d Cir. 1945)).

² See *Empagran* 124 S.Ct. 2359; see generally *Den Norske Stats Oljeselskap As v. HeereMac Vof*, 241 F.3d 420 (5th Cir. 2001) (holding that there is not jurisdiction when a foreign plaintiff alleges a foreign injury not directly flowing from U.S. effects); *Kruman v. Christie's Int'l PLC*, 284 F.3d 384 (2d Cir. 2002) (determining that there was jurisdiction when a foreign plaintiff alleges a foreign injury not directly effecting U.S. commerce because a foreign injury in the context of the global market necessarily means there was a domestic injury which gives rise to the foreign plaintiff's claim even though the injury is separate); *Empagran*, 315 F.3d 338 (finding foreign plaintiffs bringing this type of cause of action do have standing).

³ See *Empagran*, 124 S.Ct. at 2366-67.

⁴ *Id.* at 2372.

⁵ See *id.*

⁶ *American Banana. v. United Fruit*, 213 U.S. 347 (1909).

⁷ See *United States v. Sisal Sales Corp.*, 274 U.S. 268, 276 (1927).

⁸ See *United States v. Aluminum Company of America*, 148 F.2d 416 (2nd Cir. 1945).

⁹ See *Timberlane Lumber Co. v. Bank of America*, 549 F.2d 597 (9th Cir. 1976) (Listing the three prongs as "(1) the effect or intended effect on the foreign commerce of the United States; (2) the type and magnitude of the alleged illegal behavior; and (3) the appropriateness of exercising extraterritorial jurisdiction in light of considerations of international comity and fairness . . ."); see also Steven Richman, *Extra-Territorial Effect of Antitrust Laws*, NEW JERSEY LAWYER, THE MAGAZINE, June, 2004, at 11 (offering a brief look at the extraterritorial application of U.S. antitrust laws and a look at the European Union as well).

¹⁰ See *Empagran*, 124 S.Ct. at 2364-66.

¹¹ See *id.*

¹² *Den Norske Stats Oljeselskap As v. HeereMac Vof*, 241 F.3d 420 (5th Cir. 2001).

¹³ *Id.* at 422.

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ See *Id.*

¹⁸ See *Id.* at 431.

¹⁹ See *Id.*

²⁰ *Kruman v. Christie's International PLC*, 284 F.3d 384 (2d Cir. 2002).

²¹ See *Id.*

²² See *Kruman*, 284 F.3d at 396-401.

²³ *Id.* at 403.

²⁴ See *Kruman*, 284 F.3d at 403.

²⁵ See *id.*

²⁶ See e.g. [ABA Section of Antitrust Law, *Competition Laws Outside the United States* 1:13, 2:13-14, 3:16-17, 9:11, 10:10 (2001); *Global Competition Review, Cartel Regulation, Getting the Fine Down in 25 Jurisdictions Worldwide* (2002); *Global Competition Review, Private Antitrust Litigation in 16 Jurisdictions Worldwide* (2004)]. This information was taken from note 7 of the Brief for the United States as Amicus Curiae Supporting Petitioners, filed by the DOJ to the Supreme Court in *Empagran*.

²⁷ See *supra* note 5.

²⁸ *Empagran*, 124 S.Ct. at 2364.

²⁹ *Id.* at 2369-70.

³⁰ *Id.* at 2372.

³¹ See *id.*

³² See *id.* at 2370-72.

³³ See *id.* at 2366.

³⁴ The Sherman Act provides for treble damages, meaning a successful suit brought under the Act allows for recovery of damages of three times the amount of the actual injury.

³⁵ *Empagran*, 124 S.Ct. at 2369 (emphasis in original).

³⁶ *Id.* at 2366 (citing *McCulloch v. Sociedad Nacional de Marineros de Honduras*, 372 U.S. 10, 20-22 (1963)).

³⁷ See Brief for the United States in Support of Petitioners, 2004 WL 234125 at *20, 38 *Id.*

³⁹ See OECD (Organisation for Economic Cooperation and Development), Policy Brief: Using Leniency to Fight Hard Core Cartels at 2 (September 2001), available at <http://www.oecd.org/dataoecd/60/8/21554908.pdf>.

⁴⁰ Brief of the Governments of the Federal Republic of Germany and Belgium as Amici Curiae in Support of Petitioners, 2004 WL 226388 at *2.

⁴¹ See http://www.oecd.org/document/59/0,2340,en_2649_37463_4599739_1_1_1_37463,00.html

⁴² See *infra* note 40 at n. 11.

⁴³ See Brief for the United States in Support of Petitioners, 2004 WL 234125 at *13.

⁴⁴ Lindsay DeMoss, Editor-in-Chief of the *Business Law Brief*; contributed to the articulation of this point.

Are There Ways out of the Current Forum Non Conveniens Impasse Between the United States and Latin America?

By Professor Dante Figueroa

I. Introduction

GLOBALIZATION MEANS MORE TRADE, easier communications, faster means of transportation, increased international commerce, and also more litigation for U.S. companies doing business overseas. Since there are no courts with worldwide jurisdiction to resolve disputes among private individuals who are nationals of two or more states, these must be resolved by a national forum. Currently, there are no international treaties providing for the international transfer of cases or addressing the issue of convenience in international disputes. Therefore, international plaintiffs have engaged in what has been called “international forum shopping,” choosing the forum most convenient and beneficial to their case. For a variety of reasons, the U.S. courts are often the preferred forum for plaintiffs in international disputes.

U.S. courts have consistently prevented foreign plaintiffs from trying their cases in U.S. fora, invoking the doctrine of forum non conveniens (“FNC”). The effect, both intended and inadvertent, of the FNC doctrine has been to shield U.S. multinational corporations doing business in Latin America from liability resulting from torts or product injury caused to Latin American plaintiffs by barring access to U.S. courts. FNC dismissals have forced Latin American plaintiffs to re-file their complaints in their home fora. Latin American jurisdictions have responded, in turn, by refusing to hear remanded cases on various grounds, the principal being that the plaintiffs’ re-filing has not been a product of their free will and thus is null and void. This impasse is still current, and there seems to be no way out of it.

In this context, this article analyzes current developments in the FNC doctrine as applicable to Latin America, and the different options available to address the FNC deadlock between Latin America and the United States. Part I reviews the U.S. law on conflicts of jurisdiction involving foreign plaintiffs in the context of the FNC doctrine. Part II discusses the Latin American rule on jurisdiction, the consequences of FNC dismissals in Latin America, and the responses to FNC in the form

of judicial retaliation and blocking statutes. Part III focuses on proposals for the re-formulation of the FNC doctrine in the United States, and also offers views on the avenues available in Latin America for the FNC impasse. Finally, the article concludes that a more lasting solution to the FNC impasse should come from within the judiciary of the United States or new international treaties.

I. Forum Non Conveniens as a Procedural Tool to Dismiss International Litigation

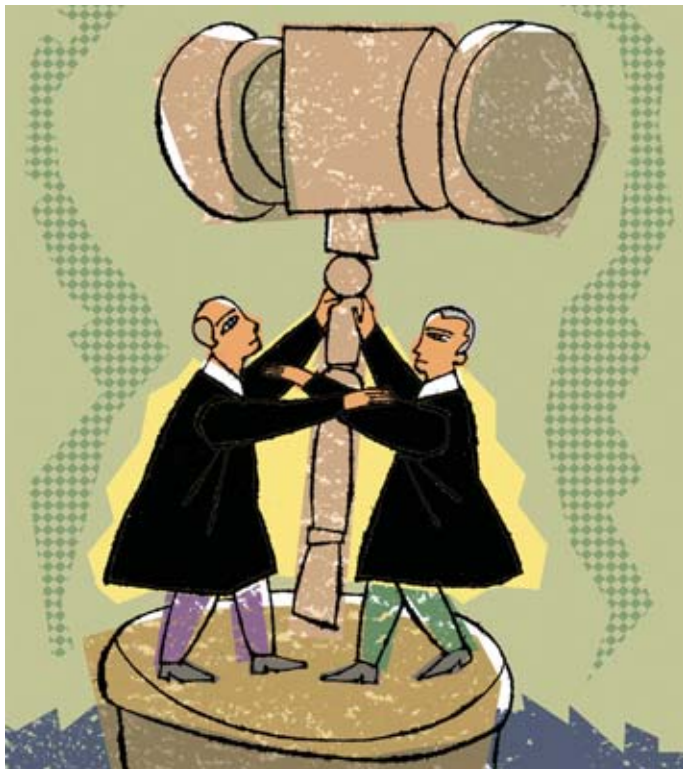
A. The FNC Doctrine in International Lawsuits

Neither the United States Constitution, nor federal statutes address the issue of jurisdiction in cases where foreign plaintiffs sue United States citizens or lawful residents based on a tort that occurred overseas. Therefore, for the most part, the FNC doctrine is judge-made law.¹ In its essence, FNC gives courts discretionary power to discriminate on the basis of the plaintiff’s citizenship in order to retain jurisdiction over a case. In fact, courts give United States plaintiffs greater deference than a non-United States plaintiff when choosing a forum.² “[C]ourts should look at the reasons or motivation that led the plaintiff to choose a particular forum,” to determine whether a forum was chosen for “legitimate reasons” or for “tactical advantage.”³ In fact, the Second Circuit stated that deference is not accorded based “bias in favor of U.S. residents. It is rather because the greater the plaintiff’s ties to the plaintiff’s chosen forum, the more likely that the plaintiff would be inconvenienced by a requirement to bring the claim in a foreign jurisdiction. Also, while our courts are of course required to offer equal justice to all litigants, a neutral rule that compares the convenience of the parties should properly consider each party’s residence as a factor that bears on the inconvenience that party might suffer if required to sue in a foreign nation.”⁴ Therefore, the problem with FNC seems to be its lack of predictability arising from the broad discretion given to trial courts, and the lack of *de novo* review of FNC decisions by appellate courts.⁵

For foreign plaintiffs, the FNC doctrine regulates access to U.S. courts. With respect to Latin America, federal and state

courts apply the FNC doctrine either when they are petitioned by a United States defendant, or *ex sua sponte* in the following circumstances: (i) the United States defendant, usually a multinational corporation doing business in Latin America, causes injury abroad; (ii) the Latin American plaintiff sues the United States defendant in a United States court; (iii) the Latin American defendant alleges that a breach of contract or a tort occurred in Latin America; and (iv) there are no international treaties, either multilateral or bilateral, between the United States and the plaintiff's country that provides equal access to United States courts.⁶

In these cases, the FNC doctrine acts as a jurisdictional rule that bars access to United States courts. Unlike in the United States system, a FNC dismissal of an international lawsuit does not transfer venue. That is, foreign plaintiffs do not



have the option, as United States plaintiffs do, of re-filing their lawsuits in another venue within the United States. Basically, Latin American plaintiffs must re-file their lawsuits in their country's courts.

Latin American plaintiffs have tried to persuade United States courts to retain jurisdiction over cases involving FNC disputes in product-injury cases, claiming that the United States is the convenient forum. They have argued that the U.S. public maintains an interest in regulating malfunctioning products that injure foreign citizens to prevent similar situations on United States soil.⁷ However, this argument is not persuasive because when accidents involving United States products occur

overseas, manufacturers rush to remedy the problems to avoid a similar disaster in the United States, where they risk millions of dollars in liability. Realistically, Latin American plaintiffs cover United States courts due to shorter litigation and higher damage recoveries.

B. FNC Dismissals

U.S. Courts have underscored the effects of foreign litigation on U.S. taxpayers who bear the costs involved in litigation brought by a foreign plaintiff in the United States. Courts have been eager to halt such a deviation of resources and potential docket congestion.⁸ Not without reason, FNC dismissals are one of the most effective docket clearing devices.⁹ For example, the Florida Supreme Court has sustained that “[W]hile it is true that the Florida Constitution guarantees every person access to our courts for redress of injuries ... that right has never been understood as a limitless warrant to bring the world’s litigation here ... Put another way, if a potential remedy exists in the alternative forum, then the ‘remedy requirement’ of article I, section 21 [of the Florida Constitution] actually is being honored.”¹⁰ But this is a false dilemma, since only cases with minimum contacts to the U.S. would be eligible for being tried in the U.S., and only if subject matter and personal jurisdiction requirements were satisfied.

In order to ameliorate the devastating effects that FNC dismissals have caused on, among other, Latin American plaintiffs, U.S. courts have contrived the mechanism of conditional FNC dismissals. These conditional dismissals include the “waiver of defendant’s statute of limitations defense, admissions of liability, and/or retention of jurisdiction under the proper control of the dismissing court.”¹¹ Another condition has been that “the defendant consent to liberal, U.S.-style discovery.”¹² Of all these conditions, the requirement that the foreign forum retain jurisdiction over the case is the one generating most controversies over FNC. For example, in one case, a district court granted a motion to dismiss on FNC on the condition that the foreign courts do not refuse “to hear the case on forum non conveniens grounds.”¹³

Some commentators have adopted a rather naïve approach to conditional FNC dismissals, arguing that “by no means is it the purpose of the U.S. court to obligate a foreign plaintiff to file its claim overseas, or to force the foreign court to hear the case.”¹⁴ But the facts show otherwise, as the Latin American plaintiffs are forced to re-file their claims in their home jurisdictions. On the other hand, since the FNC defense is legally available for a U.S. defendant, it would be highly unusual for her not to raise it in cases where the FNC defense could apply.¹⁵

The standard for an appellate court to set aside a FNC dismissal by a district court is that of abuse of discretion in granting the FNC dismissal.¹⁶ Abuse of discretion occurs when a

decision: “(1) rests either on an error of law or on a clearly erroneous finding of fact, or (2) cannot be located within the range of permissible decisions ... or (3) fails to consider all the relevant factors or unreasonably balances those factors.”¹⁷

C. Adequacy and Availability of the Latin American Forum

A forum is not adequate or inadequate *per se*. Rather, it depends on the eyes of the beholder. U.S. courts have found Latin American fora adequate and available when conducting FNC analysis, but in other instances have determined that Latin American fora are inadequate to try disputes in which a U.S. citizen is a party.¹⁸ “[A]n alternative forum is available if the defendant is ‘amenable to process’ in the other forum.”¹⁹ There is controversy as to whether amenability exists “where the defendant consents to jurisdiction in the alternative forum,”²⁰ and to whether the foreign law’s prohibition of the exercise of jurisdiction in the case trumps amenability.

U.S. courts have conducted an extensive review of the factors determining whether the Latin American forum is adequate and therefore available for purposes of FNC analyses. The many differences between the U.S. and the Latin American fora show that the Latin American forum should be judged inadequate, and thus not available to the U.S. party.²¹ But, as already stated above, the opposite conclusion has been determined in several FNC analyses, where Latin American fora have been found to be available for U.S. defendants and thus *conveniens* in most cases.

The main elements of Latin American fora that U.S. courts have taken into consideration when deciding FNC defenses have been the following: (i) the inexistence of pre-trial discovery in Latin American civil procedures;²² (ii) restrictions on testimonial evidence, especially the lack of a right to cross-examination; (iii) restrictions on the free availability of expert testimony and documentary evidence; (iv) nonexistence of a right to a jury trial in civil cases; (v) heavy limitations on third party practice and inexistence of class actions in civil cases; (vi) weakness of substantive rules on tort liability, such as restrictive rules on indemnity or contribution from third parties; lack of rules on strict liability in product liability cases;²³ lack of *stare decisis* in Latin America thus limiting a uniform construction of statutes concerning civil tort liability; low amounts for compensatory damages awarded by Latin American courts; nonexistence of punitive damages; heavy caps on tort awards;²⁴ and restrictions on the grounds for non-monetary damage compensations; (vii) litigation taxes as a pre-condition for filing complaints; (viii) restrictions on contingent fee agreements; (ix) judicial workloads and unreasonable delays; (x) political issues related to judicial corruption and lack of impartiality and independence; devaluation of money awards denominated in Latin

American currencies; and the imposition of currency and exchange rate restrictions; (xi) other practical limitations include the lack of judicial training and expertise in highly complicated legal issues; the deficient working facilities and understaffed courts; lack of technology; lack of economic resources to obtain evidence; and the general unavailability of high quality-translation services.

Despite all these substantive and procedural limitations, U.S. courts have considered Latin American fora adequate for trying cases where U.S. multinational corporations are defendants in Latin America.

II. Latin American Fora and the Consequences of FNC Dismissals

A. The Latin American Rule on Jurisdiction

The basis for jurisdiction in Latin America is found in the written law, most commonly in the codes of civil procedure, or in the Bustamante Code in those countries where this convention has been ratified.²⁵

Latin American jurisdictional rules are different from their equivalent in the United States. Jurisdiction is a matter of public policy that cannot be waived by the parties. A court either has or does not have jurisdiction to hear a case. Once jurisdiction is established, the court is not allowed to refuse to hear a case on grounds not permitted by the constitution or legislation. The rule is that the defendant’s place of domicile or business, or where the injury occurred determines the court’s jurisdiction. The choice of forum belongs to the plaintiff. A plaintiff may choose to sue in a court not corresponding to the defendant’s domicile, but the defendant has the right to petition the transfer of the case to the appropriate court (that of her domicile). After the court of the defendant’s domicile has acquired jurisdiction, such jurisdiction cannot be disturbed by the parties or by the court itself. In other words, once jurisdiction is lost, it is lost forever. Therefore, Latin American courts understand that once a plaintiff has decided to sue a U.S. defendant in the court of the defendant’s domicile, Latin American courts have lost, if they ever had it, their right to hear that case.

The Latin American rationale, however, is not foreign to the U.S. rules on jurisdiction. In general, U.S. jurisdictional rules state that once a corporation or entity incorporates in one jurisdiction, the requisite of minimum contacts is satisfied. Consequently, incorporation carries minimum contacts, and minimum contacts are a basis for jurisdiction. The U.S. corporation should, therefore, expect to be sued in the jurisdiction of its incorporation, thus barring the FNC defense. U.S. defendants have argued that under the same rule, doing business in Latin America creates minimum contacts that make them amenable to such fora, causing the Latin American court to obtain jurisdiction

over them. Here lies the core of the impasse between the United States and Latin America under the FNC analysis.

Consequently, when U.S. courts have declined to hear complaints brought by Latin American plaintiffs in the forum freely chosen by them, the overall reaction has been that Latin American courts have rejected the claims on the ground that the Latin American forum was not freely chosen, and that the U.S. forum was the proper forum.

B. Consequences of FNC dismissals

FNC dismissals have resulted largely in that plaintiffs have been unable to obtain any redress in their cases. Indeed, informal surveys show that claims rejected in the U.S. under FNC in general have not been tried elsewhere. A survey “of more than fifty personal injury actions dismissed under forum non conveniens doctrine [showed that] only one case was actually tried in a foreign court.”²⁶ Another survey of one hundred and eighty transnational cases dismissed from the United States court for forum non conveniens showed that “[O]f the returned responses of eighty-five cases, eighteen cases were not pursued further in the foreign forum, twenty-two settled for less than half the estimated value, and in twelve, the United States attorneys had lost track of the outcome. Most importantly, none of the reported cases proceeded to a courtroom victory from the foreign forum.”²⁷ The surveyor concluded that, “pretending that such dismissals are not outcome-determinative is a rather fantastic fiction.”²⁸

Understandably, criticisms of forum non conveniens have included “accusations of parochialism, naked and open chauvinism...” and its application has even been labeled as a “crazy quilt of ad hoc, capricious, and inconsistent decisions.”²⁹ FNC has also been called xenophobic.³⁰

C. Responses of Latin American Fora to FNC Dismissals

FNC dismissals have caused serious consequences to Latin American plaintiffs for two reasons. The first is the uncertainty of whether their claims will be tried by U.S. courts, or if they will have to waste time waiting for a costly dismissal. And secondly, after dismissal has occurred, they have no certainty as to whether the Latin American court will hear their claims. As already stated, Latin American courts have opted for refusing to hear cases dismissed under FNC by U.S. courts, or to resend them to U.S. fora instead of using other alternatives. Latin American dismissals have taken two forms: judicial retaliation, and blocking statutes.

1. JUDICIAL RETALIATION: REFUSAL OF REMANDS

One commentator³¹ lists the adverse effects that U.S. FNC dismissals cause in Latin America: (a) it forces plaintiffs to involuntarily file a claim, thus violating procedural freedom; (b)

it violates the plaintiff’s right to choose the forum corresponding to the defendant’s domicile, pursuant to applicable legislation (codes of civil procedure, and article 323 of the Bustamante Code);³² (c) it violates the principle of pre-emptive jurisdiction, according to which once a court acquires jurisdiction to hear a case, all other courts cease to have jurisdiction to hear the same case; (d) it has *litis pendentia* implications: it would happen when an appeal against a FNC dismissal in the United States is pending and the plaintiff re-files its complaint in a Latin American court; (e) conditions or stipulations, most commonly an involuntary waiver of statute of limitations,³³ forced on the plaintiff by a U.S. court amounts to a violation of the plaintiff’s legal rights in the Latin American jurisdiction; (f) issues of sovereignty are involved when a country’s court imposes its decision over the other country’s; and (g) the lack of jurisdiction of Latin American courts to reach assets of the defendant in the United States is also at stake.

2. LEGISLATIVE RETALIATION: ANTI-FNC OR BLOCKING STATUTES

In the wake of U.S. FNC dismissals, Latin American countries have also passed retaliatory legislation to tackle the negative effects that these dismissals have caused to Latin American plaintiffs. These statutes apply to product injury cases brought by Latin American plaintiffs against U.S. defendants in U.S. courts, for torts arising out of the defendants’ activities in Latin America. Therefore, blocking statutes do not apply to suits between Latin American nationals, or to suits brought by a Latin American plaintiff against another Latin American in the United States.

Some examples of blocking statutes are the following:³⁴ the 1996 Honduran Law in Defense of the Procedural Rights of Nationals and Residents; the 1997 Costa Rican Law for the Defense of Procedural Rights of Citizens and Residents; the 1997 Guatemalan Law for the Defense of Procedural Rights of Nationals and Residents; the 1997 Dominican Transnational Causes of Action Act; the 1998 Ecuadorian Interpretive Law for Cases of International Concurrent Jurisdiction; and the 2000 Nicaraguan Emergency Law for Banana Workers Injured by Usage of DBCP-Bases Manufactured Pesticides.

In general, blocking statutes provide that a claim filed in a foreign country (the United States) extinguishes the jurisdiction of Latin American courts, which can only be reborn if the Latin American plaintiff freely files a new claim in the Latin American forum. Some of these statutes impose strict liability onto foreign defendants in product injury liability cases. Also, some of these laws establish that the determination of the amount of compensatory damages must be made according to the same standards used by courts in the United States, and mandate the posting of a bond after foreign plaintiffs have been served with process.

III. Possible Ways to Resolve the FNC Impasse

A. Taking a Multilateral Approach to FNC

The best mechanism for solving the FNC impasse would be an international treaty between the United States and most Latin American countries. In 2000, the Organization of American States Inter-American Juridical Committee presented its *“Proposal for an Inter-American Convention on the Effects and Treatment of the ‘Forum Non Conveniens.’*”³⁵ This proposal is the result of the strong opposition and even resentment that FNC has in Latin America. However, the proposal leaves fundamental questions still unanswered. For example, the language in Article 22 of the proposed treaty would allow a Latin American court with proper jurisdiction to decline a case “if a court of another State has jurisdiction and is clearly more appropriate to resolve the dispute,” leaving room for U.S. courts to use this provision to support FNC dismissals.

B. Reformulating FNC in the United States

Various proposals have been made in the United States to deal with problems arising out of FNC dismissals. Some authors call for U.S. courts to revisit the FNC doctrine, while others advocate an abolition of the FNC doctrine altogether.³⁶ However, most of the proposals point out that the solution should come from Congress by means of federal legislation.³⁷ Policy arguments, such as “the interest the community has in resolving the issue,”³⁸ and “the egregiousness of the U.S. corporate defendant’s conduct overseas,”³⁹ are also mentioned as imperative for a reform of the FNC doctrine.

Proposals for legislative review of the FNC doctrine result in its narrow application: FNC dismissals would only be allowed when the defendant shows that “the chosen forum is unnecessarily or unreasonably inconvenient and that the alternate forum is more convenient.”⁴⁰ The idea behind these proposed legislative amendments is to make U.S. multinational corporations amenable to their domestic fora, where they are incorporated, and where they “developed, manufactured, and tested the product.”⁴¹

Despite the good intentions of these ideas, they fail to properly address the main problem with the doctrine, lack of consistency in its application. In fact, even if there were federal legislation on FNC, it could not circumvent the U.S. Constitution. This matter is subject to debate, because the U.S. Supreme Court could still achieve the desired uniformity by invoking the Due Process Clause of the U.S. Constitution.

In the search for new standards, consideration should also be made to the fact that a U.S. corporation doing business in Latin America has to run the risk of being sued both overseas and at home.⁴² New stricter standards for FNC dismissals should encourage settlements between the U.S. corporate

defendant and the Latin American plaintiff. Settlements, in the context of pending or impending litigation, would save costs and time for the parties involved. They would also save U.S. taxpayers money and ideally encourage a more socially and environmentally friendly behavior from U.S. multinational corporations in Latin America. In this context, a review of the FNC doctrine by U.S. courts should consider the following proposals:

- (i) Denying the possibility of a FNC dismissal if the U.S. defendant is sued in a venue where it is headquartered or incorporated.
- (ii) Forcing Latin American plaintiffs to prove that there are minimum contacts between the U.S. defendant and the home forum.
- (iii) Accepting jurisdiction over cases dealing with matters that are relevant for U.S. policies in the context of foreign trade and product injury. This seems to be a more realistic approach for an amendment in lieu of calling for an entire abolition of FNC.
- (iv) Allowing U.S. courts to assess the costs incurred by U.S. taxpayers and then deducting those costs from any monetary awards paid to Latin American plaintiffs. This proposal considers the policy argument that U.S. courts use to ground FNC dismissals, which is to minimize the cost of litigation incurred by U.S. taxpayers.

C. Rethinking the Latin American Reaction to the FNC Impasse

As stated earlier, the general response by Latin American countries to FNC dismissals has been the rejection of remands. As a consequence, Latin American plaintiffs have seen their complaints thwarted, and left in a situation of judicial denial. In this regard, Latin American countries could adopt several options to deal with the consequences of FNC dismissals, namely:

- (i) Passing legislation that would allow their courts to retain jurisdiction over a case dismissed under FNC in the United States, but applying innovative measures. For example, declaring evidence gathered in FNC proceedings admissible, thus circumscribing their decisions to issues of law (liability, amount of the awards, indemnity, etc.).
- (ii) Allowing the parties to contract to waive the FNC defense or the claim that the forum is improper in any action, suit, or proceeding. The parties might balance such a waiver by agreeing that a final judgment in any legal action will be conclusive and may

be enforced in other jurisdictions. In any case, judicial review should be permitted to ensure the fairness of the waiver.

- (iii) Altering the burden of proof by having the U.S. defendant prove that it acted with due diligence in negligence cases, or by proving an act of God as being the only excuse in a case of strict liability.

The flip side of these proposals is that they could be challenged as unconstitutional under domestic or international law. It would then be up to Latin American plaintiffs to show the hardships and financial burdens they suffered as a result of the U.S. corporation's harmful conduct. Therefore, those that have faced the unilateral judicial war declared by United States courts only have a Latin American court as their fair access to justice. Additionally, in the absence of multinational civil courts, an obstacle to overcome is the enforceability in the United States of monetary awards issued in overseas proceedings.

IV. Conclusion

AS DEMONSTRATED, U.S. COURTS engage in foreign policy through FNC, having held over and over that U.S. corporations doing business in Latin America cannot be held liable in U.S. courts for actions that occurred in Latin America. The best antidote to a country's unilateral action is international cooperation. In spite of their obvious benefits, international treaties between the United States and some Latin American countries addressing FNC issues would cause a general improvement in the legal and judicial systems of concerned Latin American countries, possibly by means of harmonization of laws and procedures, uniform application of comity principles, and mutual recognition and enforcement of foreign awards. But FNC problems would still persist with respect to Latin American countries not parties to such treaties.

In default of multilateral approaches to FNC, only unilateral alternatives are available. Legislative reforms dealing with FNC dismissals in Latin America have proven to be ineffective because these amendments have addressed the defects of Latin American legal systems only partially. An overall reform of the civil law system is needed in Latin America, thus addressing the consequences of mass tort litigation, including new approaches to issues such as case consolidation, third party practice, discovery proceedings, evidence, and equitable money awards. Also, *stare decisis* should be available for similar tort cases.

In the United States, FNC reforms by means of federal legislation would achieve only limited results. A new statute would bring the same problems as current FNC because it would be subject to judicial interpretation, and the courts will certainly find new ways to dismiss foreign lawsuits to avoid the complications caused by a sudden docket increase. Therefore, the solution must come from inside of the courts to be effective.

In sum, a regional treaty on FNC would be the optimal way out of the current FNC impasse. In default of such international agreement, the second-best option would be that U.S. courts re-interpret the FNC doctrine in order to provide it with more uniformity, and with a more restrictive approach, making it applicable only in exceptional circumstances. BLB

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¹ See Anne McGinness Kears, *Forfeiting the Home-Court Advantage: The Federal Doctrine of Forum Non Conveniens*, 49 S.C. L. Rev. 1303 (1998) ("Forum non conveniens is a common-law doctrine that originated in Scottish common law and was first introduced into American law through state courts in the early 1900s."); see also Peter J. Carney, Comment, *International Forum Non Conveniens: "Section 1404.5" - A Proposal in the Interest of Sovereignty, Comity, and Individual Justice*, 45 Am. U. L. Rev. 415 (1995) ("The Scots created the doctrine to counter undue hardship arising from the arrestment *ad fundadam* jurisdiction created by the attachment and seizure of foreign assets in order to force foreigners into the Scottish courts."); Jeffrey A. Van Detta, *Justice Restored: using A Preservation-of-Court-Access Approach to Replace Forum Non Conveniens in Five International Product-Injury Case Studies*, 24 Nw. J. Int'l L. & Bus. 53 (2003) ("The FNC rule was largely a brainchild of Paxton Blair, a young associate laboring in a silk-stocking Manhattan law firm. His 1929 law review article . . . deplored an alleged crisis in docket overcrowding in the Manhattan federal and state courts of his day and proposed FNC as a panacea.").

² See *Koster v. (Am.) Lumbermens Mut. Cas. Co.*, 330 U.S. 518 (1947).

³ *Iragorri v. United Technologies*, 274 F.3d 65, 72-73 (2d Cir. 2001).

⁴ *Wiwa v. Royal Dutch Petroleum Co.*, 226 F.3d 88 (2d Cir. 2000).

⁵ See Van Detta, *supra* note 1, at 3.

⁶ See *Piper Aircraft Co. v. Reyno*, 630 F.2d 149, 170-71 (3d Cir. 1980); see generally Jacqueline Duval-Major, *One Way Ticket Home: The Federal Doctrine of Forum Non Conveniens and the International Plaintiff*, 77 Cornell L. Rev. 650 (1992).

⁷ Peter J. Carney, Comment, *International Forum Non Conveniens: "Section 1404.5" A Proposal in the Interest of Sovereignty, Comity, and Individual Justice*, 45 Am. U. L. Rev. 415 (1995), at 11.

⁸ The Southern District of New York, "one of the busiest districts in the country," has stated the "need to guard our docket with disputes with little connection to this forum." *Hyland*, 807 F.Supp., at 1128, quoted by John Fellas, *Lessons on Enforcing Foreign Judgments in the United States*, N.Y. L.J., Sept. 26, 2002, at 19.

⁹ "... during the 1970s the federal docket-congestion problem dramatically increased, and Chief Justice Burger's extremely public and vigorous campaign to decrease that workload probably helped to remove any lingering sense that judges might have had that it would be unseemly to make their own convenience an overt part of the judicial process." Melissa Leigh Lauderdale, *Forum Selection Clauses and Forum Non Conveniens in International Employment Contracts*, 4 J. Int'l L. & Prac. 117 (1995), at 14.

¹⁰ Kinney, 674 So. 2d at 88, quoted by Christopher M. Marlowe, *Forum Non Conveniens Dismissals and the Adequate Alternative Forum: Latin America*, 32 U. Miami Inter-Am. L. Rev. 295, 310-11 (2001), n. 54.

¹¹ Kinney, 674 So. 2d at 92, quoted by Marlowe, *supra* note 10, n. 30.

¹² *Piper Aircraft v. Reyno*, 257 n. 25, quoted by Carney, *supra* note 7, at 22.

¹³ See BCCI, at 247, quoted by Fellas, *supra* note 8, at 20.

¹⁴ "A provisional or conditional dismissal does not force a plaintiff or a foreign court to do anything; it simply indicates that the forum may reconsider the dismissal under certain conditions," Bernard H. Oxman, *Comments on Forum Non Conveniens Issues in International Cases*, 35 U. Miami Inter-Am. L. Rev. 123, at 1.

¹⁵ It has been argued that if the U.S. defendant's counsel fails to file a motion to dismiss on FNC, she could be accused of professional malpractice. Alan Reed, *To Be Or Not To Be: The Forum Non Conveniens Performance Acted Out on Anglo-American Courtroom Stages*, 29 Ga. J. Int'l & Comp. L. 31, 73 (2000), at 12, n. 176. Also, "[I]t is part of a lawyer's job to bring suit in the forum that is best for the client's interests," Russell J. Weintraub, *Introduction to Symposium on International Forum Shopping*, 37 Tex. Int'l L.J. 463 (2002), at 1.

¹⁶ U.S. Courts have established that "... discretion has been clearly abused." *Peregrine Myanmar Ltd. v. Segal*, 89 F.3d 41, 46, 2d Cir. (1996), quoted by Fellas, *supra* note 8, at 10.

¹⁷ *Pollux Holding Ltd. v. Chase Manhattan Bank*, 329, F.3d 64, 70 (2d Cir. 2003), quoted by Fellas, *supra* note 8, at 10.

¹⁸ FNC "does not require that an identical forum exists." Christine Russel, *Should Florida be a "Courthouse for the World?": The Florida Doctrine of Forum Non Conveniens and Foreign Plaintiffs*, 10 Fla. J. Int'l L. 353 (1995), at 3.

¹⁹ *Piper Aircraft*, 454 U.S. at 254 n.22 (quoting *Gulf Oil Corp v. Gilbert*, 330 U.S. 501, 507 (1947)), quoted by Anne McGinness Kears, *Forfeiting the Home-Court Advantage: The Federal Doctrine of Forum Non Conveniens*, 49 S.C.L. Rev. 1303 (1998), at 4, n. 104.

²⁰ Douglas W. Dunham & Eric F. Gladbach, *Forum Non Conveniens and Foreign Plaintiffs in the 1990s*, 24 Brook. J. Int'l L. 665 (1999), at 6.

²¹ See Lucas Pastor Canales Martínez, et al. v. Dow Chemical Company et al., U.S. District Court for the Eastern District of Louisiana, 219 F. Suppl. 2d 719, decided on July 16, 2002 (deciding that the Costa Rican and Honduran legal systems were unavailable), quoted by Henry Saint Dahl, *Forum Non Conveniens, Latin America and Blocking Statutes*, 35 U. Miami Inter-Am. L. Rev. 21 (2003-2004), n. 67.

²² Anne M. Rodgers, *Forum Non Conveniens in International Cases*, at 207. Quoted by David J. Levy, ed., *International Litigation, Defending and Suing Foreign Parties in U.S. Federal Courts*, American Bar Association Tort Trial and Insurance Practice Section (2003), at 205.

²³ This is due to the fact that civil codes were first introduced in the early 19th century in Latin America, long before the development of product liability theories. See Edwin Borchard, *The "Minimum Standard" of the Treatment of Aliens*, 38 Mich. L. Rev. 445, 450 (1940), quoted by Eduardo A. Weisner, *Ancom: A New Attitude Toward Foreign Investment?*, 24 U. Miami Inter-Am. L. Rev. 435, n. 138 (stating that "In 1855, Venezuelan statesman Andres Bello drafted the Chilean Civil Code, the first Latin American code to grant aliens and national civil equality."):

²⁴ Duval-Major, *supra* note 6, at 10.

²⁵ Argentina, Colombia, Mexico, Paraguay, Uruguay, and the United States have not ratified the Bustamante Code.

²⁶ Himly Ismail, *Forum Non Conveniens, United States Multinational Corporations, and Personal Injuries in the Third World: Your Place or Mine?*, 11 B.C. Third World L.J. 249, 250 n. 7 (1991), quoted by Marlowe, *supra* note 10, n. 7.

²⁷ Quoted by Duval-Major, *supra* note 6, at 11.

²⁸ Quoted by Lauderdale, *supra* note 9, at 12.

²⁹ Reed, *supra* note 15, at 2-4.

³⁰ See *Proposal for an Inter-American Convention on the Effects and Treatment of the Forum Non Conveniens Theory*, OAS Doc.OEA/ser Q. CJI/doc.29/99 (1999), in Annual Report of the Inter-American Juridical Committee to the General Assembly of the Organization of American States (1999), at 81.

³¹ Saint Dahl, *supra* note 21, at 5.

³² Article 323 of the Bustamante Code provides that in personal suits "the competent judge shall be a judge of the place where the obligation is to be performed or the place of the defendant's domicile, and secondarily, the place of the latter's residence." Bustamante Code, translated into English by Julio Romafiach, Jr., Lawrence Publishing Company, 1996.

³³ "Thus, an adequate forum does not exist if a statute of limitations bars the bringing of a case in that forum;" *BCCI v. Bank of Pakistan*, 273 F.3d 241, 246 (2d Cir. 2001), quoted by Fellas, *supra* note 8, at 10.

³⁴ Saint Dahl, *supra* note 21, at 1-2.

³⁵ CJI/RES.5 (LVI-0/00) "Improving the administration of justice in the Americas." Document CJI/doc. 2/00, in Annual Report of the Inter-American Juridical Committee.

³⁶ Margaret G. Stewart, *Forum Non Conveniens: A Doctrine in Search of a Role*, 74 Cal. L. Rev. 1259 (1986), at 8. Also quoted by Lauderdale, *supra* note 9, at 151, n. 166.

³⁷ A legislative code, promulgated by Congress, adopting selective features of the pragmatic and harmonized scheme of the Brussels Convention on Civil Jurisdiction and Judgments of 1968. Reed, *supra* note 15, at 33.

³⁸ McGinness Kears, *supra* note 19, at 9.

³⁹ *Id.*

⁴⁰ McGinness Kears, *supra* note 19, at 8.

⁴¹ *Id.*

⁴² In FNC dismissals, the transnational corporation benefits from the "best of both worlds, gaining ability to reap financial benefits that indirectly result from operating in a country where citizens are excluded from the political-legal system while insulating itself from any actions that may be brought against it in home-country courts. Malcolm J. Rogge, *Towards Transnational Corporate Accountability Challenging the Doctrine of Forum Non Conveniens, In re: Union Carbide, Alfaro, Sequibua, and Aguinda*, 36 TEX. INT'L L.J. 299, 301 (2001).

In the Driver's Seat:

NAFTA'S CHAPTER 11 AS A JUDICIAL VEHICLE FOR THE EXPANSION OF INVESTOR RIGHTS

By Vincent L. Frakes

THE NORTH AMERICAN FREE TRADE Agreement (NAFTA) thrust the United States, Canada, and Mexico into a realm of new rules governing disputes between investors and governments of member countries. As outlined in Chapter 11 of the agreement, NAFTA's investor-to-state dispute resolution process allows private investors and companies to bring suit against member country governments in special tribunals to obtain monetary awards for government actions that violate their rights under the treaty. Originally intended to resolve such disputes while avoiding politicization and strained international relations, Chapter 11 instead provides investors with rights and protections unprecedented in a multilateral trade agreement.

Understanding the stark differences that exist in the economic and political systems of each member country, NAFTA tribunals hearing disputes weigh the host country's regulatory and legal framework in making a judgment. However, the vague and uncertain nature of Chapter 11 language allows foreign investors to forum shop, increasing their rights by offering an additional adjudicative body that in many cases grants more leniency than domestic courts of member countries. Moreover, there is a visible trend of favoring foreign investors by NAFTA tribunals over host country governments, bringing to light questions of the jurisdictional authority of member states' domestic courts. This trend can be easily demonstrated through the decisions in three recent cases brought under NAFTA's Chapter 11: *Metalclad Corp. v. Mexico, S.D. Myers, Inc. v. Canada*, and *Pope & Talbot, Inc. v. Gov. of Canada*. Finally, the limited number of disputes that are heard by NAFTA tribunals are a testament to the inconsistency in applicability of Chapter 11 by these courts and leaves open the question of NAFTA's ability to protect foreign investment through its arbitration process.

The Investment Chapter

CHAPTER 11 OF NAFTA OFFERS several grounds on which foreign investors can bring claims against host member countries following satisfaction of jurisdictional requirements. The arbitration mechanisms and procedures under NAFTA represent a more sophisticated system than those provided under tradition-

al bilateral investment treaties.¹ Section A of Chapter 11 establishes grounds for a claim in Articles 1102 (National Treatment), 1103 (MFN Treatment), 1104 (Standard of Treatment), 1105 (Minimum Standard of Treatment), and 1110 (Expropriation and Compensation). Moreover, Chapter 11 protects investors from "measures" taken by host governments, including laws, regulations, and policies that affect government's interaction with companies.²

While claims relating to national treatment and minimum standard of treatment present certain challenges, the expropriation provision of Article 1110 is the most contentious. As with most free trade agreements, expropriation exists when a party directly or indirectly nationalizes the investment of a foreign party, and the act does not fall under a stipulated exception.³ Differences in regulatory structures and practices in member countries contribute heavily to the large proportion of investor-state disputes involving expropriation.

Chapter 11 grants a large amount of discretion to a NAFTA tribunal in determining the merits of a claim and the satisfaction of jurisdictional requirements. Under NAFTA, the requirements of a valid investor-state claim include modest criteria, which, once met, allow the tribunal to decide the case based on factors such as the 'ordinary meaning' of the treaty's text pursuant to Article 31 of the Vienna Convention on the Law of Treaties in relation to the facts at hand.⁴ Even though Chapter 11 has been praised by some as a model after which future trade agreements should form dispute resolution systems,⁵ several cases typical of NAFTA jurisprudence demonstrate that the vague language of Chapter 11 has been applied inconsistently by the tribunals, resulting in expanded foreign investors' rights.

Expansion of Investors' Rights under Chapter 11 – Case Studies

NAFTA TRIBUNALS HAVE HEARD a variety of cases involving disputes between investors and member states since the agreement's inception in 1993. The most interesting arbitral matters involve expropriation (Article 1110), as investors fight measures taken by host governments of countries where they do business, but often include important disputes over other provisions of the agreement

as well. Three NAFTA decisions, *Metalclad Corp. v. Mexico (Metalclad)*, *S.D. Myers, Inc. v. Canada (Myers)*, and *Pope & Talbot, Inc. v. Gov. of Canada (Pope & Talbot)*, involving claims arising under Article 1110 are representative of the expansion in investors' rights by allowing companies to forum shop for a domestic court or international tribunal that issues the most favorable decision to the investor. Analysis of these three cases demonstrates the disturbing trend toward increased investors' rights under the NAFTA arbitration system that circumvents domestic courts in favor of investor friendly tribunals applying international law.

Metalclad v. Mexico

The dispute between Metalclad, a U.S. corporation, and Mexico is one of the most noted examples of the issue of the legal rights afforded international investors under Chapter 11 of NAFTA.⁶ In 1993, Metalclad purchased a Mexican waste management company, COTERIN, to build a hazardous waste landfill, which was completed in March 1995,⁷ but never opened.⁸ In its plea to the arbitral tribunal, Metalclad cited violations of two NAFTA provisions: (1) fair and equitable treatment under Article 1105 and (2) prohibition against direct or indirect expropriation without compensation under Article 1110.⁹ After a three-year long arbitration, the tribunal decided in favor of Metalclad on both counts of the claim and ordered Mexico to pay the corporation \$16.7 million in damages.¹⁰

Reassuring investors and building trust and respect for its legal framework is a key challenge to any nation seeking to participate in the global competition for investment.¹¹ Given the lack of transparency in the legal system and weak rule of law in Mexico, investors often fear harmful government intervention, especially in relation to expropriation without compensation. Rulings by domestic courts in all three NAFTA countries have traditionally been unfavorable to investors.¹² Such treatment makes sense because domestic regulatory and procedural restrictions may provide a difficult environment for a foreign investor to prevail.¹³ Increased access to arbitral panels in Mexico through NAFTA (which Metalclad utilized) grants investors the ability to forum shop and choose arbitration over domestic courts, promising more favorable treatment and outcomes.¹⁴

The *Metalclad* decision represents a potential threat to the jurisdictional authority of domestic courts of NAFTA member countries because of its successful use of international tribunals. Even though the case involved Mexican law, the tribunal's rationale may have undermined judicial systems of NAFTA member countries by rendering a decision inconsistent with those issued by domestic courts on similar issues of law.¹⁵ Consequently, an effectual new type of forum shopping could emerge where lawful and legitimate domestic courts are passed over in favor of NAFTA tribunals that are much more preferable by investors because of their likelihood to grant awards not

viable in domestic judicial systems of member countries.

More worrisome is the potential for tribunals under Chapter 11 to brush aside carefully considered state and local governmental action aimed at regulating industry in favor of economic gain. *Metalclad* provides an example where local action and an attempt at regulating investor conduct was tempered by a tribunal decision, signaling the superiority for investors of NAFTA arbitration decisions in member countries.

S.D. Myers v. Canada

S.D. Myers, Inc., a U.S. company that was at one time engaged in PCB remediation,¹⁶ experienced the slowing of its business in the United States, and consequently moved its executive operations to Canada, where only one true industry com-

“[S]everal cases typical of NAFTA jurisprudence demonstrate that the vague language of Chapter 11 has been applied inconsistently by the tribunals, resulting in expanded foreign investors' rights.”

petitor existed.¹⁷ In March 1989, Canada signed the Basel Convention, pledging to manage hazardous waste (such as PCBs) in an environmentally sound manner.¹⁸ After intense lobbying efforts on behalf of both sides, the Canadian Minister of the Environment signed an Interim Order that effectively banned the exportation of PCBs from Canada,¹⁹ adversely affecting Myers and its business interests.

Myers's claim against Canada noted a violation of four provisions of NAFTA. First, Myers argued a national treatment violation, claiming that the Interim Order issued by the Canadian government discriminated against U.S. waste disposal operators seeking to export PCBs to the United States for treatment.²⁰ Myers argued that Canada's imposition of export bans did not represent treatment in line with international law to its investment, thus resulting in a breach of Article 1105.²¹ Further, Myers stated the Canadian action was tantamount to expropriation under Article 1110, for which Myers was not paid any compensation.²²

The tribunal rejected Myers's contention that Canada's actions represented an expropriation violation, and instead ruled they amounted to a regulation.²³ Further, even though

the tribunal did not rule out the possibility that such action could be reviewed vis-à-vis Article 1110, the general body of precedent does not usually treat such action as expropriation. The most important part of the decision, however, related to Articles 1102 and 1105.

On a basic level, Article 1102 ensures that a “party may not subject enterprises to different or more onerous operating conditions simply by virtue of foreign ownership.”²⁴ Ultimately, the *Myers* tribunal decided that Canada’s motive for remaining consistent with the Basel Convention directives was justifiable, but the actions it undertook to achieve the objective (e.g. the Interim Order) were not and constituted a breach of Article 1102 of NAFTA.²⁵ The tribunal also held that a breach of Article 1105 “occurs only when it is shown that an investor has been treated in such an unjust or arbitrary manner that the treatment rises to the level that is unacceptable from the international perspective.”²⁶ Accordingly, the panel determined that the issuance of the Interim and Final Orders to close the U.S.-Canada border to PCB exports from Canada to America represented a breach of Article 1105.²⁷

The pro-investor decision of the *Myers* tribunal concerning the national treatment and fair and equitable treatment claims signifies increased investor rights under arbitral interpretation of NAFTA’s Chapter 11 that threatens the power of domestic courts in member countries. The decision further asserts that investors can prevail on claims outside the expropriation realm. The ruling in favor of *Myers* based on blatant discrimination by the Canadian government²⁸ slightly expands the legal rights afforded to investors under Chapter 11 law relative to domestic standards by offering them the choice of a potentially investor-friendly tribunal or pursuing a domestic legal claim that could result in a high damage award. This situation could potentially pose a threat to highly regulated and equitable domestic legal systems through forum shopping on behalf of foreign investors. Another NAFTA investor could use Article 1102 to seek damages for treatment ‘less favorable’ that results from the proper application of a legitimate law or regulation.²⁹ The lack of precedent and consistency in NAFTA tribunals’ decisions could allow investors to win awards for weaker claims from future tribunals based on the inconsistent nature of prior decisions.

Similar logic of the investor’s expansion of rights based on the *Myers* tribunal’s decision regarding Article 1102 can be applied to the ruling on minimum standard of treatment under Article 1105. NAFTA investors may be able to prove a valid claim that they and their investment were treated unfairly and unequally under a particular measure through the use of international obligations or principles,³⁰ an avenue that is not available to domestic investors in any of the NAFTA countries. Such an ability represents an increase in legal rights for foreign investors and confers an advantage over domestic companies

because the former can pursue claims unavailable to national companies by going through arbitration (where they might be able to secure an investor-friendly tribunal) or domestic courts (where they might secure a higher award). Ultimately, the *Myers* case illustrates that investment protection must exist in NAFTA to protect against blatantly discriminatory measures from stable member countries like Canada with properly functioning legal systems.³¹



Pope & Talbot v. Canada

Pope and Talbot, Inc., a U.S. based company that harvested timber Canada through a British Columbia subsidiary³² and was subject to Canadian law with respect to those operations, exported timber to the U.S.³³ In order to follow through with its obligations under the 1996 U.S.-Canada Softwood Lumber Agreement (SLA), Canada instituted a system of regulations requiring compliance by any foreign investor.³⁴ Pope and Talbot claimed that this allotment system discriminated against its Canadian subsidiary, and further that the Canadian government’s adoption and implementation of it violated NAFTA’s Chapter 11 provisions concerning national treatment (Article 1102), minimum standard of treatment (Article 1105), performance requirements (Article 1106), and expropriation (Article 1110).³⁵

The arbitration dispute resulted in several decisions, each dealing with a specific claim made by Pope & Talbot. Initially, Canada argued that the matter did not involve an investment dispute, and the arbitration could not proceed accordingly.³⁶ The tribunal did not agree and ruled that Canada's reading was overly narrow.³⁷ The tribunal further ruled that Canada's attempt to deter exports to the U.S. did not constitute a performance requirement as proscribed by Article 1106 because these requirements were neither imposed nor enforced.³⁸ The tribunal also ruled in favor of Canada on Pope & Talbot's claim that applying the SLA regime constituted a violation of national treatment under Article 1102 of NAFTA because there was no differential treatment of the foreign investor without reasonable rationale or without unduly undermining the investment liberalizing objectives of NAFTA.³⁹ In a lengthy opinion, the arbitration panel concluded that the conduct of the administrative agency in charge of regulating the SLA was egregious enough to constitute a violation of Article 1105,⁴⁰ though, because the obligation to afford fair and equitable treatment continues after a claimant initiates arbitration.⁴¹ Ultimately, the tribunal determined that Canada did not engage in expropriation, but refused to apply Canada's narrow interpretation that Article 1110 does not cover regulatory action.⁴²

Although the Pope & Talbot decision denied the investor's expropriation claim, the proceedings highlight the enormous discretion afforded to the tribunal to determine property interests and the broad range of rights investors possess in NAFTA arbitration.⁴³ Chapter 11, as applied by the *Pope & Talbot* tribunal, sets forth a definition of protected investment that is "enormously broad"⁴⁴ and encompasses business as well as generalized economic interests, including the interest in conducting business or profiting from an investment.⁴⁵ This contrasts sharply with the Takings Clause included in the Fifth Amendment of the United States constitution,⁴⁶ which applies only to real property and other specific interests in property, usually as defined by state law.⁴⁷ The distinction shows the basic differences between the domestic law and NAFTA arbitration approaches, where the latter heavily favors the investor by affording protections not offered under domestic law.

Despite the ruling in Canada's favor, the *Pope & Talbot* decision did not secure the power of the state regulatory system vis-à-vis the investor. Thus, the *Pope & Talbot* opinion sends a clear message to NAFTA member countries that national regulation or policing that approaches a substantive expropriation standard will not be tolerated.⁴⁸ This message goes well beyond normal concepts of judicial economy⁴⁹ and provides a strong warning to governments that seek to use agency regulation as an alternative means of enforcement as the growing rights of foreign investors suppress the powers of national and local laws. The investor now possesses an increased set of rights relative to

domestic law that could prove to be highly problematic by encouraging investor forum shopping to override carefully planned government regulation.

Conclusion

AS DEMONSTRATED BY THE THREE CASES ABOVE, NAFTA has produced a trend of increased globalization with limited judicialization.⁵⁰ Contributing to this situation is the fact that there are few cases on which future tribunals can rely and little consistency in the body of arbitration law. Moreover, the somewhat closed nature of the process discourages public discourse and deliberation on important issues brought forth by investors in their claims against host governments.⁵¹ As a result, prior tribunal decisions carry little weight in the eyes of the international community and future tribunals are not pressured to follow their decisions.

Furthermore, domestic courts in NAFTA member countries are prevented from playing an active role in the resolution process of interstate disputes, either by legislative or judicial mandate,⁵² thus expanding the rights of international investors and reducing the power of domestic courts with respect to Chapter 11 disputes. Appropriately, commentators recently criticized Chapter 11 as "an end-around the Constitution,"⁵³ and the change of tone can be attributed to the increased perception that investor protections are being used (both successfully and unsuccessfully) in progressively grander ways.⁵⁴

As the United States and the rest of the Americas edge closer to a regional trade agreement in the form of the Free Trade Area of the Americas encompassing most, if not all of the Western Hemisphere, lessons from NAFTA, particularly in respect to investor-state arbitration, become more important. Further, NAFTA's tribunal structure that results in divergent decisions⁵⁵ must be amended in future trade agreements in order to ensure the application of a single set of legal principles. NAFTA's Chapter 11 investor-state dispute mechanism represents an important element in promoting international trade. However, it is haunted by inconsistency in its application and the ability of investors to exploit the system to secure broader rights than intended by the drafters of the agreement. **BLB**

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ENDNOTES: Vincent L. Frakes

- ¹ Jack J. Coe, Jr., *Taking Stock of NAFTA Chapter 11 in its Tenth Year: An Interim Sketch of Selected Themes, Issues, and Methods*, 36 VAND. J. TRANSNAT'L L. 1381, 1391 (2003).
- ² See Kelly M. Mann, *United Mexican States v. Metalclad Corporation: The North American Free Trade Agreement Provides Powerful Private Right of Action to Foreign Investor*, 35 URB. LAW. 697, 698 (2003).
- ³ See NAFTA, art. 1110, Dec. 17, 1992, reprinted in 32 I.L.M. 289 (1993) [hereinafter NAFTA] (claiming that nationalization or expropriation only allowed for a public purpose, on a non-discriminatory basis, in accordance with due process of law and Article 1105(1), along with payment of compensation).
- ⁴ See Andrew Shapren, Note, *NAFTA Chapter Eleven: A Step Forward in International Trade Law or a Step Backward for Democracy*, 17 TEMP. INT'L & COMP. L.J. 323, 327 (2003).
- ⁵ See Matthew C. Porterfield, *International Expropriation Rules and Federalism*, 23 STAN. ENVTL. L.J. 3, 42-3 (2004) (providing modifications that USTR will incorporate into future expropriation provisions to prevent foreign investors from having greater rights than domestic investors).
- ⁶ Mann, *supra* note 2, at 698.
- ⁷ *Metalclad Corp. v. Mexico* (NAFTA Arbitration 2000), ¶¶ 10-11 [hereinafter *Metalclad*].
- ⁸ *Id.* at ¶ 11.
- ⁹ *Id.* at ¶ 20; see also Mann, *supra* note 2, at 698-99.
- ¹⁰ *Id.* at ¶¶ 133-37; see also Mann, *supra* note 2, at 700.
- ¹¹ See Patrick Del Duca, Comment, *Law and the Border: The Rule of Law: Mexico's Approach to Expropriation Disputes in the Face of Investment Globalization*, 51 UCLA L. REV. 35, 36-7 (2003) (noting the emergence of a new constitutional design in Mexico to confront the challenges and opportunities of expropriation with respect to the management of investment and expropriation disputes, of which a necessary trust of the rule of law represents an important element).
- ¹² Coe, *supra* note 1, at 1424.
- ¹³ See Porterfield, *supra* note 5, at 69-70 (arguing that the unconstitutionality of procedural takings laws considered by Congress, as noted by the Attorneys General of thirty-seven states, presents one potentially significant obstacle to the preemption of state and local law under international expropriation rules).
- ¹⁴ Compare *Metalclad with Loewen Group, Inc. v. United States* (ICSID Award 2003), ¶ 162 (showing how the investor in the former case used the arbitration setting to achieve initial victory relative to the latter, which suggests that the remedies under domestic law are broader than under NAFTA).
- ¹⁵ Dana Krueger, Comment, *The Combat Zone: Mondev, International, Ltd. v. United States and Backlash Against NAFTA Chapter 11*, 21 B.U. INT'L L.J. 399, 417 (2003).
- ¹⁶ S.D. Myers v. Gov. of Canada (NAFTA Arbitration 2000), ¶¶ 90-91 [hereinafter *Myers*].
- ¹⁷ *Id.* at ¶ 93.
- ¹⁸ *Id.* at ¶ 105.
- ¹⁹ *Id.* at ¶ 123.
- ²⁰ See *id.* at ¶¶ 130-33 (noting also that the Interim Order was specifically designed to curtail Myers' operations and investments in Canada).
- ²¹ *Id.* at ¶¶ 134-35.
- ²² *Myers* at ¶¶ 137-43.
- ²³ See *id.* at ¶¶ 279-288; see also Madeline Stone, Comment, *NAFTA Article 1110: Environmental Friend or Foe*, 15 GEO. INT'L ENVTL. L. REV. 763, 779 (2003).
- ²⁴ See Robert A. Schmoll, Comment, *NAFTA Chapter 11 and Professional Sports in Canada*, 36 VAND. J. TRANSNAT'L L. 1027, 1054 (2003) (quoting Daniel M. Price & P. Bryan Christy III, *An Overview of the NAFTA Investment Chapter: Substantive Rules and Investor-State Dispute Settlement, in The North American Free Trade Agreement: A New Frontier in International Trade and Investment in the Americas* 173 (Judith H. Bello, et al., eds., 1994)).
- ²⁵ See *Myers* at ¶¶ 255-56 (holding that Canada's legitimate goal of wanting to maintain the ability to process PCBs within Canada in the future did not comport with preventing SDMI from exporting PCBs to the U.S. for processing under the Interim Order because it contravened Canada's international commitments under NAFTA).
- ²⁶ *Id.* at ¶ 263 (further noting that such a determination of an Article 1105 breach must be made in light of the high degree of deference international law affords domestic authorities in their regulation of matters within their own borders).
- ²⁷ *Id.* at ¶ 268.
- ²⁸ Krueger, *supra* note 15, at 409.
- ²⁹ See Todd Weiler, *A First Look at the Interim Merits Award in S.D. Myers, Inc. v. Canada: It is Possible to Balance Legitimate Environmental Concerns with Investment Protection*, 24 HASTINGS INT'L & COMP. L. REV. 173, 181-83 (2001) (arguing that the tribunal's "like circumstances" test applied in the *Myers* decision represents the proper approach to quell any fears of overly broad and potentially frivolous claims under Article 1102).
- ³⁰ *Id.* at 184.
- ³¹ *Id.* at 188.
- ³² *Pope & Talbot, Inc. v. Gov. of Canada*, Interim Award (NAFTA Arbitration 2000), ¶ 4 [hereinafter *Pope & Talbot I*].
- ³³ *Id.* at ¶ 29.
- ³⁴ *Id.* at ¶ 30; see also David A. Gantz, *Protection of Protection Investment Under the NAFTA Chapter 11 – UNCITRAL Arbitration Rules: National Treatment, Performance Requirements, Fair and Equitable Treatment, Expropriation, Damages, Allocation of Costs*, 97 AM. J. INT'L L. 937, 938 (2003) (describing the categorization used to determine the exemption status from requirements under the SLA, including the definition of an "established base" (EB) for which there was no export fee, "lower fee base" (LFB), for which there was a U.S. \$0.50 per thousand board feet, and "upper base fee" (UBF), for which there was a U.S. \$1.00 per thousand board feet).
- ³⁵ *Pope & Talbot I* at ¶ 11.
- ³⁶ *Id.* at ¶¶ 8-26.
- ³⁷ See *id.* at ¶ 19 (noting that the tribunal's decision was based on fact that no provision in Chapter 11 Section A stipulates that investment and trade in goods are to be divorced from each other and further citing the tribunal's finding that "the fact that a measure may primarily be concerned with trade in goods does not necessarily mean that it does not also relate to investment or investors").
- ³⁸ *Pope & Talbot v. Gov. of Canada*, Award on the Merits of Phase 2 (NAFTA Arbitration 2001), ¶ 75 [hereinafter *Pope & Talbot II*]; see also Gantz, *supra* note 35, at 941.
- ³⁹ See *Pope & Talbot v. United States*, Award on the Merits of Phase 3 (NAFTA Arbitration), ¶¶ 87-88 [hereinafter *Pope & Talbot III*] (deciding that the Canadian government's decision to apply the regulations regime to four provinces was not discriminatorily motivated, and therefore did not violate Article 1102 and that firms in other provinces used as evidence by Pope & Talbot were not in like circumstances with the claimant).
- ⁴⁰ *Pope & Talbot v. United States*, Award on the Merits of Phase 4 (NAFTA Arbitration), ¶¶ 65-67 [hereinafter *Pope & Talbot IV*].
- ⁴¹ William W. Park, et al., *International Legal Developments in Review: 2002 Business Transactions and Disputes*, 37 INT'L LAW 445, 455 (2003).
- ⁴² See *Pope & Talbot IV* at ¶¶ 939-40 (further elucidating the tribunal's decision as based on the fact that no allegation investment was nationalized or that the export control regime was confiscatory and reliance on jurisprudence of Iran-U.S. Claims Tribunal).
- ⁴³ See Porterfield, *supra* note 5, at 44 (suggesting that despite rulings against the investor in the *Pope & Talbot* and *S.D. Myers* cases, the tribunal's language in these and *Metalclad* decisions provides foreign investors with significantly greater substantive and procedural rights than property owners in the U.S. under the Takings Clause of U.S. Constitution).
- ⁴⁴ Daniel M. Price, *NAFTA Chapter 11 – Investor-State Dispute Settlement: Frankenstein or Safety Valve?*, 26 CAN.-U.S. L.J. 107, 119 (2001).
- ⁴⁵ NAFTA, *supra* note 3, at art. 1139.
- ⁴⁶ See U.S. CONST. amend. V (stating "nor shall private property be taken for public use, without just compensation").
- ⁴⁷ Porterfield, *supra* note 5, at 44.
- ⁴⁸ *Id.* at 49.
- ⁴⁹ Gantz, *supra* note 35, at 949.
- ⁵⁰ Patricia Isela Hansen, *Judicialization and Globalization in the North American Free Trade Agreement*, 38 TEX. INT'L L.J. 489, 489 (2003).
- ⁵¹ *Id.* at 500-01.
- ⁵² See NAFTA, *supra* note 3, at art. 2021; see also Hansen, *supra* note 51 at 493 (noting that the agreement expressly proscribes the establishment of a private right of action under the law of a NAFTA country for the alleged violations by other NAFTA countries).
- ⁵³ See Krueger, *supra* note 15, at 400 (quoting Bill Moyers Reports: Trading Democracy, PBS television broadcast (Feb. 5, 2002), at http://www.pbs.org/now/printable/transcript_tdfull_print.html).
- ⁵⁴ *Id.* at 400.
- ⁵⁵ Charles N. Brower, *NAFTA's Investment Chapter: Dynamic Laboratory, Failed Experiments, and Lessons for the FTAA*

The Enron Debacle:

A GLIMPSE INTO FRAUDULENT ENERGY TRADING

By Professor James M. Day

THE COLLAPSE OF ENRON revealed one of the worst corporate frauds in American history. Enron's MBAs, CPAs, lawyers, and other scoundrels were headed by Kenneth L. Lay, a Ph.D. economist who claimed he did not know what was going on. The chicanery ran the gamut from insider trading to defrauding shareholders and creditors by cooking the books, corporate officials and employees defrauding the company, and the manipulation of electric and natural gas prices. This article provides a glimpse into the trading subterfuges that raised every American's electric and gas bills.

Enron was not alone in the sham trading.¹ The combined illicit actions of Enron and other sham traders raised electric and natural gas prices to dizzying heights in California and around the nation, partly because of California's grossly flawed energy regulatory system that invited fraud. The Federal Energy Regulatory Commission (FERC), Commodity Futures Trading Commission (CFTC) and state regulatory authorities, particularly the California Energy Commission and the California Public Utilities Commission (CPUC), were no match for the sophisticated energy companies. Representative Edward J. Markey, Massachusetts Democrat, summed it up: "We're in a supersonic-speed era of electronic trading with a horse-and-buggy system to protect consumers."

Patrick Wood III, former chairman of the Public Utility Commission of Texas and FERC chairman since September 2001, stated, "Enron's trading strategies involved deliberate misrepresentations" and Enron "exploited the flaws in California's market design." Mr. Wood also admitted that FERC has "a long way to go" in matching the sophistication of the energy companies it regulates.

The issue was over-simplified by S. David Freeman, Chairman of the California Consumer Power & Conservation Financing Authority: "They can do all these sham transactions because no one's ever seen a kilowatt hour." In a way, however, Mr. Freeman is correct. Lawyers, accountants, and government regulatory officials generally lack the technological expertise not only in trading, but also in the electronic communication involved in the world of energy and its relation to electricity, oil, and natural gas. Justice William O. Douglas' dissent in *Phillips Petroleum Co. v. Wisconsin* admitted that the "[r]egulation of the business of producing and gathering natural gas involves considerations of which we know little and are not competent to deal."² Additionally, agencies lack the manpower to monitor trading and in turn react to protect the market, investors, and consumers.

The California Energy Crisis

UNDERSTANDING THE MARKETING AND TRADING of natural gas and electricity is complex. Like most technical regulatory issues, the lawyer must work hand-in-hand with engineers and accountants whom are qualified in that particular field. If you wanted to compute the rampant fraud and collusion that occurred during California's 2000-2001 energy crisis, it would require scores of paralegals and computer whizzes experienced in trading, and an amendment to the old adage to read, "Figures never lie." In 2002, FERC obtained admissions from over a half dozen major marketers stating they provided false information to the trade press for the purpose of manipulating prices. The data, when published by the trade press, set the market prices for electricity and natural gas in many key hubs around the nation and boosted the prices to utility companies and consumers.

Before the crisis ended, former Governor Gray Davis ordered legal action filed against a number of California utilities for \$8.9 billion in refunds for overcharging and price manipulation. The mishandling of the crisis and California's resultant billions in debt ultimately led to Governor Davis' recall. In December 2002, a FERC administrative law judge (ALJ) found only \$1.8 billion in overcharges, a figure well below the \$4 billion that California alleged was overcharged from October 2000 to June 2001. Additionally, the ALJ refused to consider the alleged \$4.9 billion in overcharges that occurred prior to October 2000.

In March 2003, the FERC, which lacks power under the Federal Power Act or the Natural Gas Act to levy civil penalties, but can order refunds exceeding a "just and reasonable rate," ruled the ALJ's award was insufficient. The FERC required thirty power generators and utilities to document and justify the overcharges, in turn raising the overcharge award to \$3.3 billion. The full Commission also threatened to ban several companies from trading, including BP, the British multinational petroleum giant. Additionally, in a surprise move, the FERC named the Department of Energy's Bonneville Power Administration and the Los Angeles Department of Water and Power as alleged culprits. Both mumbled that they were not conspirators, claiming that they were government non-profit agencies merely charging what everyone else was. This issue, however, will no doubt be resolved on the basis of whether the prices were just and reasonable. As the California utilities owe the power generators and marketers \$3 billion in unpaid bills, the Californians will appeal the final FERC decisions ad nauseam, while awaiting the outcome of pending criminal fraud claims.

Wash Transactions

THE MOST POPULAR SLIGHT-OF-HAND TRANSACTIONS were the “wash” or “round-trip” electricity trades between power generators, marketers, and traders. In effect, wash transactions involve the selling and buying back of identical quantities of electricity at the same price. Why sell and then buy back electricity at neither profit nor loss? When caught, one of the culprits, CMS Energy, claimed it did it to inflate its gross revenue by \$5.2 billion in two years, amounting to 23 percent of its revenues. CMS Energy claimed it was a small company and wanted to appear like a big-time trader, which sounds logical. However, as this process might attract new business and puff up its stock value, the Securities and Exchange Commission (SEC) looks upon it with a jaundiced eye. The practice also falls within the jurisdiction of the CFTC (even though it is a cash transaction) if the wash could or tend to affect the price of a commodity. The bright line rule is whether the intent in making a wash sale was not to make a bona fide trading transaction.³

Loretta Lynch, president of the CPUC, offered several reasons for Enron’s involvement in wash trades. She claimed that four Enron affiliates traded 10 million megawatt hours of electricity at ever-increasing rates during December 2000 in order to create a volatile market and raise the market price. In 2001, the FERC identified 24 electric marketers and generators and 15 gas pipeline producers and marketers that were Enron affiliates, and estimated Enron was involved as a buyer or seller in 38 percent of the natural gas and 17 percent of the electric power marketed in the United States. This is not to say that Enron was the sole purchaser or buyer in the transactions. In many cases, Enron was just another trader in the “daisy chain” of transactions that increased prices. Additionally, as natural gas is a primary fuel for producing electricity, increasing gas costs had a synergistic effect in raising electricity prices.

Revelations about Enron’s first known cover up of wash transactions, fraud, and losses occurred in 1987, one year after Kenneth Lay took over as chairman and CEO. Lay consolidated a series of gas pipeline companies, creating one company with the name Enron. Traders in Enron’s New York office were discovered to have overstated their trading volume to inflate their division’s revenues, boost the company’s trading prominence, and increase their personal commissions on nonexistent sales. Lay failed to report the crime to Enron’s board of directors or to the SEC. Lay needed to show Wall Street analysts revenue in order to demonstrate that Enron’s market was growing. As the greedy traders continued using wash trades to fill their wallets, several of Enron’s trading partners became suspicious of the excessive trading volumes. Out of concern that the wash trades may be discovered, causing trading partners to demand that Enron cover its positions with cash that the company could not afford, Lay fired the traders and reported an \$85 million loss. This reported loss, however, was a lie. The actual loss was

instead \$142 million, not \$85 million. Why did Lay lie? By underreporting the loss, Lay could still report a profit.

Lay’s claim that he knew nothing about Enron employees’ illegal actions during his tenure as CEO is difficult to believe. Early on in Enron’s venture into trading, approximately 75 Enron employees participated in setting up a phony trading floor at Enron’s Houston headquarters. This was done to give visiting Wall Street analysts the impression that Enron was doing a booming trading business. It was a joke and common knowledge around the headquarters that some of the computers they pretended to use to impress the analysts were not even hooked up!

Trading Tricks

INTERNAL MEMOS FROM ENRON, obtained through discovery during the California litigation, described in detail Enron’s trading schemes, each labeled with cute names (see below). Used as instructions, the names of the friendly traders necessary to complete the schemes are missing. These are of course only allegations, which Enron “vigorously denies.” The company claims that the memos were misinterpreted. Opinions outside of Enron regarding the memos vary from lawyers agreeing that the transactions will be difficult to prove in court, traders claiming they are simply an arbitrage means that have been used for years, and many prosecutors asking why they were written if they were not followed.

“Ricochet”

Under this scheme, Enron purchases cheap power in California controlled by price caps and sells it to a “friendly” out-of-state buyer, who in turn sells it back at a higher price not subject to price caps. Enron then “ships” it back to California at an uncontrolled higher price. (In many cases, the “friendly” transactions were physically impossible, instead serving as mere “paper trades.”)

“Fat Boy”

Enron traders speculate whether California utilities have underestimated the next day’s electricity demand with the California Independent System Operator (CISCO). Enron is correct the vast majority of the time, since utilities will attempt to hold down the price by lowering projected demand, especially when California placed caps on consumer prices, possibly forcing utilities to purchase wholesale power at a price in excess of the retail price. Enron schedules to ship more power over the grid than its customers require, a violation of the rules many traders ignore. When demand exceeds the utilities’ estimates, Enron sells its “extra” power on the spot market at many times the original price.

Enron’s defense is that it merely overestimated its requirements and the utilities underestimated the demand. Enron delivered the electricity when needed and avoided one of seven blackouts and 38 curtailments of electricity which

occurred in California during the first five months of 2001. Hence, Enron serviced the consumers.

“Get Shorty”

For a fee, Enron agrees to provide CISCO with standby generation and transmission services the following day, if and when needed. Enron plans to purchase the services if requested, contrary to the agreement that requires it to identify the standby sources. Enron purchases the rights and services early the next day when prices are cheaper, and submits a false statement of the source.

“Load Shift”

Enron deliberately overestimates the power demand in Northern California to create a fear of transmission congestion, and raises the price in the north. At the same time, it underestimates the demand in Southern California. Enron then earns a fee to shift the load to the south from the north in order to alleviate the self-inflicted congestion.

This is a variation of the old “inc-ing” marketing ploy (short for load increasing) to earn fees for not sending power that was never intended to be sent over the lines in the first place.

“Death Star”

Enron schedules to import electricity on California’s southern border and transport it to Northern California. As the transmission lines are often booked – Californians do not like

nasty transmission lines and will not permit them to be built in their neighborhood, regardless of the need for more lines – Enron receives a fee to transmit the electricity from another direction and relieve the congestion.

Conclusion

IN OCTOBER 2002, Timothy N. Belden, Enron’s chief trader on the West Coast, pled guilty to one count of conspiracy to commit wire fraud to drive up California’s electricity prices. As part of the plea bargain, the 35-year-old agreed to testify against Enron’s corporate officers and turn over \$2.1 million in salary and bonuses he earned in 2001, representing the portion tied to fraud. Incidentally, Belden earned \$5.5 million in salary and bonuses in 2001. Thus, the question becomes what else did he do for the \$3.4 million balance he received that the feds do not know about?

Belden faces up to five years in prison and a \$250,000 fine. If I were the judge at sentencing, I would ask Belden, an electronics engineer, “Why did you schedule to send 2,900 megawatts of power over a 1,500 megawatt line?” Although physically impossible, the correct answer is that it was worth the risk. CISCO fined Belden \$25,000 for causing the congestion, which Enron gladly paid. The price jumped 70 percent, and the soon to be bankrupt Pacific Gas & Electric Co. was charged an extra \$5.5 million that day because of a blatant scam that CISCO should have stopped immediately. A second question might be, “Did you receive a bonus for the \$570 million for electricity sold to Pacific Gas & Electric, who filed for bankruptcy and may never pay?”

In early 2003, the Houston Chronicle reported that Enron’s legal fees would reach \$1 billion for its bankruptcy and the defense of 23,000 separate claims totaling \$400 billion out of Enron’s estimated net assets of \$15,000 billion. I believe Enron’s fees will exceed \$1 billion and the civil and criminal cases will drag on for years. The old saying that crime does not pay will not apply to all of Enron’s employees – the facts are too complex and proof of the fraud is too difficult.

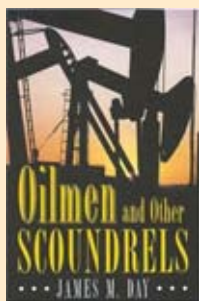
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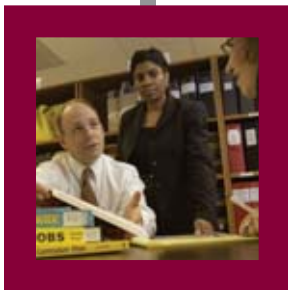
ENDNOTES: Professor James M. Day

- ¹ To name a few: American Electric Power, Calpine Corp., CMS Energy, Duke Power, Dynegy, El Paso Corp., Mirant Corp., Reliant Resources, and Williams Energy.
- ² Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672, 690 (1954) (Douglas, J., dissenting).
- ³ See Stoller v. Commodity Futures Trading Comm’n, 834 F.2d 262 (2d Cir. 1987).



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