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We have striven to make the *Journal* and this first Volume meet their expectations. Hopefully, this *Journal* will foster a discussion that will help create not only a more vigorous economy, but also one that is more just.

With the utmost gratitude,

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EVOLVING INTELLECTUAL PROPERTY PROTECTION IN THE WORLD: PROMISES AND LIMITATIONS

ARTICLE

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I. INTRODUCTION

AT NO OTHER TIME IN ECONOMIC HISTORY HAVE COUNTRIES BEEN MORE economically interdependent than they are today. Despite the current global recession since late 2008, most countries in the 21st century have not shunned globalization and are likely to continue their globalization trend. The globalization trend has been supported by the belief of firms in the efficiency of global supply chains. Even a firm that is operating in only one domestic market is not immune to the influence of economic activities external to that market. The net result of these factors has been the increased interdependence of countries and economies, increased competitiveness, and the concomitant need for firms to keep a constant watch on the international competitive and technological environment.

As the nature of value-adding activities in the world shifts more and more to information creation, manipulation, and analysis, both developed and emerging nations have started taking an increased interest in international intellectual property protection measures. Imagine a farmer in the nineteenth century headed into the twentieth century. The intrinsic value of food will not go away in the new century, but as food becomes cheaper and cheaper to produce, the share of the economy devoted to agriculture will shrink (in the United States agriculture contributes less than 3 percent to the GDP) and so will the margins for the farmer. It would be advisable to move into manufacturing, or at least into food processing, to maintain margins.

An analogous situation faces a content maker for information-related products such as software, sheet music, movies, newspapers, magazines, and education in the late-twentieth century headed into the twenty-first century. Until recently, content has always been manifested physically — first in people who knew how to do things; then in books, sheet music, records, newspapers, loose-leaf binders, and catalogs; and most recently in tapes, discs, and other electronic media. At first, information could not be *copied*: it could only be re-implemented or transferred. People could build new machines or devices that were copies of or improvements on the original; people could tell each other things and share wisdom or techniques to act upon. (Reimplementation was cumbersome and re-use did not take away from the original, but the process of building a new implementation — a new machine or a trained apprentice — took considerable time and physical resources.)

Later, with symbols, paper, and printing presses, people could copy knowledge, and it could be distributed in *fixed* media; performances could be transcribed and recreated from musical scores or scripts. Machines could be mass-produced. With such mechanical and electronic media, intellectual value could easily be reproduced, and the need (or demand from creators) to protect intellectual property arose. New laws enabled owners and creators to control the production and distribution of copies of their works. Although reproduction was easy, it was still mostly a manufacturing process, not something an individual could do easily. It took time and money. Physical implementation contributed a substantial portion of the cost.

However, with the advent of the Information Age, firms face a new situation; not only is it easy for individuals to make duplicates of many works or to re-use their content in new works, but the physical manifestation of content is almost irrelevant. Over the Internet, any piece of electronically represented intellectual property can be almost instantly copied anywhere in the world. Since more and more of value creation in the developed nations is coming from the development and sale of such information-based intellectual property, it is no surprise that developed nations are highly interested in putting strong international intellectual property laws in place. Obviously, it is costly for corporations to protect their intellectual property, and to adjust for losses in productivity and perceived damage to corporate brand and share price. The U.S. insistence on the inclusion of provisions relating to intellectual property in the World Trade Organization's (WTO's) Trade Related Aspects of Intellectual Property Rights (TRIPS) agreement is a direct consequence, and is understandable as cyber crime affects all parties with intellectual property. Technology-based protection of electronic information through hardware, software, or a combination thereof in the form of encryption and digital signatures has been suggested as the means of circumventing the problem of unauthorized copying.[1]

Further hurdles exist for content creators with the emergence of electronic commerce (e-commerce). One is the rise of a truly efficient market for information. Content used to be *unfungible*: it was difficult to replace one item with another. But most information is not unique, though its creators like to believe so. There are now specs for content such as stock prices, search criteria, movie ratings, and classifications. In the world of software, for instance, it is becoming easier to define and create products equivalent to a standard. Unknown vendors who can guarantee functionality will squeeze the prices of the market leaders. Of course the leaders (such as Microsoft) can use almost-free content to sell ancillary products or upgrades, because they are the leaders and because they have reinvested in loyal distribution channels. The content is advertising for the dealers who resell, as well as for the vendors who create. This transformation in the form of value creation and ease of dissemination implies a jump in economic integration as nations become part of an international electronic commerce network. Not only money but also products and services will flow faster.

The other consequence of fungible content, information products, and electronic networks is an additional assault on the power of national governments to regulate international commerce. Ford uses a product design process whereby designers at Dearborn, Michigan, pass on their day's work in an electronic form to an office in Japan, which then passes the baton along to

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1 *See* RAVI KALAKOTA & ANDREW B. WHINSTON, FRONTIERS OF ELECTRONIC COMMERCE (Pearson Education 1996).

designers in Britain, who pass it back to Dearborn the next day. When the information represented in the design crosses borders, how do the governments of the United States, Japan, and Britain treat this information? How will such exchanges be regulated? Less-open societies like China and Malaysia, recognizing the power of electronic networks, are already attempting to regulate the infrastructure of and access to the electronic network.

In this article, we examine how intellectual property is protected domestically as well as internationally, and how this mechanism has been evolving in recent years. Such knowledge is important in an era of globalization as an increasing number of firms, both domestic and international, have begun to realize that intellectual resources that are valuable, rare, and difficult-to-imitate are major sources of their competitive advantage.

II. Intellectual Property Protection

Intellectual property refers to "a broad collection of innovations relating to things such as works of authorship, inventions, trademarks, designs and trade secrets."[2] Intellectual property rights broadly include patents, trademarks, trade secrets, and copyrights. These ideas typically involve large investments in creative and investigative work to create the product, but fairly low costs of manufacturing. As such they are amenable to being duplicated readily by imitators. Imitation reduces the potential returns that would have accrued to the innovator, thereby limiting its ability to appropriate the large investments made. With increasing movements of goods and services across borders the potential loss of revenues to innovator firms, most of which reside in industrialized countries, is significant.

Few topics in international business have attracted as much attention and discussion in recent years as intellectual property rights.[3] In 2007, the Organization for Economic Cooperation and Development (OECD) released a report estimating the annual value of the international, physical trade of counterfeited consumer products at approximately $200 billion. This amounts to about two percent of the entire world trade and surpasses the GDP of 150 countries.[4] Apart from hurting legitimate businesses and trade, intellectual property infringement leads to the loss of government tax revenue.

Piracy is most rampant in the software industry. For example, according to the Business *Software* Alliance, a global anti-piracy watchdog group, 38% of the

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2 SUBHASH C. JAIN, *Intellectual Property Rights and International Business, in* EMERGING ISSUES IN INTERNATIONAL BUSINESS RESEARCH 37-64 (Masaaki Kotabe & Preet S. Aukakh eds., E. Elgar 2002).

3 *See* Clifford J. Shultz III & Bill Saporito, *Protecting Intellectual Property: Strategies and Recommendations to Deter Counterfeiting and Brand Piracy in Global Markets*, 31 COLUM. J. WORLD BUS. 18, 19-27 (1996).

4 *See* Andreas Geiger, *A View From Europe: The High Price of Counterfeiting, and Getting Real about Enforcement*, THE HILL, Apr. 30, 2008, *available at* http://thehill.com/business-a-lobbying/3565-a-view-from-europe-the-high-price-of-counterfeiting-and-getting-real-about-enforcement.

software installed in 2007 on personal computers (PCs) worldwide was obtained illegally, amounting to nearly $60 billion in global losses due to software piracy. In percentage terms, Central/Eastern Europe topped the piracy rate at 68% of all software used, followed by Latin America at 65%, Middle East/Africa at 60%, Asia Pacific at 59%, the European Union at 35%, Western Europe at 33%, and North America at 21%.[5] More concerning is the counterfeiting of medicines, which threatens public safety and poses a growing threat around the world.

Between 2000 and 2006, the Food and Drug Administration saw an eightfold increase in the number of new counterfeit drugs cases. In developing countries with weak regulatory systems, approximately 10 percent to 30 percent of all medicines could be counterfeit. Worldwide sales of counterfeit drugs are forecast to reach $75 billion by 2010.[6]

Various anti-counterfeiting tools and technologies are developed by firms to aid others' anti-counterfeiting efforts, or to enhance their own. Hewlett-Packard's Specialty Printing Systems, for instance, has expanded its offerings to the pharmaceutical industry with the introduction of a new ink cartridge which allows individual capsules or tablets to be marked. Eastman Kodak Co. developed a Traceless System for anti-counterfeiting on its branded rechargeable lithium-ion digital camera batteries supplied by Sanyo Electric. With "forensically undetectable" markers put on printed materials, product packaging or product components, the system can help fighting against counterfeiting as only handheld Kodak readers can detect the markers. Also among the firms deploying this anti-counterfeiting technology are DonRuss Playoff and Liz Claiborne. However, in spite of anti-counterfeiting tools and technologies, litigation, as well as legislation that we will discuss later in this section, piracy is still rampant around the world.[7]

Now, with convenient online access, it is even more difficult to ensure that copyright rules are not violated in cyberspace. Recently, Google Books was sued by the Association of American Publishers, the Author's Guild, and several authors and publishers, which accused it of breaching copyright laws. Presently, Google Books has reached a settlement agreement with authors and publishers, which will allow Google Books to work closely with these industry participants in order to make more books available online. Google aims to put up to 40 million books online from top US libraries. The critics worry that if the people can read a book online for free they would not bother purchasing it. As easy as a click to download music online to listen to offline, a recent court ruling clearly states that even though the copyright of music has lapsed, reproducing and distributing the music is a breach to the copyright law. According to New York's highest court, Naxos was found illegal to release classical recordings by Yehudi

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5 *See* BUSINESS SOFTWARE ALLIANCE, FIFTH ANNUAL BSA AND IDC GLOBAL SOFTWARE PIRACY STUDY (2007), http://global.bsa.org/idcglobalstudy2007/studies/2007_global_piracy_study.pdf.

6 Drew Buono, *Counterfeit Drugs a Growing Worldwide Danger*, DRUG STORE NEWS, June 23, 2008, at 60-62, *available at* http://findarticles.com/p/articles/mi_m3374/is_7_30/ai_n27909769/.

7 *See* Jill Jusko, *Counterfeiters Be Gone*, INDUSTRY WEEK, July 2008, at 67-68.

Menuhim and others because such recordings were still covered by the common law.[8]

Counterfeiting is not restricted to poor countries, either. Milan, Italy, for example, is a leading producer of counterfeit luxury products; the U.S. state of Florida is an international haven for fake aircraft parts; and Switzerland is a big player in pharmaceutical counterfeit production with almost forty percent of fake medicines seized by the European Union (EU). There is a globalized trend of counterfeiting activities; increasingly, all member countries of the WTO are required to implement Trade Related Aspects of Intellectual Property Rights (TRIPS) to execute intellectual property protection and companies are joining together to fight against the violations.[9]

A. Patents

A patent, if granted, offers a patent holder a legal monopoly status on the patented technology and/or process for a certain extended period (usually between fifteen to twenty-one years depending on the country). Patent laws in the United States and Japan provide an example of the differences in laws across countries and their implications for corporations.[10] The most significant difference between the two countries is on the *first-to-file* and *first-to-invent* principles. While most countries follow the *first-to-file* principle, only the United States (along with the Philippines) follows the *first-to-invent* principle. In the majority of countries, the patent is granted to the first person filing an application for the patent. In the United States, however, the patent is granted to the person who first invented the product or technology. Any patents granted prior to the filing of the patent application by the *real* inventor would be reversed in order to protect rights of the inventor. The difference between the two principles is no small matter. See Perspective 1 for far-reaching implications.[11]

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8 *See* BBC News, *Court Secures Classical Copyright*, Apr. 6, 2005, *available at* http://news.bbc.co.uk/2/hi/entertainment/4415829.stm.

9 *See Imitating Property is Theft*, THE ECONOMIST, May 15, 2003, at 52; Office of the United States Trade Representative, *Trade Delivers: Real Results April 2007*, *available at* http://www.qbpc.org.cn/uploads/download/USTR%20IPR%20Fact%20Sheet.pdf; BBC News, *Honda Wins China Copyright Ruling*, Dec. 24, 2004, *available at* http://news.bbc.co.uk/2/hi/business/4123319.stm; Buono, *supra* note 6, at 60-62.

10 *See* Masaaki Kotabe, *A Comparative Study of U.S. and Japanese Patent Systems*, 23 J. INT'L BUS. STUD. 147 (1992).

11 Forty-one nations, including the United States, the European Union, and Japan, reached a basic agreement to draft a treaty for standardizing the patent approval process based on the first-to-file principle in September 2006.

Perspective 1. Two Worlds Apart: First-to-Invent *vs.* First-to-File[12]

A diplomatic conference to discuss the initial draft of patent harmonization treaty was convened by the World Intellectual Property Organization (WIPO) in May 2002. Most neutral observers would suggest that U.S. domestic politics is one principal impediment to the conference's success. In the United States, the *first to invent* wins the patent, while in the rest of the world a patent is awarded to the *first to file* an application. The conference examined the virtue of the U.S. *first-to-invent* principle vis-à-vis the *first-to-file* principle espoused in the rest of the world. The conference's recommendation involved changing the law to award patents to the *first to file* instead of to the *first to invent*, which has guided the awarding of U.S. patents since Thomas Jefferson looked at the first ones filed in 1790.

Under current U.S. law, an individual applicant for a patent must prove that he had the idea first, not simply that he won the race to the courthouse. He can assert his priority to the invention at any time; he is entitled to a patent if thereafter he has not "suppressed, abandoned, or concealed" the invention. The U.S. system was established to protect the inventor who lacks the resources to keep up a stream of patent applications merely to invoke their priority. Not surprisingly, the system is championed today by resource-poor universities and independent inventors.

Supporters of the *first-to-file* system, largely lawyers and corporations, argue that it would better serve the public because it is simpler and conforms to the systems in the rest of the world. Moreover, it would spur inventors to file for patents earlier and to disclose their inventions sooner, thus speeding the progression from idea to finished product. Many supporters also note that most U.S. companies are equipped to act on a first-to-file basis, since they typically apply for patents as soon as inventions are produced. With the adoption of the first-to-file system, this date would also affect patent rights abroad, and thus provide greater reliability for U.S. patents worldwide.

Many are apprehensive about such a change. The principal objection to the first-to-file system is that it fosters premature, sketchy disclosure in hastily filed applications, letting the courts work things out later. Although unlikely, it leaves open the possibility of someone stealing the profits of an invention from the true inventor by beating him to the courthouse steps. In the end, the Patent Office could be deluged with applications filed for defensive purposes, as is the case in Japan where this phenomenon is called *patent flooding*.

Sensitive to these criticisms, the commission recommended several other reforms to ensure fairness in implementing the *first-to-file* proposal. These reforms include issuing a provisional patent application at reduced cost while the patent itself is undergoing examination, and establishing a grace period for

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12 Lee Edson, *Patent Wars*, ACROSS THE BOARD, April 39, 1993, at 24-29; Q. Todd Dickinson, *Harmony and Controversy*, IP WORLDWIDE, September 2002, at 22-24.

public disclosure without affecting patentability. Most importantly, the commission suggested adopting the rule of *prior-use right*, allowing users of inventions to continue their use under certain conditions, even after a patent on the invention is obtained by another party.

The effect of *first to file* vs. *first to invent* may be best illustrated by the case of the laser, a discovery generally credited to physicist Charles Townes, who won a Nobel Prize for elucidating the principle of the maser, the theoretical father of the laser. Townes owned the patent on the device. Years later, Gordon Gould, a former graduate student at Columbia University, where Townes taught physics, proved by contemporary notebooks and other means that he had developed the idea long before Townes patented it in 1958.

Gould could not have brought his case to the courts in foreign countries that give priority to the first to file. In the United States, however, the court accepted Gould's evidence of priority and awarded him the basic patents to the laser in 1977 and 1979, ruling that Townes and his employer, at the time AT&T Co., had infringed on Gould's idea. Patlex Corp., of which Gould is a director, now collects fees from laser users throughout the world.

The marketing implications of this difference for U.S. companies as well as foreign companies are significant. To protect any new proprietary technologies, U.S. companies must ensure that their inventions are protected abroad through formal patent applications being filed in various countries, especially the major foreign markets and the markets of competitors and potential competitors. For foreign companies operating in the United States, the implications are that they must be extremely careful in introducing any technologies that have been invented in the United States. A *first-to-file* mentality could result in hasty patent applications and significant financial burden in the form of lawsuits that could be filed by competitors that claim to have invented the technology earlier.

In some extreme situations, governments have broken patent law for public health reasons. For example, Brazil's government, after signing an intellectual property protection agreement, announced in August 2001 its plans to break a patent for a drug used to treat AIDS despite the international patent held by Roche, the drug's Swiss-based pharmaceutical company. Federal officials held they could not reach an agreement with Roche to lower the prices the country paid for nelfinavir, a drug blocking the HIV virus from "replicating itself and infecting new cells."[13] The Brazilian government is not the only one to grab a company's patent rights in the interest of public health. Scared by the anthrax outbreaks in the United States, Canada's health ministry decided that public health came first. It commissioned a generic drug company to make a million doses of ciprofloxacin, a drug used to treat one of the nastier forms of the disease whose patent belongs to German drug giant Bayer.[14]

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13 Cristiana Mesquita, *Brazil to Break Patent, Make AIDS Drug*,CNN WORLD, Aug. 23 2001, *available at* http://www.cnn.com/2001/WORLD/americas/08/23/aids.drug0730/index.html.

14 *See* Editorial, *Patent Problems Pending*, THE ECONOMIST, Oct. 27, 2001, at 14.

B. Copyrights

Copyrights protect original literary, dramatic, musical, artistic, and certain other intellectual works. Copyright protection lasts 50 years in the European Union countries and Japan, compared with 95 years in the United States.[15] The difference in the lengths of period of copyright protection could cause tremendous price differences between countries for those products whose copyrights expired in the EU or Japan but are still effective in the United States. This price difference may cause gray marketing activities to emerge.[16]

A computer program is also considered a literary work and is protected by copyright. A copyright provides its owner the exclusive right to reproduce and distribute the material or perform or display it publicly, although limited reproduction of copyrighted works by others may be permitted for fair use purposes. In the United States, the use of the copyright notice does not require advance permission, or registration with, the Copyright Office. In fact, many countries offer copyright protection without registration, while others offer little or no protection for the works of foreign nationals.[17]

In the United States, the *Digital Millennium Copyright Act* (DMCA) was passed in 1998 to address a growing struggle in the cyberspace between industries supplying digital content and those arguing against strict enforcement of copyright on the Internet. The DMCA bans any efforts to bypass software that protects copyrighted digital files. Similar laws have been passed in other countries as well. For example, selling *mod* (modification) chips, a device used to play copied games, tinkering with a game console to play legally and illegally copied software, is a practice that has turned into a legal landmine for the video game sector. In 2004, Sony filed a lawsuit against David Ball, a British national, in Britain's High Court for selling thousands of *mod chips* called Messiah 2 for Sony's PlayStation 2 game consoles. He also published information explaining how to install the *chips* in PlayStation 2 consoles. He was found guilty of violating all counts of UK copyright law.[18]

C. Trademarks

A trademark is a word, symbol, or device that identifies the source of goods and may serve as an index of quality. It is used primarily to differentiate or distinguish a product or service from another. Trademark laws are used to

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15 *See* Editorial, *Copyright Revisions Have Japan's Majors Jumping into the Vaults*, BILLBOARD, Apr. 18, 1998, at 52; Editorial, *Companies in U.S. Sing Blues As Europe Reprises 50's Hits*, N.Y. TIMES, Jan. 3, 2003, (Late Edition), at A1.

16 Gray marketing refers to the legal export/import transaction involving genuine products into a country by intermediaries other than the authorized distributors to take advantage of existing price differentials between the markets.

17 *See* Jain, *supra* note 2.

18 *See Game Over for Mod Chip Dealer*, MANAGING INTELLECTUAL PROPERTY, Sept. 2004, at 113-14.

prevent others from offering a product or service with a confusingly similar mark. In the United States, registration is not mandatory, since *prior use* technically determines the rightful owner of a trademark. However, because determining who used the trademark prior to anyone else is difficult and subject to lawsuits, trademark registration is highly recommended. In most foreign countries, registration is mandatory for a trademark to be protected. In this sense, the legal principle that applies to trademarks is similar to the one that applies to patents: the *first-to-use* principle in the United States and the *first-to-file* principle in most other countries. Therefore, if companies are expected to do business overseas, their trademarks should be registered in every country in which protection is desired (see Perspective 2 for the extent to which U.S. firms could legally protect their own copyright and trademark used by other firms abroad).

Perspective 2. Could U.S. firms always protect their own Copyrights and Trademarks used by other firms abroad? The answer is clearly no[19]

Infringement of intellectual property rights is not confined to the United States. Inadequate protection of intellectual property rights in foreign countries could also result in copyrights and trademarks illegally used abroad making their way back to the United States. In many industrialized countries, it is possible to stem illegally used copyrights and trademarks from entering the home country. For example, in the United States, the U.S. Customs Service provides protection to copyrights and trademarks.

Prior to receiving U.S. Customs protection, copyrights and trademarks have to be registered first with the U.S. Copyright Office and the U.S. Patent and Trademark Office, respectively. Then for U.S. Customs protection, each copyright and trademark must be recorded at the U.S. Customs Service Office. The fee is $190. Although there are no standard application forms, the application requirements for recording a copyright and a trademark are listed in Section 133.1–133.7 of the U.S. Customs regulations. An application should include the following information: (1) a certified status copy and five photocopies of the copyright or trademark registration, (2) the name of its legal owner, (3) the business address of the legal owner, (4) the states or countries in which the business of the legal owner is incorporated or otherwise conducted, (5) a list of the names and addresses of all foreign persons or companies authorized or licensed to use the copyright or trademark to be protected, (6) a list of the names and addresses of authorized manufacturers of goods, and (7) a list of all places in which goods using the copyright or bearing the trademark are legally

19 Maxine Lans Retsky, *Curbing Foreign Infringement*, MARKETING NEWS, Mar. 31, 1997, at 10; *Brazilian ISP Prevails in AOL Lawsuit*, a news report provided by "LatPro.com ejs@LatPro.com, May 31, 1999; *No Free Ride*, LATIN TRADE, May 2001, at 54; *AOL Latin America Launches Upgraded Wireless E-Mail in Brazil, Mexico and Argentina*, WORLD IT REPORT, Feb. 17, 2002, at N.

manufactured. Although it is not necessary to submit a separate application for protection of each copyright or trademark, the filing fee of $190 still applies to each and every copyright or trademark being recorded with the Customs Service. Additional information can be obtained by contacting the U.S. Customs Service at the Intellectual Property Rights Branch, Franklin Court, 1301 Constitution Avenue, N.W., Washington, D.C. (Ph. 202-482-6960).

Unfortunately, the U.S. Patent and Trademark Office has little or no legal recourse when it comes to U.S. copyrights or trademarks used by foreign companies outside the United States. For example, in Brazil, America Online's famous *aol.com* domain is legally owned by StarMedia Network, a small Internet services Brazilian company in the fast-growing Latin American market. America Online (AOL) had sued StarMedia Network alleging trademark infringement and contested the Brazilian provider's use of the domain name *aol.com.br*. However, the Brazilian court ruled in May 1999 that since Brazil's America Online registered the name first, it would not have to surrender the domain name to its US rival. As a result of the Brazilian court's ruling in favor of StarMedia Network, its shares rose 74 percent in its first day of trading. AOL was then forced to market its Brazilian services under *br.aol.com*.

Although no other news leaked on a possible out-of-court settlement on StarMedia's *aol.com.br* vs. AOL's *br.aol.com*, recent news articles suggest that AOL may have eventually purchased the right to use *aol.com.br* for an undisclosed sum of money (which would not come cheap).

The decision may touch off concerns about international cybersquatting as many Internet dotcom companies begin to launch overseas operations, only to find that country-level version of the domain name is already registered. For example, the AOL domain had been registered in about 60 countries in addition to Brazil, and not all of these registrations were made by the American company.

D. Trade Secrets

A trade secret is another means of protecting intellectual property and fundamentally differs from patent, copyright, and trademark in that protection is sought without registration. Therefore, it is not legally protected. However, it can be protected in the courts if the company can prove that it took all precautions to protect the idea from its competitors and that infringement occurred illegally by way of espionage or hiring employees with crucial working knowledge.

III. International Treaties for Intellectual Property Protection

Although patent and copyright laws have been in place in many countries for well over a hundred years, laws on trademarks and trade secrets are of relatively recent vintage, having been instituted in the late nineteenth century and beginning of the twentieth century.[20] These laws are essentially national laws, and as such, do not protect intellectual property across national boundaries. There are many international treaties to help provide intellectual property protection across national boundaries, however. Some of the most important treaties are the Paris Convention, Patent Cooperation Treaty, Patent Law Treaty, European Patent Convention, and Berne Convention.

A. Paris Convention

The Paris Convention for the Protection of Industrial Property was established in 1883, and the number of signatory countries currently stands at 140. It is designed to provide *domestic* treatment to protect patent and trademark applications filed in other countries. Operationally, the convention establishes rights of priority that stipulate that once an application for protection is filed in one member country, the applicant has twelve months to file in any other signatory countries, which should consider such an application as if it were filed on the same date as the original application.[21] It also means that if an applicant does not file for protection in other signatory countries within a grace period of twelve months of original filing in one country, legal protection could not be provided. In most countries, other than the United States, the *first-to-file* principle is used for intellectual property protection. Lack of filing within a grace period in all other countries in which protection is desired could mean a loss of market opportunities to a competitor who filed for protection of either an identical or a similar type of intellectual property. The two new treaties, explained below, are further attempts to make international patent application as easy as domestic patent application.

B. Patent Cooperation Treaty.

The Patent Cooperation Treaty (PCT) was established in 1970, amended in 1979 and modified in 1984. It is open to any signatory member country to the Paris Convention. The PCT makes it possible to seek patent protection for an invention simultaneously in each of a large number of countries by filing an *international* patent application. The patent applicant can file his or her international patent application with his or her national Patent Office which will act as a *PCT Receiving Office* or with the International Bureau of World Intellectual Property Organization (WIPO) in Geneva. If the applicant is a national or resident of a contracting State which is party to the European Patent Convention, the Harare Protocol on Patents and Industrial Designs (Harare Protocol) or the Eurasian Patent Convention, the international application may

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20 *See* Bruce A. Lehman, *Intellectual Property: America's Competitive Advantage in the 21st Century*, 31 COLUM. J. WORLD BUS. 8, 8-9, (1996).

21 *See* WORLD INTELLECTUAL PROPERTY ORGANIZATION, PARIS CONVENTION FOR THE PROTECTION OF INDUSTRIAL PROPERTY, *available at* http://www.wipo.int/treaties/en/ip/paris/trtdocs_wo020.html.

also be filed with the European Patent Office (EPO), the African Regional Industrial Property Organization (ARIPO) or the Eurasian Patent Office (EAPO), respectively.[22]

C. Patent Law Treaty

The Patent Law Treaty (PLT), adopted in Geneva in June 2000, comes as the result of a World Intellectual Property Organization (WIPO) initiative. Its aim is to harmonize the formal requirements set by patent offices for granting patents, and to streamline the procedures for obtaining and maintaining a patent. Initially, PLT will apply to all European Union countries, the United States, Japan, Canada, and Australia. Eventually it will include virtually all countries in the world. While the PLT is only concerned with patent formalities, many of the provisions will prove extremely useful when the PLT comes into force for a large number of states, providing speedier and less costly procedures for years to come.[23]

D. European Patent Convention

The European Patent Convention is a treaty among thirty-six (as of March, 2010) European countries (not necessarily members of the EU) setting up a common patent office, the European Patent Office, headquartered in Munich, Germany, which examines patent applications designated for any of those countries under a common patent procedure and issues a European patent valid in all of the countries designated. The European Patent Office represents the most efficient way of obtaining protection in these countries if a patent applicant desires protection in two or more of the countries. The European Patent Convention is a party to the Paris Convention, and thus recognizes the filing date of an application by anyone in any signatory country as its own priority date if an application is filed within one year of the original filing date. The European Patent Office receives applications in English. The application are published 18 months after the filing, consistent with the *first-to-file* principle. Once a patent is approved, registrations in, and translations into the language of, each designated country will be required. The European Patent Convention does not supersede any signatories' pre-existing national patent system. Patent applicants still should file and obtain separate national patents, if they would prefer national treatment (favored over pan-European treatment by individual national courts).[24]

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22 *See* WORLD INTELLECTUAL PROPERTY ORGANIZATION, PATENT COOPERATION TREATY, *available at* http://www.wipo.int/pct/en/treaty/about.htm.

23 *See* Q. Todd Dickinson, *Harmony and Controversy*, IP WORLDWIDE, Sept. 2002, at 22-24.

24 *See* Martin Grund & Stacey J. Farmer, *The ABCs of the EPC 2000*, MANAGING INTELLECTUAL PROPERTY, Apr. 2008, at 85-88.

E. Berne Convention

The Berne Convention for the Protection of Literary and Artistic Works is the oldest and most comprehensive international copyright treaty. This treaty provides reciprocal copyright protection in each of the fifteen signatory countries. Similar to the Paris Convention, it establishes the principle of national treatment and provides protection without formal registration. The United States did not join the Berne Convention until 1989.[25]

Although there are separate laws to protect the various kinds of intellectual property, there appears to be a strong correlation between the levels of intellectual property in various countries. Although a new study is not available, the 1996 study provides some of the results of a 1996 academic study based on survey questionnaires administered to experts/practitioners in the various countries (See Table 1).

Table 1. Ratings for the Level of Intellectual Property Protection in Various Countries (Minimum = 0 . . . 10 = Maximum)[26]

COUNTRY	PATENTS	COPYRIGHTS	TRADEMARKS	TRADE SECRETS
Argentina	3.8	5.7	7.1	4.4
Brazil	3.3	5.2	3.3	3.3
Canada	8.1	7.7	9.0	7.8
Chile	5.7	5.7	7.6	7.8
China	2.4	2.9	6.2	3.3
Germany	8.6	8.6	9.0	10.0
India	3.3	5.7	3.8	3.3
Israel	7.1	7.1	8.6	8.9
Mexico	3.3	7.6	3.8	3.3
New Zealand	7.1	8.1	9.5	7.8
Philippines	7.1	6.2	7.6	7.8
Singapore	7.1	6.7	8.6	5.6
South Korea	3.3	4.8	3.8	3.3
Thailand	2.4	4.8	6.7	5.6
United States	9.0	8.1	9.0	7.8

A feature that corporations as well as individual managers have to deal with is the growing importance of intellectual property as a significant form of

25 *See* Nancy R. Wesberg, *Canadian Signal Piracy Revisited in Light of United States Ratification of the Free Trade Agreement and the Berne Convention: Is This a Blueprint for Global Intellectual Property Protection?* 16 SYRACUSE J. INT'L L. & COM. 169, 169-205, (1989).

26 Adapted from Belay Seyoum, *The Impact of Intellectual Property Rights on Foreign Direct Investment*, 31 COLUM. J. WORLD BUS. 51 (1996), at 56.

competitive advantage. The laws to deal with this issue are neither uniform across countries, nor are they extended across national boundaries (outside of the government pressure). Even if they are similar, the implementation levels vary significantly. Essentially, protection of intellectual property requires registration in all the countries in which a firm plans to do business. Managers need to be cognizant of this and take proactive measures to counteract any infringements.

One of the most recent developments in international copyright protection is the WIPO Copyright Treaty, which entered into force in Mach 2002, addressing copyright protection in the Internet era. This treaty updates and supplements the Berne Convention by protecting the rights of authors of literary and artistic works distributed within the digital environment. The treaty clarifies that the traditional right of reproduction continues to apply in the digital environment and confers a right-holder's right to control on-demand delivery of works to individuals.[27]

F. Further Developments

In 2007 a select handful of the wealthiest countries began a treaty-making process to create a new global standard for intellectual property rights enforcement, the Anti-Counterfeiting Trade Agreement (ACTA). ACTA "is spearheaded by the United States, the European Commission, Japan, and Switzerland — those countries with the largest intellectual property industries."[28] Other countries that have joined ACTA's negotiation process are Canada, Australia, Korea, Mexico, New Zealand, and United Arab Emirates. Noticeably absent from ACTA's negotiations are leaders from developing countries who hold national policy priorities that differ from the international intellectual property industry.[29]

At the 34th G8 summit held by Japan in July 2008, the eight leaders in their document on the world economy called for finalizing negotiations of the much-debated ACTA by the end of the year. As of today, negotiations are still ongoing and the 8th Round of Negotiation is scheduled to be held on April 2010 in New Zealand.[30] The summit also declared patent harmonization a topic of high importance, asking for , accelerated discussions of the Substantive Patent Law Treaty (SPLT), a proposed international patent law treaty aimed at harmonizing substantive points of patent law. In contrast with the Patent Law Treaty which only relates to formalities, the SPLT aims at going far beyond formalities to

27 Amanda R. Evansburg, Mark J. Fiore, Brooke Welch, & Lusan Chua, & Phyllis Eremitaggio, *Recent Accessions to WIPO Treaties*, 16 INTELL. PROP. & TECH. L.J. 23, 23 (2004).

28 *The Anti-Counterfeiting Trade Agreement (ACTA),* IP JUSTICE, *available at* http://ipjustice.org/wp/campaigns/acta/.

29 *See id.*

30 *See* Malini Aisola, *ACTA New Zealand Meeting Agenda,* KNOWLEDGE ECOLOGY INTERNATIONAL, March21, 2010, *available at* http://keionline.org/node/809.

harmonize substantive requirements such as novelty, inventive step and non-obviousness, industrial applicability and utility, as well as sufficient disclosure, unity of invention, or claim drafting and interpretation.[31]

IV. SUMMARY

Despite increased business activities transcending national boundaries and the importance of intellectual property in international business, protection of intellectual property in foreign countries is granted essentially by registration in those countries. International business managers should be aware that domestic protection usually cannot be extended beyond their national boundary because the laws are essentially national and do not extend to foreign countries. As a rule of thumb, firms should apply for such protection in every single foreign market in which they sell products that use intellectual property. Various international agreements are primarily designed to make this application process easier across national boundaries.

However, some of the illustrations indicated all countries are inherently interested in protecting or giving preferential treatment (both consciously or unconsciously) to their domestic firms although various international agreements are supposed to treat all intellectual property equally regardless of the source of its origin. This is where politics comes to play. Business has been considered an integral part of economic forces. Indeed, economics was once called *political economy*, and as such, business could not be conducted devoid of political and legal forces. Although we tend to take political and legal forces for granted most of the time in doing business domestically, they could become central issues in international business and cannot be ignored.

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31 *See* Liza Porteus Viana, *Business, Governments See Momentum for ACTA, But EU Snags*, INTELLECTUAL PROPERTY WATCH, Mar. 4, 2008, *available at* http://www.ip-watch.org/2008/03/04/business-governments-see-momentum-for-acta-but-eu-snags/; *see also* *Substantive Patent Law Harmonization*, WORLD INTELLECTUAL PROPERTY ORGANIZATION, http://www.wipo.int/patent-law/en/harmonization.htm.

HARMONIZING EBAY

ARTICLE

WALTER O. ALOMAR-JIMÉNEZ[*]

INTRODUCTION

AFTER THE 2006 SUPREME COURT'S DECISION OF *EBAY V. MERCEXCHANGE*,[1] some commentators have expressed their concerns and argue that said decision: a) weakens the patentee's fundamental right to exclude; b) threatens the status of patents as property rights; and c) puts the United States in noncompliance with the Agreement on Trade Related Aspects of Intellectual Property (TRIPS).[2] They have brought up these concerns because

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1 eBay Inc. v. MercExchange, L.L.C., 547 U.S. 388 (2006).

2 *See, e.g.,* Christopher A. Crotopia, *Compulsory Licensing Under TRIPS and the Supreme Court of the United States' Decision in eBay v. MercExchange (*available at www.cotropia.com/bio/Chapter26--Cotropia--PatentLawHandbook.pdf, last visited on Mar. 18, 2009) (arguing that the decision in eBay, regardless of how it is described and applied, weakens the patentee's right to exclusivity); Yixin H. Tang, Note, *Recent Development: The Future of Patent Enforcement After* eBay v. MercExchange, 20 HARV. J. L. & TECH. 235 (2006) (interpreting *eBay* as stating that patents bestow no property-like

in *eBay,* the Supreme Court abolished the Federal Circuit's general rule that obliged courts to issue permanent injunctions against defendants-infringers once a patent was found valid and infringed. Rather, the Supreme Court held that the decision to grant or deny injunctive relief rests within the equitable discretion of the district courts. Thus, after *eBay*, permanent injunctions should not be granted automatically by the courts. Instead, courts will apply their equitable discretion to determine if the specific circumstances of the case before them merit issuing an injunction to stop further infringement by the defendant-infringer.

If the court denies the issue of an injunction, the patentee will be forced to grant the defendant-infringer a license to practice his invention. This can be done in two ways: a) the patentee could negotiate the terms of the license with the defendant-infringer; or b) the court sua sponte could issue as damages an *ongoing royalty*, setting the terms of said license. In either case, the court will force the patentee to grant a license to the defendant-infringer without the patentee's consent; this practice is internationally known as a compulsory license.[3]

Although the United Sates has traditionally expressed disregard for compulsory licensing systems,[4] *eBay*'s decision, if interpreted broadly, could change said practice. However, this has not been the case.

To date, there have been fifty-eight district court decisions interpreting *eBay* when determining whether to grant injunctive relief to a patent holder.[5] Of these decisions, forty-four have granted permanent injunctions, [6] while fourteen have denied it. [7]

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rights beyond the provisions of the federal patent statues); Harold C. Wegner, Post-eBay Compulsory Licenses: TRIPS Standards, Paper Presented at the 41st World Congress of the Association Internationale pour la Protection de la Propriété Intellectuelle (Sept. 6-11, 2008) (arguing that violations of the United States of the TRIPS may in theory be basis to trigger a dispute settlement resolution in Geneva under the auspices of the World Trade Organization).

3 *See* Paice LLC v. Toyota Motor Corp., 504 F.3d 1293 (Fed. Cir. 2007) (Rader, concurring) (stating that "calling a compulsory license an *ongoing royalty* does not make it any less a compulsory license").

4 *See* Harold C. Wegner, *Injunctive Releif: A Charming Betsy Boomerang,* 4 NW. J. TECH. & INTELL. PROP. 156 (stating that "[t]he United States, led by the pharmaceutical industry, created a treaty framework to restrict a foreign government's grant of a compulsory licenses as part of an increased emphasis on global patent protection.").

5 As of February 2009.

6 Joyal Prods. v. Johnson Elec. North Am., Inc., 2009 U.S. Dist. LEXIS 15531 (D.N.J. 2009); Broadcom Corp. v. Qualcomm, Inc., 543 F.3d 683 (Fed. Cir. 2008); United States Philips Corp. v. Iwasaki Elec. Co., 2009 U.S. Dist. LEXIS 6869 (S.D.N.Y. 2009); Funai Elec. Co., LTD. v. Daewoo Elecs. Corp., 2009 U.S. Dist. LEXIS 1618 (N.D. Cal. 2009); Sensormatic Elecs. Corp. v. Tag Co. US, LLC, 2008 U.S. Dist. LEXIS 102690 (2009); Power Integrations, Inc. v. Fairchild Semiconductor Int'l, Inc., 2008 U.S. Dist. LEXIS 100539 (D. Del. 2008); Fresenius Med. Care Holdings, Inc. v. Baxter Int'l, Inc., 2008 U.S. Dist. LEXIS 79689 (N.D. Cal. 2008); Amgen, Inc. v. F. Hoffmann La Roche Ltd., 2008 U.S. Dist. LEXIS 77343 (D. Mass. 2008); Extreme Networks, Inc. v. Enterasys Networks, Inc., 2008 U.S. Dist. LEXIS 88540 (W.D. Wis. 2008); Power-One, Inc. v. Artesyn Techs., Inc., 2008 U.S. Dist. LEXIS 30338 (E.D. Tex. 2008); TruePosition Inc. v. Andrew Corp., 568 F. Supp. 2d 500, 2008 U.S. Dist. LEXIS 58351

Therefore, courts have been interpreting *eBay* narrowly, granting permanent injunctions in the vast majority of cases (seventy-six percent), and denying injunctions solely in particular circumstances. For that reason, the American

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(D. Del. 2008); Emory Univ. v. Nova BioGenetics, Inc., 2008 U.S. Dist. LEXIS 57642 (N.D. Ga. 2008); Mannatech, Inc. v. Glycoproducts Int'l, Inc., 2008 U.S. Dist. LEXIS 52537 (N.D. Tex. 2008); Trading Techs. Int'l, Inc. v. eSpeed, Inc., 2008 U.S. Dist. LEXIS 86953 (N.D. Ill. 2008); Becton Dickinson & Co. v. Tyco Healthcare Group Lp, 2008 U.S. Dist. LEXIS 87623 (D. Del. 2008); Callaway Golf Co. v. Acushnet Co., 585 F. Supp. 2d 600 (2008); Verizon Servs. Corp. v. Vonage Holdings Corp., 503 F.3d 1295, 1298 (Fed. Cir. 2007); Acumed LLC v. Stryker Corp., No. 04-CV-513-BR, 2007 U.S. Dist. LEXIS 86866, at (Nov. 20, 2007); Martek Biosciences Corp. v. Nutrinova Inc., 520 F. Supp. 2d 537, 560 (D. Del. 2007); Sundance, Inc. v. DeMonte Fabricating Ltd., No. 02-73543, 2007 U.S. Dist. LEXIS 77728, at (E.D. Mich. 2007); Allan Block Corp. v. E. Dillon & Co., 509 F. Supp. 2d 795, 811 (D. Minn. 2007); Johns Hopkins Univ. v. Datascope Corp., 513 F. Supp 2d 578, 586 (D. Md. 2007); Muniauction, Inc. v. Thomson Corp., 502 F. Supp. 2d 477, 493 (W.D. Pa. 2007); Sanofi-Synthelabo v. Apotex Inc., 492 F. Supp. 2d 353, 356 (S.D.N.Y. 2007); Commw. Scientific and Indus. Research Org. v. Buffalo Tech. Inc., 492 F. Supp. 2d 600, 601 (E.D. Tex. 2007); Brooktrout, Inc. v. Eicon Networks Corp., No. 2:03-CV-59, 2007 U.S. Dist. LEXIS 43107 (E.D. Tex. 2007); MGM Well Servs., Inc. v. Mega Lift Sys., LLC, 505 F. Supp. 2d 359, 365 (S.D. Tex. 2007); 800 Adept, Inc. v. Murex Secs., Ltd., 505 F. Supp. 2d 1327, 1340 (M.D. Fla. 2007); O2 Micro Int'l, Ltd. v. Beyond Innovation Tech. Co., No. 2-04-CV-32 (TJW), 2007 U.S. Dist. LEXIS 25948 (E.D. Tex. 2007); Ortho-McNeil Pharm., Inc. v. Mylan Labs. Inc., Nos. 04-1689, 06-757 and 06-5166, 2007 U.S. Dist. LEXIS 19494 (D.N.J. 2007); Novozymes A/S v. Genencor Int'l Inc., 474 F. Supp. 2d 592, 613 (D. Del. 2007); MPT, Inc. v. Marathon Labels, Inc., 505 F. Supp. 2d 401, 423 (N.D. Ohio 2007), aff'd in part, rev'd in part, Nos. 2007-1183, -1204, -1238, 2007 U.S. App. LEXIS 28911 (Fed. Cir. 2007); Transocean Offshore Deepwater Drilling, Inc. v. Global SantaFe Corp., No. H-03-2910, 2006 U.S. Dist. LEXIS 93408 (S.D. Tex. 2006); Visto Corp. v. Seven Networks, Inc., No. 2:03-CV-333-TJW, 2006 U.S. Dist. LEXIS 91453 (E.D. Tex. 2006); Black & Decker Inc. v. Robert Bosch Tool Corp., No. 04 C 7955, 2006 U.S. Dist. LEXIS 86990, at (N.D. Ill. 2006), aff'd in part, vacated in part, Nos. 2007-1243, -1244, 2008 U.S. App. LEXIS 207 (Fed. Cir. 2008); Rosco, Inc. v. Mirror Lite Co., No. CV-96-5658 (CPS), 2006 U.S. Dist. LEXIS 73366 (E.D.N.Y. 2006); Smith & Nephew, Inc. v. Synthes (U.S.A.), 466 F. Supp. 2d 978, 990 (W.D. Tenn. 2006), appeal dismissed, No. 2007-1048, U.S. App. LEXIS 4889 (Fed. Cir. 2008); 3M Innovative Props. Co. v. Avery Dennison Corp., No. 01-1781 (JRT/FLN), 2006 U.S. Dist. LEXIS 70263 (D. Minn. 2006); Litecubes, L.L.C. v. N. Light Prods., No. 4:04CV00485 ERW, 2006 U.S. Dist. LEXIS 60575 (E.D. Mo. 2006); Floe Int'l, Inc. v. Newmans' Mfg. Inc., No. 04-5120 (DWF/RLE), 2006 U.S. Dist. LEXIS 59872 (D. Minn. 2006); Am. Seating Co. v. USSC Group, Inc., No. 01-00578, 2006 U.S. Dist. LEXIS 59212 (WD. Mich. 2006); TiVo Inc. v. EchoStar Commc'ns. Corp., 446 F. Supp. 2d 664, 671 (E.D. Tex. 2006), aff'd in part, rev'd in part, 516 F.3d 1290 (Fed. Cir. 2008); Telequip Corp. v. Change Exch., No. 5:01-CV-1748 (FJS/GJD), 2006 U.S. Dist. LEXIS 61469 (N.D.N.Y. 2006); Wald v. Mudhopper Oilfield Servs., No. CIV-04-1693-C, 2006 U.S. Dist. LEXIS 51669 (W.D. Okla. 2006).

7 Hynix Semiconductor, Inc. v. Rambus Inc., 2009 U.S. Dist. LEXIS 13530 (N.D. Cal. 2009); Telcordia Techs., Inc. v. Cisco Systems, Inc., 592 F. Supp. 2d 727 (D. Del. 2009); Nichia Corp. v. Seoul Semiconductor, Ltd., 2008 U.S. Dist. LEXIS 12183 (N.D. Cal. 2008); Advanced Cardiovascular Sys. v. Medtronic Vascular, Inc., 2008 U.S. Dist. LEXIS 75097 (D. Del. 2008); Amado v. Microsoft Corp., No. 8:03-CV-242, 2007 U.S. Dist. LEXIS 96487 (C.D. Cal. 2007); Am. Calcar, Inc. v. Am. Honda Motor Co., 2008 U.S. Dist. LEXIS 106476 (2008); Innogenetics, N.V. v. Abbott Labs., 512 F.3d 1363, 1380 (Fed. Cir. 2008); Respironics, Inc. v. Invacare Corp., No 04-0336, 2008 U.S. Dist. LEXIS 1174 (W.D. Pa. 2008); MercExchange, L.L.C. v. eBay, Inc., 500 F. Supp. 2d 556, 591 (E.D. Va. 2007); Praxair, Inc. v. ATMI, Inc., 479 F. Supp. 2d 440, 444 (D. Del. 2007); Voda v. Cordis Corp., No. CIV-03-1512-L, 2006 U.S. Dist. LEXIS 63623 (W.D. Okla. 2006); Paice LLC v. Toyota Motor Corp., No. 2:04-CV-211-DF, 2006 U.S. Dist. LEXIS 61600 (E.D. Tex. 2006), aff'd in part, vacated in part, 504 F.3d 1293 (Fed. Cir. 2007); Finisar Corp. v. DirecTV Group, Inc., No. 1:05-CV-264, 2006 U.S. Dist. LEXIS 76380 (E.D. Tex. 2006); z4 Techs., Inc. v. Microsoft Corp., 434 F. Supp. 2d 437, 438 (E.D. Tex. 2006), aff'd, 507 F.3d 1340 (Fed. Cir. 2007).

traditional law standpoint of strong proscription against compulsory licensing has been maintained after eBay.

PART I. PATENT RIGHTS

A. Overview

A patent gives its owner the right to exclude others from making, using, selling, and offering for sale the patented invention within the United States for a period of 20 years.[8] This monopoly, granted by the State to the patentee, endows him with a method by which he can recoup all the time, effort, and research costs attributed to the development of his invention as an incentive for further innovation.[9] In exchange of the right to exclude, the inventor is required to teach others how to practice his invention in his patent application.[10]

Anyone who practices the patented invention without the patentee's authorization is infringing the patentee's patent and therefore, is subject to liability.[11] The usual remedies for patent infringement are both, monetary damages to compensate for past harm to the patentee, and the issuance of an injunction to stop further use of the invention by the infringer.[12]

B. Pre eBay

Up until *eBay*, granting automatic injunctive relief was the general course of action after a patent was found valid and infringed. The rationale for this general rule was that "the right to exclude recognized in a patent is but the essence of the concept of property."[13] Furthermore, in *Panduit Corp. v. Stahlin Bros. Fiber Works, Inc.*,[14] the Sixth Circuit described the patentee's right to enjoin the defendant-infringer from continuing infringement activities as follows:

> Patents must by law be given "the attributes of personal property." The right to exclude others is the essence of the human right called "property." The right to exclude others from free use of an invention protected by a valid patent does not differ from the right to exclude others from free use of one's automobile, crops,

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8 35 U.S.C. § 154(a).

9 See Diamond v. Chakrabarty, 447 U.S. 303 (where the Supreme Court stated that "[t]he authority of Congress is exercised in the hope that the productive effort thereby fostered will have a positive effect on society through the introduction of new products and process of manufacture into the economy, and the emanations by way of increased employment and better lives to our citizens").

10 *See* J.E.M. Ag Supply, Inc. v. Pioneer Hi-Breed Int'l, Inc., 534 U.S. 124, 142 (2001) ("[t]he disclosure required by the Patent Act is the *quid pro quo* of the right to exclude").

11 35 U.S.C. § 271.

12 35 U.S.C. §§ 283, 284.

13 Richardson v. Suzuki Motor Co., Ltd., 868 F.2d 1226, 1246-47 (Fed. Cir. 1989).

14 575 F.2d 1152 (6th Cir. 1978).

> or other items of personal property. Every human right, including that in an invention, is subject to challenge under appropriate circumstances. That one human property right may be challenged by trespass, another by theft, and another by infringement, does not affect the fundamental indicium of all "property," i.e., the right to exclude others.[15]

In light of this background, the Federal Circuit developed a general rule which states that courts will issue permanent injunctions against patent infringement absent exceptional circumstances.[16] Some examples of these exceptional circumstances include cases like *Vitamin Technologists, Inc. v. Wis Alumni Research Fund*,[17] and *City of Milwaukee v. Activated Sludge, Inc.*,[18] where courts denied permanent injunctions based on a threat to public health or safety (public interest).[19]

C. eBay

In *eBay* the Supreme Court overruled the above-mentioned practice. The Supreme Court held that "the decision whether to grant or deny injunctive relief rests within the equitable discretion of the district courts, and that such discretion must be exercised consistent with traditional principles of equity, in patent disputes no less than in other cases governed by such standards."[20] In concluding so, the Supreme Court relied in part on the Patent Act, which expressly provides that injunctions *may* be issued "in accordance with the principles of equity."[21] Thus, the Patent Act does not oblige a court to grant such remedy in all cases. On the contrary, the Patent Act allows the court to exercise its discretion according to the well-established principles of equity.

In accordance with such principles, a plaintiff seeking a permanent injunction must satisfy a four-factor test before a court may grant an injunctive

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15 *Id*. at 1158 n.5 (citation omitted).

16 Mercexchange, L.L.C. v. eBay, Inc., 401 F.3d 1323, 1339 (2005).

17 146 F.2d 941, 946 (9th Cir. 1945) (public interest warranted refusal of injunction on irradiation of oleomargarine).

18 69 F.2d 577, 593 (7th Cir. 1934) (the court vacated an injunction against the use of an infringing system of sewerage disposal where its grant would have caused harm by relegating the city to dumping its sewerage in Lake Michigan).

19 *See* Wegner, *supra* note 4 at 162 n.41, citing Rebecca S. Eisenberg, *Exclusive Rights And Experimental Use,* 56 U. CHI. L. REV. 1017, 1077 n.230 (1989); Maureen A. O'Rourke, *Toward A Doctrine of Fair Use in Patent Law*, 100 COLUM. L. REV. 1177, 1209 n. 130 (2000); Janice M. Mueller, *Patent Misuse through the Capture of Industry Standards*, 17 BERKELEY TECH. L.J. 623, 661 (2002) (citing *Vitamin Technologists, Inc.*, 146 F.2d at 954-56); Mark A. Lemley & Ragesh K. Tangri, *Ending Patent Law's Willfulness Game*, 18 BERKELEY TECH. L.J. 1085, 1123 n.114 (2003) (citing *Vitamin Technologists*, 146 F.2d at 944-47).

20 *eBay*, 547 U.S. at 393.

21 35 U.S.C. § 283 provides that "[t]he several courts having jurisdiction of cases under this title may grant injunctions in accordance with the principles of equity to prevent the violation of any right secured by patent, on such terms as the court deems reasonable."

relief. To comply with said test, a plaintiff must establish: (1) that it has suffered an irreparable injury; (2) that remedies available at law, such as monetary damages, are inadequate to compensate for that injury; (3) that, considering the balance of hardships between the plaintiff and the defendant, a remedy in equity is warranted; and (4) that the public interest would not be disserved by a permanent injunction.[22]

There were two concurring opinions in *eBay*. The first one, written by Chief Justice Roberts, with whom Justice Scalia and Justice Ginsburg joined, acknowledged that "from at least the early 19th century, courts have granted injunctive relief upon a finding of infringement in the vast majority of patent cases."[23] Although such traditional practices do not entitle a patentee to a permanent injunction in all cases, or justify a general rule that such injunctions should be issued, the opinion suggested that this long tradition of equity practice should not be completely disregarded. Thus, Chief Justice Roberts' concurring opinion reaffirms past practices favoring the issuance of an injunction in the majority of cases.

The second concurring opinion, written by Justice Kennedy, with whom Justices Stevens, Souter, and Breyer joined, explained that "[t]o the extent earlier cases established a pattern of granting an injunction against patent infringers almost as a matter of course, this pattern simply illustrates the result of the four-factor test in the contexts then prevalent."[24] It is quite clear that Kennedy's concurring opinion tries to differentiate past litigation practices from current litigation practices. The concurrence acknowledged that an industry now exists in which firms use patents primarily for licensing fees instead of producing products, and these firms could use the issuance of an injunction as leverage to negotiate excessive license fees.[25] These firms are referred to as non-practicing entities or *patent trolls*. Fearing that such patents may be abused as a bargaining tool to charge exorbitant fees, the opinion suggests that in cases where the patent holder does not practice the invention, and where the patented component is but a small component of the infringing product, an injunction is unnecessary because monetary damages provide sufficient compensation.[26]

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22 Weinberger v. Romero-Barcelo, 456 U.S. 305, 311-13 (1982).

23 *eBay*, 547 U.S. at 395.

24 *Id.* at 396.

25 *Id.*

> In cases now arising trial courts should bear in mind that in many instances the nature of the patent being enforced and the economic function of the patent holder present considerations quite unlike earlier cases. An industry has developed in which firms use patents not as a basis for producing and selling goods but, instead, primarily for obtaining licensing fees. For these firms, an injunction, and the potentially serious sanctions arising from its violation, can be employed as a bargaining tool to charge exorbitant fees to companies that seek to buy licenses to practice the patent.

Id.

26 *Id.*

D. Post eBay

In the years following *eBay*, courts have relied heavily on Kennedy's concurrence when analyzing whether or not to grant a permanent injunction to a patent holder.[27] *eBay*'s rationales for denying an injunction can be divided in two: First, when the patent holder does not practice his invention and is using the threat of an injunction solely as leverage to negotiate excessive license fees (known as a *patent troll)*; second, when the patent holder's invention is but a small component of the defendant-infringer's product. Each one has its particular analysis, which will be explained below.

II. Reasons for Granting a Compulsory License in the United States

A. Patent Trolls

1. Generally

Peter Detkin, a former assistant general counsel for Intel, first coined the term *patent troll* in 1991.[28] According to his experiences in dealing with this new breed of entrepreneurs, he defined *patent troll* as "somebody who tries to make a lot of money off a patent that they are not practicing and have no intention of practicing and in most cases they never practiced at all."[29] Similarly, courts have described patent trolls as "non-practicing entities" who "do not manufacture products, but instead hold . . . patents, which they license and enforce against alleged infringers."[30]

In essence, these *trolls* bring infringement suits based on a patent that was not practiced before. The ensuing litigation comes as a surprise to a defendant-

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> When the patented invention is but a small component of the product the companies seek to produce and the threat of an injunction is employ simply for undue leverage in negotiations, legal damages may well be sufficient to compensate for the infringement and an injunction may serve the public interest.

Id.

27 *See, e.g.*, Amado v. Microsoft Corp., 517 F.3d 1353 (Fed. Cir. 2008); z4 Technologies, Inc. v. Microsoft Corp., 434 F. Supp. 2d 437 (E.D. Tex., 2006); Paice LLC v. Toyota Motor Corp., 2006 U.S. Dist. LEXIS 61600 (E.D. Tex. 2006), aff'd in part, vacated in part, 504 F.3d 1293 (Fed. Cir. 2007).

28 *See* Joe Brennan et al., *Patent Trolls in the U.S., Japan, Taiwan, and Europe*, Summer 2009 (Center for Advanced Study & Research on Intellectual Property), *available* at http://www.law.washington.edu/Casrip/Newsletter/default.aspx?year=2006&article=newsv13i2BrennanEtAl.

29 *Id.*

30 *See* Amgen, Inc. v. F. Hoffmann La Roche Ltd., 2008 U.S. Dist. LEXIS 77343 (D. Mass., Oct. 2, 2008).

infringer, for which these suits are analogized to mythical trolls that hid under bridges and leapt out to demand a ransom from travelers.[31]

Defendants facing this kind of lawsuit are placed in a tough position because the product in question is already being made and usually cannot be redesigned to avoid infringement without incurring in substantial costs. In addition, *patent trolls* are entitled to seek injunctive relief that could shut down the production of the product, which gives them powerful leverage in settlement negotiations.

Furthermore, as of 2004, the cost of defending against a patent infringement suit typically exceeds $1 million before trial, and $2.5 million for a complete defense.[32] Due to the high costs and risks of an injunction, defendants may settle even non-meritorious suits they consider frivolous. The uncertainty and unpredictability of the outcome of jury trials also encourages settlement.[33]

It is important to point out that patent trolls do not invest in research and development (R&D) to create their inventions. Instead, they buy patents cheaply from entities not actively seeking to enforce them. For instance, a patent troll may purchase hundreds of patents from a technology company, who is forced by bankruptcy to auction its patents.[34] Also these patents often make only small contributions to a successful product that is being manufactured by the defendant-infringer. Obviously, the patent troll will be monitoring the technology field of his acquired patents, and at the first instance where he suspects that a product may be infringing his patent, the troll will sue the defendant-infringer, threaten him with an injunction that could shut down the business, while demanding a licensing fee disproportionate with the patent's contribution to the defendant-infringer's product. This is the *modus operandis* of a patent troll.

Now, the objective of the Constitution in granting Congress the power to legislate in the area of intellectual property is to 'promote the Progress of Science and useful Arts'.[35] The patent system promotes progress by guaranteeing inventors exclusive rights over their works as an 'incentive for further innovation.' It is quite clear then that the right to exclude is not granted for

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31 *See* Donald J. Chisum, *Reforming Patent Law Reform*, 4 J. MARSHALL REV. INTELL. PROP. L. 336, 340 (2005) explaining that:

> [T]roll[s] hide under bridges, metaphorically speaking, waiting for companies to produce, that is, to approach and cross the bridge. The ugly, evil troll then leaps up and demands a huge toll, that is, a licensing fee settling actual or threatened patent litigation, litigation that could result in an injunction halting the product line

Id.

32 *See* Craig Tyler, *Patent Pirates Search For Texas Treasure*, Texas Lawyer, Sep. 20, 2004, *available at* www.wsgr.com/PDFSearch/09202004_patentpirates.pdf.

33 *See* Brennan, *supra* note 28 (explaining that Research in Motion Company (RIM), the producers of BlackBerrys, agreed to pay NTP, Inc., a non-practicing entity, $612.5 million for a perpetual license that will allow RIM to continue its wireless-related business).

34 Michael Kanellos, *Patent auctions: Lawyer's dream or way of the future?,* ZDNet, http://news.zdnet.com/2100-9595_22-6045371.html, (last visited on April 15, 2009).

35 U.S. CONST. art. I, § 8, cl. 8.

blackmailing purposes or as a threatening tool in licensing negotiations. Such actions do not promote innovation in any way. Under those circumstances, *eBay* allows courts to deny injunctive relief.[36]

It is true that if the court denies the issue of an injunction said court is limiting the patent holder's property rights (the right to exclude). But that is not different from any other property right since property rights are not absolutes. For instance, in nuisance cases, if a landowner uses his property in an unreasonable manner which interferes with another landowner's property courts have the authority to stop said unreasonable use. The law of nuisance stems from the general principle that "[i]t is the duty of every person to make a reasonable use of his own property so as to occasion no unnecessary damage or annoyance to his neighbor. [37]

For that reason, the argument that *eBay* threatens the status of patents as property rights is misplaced. Patents, as any other property right, could be limited if its owner uses it in an unreasonable way, as patent trolls do.

2. Identifying a Patent Troll

On *eBay*'s remand, the lower court determined that plaintiff-patent holder does not manufacture a product encompassing the patented invention, and has showed a willingness to license its patents to others.[38] Nonetheless, the court was aware that such behavior was not sufficient to deny an injunctive relief. The court recognized that self-made inventors or university researchers opting to enter into licensing agreements in lieu of practicing their patents consist as a reasonable use of patent rights that will not preclude the issuance of an injunction.[39]

Consequently, the court relied on the business model of the plaintiff-patent holder to deny the injunction. For instance, the court noted that the patent holder's *modus operandi* was to seek out companies that were already manufacturing a product that was infringing—or potentially infringing—his

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36 *See* Nerney v. New York, N.H. & H.R. Co., 83 F.2d 409, 411 (2d Cir. 1936) (where the court denied a permanent injunction to a railroad company where it was "recognized that the only real advantage to a plaintiff in granting the injunction would be to strengthen its position in negotiating a settlement").

37 Pestsey v. Cushman, 259 Conn. 345 (2002).

38 MercExchange, L.L.C. v. eBay, Inc., 500 F. Supp. 2d 556 (E.D. Va. 2007).

39 *eBay*, 547 U.S. at 393:

> [S]ome patent holders, such as university researchers or self-made inventors, might reasonably prefer to license their patents, rather than undertake efforts to secure the financing necessary to bring their works to market themselves. Such patent holders may be able to satisfy the traditional four-factor test, and we see no basis for categorically denying them the opportunity to do so.

Id.

patents and negotiate to maximize the value of a license agreement or a settlement to avoid litigation. The court concluded that:

> [s]uch consistent course of litigating or threatening litigation to obtain money damages…indicates that MercExchange [patent holder] has utilized its patents as a sword to extract money rather than as a shield to protect its right to exclude or its market-share, reputation, goodwill, or name recognition, as MercExchange [patent holder] appears to possess none of these.[40]

As this case shows, when a patent holder uses his patent rights in a reasonable way, which means to protect his business, goodwill, reputation or market share, courts would favor the issue of an injunction. On the other hand, when the patent holder uses his patent in an unreasonable way, which means as a blackmailing tool to obtain excessive royalty fees, courts should not favor the issue of an injunction.

Another factor that courts consider when determining whether a patent holder is a patent troll, is whether said patent holder is engaged in research and development activities. For example, in *Commonwealth Scientific and Industrial Research Organization* (CSIRO) *v. Buffalo Technology Inc.*,[41] the principal scientific research organization of the Australian Federal Government (CSIRO) was awarded an injunction even though it did not practice its patents and had showed willingness in license its patents to others. In its decision, the court gave great value to the fact that CSIRO—the patent holder—was a research institution which relied heavily on licensing its intellectual property to finance its research and development program.

As this case shows, a patent holder who invests in research and development would satisfy *eBay*'s four-factor test. This because the patent holder promotes the progress of science by investing in research and development, in contrast with patent trolls who invest solely in litigation.

Patent trolls have also been found among industry-standard technologies. A standard is a set of technical specifications intended to provide a common design for a product or process.[42] They are adopted by a standard-setting organization in which companies participate to develop and adopt an acceptable paradigm.

Anyone who wishes to use this standard has to obtain rights under such patent. For that reason, standard-setting organizations require that every participant disclose any patent or patent application necessary to practice said norm. Furthermore, each participant commits to license for free anyone who decides to implement this benchmark under any patent owned by the participant. A participant is considered a patent troll when it fails to disclose

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40 MercExchange, L.L.C., 500 F. Supp. 2d 556, 572.

41 Commonwealth Sci. & Indus. Research Organization v. Buffalo Tech. Inc., 492 F. Supp. 2d 600 (E.D. Tex. 2007).

42 Mark A. Lemley, *Intellectual Property Rights and Standard–Setting Organizations*, 90 CAL. L. REV. 1889, 1896 (2002).

any pertinent patents and then seeks to enforce its patents against others who implement the newly minted standard.

For example, in *Hynix Semiconductor Inc. v. Rambus Inc,*[43] Rambus (patent holder) patented a technology known as dynamic random access memory ("DRAMs"). This technology is used to store of information and allow an electronic device to quickly access that information. Hynix, a competitor of Rambus, manufactured a product, which infringed Rambus' patent. Hynix incorporated Rambus' technology to its own product in order to comply with industry standards promulgated by the Joint Electron Devices Engineering Council (JEDEC), an organization that develops standards for semiconductor devices. JEDEC adopted the standard without knowing that Rambus had the DRAMs patent, since Rambus did not disclose said patents to JEDEC. By the time Hynix became aware of Rambus's asserted patents, Rambus's technologies were commonly used in the industry standard DRAM interface.

In an infringement suit, Rambus asked the court for an injunction against Hynix. The court denied said injunction. The court noted that changing to a non-infringing technology would have cost the electronics industry hundreds of millions of dollars. Applying *eBay*'s four-factor test, the court ruled that in this circumstance monetary damages were adequately to compensate for that injury and, therefore, the injunction should be denied.

It is important to highlight that Rambus, as a participant of the standard, had an obligation to disclose any patent or patent application necessary to practice the standard to JEDEC, which it did not do. It would be very unfair to penalize Hynix or the whole electronic industry for Rambus' own actions. In this circumstance, *eBay*'s decision gives flexibility to the courts to determine whether the patent holder is using his patent rights in a *reasonable* manner and thus, merits the issue of an injunction.

B. The patented invention is but a small component of the infringer's product

This problem is most likely to occur with very complex technologies involving numerous components, such as semiconductor chips and large software programs. A single patent on a component that cannot be easily replaced, for reasons such as interconnections with other components, can give the patentee enormous leverage, even though the intrinsic value of the patented technology is not very high .[44]

Moreover, in some industries such as computer hardware and software development, firms can require access to dozens or thousands of patents to produce just one commercial product. Many of these patents overlap, with each

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43 Hynix Semiconductor Inc. v. Rambus Inc., 609 F. Supp. 2d 951, 2009 U.S. Dist. LEXIS 13530 (N.D. Cal. 2009).

44 *See*, e.g., Joseph K. Siino, Lisa G. McFall, Robert P. Merges, Christopher J. Wright, Timothy J. Simeone, and Bruce L. Gottlieb, *Brief of Amicus Curiae Yahoo!, Inc*., 21 BERKELEY TECH. L.J. 999 (2006) (describing potential for such a scenario in the internet services industry).

patent blocking several others.[45] This is known as a *patent thicket*, defined as a "dense web of overlapping intellectual property rights that a company must hack its way through in order to actually commercialize new technology."[46]

The rationale to deny an injunction when the patented invention is but a small component of the defendant-infringer product is based on public interest rather than an unreasonable use by the patent holder. As explained above, a patent holder unreasonably exploits his patent rights by using the right to exclude solely to enhance his position in a licensing or settlement negotiation. In contrast, when the patented technology is but a small component of the defendant-infringer's product, the analysis of the patent holder (whether or not he is a *patent troll*) is kept to a minimum. Obviously, if he is considered a *patent troll*, the court should deny the injunction. However, even in cases where the patentee of the small component is not a *patent troll*, public interest reasons such as trade, economy and competition will weigh in favor of also denying the injunction.

For example, in *z4 Technologies, Inc. v. Microsoft Corp.,*[47] the court refused to grant a permanent injunction where the invention, a software activation technology, read on only a small part of Microsoft's Office and Windows infringing systems. The court found that the infringing component of the software "was in no way related to the core functionality for which the software is purchased by consumers."[48] Accordingly, the court concluded that monetary damages would be sufficient to compensate z4 for any future infringement by Microsoft.

Similarly, in *Paice LLC v. Toyota Motor Corp.,*[49] the court denied the injunction based on the fact that the invention, drivetrains for hybrid vehicles, comprised only a small part of the infringing product, the hybrid vehicle itself, noting that "the jury's damages award also indicates that the infringed claims constitute a very small part of the value of the overall vehicles."[50]

Both cases highlight the courts' reluctance to issue an injunction that would stop or disrupt an industry, or result in job losses just because a small component of a product infringes on others' patents. These lines of cases reflect that economic and public interest policies can outweigh the patentee's individual right to exclude.

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45 *See* FEDERAL TRADE COMMISSION, PROMOTE INNOVATION: THE PROPER BALANCE OF COMPETITION AND PATENT LAW AND POLICY, PAPER PREPARED BY THE FEDERAL TRADE COMMISSION (2003) *available at* http://www.ftc.gov/os/2003/10/innovationrpt.pdf.

46 Carl Shapiro, *Navigating the Patent Thicket: Cross Licenses, Patent Pools, and Standard-Setting,* in 1 INNOVATION POL'Y & ECON. 119, 120 (2001).

47 z4 Techs., Inc. v. Microsoft Corp., 434 F. Supp. 2d 437 (E.D. Tex. 2006).

48 *Id.* at 441.

49 Paice LLC v. Toyota Motor Corp., 2006 U.S. Dist. LEXIS 61600 (E.D. Tex. 2006), aff'd in part, vacated in part, 504 F.3d 1293 (Fed. Cir. 2007).

50 *Id.*

But again, that is not different from any other property right.[51] For example, it is well-settled law that States have the power to limit the uses of certain properties in an area or community by implementing zoning ordinances provided however that such zoning limitations are reasonable and are implemented for a legitimate public purpose substantially related to the public health, safety, morals or general welfare of the community.[52] Therefore, patents—just as tangible property—could be limited if said limitation would result in benefits to the public interest and welfare.

III. COMPULSORY LICENSING UNDER THE AGREEMENT *ON TRADE RELATED ASPECTS OF INTELLECTUAL PROPERTY RIGHTS* (TRIPS)[53]

The TRIPS Agreement was negotiated at the World Trade Organization (WTO) by the end of the Uruguay Round of the General Agreement on Tariffs and Trade (GATT) in 1994. This international agreement establishes minimum levels of protection that each State has to provide to the intellectual property of fellow WTO Members.

The objective of the TRIPS centers on the belief that,

> the protection and enforcement of intellectual property rights should contribute to the promotion of technological innovation and to the transfer and dissemination of technology, to the mutual advantage of producers and users of technological knowledge and in a manner conducive to social and economic welfare, and to a balance of rights and obligations.[54]

With respect to patents, TRIPS requires that WTO Members provide exclusive rights to a patent holder over his invention.[55] Also, it requires that the judicial authority of each WTO Member has the authority to grant injunctions to stop infringement.[56]

Although TRIPS promotes the protection of intellectual property rights, it also recognizes that too much protection could lead to barriers that impede trade in each State Member.[57] To strike a balance between patent protection and social welfare, TRIPS allows WTO Members to grant compulsory licenses instead

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51 *See, e.g.,* International News Service v. Associated Press, 248 U.S. 215 (1918) (Brandeis, dissenting) ("[a]n essential element of individual property is the legal right to exclude. If the property is private, the right of exclusion may be absolute; if the property is affected with a public interest, the right of exclusion is qualified.").

52 Best v. Zoning Bd. Of Adjustment, 393 Pa. 106, 111-112 (Pa. 1958); *See also* Nectow v. Cambridge, 277 U.S. 183, 188 (1928).

53 Agreement on Trade-Related Aspects of Intellectual Property Rights 33 I.L.M. 81 (1994) [hereinafter TRIPS].

54 TRIPS, *supra* note 53 art. 7.

55 TRIPS, *supra* note 53 art. 27.

56 TRIPS, *supra* note 53 art. 44.

57 *See* the preamble of TRIPS, *supra* note 53.

of an injunction, in some cases. For example, according to TRIPS Article 8, WTO Members may grant compulsory licenses: a) to protect public health and nutrition; b) to promote the public interest in socio-economic and technological development; and c) to prevent the abuse of intellectual property rights by patent holders which unreasonably restrain trade.[58]

Also, WTO Members are allowed to grant compulsory licenses to impede anti-competitive practices in contractual licenses. According to Article 40(2) WTO Members may specify "licensing practices or conditions that may in particular cases constitute an abuse of intellectual property rights having an adverse effect on competition in the relevant market" and to adopt "appropriate measures to prevent or control such practices."[59] Although Articles 8 and 40(2) of the TRIPS Agreement indicate reasons for granting compulsory licenses, these reasons are not exclusive.[60]

Now, once a WTO Member has determined that there is a valid reason to grant a compulsory license, said WTO Member must comply with the procedural and substantive terms of TRIPS Article 31.[61] First, the WTO Member must consider the petition to grant a compulsory license on its individual merits. Second, the person who wants to use the patented technology must try to obtain a license from the patent holder on reasonable terms before seeking a compulsory license. Third, the compulsory license must set the scope and duration of the use of the patented technology. Fourth, the use of the patented technology would be non-exclusive and non-assignable. Fifth, the use of the patented technology should be predominantly to satisfy the domestic market of the WTO Member which granted the compulsory license. Sixth, a WTO Member may terminate the compulsory license at any time, if its reason for granting the license ceases to exist or is unlikely to recur. Seventh, the patent holder must be paid an adequate remuneration for the use of his patented technology. Finally, both the decision for granting the compulsory license and the established remuneration to be paid to the patent holder must be subject to judicial review by a distinct higher court.

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58 TRIPS, *supra* note 53 art. 8.

59 TRIPS, *supra* note 53 art. 40(2).

60 *See, e.g.* Jayashree Watal, *The TRIPS Agreement and Developing Countries Strong, Weak or Balanced Protection*, 1 J. WORLD INTELL .PROP. 281, 297 (1998) ("Others have rightly pointed out that there are no restrictions whatsoever on the purposes for the grant of compulsory licenses, although there is some reference to some grounds in Articles 7, 8 and 31 of the TRIPS.").

61 Both, Article 8 and Article 40 expressly require that such a *measure* (compulsory licensing) be consistent with other TRIPS provisions.

IV. United Sates' Compliance with TRIPS

A. Reasons for Granting a Compulsory License

Under TRIPS Article 8 WTO Members are allowed to grant compulsory licenses to prevent the abuse of intellectual property rights. The *abuse of rights* doctrine is akin to America's *good faith* principle of law.[62] Under said doctrine actions constitute an abuse if: (1) the predominant motive for the action is to cause harm; or (2) the exercise of a right is totally unreasonable given the lack of any legitimate interest in the exercise of the right and its exercise harms another; or (3) the right is exercised for a purpose other than that for which it exists.[63]

Definitively, patent trolls meet at least one of these criteria when they use their right to exclude solely as a threatening tool to charge exorbitant royalty fees against a defendant-infringer. First, to threaten a defendant-infringer with shutting down of its business is—per se—an action predominant to cause harm. Second, as explained in part II, the exercise of said right is *unreasonable*. Finally, the exercise of the right to exclude is being used for a purpose other than that for which it exists. As explained earlier, the right to exclude is created to protect the patent holders' market share, reputation, or goodwill as an incentive for further innovation; it is not created to strengthen the position of a patent holder in licensing negotiations so that said patent holder could obtain exorbitant royalty fees.

In light of the foregoing, patent trolls abuse their intellectual property rights when they threat a defendant-infringer with an injunction solely to gain undue leverage during licensing negotiations. Due to that fact, the United States is in compliance with TRIPS when it grants compulsory licenses in patent troll cases to avoid the abuse of patent rights.

Similarly, TRIPS Article 8 authorizes WTO Members to grant compulsory licenses to promote the public interest in socio-economic and technological development. As explained earlier, this is the reason why federal courts have been denying injunctive relief in cases where the patented invention is but a small component of the defendant-infringer's product. In said circumstances, the patentee's right to exclude cedes to social welfare regarding jobs and trade. Thus, such compulsory licenses granted in the United States are also permitted under TRIPS.

B. Substantive and Procedural Terms under TRIPS Article 31.

The United States has completely ignored TRIPS Article 31 when granting a compulsory license. The federal courts have relied exclusively on section 283 of

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62 *See* Joseph M. Perillo, ***Abuse of Rights:*** *A Pervasive Legal Concept*, 27 PAC. L.J. 37 (1995).

63 *See* JOHN D. CALAMARI & JOSEPH M. PERILLO, THE LAW OF CONTRACTS, § 11.39 (4th ed. 1998).

the Patent Act[64] to award an *ongoing royalty* (compulsory license) on such terms that the courts deem *reasonable.*[65] Thus, federal courts could—in theory—issue a compulsory license in a manner contradictory to the terms set in TRIPS Article 31 if said courts determine that the terms they are establishing are *reasonable*.

However, domestic law should, to the extent possible, be construed consistent with treaties.[66] Therefore, courts should construe the language of Section 283 of the Patent Act "on such terms that the court deems reasonable" as to include all the procedures and steps in TRIPS Article 31.

Nonetheless, and despite its lack of recognition of TRIPS Article 31, federal courts have been complying with the above-mentioned article to a considerable extent. For example, in the United States the grant of a compulsory license is based on a *case by case* analysis. Thus, the first requirement of TIPS Article 31 has been met.

Also, federal courts have been ordering the parties to negotiate the terms of a compulsory license—*reasonably*—after said court denies a request for injunctive relief.[67] Therefore, the United States is complying with TRIPS Article 31(b), which requires that prior granting a compulsory license, the proposed user has tried and failed to obtain a license on *reasonable* terms. In addition, the compulsory license granted by the federal courts is non-exclusive, and requires that the proposed user pay a reasonable royalty fee to the patent holder for such use. On the other hand, federal courts are overlooking the fact that said compulsory licenses have to be of limited scope and duration, and predominantly used to supply the domestic market only. Because of this, the United States is not fully complying with TRIPS Article 31.

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64 35 U.S.C. § 283: "The several courts having jurisdiction of cases under this title may grant injunctions in accordance with the principles of equity to prevent the violation of any right secured by patent, on such terms as the court deems reasonable." *Id.*

65 *See* Paice LLC v. Toyota Motor Corp., 504 F.3d 1293 (Fed. Cir. 2007) (stating that "[u]nder some circumstances, awarding an ongoing royalty for patent infringement in lieu of an injunction may be appropriate").

66 *See* Murray v. The Schooner Charming Betsy, 6 U.S. (2 Cranch) 64, 118 (1804) stating that:

> [A]n act of Congress ought never to be construed to violate the law of nations if any other possible construction remains, and, consequently can never be construed to violate neutral rights, or to affect neutral commerce, further than is warranted by the law of nations as understood in this country.

Id.

67 *See, e.g.,* Telcordia Techs., Inc. v. Cisco Sys., 592 F.Supp. 2d 727 (D.Del. 2009). In this case the court declined to adopt patent holder's request for a compulsory license, and ordered the parties to negotiate the terms of a reasonable royalty rate going forward. The court stated that "[s]hould the parties fail to reach an agreement, the court will permit the filing of competing proposals. The court not only orders the parties to meet and confer but, given its limited time and resources, strongly encourages the parties to be reasonable in their negotiations." *Id.* at 748.

CONCLUSION

Patent rights have the attributes of property rights. Therefore, the patent holder has the authority to exclude others from practicing his invention without his consent. However, said right, just as any other property right, is not absolute. That means that the right to exclude given by a patent could be curtailed by the courts if : a) its owner uses it in an unreasonable manner, as the patent trolls do; or b) it conflicts with the public welfare, economic-development or public interest, as it does when the patented invention is but a small component of the infringer's product. Under these limited circumstances, *eBay*'s decision allows courts to limit the right to exclude of a patent holder by denying an injunctive relief and, consequently, granting the defendant-infringer a compulsory license.

The above-mentioned practice complies with the TRIPS agreement, whose goal is to promote the protection of intellectual property while maintaining a balance between the patent holders' rights, his obligations, and the public welfare. Using the four-factor test discussed in *eBay*, courts can properly make such balance.

Despite the fact that compulsory licenses are available, it does not mean that every situation merits granting one. In fact, Chief Justice Roberts' concurring opinion in *eBay* suggested that injunctions should be issued on the vast majority of cases. Indeed, that has been the case.

As explained earlier, out of fifty-eight decisions interpreting *eBay*, forty-four have granted permanent injunctions while only fourteen have denied it. Thus, federal courts have been interpreting eBay narrowly. As one district court pointed out: "[w]hile *eBay* has allowed courts to decline requests for injunctive relief where the plaintiff is a *patent troll, eBay* has changed little where a prevailing plaintiff seeks an injunction to keep an infringing competitor out of the market."[68]

In light of the foregoing, *bona fide* inventors and scientists who use the patent system and their right to exclude to protect their reputation, goodwill and market-share can feel secure that their inventions and patents are very well protected and that the injunctive relief is still available.

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68 Amgen, Inc. v. F. Hoffmann La Roche Ltd., 2008 U.S. Dist. LEXIS 77343 (D. Mass. 2008).

THE REMAINING HOSTILITY TOWARDS ARBITRATION SHIELDED BY THE MCCARRAN-FERGUSON ACT: HOW FAR SHOULD THE PROTECTION TO POLICYHOLDERS GO?

ARTICLE

MARIANA ISABEL HERNÁNDEZ-GUTIÉRREZ*

I. INTRODUCTION

STATES HAVE THE POWER TO REGULATE THE BUSINESS OF INSURANCE. UNDER the veil of their power to regulate this business, some States and Territories have prohibited pre-dispute arbitration agreements in insurance contracts. Others have limited the statutory preclusion to arbitration agreements contained in insurance contracts between a policyholder and an insurer, thus allowing pre-dispute arbitration agreements in contracts of reinsurance or in contracts between insurance companies. At the same time, there is a strong national policy favoring arbitration and, in some cases, a State public policy fa-

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voring arbitration in evident tension with the broad anti-insurance arbitration statutes in these jurisdictions.

In this paper, I will analyze the provisions of the McCarran-Ferguson Act, the case law pertaining to the States' powers to regulate the business of insurance and the reverse-preemption rule over federal statutes that do not specifically relate to the business of insurance. With more detail, I will examine the case law and governing rules of law that are considered, and those that should be but have not been properly considered, in determining whether an anti-insurance arbitration state law does reverse-preempt the provisions of the Federal Arbitration Act under the McCarran-Ferguson Act. Furthermore, I will argue that, formally, arbitration agreements do not have the effect of transferring or spreading a policyholder's risk, which in turn considerably weakens the theory that anti-insurance arbitration state laws regulate the business of insurance.

I will examine in detail the statutes and related case law of those U.S. jurisdictions that preclude arbitration agreements in insurance policies or, more generally, in insurance contracts, as well as the policy reasons that have inspired these statutes *vis à vis* the strong national public policy favoring arbitration. In Part IV I will discuss the recent *en banc* holding of the Court of Appeals for the Fifth Circuit in *Safety Nat'l. Casualty Corp. v. Certain Underwriters at Lloyd's London*. In that case, the Fifth Circuit concluded that the Convention on the Recognition and Enforcement of Foreign Arbitral Awards is not within the scope of the McCarran-Ferguson Act, and, thus, the anti-insurance arbitration statute of Louisiana does not reverse-preempt the Convention.

Finally, I will propose alternatives that State legislatures may adopt in order to regulate arbitration of insurance contracts, instead of precluding arbitration agreements in insurance contracts. These alternatives are driven to be more consistent with the national policy favoring arbitration as well as the parties' liberty to contract. The reason for formulating these proposals is to allow the states to protect policyholders from insurance companies' potential abuse of arbitration procedures, while at the same time leaving the door open for the benefits of arbitration.

II. THE MCCARRAN-FERGUSON ACT AND THE REVERSE-PREEMPTION OF THE FEDERAL ARBITRATION ACT

In 1925, the Federal Arbitration Act[1] ("FAA") was enacted to declare a national policy favoring arbitration and to reverse the longstanding judicial hostility to arbitration agreements that had been inherited by American courts from the English common law.[2] As a result, arbitration agreements were placed upon

1 9 U.S.C. § 1

2 *See* Southland Corp. v. Keating, 465 U.S. 1, 10 (1984); *See also* Allied-Bruce Terminix Co. Inc. v. Dobson, 513 U.S. 265, 270-271 (1995) ("The origins of [court's refusals to enforce agreements to arbitrate] apparently lie in 'ancient times' when the English courts fought for extension of jurisdiction-all

the same footing as other contracts.[3] With a few exceptions, the FAA applies to written arbitration agreements in any maritime transactions or contracts evidencing a transaction involving interstate or international commerce.[4] The Supreme Court has interpreted this language to cover all transactions affecting interstate or international commerce.[5]

Some debate emerged as to the preemptive nature and scope of the FAA over conflicting arbitration law of the States.[6] Although the Supreme Court has not answered the question regarding the extent on which the FAA preempts State law, it has applied the FAA to State court cases and affirmatively held that the FAA's substantive provisions preempt conflicting State law.[7] As a result, the FAA presently preempts arbitration laws if the arbitration agreement is within the scope of the FAA and the State statute either invalidates arbitration agreements or "discriminates" against arbitration agreements. By the term "discriminates", I mean that the State law in question establishes grounds for denying the enforcement of arbitration agreements that are not grounds for the revocation of any contract.[8]

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of them being opposed to anything that would altogether deprive every one of them of jurisdiction.").

3 9 U.S.C. § 2 ("[A]n agreement in writing to submit to arbitration an existing controversy arising out of such a contract, transaction, or refusal, shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract."); *See also* Gilmer v. Interstate/Johnson Lane Corp., 500 U.S. 20, 24 (1991); American Bankers Ins. Co. v. Inman, 436 F.3d 490, 492-493 (5th Cir. 2006); STEPHEN W. WARE, PRINCIPLES OF ALTERNATIVE DISPUTE RESOLUTION 26 (2nd ed. 2007).

4 9 U.S.C. §§ 1-2.

5 *See* Allied-Bruce Terminix Co. Inc. v. Dobson, 513 U.S. at 273-274; WARE, *supra* note 3, at 26.

6 *See* WARE, *supra* note 3, at 29 ("While many believe that the FAA was originally understood to be merely a *procedural* law governing only in federal courts, some evidence suggests that those who enacted the FAA intended it to be *substantive* federal law governing both in state court and thus preempts inconsistent state law.")

7 *See* WARE, *supra* note 3, at 30; Southland Corp. v. Keating, 465 U.S. at 10 ("In enacting § 2 of the federal Act, Congress declared a national policy favoring arbitration and withdrew the power of the states to require a judicial forum for the resolution of claims which the contracting parties agreed to resolve by arbitration."); Allied-Bruce Terminix Co. Inc. v. Dobson, 513 U.S. at 272-273 ("Did Congress intend the Act also to apply in state courts? Did the Federal Arbitration Act pre-empt conflicting state anti-arbitration law, or could state courts apply their anti-arbitration rules in cases before them, thereby reaching results different from those reached in otherwise similar federal diversity cases? In Southland ... this Court decided that Congress would not have wanted state and federal courts to reach different outcomes about the validity of arbitration in similar cases. The Court concluded that the Federal Arbitration Act pre-empts state law; and it held that state courts cannot apply state statutes that invalidate arbitration agreements. ... Further, Congress, both before and after Southland, has enacted legislation extending, not retracting, the scope of arbitration. . . . For these reasons, we find it inappropriate to reconsider what is by now well-established law.")

8 9 U.S.C. § 2; Preston v. Ferrer, 552 U.S. 346, 353 (2008) ("Section 2 'declare[s] a national policy favoring arbitration' of claims that parties contract to settle in that manner. ... That national policy, we held in *Southland*, 'appli[es] in state as well as federal courts' and 'foreclose[s] state legislative attempts to undercut the enforceability of arbitration agreements.' ... The FAA's displacement of

In *Allied-Bruce Terminix Co. Inc. v. Dobson*, the Supreme Court of the United States reviewed the legislative history of the FAA. The Court concluded that "Congress, when enacting this law, had the needs of consumers, as well as others, in mind", and that the advantages of arbitration would often seem helpful to individuals who need a less expensive alternative to litigation. [9] In support of this contention, the Court cited a Senate Report indicating that the Act avoided "the delay and expense of litigation" as well as a Report of the House of Representatives stating that "the advantages of arbitration are many: it is usually cheaper and faster than litigation; it can have simpler procedural and evidentiary rules; it normally minimizes hostility and is less disruptive of ongoing and future business dealings among the parties; it is often more flexible in regard to scheduling of times and places of hearings and discovery devices."[10] In addition, the Court took into account the *amicus* brief of the American Arbitration Association, which asserted that cases involving claims between ten and fifty thousand dollars have an average processing time of less than six months.[11] In subsequent years, the Supreme Court has repeatedly acknowledged that "[a] prime objective of an agreement to arbitrate is to achieve 'streamlined proceedings and expeditious results'."[12]

Some scholars have questioned the certainty of these statements favoring arbitration by highlighting the abuses that can stem from arbitration procedures, particularly in cases between consumers and individuals against insurance companies and other wealthy corporations.[13] Among other things, opponents of the arbitration of customer claims have argued that arbitration can entail higher costs (due to filing and arbitrators' fees) than litigation; arbitrators are often biased in favor of companies that are frequent users of the arbitration procedures; discovery is limited in arbitration procedures to the discretion of the arbitrator; arbitration awards must be confirmed or recognized by a court in order to be enforceable; and that arbitration awards are usually final even when the arbitrator ignored the applicable law. [14] While some of these criticisms are more me-

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conflicting state law is 'now well-established,'... and has been repeatedly reaffirmed,") (citations omitted); Southland Corp. v. Keating, 465 U.S. at 15-16; WARE, *supra* note 3, at 37.

9 *See* Allied-Bruce Terminix Co. Inc. v. Dobson, 513 U.S. at 280.

10 *Id*.

11 *Id*.

12 Preston v. Ferrer, 552 U.S. at 357.

13 *See* Jean R. Sternlight, *Creeping Mandatory Arbitration: Is it Just?*, 57 STAN. L. REV. 1631 (2005); David S. Schwartz, *Enforcing Small Print to Protect Big Business: Employee and Consumer Rights Claims in an Age of Compelled Arbitration*, 1997 WIS. L. REV. 33 (1997).

14 *See* Sternlight, *supra* note 12, at 1648-1653; Schwartz, *supra* note 12, at 39-53; Susan Randall, *Mandatory Arbitration in Insurance Disputes: Inverse Preemption of the Federal Arbitration Act*, 11 CONN. INS. L. J. 253, 257-262 (2005); Maureen A. Weston, *Checks on Participant Conduct in Compulsory ADR: Reconciling the Tension in the Need for Good-Faith Participation, Autonomy, and Confidentiality*, 76 IND. L.J. 591, 595-596 (2001).

ritorious than others, some of these arguments can also easily be raised, and have been raised, against court procedures as well.[15]

As mentioned above, like almost every other federal law, the FAA preempts conflicting State law.[16] However, the McCarran-Ferguson Act, enacted by Congress in 1945,[17] provides an important exception to this rule in cases where a State law that is directed to regulate the business of insurance conflicts with a federal statute that is not specifically related to the business of insurance, like the FAA.[18] The McCarran-Ferguson Act empowers State statutes regulating the business of insurance with a reverse-preemption effect over conflicting federal statutes that, in contrast to a State statute, do not specifically relate to the business of insurance.

With the enactment of the McCarran-Ferguson Act, Congress declared "that the continued regulation and taxation by the several States of the business of insurance is in the public interest, and that silence on part of the Congress shall not be construed to impose any barrier to the regulation or taxation of such business by the several States."[19] Accordingly, the McCarran-Ferguson Act provides that "[t]he business of insurance, and every person engaged therein, shall be subject to the laws of the several States which relate to the regulation or taxation of such business".[20] Thus, in order to avoid the federal preemption rule from eroding the States' power to regulate the business of insurance, the Act further adds that "[n]o Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business

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15 *See, e.g.*, Jeffrey Stempel, *Chief William's Ghost: The Problematic Persistence of the Duty to Sit*, 57 BUFF. L. REV. 813 (2009); John S. Beckerman, *Confronting Civil Discovery's Fatal Flaws*, 84 MINN. L. REV. 505 (2000); Virginia E. Hench, *Mandatory Disclosure and Equal Access to Justice: The 1993 Federal Discovery Rules Amendments and the Just, Speedy and Inexpensive Determination of Every Action*, 67 TEMP. L. REV. 179 (1994); Jane Rutherford, *The Myth of Due Process*, 72 B.U. L. REV. 1 (1992); John C. Reitz, *Why We Probably Cannot Adopt the German Advantage in Civil Procedure*, 75 IOWA L. REV. 987 (1990).

16 *See supra* note 6; Altria Group, Inc. v. Good, 555 U.S. ___ (2008), 129 S.Ct. 538, 543; Sprietsma v. Mercury Marine, a Div. of Brunswick Corp., 537 U.S. 51, 64-65 (2002) ("We have recognized that a federal statute implicitly overrides state law either when the scope of a statute indicates that Congress intended federal law to occupy a field exclusively . . . or when state law is in actual conflict with federal law. We have found implied conflict pre-emption where it is 'impossible for a private party to comply with both state and federal requirements' . . . or where state law 'stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress'.") (citations omitted).

17 The McCarran-Ferguson Act was enacted as a response to the Supreme Court opinion in *United States v. South-Eastern Underwriters Assn*., 322 U.S. 533 (1944). In *South-Eastern*, the Supreme Court reversed the doctrine stating that issuing an insurance policy is not a transaction of commerce, and held that "an insurance company that conducted a substantial part of its business across state lines was engaged in interstate commerce and thereby subject to [Congressional authority under the commerce clause]." *See* United States v. Fabe, 508 U.S. 491, 499 (1993).

18 *See* Pilot Life Insurance Co. v. Dedeaux, 481 U.S. 41, 50 (1987).

19 15 U.S.C. § 1011

20 15 U.S.C. § 1012(a).

of insurance… unless such Act specifically relates to the business of insurance".[21] Therefore, through Section 1012 of the McCarran-Ferguson Act, Congress relinquished some of its powers to State legislatures by allowing State laws regulating the business of insurance to reverse-preempt an otherwise applicable federal statute.

In sum, under the McCarran-Ferguson Act, a State law reverse-preempts a federal law when (1) the federal statute does not specifically relate to the "business of insurance"; (2) the State law was enacted specifically for the purpose of regulating the "business of insurance"; and (3) the federal statute operates to invalidate, impair or supersede the State law.[22] In this regard, the Supreme Court has clarified that the McCarran-Ferguson Act *does not* make State legislation supreme in regulating *all* the activities of insurance companies. Rather, the language of the McCarran-Ferguson Act refers *only* to laws "regulating the business of insurance."[23] Therefore, "insurance companies may do many things which are subject to paramount federal regulation".[24]

In defining the scope of the McCarran-Ferguson Act's reverse-preemption rule, the Supreme Court has stated three factors that must be considered in the task of determining whether a State law "regulates the business of insurance". Even though none of these criteria are conclusive by themselves, they are meant to provide a guideline to assist courts in answering the question whether a particular State law does or does not regulate the "business of insurance".[25] These three factors are (1) whether the practice regulated in the law has the effect of transferring or spreading the policyholder's risk; (2) whether the practice is an integral part of the policy relationship between the insurer and the insured; and (3) whether the practice is limited to entities within the insurance industry.[26]

In cases where the question of whether an arbitration state law reverse-preempts the FAA pursuant to the McCarran-Ferguson Act is posed, the analysis of whether the statute in question regulates the business of insurance requires detailed thinking about some theoretical issues. Specifically, the effect that arbitration clauses may have in transferring or spreading policyholders' risks constitutes a rather big hurdle in this analysis. The Supreme Court explained in *Group Life & Health Ins. Co. v. Royal Drug Co*. that—

> the primary elements of an insurance contract are the spreading and underwriting of a policyholder's risk. 'It is characteristic of insurance that a number of risks

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21 15 U.S.C. § 1012(b).

22 *See* American Bankers Ins. Co. v. Inman, 436 F.3d at 493; *Standard Sec. Life Ins. Co. of New York v. West*, 267 F. 3d 821, 824 (8th Cir. 2001).

23 SEC v. National Securities, Inc., 393 U.S. 453, 459-460 (1969).

24 *Id*.

25 *See* Union Labor Life Ins. Co. v. Pireno, 458 U.S. 119, 129 (1982); American Bankers Ins. Co. v. Inman, 436 F.3d at 493.

26 *Id*.

> are accepted, some of which involve losses, and that such losses are spread over all the risks so as to enable the insurer to accept each risk at a slight fraction of the possible liability upon it.'"[27]

In this quest, it is important to keep in mind the distinction between the obligations of insurance companies under their insurance policies (*i.e.* insuring against the risk that policyholders will be unable to pay for particular losses or damages) and those arrangements made by insurance companies with the only purpose of minimizing the costs incurred in fulfilling their underwriting obligations.[28] The latter play no part in the "spreading and underwriting of a policyholder's risk".[29]

Some courts have concluded that State laws precluding arbitration clauses in insurance contracts have the effect of transferring or spreading the policyholder's risk by subjecting insurance disputes to the possibility of a jury trial.[30] While this is a reasonable argument from the prudential perspective that refers to the fact that juries tend to dislike insurance companies and powerful corporations in general,[31] there are some legal principles that considerably undermine the merits of such conclusion and that must be explored.

In *Standard Sec. Life Ins. Co. of New York v. West* the Eighth Circuit held that a Missouri statute declaring arbitration provisions in insurance contracts unenforceable[32] transfers or spreads the policyholder's risk.[33] The Eighth Circuit based

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27 Group Life & Health Ins. Co. v. Royal Drug Co. , 440 U.S. 205, 211 (1979).

28 *See Id*. at 213; Union Labor Life Ins. Co. v. Pireno, 458 U.S. at 130.

29 Union Labor Life Ins. Co. v. Pireno, 458 U.S. at 130.

30 *See* Standard Sec. Life Ins. Co. of New York v. West, 267 F. 3d at 824; Mutual Reinsurance Bureau v. Great Plains Mut. Ins. Co., 969 F.2d 931 (10th Cir. 1992); McKnight v. Chicago Title Ins. Co., 358 F.3d 854, 858 (11th Cir. 2004); Cox v. Woodmen of World Ins. Co., 556 S.E.2d 397, 401-401 (2001) (The arbitration exception "sets forth the method for resolving disputes between the insured and the insurer. Through the exception, the legislature placed limits on the enforceability of an agreement to spread risk.")

31 *See* Honda Motor Co., Ltd. v. Oberg, 512 U.S. 415, 431 (1994) ("If anything, the rise of large, interstate and multinational corporations has aggravated the problem of arbitrary awards and potentially biased juries."); Stephen Pate, *Representing Carriers in a Negative Environment*, Aspatore, (February 2010), 2010 WL 561456, *1 ("[Y]et many judges, juries, and mediators seem to dislike insurance companies so much that they are willing to overlook any misdeeds on the part of policyholders."); Hon. Kimberly A. Moore, *Populism and Patents*, 82 N.Y.U. L. REV. 69, 70 (2007) ("The perception that American juries are biased in favor of individuals and prejudiced against corporations is widespread. As one commentator noted, 'A common belief is that jurors are so prone to favor individual plaintiffs over corporate defendants that they pick the 'deep pockets' of rich business corporations and deliver extremely high awards that are not merited by the company's actions or the plaintiff's injuries.' Anecdotal accounts often bear great weight in the formation of these impressions. Whether jury populism is perceived as anticorporate prejudice, a preference for the underdog, or a desire to redistribute wealth, there is no doubt that the prevailing wisdom among commentators is that juries are prejudiced against the large corporate entity and biased in favor of the small, often injured, individual.")

32 MO. REV. STAT. § 435.350.

33 Standard Sec. Life Ins. Co. of New York v. West, 267 F.3d 821 (8th Cir. 2001).

this holding in its reading of *United States v. Fabe*,[34] in which the Supreme Court observed "that without the performance or enforcement of contract terms, no risk transfer occurs".[35] However, the Eighth Circuit did not consider that the Supreme Court made those statements in the context of explaining the holdings in *Union Labor Life Ins. Co. v. Pireno* and *Royale Drug*.[36] In *Fabe*, the Supreme Court explained that—

> the statement in *Pireno* that the "transfer of risk from insured to insurer is effected by means of the contract between the parties … and … is complete at the time that the contract is entered", presumes that the insurance contract in fact will be enforced. Without *performance of the terms of the insurance policy*, there is no risk transfer at all. Moreover, *performance of an insurance contract* also satisfies the remaining prongs of the Pireno test: It is central to the policy relationship between insurer and insured and is confined entirely to entities within the insurance industry.[37] [(Emphasis provided.)]

Before proceeding, I must make clear the fact that I am not questioning the fact that regulations governing the *performance of insurance contracts* fall within the category of "regulating the business of insurance", nor that the performance of an insurance contract is central to the relationship between the insurer and the insured. Neither am I questioning whether an arbitration agreement in an insurance contract may be considered an integral part of the relationship between the insurer and the insured,[38] nor that under some statutes the preclusion of arbitration clauses is limited to entities within the insurance industry. What I am questioning is the reasoning in *West*, *Mutual Reinsurance Bureau* and other state and federal cases that have held that arbitration clauses are catalytic agents in the transferring and spreading of risk. My questioning is based on statements and case law of the Supreme Court regarding the nature and effect of arbitration clauses, the analysis of what is risk transferring for the purpose of determining

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34 United States v. Fabe, 508 U.S. 491 (1992). The Court of Appeals also considered the opinion of the Tenth Circuit in *Mutual Reinsurance Bureau v. Great Plains Mut. Ins. Co.*, 969 F.2d 931 at 933 (concluding that a Kansas statute providing that arbitration agreements in a contract of insurance are unenforceable regulates the business of insurance because it is a statute "aimed at protecting [and regulating] the relationship between the insurance company and the policyholder 'directly or indirectly'").

35 Standard v. West, 267 F.3d at 824.

36 Previously, in the *Fabe* opinion, the Supreme Court indicated in relation to *Pireno* that the peer review practice that advised the insurance company in evaluating policyholder's claims "had nothing to do with whether the insurance contract was performed; it dealt only with calculating what fell within the scope of the contract's coverage" and that the peer review process "is a matter of indifference to the policyholder, whose only concern is *whether* his claim is paid, not *why* it is paid." Fabe, 508 U.S. at 503.

37 *Id*. at 503-504.

38 *See* SEC v. National Securities, Inc., 393 U.S. at 460.

whether a state law regulates the business of insurance, and the relationship between an arbitration agreement and the container contract.

Looking at arbitration agreements contained in insurance policies as vehicles to transfer or spread risk operates, by analogy, in tension with the well-known doctrine of separability. Under the separability doctrine, arbitration clauses are considered as a separate contract from the contract in which they are contained, or in this case, the insurance policy.[39] Therefore, because the separability doctrine treats an arbitration agreement as a different and separate contract from the container contract, then the performance of the arbitration clause is or should be a separate obligation and its enforceability is or should be a separate matter from the performance and enforceability of the insurance contract. Theoretically, the enforcement or performance of an arbitration agreement cannot have any effect on the transferring or spreading of the risk under the insurance contract, since the enforceability and performance of the terms of the insurance policy suppose certain rights and obligations distinct from the enforceability and performance of an arbitration agreement.

The Fifth Circuit has raised similar concerns and has questioned whether a State statute that prohibits arbitration agreements in insurance contracts regulates the business of insurance. Specifically, in *Safety Nat'l.* the Fifth Circuit said that "[a]n argument could be made that, at least in theory, resolving claims in an arbitration rather than in a court or potentially before a jury does not substantially affect the risk pooling arrangement between the insurer and the insured."[40] In support of this interpretation, the Fifth Circuit cited Supreme Court case law holding that "[b]y agreeing to arbitrate a statutory claim, a party does not forgo the substantive rights afforded by the statute; it only submits to their resolution in an arbitral . . . forum."[41] Moreover, considering the procedural nature of arbitration and the procedural differences between arbitration and court proceedings, arbitration agreements could be easily characterized as one of those arrangements made by insurance companies with the purpose of minimizing the costs incurred in fulfilling their underwriting obligations. As the Supreme Court clarified in *Pireno*, these arrangements play no part in the "spreading and underwriting of the policyholder's risk"; the dispute resolution procedure takes place after the risk has been transferred by means of the policy.[42]

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39 *See* Prima Paint v. Flood & Conklin, 388 U.S. 395 (1967); Buckley v. Cardegna, 546 U.S. 440 (2006); West, *supra* note 3, at 49; TIBOR VÁRADY ET AL., INTERNATIONAL COMMERCIAL ARBITRATION: A TRANSNATIONAL PERSPECTIVE 144-159 (4th ed. 2009).

40 Safety Nat'l. Casualty Corp. v. Certain Underwriters at Lloyd's, London, 587 F.3d at 720-721, n. 21.

41 *Id*.; *See also* Preston v. Ferrer, 552 U.S. at 359; Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614, 628 (1985); cf. Int'l Ins. Co. v. Duryee, 93 F.3d 837, 839-840 (6th Cir. 1996).

42 *See* Group Life & Health Ins. Co. v. Royal Drug Co., 440 U.S. at 213; Union Labor Life Ins. Co. v. Pireno, 458 U.S. at 130.

Even though the "risk transferring" factor does not by itself exclude a statute precluding arbitration clauses in insurance contracts from the category of "regulating the business of insurance", it is debatable whether the enforcement of an arbitration clause in an insurance contract has the effect of spreading or transferring a policyholder's risk. Furthermore, it is questionable whether the rationale of the Supreme Court in *Pireno* as to "risk transferring" and the performance of the insurance policy was meant to include the performance of an arbitration agreement contained in an insurance policy.[43] In view of the Supreme Court's statements stressing the procedural nature of arbitration procedures, the effects of the separability doctrine, and with regards to risk transferring, I assert that it does not.

In addition, the possibility of a civil jury trial cannot be used to justify the preclusion against arbitration as a regulation of the "business of insurance" in a jurisdiction such as Puerto Rico, where there is no right to a civil jury trial.[44] The argument also has a limited application in Louisiana, where the right to a civil jury trial is limited to those cases where the amount in controversy exceeds fifty thousand dollars.[45] As I will further discuss, Puerto Rico and Louisiana are both jurisdictions where arbitration clauses are prohibited without exception in insurance contracts.

Generally, the other two elements of the "regulating business of insurance" test have not constituted hurdles to courts finding for the reverse-preemption effect of State laws precluding arbitration clauses in insurance contracts. Presently, the consensus among courts is that such preclusions are regulations of the business of insurance because these are regulations of the dispute resolution procedure between the parties to an insurance contract that have a substantial

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43 *See* Triton Lines, Inc. v. Steamship Mut. Underwriting Ass'n (Bermuda) Ltd., 707 F. Supp. 277, 279 (S.D. Tex. 1989) ("A disputed claim is not the business of insurance. The business of regulating the insurance industry focuses on the underwriting and spreading of the policyholder's risk . . . . [S]tate regulation of a practice of an insurance company does not mean that the practice is the 'business of insurance'." [citing Royal Drug.] "The McCarran Act has never been held to have abrogated federal procedural practices in federal court cases. The anti-arbitration provision of the Texas Insurance Code, therefore, is countermanded by the Federal Arbitration Act." [citing Life of America Ins. Co. v. Aetna Life Ins. Co., 744 F.2d 409 (5th Cir.1984)]); Smith v. PacifiCare Behavioral Health of California, Inc., 93 Cal.App.4th 139, 156-157 (2001).

44 García Mercado v. Tribunal Superior, 99 D.P.R. 293, 304 (1970) ("por no existir en Puerto Rico juicios por jurado en los casos civiles, por ser eso extraño a nuestra tradición jurídica civil, por no proveer nuestras leyes ni nuestras Reglas de Procedimiento para eso, y por disponer nuestra legislación para la celebración de los juicios civiles ante tribunal de derecho, sin jurado…") (Translation provided by the author: "because in Puerto Rico there are no jury trials in civil cases, because that institution is foreign to our Civil Law legal tradition, because our laws and Civil Procedure Rules do not provide for civil jury trials, and because our legislation provides for civil trials before a bench trial.")

45 *See* LSA-C.C.P. Art. 1732.

effect on the insurer-insured relationship.[46] This issue should be thoroughly reexamined, particularly considering the principles of the separability doctrine and the expressions of the Supreme Court to the effect that an arbitration clause is a kind of forum-selection clause which does not affect substantive rights afforded by a statute or other substantive law.[47]

III. States and Territories Precluding or Limiting the Enforcement of Arbitration Clauses in Insurance Disputes

In the United States there are several jurisdictions that preclude arbitration clauses in insurance contracts. A minority of these States and Territories forbid arbitration clauses in insurance contracts "across the board", while the majority either preclude arbitration clauses in some insurance contracts or limit the enforceability of arbitration agreements by imposing conditions of validity.[48] Because of the multiplicity of statutes and jurisdictions involved, in this paper I will concentrate my analysis on those jurisdictions that have statutes broadly prohibiting the enforceability of arbitration agreements in insurance contracts.

It is important to highlight that in the anti-insurance arbitration statutes of Louisiana and Puerto Rico, as well as in the majority of other statutes precluding arbitration agreements in certain insurance contracts, the scope of the preclusion is limited to pre-dispute agreements to arbitrate contained in insurance policies.[49] Although it is rather unusual for parties to enter into an arbitration agreement after a dispute has emerged,[50] *generally*, the language used in these statutes does not seem to forbid post-dispute arbitration agreements between the insurer and the insured.

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46 *See, e.g.,* McKnight v. Chicago Title Ins. Co., 358 F.3d at 858-859; Mut. Reinsurance Bureau v. Great Plains Mut. Ins. Co., 969 F.2d at 933; Standard Sec. Life Ins. Co. of New York v. West, 267 F. 3d at 823; Love v. Money Tree, Inc., 279 Ga. 476, 479-480 (2005).

47 *See* Safety Nat'l. Casualty Corp. v. Certain Underwriters at Lloyd's, London, 587 F. 3d at 721 n.21; Preston v. Ferrer, 552 U.S. at 359; Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. at 628; Little v. Allstate Ins. Co., 167 Vt. 171, 174 (1997).

48 *See* Randall, *supra* note 11, at 270-276; WARE, *supra* note 3, at 36; Margaret M. Harding, *The Clash Between Federal and State Arbitration Law and the Appropriateness of Arbitration as a Dispute Resolution Process*, 77 NEB. L. REV. 397, 439, n. 280 (1998); Joseph T. Mclaughlin, *Arbitrability: Current Trends in the United States*, 59 ALB. L. REV. 905, 924-925, n. 170 and 171 (1996). Because for the purpose of this paper I am concentrating on those state statutes that prohibit arbitration clauses in insurance contracts, I will not discuss the Alabama statute providing that agreements to submit a controversy to arbitration are unenforceable in that state. *See* ALA. CODE 1975 § 8-1-41. The FAA preempts this Alabama statute even in insurance disputes because its anti-arbitration rule is not limited to insurance contracts (*i.e.* it was not enacted for the purpose of regulating the business of insurance), but to all arbitration agreements. *See* ALA .CODE 1975 § 27-14-22, Note 4; Mclaughlin, *supra*, at 924.

49 *See, e.g.,* Federated Rural Elec. Ins. Co. v. Nationwide Mut. Ins. Co., 874 F. Supp. 1204, 1208 (D. Kan. 1995).

50 WARE, *supra* note 3, at 20.

If post-dispute arbitration agreements are valid and enforceable in these jurisdictions—like the language used in most anti-insurance arbitration statutes suggests—the argument in support of preclusion cannot stand for the proposition that insurance disputes are nonarbitrable as a matter of public policy.[51] In other words, because the language used in most of these statutes seems to preclude only those arbitration agreements contained in insurance policies and not post-dispute arbitration agreements between insurer and insured, the concern that moves these anti-insurance arbitration statutes is not insurance law as a subject matter. The common concern is rather about adhesion contracts with arbitration clauses entered into because of necessity; or more specifically, about policyholders without bargaining power being "ousted" from courts and "forced" to arbitrate.[52] The nature of the concern can be perceived more clearly in those jurisdictions that have chosen to preclude arbitration agreements in insurance contracts with the exception of those arbitration agreements contained in reinsurance contracts or contracts between insurance companies.

Other courts have said that the preclusion is motivated by an effort to protect the rights of the insured to redress their claims in court.[53] Until now, the only reason why these jurisdictions have been able to guarantee the rights of the insured—as opposed to other citizens—to redress their claims in court, in spite of waivers in pre-dispute arbitration agreements and in spite of the FAA, is the rationale that these anti-insurance arbitration statutes regulate the business of insurance and supersede the FAA through the reverse-preemption rule provided in the McCarran-Ferguson Act. In addition to the deficiencies of this reasoning discussed above, from the standpoint of the strong national public policy favor-

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51 VÁRADY, *supra* note 34, at 99 ("Arbitrability also has a narrower meaning, referring to whether mandatory law in a given jurisdiction disallows arbitration disputes dealing with particular subject matter because that subject matter is infused with high-order public policy concerns".); Lozano v. AT & T Wireless Services, Inc., 504 F.3d 718, 726-727 (2007) ("Accordingly, we conclude that, even considering the important public policy concerns associated with [Federal Communications Act] claims, these claims are arbitrable absent evidence of congressional intent to the contrary.")

52 *See, e.g.,* Buck Run Baptist Church, Inc. v. Cumberland Sur. Ins. Co., Inc., 983 S.W.2d 501, 504 (Ky. 1998) ("There is a significant difference between types of insurance contracts contemplated by KRS 417.050 as exempt from arbitration and the typical construction contract. In the case of the ordinary insurance contract between a policyholder and an insurance company, *it can readily be understood why the legislature exempted future disputes from being subjected to compulsory arbitration because such contracts are contracts of adhesion to which the insured parties have limited bargaining power*. However, a contractual relationship which involves a commercial construction project, such as we have here, involves a negotiated voluntary agreement between relatively sophisticated commercial entities and a surety company, each of which undertakes a significant financial obligation.") (emphasis added).

53 *See, e.g.,* Friday v. Trinity Universal of Kansas, 262 Kan. 347, 350 (1997); Hobbs v. IGF Ins. Co., 834 S.O.2d 1069, 1071 (La. App. 3 Cir. 2002); 26 L.P.R.A. § 1119.

ing arbitration, these anti-insurance arbitration statutes shielded by the McCarran-Ferguson Act respond to hostility and parochial views against arbitration.[54]

A. *Louisiana*

Section 868 of the Louisiana Insurance Code, renumbered from LA R.S. 22:629, states in its pertinent part that:

> A. No insurance contract delivered or issued for delivery in this state and covering subjects located, resident, or to be performed in this state . . . shall contain any condition, stipulation or agreement:
>
> (1) Requiring it to be construed according to the laws of any other state or country except as necessary to meet the requirements of the motor vehicle financial responsibility laws of such other state or country; or
>
> (2) Depriving the courts of this state of the jurisdiction of action against the insurer.
>
> ...
>
> C. Any such condition, stipulation, or agreement in violation of this Section shall be void, but such voiding shall not affect the validity of the other provisions of the contract.

Even though it is not clear from the text of this provision that its purpose is to preclude arbitration clauses,[55] in *Doucet v. Dental Health Plans Management Corporation* the Louisiana Supreme Court interpreted it as a total prohibition of arbitration clauses in contracts of insurance under the premise that these clauses operate to deprive Louisiana courts of "the jurisdiction of action against the insurer".[56] The rationale is that arbitration clauses in contracts of insurance are prohibited as a matter of public policy because their enforcement would deny Louisiana citizens free access to its courts, a right guaranteed by the State's constitution.[57]

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54 *See, e.g.,* Vimar Seguros y Reaseguros, S.A. v. M/V Sky Reefer, 515 U.S. 528, 537-538 (1995); Carnival Cruise Lines, Inc. v. Shute, 499 U.S. 585 (1991) (Several Washington residents argued that a forum selection clause contained in a cruise ticket providing for litigation in Florida should not be enforced because the expense and inconvenience of litigation in Florida would "caus[e] plaintiffs unreasonable hardship in asserting their rights," and would "lessen, weaken, or avoid the right of any claimant to a trial by court of competent jurisdiction on the question of liability for ... loss or injury, or the measure of damages therefore". Despite the disparate bargaining power between the parties, the Supreme Court enforced the challenged agreement.)

55 Safety Nat'l. Casualty Corp. v. Certain Underwriters at Lloyd's, London, 587 F.3d at 719.

56 412 So.2d 1383, 1384 (La. 1982); Hobbs v. IGF Ins. Co., 834 So.2d at 1071; Macaluso v. Watson, 171 So.2d 755 (La. App. 4 Cir. 1965); LA R.S. 22:868.

57 *See* Hobbs v. IGF Ins. Co., 834 So.2d at 1071; Lawrence v. Continental Ins. Co., 199 So.2d 398, 399 (La. App. 3 Cir. 1967).

The Louisiana approach against arbitration clauses in insurance contracts suffers from two notable weaknesses. The first is as to the not so plausible interpretation that the Supreme Court of Louisiana has given to Section 868 of the Insurance Code. As the Fifth Circuit suggested in *Safety Nat'l*, and as Louisiana case law demonstrates, it is not correct to say that arbitration procedures deprive courts of their jurisdiction. The fact that other jurisdictions like Hawaii,[58] Maine,[59] Virginia,[60] Massachusetts,[61] Virgin Islands,[62] and Washington[63] have identical provisions, but nonetheless allow the enforcement of arbitration clauses in insurance contracts,[64] is strong evidence against the interpretation adopted by Louisiana courts.

After an arbitrator or arbitral panel renders a final decision, judicial enforcement of the award may be needed if the losing party in the arbitration procedure does not comply voluntarily with the orders in the award.[65] In those cases, the winning party can request a court order confirming the award, which in turn converts the award into a judgment of the court.[66] If the court confirms the award, the court can enforce the award in the same manner as any other court judgment.[67]

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58 HRS § 431:10-221.

59 24-A M.R.S.A. § 2433 ("No conditions, stipulations or agreements in a contract of insurance shall deprive the courts of this State of jurisdiction of actions against *foreign* insurers…" (emphasis added) During the course of the investigation realized for this paper, I could not find any state or federal court case interpreting this provision.)

60 VA. CODE ANN. § 38.2-312.

61 M.G.L.A. 175 § 22.

62 22 V.I.C. § 820.

63 RCWA 48.18.200, Note 11.

64 *See* Christiansen v. First Ins. Co. of Hawai`i, Ltd., 88 Haw. 136, 138 (1998) ("In the meantime, in a separate proceeding… First Insurance filed a motion to compel arbitration and for court appointment for a neutral umpire, which was subsequently granted… [A]n umpire was selected [and] the Christiansens were awarded an amount, undisclosed in the record, for the "loss" caused to their property by Hurricane Iniki."); Primoff v. Slocum, 31 Va. Cir. 179, *2 (1993), Not Reported in S.E.2d ("Primoff opposes Stewart Title's Motion to Stay and Compel Arbitration based on two arguments. Primoff contends that Stewart Title waived its right to enforce the arbitration clause since this issue was not raised earlier in this suit. Secondly, Stewart Title argues that even if the Court chooses to enforce the arbitration clause in reference to the Breach of Contract claim, the remaining five counts in Primoff's Amended Motion for Judgment are not directly based on the title insurance contract and do not present issues which are subject to arbitration."); Wilson v. Merrimack Mut. Fire Ins. Co., 66 Mass. App. Ct. 1102 (2006), 844 N.E.2d 1124 (Table), Unpublished Disposition; Ortiz v. One Beacon Ins. Co., No. 0501047L2, *4 (2006), Not Reported in N.E.2d; Brisco v. Schreiber, ____ F.Supp.2d ____ (2010), Civ. No. 06-cv-132 (decided on March 16, 2010); Keesling v. Western Fire Ins. Co. of Fort Scott, Kansas, 10 Wash. App. 841, 845 (1974).

65 WARE, *supra* note 3, at 22 and 109.

66 *Id.*

67 *Id.*

On the other hand, while as a general rule arbitration awards cannot be appealed[68] and a court cannot substitute its conclusions for those of the arbitrators,[69] under Louisiana law—just like in most jurisdictions—courts have jurisdiction to conduct a limited review of arbitration awards and can vacate a challenged award in any of the circumstances provided in LA R.S. 9:4210, or modify the award under the grounds stated in LA R.S. 9:4211.[70]

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68 Some arbitral institutions provide for an arbitration structure with an appellate level. *See* VÁRADY, *supra* note 34, at 742. Since arbitration is a creature of contract, the parties are free to draft their agreement almost any way they like and provide for particular discovery standards and procedural rules. WARE, *supra* note 3, at 22. The parties' freedom of contract does not extend to create additional grounds for vacating the award or regimes of judicial review *under the FAA*. *See* Hall Street Associates, L.L.C. v. Mattel, Inc., 552 U.S. 576 (2008); Ernesto R. Blanes, *Normativismo y Decisionismo: El Estándar Federal para la Revisión Judicial del Arbitraje,* 76 REV. JUR. U.P.R. 357, 365-366 (2007) ("En otras palabras, en *Mattel* el Tribunal Supremo establece una norma para la revisión judicial del arbitraje, pero limita esta norma a laudos que surjan exclusivamente bajo el F.A.A. y que no presenten otro posible vehículo para su puesta en vigor.") (Translation provided by the author: "In other words, in *Mattel* the Supreme Court establishes a rule for the judicial review of arbitration awards, but limits such rule to those awards rendered under the scope of the FAA and which can only be enforced through the provisions of the FAA.")

69 Firmin v. Garber, 353 So.2d 975, 977 (La. 1977); In re Arbitration Between U.S. Turnkey Exploration, Inc. and PSI, Inc., 577 So.2d 1131, 1133-1134 (La. App. 1 Cir. 1991).

70 Many states have adopted either the Uniform Arbitration model law or the Revised Uniform Arbitration model law, both of which are similar to the FAA. WARE, *supra* note 3, at 27 and 113-124; Young v. Peaslee Capital Group, LLC, 7 So.3d 1258 (La. App. 3 Cir. 2009); 9 U.S.C. § 10. LA R.S. 9:4210 provides:

> In any of the following cases the court in and for the parish wherein the award was made shall issue an order vacating the award upon the application of any party to the arbitration.
>
> A. Where the award was procured by corruption, fraud, or undue means.
>
> B. Where there was evident partiality or corruption on the part of the arbitrators or any of them.
>
> C. Where the arbitrators were guilty of misconduct in refusing to postpone the hearing, upon sufficient cause shown, or in refusing to hear evidence pertinent and material to the controversy, or of any other misbehavior by which the rights of any party have been prejudiced.
>
> D. Where the arbitrators exceeded their powers or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made.
>
> Where an award is vacated and the time within which the agreement required the award to be made has not expired, the court may, in its discretion, direct a rehearing by the arbitrators.

Furthermore, LA R.S. 9:4211 provides:

> In any of the following cases the court in and for the parish wherein the award was made shall issue an order modifying or correcting the award upon the application of any party to the arbitration.
>
> A. Where there was an evident material miscalculation of figures or an evident material mistake in the description of any person, thing, or property referred to in the award.

In addition, Louisiana courts can vacate an arbitration award whenever the award in question has errors regarded as a manifest disregard of the law or when "the award is so misconceived that it compels the violation of law or conduct contrary to accepted public policy."[71] That is, after the arbitration award is issued, Louisiana courts can vacate the award if the decision of the arbitrator(s) is contrary to the public policy of Louisiana or if the arbitrator(s) incurred in an error of law that is obvious and capable of being readily and instantly perceived by an average person qualified to serve as an arbitrator.[72] The "manifest disregard of the law" jurisprudential rule implies that the arbitral tribunal knew of the existence of a clearly governing legal principle but decided to ignore or pay no attention to it.[73]

Because the assistance of the courts is often needed to enforce an arbitration award, the opposing party can challenge the validity of the award before the courts. In Louisiana, courts have the power to vacate an arbitration award under several grounds stated in Louisiana law, including whenever the award is contrary to public policy or issued in manifest disregard of the law. Therefore, in spite of an arbitration clause, Louisiana courts are clearly not deprived of jurisdiction.[74] In any insurance dispute where the parties have agreed to arbitrate,

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> B. Where the arbitrators have awarded upon a matter not submitted to them unless it is a matter not affecting the merits of the decision upon the matters submitted.
>
> C. Where the award is imperfect in matter of form not affecting the merits of the controversy.
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> The order shall modify and correct the award so as to effect the intent thereof and promote justice between the parties.

71 In re Arbitration Between U.S. Turnkey Exploration, Inc. and PSI, Inc., 577 So.2d at 1134; Matter of Standard Coffee Service Co., 499 So.2d 1314, 1316 (La. App. 4 Cir. 1986).

72 *See* Robert S. Robertson, Ltd. v. State Farm Ins. Companies/State Farm Fire and Cas. Companies, 921 So.2d 1088, 1091 (La. App. 5 Cir. 2006); Welch v. A.G. Edwards & Sons, Inc., 677 So.2d 520, 524 (La. App. 4 Cir. 1996); In the Matter of Standard Coffee Service Co., 499 So.2d 1314, 1316 (La. App. 4 Cir. 1986); WARE, *supra*, note 3 at 119-120 citing Merrill Lynch v. Bobker, 808 F. 2d 930, 933 (2nd Cir. 1986).

73 *Id*. As traditionally understood, in order to meet the "manifest disregard of the law" test, the challenging party has to demonstrate that the arbitrator made an egregious error while consciously disregarding the correct law. This test is very difficult to meet. WARE, *supra* note 3, at 119-120. However, in recent years some courts have expanded the test for vacating an award due to a manifest disregard of the law, and are beginning to review arbitrator's legal rulings more closely. WARE, *supra* note 3, at 120-121 (citing Cole v. Burns International Security Services, 105 F.3d 1465 (D.C. Cir. 1997) and Halligan v. Piper Jaffray, Inc., 148 F. 3d 197 (2nd Cir. 1998)). ("The *Halligan* opinion seems to challenge the longstanding practice of arbitrators not to write reasoned opinions justifying their decisions... If arbitrators must write reasoned opinions, it seems that courts will be more likely to vacate awards on the ground that the arbitrator did not adequately apply the law"). Under this case law, the "manifest disregard of the law" doctrine appears to be limited to disregard of the law excluding disregard of facts or evidence. WARE, *supra* note 3, at 121.

74 *See* Rollings v. Thermodyne Industries, Inc., 910 P.2d 1030, 1033 (Okl. 1996) ("Although the legislature is permitted to enact legislation to facilitate speedy resolution of differences, that legislation cannot be used to deny access to court. . . . Oklahoma has adopted the Uniform Arbitration Act.

Louisiana courts will still be able to exercise their jurisdiction and review the award in the stage of the confirmation and the enforcement of the award if one of the parties to the arbitration proceeding challenges the validity of the award and requests that the award be vacated or modified by the court.

The other weakness of the Louisiana approach against arbitration agreements in insurance contracts is the public policy argument that the Louisiana Court of Appeals has offered to explain why arbitration agreements in insurance contracts are held to be void and unenforceable. As I mentioned above, the Louisiana Court of Appeals has reasoned that arbitration clauses in contracts of insurance are prohibited because if enforced, these clauses would deny Louisiana citizens of their constitutional right to have access to the State courts. Considering that there is a strong public policy favoring arbitration in Louisiana, and that contracting parties can freely waive their right of access to courts by entering into an arbitration agreement,[75] the "access to courts" argument is without merits. Under the rationale of the Louisiana Court of Appeals, all arbitration agreements that are not within the scope of the FAA would be unconstitutional, unenforceable and contrary to public policy under Louisiana law. This result has no support in Louisiana law (since Louisiana indeed has a public policy favoring arbitration and has enacted an arbitration act similar to the FAA) and is unconvincing.[76] Up to this point, the Supreme Court of Louisiana has not released an opinion explaining the holding in *Doucet* and the far-reaching interpretation given to the provisions in LA R.S. 22:868 (A)(2).

B. Puerto Rico

Similar to Louisiana's statute LA R.S. 22:868, Section 11.90 of the Insurance Code of Puerto Rico[77] provides the following in its relevant part:

> (1) No policy delivered or issued for delivery in Puerto Rico and covering a subject of insurance resident, located, or to be performed in Puerto Rico, shall contain any condition, stipulation, or agreement:
>
> (a) Depriving the insured of right of access to the courts for determination of his rights under the policy in event of dispute.

. . . The Act, in Section 802, states that the making of a written arbitration agreement confers upon the courts the jurisdiction to enforce the agreement to arbitrate any existing or future controversies. It further states the grounds which may serve as a basis to vacate the award by a reviewing court: (1) fraud, (2) bias of an arbitrator, (3) arbitrator exceeded his or her power, (4) hearing was not conducted fairly, (5) there was no arbitration agreement. *Clearly, the Uniform Arbitration Act provides for judicial review, albeit limited*.") (emphasis added).

75 *See* National Tea Co. v. Richmond, 548 So.2d 930, 932 (La. 1989); Tubbs Rice Dryers, Inc. v. Martin, ___ So.3d ___ (La. App. 2 Cir. 2010), No. 44,800-CA, *2.

76 *See* Standard Co. of New Orleans, Inc. v. Elliott Const. Co., Inc., 363 So.2d 671, 674 (1978).

77 26 L.P.R.A. § 1119.

> (b) Depriving the courts of Puerto Rico of jurisdiction of action against the insurer.
>
> ...
>
> (2) Any condition, stipulation, or agreement in violation of this section shall be void, but such voidance shall not affect the validity of the other provisions of the policy.

In 1974, the Supreme Court of Puerto Rico had the opportunity to interpret this statute in *Berrocales v. Superior Court*.[78] In *Berrocales*, the plaintiff bought a new truck for $34,809.20. The price of the truck included an insurance policy with the American Motorists Insurance Company of Chicago. The insurance policy contained an arbitration clause.

A few months later, differences arose between Berrocales and the insurance company, which led the plaintiff to file a complaint before the court of first instance in Puerto Rico. American did not answer the complaint until ten months after it was summoned. The trial court compelled the parties to arbitrate in accordance with the arbitration clause in the policy.

The Supreme Court of Puerto Rico granted the certiorari requested by Berrocales and reversed. The Court concluded that the arbitration clause in question was in contravention to the *lex specialis* (*i.e.* Section 11.90 of the Insurance Code) and thus, void and unenforceable. The Court rejected American's argument that this case was governed by the Arbitration Law of Puerto Rico, and stressed that the parties cannot voluntarily agree to an arbitration procedure when it is contrary to the provisions of the Insurance Code.[79]

After *Berrocales*, neither the Supreme Court nor the Court of Appeals of Puerto Rico have addressed any controversy related to the enforceability of an arbitration clause contained in an insurance policy. It is important to note, however, that the holding in *Berrocales* has a stronger foundation than the Supreme Court of Louisiana's holding in *Doucet*. Although Section 11.90 seems to be very similar to Louisiana's Section 868, there is an important difference between the two that possibly makes the holding in *Berrocales* the only plausible interpretation of Section 11.90. Unlike Louisiana's Section 868, in addition to the provision stating that no policy or insurance contract shall contain a stipulation "[d]epriving the courts... of jurisdiction of action against the insurer", the Puerto Rican statute also states that no insurance policy shall contain a stipulation "[d]epriving the insured of right of access to the courts for determination of his rights under the policy in event of dispute."[80]

The same analysis above with regards to the Louisiana statute in *Doucet* can certainly be made to any interpretation concluding that arbitration agreements

78 Agustín Berrocales Gómez v. Tribunal Superior de P.R., 102 D.P.R. 224 (1974), 2 P.R. Offic. Trans. 281.

79 *See* Berrocales v. Superior Court, 102 D.P.R. at 227.

80 26 L.P.R.A. § 1119.

are prohibited under subparagraph (1)(b) of Section 11.90 of the Puerto Rico Insurance Code.[81] Nevertheless, the legislative intent to preclude arbitration clauses is clearly manifested in subparagraph (1)(a).[82] If an insurance policy contains an arbitration clause, as a matter of fact and of law, the insured will not have the right to present his or her case on its merits before a court in the event of a dispute.

C. Vermont

The Vermont Arbitration Act provides that written agreements to submit any existing controversy to arbitration or to submit to arbitration any controversy thereafter arising between the parties are valid, enforceable and irrevocable, except upon such grounds as exist for the revocation of a contract.[83] Further on, the Arbitration Act adds that *its provisions do not apply* to arbitration agreements contained in a contract of insurance.[84] This provision has been construed by the Supreme Court of Vermont as allowing "insurance arbitration agreements to continue to be governed by the common law" instead of by the Vermont Arbitration Act, as opposed to a prohibition against the enforcement of arbitration agreements in insurance contracts.[85]

The Supreme Court of Vermont has also held that the Vermont Arbitration Act, as well as the "common-law rule making arbitration agreements revocable up to the time of award is not a state law regulating the business of insurance."[86] The highest court of Vermont has reasoned that Section 5653 of the Vermont Arbitration Act pertains to methods of handling contractual disputes, and does not constitute a *regulation* of the business of insurance.[87] Thus, the McCarran-Ferguson reverse-preemption rule does not apply, and the FAA preempts Section 5653 of the Vermont Arbitration Act.

D. Arkansas

The Uniform Arbitration Act of Arkansas provides the following:

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81 *See* 32 L.P.R.A. § 3201 et seq.; Municipio de Mayagüez v. Lebrón, 167 D.P.R. 713 (2006); Febus, et al. v. MARPE Const. Corp., 135 D.P.R. 206 (1994), 1994 P.R.-Eng. 909; Omega Engineering, S.E. v. Corporación Rodum, Inc., KLCE200901566.

82 26 L.P.R.A. § 1119.

83 VT. STAT. ANN. TIT. 12 § 5652.

84 VT. STAT. ANN. TIT. 12 § 5653.

85 *See* Little v. Allstate Ins. Co., 167 Vt. at 174.

86 *Id*.

87 *Id*. ("All the insurance contract exclusion from the [Vermont Arbitration Act] has done is to allow insurance arbitration agreements to continue to be governed by the common law. Thus, the VAA regulates those arbitration agreements subject to its terms. Those that are excluded are not regulated by the VAA.")

> (a) A written agreement to submit any existing controversy to arbitration arising between the parties bound by the terms of the writing is valid, enforceable, and irrevocable, save upon such grounds as exist for the revocation of any contract.
>
> (b)(1) A written provision to submit to arbitration any controversy thereafter arising between the parties bound by the terms of the writing is valid, enforceable, and irrevocable, save upon such grounds as exist for the revocation of any contract.
>
> (2) *This subsection shall have no application* to personal injury or tort matters, employer-employee disputes, *nor to any insured or beneficiary under any insurance policy* or annuity contract.[88]

Contrary to the Supreme Court of Vermont, the Supreme Court of Arkansas has interpreted the provision above as a nonarbitrability rule.[89] Moreover, according to the language in subsection (2), the scope of this nonarbitrability rule is limited to making arbitration agreements contained in insurance policies unenforceable *only* against the insured.[90] Therefore, considering that an insured party may enforce a pre-dispute mandatory arbitration agreement against the insurer, it is evident that the purpose of this statute is to benefit policyholders.

E. South Carolina

Like the Arkansas statute, the Uniform Arbitration Act of South Carolina states that its provisions are *not applicable* to "[a]ny claim arising out of personal injury, based on contract or tort, *or to any insured* or beneficiary under any insurance contract or annuity contract."[91] In *Cox v. Woodmen of World Ins. Co.*, the Court of Appeals of South Carolina indicated that this provision regarding arbitration agreements in insurance contracts is an exception to the public policy in South Carolina favoring the arbitration of disputes.[92] Following the Tenth Circuit's rationale in *Mutual Reinsurance Bureau* regarding a Kansas statute, the Court of Appeals of South Carolina determined that by enacting this exception – limited to entities within the insurance industry- in the Uniform Arbitration Act, the legislature placed limits on the enforceability of an agreement to spread risk.[93]

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88 A.C.A. § 16-108-201.

89 *See* Cash in a Flash Check Advance of Arkansas, L.L.C. v. Spencer, 348 Ark. 459, 466-467 (2002); IGF Ins. Co. v. Hat Creek Partnership, 349 Ark. 133, 143 (2002); Matson, Inc. v. Lamb & Associates Packaging, Inc., 328 Ark. 705, 713 (1997); Terminix Intern. Co. v. Stabbs, 326 Ark. 239, 242 (1996).

90 *See* IGF Ins. Co. v. Hat Creek Partnership, 349 Ark. at 137.

91 S.C. ST. § 15-48-10 (emphasis added).

92 Cox v. Woodmen of World Ins. Co., 347 S.C. 460, 464 (2001).

93 *Id*. at 468.

Furthermore, through a construction of the decision of the Court of Appeals of South Carolina *vis à vis* the "exception" contained in S.C. ST sec. 15-48-10(b)(4), the federal District Court of South Carolina gave the statute a somewhat broader interpretation than what the statute necessarily calls for. Even though it recognized that the *Cox* court did not address the possibility of giving the statute a more constricted interpretation, in *American Health and Life Ins. Co. v. Heyward* the District Court held that Section 15-48-10(b)(4) prohibits the enforcement of arbitration clauses "across the board" in insurance policies under South Carolina law.[94]

F. Missouri

According to the Uniform Arbitration Act of Missouri, arbitration agreements are valid, enforceable and irrevocable, except for those arbitration agreements contained in contracts of insurance and contracts of adhesion.[95] The statute, however, clarifies that "reinsurance contracts are not 'contracts of insurance or contracts of adhesion' for purposes of [this provision]".[96] Therefore, under Missouri law, arbitration agreements contained in insurance contracts are not enforceable unless the container contract is a reinsurance contract.

G. Montana, Oklahoma, Kansas, Nebraska, South Dakota, Georgia, and Kentucky

The common ground between these states is that they have enacted statutes providing that *statutory rules* governing the validity and enforcement of arbitration agreements, or arbitration agreements in general, *do not apply* to insurance policies or contracts of insurance, except for contracts between insurance companies.[97] The South Dakota statute goes further and expressly declares that any

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94 272 F. Supp. 2d 578, 582-583 (2001) (Rejecting that the exception contained in S.C. ST. § 15-48-10 only "makes inapplicable the various rights and duties imposed by the South Carolina Uniform Arbitration Act (*e.g.*, the requirement that the arbitration clause be in typed, underlined capital letters on the front page of the policy)" and holding instead that the statute in question "prohibits the enforcement of arbitration clauses in insurance policies under South Carolina law".). Apparently, neither in *Cox* nor in *American* the insurance companies proposed a construction of the South Carolina statute similar to those given to similar statutes given in Vermont or Arkansas.

95 V.A.M.S. 435.350.

96 *Id*.

97 MCA 27-5-114 ("A written agreement to submit to arbitration any controversy arising between the parties after the agreement is made is valid and enforceable except upon grounds that exist at law or in equity for the revocation of a contract. … [T]his subsection does not apply to… any agreement concerning or relating to insurance policies or annuity contracts except for those contracts between insurance companies…"); NEB. REV. ST. § 25-2602.01; K.S.A. § 5-401; 12 OKL. STAT. ANN. § 1855; GA. CODE ANN. § 9-9-2; KRS § 417.050.

provision requiring arbitration or restricting a party or beneficiary from pursuing legal proceedings in ordinary tribunals is void and unenforceable.[98]

In Montana, the normative effect of the statute exempting arbitration agreements concerning or relating to insurance policies from the validity and enforceability provisions is uncertain. In *Garretson v. Mountain West Farm Bureau Mutual Ins. Co.*, the Supreme Court of Montana found that the insurance policies exception in MCA Section 27-5-114 made the Uniform Arbitration Act inapplicable to an auto insurance policy.[99] The court explained that prior to 1985, the general rule in Montana was that contract provisions requiring arbitration to resolve all future disputes were invalid. However, under a common law exception to this rule, the parties could validly agree to arbitrate future disputes relating solely to questions of fact, such as value or quantity.[100] Based on this common law principle, the *Garretson* court enforced an insurance policy clause under which the amount of the loss had to be set by an appraisal if either party so requested.

Ten years later, the Supreme Court of Montana revisited MCA Section 27-5-114. This time the court concluded without hesitation that under this statute arbitration agreements in "insurance policies" are invalid and unenforceable.[101] In its analysis the court did not mention exceptions to the holding. Nevertheless, this does not mean that the court overruled *Garretson* and its progeny. In this regard, it is important to note that the issue in *Young* was not the arbitration of questions of fact, such as value or quantity, but the enforceability of an arbitration provision in a title insurance policy. In addition, the court observed that "[n]either the Insurer nor the Title Company contend that Montana's statutory provision exempting insurance policies from arbitration requirements is invalid or otherwise unenforceable as a matter of law."[102]

In *Friday v. Trinity Universal of Kansas*, the Supreme Court of Kansas held that the Uniform Arbitration Act of Kansas precludes arbitration clauses in insurance contracts when it states that the rule declaring arbitration agreements as "valid, enforceable, and irrevocable, except upon such grounds as exist at law or in equity for the revocation of any contract" does not apply to contracts of insur-

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98 *See* SDCL § 21-25A-3 ("This chapter [*i.e.* Enforcement of Arbitration Agreements] does not apply to insurance policies and every provision in any such policy requiring arbitration or restricting a party thereto or beneficiary thereof from enforcing any right under it by usual legal proceedings in ordinary tribunals or limiting the time to do so is void and unenforceable. However, nothing in this chapter may be deemed to impair the enforcement of or invalidate a contractual provision for arbitration entered into between insurance companies.").

99 Garretson v. Mountain West Farm Bureau Mut. Ins. Co., 234 Mont. 103, 106 (1988). Although the statute interpreted by the court is a previous version of the actual MCA § 27-5-114, the language of the insurance policies exception was the same.

100 *Id.*; Randall v. American Fire Ins. Co., 10 Mont. 340 (1891); School District No. 1 v. Globe & Republic Ins. Co., 146 Mont. 208 (1965).

101 *See* Young v. Security Union Title Ins. Co., 292 Mont. 310, 316 (1998).

102 *Id.*

ance (except for contracts between insurance companies and reinsurance contracts).[103] Further, this court held that this statutory preclusion extends to appraisals as well as any other agreement to arbitrate a part of a controversy.[104] According to the court, the legislative intent behind the antiarbitration statute is to protect the right of insured to redress their claims in court.[105]

Arbitration agreements in insurance contracts are unenforceable and against public policy under Oklahoma common law.[106] Since the Oklahoma Uniform Arbitration Act states that its provisions do not apply to contracts that reference insurance, arbitration agreements contained in insurance contracts—except for those contracts between insurance companies—are invalid and unenforceable under Oklahoma law.[107] Thus, by express legislative approval, the Uniform Arbitration Act applies and validates arbitration agreements in contracts between insurance companies, as well as in other contracts that are within the scope of the statute.[108]

Georgia courts have also interpreted the provisions in the Georgia Arbitration Code as prohibiting arbitration agreements in contracts of insurance, except for contracts between insurance companies.[109] Different from some of the statutes previously examined, the provisions of the Georgia Arbitration Code do not leave much space for another interpretation. The statute in question provides, in its relevant part, the following:

> (a) …

103 262 Kan. at 349-350; K.S.A. § 5-401; Hopseker v. Coleman, No. Civ. A. 04-2409-DJW, *2 (D. Kan. 2005), Not Reported in F. Supp. 2d ("Even before the 1973 enactment of Kansas' Uniform Arbitration Act, the Kansas Supreme Court considered arbitration agreements in insurance contracts to be unenforceable. The K.S.A. 5-401(c)(1) exemption of insurance contracts merely codified the existing common law.")

104 *Id*. at 350 ("Arbitration can be for all or any part of a controversy. The parties can limit the issues to be arbitrated and can, for example, limit arbitration to the value of a loss. Actually, arbitration is a more adversarial proceeding than a normal appraisal. However, the end result is the same. A controversy is settled. . . . The legislature is presumed to know the law, and it would have been aware that an entire controversy or only one part of a controversy may be arbitrated. We see no indication that the legislature understood there to be some distinction between arbitration and appraisal, terms that appellate courts frequently use interchangeably.")

105 *Id*.

106 *See* Cannon v. Lane, 867 P.2d 1235, 1238-1239 (Okl. 1993). ("Generally, agreements to submit future controversies to arbitration are contrary to public policy."); Boughton v. Farmers Ins. Exch., 354 P.2d 1085, 1089 (Okla. 1960); Mid-Continent Cas. Co. v. General Reinsurance Corp., 331 Fed. App'x. 580 (10th Cir. 2009).

107 *See* 12 OKL. STAT. ANN. § 1855; *id*.

108 *See* Mid-Continent Cas. Co. v. General Reinsurance Corp., 331 Fed. App'x. 580 (10th Cir. 2009); Rollings v. Thermodyne Industries, Inc., 910 P.2d at 1033.

109 *See* Love v. Money Tree, Inc., 279 Ga. at 479; Continental Ins. Co. v. Equity Residential Properties Trust, 255 Ga. App. 445, 446 (2002).

> (c) This part [*i.e.* the Arbitration Code] shall apply to all disputes in which the parties thereto have agreed in writing to arbitrate and *shall provide the exclusive means by which agreements to arbitrate disputes can be enforced*, except the following, to which this part shall not apply:
>
> (1) ...
>
> (3) Any contract of insurance, as defined in paragraph (1) of Code Section 33-1-2; provided, however, that nothing in this paragraph shall impair or prohibit the enforcement of or in any way invalidate an arbitration clause or provision in a contract between insurance companies;[110]

The scope of this anti-insurance arbitration statute, however, does not extend to appraisal clauses contained in insurance policies.[111] Considering the language used in the statute, it is hard to say if post-dispute agreements to arbitrate insurance disputes are enforceable under the Georgia Arbitration Code.

Except for arbitration agreements between two or more insurers, the Kentucky statute KRS section 417.050 not only precludes arbitration agreements providing for arbitration contained in insurance contracts but *any* arbitration agreement providing for arbitration of a dispute *arising* from an insurance contract.[112] That is, through KRS section 417.050 the Kentucky legislature has expressly prohibited pre-dispute agreements providing for mandatory arbitration of disputes, as well as post-dispute agreements to arbitrate disputes arising from a contract of insurance. According to the Supreme Court of Kentucky, "the legislature exempted future disputes from being subjected to compulsory arbitration because such contracts are contracts of adhesion to which the insured parties have limited bargaining power."[113] This reasoning, however, only explains the legislative prohibition of pre-dispute mandatory arbitration agreements; but it certainly does not explain why the Kentucky legislature would want to prohibit arbitration agreements between a policyholder and an insurer to submit existing controversies to arbitration. No legitimate reason comes to mind.

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110 GA. CODE ANN. § 9-9-2.

111 *See* McGowan v. Progressive Preferred Ins. Co., 281 Ga. 169, 172-173 (2006).

112 *See* KRS § 417.050; Buck Run Baptist Church, Inc. v. Cumberland Sur. Ins. Co., Inc., 983 S.W.2d at 502-504. KRS § 417.050 provides, in its pertinent part, the following:

> A written agreement *to submit any* existing *controversy to arbitration* or a provision in written contract to submit to arbitration any controversy thereafter arising between the parties is valid, enforceable and irrevocable, save upon such grounds as exist at law for the revocation of any contract. This chapter does not apply to:
>
> (1) ...
>
> (2) Insurance contracts. Nothing in this subsection shall be deemed to invalidate or render unenforceable contractual arbitration provisions between two (2) or more insurers, including reinsurers (emphasis added).

113 Buck Run Baptist Church, Inc. v. Cumberland Sur. Ins. Co., Inc., 983 S.W.2d at 504.

IV. The New York Convention Escapes the McCarran-Ferguson Reverse-Preemption Rule

Recently, in *Safety Nat'l. Casualty Corp. v. Certain Underwriters at Lloyd's, London,* the Fifth Circuit addressed *en banc* the question of whether the Convention on the Recognition and Enforcement of Foreign Arbitral Awards[114] ("New York Convention") and its implementing legislation ("Convention Act")[115] is an "act of Congress" as used in section 1012 of the McCarran-Ferguson Act.[116] Section 1012, as discussed in Part II, is the provision related to the reverse-preemption effect of State statutes regulating the business of insurance over federal statutes that do not specifically relate to the business of insurance.

The Fifth Circuit held that the New York Convention is not an "Act of Congress" as used in McCarran-Ferguson, but a contract negotiated by the Executive Branch and ratified by the Senate.[117] Moreover, the Court reasoned that even if the New York Convention were a non-self executing treaty, "[t]he fact that a treaty is implemented by Congress does not mean that it ceases to be a treaty and becomes an 'Act of Congress'."[118]

Safety Nat'l. is a diversity case between two insurance companies to which Louisiana law applies. According to the facts, the Louisiana Safety Association of Timbermen-Self Insurers Fund ("LSAT") is a self-insurance fund operating in that State. Certain Underwriters at Lloyd's, London ("Underwriters") provided LSAT with excess insurance by reinsuring certain insurance claims for occupational-injury insurances. All the reinsurance contracts between the parties contained arbitration agreements. However, as I have discussed in detail, arbitration agreements contained in insurance contracts are not enforceable under Louisiana law.

Safety National Casualty Corporation ("Safety") claimed that in a loss portfolio transfer agreement, LSAT assigned Safety its rights under the reinsurance contracts with the Underwriters. After the Underwriters refused to recognize the assignment, Safety sued the Underwriters in the District Court of Louisiana. The Underwriters filed a motion to stay the proceedings and to compel arbitration, which the district court granted.

The Underwriters, Safety and LSAT commenced the arbitration proceedings, but could not agree on how to select the arbitrators. When the Underwriters sought the assistance of the court on the composition of the arbitration panel,

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114 21 U.S.T. 2517, June 10, 1958.

115 9 U.S.C. §§ 201 *et seq*.

116 *See* 15 U.S.C. § 1012(b) ("[n]o Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance... unless such Act specifically relates to the business of insurance").

117 *See* Safety Nat'l. Casualty Corp. v. Certain Underwriters at Lloyd's, London, 587 F.3d at 722-723.

118 *Id*.

LSAT intervened and moved to quash arbitration arguing that the arbitration agreements in the reinsurance contracts are unenforceable under Louisiana law. The district court reconsidered its initial order compelling arbitration and granted LSAT's motion to quash arbitration. It concluded that the New York Convention is an "Act of Congress" under the McCarran-Ferguson Act, and that the Louisiana statute interpreted as prohibiting arbitration agreements in insurance contracts reverse-preempted the New York Convention.

The Fifth Circuit reversed *en banc*. Since none of the parties challenged the district court's conclusion that Section 22:868 of the Louisiana Revised Statutes regulates the business of insurance within the meaning of the McCarran-Ferguson Act, the Circuit limited its inquiry to determine whether the New York Convention is an "act of Congress" under the McCarran-Ferguson Act (in which case, it would be open to reverse-preemption by the Louisiana anti-insurance arbitration statute). While LSAT conceded that the New York Convention would not be reverse-preempted by the McCarran-Ferguson Act and the Louisiana anti-insurance arbitration statute *if* the New York Convention was deemed to be a self-executing treaty, the Court concluded that the commonly understood meaning of an "Act of Congress" (as used in the McCarran Ferguson Act) does not include a treaty, even if—like the New York Convention—the treaty required implementing legislation.[119] A treaty, the Court reasoned, is not an "act of Congress" because a treaty is ratified only by the Senate and not by both legislative houses. The Court found no reason why Congress would choose to make a distinction between self-executing and non self-executing treaties in the McCarran-Ferguson Act.[120]

In its analysis, the Court examined the provisions of the FAA that deal with the NY Convention (the "Convention Act"),[121] and noticed that, among other things, the Convention Act regulates the jurisdiction of the courts. Nevertheless, the Court highlighted that "the Convention Act does not . . . operate without

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119 587 F.3d at 723.

120 Regarding this particular issue, the Court in *Safety Nat'l.* said:

> Even if the Convention required legislation to implement some or all of its provisions in United States courts, that does not mean that Congress intended an "Act of Congress," as that phrase is used in the McCarran-Ferguson Act, to encompass a non-self-executing treaty that has been implemented by congressional legislation. Implementing legislation that does not conflict with or override a treaty does not replace or displace that treaty. A treaty remains an international agreement or contract negotiated by the Executive Branch and ratified by the Senate, not by Congress. The fact that a treaty is implemented by Congress does not mean that it ceases to be a treaty and becomes an "Act of Congress."

587 F.3d at 722-723; *See also* AKHIL REED AMAR, AMERICA'S CONSTITUTION: A BIOGRAPHY 303 (2005) (arguing that federal statutes should prevail over conflicting federal treaties because "[a]fter all, treaties cut the House of Representatives out of the loop.")

121 9 U.S.C. §§ 201 *et seq*.

reference to the contents of the Convention"; it directs courts to the text of the treaty it implemented.[122] Furthermore, the Court asserted that—

> [i]t is *the Convention* under which legal agreements "fall"; it is an action or proceeding under *the Convention* that provides the court with jurisdiction; such an action or proceeding is "deemed to arise under the laws *and treaties*" of the United States, the treaty in this case being the Convention; and when chapter 1 of title 9 (the FAA) conflicts with the Convention, *the Convention* applies.[123]

I agree with the Fifth Circuit's holding and rationale in this case. From a practical standpoint, the strong national policy favoring arbitration should prevail over a broader-than-necessary Louisiana statute conflicting with such policy; the nature of the parties involved and the nature of the dispute in which arbitrability is in question make the Louisiana anti-insurance arbitration statute seem without purpose. The controlling question of law presented in *Safety Nat'l.* is a rather complicated constitutional matter, as is evidenced by the discussion engaged between the dissenting opinion and the opinion of the majority of the Circuit Court, as well as the work of legal experts in the field.[124] The issue is now pending before the consideration of the Supreme Court,[125] and is beyond the scope of this paper. Irrespective of the final result of this case, I believe it should serve as a wake-up call to the Louisiana legislature to revise and modify the scope of Section 22:868.

V. CONCLUSION

It is understandable that States would want to protect policyholders from actual and potential abuses from insurance companies. While legitimate concerns have been formulated against arbitration procedures, particularly when arbitration agreements are contained in contracts of adhesion where one of the contracting parties has little or no bargaining power against the other,[126] the preclusion of arbitration agreements in contracts of insurance is a rather extreme measure in evident tension with the strong national public policy favoring arbitration.

Instead of precluding arbitration agreements, there are less drastic alternatives that can be adopted by State legislatures that will allow the contracting parties the benefit and liberty of choosing between arbitration and litigation. At

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122 587 F.3d at 724-725.

123 *Id.* (emphasis in the original).

124 *See* RICHARD H. FALLON, JR., ET AL., HART AND WECHSLER'S THE FEDERAL COURTS AND THE FEDERAL SYSTEM 712-714, (6th ed. 2009); AMAR, *supra* note 120, at 304-306.

125 *See* Safety Nat'l Casualty Corp. v. Certain Underwriters at Lloyd's, London 587 F.3d 714 (5th Cir. 2009) *petition for cert. filed sub nom.* Louisiana Safety Association of Timbermen - Self Insurers Fund v. Certain Underwriters at Lloyd's, London, et al. No. 09-945.

126 *See* Part II above.

the same time, if the parties choose arbitration, these alternatives will provide for safety measures against abuses of the arbitration procedure and against arbitrary decisions from the arbitrator or arbitral panel. State legislatures can either adopt all of the following proposals or only those deemed necessary, depending on the desired balance between governmental control and party autonomy: (1) preclude arbitration agreements in insurance contracts only when the policyholder is a natural person; (2) preclude arbitration of insurance disputes when the underlying claim does not exceed the amount of $50,000.00 (or any other reasonable amount); (3) provide that the arbitrator or arbitral panel must decide the controversy in accordance with applicable substantive law; (4) provide for the review of arbitration awards, if so requested to the court by one of the parties in the confirmation stage, consisting of a review for errors of law and clearly erroneous findings of fact, provided that courts may set aside an award if the findings of fact have no basis in the record;[127] and (5) if the policyholder results victorious, the policyholder will have the right to recover costs and arbitration fees from the insurer.

Through the adoption of some or all of these proposals, those jurisdictions that have enacted legislation and developed case law precluding arbitration agreements in insurance policies or the arbitration of disputes arising out of contracts of insurance –like Kentucky-, may explore a different avenue to effectively address their concerns. For example, requiring the arbitrators to decide the insurance controversies before them in accordance to the applicable substantive law and providing for the review of the award will allow courts to more closely supervise arbitration awards on their merits. By the same token, the parties will be able to benefit from the speedier, informal and relaxed procedures of arbitration.[128] If the parties choose to have the dispute decided by an arbitration

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127 *Cf.* Hall Street Associates, L.L.C. v. Mattel, Inc., 552 U.S. 576, 579 ("One paragraph of the agreement provided that '[t]he United States District Court for the District of Oregon may enter judgment upon any award, either by confirming the award or by vacating, modifying or correcting the award. The Court shall vacate, modify or correct any award: (i) where the arbitrator's findings of facts are not supported by substantial evidence, or (ii) where the arbitrator's conclusions of law are erroneous.'"); Krygoski Const. Co., Inc. v. U.S., 94 F.3d 1537, 1540 (Fed. Cir. 1996) ("This court reviews Court of Federal Claims decisions for errors of law and clearly erroneous findings of fact"); 3 L.P.R.A. § 2175 ("The findings of fact of the decisions of the agencies shall be upheld by the court if they are based upon substantial evidence contained in the administrative files. All aspects of conclusions of law shall be reviewable by the court."); Otero v. Toyota, 163 D.P.R. 716, 727-29 (2005).

128 *But see* Hall Street Associates, L.L.C. v. Mattel, Inc., 552 U.S. at 588 ("Instead of fighting the text, it makes more sense to see the three provisions, [Sections 9-11 of the FAA], as substantiating a national policy favoring arbitration with just the limited review needed to maintain arbitration's essential virtue of resolving disputes straightaway. Any other reading opens the door to the full-bore legal and evidentiary appeals that can "rende[r] informal arbitration merely a prelude to a more cumbersome and time-consuming judicial review process . . . and bring arbitration theory to grief in post-arbitration process.") While the incidental procedural effects of a broader review standard are still to be seen, the dissenting opinion by Justice Stevens, joined by Justice Kennedy, makes a fairly good point in asserting that—

panel instead of a sole arbitrator, then each party will have the benefit of appointing an arbitrator, an alternative that is not available in the court system. In addition, the parties will be able to tailor the qualifications that the appointed arbitrator(s) should have, which is another important advantage of arbitration.

Even though, for the reasons discussed in Part II the reverse-preemption effect of these anti-insurance arbitration statutes over the FAA is debatable, under the reasoning of the Tenth and Eight Circuit in *Mutual Reinsurance Bureau* and in *West*, a State statute adopting any or all of these proposals to regulate the arbitration of insurance disputes will supersede the provisions of the FAA under the McCarran-Ferguson reverse-preemption rule.

> [w]hile § 9 of the FAA imposes a 1-year limit on the time in which any party to an arbitration may apply for confirmation of an award, the statute does not require that the application be given expedited treatment. Of course, the premise of the entire statute is an assumption that the arbitration process may be more expeditious and less costly than ordinary litigation, but that is a reason for interpreting the statute liberally to favor the parties' use of arbitration. An unnecessary refusal to enforce a perfectly reasonable category of arbitration agreements defeats the primary purpose of the statute.

Id.

2009 SEC PROXY AMENDMENTS: A PROBLEMATIC SOLUTION TO SHAREHOLDER DIRECTOR NOMINATION

ARTICLE

NICHOLAS D. HARKEN*

> The corporate election process, if it is to have any validity, must be conducted with scrupulous fairness and without any advantage being conferred or denied to any candidate or slate of candidates.
> -Vice Chancellor Hartnett[1]

I. INTRODUCTION

SHAREHOLDERS ELECT DIRECTORS, BUT THEY TYPICALLY DO NOT SELECT them.[2] THE apparent paradox of that statement has been the subject of significant discussion regarding the effectiveness of the corporate election process.[3] While corporate scholars generally agree that the shareholder election is intended to ensure that directors are accountable to shareholders, the

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1 Aprahamian v. HBO & Company, 531 A.2d 1204, 1206 (Del. Ch.1987).

2 *See* JEFFREY D. BAUMAN ET AL., CORPORATIONS LAW AND POLICY 491 (Thomson West ed., 6th ed. 2007).

3 *See* discussion *infra* Parts I.B, I.C.

disagreement is whether it has that effect.[4] That disagreement has, consequently, resulted in debate over whether shareholders should have a more meaningful role in the selection of directors through proxy contests.[5] Under current election rules, shareholders may offer a competing slate of directors for election through a proxy contest, but significant costs in mounting such a contest serve as an effective barrier to pursuing that action.[6] Supporters of corporate election reform argue that the rules governing proxy contests should be amended to facilitate shareholders' ability to nominate and elect directors.[7]

On June 10, 2009, the Securities and Exchange Commission (SEC) proposed amendments to the federal proxy rules that would facilitate shareholders' ability to nominate directors to company boards of directors.[8] The amendments would allow nominees of dissident shareholders to avoid the full expense of a proxy campaign and the current requirement to print and mail their own proxy statement.[9] Instead, if shareholders met certain requirements, they could submit their nomination to the company, and the company would have to include it in their own proxy statement.[10]

Not surprisingly, the proposed amendments to the federal proxy rules have been very contentious. Since proposed, they generated more than 500 comment letters during the initial comment period,[11] and the SEC postponed its decision on the proposed amendments until 2010 to review the comments.[12] Recently, the SEC re-opened the comment period, and a final ruling is still pending.[13]

In this paper I argue that the SEC proposal is appropriate. However, *whether* proxy reform is appropriate is a separate question from *how* it should be accomplished. Although I agree with the SEC that shareholders eligible to nominate directors should be restricted to shareholders with long-term

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4 *See* discussion *infra* Parts I.B.

5 *Compare, e.g.*, Lucian Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675 (2007), *with* Martin Lipton & William Savitt, *The Many Myths of Lucian Bebchuk*, 93 VA. L. REV. 733 (2007).

6 *See* discussion *infra* Part I.A.

7 Leo E. Strine, Jr., *Breaking the Corporate Governance Logjam in Washington: Some Constructive Thoughts on a Responsible Path Forward*, 63 BUS. LAW. 1079, 1085-86 (2008) (discussing the SEC's role on Proxy access and corporate elections).

8 Facilitating Shareholder Director Nominations, 74 Fed. Reg. 29024 (proposed June 10, 2009) (to be codified at 17 CFR pts 200, 232, 240, 249 and 274).

9 *Id.*

10 *Id.*

11 Posting of Annette L. Nazareth to Harvard Law School Forum on Corporate Governance and Financial Regulation, http://blogs.law.harvard.edu/corpgov/2009/10/06/sec-urged-to-defer-adopting-proxy-access-rules/#more-4419 (October 6, 2009 at 9:01 am EST).

12 Jesse Westbrook, *SEC to Delay Proxy-Access Rule, Giving Banks Reprieve*, BLOOMBERG, Oct. 2, 2009, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aCVx6r4wx15Q.

13 Facilitating Shareholder Director Nominations, 74 Fed. Reg. 67144 (re-opening of comment period Dec. 14, 2009).

investment interests, I argue that the SEC's proposed one-year holding requirement—that shareholders who seek to have their nominees included in the proxy materials to have held their shares for at least one year—fails to identify those *long-term* shareholders.

Part I of this paper addresses the controversy over the director election process and whether proxy access should be facilitated. This discussion looks at the director election process in its current form as well as past occurrences of proxy contests. As I argue in the latter sections within this Part, the election process, including proxy contests, in its current form cannot be considered to ensure that directors are accountable to shareholder interests. Thus, the SEC's proposal to remove impediments to shareholders' rights to nominate and elect directors should be approved so that director accountability to shareholders is established. Furthermore, removing such impediments will have other benefits such as keeping U.S. corporations and its capital markets competitive on a global scale in addition to weakening arguments that shareholders should have more say on specific corporate matters—such as executive compensation—which intrude more directly into directors' decision-making functions.

Part II addresses the question of whether the SEC's specific proposals for facilitating shareholders are appropriate. As I argue in this section, because the SEC's proposal lacks a retention period following an election, the one-year holding requirement falls short of its purpose to restrict shareholders eligible to nominate directors to those shareholders that are long-term shareholders and, thus, more likely to have interests that are better aligned with other shareholders.

Relying on a recent study documenting stock value trends following proxy contests, in Part III I propose that the SEC's holding requirement include a minimum eighteen-month retention period of shares after an election if the shareholder's nominated director is elected. This retention period would effectively eliminate an incentive to nominate directors solely to achieve a short-term "spike" in stock value rather than to nominate directors that would contribute to the long-term success of the company. This Part ends with a discussion of the enforcement mechanism for the retention period. Part V then concludes.

II. Removing Impediments to Nominate and Elect Directors

This part begins with a discussion of the largely symbolic nature of the shareholder vote as a result of the election process in its current form. Included in this discussion is empirical evidence indicating that although proxy contests are available to shareholders, they are rarely used apart from a small population of hedge funds. Section B begins the discussion as to why facilitating shareholder proxy access is necessary to maintain the election process as an accountability mechanism. Section C discusses other benefits to facilitating shareholder proxy access.

A. Director Election in its Present Form

Corporate law textbooks often begin their discussion of the shareholders' role in corporations with a fundamental tenet of corporate law governance: shareholders elect directors, and the directors manage the business and affairs of the corporation.[14] But students of corporate law do not have to read far to learn that, despite that tenet, shareholders have no such power in publicly-held corporations. Rather, the shareholder vote is little more than a formality:

> Shareholders, to be sure, formally *elect* directors, but rarely do they play a meaningful role in *selecting* them. The rules governing proxy voting make it impractical for most shareholders to nominate or solicit support for board candidates. Incumbent directors, who control access to the corporation's proxy materials and can use corporate funds for proxy solicitations, effectively determine who is nominated—and thus who is elected. The corporation's CEO is far more likely to influence these decisions than any shareholder or shareholder group.[15]

The futility of the shareholder vote is evident even when considering recent shareholder "empowerment" measures such as majority voting or a withhold vote campaign.[16] First, a "holdover" default rule in many jurisdictions allows directors, who are not reelected as a result of majority voting or a withhold vote campaign, to stay on as director until a new director is elected.[17] And even without a holdover rule, directors are often simply reinstated, although they have failed to win the majority of votes.[18] Thus, the election process—regardless of whether it involves majority voting or a withhold vote campaign—remains a mere formality in the board's and chief executive's ultimate sole ability to select the board members.[19]

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14 *See, e.g.*, JEFFREY D. BAUMAN ET AL., CORPORATIONS LAW AND POLICY 491 (Thomson West ed., 6th ed. 2007); LARRY R. SODERQUIST ET AL., CORPORATE LAW AND PRACTICE, 147 (Practicing Law Institute ed., 2nd ed. 1999).

15 BAUMAN ET AL., *supra* note 14, at 491.

16 *See generally* J.W. Verret, *Pandora's Ballot Box, Or a Proxy with Moxie? Majority Voting, Corporate Ballot Access and the Legend of Martin Lipton Re-Examined*, 62 BUS. LAW. 1007 (2007) (discussing the majority voting and withhold vote campaigns).

17 *See id.* at 1018-19 (noting that the MBCA recognized that the holdover rule in states such as Delaware make a majority voting bylaw largely symbolic).

18 Joann S. Lublin, *Director Lose Elections, but Not Seats; Staying Power of Board Members Raises Questions About Investor Democracy*, WALL ST. J., Sept. 28, 2009, at B4. (signaling that ninety-three board members at fifty companies in 2009 received fewer than 50% of votes cast during annual meetings, and none of those directors lost their position on the board—after directors failed to win majorities at the annual meetings, they submitted their resignations, but fellow directors simply reappointed them).

19 Ann M. Scarlett, *A Better Approach for Balancing Authority and Accountability in Shareholder Derivative Litigation*, 57 U. KAN. L. REV 39, 45 (2008) ("Even director elections are essentially determined by the existing board, because the existing board typically nominates the slate of directors on which shareholders then vote.").

Of course shareholders may nominate directors, but they can only do this through a costly proxy contest.[20] Still, all costs for the campaigns of the board's nominees are paid for out of corporate funds.[21] The inequity of that proxy access was expressed in a comment on the 2003 SEC proposal to facilitate shareholder proxy access:

> [Shareholders] can run their own slate of candidates, paying 100 percent of the costs, which may come to hundreds of thousands or even millions of dollars, for only a pro rata share of any increase in shareholder value as a result of the contested election. Meanwhile, management will spend the shareholders' money to fight them. This is not a level playing field. It is close to perpendicular.[22]

To be sure, the 2006 SEC e-proxy rule allowing for online proxy solicitation lowered proxy contest costs.[23] However, the SEC continues to recognize that shareholders still face significant costs in undertaking proxy contests.[24] Furthermore, although a decrease in costs resulting from the 2006 e-proxy SEC rule would perhaps result in a greater number of shareholder proposals, this has not happened. In an analysis of the 2008 proxy season by Georgeson Shareholder, a well-known proxy solicitation firm, Georgeson noted that the number of shareholder proposals submitted to companies on governance-related topics in 2008 was the fourth lowest out of the past five years—down 2% from 2007 and 15% from 2004.[25] Georgeson did note, however, that proxy contests increased significantly in 2007 and 2008; but Georgeson contributed the rise to factors such as the declining market and media focus rather than lower costs as a result of the 2006 SEC e-proxy rule.[26]

Given the costs associated with proxy contents, not surprisingly, shareholders have rarely offered their own competing slate of candidates; even in such instances, the success rates are unremarkable. Based on empirical evidence of director elections from October 1984 through September 1990, Joseph Grundfest noted that the probability of conducting a successful proxy contest

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20 *See* Joseph A. Grundfest, *Just Vote No: A Minimalist Strategy for Dealing with the Barbarians Inside the Gates*, 45 STAN. L. REV. 857, 909 (1993).

21 BAUMAN ET AL., *supra* note 14, at 491-92.

22 Summary of Comments: In Response to the Commission's Proposed Rules Relating to Security Holder Director Nominations, Exchange Act Release No. 34-48626, http://www.sec.gov/rules/extra/s71903summary.htm (last visited May 9, 2010); *see also* Grundfest, *supra* note 20, 909 (illustrating the absence of incentive to conduct a proxy contest).

23 *See* Press Release, Securities and Exchange Commission 2006-209, SEC Votes to Adopt E-Proxy Rule Amendments and Propose Mandatory Model (Dec. 13, 2006), *available at* http://www.sec.gov/news/press/2006/2006-209.htm.

24 *2009 SEC Proposal*, *supra* note 8, at 29028.

25 Georgeson S'holder, 2008 ANNUAL CORPORATE GOVERNANCE REVIEW, (2008), at 4, http://www.georgesonshareholder.com/usa/download/acgr/acgr2008.pdf.

26 *Id.* at 8, fig. 19 at 46.

was only 0.175%.[27] Additionally, Lucian Bebchuk's more recent 2007 study indicated that from 1996 to 2005, incumbent directors faced a competing slate of candidates in only 118 elections.[28] Forty-five of the 118 elections were successful—an average of about 5 per year.[29] To roughly compare Bebchuk's data to Grundfest's earlier study, the probability of a proxy contest achieving any success in a single year from 1996 to 2005 was only 0.000633%.[30]

Indeed, proxy contests do occur, and the past several years have seen an increase in them.[31] However, those contests were almost entirely conducted by hedge funds.[32] And not only does hedge fund capital *pale in comparison* with capital from other investors,[33] but hedge funds, one researcher has noted, are not *normal* investors.[34] They primarily launch proxy fights for corporate control so that their short-term investment agendas can be carried out.[35] Certainly, the proxy rules should not exist for the almost exclusive use of a small population of hedge funds with relatively little capital in the markets and which pursue short-term results.

Ultimately, most shareholders offering a competing slate of directors not only face the reality that the costs of such a campaign are recovered only through a relatively minimal (and uncertain) increase in stock price, but they also face risk of not even being successful in having their slate elected. These

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27 Grundfest, *supra* note 20, at 862-63 n.17.

28 Bebchuk, *supra* note 5, at 685-86 tbl. 2.

29 *Id.* at 687 tbl. 4.

30 The percentage was arrived at by dividing the average successful proxy contests per year (5) with total 7896 firms listed on Amex, NASDAQ, and NYSE in 2001 which had individually 704, 4,378 and 2,814 registered firms, respectively. *See* U.S. GEN. ACCOUNTING OFFICE, SECURITIES REGULATION: IMPROVEMENTS NEEDED IN THE AMEX LISTING PROGRAM, 5 (2001), http://www.gao.gov/new.items/d0218.pdf. This is a similar method that Grundfest applied in arriving at his probability. *See* Grundfest, *supra* note 20, at 862, n.17. The much lower probability Bebchuk arrives at may reflect both a decrease in proxy contests in recent years as well as Bebchuk controlling for contested proxy solicitations that did not involve director replacement. *See* Bebchuk, *supra* note 5, at 684-85 (eliminating solicitations that involved matters such as whether a merger proposal should be approved or whether bylaws should be amended).

31 CHRIS CERNICH ET AL., INVESTOR RESPONSIBILITY RESEARCH CTR. INST., EFFECTIVENESS OF HYBRID BOARDS 5 (May 2009), http://www.irrcinstitute.org/pdf/IRRC_05_09_EffectiveHybridBoards.pdf (noting that from 2005 to 2008 proxy contests rose from 18 to 45).

32 *Id.* at 12 (noting that hedge funds initiated 89% of all proxy contests conducted between 2005 and 2008).

33 BARRY J. EICHENGREEN ET AL., HEDGE FUNDS AND FINANCIAL MARKET DYNAMICS 6 (Int'l Monetary Fund ed., 1998) (estimating that capital in hedge funds is just under $110 billion and capital in institutional investors exceeds $20 trillion).

34 Thomas W. Briggs, *Corporate Governance and the New Hedge Fund Activism: an Empirical Analysis,* 32 J. CORP. L. 681 (2007).

35 *Id. See also* Nadelle E. Grossman, *Turning a Short-Term Fling into a Long-Term Commitment: Board Duties in a New Era*, MICH. J. L. REFORM (forthcoming June 2009) (manuscript at 26-30, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1413949).

formidable risks make the proxy contest effectively impractical.[36] One commentator stated regarding the bleak reality of shareholder voting: "Democracy is a cruelly misleading word to describe the situation of the American shareholder."[37]

B. Promoting Director Accountability to Shareholders

If shareholders lack any meaningful ability to elect directors not nominated by the incumbent board and managers, why does corporate America even bother with shareholder election of directors? While the specific reasons for it may depend on one's theory of the firm,[38] corporate scholars agree that shareholder election of directors promotes accountability of directors to shareholders.[39] Bebchuk further notes that Delaware courts recognize the superior accountability mechanism of the shareholder power to replace directors and, consequently, the courts abstain from heavily scrutinizing director decisions.[40] To signify the Delaware courts' deference to director decisions as a result of the election process, Bebchuk quotes Chancellor Chandler in the *Disney* shareholder suit: "redress for [directors'] failures . . . must come . . . through the action of shareholders . . . and not from this Court."[41] Thus, the election process serves not only as a basis for director accountability, but it also serves to legitimize the exercise of power by the directors.[42]

Even opponents of shareholder empowerment initiatives note that shareholder election of directors serves as an important accountability mechanism. For example, in several articles, leading corporate governance

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36 The impracticality of the proxy contest, as supported by empirical evidence, severely weakens the assertion that a proxy contest is a viable option employed by shareholders. *See* Bebchuk, *supra* note 5, at 682 (noting the New York Bar Association inappropriately stated that "[u]nder the existing proxy rules, running an election contest is a viable alternative and a meaningful threat, and election contests occur regularly.").

37 *Special Report: Battling for corporate America—Shareholder democracy*, THE ECONOMIST, March 11, 2006, at 75 (quoting Bob Monks, a shareholder activist).

38 *Compare, e.g.*, ADOLF BERLE & GARDINER MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (Transaction Publishers 1991) (1932) (indicating that shareholders vote as owners of the corporation) *with* Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416 (1989) (indicating that the shareholder vote arises out of a contractual relationship).

39 *See, e.g.*, Scarlett, *supra* note 19, at 45; Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV 547, 570 (2003). In the context of this paper, director accountability to shareholders is not intended to suggest that directors are accountable only to shareholders. As many have recognized recently, directors need to be cognizant of the interests of other stakeholders. E.g., Grossman, *supra* note 35; Margaret M. Blair & Lynn A. Stout, *Director Accountability and the Mediating Role of the Corporate Board*, 79 WASH. U. L.Q. 403 (2001).

40 *See* Bebchuk, *supra* note 5, at 680.

41 *Id.* (quoting In re Walt Disney Co. Derivative Litig., 907 A.2d 693, 698 (Del. Ch. 2005)).

42 *See also* Blasius Industries, Inc., v. Atlas Corp., 564 A.2d. 651, 659 ("[Voting] is critical to the theory that legitimizes the exercise of power by some (directors and officers) over vast aggregations of property that they do not own.").

scholar Stephen Bainbridge explains the role of the shareholder vote: "[Shareholder interest] is enforced indirectly through a complex and varied set of extrajudicial accountability mechanisms, of which shareholder voting is one."[43] Again Bainbridge states that the market for corporate control as an important accountability mechanism "depends on the existence of shareholder voting rights".[44]

Indeed, a proxy contest should be used sparingly so that directors have adequate freedom to make decisions affecting the business and affairs of the corporation.[45] However, the current form of the election process and, consequently, the role of the vote as an accountability mechanism beg the question: shareholder election of directors cannot promote accountability when the shareholder vote is largely a symbolic formality.

The intent of this paper is not to conclude that a higher proxy contest rate is needed; as Martin Lipton points out, concluding whether the annual rates of proxy contests are somehow too low is difficult.[46] But this author disagrees with Martin Lipton's presumption that the low number of contested elections "reflects the simple truths that director nomination process works" and "that incumbent directors are far more often than not the best people for the job."[47] An equally, if not more, reasonable presumption is that the low number of proxy contests is a result of the high costs of mounting a proxy contest coupled with only minimal potential benefits.[48]

Consequently, the low rate of proxy contests as a reflection that incumbent directors are "the best people for the job" can be considered reliable only if financial impediments to proxy contests are removed. Related to that, the election process as an adequate mechanism for director accountability can be established only if the ability of shareholders to select directors is based on their fundamental right to elect directors rather than on financial constraints impeding shareholders from considering a slate of directors not nominated by an incumbent regime. In arguing for greater shareholder proxy access in 2007, then-SEC Commissioner Annette L. Nazareth stated:

> [A] system in which there is a reasonable possibility that shareholders could nominate directors would serve as an important reminder to Boards that they are accountable to their shareholders. Even if a shareholder-nominated director

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43 Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1750 (2006).

44 Bainbridge, *supra* note 39, at 570.

45 Bainbridge, *supra* note 43, at 1750-52.

46 Lipton & Savitt, *supra* note 5, at 740.

47 *Id.*

48 *See* discussion *supra* Part I.A; s*ee also* Leo E. Strine, Jr., *Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate America*, 119 HARV. L. REV. 1759, 1781 (2006) (stating that reimbursing shareholders for proxy contests would "help alleviate the real barrier to electoral challenges").

never is elected, the real possibility of that election would serve a useful purpose in maintaining Board accountability.[49]

C. Additional Benefits of Removing Impediments to Proxy Contests

Removing impediments to proxy contests will likely create benefits beyond simply establishing director accountability to shareholders. First, while opponents to any shareholder empowerment initiative have pointed to *past* performance of U.S. corporations to question whether any fundamental changes in corporate governance are needed,[50] the more important issue is whether failing to remove impediments may put U.S. corporations and its capital markets at a competitive disadvantage *in the future*. Two points can be made on that assertion: (1) other countries have been implementing laws that facilitate shareholder proxy access in foreign corporations; and (2) emerging evidence indicates that shareholder access to corporate ballots increases corporate value. Second, although a more indirect effect, opponents of shareholder empowerment initiatives should concede to removing proxy impediments because, as many have stated, having greater shareholder access to election proxies weakens the argument that shareholders should also have more say on other more specific matters—such as executive compensation—which would intrude more directly on director discretion in overseeing corporate matters.[51]

With regard to the first point, in 2006 the SEC stated that "[t]he strength of shareholder rights in publicly traded firms directly affects the health and efficient functioning of U.S. capital markets."[52] The SEC further noted that "[o]verall, shareholders of U.S. companies have fewer rights in a number of important areas than do their foreign competitors. This difference creates an important potential competitive problem for U.S. companies."[53] Accordingly, if increased shareholder rights increase corporate value, then the public would be much more willing to invest in those corporations allowing for such rights—which are currently foreign corporations.[54]

Specifically with regard to corporate value, the SEC found that "[s]hareholder rights serve the critical function of reducing the agency costs associated with the potential divergence of interests between professional

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49 Annette L. Nazareth, Comm'r, U.S. Sec. & Exch. Comm'n, Speech by SEC Commissioner: Opening Statement--Shareholder Proposals Relating to the Election of Directors (Nov. 28, 2007) (transcript *available at* http:// www.sec.gov/news/speech/2007/spch112807aln.htm).

50 *E.g.*, Lipton & Savitt,, *supra* note 5, at 734.

51 *American Corporate Governance: Hail, Shareholder!*, THE ECONOMIST, June 2, 2007, at 65.

52 COMM. ON CAPITAL MKT. REGULATION, INTERIM REPORT OF THE COMM. ON CAPITAL MKTS REGULATION 16 (Nov. 30, 2006), http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf.

53 *Id.*

54 *Id.*

managers and dispersed public shareholders."[55] Absent sufficient shareholder rights, however, investors reduce the value of shares due to the expected higher agency costs.[56] Because U.S. corporate law lags behind in shareholder rights when compared to foreign law, that affects both the value of U.S. corporations and its public markets: U.S. corporations are valued less than their potential as a result of inadequate shareholder rights, and foreign corporations likewise would have "an incentive either not to enter the U.S. public markets in the first place or to exit them in response to inadequate legal protection of shareholder rights."[57]

Additionally, emerging evidence suggests that shareholder access to the corporate ballot improves corporate value. A recent 2009 study by Investor Responsibility Research Center Institute (IRRC) analyzed 120 "hybrid boards"—boards with members elected from proxy contests—formed from 2005 through 2008.[58] On average, from the beginning of the contest period through the first year of a hybrid board's existence, those companies' total share price returns were 19.1 percent—16.6 percentage points better than peers' total returns.[59] And the outperformance may not simply be a fleeting result of temporary higher bidding of shares by those who thought the company was underperforming and undervalued: initial results show that total share price performance through the three-year anniversary of a sample of fifteen hybrid boards averaged 21.5 percent—almost 18 percentage points more than their peers.[60] Although the increased share price was an average and companies with hybrid boards did not equally share in the same success,[61] the ability to mount a proxy contest appears to often translate into increased corporate value.

Finally, a more indirect benefit of increasing access to proxy contests is that it weakens the recent call for other shareholder empowerment initiatives pertaining to specific business matters.[62] As Stephen Bainbridge has noted,

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55 *Id.*

56 *Id.*

57 *Id.*

58 CERNICH ET AL., *supra* note 31, at 3.

59 *Id.* at 28.

60 *Id.* at 28. Perhaps contradicting his own position, Martin Lipton even notes evidence that proxy contests improve corporate performance. *See* Lipton & Savitt, supra note 5, at 742-43 n.31 (quoting Steven Gray, *Bigger Than They Look: How Can Investors with Small Stakes Have Such a Large Impact in Proxy Fights?*, WALL ST. J., Oct. 9, 2006, at R6.) In his parenthetical to that cite, Lipton writes "noting that a rising trend in proxy contests by small stakeholders is 'likely to persist, largely because investors are increasingly impressed with the improved performance at companies [where such proxy contests have succeeded]".

61 CERNICH ET AL., *supra* note 31, at 36 (noting that bankruptcy resulted in 5% of businesses in the sample of hybrid board, although the authors did not know if that was in fact a result of the hybrid boards).

62 *See, e.g.*, American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115, 516 (2009) (applying "say on pay" to companies receiving Troubled Asset Relief Program (TARP) funds); Corporate and Financial Institution Compensation Fairness Act of 2009, H.R. 3269, 111th Cong.

efficiency in corporate decision-making can only be established by "[a]chieving an appropriate balance between authority and accountability."[63] However, those accountability mechanism initiatives—such as shareholder approval of executive compensation—make the decision-making process of corporate boards less efficient because they intrude more directly into directors' decision-making functions.[64]

Rather, the proper balance should be achieved through improving shareholder access to the corporate ballot. As discussed above, legitimacy of directors to freely exercise their business judgments is partly a result of the shareholder election.[65] But because the shareholder vote as it presently exists is largely symbolic, then perhaps directors' decisions should be subject to federally-mandated referenda on specific corporate issues.[66] Alternatively, if shareholders are given adequate ability to elect their directors through more competitive elections, then directors accordingly should be given greater freedom to make decisions affecting the business and affairs of the corporation without input from shareholders.[67] One researcher expressed that latter view:

> [H]arried managers may conclude that the best approach is to adopt corporate-governance reforms that increase shareholder democracy and so give them a stronger mandate. If shareholders are able to elect directors and hold them properly accountable for their performance, then they should be more willing to let them get on with the job.[68]

III. Shortcomings of the Long-term Requirement

The equally important question to whether shareholders should have greater access to the corporate ballot is precisely how to accomplish that. To restate, the SEC's proposed amendments to the federal proxy rules gives shareholders greater access to the corporate ballot, provided that a nominating shareholder meets certain requirements. One important condition to shareholders' ability to nominate directors under the current SEC proposal is the SEC's one-year holding

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(seeking to regulate the executive compensation, partly through a "say on pay" provision, regardless of whether a corporation receives TARP funds).

63 Bainbridge, *supra* note 39, at 605.

64 *Id.*

65 *See supra* note 42 and accompanying text.

66 *See* Strine, *supra* note 7, at 1104 ("[Opponents'] argument against [the federal 'say on pay'] bill, however is weakened by the lack of progress on proxy access for election reform proposals.").

67 *See Id.*

68 *Hail, Shareholder!, supra* note 51; *see also* Julian Velasco, *Taking Shareholder Rights Seriously,* 41 U.C. DAVIS L. REV. 605, 662, 664 (2007) (stating that "[c]onsistent with their right to elect directors, shareholders should be permitted to nominate director candidates" but that shareholder "say on pay" is not a proper subject for shareholder action because "[u]nder state corporate law, directors have responsibility for setting officers' salaries, and shareholders do not have any say on the matter").

requirement.[69] It requires shareholders who seek to have their nominees included in the proxy materials to have held their shares for at least one year.[70] The purpose of the requirement is to restrict shareholders seeking proxy access to those with long-term interests, thus eliminating shareholders that may use a proxy contest for short-term gain.[71]

However, the one-year holding requirement falls short of its intended purpose. Rather, despite the holding requirement, the proposed proxy amendments present a powerful incentive to use them solely for short-term gain—specifically, taking advantage of the short-term "spike" in share value that typically follows proxy contests.[72]

Superficially, the requirement appears adequate for its intended purpose (although the SEC does not go into any depth as to the reasons behind the requirement). The one-year requirement presumably reflects the idea that shareholders do not need to have long holding periods because stock price reflects long-term value of a company and, thus, long-term value matters to all shareholders—regardless of whether they are short- or long-term shareholders. If a shareholder would want to change directors through a proxy contest, the shareholder would want to make a change that helps the company in the long term because that helps present stock price value.[73] Also, the one-year holding requirement theoretically eliminates many powerful short-term investors such as hedge funds, who typically only hold shares for an average of one and one-half quarters—consistent with their short-term investment practices.[74]

However, the one-year requirement does not adequately eliminate those shareholders that may use the proxy contest for short-term gain. First, initial analysis of comments in response to the SEC proposal suggests overwhelming support for it, but, interestingly, hedge funds favor the one-year holding period.[75] As the subsequent discussion will explain, while the one-year holding requirement does not entail a "short-term" investment in the traditional sense, the holding requirement does not eliminate incentives to seek purely short-term gain. Along with the fact that "activist" hedge funds hold onto their shares for one year or more,[76] that short-term incentive is likely why hedge funds do not

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69 *2009 SEC Proposal*, *supra* note 8, at 29037.

70 *Id.*

71 *Id.*

72 *See* discussion *infra*.

73 *See* William W. Bratton, *Supersize Pay, Incentive Compatibility and the Volatile Shareholder Interest*, 1 VA. L. & BUS. REV. 55, 67 (2006).

74 Robin Greenwood & Michael Schor, *Hedge Fund Investor Activism and Takeovers* 13 (Harvard Bus. Sch. Working Papers, Paper No. 08-004) (July 2007), *available at* http://www.hbs.edu/research/pdf/08-004.pdf.

75 Nazareth, *supra* note 11.

76 Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729 (2008), http://www.columbia.edu/~wj2006/HFActivism.pdf (finding that the holding period for activist hedge funds average from one year to 20 months).

view the one-year holding requirement as an obstacle to their short-term investment practices.

Second, with regard to share price reflecting the long-term value of a company, although long-term value may "matter" to all shareholders, a consistent shareholder perspective on value cannot be assumed.[77] As many have noted, "shareholder preference respecting investment policy, financial reporting, and payout policy vary with behavioral characteristics, time horizons, and the state of the market."[78] Thus, although all shareholders may be concerned with long-term value, shareholders do not always act rationally or primarily with a firm's long-term success in mind.[79]

For example, a shareholder, despite holding onto shares for one or even more than one year, may be enticed by an opportunity to achieve a short-term increase in stock price, regardless of its long-term effects.[80] William Bratton recognized this perverse short-term incentive with regard to stock options in executive compensation packages.[81] He noted that even stock options that have long vesting periods (such as the prevailing ten year duration) but are set to vest in the near future lure executives to manage for the short-term in order to quickly increase stock value as the vesting period nears.[82] If executives will soon acquire stock through option exercise, they have an incentive to choose a "glamour investment," although "[f]rom a long-term, fundamental value point of view, the glamour investment is sub-optimal."[83]

The perverse incentive inherent in stock options is also present in the context of proxy contests regardless of the SEC's proposed holding requirement. The above-mentioned IRRC proxy contest study indicates that share price spikes immediately after contested elections because investors perceive the proxy contest as an indication that the company was underperforming and undervalued.[84] Accordingly, the incentive for a shareholder to mount a proxy contest may be simply to achieve that short-term "spike" in value—especially if a company's stock price had been showing a lack of upward movement—rather than establishing true long-term success for the company. Once the short-term spike is achieved, the shareholder can simply sell its shares to capitalize on the increased value.

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77 *See* Bratton, *supra* note 73, 67-68.

78 *Id.*; *see generally* Lynn A. Stout, *The Mechanisms of Market Inefficiency: An Introduction to the New Finance*, 28 J. CORP. L. 635 (2002-2003) (discussing the fallacy of the Efficient Capital Market Hypothesis, which fails to capture the true value of companies due in large part to shareholder behavior).

79 *Id.*

80 *See* Bratton, *supra* note 73, at 71-73 (discussing perverse incentives inherent in stock options).

81 *Id.*

82 *Id.*

83 *Id.* Bratton defines a "glamour investment" as a high-risk, and potentially high-return investment. *Id.* at 71-72.

84 CERNICH ET AL., *supra* note 31, at 33-35.

Thus, the shortcoming of the holding requirement is that it fails to ensure that shareholders, who exercise their right to nominate a director once the right vests by way of the holding requirement, continue to have a significant economic interest in the company following the election. Similar to Bratton's analysis of stock options, here, simply because a shareholder's right to nominate a director vests as a result of meeting the one-year holding requirement, that holding period does not necessarily direct shareholders to nominate directors out of an incentive to create long-term value for the company. Rather, a shareholder, in order to achieve a short-term stock value spike typically associated with a proxy contest,[85] has an incentive to nominate a "glamorous" director—regardless of whether that director may be sub-optimal from a long-term value point of view—and then sell its shares to capitalize on their short-term increased value.

As a final note, the SEC-proposed requirement that nominating shareholders sign a statement disclosing their intent to continue to own their shares through the annual meeting and after the election cannot be considered an adequate measure to ensure that shareholders nominate directors out of long-term interests. First, the statement and disclosures appear to have no binding effect or repercussions associated with them if disregarded.[86] In fact, the SEC proposal even states that the "nominating shareholder or group would not be bound by the same fiduciary duties applicable to the members of a board's nominating committee in selecting director nominees."[87] Second, the hypothetical situation discussed above notes that simply holding the share through the meeting or until the next election does not eliminate the incentive to mount a proxy contest out of short-term interests or, in the words of the SEC, to ensure that a shareholder "continue[s] to have a significant economic interest in the company following the election."[88] Ultimately, the SEC's proposed one-year holding requirement does not ensure that only shareholders with long-term interest are eligible to nominate directors.

IV. Time Holds the Cure: Correcting the Long-term Shortcoming

The shortcoming of the one-year holding requirement is a result of the lack of an adequate requirement that shareholders retain their shares if their nominated director is elected. In the context of stock options, Bratton recognized that the perverse incentives for executives to manage for the short-term, in order to achieve a spike in share value upon an option vesting, was a result of the lack of a retention requirement on shares acquired through stock

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85 *See* discussion *supra* Part II.

86 *See 2009 SEC Proposal*, *supra* note 8, at 29047.

87 *Id.*

88 *Id.* at 20937.

options.[89] Given the similar criticisms of stock options and the proposed SEC holding requirement, Bratton's general recommendations to eliminate short-term incentives inherent in stock options provide general guidance as to how to improve upon the holding requirement.[90] Above all, the holding requirement must restrict alienation of shares *even after* a shareholder exercises itsright to nominate a director and that director is elected.[91] The restriction on alienation aligns the shareholder's incentive to nominate a director with a firm's long-term success, and thus the long-term shareholder interest.

A duration requirement can be recommended based on the IRRC study.[92] The IRRC study indicates that the short-term "spike" in share value occurred during the standard three month contest period (average increase of 9.8 percent) and in the twelve months following the contest (average increase of 5.0 percent)—both periods outperforming peers.[93] Following those periods, share price increased just 0.7 percent—6.6 percentage points worse than peers (although still outperforming peers overall).[94] Based on those statistical trends, a shareholder with a short-term interest would sell the stock within a year of the election.

Thus, the share retention period following the election of a nominated director should be set at a minimum of eighteen months. This would bypass the short-term "spike" and put the holding of shareholders' stock into the months where the share value "spike" levels off. Having that retention requirement forces a nominating shareholder to look past the share value spike period and nominate a director out of long-term interests rather than a short-term incentive.

The mechanism for enforcing the retention requirement can be modeled after Section 16(b) of the Securities Exchange Act.[95] Section 16(b) imposes liability on listed insider short-swing profits, where listed insiders are required to disgorge to the issuer any profit realized as a result of a purchase and sale of covered equity securities occurring within a six month period.[96] Applying section 16(b) in the context of proxy contests, the SEC can require disgorgement of any profit realized by a nominating shareholder who sells its shares prior to the end of the eighteen month retention period. Also, similar to section 16(b), recovery of the profit will be either enforced by the issuer or a shareholder suing on its behalf.[97] Thus, the potential for liability will not only have a deterrent

89 Bratton, *supra* note 73, at 75.

90 *See Id.*

91 *See Id.*

92 CERNICH ET AL., *supra* note 31.

93 *Id.* at 27.

94 *Id.*

95 15 U.S.C.A § 78p (West 2009).

96 *Id.*

97 *See Id.*

effect, but any action seeking profit disgorgement for abuse of the new proxy rules will be left to the discretion of the firm or its shareholders.

V. CONCLUSION

Facilitating shareholders' ability to mount a proxy contest is needed. Nevertheless, the recent SEC proposal to amended the rules regarding proxy contests needs to be implemented with due caution. As stated, "[t]he most direct way for . . . investors to influence corporate policy is to elect corporate directors they believe will support their interests."[98] Thus, it is important that investors nominating directors through a proxy contest have the company's long-term success in mind.

The proposed SEC amendments to the proxy contest rules recognize that shareholders eligible to nominate directors should be restricted to long-term shareholders and not include shareholders who may use the new proxy rules solely for short-term gain. However, the one-year holding requirement as proposed by the SEC does not adequately control for that latter possibility. The new proxy rules should include a retention period for shares following the election of a nominated director; that retention period should be a minimum of eighteen months.

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98 Frank S. Partnoy & Randall S. Thomas, *Gap Filling, Hedge Funds, and Financial Innovation* (Oct. 2006), (manuscript at 9), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=931254.

LA ACCIÓN DERIVATIVA COMO MECANISMO DE CONTROL Y MONITOREO EN PUERTO RICO

ARTICLE

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INTRODUCCIÓN

ESTE ESCRITO PRETENDE SER UNA CORTA CONSULTA REFLEXIVA COMO UNA aportación al Derecho Corporativo en Puerto Rico. No pretende ser exhaustiva porque se trata del análisis ejemplar con énfasis en los casos más recientes, sus estatutos, reglas y la jurisprudencia pertinente en Puerto Rico sobre la Acción Derivativa como mecanismo de control y monitoreo de la gestión empresarial. Por el contrario, es una invitación a juristas, profesores y estudiantes para abordar el tema profundamente.

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La Acción Derivativa, (*Derivative Suit*) es una acción contra los directores de una corporación fundamentándose en que los directores no están tomando decisiones para el beneficio de los accionistas. Por lo general, quien decide si demanda a nombre de la corporación es la junta de directores, ya que los accionistas delegaron en ellos esa facultad. Si la junta y los oficiales no utilizan los fondos corporativos para el bienestar de los accionistas, es decir, por ejemplo, malversación de fondos o conflicto de intereses, a modo de excepción los accionistas pueden instar una Acción Derivativa, a nombre de la corporación y en contra de la junta de directores, reclamando los daños que esos funcionarios corporativos ocasionaron. Esta acción se fundamenta en la alegación de que no se están administrando los fondos en el mejor interés de los accionistas. De esta forma la Acción Derivativa se convierte en un mecanismo de control y monitoreo.

I. GOBERNANZA CORPORATIVA

Actualmente existe en el derecho corporativo una clara dicotomía sustancial entre el capital y la gestión, que se exterioriza cuando quienes administran y gestionan la corporación no son quienes soportan el riesgo empresarial o financiero. La disociación entre la tarea gerencial y los accionistas no se presentaba en la era inicial del capitalismo, donde prevalecía la mano invisible del mercado y la competencia, dado que los empresarios eran los dueños de las empresas y los límites se fijaban a través del mercado. Sin embargo, transitamos hacia la gobernanza corporativa, donde el control de los accionistas se cede a los administradores, oficiales y junta de directores.

El mercado se caracteriza por una creciente competitividad, que exige a las empresas mayor agresividad en sus políticas de gestión; lo que implica la asunción de un mayor riesgo empresarial y financiero. En este contexto los nuevos supuestos de responsabilidad civil aumentan cualitativa y cuantitativamente, con lo que aquéllos adquieren mayor relevancia respecto de los administradores, oficiales y directores corporativos. Dentro de este contexto analizamos la Acción Derivativa como un mecanismo eficaz y de reciente utilidad emergerte para el control y monitoreo de la gestión empresarial.

II. ACCIÓN DERIVATIVA EN PUERTO RICO

A. *Legislación*

1. Legislación sobre Acción Derivativa

La Acción Derivativa es un remedio en equidad reconocido por los tribunales para vindicar los derechos de una corporación, cuando las personas llamadas a hacerlo no lo hacen. En algunas situaciones los accionistas, en nombre de la corporación, pueden entablar aquellas acciones legales que resulten en beneficio de la corporación. La Ley de Corporaciones recoge la acción llamada derivativa, la cual permite al accionista o a un grupo de éstos el que, para evitar o remediar un daño, lesión, incumplimiento o abuso contra la corporación misma, presentaren una acción judicial para beneficio de la corporación, remediando el daño o impidiendo la lesión o requiriendo el cumplimiento. En nuestro ordenamiento legal corporativo dicha acción ha sido incorporada en la Ley General de Corporaciones de 1995.[1] Esta Ley derogó la antigua Ley Núm. 3 del 9 de enero de 1956, según enmendada, conocida también como Ley General de Corporaciones.

El Artículo 12.06 de este estatuto vigente define la acción derivativa en los siguientes términos:

> En cualquier pleito entablado por un accionista a beneficio de alguna corporación organizada con arreglo a las leyes del Estado Libre Asociado, deberá alegarse en la demanda que el demandante era accionista de la corporación cuando se efectuó la transacción impugnada, o que las acciones le fueron transferidas luego de la transacción por ministerio de ley.[2]

Posteriormente la Asamblea Legislativa de Puerto Rico aprobó la Ley Núm. 487 de 23 de septiembre de 2004 para enmendar la Ley Núm. 144 de 10 de agosto de 1995, según enmendada, como dijimos conocida como Ley General de Corporaciones, con el propósito de añadir los nuevos Capítulos XIX, XX, y XXI, que dispondrán sobre la creación y las normas aplicables a las *compañías de responsabilidad limitada*; y otros extremos relacionados.[3]

Según se refleja en la exposición de motivos de esta ley se pretende con la misma flexibilizar la manera de organizar las empresas y hacer negocios. Al mismo tiempo se amplía el ámbito de la Acción Derivativa como mecanismo de control y monitoreo:

> Pertenecemos a un sistema global económico donde la rigorosa competencia nos obliga a modernizar nuestras leyes de comercio y adoptar aquellas leyes que otorguen a los ciudadanos del Estado Libre Asociado de Puerto Rico (ELA), al igual que a inversionistas extranjeros, la mayor flexibilidad para levantar capital y poder mantenernos competitivos a nivel mundial. La formación de capital local y la atracción del inversionista del exterior es una función de las organizaciones empresariales, como, por ejemplo, la corporación y las sociedades. Sin embargo, la dinámica de la entidad empresarial va cambiando a través de los tiempos. La evolución de las corporaciones y las sociedades, incluyendo la sociedad de responsabilidad limitada, son productos del desarrollo económico y social y de la necesidad de maximizar los recursos. La más reciente de estas entidades es la compañía de responsabilidad limitada. Al adoptar esta ley autorizando la creación de las compañías de responsabilidad limitada, se facilita la creación de

1 Ley Núm. 144 del 10 de agosto de 1995, según enmendada, 14 LPRA § 2601 *et seq.*, (2008).

2 14 LPRA § 3131 (2008).

3 14 LPRA § 3426 *et seq.*, (2008).

> nuevas entidades y se convierte al ELA en un lugar más atractivo para el establecimiento de negocios, lo que ayuda a promover nuestro desarrollo económico.[4]

En el sub-capítulo VII del mencionado capítulo 19 de la Ley General de Corporaciones, que tiene que ver con las Acciones Derivativas en relación a las compañías de responsabilidad limitada, indica el Artículo 19.48 sobre el Derecho a presentar una Acción Derivativa que:

> Un miembro o un cesionario de un interés en una CRL podrá presentar una acción ante el Tribunal de Primera Instancia, para cobrar una sentencia a su favor *si los administradores o miembros con autoridad para hacerlo se han negado a presentar la acción o si un intento de ocasionar que dichos administradores o miembros presenten la acción es improbable que funcione.*[5]

Al incorporar esta legislación a nuestro ordenamiento jurídico corporativo se declara la intención de controlar y monitorear a las empresas, sus administradores, oficiales y directores a través del mecanismo de la Acción Derivativa. Nótese que esta disposición establece el principio o concepto de esfuerzo fútil, es decir cuando no vale la pena acudir con el reclamo a los administradores, oficiales y directores de la junta.[6] Esto es, en el sentido coloquial, cuando los cabros están velando las lechugas.

Añade el Artículo 19.49 sobre el Demandante:

> En una acción derivativa, el demandante tendrá que ser un miembro o un cesionario de un interés en una CRL al momento de presentar la acción y:
>
> 1. Al momento de ocurrir la transacción de la cual surge la reclamación del demandante-, o
> 2. El carácter de miembro o cesionario de un interés en una CRL del demandante ha surgido por operación de ley o conforme a los términos de un CCRL de una persona que era un miembro o un cesionario de un interés en una CRL al momento de la transacción.[7]

Los Artículos 19.50 y 19.51 hablan sobre la Demanda y de los Gastos respectivamente:

> En una acción derivativa el demandante deberá detallar las gestiones, si alguna, del demandante para ocasionar el comienzo de la acción por el miembro o administrador, o las razones para no hacer las gestiones.[8]
>
> En caso de que en una acción derivativa se resuelva a favor, en todo o en parte, sea mediante sentencia, acuerdo o transacción, el Tribunal podrá conce-

4 Ley Núm. 487 del 23 de septiembre de 2004, 14 LPRA § 3426, Exposición de Motivos, (2008).

5 14 LPRA §3433 (2008) (énfasis suplido).

6 *Véase id.*

7 14 LPRA § 3433(a) (2008).

8 14 LPRA § 3433(b) (2008).

der al demandante compensación por gastos razonables, incluyendo honorarios legales razonables, de cualquier recobro en dicha acción o de la CRL.[9]

He aquí de nuevo el fortalecimiento de la Acción Derivativa como mecanismo de control y monitoreo al conceder al demandante triunfante compensación por gastos razonables, incluyendo honorarios legales razonables, de cualquier recobro en dicha acción.

De otra parte, el accionista puede entablar una acción directa contra la corporación cuando se le ocasionan daños o en caso de que se lesionen o violen sus derechos como accionistas de la corporación. Esta acción puede tramitarse contra la corporación o contra aquel accionista, oficial, director o agente que directamente le causare daño al accionista. Se diferencia esta acción directa de la derivativa en el sujeto al cual se intenta beneficiar con la acción. En la acción derivativa el sujeto beneficiado será la corporación misma, mientras que en la directa el beneficio es para el accionista como accionista mismo. Cuando el daño alegado sea causado a la persona de modo individual y particular, no a la corporación o al accionista como tal, no existe duda de que se tiene una causa de acción separada y distinta por razón de la relación muy particular que les vincula, la cual no depende de su condición de accionista. [10]

2. *Regla del Juicio Comercial*

Como parte de la legislación hablamos sobre la Regla del Juicio Comercial porque es importante conocerla para poder entender los requisitos de la Acción Derivativa que comentaremos más adelante.[11]

La Asamblea Legislativa de Puerto Rico incorporó dentro de sus normas en el derecho de corporaciones el principio sobre la Regla del Juicio Comercial. Observamos que en el Artículo 4.03 de nuestra Ley se protege al director u oficial que haya tomado una decisión comercial en forma racional, con la atención y cuidado que desplegaría un director u oficial responsable y competente en dicho puesto, y que haya obrado de buena fe.[12] Sólo habrá de perderse la protección cuando el oficial o director haya incurrido en negligencia crasa en el desempeño de sus obligaciones y deberes.[13]

La regla fue adoptada con el objetivo de ofrecer deferencia hacia el juicio comercial y de alentar la toma de decisiones, considerando la naturaleza riesgosa de los negocios en el comercio y las empresas. La Regla del Juicio Comercial protege al individuo que desempeña la función de director u oficial en casos de decisiones honestas o por errores de juicio cometidos de buena fe y sin ánimo

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9 14 LPRA § 3433(c) (2008).

10 Artículo 12.04, 14 LPRA § 3129 (2008).

11 Sección II.B.3 de este escrito, Requisitos de la Acción Derivativa, *infra*.

12 14 LPRA § 2723 (2008).

13 *Id.*

personal de lucro o ventaja. Este criterio parte de la premisa de la deferencia hacia el juicio comercial por la necesidad de flexibilidad, discreción y autonomía en la toma de decisiones, que en muchas ocasiones se llevan a cabo de forma rápida y bajo mucha presión.

La regla reconoce que los tribunales deben tener cierta cautela o deferencia en intervenir con el juicio de los directores u oficiales responsables y competentes en las decisiones comerciales. Esto es así, primero, porque el conocimiento o *expertise* del tribunal no es el económico, sino el judicial. En segundo lugar, aun cuando tuviesen el conocimiento o *expertise*, quien se supone que dirija la empresa es la junta de directores y no los jueces. Tercero, el juez representa al estado, no se debe suplantar el juicio privado por el juicio del gobierno.

El principio sobre el juicio comercial tiene como fundamento el deber de diligencia que se les exige a los directores y oficiales para que actúen con responsabilidad, competencia, de buena fe y razonabilidad, para el beneficio y mejores intereses de la corporación. El cumplimiento de este deber habrá de evaluarse, comparando la decisión con la diligencia con que un director u oficial responsable y competente llevaría a cabo sus negociaciones en iguales circunstancias.[14]

El Artículo 2.03 de la Ley de Corporaciones[15] nos habla del ejercicio de la gerencia en beneficio de la corporación. La autoridad y los poderes conferidos a toda corporación organizada al amparo de las leyes del ELA, o a los directores u oficiales de la misma, por ley o en el certificado de incorporación o instrumento de igual fuerza y vigor, o en los estatutos corporativos, se disfrutarán y deberán ejercerse por la corporación o por los directores u oficiales, según sea el caso, en (1. Lealtad) beneficio de los accionistas de la corporación y (2. Diligencia) para la gestión prudente de sus negocios y asuntos, (3. Intra Vires) así como para la promoción de sus objetivos y propósitos.[16] Un director o administrador que violenta esos deberes está quebrantando la ley y como consecuencia está expuesto a responsabilidad personal.

La Regla sobre el juicio comercial actúa conjuntamente con una presunción de regularidad y corrección; la Regla presume que un director u oficial ha sido responsable y competente. Para rebatir la misma hay que demostrar que el oficial o director tenía un interés personal, no tuvo la información adecuada al decidir o no tomó en cuenta el mejor interés de la corporación.[17]

La Asamblea Legislativa de Puerto Rico ha incluido dentro de sus normas en el derecho de corporaciones otras disposiciones complementarias que recogen la regla sobre el juicio comercial como lo son los Artículos 4.01(i) y 4.08(a) de la Ley General de Corporaciones.[18] El primero protege al oficial o director cuando con-

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14 *Id.*

15 14 LPRA § 2653 (2008).

16 *Id.*

17 Artículo 4.04 de la Ley General de Corporaciones, 14 LPRA § 2724 (2008).

18 14 LPRA § 2721(i) y 2778(a) (2008).

fió de buena fe en los récords de la corporación, o en la información que le hayan presentado a la corporación oficiales, empleados, comités de la junta de directores y otras personas peritas en la materia. Un miembro de la junta de directores, o un miembro de cualquier comité designado por la junta de directores, estará, en el desempeño de sus funciones, completamente protegido al confiar de buena fe en los récords de la corporación y en la información, opiniones, informes o ponencias presentados a la corporación por cualquiera de los oficiales o empleados de la corporación, o comités de la junta de directores, o por cualquier otra persona, sobre asuntos que el miembro razonablemente cree están dentro del ámbito de la competencia profesional o experta de dicha persona que fue seleccionada con cuidado razonable por o para la corporación.[19]

El otro artículo faculta a la corporación a asumir los costos de la litigación, los honorarios de abogados y la sentencia que un tribunal le imponga a un oficial, director o empleado cuando haya actuado de buena fe, con prudencia y diligentemente, y no tenía causa razonable para creer que su conducta fuera ilícita. Añade el precepto que el hecho de que haya recaído una sentencia en contra del oficial, director o empleado, no crea una presunción de que éstos incumplieran con su deber de diligencia, y que no tuvieran una causa razonable para creer que su decisión fuera antijurídica.[20]

Por el contrario, si prevalece el oficial o el director, la corporación deberá indemnizarle por los gastos de litigios y los honorarios de abogados en que haya incurrido. En la medida en que un director, oficial, empleado o agente de una corporación haya prevalecido en los méritos o, de otro modo, en la defensa de la acción, pleito o procedimiento o en la defensa de cualquier reclamación, asunto o controversia relativa a los mismos, se le indemnizará por los gastos razonables incurridos, incluso los honorarios de abogados, por razón de dicha acción, pleito o procedimiento.[21]

B. Jurisprudencia

1. Aspectos Generales

Además de la condición de accionista cuando ocurrió el daño y durante el transcurso del procedimiento judicial, se requiere que la corporación se incluya como parte demandada en el pleito aunque ésta sea su beneficiaria ulterior. Por otra parte, en el caso de las corporaciones íntimas o familiares, en las cuales se da una relación interna distinta a la que se desarrolla en las corporaciones tradicionales, los directores y accionistas se consideran más socios y asumen posición de directores o accionistas únicamente en sus negociaciones con terceros. De

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19 *Véase* 14 LPRA § 2721(i) (2008).

20 *Véase* 14 LPRA § 2728(a) (2008).

21 Artículo 4.08(c), 14 LPRA § 2728(c) (2008).

ordinario en el caso de las corporaciones íntimas, los derechos de los accionistas que controlan la corporación y los derechos de la propia corporación son idénticos e inseparables. [22]

Recientemente, en abril de 2009, en el Tribunal Supremo de Puerto Rico se vio un caso donde un accionista minoritario presentó una demanda que dentro de las causas de acción incluía la Acción Derivativa para proteger los mejores intereses de una empresa y evitar la enajenación de su activo principal. Lamentablemente la controversia se trabó por una anotación preventiva en el Registrador de la Propiedad y no tuvimos la oportunidad de que nuestro Tribunal Supremo se expresara sobre el alcance de la Acción Derivativa.[23]

Liquilux Gas Corporation v. Berrios,[24] un caso muy famoso por la representación legal simultánea de una corporación íntima y sus accionistas, se originó por las discrepancias entre los directores y se alegó defender los intereses de la empresa en una Acción Derivativa. En una opinión suscrita por el Juez Hernández Denton en la cual el Juez Rebollo López no intervino y con la cual el Juez Fuster Berlingeri disintió sin opinión escrita, el Tribunal Supremo confirmó una descalificación ordenada por el tribunal de instancia dentro de un pleito derivativo.

Los hechos según relatados en la opinión establecen que Liquilux Gas Corporation (Liquilux), una corporación íntima compuesta por tres accionistas, a saber, Zaragoza (67%), Newell (25%) y Berrios (8%), demostró interés en adquirir la totalidad de las acciones de Tropigas de Puerto Rico, Inc. (Tropigas). Liquilux autorizó a Newell y Berrios a adquirir, para beneficio de la corporación, dichas acciones. Durante la negociación con Tropigas, Newell y Berrios se percataron de que si comparecían a nombre de Liquilux, la compraventa podría fracasar debido a que Zaragoza tenía una deuda contributiva considerable. Por lo tanto, y alegadamente para evitar que esto sucediera, optaron por realizar la gestión de compra a nombre propio. Cuando Zaragoza se enteró de que Newell y Berrios estaban tramitando la compra a nombre propio, se suscitó una controversia entre Zaragoza, por un lado, y Newell y Berrios, por el otro, que impidió que éstos pudieran realizar un pago requerido por Tropigas para una fecha estipulada, por lo que Tropigas dio por resuelto el contrato de opción de compra.

Liquilux contrató los servicios de un bufete de abogados, e instó demanda contra Newell y Berrios. Se alegó que éstos habían violado el deber de fiducia al usurpar una oportunidad corporativa. Poco después, Zaragoza, también representado por el mismo bufete, demandó a Newell y Berrios con prácticamente las mismas alegaciones contenidas en la demanda contra Liquilux. Al tiempo, Liquilux enmendó la demanda para traer a otra parte como demandada y, por su parte, Newell y Berrios interpusieron demanda de tercero contra Zaragoza en la cual alegaron que éste era el único culpable de que la compraventa de Tropigas

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22 Liquilux Gas Corporation v. Berríos, 138 DPR 850, 862-863 (1995).

23 Quiñones Reyes, et al v. Registrador de la Propiedad, 2009 TSPR 63, en la pág. 4, 176 DPR ___.

24 *Liquilux*, 138 DPR en las págs. 855-856 y 870.

se frustrara. Solicitaron, mediante Acción Derivativa, que Zaragoza resarciera a Liquilux y, mediante acción directa, que también los resarciera a ellos como accionistas minoritarios.

Aun antes de la Ley Núm. 144 de 10 de agosto de 1995 conocida como Ley General de Corporaciones de 1995 el Tribunal Supremo de Puerto Rico tipificó una causa de acción como Acción Derivativa de accionistas minoritarios en protección de intereses corporativos, además de los intereses de los accionistas minoritarios.[25] El caso trata sobre un Recurso Gubernativo para revisar una Nota de Carmen J. Rocafort de López, Registro de la Propiedad de San Juan, que deniega una anotación de lis pendens. El Tribunal Supremo permite la alegación como una alternativa de derecho a una anotación preventiva sin resolución judicial sobre la premisa de que en la Acción Derivativa en que los accionistas minoritarios representan el interés de la corporación, ésta que es la titular registral de los inmuebles es la verdadera parte demandante.[26] En perjuicio de los promovidos anota el Tribunal: "[p]ero resulta que en su reclamación de condominios, los promovidos representan exclusivamente su interés y derecho, y no el de la corporación".[27]

2. Responsabilidad Derivativa

En el 1968 el Tribunal Supremo de Puerto Rico hablaba de Responsabilidad Derivativa dentro del derecho corporativo en el contexto de cosa juzgada:

> [E]s preciso distinguir entre los dos efectos que produce una sentencia, el positivo, que consiste en su cumplimiento mediante la ejecución, y el negativo, *la imposibilidad de reproducir la contienda*. El primero da lugar a la *actio judicati* ; el segundo, a la *exceptio rei judicatae*. Esta última 'impide reproducir la cuestión fallada, *promoviendo un nuevo pleito sobre el mismo asunto* las que sostuvieron el primero.' A poco que se examine la situación que consideramos vemos que estrictamente no se trata de un nuevo pleito, sino del mismo pleito, sólo que en una etapa posterior, y que, más decisivo aun, no se trata del mismo asunto ya que en la ocasión anterior se incluyo a Fajardo, aunque no se alegó expresamente, para exigirle, junto a la corporación, una responsabilidad directa por los defectos de construcción; ahora, se solicita autorización para incluirle a base de la responsabilidad derivativa aneja a todo accionista que recibe bienes de una corporación disuelta.[28]

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25 Rocafort de López v. Álvarez, 112 DPR 563, 565 (1982).

26 *Id.* citando a 13 William Fletcher, CYCLOPEDIA OF CORPORATIONS, § 5994, en la pág. 500 (1980); William Clark, HANDBOOK OF THE LAW OF PRIVATE CORPORATIONS, §149-151a págs. 503-504 (3ra ed. 1916).

27 *Rocafort de López*, 112 DPR en la pág. 565, nota 2.

28 Feliciano Ruiz v. Alfonso Dev. Corp., 96 DPR 108, 113-114 (1968) (énfasis en el original).

3. Requisitos de la Acción Derivativa

Como hemos mencionado antes, los tribunales tradicionalmente han exigido el cumplimiento con una serie de requisitos para autorizar la Acción Derivativa. Estos requisitos son: (1) la corporación debe incluirse como parte demandada; (2) la persona que insta la acción debe haber sido accionista al momento en que ocurrió el daño por el que reclama y durante todo el litigio; (3) antes de acudir al tribunal, el accionista debe reclamar a los administradores de la corporación que tiene una acción sobre el particular; (4) por tratarse de una acción en equidad, el accionista está sujeto a las defensas tradicionales de equidad, como son las de manos limpias, impedimento, incuria y renuncia, entre otras; y, (5) el pleito no puede transigirse ni desistirse sin la autorización del tribunal.[29]

a. Primer Requisito

La corporación debe incluirse como parte demandada. Esto es, la corporación es parte indispensable, y como tal hay que incluirla como parte demandada aunque abstractamente debería ser parte demandante. Esto es así porque como es la junta de directores la que crea el daño, ésta no van a traer el pleito a nombre de la corporación, por lo que hay que demandar a los directores para incluirlos como parte, al mismo tiempo que la corporación.

b. Segundo Requisito

La persona que insta la acción debe haber sido accionista al momento en que ocurrió el daño por el cual reclama y durante todo el litigio. La condición de accionista debe estar presente al momento en que se insta la acción y dicha condición debe mantenerse a través de todo el proceso judicial.[30] No pueden instar acciones derivativas aquellos accionistas que han solicitado el derecho de avalúo, tampoco podrán instar este tipo de acción aquellos accionistas que hayan consentido a la acción impropia o que hayan participado de la acción que intentan impugnar. Hay una excepción a este caso y es cuando se adquieren las acciones por ministerio de ley; como por ejemplo en la herencia, que aunque la persona no ha sido todo el tiempo accionista, la persona de quién heredo sí lo era. Otra excepción es cuando hay un esquema continuo de hacerle daño a la corporación, en cuyo caso basta con que en algún momento haya sido accionista para poder llevar la acción.

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29 Oliveras v. Centro Unido de Detallistas, KLCE 2008-00224 en la pág. 10, citando a Carlos E. Díaz Olivo, CORPORACIONES, (1999), págs. 278-279.

30 Las acciones no tienen que permanecer inalteradas durante todo el proceso judicial, ni tienen que estar registradas en los libros. La parte demandante tiene que tener acciones en la corporación porque de lo contrario no tendría legitimación activa. Son los accionistas bona fide los que tienen capacidad en ley o legitimación activa para presentar la Acción Derivativa. No se pueden *adquirir* pleitos derivativos comprando acciones de una corporación particular.

c. Tercer Requisito

Antes de acudir al Tribunal, el accionista debe reclamar a los administradores de la corporación que tomen acción sobre el particular. No debemos perder de vista que la facultad de instar acciones a nombre de la entidad corporativa le fue delegada a la junta de directores. Es por esto último que el accionista que interesa instar una Acción Derivativa viene obligado, so pena de perder su derecho de acudir a los tribunales, a informar a la propia junta de directores acerca de la conducta que le aqueja de los directores corporativos antes de acudir a los tribunales. Si la junta de directores toma cartas en el asunto y resuelve la situación el accionista estará vedado de acudir a los tribunales, puesto que la controversia se habría tornado académica.

En cambio, si la junta de directores opta por no atender el reclamo, el accionista podrá, después de esperar un período de tiempo razonable, acudir a los tribunales a vindicar el derecho de la entidad. Este requisito tiene un propósito similar al de agotar los remedios administrativos qu es darle a la junta de directores la oportunidad de atender el problema para mantener la estructura corporativa. Si se lleva el pleito derivativo y luego la junta de directores resuelve el problema, se estarían consumiendo los recursos judiciales y privados innecesariamente. La excepción lo es el esfuerzo fútil, es decir, cuando no vale la pena acudir con el reclamo a los administradores, oficiales y directores de la junta por ser precisamente ellos los responsables de la acción impugnada, pues son los malversadores de fondos o los involucrados en algún conflicto de intereses, entonces se puede obviar este tercer requisito.

¿Qué sucede si se le plantea el problema a la junta de directores y ésta no actúa al respecto? Está el asunto de la Regla del Juicio Comercial,[31] pero hay que tener presente, que si la junta de directores fue la que causó el daño, el conflicto de interés desactiva la Regla del Juicio Comercial. Por ejemplo: la corporación llegó a un acuerdo con un suplidor para que le suministre un producto y el suplidor incumple el contrato y no envía el suministro. Si la corporación no actúa podría surgir la situación de que se quiera llevar un pleito derivativo por la inacción de la junta de directores en demandar al suplidor. Primero hay que informarle el problema a la junta de directores y esperar que la junta determine si va a actuar o no. Hay que tomar en consideración que en muchas situaciones hay razones para que la empresa que sufre un daño decida no demandar. Esto puede ampararse en la Regla del Juicio Comercial porque la junta de directores puede alegar que no conviene llevar la acción porque los costos de un litigio pueden ser mayores que los beneficios o por mantener la imagen pública de la empresa, entre otras consideraciones.

Otro ejemplo: Se están malversando los fondos de la corporación y se están desviando a una cuenta bancaria en Suiza. Es la misma junta de directores la que está llevando a cabo estos actos ilícitos. ¿Se va a ir a donde la junta de direc-

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31 *Véase* la sección II.A.2 de este escrito, Regla del Juicio Comercial, *supra*.

tores a pedirle que tome medidas contra sí misma para corregir una acción de la cual ellos son responsables? El incumplir con el requisito de que se lleve el planteamiento a la junta de directores antes que al tribunal podría conllevar la desestimación de la demanda. Sin embargo, el demandante podría alegar que esta acción no tiene sentido porque es la junta de directores la responsable del esquema y por lo tanto que este paso sería un esfuerzo fútil. La Asamblea Legislativa de Puerto Rico ha considerado este planteamiento.[32]

El problema es bajo qué parámetros el tribunal va a permitir que se omita el requisito de llevar primero la controversia a la junta de directores. El tribunal debe determinar si los directores son o no independientes de la transacción, en otras palabras, que no tengan conflicto de interés. Además, debe determinar si el tipo de acto que se cuestiona es uno de los protegidos bajo la Regla del Juicio Comercial. El tribunal debe examinar si se crea una duda razonable de que: (1) los directores son razonables e independientes y (2) la transacción atacada, es producto del ejercicio básico del juicio comercial.

d. Cuarto Requisito

Por tratarse de una acción en equidad, el accionista está sujeto a las defensas tradicionales. El origen de la acción derivativa como remedio en equidad implica para el accionista que insta el pleito la posibilidad de que se invoque en su contra alguna de las defensas tradicionales de equidad, como manos limpias, impedimento, incuria y renuncia, entre otras. La más compleja de las defensas, en términos corporativos, es la de incuria y con ella el problema de la prescripción. Para la prescripción hay que tener en cuenta que el accionista no está presentando una acción personal, sino una que en realidad le pertenece a la corporación. Esto significa, que la naturaleza de la acción y el término prescriptivo aplicable no deben analizarse desde la perspectiva del accionista. Por el contrario, el plazo prescriptivo pertinente debe ser aquel que aplicaría si la acción hubiera sido presentada por la corporación.

En los pleitos derivativos, los tribunales aplican los plazos prescriptivos de la acción corporativa subyacente. Dependiendo de si la acción es contractual o extracontractual, así también dependerá el plazo prescriptivo. Cuando la acción se inicia contra alguno de los componentes de la estructura corporativa, esto es administradores, directores u oficiales, la acción deberá entablarse dentro de los tres años de adquirirse conocimiento de los hechos que originan la responsabilidad.[33] En este caso el término empieza a transcurrir tan pronto se adquiere el conocimiento de los hechos que dan paso a la responsabilidad.

Esto no es tan sencillo como parece, pues son los mismos directores quienes infligen el daño a la entidad. Se debe enfatizar en el enfoque de mayoría desinte-

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32 14 LPRA § 3433 (2008). Véase la sección II.A.1 de este escrito, Legislación sobre Acción Derivativa, *supra*.

33 Artículo 47 del Código de Enjuiciamiento Civil, 32 LPRA § 261 (2004).

resada. Se considera que el término no empieza a transcurrir hasta que en la junta de directores no exista una mayoría de directores inocentes, no involucrados o desinteresados respecto a la transacción que da base a la reclamación.

Como parte del enfoque se establece una presunción de que los funcionarios corporativos demandados están en control de la corporación e impiden que se tome cualquier acción contra las irregularidades o fallas por ellos cometidas. Esta presunción, como cualquier otra es controvertible. La defensa de incuria puede invocarse para cerrar el acceso judicial a una Acción Derivativa, en vista de los factores especiales que rodean la tardanza en la iniciación del pleito, aun cuando la tardanza no excediera el término prescriptivo dispuesto en la ley.

e. Quinto Requisito

Antes de que se transija un pleito tiene que contar con el aval del tribunal. Esto es para asegurarse que la transacción es en el mejor interés de la corporación y los accionistas. La Acción Derivativa no puede desistirse o transigirse sin la aprobación del tribunal y sin efectuar una notificación de esta determinación a los accionistas. En caso de una transacción el tribunal deberá determinar que el acuerdo propuesto es justo y razonable. La razón de ser de esta exigencia es la naturaleza fiduciaria de la Acción Derivativa y su objetivo es proteger de los abusos que podría acarrear los acuerdos privados entre la corporación y el accionista demandante. La determinación de la razonabilidad de la transacción deberá realizarse de conformidad con las exigencias de la regla del juicio comercial que tenga el tribunal.

Los elementos que de ordinario son considerados por el tribunal son los siguientes: (1) la posible validez de la reclamación; (2) las dificultades de hacer valer tales reclamaciones en un tribunal; (3) la posibilidad de cobrar cualquier sentencia; (4) la tardanza, los gastos y los problemas que conllevarían un litigio; (5) el monto de la transacción en comparación con el importe que pudiera obtenerse y cobrarse de la sentencia; y (6) las posiciones a favor y en contra de las partes en el pleito. Los proponentes de la transacción tendrán el peso de probar su razonabilidad. Al transigir el pleito, se supone que el accionista no se lucre a costa o en perjuicio de los restantes accionistas de la corporación; pero, no es impropio que como parte del acuerdo, al demandante se le trate un tanto diferente del resto de los accionistas.

4. Mecanismo de Control y Monitoreo

El 11 de marzo de 2008 el Tribunal de Apelaciones emitió una Resolución donde afirma la Acción Derivativa como mecanismo de control y monitoreo en la gestión y administración de una corporación sin fines de lucro. Como medida de control, monitoreo y corrección de deficiencias en la administración por parte de la junta de directores, un socio presentó una demanda ante el Tribunal de

Primera Instancia contra el Centro Unido de Detallistas (en adelante CUD) donde solicitó que se dictara sentencia declaratoria.[34]

En síntesis, fundamentó dicha solicitud en que, en su capacidad de socio o miembro *bona fide* del CUD, impugnaba la designación del señor Pedro Malavé como ayudante del Presidente de la organización, con remuneración, por constituir la misma una violación al Reglamento del CUD. Solicitó como remedios que se ordenara el cese y desista del señor Malavé como ayudante del Presidente del CUD; la devolución por éste de cualquier remuneración recibida por ocupar dicho cargo; la anulación de todas las determinaciones de la Junta de Directores del CUD a partir del 1 de noviembre de 2006; la celebración de elecciones para cubrir ciertas vacantes en dicha Junta; y la designación de un Administrador Judicial.[35]

El CUD planteó que el socio demandante no tenía capacidad o legitimación activa para presentar la demanda instada por no ser socio del CUD, razón por la cual no le era permisible promover una Acción Derivativa por derecho propio contra el CUD. El socio expresó que sin su presencia y sin la oportunidad de ser oído, en una asamblea general ordinaria del CUD celebrada el 10 de septiembre de 2006, se había presentado una moción de expulsión en su contra, sobre la cual hubo objeción por ciertos socios presentes y que, aun así y contrario al reglamento de la organización y a los procedimientos parlamentarios aplicables, se decretó su expulsión.[36]

El Tribunal de Apelaciones concluyó que el foro primario resolvió correctamente el mantener al socio demandante por derecho propio en la Acción Derivativa, hasta que la cuestión sobre cómo se decretó su expulsión fuera finalmente resuelta, es decir, hasta tanto se demostrara al Tribunal de Primera Instancia el hecho que el socio demandante inició la Acción Derivativa a sabiendas de que no era socio *bona fide* del CUD. En apretada síntesis este caso demuestra la utilización de la Acción Derivativa como mecanismo para controlar y monitorear la gestión empresarial cuando el Tribunal declara que la Acción Derivativa es un remedio en equidad reconocido por los tribunales y dentro de nuestro derecho corporativo para vindicar los derechos de una corporación.[37]

En Martínez Ruiz v. Triple-S, Inc.,[38] aun cuando los demandantes no plantearon el caso como una Acción Derivativa fue el Tribunal de Apelaciones quien planteó que para que una de las causas de acción prosperara tenía que ser planteada como una Acción Derivativa.[39] El Tribunal de Apelaciones indicó que:

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34 Oliveras v. Centro Unido de Detallistas, en la pág. 2.

35 *Id.* en las págs. 2-3.

36 *Id.* en las págs. 4-5.

37 *Id.* en las págs. 7, 9 y 16.

38 Martínez Ruiz v. Triple-S, Inc., KLCE 2007-00332; KLCE 2007-00491, en la pág. 5.

39 *Id.* en las págs. 12 y 51.

> [e]l único demandante que tiene legitimación activa para hacer ese reclamo en favor de la corporación es el doctor Hau. Pero tiene que acreditar expresamente, que era accionista de la corporación cuando se efectuaron las transacciones impugnadas o que le fueron transferidas después por ministerio de ley. De no hacerlo procederá la desestimación de la acción derivativa. Así lo manda la ley.[40]

El mencionado caso es uno complicado, cuya demanda cuenta con 197 hechos alegados que se entrelazan para sostener ocho causas de acción. La demanda fue incoada por once médicos que alegan haber sido excluidos del listado de proveedores del plan de seguro de salud Triple S. Les acompañan como codemandantes: otro médico que es proveedor dentro del plan y además accionista de Triple S; tres pacientes que alegan que sus médicos han sido excluidos del listado de proveedores de Triple S; y una persona interesada en la suscripción directa del plan, pero que alega que es muy costoso. Los demandados son Triple S Inc. y otras corporaciones subsidiarias e individuos que se alega están relacionados con las acciones imputadas a Triple S Inc. en la demanda.[41]

El planteamiento de Acción Derivativa como mecanismo de control y monitoreo por resarcimiento de daños está en la primera causa de acción, los demandantes piden que se obligue a los demandados a devolverle a Triple S los $67,000,000 que tuvo que pagar a Hacienda por concepto de contribuciones y la devolución de toda pérdida económica causada o gasto indebido cargado a los activos de la corporación por alegados actos fraudulentos de sus oficiales y administradores. Para que proceda una reclamación de esa naturaleza existe y hay que atenerse a las disposiciones de la Ley de Corporaciones.[42]

Otro caso donde observamos la reafirmación de la Acción Derivativa en nuestro ordenamiento jurídico como mecanismo de control y monitoreo para evitar o remediar un daño, lesión, incumplimiento o abuso contra la corporación misma lo es el caso de Bahía Hotel.[43] Éste fue resuelto mediante Resolución por el Tribunal de Apelaciones y devuelto al Tribunal de Primera Instancia para que continuaran los procedimientos de acuerdo a lo expresado por el Tribunal.

Allí la demandante solicitó una acción directa contra sus hermanos y a su vez, Acción Derivativa a favor de la corporación por el alegado daño que éstos le ocasionaron a Bahía Hotel por el alegado mal uso y administración de fondos corporativos. El Tribunal expresó que:

> [s]i el foro recurrido en su día le impone responsabilidad al Dr. Antonio y al Dr. Rafael Gallardo, entonces podría ordenarse una compensación en el carácter personal de éstos a favor de la Dra. María Gallardo y al mismo tiempo pueda or-

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40 *Id.* en la pág. 21.

41 *Id.* en las págs. 1-2.

42 *Id.* en las págs. 3 y 20.

43 Dra. Gallardo Méndez v. Dr. Gallardo Méndez, KLCE 2001-00038, en la pág. 7.

denar una compensación a favor de la corporación Bahía Hotel como resultado de la acción derivativa instada por la Dra. María Gallardo.[44]

En el caso de Mamacitas Enterprises, Inc., el Tribunal de Apelaciones se refiere a la Acción Derivativa como una de vindicar derechos de la empresa:

> [l]a acción derivativa, al ser una reclamación judicial de la corporación iniciada por los accionistas para vindicar los derechos de la corporación, tiene una naturaleza dual. Por un lado, es un pleito iniciado por un accionista . . . y, por el otro lado, es una acción de la propia corporación . . . en un pleito derivativo, el interés de la corporación es el que se quiere vindicar . . . [45]

5. Legitimación Activa de la propia Corporación

Cuando la causa de acción es incoada por la propia corporación haciendo acopio de su propia capacidad o legitimación activa no es necesaria y es hasta improcedente la Acción Derivativa pues la propia empresa está reclamando y vindicando sus derechos. Este particular se discutió hasta la saciedad en el caso de Ponce Rolling Mills of Puerto Rico, Inc.[46] donde los demandados alegaron que la corporación no tenía capacidad o legitimación activa para accionar ante un tribunal de justicia, facultad que le correspondía a terceros que nunca fueron parte del pleito, refiriéndose a los accionistas.[47]

Allí comparecieron ante el Tribunal de Apelaciones Ponce Rolling Mills of Puerto Rico, Inc., (PRM), Caribbean Refractory Services, Inc. (CRS) y CIGNA Insurance Company, ahora Ace Insurance Company (CIGNA). Apelaron dichas partes de una sentencia dictada el 31 de enero de 2006 ante el Tribunal de Primera Instancia de Puerto Rico, que condenó a CRS a resarcirle a PRM $2,612,299.00 por los daños resultantes del incumplimiento contractual de CRS, disponiendo que CIGNA, como aseguradora de CRS, viene obligada al pago de hasta $1,000,000.00 de dicha cantidad, límite dispuesto en la póliza. Luego de dictar sentencia, el foro apelado le impuso a CRS y a CIGNA las costas y el interés legal sobre el monto de la sentencia, desde la fecha de su dictamen hasta su satisfacción, lo que dio lugar a la presentación de dos recursos de *certiorari,* KLCE2006-1380 y KLAN2006-1475.[48]

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44 *Id.* en las págs. 11-13.

45 McCarty v. Hollingsworth; Grant, Mamacitas Enterprises, Inc., KLCE 2006-061241, en la pág. 5.

46 Ponce Rolling Mills of PR, Inc. v. Caribbean Refractory Services, Inc., KLAN 2006-00345; KLAN 2006-00339; KLAN 2006-00359; KLAN 2006-01475, consolidados.

47 *Id.* en la pág. 13.

48 *Ponce Rolling Mills*, KLAN 2006-00345, en las págs. 1-2.

Es un principio básico del derecho corporativo que las corporaciones poseen personalidad jurídica separada de sus directores, accionistas y oficiales.[49] Por lo tanto, PRM tiene personalidad jurídica conforme a derecho, separada de sus accionistas.[50] El Tribunal Supremo de Puerto Rico ha expresado que la corporación tiene su propia personalidad jurídica y su propio patrimonio, distinto al de sus accionistas.[51]

El caso de Ponce Rolling Mills of Puerto Rico, Inc. trataba de una reclamación por daños económicos sufridos por PRM, respecto a los cuales sus accionistas carecen totalmente de capacidad en ley para reclamarlos y por lo tanto, de legitimación activa para accionar ante un tribunal de justicia. Una corporación tiene su propia personalidad jurídica y su propio patrimonio, distintos a la personalidad y al patrimonio de sus accionistas, sean estas últimas personas naturales o jurídicas.[52] El Tribunal de Apelaciones estableció que:

> [n]o estamos en este caso ante una de las situaciones donde procede una acción derivativa conducida por un accionista frente a un tercero, para beneficio del ente corporativo en primera instancia y en forma derivada en beneficio de su interés particular como accionista. Una acción derivativa consiste de una causa de acción que pertenece a un ente corporativo pero es llevada por sus accionistas, a nombre y para beneficio de la corporación, cuando la corporación ha fallado en reclamar sus derechos.[53]

La causa de acción de PRM contra CIGNA y CRS le pertenece a PRM, no a sus accionistas. De la prueba presentada se desprende que la mayoría de los accionistas de PRM eran dueños de compañías constructoras que, por la escasez de materiales de construcción, invirtieron para consumir productos hechos localmente y no tener que incurrir en los gastos de importación de dichos materiales. La reclamación por pérdida de inversión se refiere a la pérdida en virtud del contrato mediante el cual PRM se comprometía a entregar el producto de su labor (varillas de construcción) a cambio de adelantos monetarios para sufragar sus gastos. Por lo anterior, el Tribunal de Apelaciones concluyó que PRM tenía legitimación activa para reclamar los daños sufridos al no poder cumplir el contrato con sus inversionistas.[54]

No erró el Tribunal de Primera Instancia al conceder a PRM una compensación de $2,612,289.00 por concepto de pérdida de inversión, pues dicha partida se circunscribe a los adelantos monetarios que dicha entidad recibió a cambio del

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49 *Véase* Ponce Rolling Mills Of PR, Inc. v. Caribbean Refractory Services, Inc., KLAN 2006-00345; KLAN 2006-00339; KLAN 2006-00359; KLAN 2006-01475, consolidados, en la pág. 35, citando a In re Castillo Herrera, 159 DPR 276, 279 (2003).

50 *Ponce Rolling Mills*, KLAN 2006-00345, en las págs. 35-36.

51 *Id.* en la pág. 36, citando a Sucesión Santaella v. Srio. de Hacienda, 96 DPR 442, 451 (1968).

52 *Véase Ponce Rolling Mills* KLAN 2006-00345

53 *Id.*

54 *Id.* en la pág. 37, citando a Pagán v. Calderón, 448 F.3d 16 (1st Cir. 2006).

material que habría de producir. Debido al incumplimiento contractual de CRS, PRM se vio obligada a incumplir con New Jersey Steel, quien le proveía materia prima. Así mismo, incumplió los acuerdos con las compañías Metal Processing, Roll Products y Gabriel Fuentes Junior Construction, quienes adelantaron capital a cambio de obtener el producto que PRM se dedicaría a proporcionar. Dichos incumplimientos finalmente extinguieron su vida corporativa.[55]

Otro caso que trató el tema de la causa de acción incoada por la propia corporación haciendo acopio de su propia capacidad o legitimación activa distinguiéndola de la Acción Derivativa fue el de La Costa Sampedro v. Mitsubishi Motor Sales Of Caribbean Inc.[56] Allí realmente se trataba de reclamos por daños económicos alegadamente sufridos por el ente jurídico Charlie Auto Sales, Inc., respecto a los cuales los señalados accionistas de Charlie Auto Sales, Inc. carecían totalmente de capacidad en ley y por tanto de legitimación activa para accionar ante un tribunal de justicia.[57]

Expresó el Tribunal de Apelaciones que nuestro ordenamiento sustantivo y procesal reconoce y le otorga al ente corporativo personalidad jurídica separada, distinta e independiente de la personalidad (jurídica o civil) de sus accionistas.[58] Por tanto, carece totalmente de capacidad jurídica todo accionista corporativo para obviar el ente jurídico de la corporación con el propósito de accionar ante el foro judicial a favor de una o de varias causas que en el mejor de los casos sólo compete ejercer a la corporación, conforme lo establecen los hechos que informan esta causa.[59]

No estamos aquí ante una de las situaciones en que el ordenamiento permite las llamadas Acciones Derivativas, conducidas por un accionista frente a tercero, para beneficio del ente corporativo en primera instancia y en forma derivada, en beneficio de su interés particular de accionista.[60] Como se sabe, una Acción derivativa consiste de una causa de acción que pertenece a un ente corporativo pero es llevada por sus accionistas, a nombre y para beneficio de la corporación, cuando la corporación ha fallado en reclamar sus derechos.[61]

Se trataba allí de un impedimento insubsanable, de falta de legitimación activa, también señalada como legitimación en causa activa. Los allí demandantes, como accionistas de Charlie Auto Sales, Inc. no contaban con capacidad legal para comparecer ante el foro judicial y en calidad personal civil reclamar para sí compensación por alegados daños sufridos por el ente corporativo, cuando la

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55 *Véase Ponce Rollling Mills,* KLAN 2006-00345.

56 La Costa Sampedro v. Mitsubishi Motor Sales of Caribbean Inc., KLCE 2004-00525.

57 *Id.* en la pág. 5.

58 *Id.* citando a *Liquilux* 138 DPR en las págs. 860 y 870 (1995); Flamingo v. Toa Alta Dev. Corp., 96 DPR 240, 243 (1968).

59 Véase *La Costa Sampedro*, KLCE 2004-00525.

60 *Id.* en las págs. 5-6, citando a *Liquilux* 138 DPR en la pág. 856.

61 *Véase La Costa Sampedro*, KLCE 2004-00525.

corporación, alegada titular, de la acción no la ejercita para sí, por la razón que fuere. Se trata de una parte allí demandante no realmente interesada dentro del contexto de la Regla 15.1 de Procedimiento Civil.[62] De prevalecer en esta causa la parte demandada, los codemandados podrían verse nuevamente confrontados por la misma acción, posteriormente incoada por Charlie Auto Sales, Inc., directamente o por conducto del Síndico de Quiebras de continuar el proceso 2000-14388 (SEK).[63]

6. Fusión o Consolidación

Un aspecto muy interesante lo es la situación siguiente: cuando las corporaciones desaparecen como consecuencia de una fusión o consolidación pierden su personalidad jurídica independiente, y la identidad que sobrevive se convierte automáticamente en titular de todas las propiedades, los derechos y las obligaciones de la corporación o corporaciones que desaparecen. La Acción Derivativa, por su propia naturaleza, se insta en nombre y a beneficio de la corporación y no del accionista que la presenta; por lo que, al desaparecer la corporación ya sea por fusión o consolidación con otra, el accionista ya no posee capacidad para continuar un pleito derivativo a nombre de la corporación desaparecida. Esta situación se discutió en el caso Viqueira Mariani v. First Bank.[64]

En síntesis relatamos lo acontecido con pertinencia a la Acción Derivativa. El apelante, Dr. Jaime Viqueira Mariani solicitó al Tribunal de Apelaciones que revocara la sentencia sumaria y parcial emitida por el Tribunal de Primera Instancia, Sala Superior de Mayagüez, el 18 de octubre de 2004. Mediante dicha sentencia el tribunal declaró Con Lugar la moción de sentencia sumaria presentada por la apelada, Rovica Development Corporation, y desestimó con perjuicio la Acción Derivativa presentada por el apelante.[65]

La sentencia parcial apelada resolvió solamente la controversia relacionada con la Acción Derivativa presentada por el apelante por la cual se intentaba anular la fusión entre Centro Radiológico Clínica Llagues, Inc. y Rovica Development Corporation. Como resultado de dicha fusión sobrevivió El Centro Radiológico Clínica Llagues, Inc. A esta corporación se le enmendó el nombre posteriormente a Clínica Llagues, Inc.[66]

La fusión fue efectiva el 31 de diciembre de 2003. El 6 de febrero de 2004 el apelante notificó su oposición a la fusión. El apelante fue accionista de Rovica Development Corporation que como antes señalamos, fue la corporación que no sobrevivió la fusión. El 5 de agosto de 2004 emite una carta informando su deci-

62 32 LPRA Ap. III, R. 15.1, (2007).

63 *La Costa Sampedro,* KLCE 2004-00525, en la pág. 6.

64 Viqueira Mariani v. First Bank, First Federal Savings Bank, et al, KLAN 2004-01348.

65 *Id.* en la pág. 1.

66 *Id.* en la pág. 2.

sión de otorgarle al apelante la liquidación por sus acciones, conforme al valor establecido en la reunión del 26 de diciembre de 2003 en la cual éste participó.[67]

El Tribunal de Apelaciones confirma al tribunal *a quo* cuando dice:

> [a]nte estos hechos, que el Tribunal de Primera Instancia catalogó como hechos que no están en controversia, dictamina que el apelante ya no es accionista y por tanto no puede representar a la corporación desaparecida en una acción derivativa. Determina también que las corporaciones que desaparecen como consecuencia de una fusión o consolidación pierden su personalidad jurídica independiente, y la identidad que sobrevive se convierte automáticamente en titular de todas las propiedades, los derechos y las obligaciones de la corporación o corporaciones que desaparecen. Sigue determinando el tribunal que la acción derivativa, por su propia naturaleza, se insta en nombre y a beneficio de la corporación y no del accionista que la presenta; por lo que, al desaparecer la corporación ya sea por fusión o consolidación con otra, el accionista ya no posee capacidad para continuar un pleito a nombre de aquella.[68]

Sin embargo, este caso se resolvió por sentencia sumaria lo que provocó que el Tribunal de Apelaciones revocara la resolución para que se dilucidara la legalidad de la fusión. Se ha controvertido la autoridad de Rovica Development Corp para fusionarse según antes expresado, ya que alegadamente la fusión no se hizo con el voto unánime. De ser esto cierto se podría sostener que la fusión es ilegal. Esta importante controversia se tiene que dilucidar tomando en cuenta que la documentación presentada es conflictiva en cuanto a este aspecto. Conforme a como se resuelva esta controversia podría depender el curso de una de las causas de acción del apelante.[69]

Conforme a lo antes expuesto se revocó la Sentencia Sumaria Parcial apelada y se ordenó al Tribunal apelado permitir la enmienda a la demanda solicitada por el apelante a los fines que se le permitiera presentar una causa de acción impugnando la fusión entre Rovica Development Corp. y Centro Radiológico Clínica Llagues.[70]

III. CONCLUSIÓN

Es necesario concluir que la Acción Derivativa es un mecanismo de control y monitoreo dentro de nuestro ordenamiento jurídico corporativo, demostrado tanto en la rama legislativa como en la rama judicial. Las expresiones de nuestro más Alto Foro sobre la Acción Derivativa han sido parcas, pero existe una amplia discusión sobre el tema en las sentencias del Tribunal de Apelaciones.

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67 *Véase id.*

68 *Id.* en las págs. 2-3.

69 *Id.* en la pág. 6.

70 *Véase id.*

Con la reciente legislación de la Ley Núm. 487 de 23 de septiembre de 2004 se pretende flexibilizar la manera de organizar las empresas y hacer negocios. También se amplía el ámbito de la Acción Derivativa como mecanismo de control y monitoreo que permite a las empresas la mayor flexibilidad para levantar capital y mantenerse competitivas a nivel mundial.

Tanto la legislación como la jurisprudencia en Puerto Rico recogen la Acción Derivativa como mecanismo de control y monitoreo, la cual permite al accionista o a un grupo de éstos el que, para evitar o remediar un daño, lesión, incumplimiento o abuso contra la corporación misma, presentaren una acción judicial para beneficio de la corporación, remediando el daño o impidiendo la lesión o requiriendo el cumplimiento.

No podemos afirmar que la Acción Derivativa esté en el olvido sino todo lo contrario. Recomendamos que esta reflexión se convierta en una invitación a juristas, profesores y estudiantes para abordar el tema profundamente.

THE CREDIT CRISIS AND SUBPRIME LITIGATION: HOW FRAUD WITHOUT MOTIVE 'MAKES LITTLE ECONOMIC SENSE'*

ARTICLE

PETER H. HAMNER**

I. INTRODUCTION

ON SEPTEMBER 29, 2008, THE DOW JONES INDUSTRIAL AVERAGE DROPPED 777 points, the greatest single day point drop ever.[1] The precipitous drop illustrated the volatile state of the market during the recent

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* Luminent Mortg. Capital, Inc. v. Merrill Lynch & Co., 652 F. Supp. 2d 576 (E.D. Pa. Aug.20, 2009).

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1 *See* Eric Martin, *U.S. Stocks Drop as Recession Concern Outweighs Bailout Passage*, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aeuIcKoruEHs (last visited Aug. 4, 2010). (Reporting losses sustained in U.S. market).

Credit Crisis.[2] The Credit Crisis[3] began with a complex chain of events.[4] Falling housing prices and subprime mortgages are generally considered the starting blocks of the Crisis.[5] Subprime mortgage origination accounted for $1.2 trillion in 2005 and 2006.[6] Ten percent of subprime mortgages, however, were more than sixty days delinquent or in foreclosure by the end of 2006, well above normal levels.[7] These deteriorating loans sent shockwaves through the financial system because the loans were held by several financial market participants.[8] The credit market subsequently halted as lenders became wary of borrower credit.[9]

The global economy suffered and continues to suffer enormous losses from the Credit Crisis.[10] With financial losses came lawsuits.[11] The majority of subprime plaintiffs follow comparable narratives to their claims.[12] Plaintiffs blame their economic losses during the Credit Crisis on banks originating faulty subprime loans for distribution.[13] According to the originate-to-distribute narrative,

2 *See id.* (stating market conditions).

3 *See* Catherine Rampell, *'Great Recession': A Brief Etymology*, NYTimes.com, Mar. 11, 2009, *available at* http://economix.blogs.nytimes.com/2009/03/11/great-recession-a-brief-etymology/ (discussing naming of the "Credit Crisis"). This paper will refer to the 2007-2008 financial disruption as the "Credit Crisis."

4 *See* JOHN B. TAYLOR, GETTING OFF TRACK: HOW GOVERNMENT ACTIONS AND INTERVENTIONS CAUSE, PROLONGED, AND WORSENED THE FINANCIAL CRISIS 15 (Hoover Institution Press 2009) (noting importance of August 9th, 2007).

5 *See id.* at 1 (describing falling housing prices role in Credit Crisis).

6 *See* Gary Gorton, *The Panic of 2007* at 3 (Yale ICF, Working Paper No. 08-24, 2008), *available at* http://ssrn.com/abstract=1255362 (conveying economic importance of subprime mortgage origination).

7 *See* TECHNICAL COMMITTEE OF THE INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS, IOSCO, REPORT ON THE SUBPRIME CRISIS 4 (May 2008), *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD273.pdf (reporting on subprime mortgage delinquencies).

8 *See* Gorton, *supra* note 6, at 34 ("If this was the end of the story, it is not clear whether there would have been a systemic problem when the house price bubble burst.").

9 *See* TAYLOR, *supra* note 4, at 16 (describing credit freeze).

10 *See generally*, CHARLES R. MORRIS, THE TWO TRILLION DOLLAR MELTDOWN 64 (2008) (detailing losses suffered in global economies).

11 *See* Jennifer Bethel, Allen Farrell & Gang Hu, *Law and Economic Issues in Subprime Litigation* 2-3, (Harvard John M. Olin Discussion Paper Series, No. 612, 2008), *available at* http://www.law.harvard.edu/programs/olin_center/papers/pdf/Ferrell_et_al_612.pdf (stating increase in securities fraud cases following crisis).

12 *See, e.g.*, Plumbers' Union Local No. 12 Pension Fund v. Nomura Asset Acceptance Corp., 658 F. Supp. 2d 299, 303 (D.Mass. 2009) (discussing plaintiffs' allegations); *Atlas* , 556 F.Supp.2d at 1149 (S.D.Cal. 2008) (blaming inflated stock price on misrepresentations regarding companies' core business); New York State Teachers' Retirement Systems v. Fremont General Corp., 2009 U.S. Dist. LEXIS 94241, *3-4 (C.D. Cal. 2009) (arguing poor lending standards contributed to common stock devaluation).

13 *See* Bethel, et. al., *supra* note 11, at 33-34 (describing claims by MBS purchasers).

lenders originated poor quality loans and passed the risk onto investors through securitization.[14] The risks associated with the loans were allegedly not disclosed to investors.[15] Therefore, according to this narrative, originators committed securities fraud to their investors by not disclosing.[16]

This article argues that the majority of securities fraud claims arising out of the Credit Crisis are ill founded. Section II presents background information on the subprime mortgage securitization process. Section III discusses the relevant securities law. Section IV analyzes the validity of securities fraud claims in light of what we know about the causes of the Credit Crisis. Finally, Section V concludes the paper with final remarks on the Credit Crisis and securities fraud claims connected with the Credit Crisis.

II. SECURITIZATION: FINANCIAL INNOVATION OR FINANCIAL FRANKENSTEIN?

A. The Subprime Mortgage Market and Housing Prices

From 2000-2007, the subprime mortgage market grew 800 percent, whereas overall mortgages merely doubled.[17] Lenders categorize borrowers by the risk associated with their ability for loan repayment.[18] Borrowers are defined as "prime" and "nonprime."[19] Prime borrowers are the traditional borrower and exhibit great credit characteristics.[20] A standard prime mortgage is set at a fixed-interest rate for thirty years.[21] The borrower has the right to default or prepay the mortgage.[22]

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14 *See* Frederic S. Mishkin, Governor, Bd. Of Governors Federal Reserve System, Speech at the Wharton Financial Institutions Center and Oliver Wyman Institute's Annual Financial Risk Roundtable: How Should We Respond to Asset Price Bubbles? (May 15, 2008), http://www.federalreserve.gov/newsevents/speech/mishkin20080515a.htm (discussing misaligned incentives of originators and investors in originate-to-distribute banking) (last visited Aug. 11, 2010).

15 *Nomura Asset Acceptance Corp.*, 658 F. Supp. 2d 299, 303 (stating that lender misrepresented loan quality).

16 *See id.* (providing plaintiffs' argument that lender committed securities fraud).

17 *See* Gorton, *supra* note 6, at 8 (reporting growth of subprime market).

18 *See* Sumit Agarwal & Calvin T. Ho, The Federal Reserve Bank of Chicago, *Comparing the Prime and Subprime Mortgage Markets*, Chicago Fed Letter No. 241, August 2007, *available at* http://www.chicagofed.org/digital_assets/publications/chicago_fed_letter/2007/cflaugust2007_241.pdf (stating varying risk characteristics in borrowers).

19 *See id*. (discussing differences between prime and nonprime borrowers).

20 *See id*.

21 *See* Gorton, *supra* note 6, at 13 (describing standard prime mortgage operation).

22 *See id.* ("The usual way of thinking of mortgage design and pricing is to recognize the embedded optionality in these mortgages: the borrower has the right to prepay the mortgage (a call option to refinance) and the right to default (a put option).").

Nonprime borrowers are broken down into Alt-A and subprime.[23] Alt-A borrowers generally have good credit scores and are considered between subprime and prime borrowers in terms of risk.[24] For conveniences purposes I will refer to Alt-A and subprime borrows collectively as subprime unless otherwise indicated. The *Interagency Expanded Guidance for Subprime Lending* defines a subprime borrower as a person who exhibits one or more of the following credit risk characteristics:

> two or more 30-day delinquencies in the last 12 months, or one or more 60-day delinquencies in the last 24 months; judgment, foreclosure, repossession, or charge-off in the last 24 months; bankruptcy in the last five years; relatively high probability of default as evidenced by, for example a credit bureau risk score (FICO) of 660 or below; debt service-to-income ratio of 50 percent or greater; or, otherwise limited ability to cover family living expenses after deducting total debt-service requirements from monthly income.[25]

Subprime borrowers are therefore riskier borrowers than prime borrowers because there is a history of poor repayment ability.[26]

Subprime lending is based upon the assumption that potential home equity is the greatest form of wealth for a low-income household.[27] "If borrowers can lend to these households for a short time period, two or three years, at a high, but affordable interest rate, and equity is built up in their homes, then the mortgage can be refinanced with a lower loan-to-value [("LTV")] ratio, reflecting the embedded price appreciation."[28] The LTV ratio is "[t]he balance of a mortgage loan expressed as a percentage of the property's appraised value. For example, a $200,000 loan on a home appraised at $250,000 has an LTV of 80% ($200,000 / $250,000)."[29] Subprime mortgages start with an initial fixed-rate ending with the "reset date," (usually after 2 or 3 years) whereupon the borrower is incentivized

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23 *See* Sumit Agarwal & Calvin T. Ho, *supra* note 18 (explaining borrower classes).

24 *See id.* (defining Alt-A borrowers).

25 Press Release, Federal Deposit Insurance Corporation, Expanded Guidance for Subprime Lending Programs (Jan. 31, 2001), http://www.fdic.gov/news/news/press/2001/pr0901a.html (last visited August, 5, 2010). "Sub-prime lending involves originating and purchasing loans for borrowers considered high-risk by traditional credit and underwriting standards." In re New Century, 588 F.Supp.2d 1206, 1209 (C.D. Cal. 2008).

26 *See* Federal Deposit *supra* note 30. (detailing characteristics of subprime borrowers). *See also* Gorton, *supra* note 6, at n.17. Commenting on how a prime borrower may be defined as subprime because of little documentation.

27 *See* Gorton, *supra* note 6, at 7 (describing basic assumption used for lending to subprime borrowers).

28 *Id.*

29 *See* Credit Suisse, *CSFB's Starter Kit for Non-Agency Residential Mortgage-Backed Securities,* Oct. 20, 2005, at 90, *available at* http://www.scribd.com/doc/19605788/Credit-Suisse-CFBSs-Starter-Kit-for-NonAgency-Residential-MortgageBacked-Securities) (defining loan-to-value ratios).

to refinance the mortgage otherwise triggering a much higher rate.[30] The overwhelming majority of subprime mortgages include prepayment penalties to discourage prepayment.[31] The combination of the hybrid adjusted-rate mortgage ("ARM") and prepayment penalties deter the borrower from refinancing before or after the reset date allowing the lender to decide whether to refinance or take the recovery value left after foreclosure.[32] Subprime mortgages work by "forcing" the borrower to refinance after two or three years.[33] "The lender is essentially long [on] the house, exposing the lender to house prices more sensitively than conventional mortgages."[34] Moreover, "[t]he key security design feature of subprime mortgages was the ability of borrowers to finance and refinance their homes based on the capital gains due to house price appreciation over short horizons and then turning this into collateral for a new mortgage (or extracting the equity for consumption)."[35] Without house appreciation, a great number of subprime mortgages default.[36] Subprime mortgage loans are more sensitive to housing prices than prime mortgage loans because of the forced refinancing.[37] Thus, the lender and borrower are attempting to benefit from price appreciation in the home over a short time horizon.[38]

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30 *See* Gorton, *supra* note 6, at 12 (explaining "reset date" feature of subprime mortgages). Mortgage loans are of the "2/28" and "3/27" variety. *See id.* Most loans have a 30-year amortization so the 2 and 3 represent the yearly amount the rate is fixed. *See id.*

31 *See* Gorton, *supra* note 6, at 13 (detailing importance of prepayment penalties).

32 *See id. at* 16 (analyzing rationale behind forcing borrower to refinance). Using a sample pool of securitized subprime mortgages originated by New Century Financial, it is noted by Adam Ashcraft and Til Schuermann that the majority of subprime loans in the pool are for refinancing and not purchasing a home. *See* ADAM B. ASHCRAFT & TIL SCHUERMANN, UNDERSTANDING THE SECURITIZATION OF SUBPRIME MORTGAGE CREDIT, FEDERAL RESERVE BANK OF NEW YORK STAFF, REPORT NO. 318, at 21-23 (2008), *available at* http://ssrn.com/abstract_id=1071189.

33 *See* Gorton, *supra* note 6, at 12 (noting how subprime mortgages "force" borrowers to refinance). Subprime mortgages are hybrid mortgages with an initial two or three year fixed-rate followed by a generally higher adjustable-rate. *See id.*

34 *Id.* at 17 (explaining rationale for subprime mortgage origination).

35 *Id.* at 3.

36 *See* ASHCRAFT, *supra* note 32, at 21-23 (portraying problems subprime mortgages have in both stagnate and declining housing markets). "[A] national price decline of 10 percent could put half of all subprime borrowers underwater." *Id.* at 22.

37 *See* Gorton, *supra* note 6, at 4 (remarking on added sensitivity of housing prices to securitization of subprime mortgage loans).

38 *See Id.* at 12 (examining relationship of house price appreciation to subprime mortgage loan).

B. The Securitization Process

Securitization converts mortgage loans into mortgage-backed securities ("MBS").[39] Securitization is important because it can transform previously un-tradeable assets into tradable asset-backed securities ("ABS").[40] MBS are a type of ABS whereby mortgage loans are pooled and sold as a debt obligation for the claim to the future payments on the mortgage loans by the home owner.[41]

A typical mortgage loan to MBS conversion and transaction consists of several steps.[42] A mortgage lender, the originator, lends money to many home owners to finance the purchase of homes.[43] The originator holds the mortgage loans representing a right to future payments on the originators' balance sheet; these rights are called "receivables."[44] The originator determines the average rate of default for the loans and securitizes them for sale to a third party investor.[45] The originator contributes the receivables related to the loan to a trust, new special purpose corporation, or other legally separate entity, a/k/a a Special Purpose Entity ("SPE").[46] By transferring the loan to a SPE, investors are assured that if the originator files for bankruptcy, third-party creditors have no claim against

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39 *See* Richard J. Rosen, The Federal Reserve Bank of Chicago, *The role of securitization in mortgage lending*,, Chicago Fed Letter No. 244, November 2007, *available at* www.bus.ucf.edu/ssmith/MtgSec11.07.pdf (discussing subprime securitization). According to Frank J. Fabozzi & Vinod Kothari, *Securitization: The Tool of Financial Transformation* 3, (Yale ICF Working Paper No. 0707, 2007), *available at* http://ssrn.com/abstract=997079:

> Today securitization is understood to mean a process by which an entity pools together its interest in identifiable future cash flows, transfers the claims on those future cash flows to another entity that is specifically created for the sole purpose of holding those financial claims, and then utilizes those future cash flows to pay off investors over time, either with or without credit support from a source other than the cash flows.

40 *See* Ronel Elul, *The Economics of Asset Securitization*, 2005 BUS. REV. Q3, 16 (2005) (detailing asset securitization process).

41 *See* U.S. Securities & Exchange Commission, *Mortgage-Backed Securities*, http://www.sec.gov/answers/mortgagesecurities.htm (last visited Aug. 5, 2010) (providing definition for mortgage-backed securities).

42 *See* SCHWARCZ, *infra* note 64, at 6-8 (walking through typical mortgage loan to MBS conversion and transaction). For a graphical representation of the securitization process and the players involved, *see* Christopher L. Peterson, *Subprime Mortgage Market Turmoil: Examining the Role of Securitization – A hearing before the U.S. Senate Committee on Banking, Housing, and Urban Affairs Subcommittee on Securities, Insurance, and Investment* 4, http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=4f40e1b9-ec5b-4752-ba8f-0c14afc44884 (last visited Aug. 11, 2010) (providing complex graphical representation of securitization process).

43 *See* Elul, *supra* note 40 (detailing mortgage loan origination).

44 *See* SCHWARCZ, *infra* note 69, at 135 (defining receivables).

45 *See id.* (explaining importance of risk assessment by originator when securitizing loan).

46 *See id.* (describing separation of assets from firm).

the loans.[47] The SPE pools and holds onto the mortgages and issues securities or bonds to investors.[48]

MBS are tranched by the SPE so that investors can further assess the risk they wish to purchase.[49] Tranching the mortgages splits the receivables according to the pre-payments and future payments of the mortgages.[50] A standard mortgage pool is sliced "into a senior (AAA) tranche, mezzanine tranches (AA, A, BBB), [and] subordinated tranches (BB, B, and unrated)" resulting in a typical "senior/sub" tranching structure.[51] A "senior" mortgage tranche becomes the claim for first payment.[52] The next mortgage tranche is a claim to the next allocation of payment and so on.[53] The senior tranche is paid off first followed by the next tranche.[54] The lower tranche must wait longer than the senior tranche before being paid.[55] The risk of mortgage default increases the longer the wait.[56] Therefore, the risk of non-payment increases the lower the tranche.[57]

Generally, MBS are broken into the traditional "six-pack" structure so the senior tranche is protected by six layers of subordination.[58] Tranching allows the firm to overcollateralize the lower tranches.[59] Overcollateralization means the debt issued is backed by an amount of debt greater than that issued.[60] In addition to overcollateralization, mezzanine and subordinate subprime tranches "are tranched to be thick enough to absorb collateral losses to ensure that the senior

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47 *See id.* (briefly mention why this occurs). The transfer to the SPE generally is a "true sale." *See id.* A "true sale" is required for bankruptcy purposes. *See id.* (citing 11 U.S.C. §541 (1988)). Additionally, the SPE's business operations are limited because of the bankruptcy concerns. *See id.* If the originator controls the SPE, the SPE will need one or more independent directors. *See id.* at 136.

48 *See* SCHWARCZ, *infra* note 64, at 7 (describing securitization process).

49 *See* Elul, *supra* note 45, at 18 (analyzing mortgage tranching). *See also* Securities Industry & Financial Markets Association, *The Various Types of CMOs*, http://www.investinginbonds.com/learnmore.asp?catid=5&subcatid=17&id=35 (last visited Aug. 5, 2010) (providing basic understanding of collateralized mortgage obligations).

50 *See* Elul, *supra* note 45, at 18 (describing MBS tranching).

51 Gorton, *supra* note 6, at 23-24 (remarking on distribution of tranches).

52 *See* Elul, *supra* note 45, at 18 (discussing mortgage loan tranching).

53 *See id.*

54 *See id.* (explaining payment order following tranching).

55 *See id.*

56 *See id.* (detailing risk associated with later payment).

57 *See id.*

58 *See* Rosen, *supra* note 39 ("For example, some MBSs backed by jumbo loans use a "six-pack" structure, with six layers of subordination."). "Of the MBSs issued by private firms in 2006, 93% had subordination." *Id.*

59 *See* ASHCRAFT, *supra* note 32, at 29 (stating relationship of tranching to overcollateralization). Excess spread averaged 2.5% for subprime. *See Id.* at 31.

60 *See* Gorton, *supra* note 6, at 21 (defining overcollateralization).

bonds have a probability of loss sufficiently low to justify a triple-A rating."[61] Overcollateralization and thickness in mezzanine and subordinated tranches allows these tranches to take losses before the senior tranches, thereby enhancing the senior tranche's credit rating.[62]

Eighty percent of subprime mortgage origination in 2005 and 2006 resulted in securitization.[63] There are four financial and economic reasons for securitizing mortgages and other assets.[64] First, securitization enhances the mortgage loans' credit rating making them easier to sell.[65] Investors do not have the time or resources to inspect the financial condition of the companies' assets.[66] Thus, credit ratings help firms assess the level of risk associated with specific securities.[67] Second, selling the underlying assets removes them from the firm's balance sheet.[68] Third, investors are more willing to purchase a pool of mortgages as opposed to the individual mortgage because the risk is diversified and hypo-

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61 *Id.* at 24.

62 *See* Credit Suisse, *supra* note 29, at 22 (explaining effect of overcollateralization and subordination on credit rating of senior tranche).

63 *See* Gorton, *supra* note 6, at 3 (citing *The 2007 Mortgage Market Statistical Annual*, INSIDE MORTGAGE FINANCE, Joint Economic Committee (October 2007) (relaying securitization statistics).

64 *See generally*, STEVEN L. SCHWARCZ ET. AL., SECURITIZATION, STRUCTURED FINANCE AND CAPITAL MARKETS, §1(2004) (examining economic benefits behind securitization). Investors also benefit from the securitization process through a better yield premium compared to treasuries, limited credit risk, and liquidity. *See* Goldman Sachs, *A Mortgage Primer* 20, *available at* http://www.scribd.com/doc/19601589/Goldman-Sachs-a-Mortgage-Product-Primer (Fall 2004).

65 *See* John D. Martin, *A Primer on the Role of Securitization in the Credit Market Crisis of* 2007 at 4 (2009), http://ssrn.com/abstract=1324349 (last visited Aug. 7, 2010) (providing analysis of asset credit enhancement through securitization). A firm may enhance the assets credit rating by purchasing a surety bond, a letter of credit from another financial institution, or credit insurance from monocline insurance companies such as Ambac Financial Group, Inc. and MBIA, Inc. *See id.* Moreover, credit ratings may be enhanced through a government sponsored entity ("GSE"), overcollateralization and tranching. *See* Elul, *supra* note 40, at 16-18. A GSE guarantees the payments of the mortgages to the investor similar to the above mentioned surety bond or insurance method. *See id.* at 17. Overcollateralization occurs when a firm issues a smaller dollar value of securities against a larger pool of mortgages. *See* Martin, *supra* note 65, at 4. Tranching allows the firm to pool its loans together to enhance the credit of some of the tranches while it can hold onto the riskier tranches. *See id.*

66 *See* Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133, 136 (1994) (detailing importance of credit ratings).

67 *See id*. The greater the investment grade of the securities offered the lower the interest rate the firm must charge; See *also id.* at 137 (arguing that it will reduce the overall cost of funding).

68 *See* Elul, *supra* note 40, at 16 (explaining benefits of securitizing assets). The transfer of the assets to an Special Purpose Entity ("SPE") raises the originator's capital "without increasing the originator's leverage or debt-to-equity ratio on its financial statements." Schwarcz, *supra* note 71, at 143.

thetically easier to calculate when spread.[69] Finally, mortgages can be split into tranches through securitization.[70] Tranching allows investors to determine the amount of risk to which they are willing to expose themselves because the investor knows with greater likelihood the risk of default.[71]

C. Subprime Mortgage Backed Securities

Subprime securitization is different from ordinary MBS securitization because of the greater credit risk associated with subprime borrowers.[72] In response to the credit risk posed, the subprime securitization process features many structural innovations.[73] First, subprime MBS issuers can use excess spread.[74] Excess spread is the difference between the interest paid from the subprime mortgages and the interest issued on the MBS.[75] The excess spread creates overcollateralization to be used in conjunction with the senior/sub structure to further enhance the senior tranche's credit.[76] The excess spread is used by the issuer to protect investors against losses in the underlying mortgages.[77] Second, senior bond holders may receive all principal payments before the mezzanine bondholders by shifting the interest payments to the mezzanine holders for lat-

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69 *See* Elul, *supra* note 40 (providing benefits to investors of securitized assets). Additionally, investors require less information in a MBS because the mortgages' differences are no longer relevant when pooled. *See id.* at 18.

70 *See id.* at 18 (stating mechanics of asset security tranching). "[I]nvestors in the first — senior — tranche receive principal payments from the underlying assets first, those in the second tranche next, and so on. Investors in the last — most junior — tranche receive principal payments from the mortgages in the pool only when the tranches ahead of them in priority have been fully paid." *Id.*

71 *See id.* (listing benefits of securitization process for investors).

72 *See* Gorton, *supra* note 6, at 19-20 (explaining securitization differences attributable to subprime mortgages).

73 *See id.* at 21 (detailing design features of subprime MBS).

74 *See* ASHCRAFT, *supra* note 32, at 31 (discussing use of excess spread by issuers). *See also* Rosen, *supra* note 39 Stating that excess spread averaged 2.5% for subprime mortgages in 2006.

75 *See* Gorton, *supra* note 6, at 21 (defining excess spread). Excess spread increases the underlying assets overcollateralization. *See id.* at 24.

76 Credit Suisse, *supra* note 29, at 23 (providing relationship of excess spread to OC).

> This excess [spread] is initially applied to the reduction of the aggregate principal balance of securities, resulting in a more rapid amortization of the aggregate principal balance of these securities, as compared to the decline in the aggregate mortgage collateral balance. This creates OC and this application of excess interest continues until the OC target is met. Upon funding of the OC, any realized losses on the collateral are covered by the OC and the monthly excess spread prior to the subordinate classes being hit. Remaining excess spread is directed to the residual holder, which may or may not be the issuer.

Id.

77 *See* ASHCRAFT, *supra* note 32, at 31 (stating purpose of excess spread in MBS).

er.[78] Third, issuers include performance triggers which transfer principal payments immediately from the subordinated bonds to the senior bonds[79] Performance triggers trigger when there are losses or delinquencies in the underlying mortgages and a specified target level of collateral is not reached.[80] This process protects the credit enhancement of the senior bonds by ensuring payment on the senior bonds and slowing down or stopping the payments on the subordinated bonds.[81]

Additionally, because the majority of the underlying loans are hybrid ARMs and the first couple periods are set at the fixed rate, the issuer may be "exposed to the risk that interest rates increase, so that the cost of funding increases faster than interest payments received on the mortgages."[82] Issuers, therefore, enter into interest rate swap agreements with third-parties.[83] The issuer agrees to pay the third-party a fixed rate while the third-party pays the issuer an adjustable rate.[84] Furthermore, issuers provided representations and warranties guaranteeing loan performance.[85] It is important to also note that the underlying mortgage loans are not homogenous and there is great diversity and complexity across states regarding defaults, housing price appreciation and housing appraisal methods.[86]

D. The Derivatives Market

Credit derivatives are financial instruments "whose payoffs are linked in some way to a change in credit quality of issuer or issuers."[87] A type of credit

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78 *See id.* at 32 (noting shifting interest protection for senior bond holders). *See also* Gorton, *supra* note 6, at 25 Explaining that after senior bond holders are paid, the next class of bonds is paid sequentially.

79 *See* Gorton, *supra* note 6, at 25 (explaining performance triggers).

80 *See id.*

81 *See id.* at 25. Trigger levels typically change as payments progress. *See id.* "For example, the loss trigger in months 1- 48 might be 3.5 percent, rise to 5.25 percent in months 49-60, 6.75 percent in months 61-72, and stay flat at 7.75 percent thereafter." *Id.*

82 ASHCRAFT, *supra* note 32, at 33.

83 *See id.* (explaining interest rate swap agreements).

84 *See id.* Another method of solving the ARM risk problem is making the deal subject to an available funds cap. *See* Gorton, *supra* note 6, at 25 (stating available funds cap feature of some MBS deals). In an available funds cap deal, "[i]nvestors receive interest as the minimum of Index (e.g., 1-month [London Interbank Offered Rate] LIBOR) plus Margin or the Weighted Average [available funds cap]." *Id.*

85 *See* Lone Star Fund v. Barclays Bank, 2008 WL 4449508, *8 (N.D. Tex. 2008) (describing representations and warranties provided by MBS issuer).

86 *See* Gorton, *supra* note 6, at 11-12 (presenting graphical representation of differences state-to-state of subprime mortgage loan characteristics).

87 Frank Partnoy et. al., *The Promise and Peril of Credit Derivatives*, 75 U. CIN. L. REV. 1019, 1021 (2007).

derivative is the credit default swap (CDS).[88] A CDS is "a bilateral contract that enables an investor to buy protection against the risk of default of an asset [generally] issued by a [corporation or bank]."[89] For example, a bank that lends millions to a company may wish to hedge their risk against the company defaulting on the loan.[90] The bank enters a CDS with a third-party.[91] The third-party pays the bank if the company defaults and the bank will pay the third-party if the company does not default.[92] CDS account for a large part of the credit derivatives market.[93] "The primary purpose of credit derivatives is to enable the efficient transfer and repackaging of credit risk."[94] Firms use CDS to "bet on a debt issuer's bankruptcy, default, or restructuring."[95] Thus, CDS allow banks and other market participants to hedge their risks against borrowers.[96] CDS lower the potential costs for a lender of a borrower's default.[97] Former Federal Reserve Chairman Alan Greenspan credited CDS with preventing losses from spreading to the financial sector during the scandals of Enron and WorldCom.[98]

MBS were further purchased and pooled into credit derivatives known as collateralized debt obligations ("CDO").[99] A cash flow CDO purchases fixed income assets, such as MBS, to sell in the market after enhancing the assets cre-

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88 *See id.* at 1021

89 Dominic O'Kane, Lehman Brothers, *Credit Derivatives Explained* 25, http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.129.429&rep=rep1&type=pdf (last visited Aug. 11, 2010) (explaining CDS operation).

90 *See* Partnoy, *supra* note 87, at 1021-22 (providing example of CDS).

91 *See id.*

92 *See id.* (explaining CDS operation).

93 *See* O'Kane, *supra* note 89, at 3 (noting importance of CDS in chain of financial instruments).

94 *Id*.

95 Partnoy, *supra* note 87, at 1021.

96 *See id.* at 1023 (listing benefits of CDS to companies).

97 *See id.* at 1023-24 (discussing CDS benefits to lenders).

98 *See id.* at 1024 (stating benefits of CDS when financial sector was faced with scandals). According to Greenspan, credit derivatives "appear to have effectively spread losses from defaults by Enron , Global Crossing, Railtrack, WorldCom, and Swissair." Alan Greenspan, Chairman, Fed. Res. Bd, Address before the Council on Foreign Relations, Washington, D.C.: International Financial Risk Management (Nov. 19, 2002) http://www.federalreserve.gov/boarddocs/Speeches/2002/20021119/default.htm (last visited Aug. 7, 2010).

99 *See* Rosen, *supra* note 39 (discussing RBMS securitization process); U.S. Securities & Exchange Commission, *Collateralized Mortgage Obligation*, ,http://www.sec.gov/answers/tcmos.htm (last visited Aug. 7, 2010) (defining collateralized mortgage obligations). CMOs are issued through Real Estate Mortgage Investment Conduits (REMICs) for tax and accounting advantages. *See* SECURITIES INDUSTRY & FINANCIAL MARKETS ASS'N, *The CMO: An Overview*, http://www.investinginbonds.com/learnmore.asp?catid=5&subcatid=17&id=24 (last visited Aug. 7, 2010).

dit.[100] Bonds or certificates issued by cash flow CDOs included many of the same innovations as MBS such as tranching, subordination, overcollateralization, and excess spread to enhance the credit.[101] These credit enhancement techniques allowed cash flow CDOs to buy low-rated MBS to repackage and sell.[102]

CDOs can be a hybrid of "cash flow" and "synthetic."[103] A "synthetic" CDO is composed of credit derivatives.[104] A synthetic CDO, consisting of several CDS with third parties, creates "synthetic exposure to the outstanding debt" of several companies.[105] Cash flow, synthetic and hybrid CDOs were further purchased and pooled into additional CDOs, known as CDO^2 or CDO-squared.[106] No data exists explaining the extent of CDOs' exposure to subprime risk.[107] CDS contracts may have also resulted in the amplification in the amount of CDO exposure.[108] The exposure problem is compounded by the lack of transparency in the derivatives market.[109] In the end, securitization built upon other securitization and derivatives written upon securitized assets made it impossible for investors to examine the underlying assets in CDO portfolios.[110]

Companies purchased CDOs through off-balance sheet Structured Investment Vehicles ("SIV").[111] "An SIV is a limited-purpose operating company that undertakes arbitrage activities by purchasing mostly highly rated medium- and long-term fixed income assets and funding itself with cheaper, mostly shorter,

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100 *See* Rosen, *supra* note 39 (defining CDOs).

101 *See id.* at n.5 (providing analysis of CDOs).

102 *See id.* (reporting on CDO issuers purchase of low-rated securities).

103 *See* Gorton, *supra* note 6, at 37 (providing discussion of CDOs).

104 *See* Partnoy, *supra* note 87, at 1022 (discussing differing CDOs). Credit default swaps are used for hedging risk, speculating, or arbitrage. *See id.* at 1022.

105 *Id.*

106 *See* Martin, *supra* note 65, at 2 (describing CDOs).

107 *See* Gorton, *supra* note 6, at 39 ("It is also notable what data are missing. There is no data on the amount of subprime exposure in CDOs, whether cash or synthetic."). *Id.*

108 *See* Jody Shenn, *Overlapping Subprime Exposure Mask Risks of CDOs, Moody's Says*, Bloomberg.com, Apr. 4, 2007, http://www.bloomberg.com/apps/news?pid=20601170&sid=aszosOrxVmjk&refer=home (last visited Aug. 7, 2010) (explaining role of credit default swaps in crisis). Although no new risk is created through the synthetic derivative market, the risk exposure increases. *See* Gorton, *supra* note 6, at 42.

109 *See* Gorton, *supra* note 6, at 43 (noting difficulty in assessing where CDO tranches ended). The derivative market is largely unregulated resulting in asymmetric information. *See* Partnoy, *supra* note 92, at 1036-1037.

110 *See* Martin, *supra* note 65, at 10-11(discussing problems with derivative market). "CDO investors and other investors in other instruments that have CDO tranches in their portfolios (so called CDO squares or CDO^2) cannot penetrate the chain backwards and value the chain based on the underlying mortgages." *Id.* at 11.

111 *See* Gorton, *supra* note 6, at 44 (stating SIVs role in CDO dispersal).

highly rated [commercial paper] and [medium term notes]."[112] Thus, SIVs leveraged themselves by borrowing short and purchasing long assets.[113] SIVs were purchasers of subprime CDO tranches and were exposed to a great deal of subprime risk.[114] During the Credit Crisis, the majority of SIVs were put back onto their firm's balance sheets, restructured, or defaulted.[115]

Information on subprime risk became available to the market in the form of the ABX.HE indices ("ABX").[116] The ABX was created by Markit Partners in January of 2006.[117] The ABX tracks CDS referencing twenty equally-weighted MBS transactions.[118] Investors use the ABX to trade subprime CDS.[119] Thus, the ABX allowed investors to trade on the risk of subprime default through CDS.[120] The ABX serves as a barometer of investor confidence in subprime mortgages.[121] "Changes in investor views about the risk of the mortgage loans over time will affect the price at which investors are willing to buy or sell credit protection [on the ABX]."[122] Thus, the ABX played a key role in disseminating information regarding investor confidence in subprime risk.[123] In 2007 investors ran for protection from subprime risk by purchasing CDS on the ABX causing ABX prices to dramatically fall.[124]

III. Relevant Securities Law

The majority of claims arising out of the 2007 Credit Crisis involve alleged violations under Securities and Exchange Commission ("SEC") Rule 10b-5 and Section 10(b) of the Securities Act of 1934, and Sections 11 and 12(a)(2) of the Securities Act of 1933.[125] Congress promulgated the acts "'to insure honest securities markets and thereby promote investor confidence' after the market crash of

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112 *Id*. SIVs are different from SPEs in that they are managed and marked-to-market. *See id.*

113 *See id.* at 44 (describing SIVs).

114 *See id.* at 43 (representing graphically the estimated holders of CDO tranches).

115 *See id.* at 82 (listing SIV outcomes).

116 *See id.* at 3 (stating ABX's role in solving information problem of securitization).

117 *See id.* at 42 (describing ABX).

118 *See* Ingo Fender & Martin Scheicher, *The ABX: How Do the Markets Price Subprime Mortgage Risk?,* BIS Quarterly Review, September, 2008 *available at* http://ssrn.com/abstract=1473648.

119 *See* Gorton, *supra* note 6, at 42. The ABX comprised of five different indices; differentiated by credit rating: AAA, AA, A, BBB, and BBB-. *See* ASHCRAFT, *supra* note 32, at 26.

120 *See* Gorton, *supra* note 6, at 42 (discussing synthetic attributes of ABX).

121 *See* ASHCRAFT, *supra* note 32, at 27 (explaining purpose of ABX).

122 *Id.*

123 *See* Gorton, *supra* note 6, at 3 (stating role of ABX in Credit Crisis).

124 *See id.*

125 *See* Bethel, *supra* note 11, at 3 (stating causes of action by plaintiffs in subprime litigation).

1929."[126] To state a securities fraud claim, the plaintiff must prove: (1) a material misrepresentation or omission; (2) scienter, i.e. wrongful intent; (3) connection to the purchase or sale of the security; (4) reliance; (5) economic loss; and (6) causation.[127]

SEC Rule 10b-5 imposes liability on any person who, in a registration form makes, "an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security."[128] Section 11 of the Securities Act of 1933 imposes liability upon any person who makes an untrue statement of material fact or omits a material fact, required to be stated or necessary to make the statements not misleading, in a registration statement.[129] Section 12(a)(2) "imposes liability upon any person who 'offers or sells a security . . . by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the tight of the circumstance under which they were made, not misleading.'"[130]

IV. Subprime Lending and Fraud: Examining the Alleged Relationship

A. *Originate-to-Distribute and the Subprime Lawsuit Narrative*

The majority of subprime related lawsuits blame the financial markets collapse and their securities devaluation on the originate-to-distribute model of banking.[131] Some commentators also blame weaknesses in the originate-to-distribute model for the Credit Crisis.[132] The originate-to-distribute model differs

126 SEC v. Zandford, 535 U.S. 813, 819 (2002) (quoting United States v. O'Hagan, 521 U.S. 642, 658 (1997)).

127 *See* Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 341-42 (2005) (listing basic required elements of securities claim).

128 15 U.S.C.S. § 77k (2010).

129 *See* 15 U.S.C.S. § 77k(a) (imposing civil liability for false or misleading statements made in registration statement).

130 Recupito v. Prudential Secs., Inc., 112 F. Supp. 2d 449, 454 (D.C. Md. 2000) (quoting 15 U.S.C. § 77l(a)(2)).

131 *See, e.g.*, *Atlas,* 556 F.Supp.2d at 1149 (S.D.Cal. 2008) (blaming misrepresentations regarding companies' core business for stock inflation and subsequent devaluation); *New York State Teachers'*, 2009 U.S. Dist. LEXIS 94241, *3-4 (C.D. Cal. 2009) (stating basis for complaint).

132 *See* Quinn, Brian J. M., *The Failure of Private Ordering and the Financial Crisis of 2008*, NEW YORK UNIVERSITY JOURNAL OF LAW AND BUSINESS, Vol. 5, p. 549, 2009; (Boston College Law School Legal Studies Research Paper No. 177, April 22, 2010), *available at* http://ssrn.com/abstract=1354669 (describing role of originate-to-distribute in crisis); *see also* S.L. Schwarcz, *Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown*, 93 MINN. L. REV. 373, 387 (2008) (analyzing originate-to-distribute and potential solutions).

from the traditional lend and hold approach of banking where the bank lent to the borrower and held onto the loan until full payment.[133] In the originate-to-distribute model, the originator of a loan processes the loan for a fee and sells the rights of payment to a third party.[134] This allows the originator to hand off the risk of repayment to the third party.[135] Thus, "[u]nder this [originate-to-distribute] model lenders originate loans that are then distributed through securitization such that the lender retains little or no exposure to the loan. This change, many now argue, gave rise to the problems that are at the very heart of the credit crisis."[136]

According to proponents of the originate-to-distribute hypothesis, profit maximizing behavior resulted in lower underwriting standards thereby increasing the risk of systematic mortgage default.[137] Consequently, originators became focused on the fees from origination volume instead of the underlying loan quality.[138] Reserve Chairman Ben Bernanke, in reference to the crisis, stated that "[t]he revenues of the originators of subprime mortgages were often tied to loan volume rather than to the quality of the underlying credits, which induced some originators to focus on the quantity rather than the quality of the loans being passed up the chain."[139] Therefore, the originate-to-distribute theory of the crisis posits that the reduced incentive of lenders to monitor loan quality resulted in weak loans prone to default.[140] When housing prices soured the inferior loans defaulted in mass.[141] The proliferation of the inferior loans into the financial system through securitization magnified the damage to the economy.[142] Former

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133 *See* Quinn, *supra* note 132, at 23 (distinguishing originate-to-distribute and lend-to-hold).

134 *See id.* (explaining transfer of risk in originate-to-distribute model).

135 *See id.* at 22-23 (citing Annand K. Bhattaharya, Frank Fabozzi, & S. Esther Chang, *Overview of the Mortgage Market* in HANDBOOK OF MORTGAGE-BACKED 4 (Frank Fabozzi, ed. 2001) (defining originate-to-distribute).

136 Martin, *supra* note 70, at 9.

137 *See* Quinn, *supra* note 132, at 27 ("The front-loaded structure of incentives in the originate-to-distribute model, however, induced originators of mortgages to lower lending standards and continue to underwrite mortgages precisely when they should have been cutting back.").

138 *See* Frederic S. Mishkin, Governor of the Bd. Of Governors of the Federal Reserve System, Speech at the U.S. Monetary Policy Forum, New York: *On "Leveraged Losses: Lessons from the Mortgage Meltdown"* (Feb. 29, 2008) http://www.federalreserve.gov/newsevents/speech/mishkin20080229a.htm (last visited Aug. 11, 2010) (discussing misaligned incentives of lenders).

139 Ben Bernanke, Chairman of the Bd. Of Governors of the Federal Reserve System, Address at the Federal Reserve Bank of Chicago's Annual Conference on Bank Structure and Competition, Chicago, Illinois: *Risk Management in Financial Institutions* (May 15, 2008),

http://www.federalreserve.gov/newsevents/speech/bernanke20080515a.htm (last visited Aug. 11, 2010).

140 *See* Mischkin, *supra* note 138 (stating basic theory behind crisis on originate-to-distribute).

141 *See id.* (providing history of crisis).

142 *See id.* (discussing role of structured credit products within crisis).

United States Secretary of the Treasury Henry Paulson remarked, "[t]his turbulence wasn't precipitated by problems in the real economy. This came about as a result of some bad lending practices."[143]

B. A 'Fusillade' of Cautionary Statements

Many subprime plaintiffs blame their economic losses on poor lending practices.[144] Subprime plaintiffs organize their securities fraud claims based upon alleged misrepresentations companies made about their lending procedures and other loan related practices.[145] Cautionary statements in prospectuses and registrations statements, however, put potential plaintiffs on notice of the risks associated with the subprime mortgage industry.[146] The United States District Court for the District of Massachusetts dismissed all claims by purchasers of mortgage pass-through certificates issued by Nomura Asset Acceptance Corporation ("Nomura").[147] In *Plumbers' Union Local No. 12 Pension Fund v. Nomura Asset Acceptance Corp.*, plaintiffs alleged that defendants were liable under Sections 11, 12(a)(2) and 15 of Securities Act of 1933.[148] Nomura's certificates were significantly backed by Alt-A loans and the certificates suffered severe losses following the collapse of the subprime market.[149] On July 17, 2007, Moody's Investors Services announced that it might downgrade the certificates' ratings.[150] This action resulted in significant losses on the certificates and Nomura closing its U.S. mortgage loan business.[151]

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143 Reuters, *Paulson Says Subprime Woes Will Linger*, Reuters.com, Sept. 12, 2007, http://www.reuters.com/article/idUSWBT00756020070912 (last visited Aug. 7, 2010).

144 *Plumbers' Union*, 658 F. Supp. 2d 299, 303 (D.Mass. 2009) (listing alleged misrepresentations within registration statements and prospectuses); *Atlas*, 556 F.Supp.2d at 1149 (S.D.Cal. 2008) (blaming inflated stock price on misrepresentations regarding companies' core business); *New York State Teachers'*, 2009 U.S. Dist. LEXIS 94241, *3-4 (C.D. Cal. 2009) (blaming misrepresentations for common stock devaluation).

145 *See Atlas*, 556 F. Supp. 2d at 1149 ("The gravamen of Plaintiff's Complaint is that Defendants concealed Accredited's true financial condition and made materially false and misleading statements regarding the company's operations and income, as a result, artificially inflated the price of Accredited's stock during the class period.").

146 *See Plumbers' Union*, 658 F. Supp. 2d at 305 (D.Mass. 2009) (discussing problems with plaintiffs' complaint because of cautionary language included in defendants' prospectuses and registration statements).

147 *See id.* at 310 (D.Mass. 2009) (stating dismissal of case).

148 *See id.* at 299 (stating cause of action).

149 *See id.* (describing problems company had following subprime market crisis). Nomura expected losses ranging from $340 to $510 million. *See id.*

150 *See id.* (noting Moody's involvement in downgrading of certificates).

151 *See id.* (reporting Nomura's response to potential of Moody's rating downgrade).

Plaintiffs' alleged material misrepresentations and/or omissions in Nomura's registrations statements and prospectus supplements.[152] Plaintiffs argued that Nomura's underwriting and loan originating standards were focused on volume instead of quality.[153] Defendants' prospectuses stated that prospective borrowers were required to complete an application so defendants could determine the credit risk of the borrower.[154] Additionally, defendants' prospectus stated that a "key" originator "adhered to 'underwriting guidelines [that] are primarily intended to evaluate the prospective borrower's credit standing and ability to repay the loan,' and that these guidelines 'are applied in a standard procedure that is intended to comply with federal and state laws and regulations.'"[155] Plaintiffs argued that these statements were false when made by Nomura because Nomura did not filter out potentially risky borrowers using such methods.[156] The court, however, stated that statements in Nomura's prospectuses warned the plaintiffs of lower than average credit standards.[157] Nomura's prospectuses stated,

> The underwriting standards applicable to the Mortgage Loans . . . may or may not conform to Fannie Mae or Freddie Mac guidelines. As a result, the Mortgage Loans may experience rates of delinquency, foreclosure and borrower bankruptcy that are higher, and that may be substantially higher, than those experienced by mortgage loans underwritten in strict compliance with Fannie Mae or Freddie Mac guidelines.[158]

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152 *See id.* at 305 - 306 (alleging misrepresentations and/or omissions in registration and prospectus statements).

153 *See id.* (arguing that underwriting and loan origination standards were opposite those purported in prospectuses and registrations statements).

154 *See id.*

> Generally, each borrower will have been required to complete an application designed to provide to the original lender pertinent credit information concerning the borrower. As part of the description of the borrower's financial condition, the borrower generally will have furnished certain information with respect to its assets, liabilities, income (except as described below), credit history, employment history and personal information . . . .
>
> Based on the data provided in the application and certain verifications (if required), a determination is made by the original lender that the borrower's monthly income (if required to be stated) will be sufficient to enable the borrower to meet their monthly obligations on the mortgage loan and other expenses related to the property . . . . (quoting Complaint).

Id.

155 *Id.*

156 *See id.* at 305 (stating plaintiffs' argument that statements in prospectuses and registration statements were false and misrepresentative).

157 *See id.* (quoting language from prospectuses demonstrating relaxed credit standards).

158 *Id.*

The court stated that the "fusillade" of cautionary language and offering materials refuted the plaintiffs' contention that they were misled as to the underwriting and loan originating standards of Nomura.[159] This ruling confirms that investors were put on notice ofr the risks associated with subprime MBS.

Plaintiffs alleged that defendants misrepresented their LTV ratios because they were not within the Uniform Standards of Professional Appraisal Practice as claimed in defendants' registration statements.[160] The court found these allegations unsubstantiated because plaintiffs allegations relied on general testimony on industry standards and differing appraisal methods.[161] Next, the court rejected the plaintiffs' argument on material misrepresentations from statements about loan delinquencies greater than 30 days.[162] Only two loans out of 1,774 loans were delinquent for more than 30 days.[163] Thus, the court reasoned that the misrepresentation that no loans were delinquent for more than 30 days was not material.[164]

Finally, plaintiffs alleged misrepresentations on the ratings of the certificates.[165] The court stated that the plaintiffs' allegations amounted to an inference that "eventualities must have been known (or knowable) to defendants on the effective date of the registration statement" based on after the fact "insider" admissions.[166] As noted by the court and the defendants' registration statements, "'[a] security rating is not a recommendation to buy, sell or hold securities.'"[167] The court found that the plaintiffs did not sufficiently allege any securities violations against defendants and the court dismissed all claims.[168]

> All of the mortgage loans have been originated either under FNBN's "full" or "alternative" underwriting guidelines (i.e., the underwriting guidelines applicable to the mortgage loans typically are less stringent than the underwriting guidelines established by Fannie Mae or Freddie Mac primarily with respect to the income and/or asset documentation which borrower is required to provide).

Id.

159 *See id.* at 307 ("Plaintiffs' argument that they were not on notice of the originator's "soft" underwriting practices begs credulity.").

160 *See id.* (stating that plaintiffs' alleged misrepresentations and/or omissions regarding defendants loan-to-value appraisals).

161 *See id.* at 307-308 (rejecting plaintiffs' argument of loan-to-value appraisal misrepresentations).

162 *See id.* at 308 (discussing loan delinquencies in trust pools).

163 *See id.* (noting amount of loans delinquent beyond 30 days). The amount of loans delinquent accounted for 0.7 percent of the loan vintage. *See id.*

164 *See id.* (finding loan delinquency misrepresentation immaterial).

165 *See id.* 310 (alleging misrepresentations about certificates' ratings).

166 *Id.* According to the court, "plaintiffs were duly cautioned that '[t]he security ratings assigned to the Offering Certificates should be evaluated independently from similar ratings on other types of securities.'" *Id.*

167 *Id.*

168 *See id.* (stating holding of case dismissing all claims against defendants).

The *Nomura* ruling confirms that investors were put on notice of the many risks associated with subprime MBS.[169] Investors were provided "numerous warnings" and were told of "originator's 'soft' underwriting practices."[170] Therefore, subprime MBS originators did not commit securities fraud to investors because the investors were given such warnings.[171]

C. Economic Research on Lending Standards

There is a difference of opinion between economists on whether lending standards materially relaxed prior to the Credit Crisis.[172] Some economists argue that lending standards radically deteriorated due to the originate-to-distribute banking model.[173] According to these commentators, lenders originated as many loans as possible because the risk was subsequently sold to third-parties.[174] One study connected the proportion of default rates to the proportion of company's originate-to-distribute banking.[175] According to the study, the more a bank participated in the originate-to-distribute market, the harder it became when market conditions deteriorated to sell the loans.[176] Lenders in the originate-to-distribute market experienced a greater proportion of borrower default and

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169 *See id.* at 306-307 (acknowledging information provided to investors of risks associated with MBS).

170 *See id.* (describing underwriting practices and warnings provided to investors regarding such practices).

171 *See id*.

172 *Compare* Geetesh Bhardwaj & Rajdeep Sengupta, *Where's the Smoking Gun? A Study of Underwriting Standards for US Subprime Mortgages* 3, (Federal Reserve Bank of St. Louis, Working Paper 2008-036B, 2008), *available at* http://research.stlouisfed.org/wp/2008/2008-036.pdf (finding no deterioration in lending practices leading up to Credit Crisis) *with* Benjamin J. Keys, et. al., *Did Securitization Lead to Lax Screening? Evidence From Subprime Loans*, (EFA 2008 Athens Meetings Paper, Dec. 25, 2008), *available at* http://ssrn.com/abstract=1093137 (noting relaxed lending standards based on FICO scores).

173 *See, e.g.,* Amiyatosh Purnanandam, *Originate-to-Distribute Model and the Subprime Mortgage Crisis*, April 27, 2009, at 13, *available at* http://webuser.bus.umich.edu/amiyatos/subprime_march09.pdf (connecting originate-to-distribute mode with weakening lending standards); Benjamin J. Keys, et. al., *Did Securitization Lead to Lax Screening? Evidence From Subprime Loans* 1, (EFA 2008 Athens Meetings Paper), *available at* http://ssrn.com/abstract=1093137 ("By creating distance between a loan's originator and the bearer of the loan's default risk, securitization may have potentially reduced lenders' incentives to carefully screen and monitor borrowers.").

174 *See* Purnanandam, *supra* note 178, at 2 (stating incentive to relax credit screening when originating subprime loans).

175 *See id.* at 29 (concluding results of research finding relationship between delinquencies and originate-to-distribute banking).

176 *See id.* at 3 ("We first confirm that banks with large quantity of origination in the immediate pre-disruption period were unable to sell their OTD loans in the post-disruption period.").

chargeoffs suggesting lower quality loans.[177] Another study suggests that loans originated with a greater likelihood of securitization defaulted at a higher rate than loans originated with little likelihood of securitization.[178] Borrowers with a FICO score slightly above 620 are considered liquid and likely to be securitized.[179] Looking at loans above this mark and loans below the mark, the study states that loans above the threshold defaulted with greater frequency than loans below the threshold.[180] The FICO score ordinarily measures a borrowers' credit risk.[181] The study argues that if the FICO score is higher yet defaults with greater frequency the loan must be a consequence of relaxed screening.[182] Therefore, relaxed lending standards created a higher rate of default.[183]

Other economists, however, argue that underwriting standards in the United States neither deteriorated over time nor had a great effect on the market when compared to the consequences of real estate prices.[184] Many plaintiffs argue that underwriting standards started to relax and decline after 2004 as evidenced by mortgage foreclosures and delinquencies beginning in 2005.[185] In one study, researchers demonstrated that underwriting standards from 1998-2007 did not decline, specifically after 2004.[186] The authors do not assess whether lending standards were low before 1998; rather, the authors only analyzed whether lending standards deteriorated during this specific time period.[187] According to their research, "the underwriting process attempted to adjust riskier borrower characteristics with lower loan-to-value ratios (and higher mortgage rates)."[188] Even so, dramatic changes did not occur in lending standards post-2004 because while some dimensions of underwriting weakened, other dimen-

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177 *See id.* at 3 ("[T]hese results suggest that OTD loans were of inferior quality and banks that were stuck with these loans in the post-disruption period had disproportionately higher chargeoffs and borrower defaults.").

178 *See* Keys, *supra* note 172, at 3 (stating that easily securitized loans defaulted with greater frequency than other loans.)

179 *See id.* at 2 (providing rule of thumb for study).

180 *See id.* at 3 (noting default rates higher among greater FICO scored borrowers).

181 *See id.* at 2 (describing FICO score importance for investors, lenders, and other market participants).

182 *See id.* at 3 (describing relationship between defaults and FICO score).

183 *See* Purnanandam, *supra* note 178, at 29 (discussing originate-to-distribute hypothesis).

184 *See* Bhardwaj, *supra* note 172, at 3 ("Our results show that the hard information available on mortgage originations does not reveal deterioration in underwriting standards for subprime originations, particularly after 2004.").

185 *See* In re New Century, 588 F. Supp. 2d 1206 (C.D. Cal. 2008) ("New Century Complaint") (stating claim of poor lending standards).

186 *See* Bhardwaj, *supra* note 172, at 3 (stating that lending standards did not weaken from 1998-2007).

187 *See id.* at 4 (noting that research did not analyze whether standards were poor to begin with).

188 *Id.* at 22.

sions strengthened.[189] Although lending standards declined in some areas, it improved in others.[190] Documentation of borrowers may have lowered, whereas FICO scores increased.[191] Moreover, using counterfactual analyses, the study argues that had loans underwritten in 2005 been underwritten in 2001 or 2002, the loans would have performed *significantly better* than loans actually originated in 2001 or 2002 had housing prices behaved similarly.[192] Overall, the study states that lending standards did not drastically weaken in the subprime market from 1998-2004.[193] Another study notes that borrower characteristics improved while documentation may have fallen.[194]

Several other economists point to real estate price depreciation as the greatest factor in the Credit Crisis, not relaxed lending standards.[195] Lending standard deviations, if correct, may have been immaterial to the losses suffered on MBS.[196] The real problem was housing prices.[197] Thus, the extreme decline in housing prices is likely to blame for subprime default, and it would not matter if underwriting practices relaxed because there would be no causation to the alleged losses.[198] Consequently, securities fraud would not explain the losses suffered by investors.

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189 *See id.* at 22 (finding no dramatic changes in lending standards post-2004).

190 *See id.* at 3 (describing multi-dimensional nature of risk). Ex ante risk in one borrower can be mitigated through higher standards along another dimension. *See id.* Moreover, credit risk is affected by both the borrower's credit characteristics and the mortgage's characteristics. *See id.*

191 *See id.* at 3 (providing examples of increasing risk factors and decreasing risk factors).

192 *See id.* at 4 ("[I] if loans underwritten in 2005(or 2006 or 2007) were originated in 2001 or 2002, then they would have performed significantly better on average than loans underwritten in 2001 or 2002.").

193 *See id.* at 3 (highlighting conclusion of study).

194 *See* Charles D. Anderson, Dennis Capozza & Robert Van Order, *Deconstructing a Mortgage Meltdown: A Methodology for Decomposing Underwriting Quality*, May 29, 2009, at 21, http://ssrn.com/abstract=1411782 (last visited Aug. 11, 2010) (discussing credit characteristics of subprime borrowers before Credit Crisis).

195 *See, e.g.*, Dean Corbae & Erwan Quintin, *Mortgage Innovation and the Foreclosure Boom*, Oct. 23, 2009, at 5, http://sites.google.com/site/deancorbae/research/foreo61610tc.pdf?attredirects=0 (last visited Aug. 11, 2010) (noting importance of housing prices in Credit Crisis); Christopher J. Mayer, Karen M. Pence & Shane M. Sherlund, Federal Reserve Board, Washington, D.C., *The Rise in Mortgage Defaults*, *available at* http://www.federalreserve.gov/pubs/FEDS/2008/200859/200859pap.pdf ("We find substantial evidence that declines in house prices are a key factor in the current problems facing the mortgage market."); Kristopher S. Gerardi, et. al., *Making Sense of the Subprime Crisis* 6, (Federal Reserve Bank of Atlanta Working Paper No. 2009-2, Feb. 2009), *available at* http://www.frbatlanta.org/filelegacydocs/wp0902.pdf ("One of our key findings is that most of the uncertainty about losses stemmed from uncertainty about the evolution of house prices and not from uncertainty about the quality of the underwriting.").

196 *See id.*

197 *See* Mayer, *supra* note 195 (discussing falling housing prices impact on economy).

198 *See id*.

D. Misplaced Anger: What Really Happened

1. The Role of Securitization

The complexity of financial instruments created a loss of information in financial transactions.[199] According to one commentator,

> the increased complexity introduced to the market, combined with a decided lack of transparency, caused a high proportion of skilled investors to make poor decisions. Financial institutions overestimated their ability to disseminate values and comprehend risk. This same lack of transparency and true understanding of the market led to the knee-jerk reaction whereby investors fled and refused to invest when the Credit Crisis struck.[200]

As noted above, investors were not able to keep track of the risk underlying securities, derivatives and SIVs. Declining housing prices substantially increased the rate of default amount recent vintages of subprime loans.[201] Market participants did not know the true value of their portfolios because of their inability to track back to the individual loans pooled together in the MBSs, CDOs, and SIVs.[202] The complexity in the financial chain damaged their ability to run valuations.[203] Additionally, the lack of transparency created uncertainty in the market

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199 *See* Gorton, *supra* note 6, at 49 (arguing that complexity of structured finance resulted in a loss of information); *see generally*, Jean-Pierre Landau, Introductory remarks at the Conference on The Macroeconomy and Financial Systems in Normal Times and in Times of Stress: Complexity and the Credit Crisis (June 8, 2009), http://www.banque-france.fr/gb/instit/telechar/discours/2009/090608.pdf (last visited Aug. 4, 2010) (pointing to complexity of finance as cause of Credit Crisis).

200 Aaron Unterman, *Innovative Destruction – Structured Finance and Credit Market Reform in the Bubble Era*, 5 HASTINGS BUS. L.J. 53, 72 (2009).

201 *See* Gorton, *supra* note 6, at 34 (providing example of different MBS deals and the consequences of housing prices). According to one commentator, "a sudden reversal in house price appreciation increased default in this market because it made this prepayment exit option cost-prohibitive." Bhardwaj, *supra* note 172, at 28. Moreover, the subprime securitization structure required stable or a downward trend in interest rates to sustain itself. When the Fed began to raise interest rates in 2004-5, demand for subprime borrowing cooled leading to a decline in real estate prices. Declines in real estate prices had the double effect of reducing incentives for servicers to refinance subprime borrowers as the fixed terms of those mortgages reset to variable rates. As marginal borrowers, now forced to pay higher rates, began to default on their mortgages, the air quickly came out of the real estate bubble as subprime borrowers were forced into foreclosure. Quinn, *supra* note 123, at 20-21. *See also* Corbae *supra* note 195 ("Mortgage innovation, in other words, makes the economy much more sensitive to price shocks."). Kristopher Gerardi, et. al., *Decomposing the Foreclosure Crisis: House Price Depreciation versus Bad Underwriting* 1, (Working Paper 2009-25, Sept. 2009), *available at* http://www.frbatlanta.org/filelegacydocs/wp0925.pdf (arguing that Credit Crisis resulted from house price depreciation).

202 *See* Gorton, *supra* note 6, at 45 (stating impossibility of an investor to look through CDO to determine subprime risk exposure).

203 *See id.* at 61 ("The structure itself does not allow for valuation based on the underlying mortgages, as a practical matter.").

because no one knew the "toxic assets" final resting spot or the extent of a market participant's subprime risk exposure.[204] Because no one knew where the assets lay it became a guessing game as to who had exposed themselves to default risk.[205] Therefore, complexity in financial transactions and lacking transparency created compounded asymmetric and lack of information problems.[206]

2. The Housing Bubble and Monetary Policy

Historically, asset-price increases are "encouraged" by relaxed monetary policies.[207] Housing prices are hyper sensitive to interest rate changes because housing is incredibly leveraged.[208] The Taylor Rule, named after Stanford economist John B. Taylor, is a suggestion for the Federal Reserve or any central bank on setting the short-term interest rate.[209] Beginning in 2001, the Federal Reserve lowered short-term interest rates well below the recommended Taylor Rule for an unusually extended amount of time.[210] Taylor argues that housing prices became inflated because of the unusually low short-term interest rates.[211] This monetary policy made it attractive for consumers to borrow as credit became easier to obtain.[212] It became very rational for consumers to purchase homes because the lending was in essence subsidized by the government.[213] Consumers purchased secondary homes and home speculation became a thriving business.[214] In Miami, for example, real estate speculators saw profit margins of twenty to

204 *See id.* at 45 (stating information problem of securitization).

205 *See id.* at 3-4 (describing lack of confidence among market participants).

206 *See* Untermann, *supra* note 200, at 72 (detailing problems that created Credit Crisis).

207 Jean Claude Trichet, President European Central Bank, Speech at the fifth MAS Lecture: Asset Price Bubbles and Monetary Policy (Wednesday 8 June 2005) http://www.mas.gov.sg/news_room/statements/2005/Speech_by_Mr_Jean_Claude_Trichet_for_MAS_Lecture.html (last visited Aug. 11, 2010) (stating historical relationship between monetary policies and asset prices).

208 *See* MORRIS, *supra* note 10, at 64 (discussing relationship between housing prices and interest rates).

209 *See* TAYLOR, *supra* note 4, at 67 (defining Taylor Rule).

210 *See id.* at 3 (noting importance of following Taylor Rule).

211 *See id.* at 3-4 (providing counterfactual to demonstrate correlation between interest rates and housing boom and bust).

212 *See id.* at 11 (stating attractiveness of short-term interest rates for potential home owners).

213 *See* Adam Levitin, Andrey Pavlov & Susan Wachter, *Securitization: Cause or Remedy of the Financial Crisis* 9 (Georgetown Law and Economics, Research Paper No. 1462895, Aug. 27, 2009) *available at* http://realestate.wharton.upenn.edu/newsletter/pdf/Levitin_et_al.pdf (discussing ease of credit for home purchasers).

214 *See* Les Christie, Homes: Big Drop in Speculation, CNN.com, April 30, 2007 http://money.cnn.com/2007/04/30/real_estate/speculators_fleeing_housing_markets/index.htm (last visited Aug. 11, 2010) (describing fall in home speculation with increaser in secondary home purchases).

twenty-five percent during the housing boom.[215] Moreover, during the period of low short-term interest rates the number of ARMs increased to cover one third of the total mortgages issued.[216] The ARM attracted borrowers with teaser rates.[217] The ARMs, as stated above, were unique to subprime mortgages. ARMs allowed the lender to decide whether to refinance the loan or extract the recovery value.[218] From 1997 to 2006, housing prices rose 40% above their traditional long run level.[219] As housing prices increased, so did housing price inflation.[220] Demand for housing subsequently increased to historic levels.[221]

During the housing market boom subprime mortgage origination worked very well.[222] Subprime loans originated between 2001 and 2005 performed better than loans originated in 2000.[223] Subprime loan delinquency and foreclosure rates declined over the same time period because of the increase in housing prices.[224] Moreover, participants in the subprime market considered a decline in housing prices highly unlikely.[225] Many participants believed that price appreciation would continue, even if only at the traditional long run average.[226] The worst case scenario, according to participants, was stagnate growth in prices.[227] One participant gave a decline of five percent in housing prices an overall probability of five percent.[228]

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215 *See* JustNews.com, Miami's Changing Skyline: Boom Or Bust?, Mar. 11, 2005, http://www.justnews.com/news/4277615/detail.html (last visited Aug. 11, 2010) (explaining real estate speculation market in Miami during 2000s).

216 *See id.* (indicating growth in ARM market during relaxed monetary policy).

217 *See* John Taylor, Address at the Federal Reserve Bank of Kansas City Policy Panel at the Symposium on Housing, Housing Finance, and Monetary Policy: Housing and Monetary Policy, (September 2007). http://www.stanford.edu/~johntayl/Housing%20and%20Monetary%20Policy--Taylor--Jackson%20Hole%202007.pdf (last visited Aug. 11, 2010) (noting ARM teaser rates and ease of credit for borrowers).

218 *See* Gorton, *supra* note 6, at 16 (discussing purpose of ARMs).

219 *See* Anderson, *supra* note 194, at 6 (providing statistics on home price appreciation).

220 *See* Taylor, *supra* note 217, at 2 (stating relationship between housing prices and home inflation).

221 *See id.* at 2 (discussing causes of rising real estate prices).

222 *See* Bethel, *supra* note 11, at 24 (discussing benefits associated with subprime loan business).

223 *See id.* (noting loan performances).

224 *See* Bethel, *supra* note 11, at 24 (discussing subprime loan performances).

225 *See* Gerardi, *supra* note 195, at 45 (stating prominent views of subprime market participants).

226 *See id.*

227 *See id.*

228 *See id.* at 46 (discussing views of market participants).

Federal Reserve Chairman Bernanke counters that that the housing bubble is not attributable to loose monetary policy.[229] Bernanke states that "only a small portion of the increase in house prices [...] can be attributed to the stance of U.S. monetary policy.[230] According to Bernanke, subprime lending and the global savings glut are responsible for the housing bubble.[231] As noted above, subprime lenders believed that housing prices could only go up. As subprime lending expanded this view became a self-fulfilling prophecy.[232] Additionally, Bernanke argues that the global savings glut increased housing prices.[233] The global savings glut hypothesis states "that capital inflows from emerging markets to industrial countries can help explain asset price appreciation and low long-term interest rates in the countries receiving the funds."[234] Greenspan also argues that low long-term interest rates resulting from the global savings glut, not the government's short-term interest rate, account for the housing bubble.[235]

Taylor replied to Bernanke, stating that Bernanke's argument ignored evidence explaining further the relationship between monetary policy and the housing bubble.[236] Regardless of which theory is correct, for the purpose of this

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229 *See generally*, Ben Bernanke, Speech at the Annual Meeting of the American Economic Association: Monetary Policy and the Housing Bubble (Jan. 3, 2010) http://www.federalreserve.gov/newsevents/speech/bernanke20100103a.pdf (last visited Aug. 11, 2010) (arguing that monetary policy did not cause housing bubble).

230 *Id.* at 12-13.

231 *See id.* at 16-19 (stating that housing bubble is attributable to global savings glut and subprime lending).

232 *See id.* at 16-17 ("For a time, rising house prices became a self-fulfilling prophecy, but ultimately, further appreciation could not be sustained and house prices collapsed.").

233 *See id.* at 18 (explaining global savings glut hypothesis); *see also* Ben Bernanke, , Speech at the Bundesbank Lecture*: Global Imbalances: Recent Developments and Prospects* (September 11, 2007) http://www.federalreserve.gov/newsevents/speech/bernanke20070911a.htm (last visited Aug. 11, 2010) (examining global savings glut hypothesis).

234 Bernanke, *supra* note 236, at 18.

235 *See* Alan Greenspan, *The Fed Didn't Cause the Housing Bubble*, WALL STREET J., Mar. 19, 2009, at A15 *available at* http://online.wsj.com/article/SB123672965066989281.html (arguing that low long-term rates accounted for housing bubble); *see also* Frederic S. Mishkin, *Housing and the Monetary Transmission Mechanism*, Finance and Economics Discussion Series, August 2007, *available at* http://www.federalreserve.gov/PUBS/FEDS/2007/200740/200740pap.pdf (rebuking argument that loose monetary policy created housing bubble).

236 *See* John Taylor, *The Fed and the Crisis: A Reply to Ben Bernanke*, WALL STREET J., Jan. 10, 2010, *available at* http://online.wsj.com/article/SB10001424052748703481004574646100272016422.html (discussing research pointing to significant relationship between monetary policy and housing bubble); *see also* Thomas Hoenig, President, Fed. Res. Bank of Kansas City, Address at The Central Exchange Kansas City, Missouri: *The 2010 Outlook and the Patch Back to Stability* (Jan. 7 2010), http://www.kc.frb.org/speechbio/hoenigpdf/hoenig.01.07.10.pdf (last visited Aug. 11, 2010)(stating that easy monetary policy contributed to crisis); Marek Jarociński & Frank Smets, *House Prices and the Stance of Monetary Policy* (ECB Working Paper No. 891, Apr. 2008), *available at* http://ssrn.com/abstract_id=1120167 ("There is also evidence that monetary policy has significant effects on residential investment and house prices and that easy monetary policy designed to stave article both arguments explain the housing bubble outside of the originate-to-distribute narrative and securities fraud.

3. The Black Swan

A black swan is rare event causing severe consequences.[237] Because the black swan is a rare occurrence people underestimate the risk it presents.[238] Many commentators claim that the current Credit Crisis is a black swan.[239] The United States Supreme Court stated in *Dura Pharmaceuticals v. Broudo*, stated that losses from "changed economic circumstances, changed investor expectations, new industry-specific . . . conditions, or other events, which taken separately or together account for some or all of that lower price" are not recoverable in a securities fraud case.[240] As explained above, securitization left MBS and credit derivatives sensitive to housing prices. Housing prices hit their peak in 2006 and started to fall.[241] Subprime lenders did not believe housing prices could fall so precipitously.[242] When housing prices started to fall borrowers became unable to pay or refinance their loans.[243] Foreclosures and delinquencies grew exponentially because the subprime mortgages were not designed for falling home prices.[244] Generally, the 2005 MBS vintages passed the credit enhancement triggers

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off perceived risks of deflation in 2002 to 2004 has contributed to the boom in the housing market in 2004 and 2005.").

237 *See* Bethel, *supra* note 11, at 26-27 (defining black swan).

238 *See id.* at 27 (stating relationship of black swan to finance).

> The tools we have in quantitative finance do not work in what I call the "Black Swan" domain . . . people underestimate the impact of infrequent occurrences. Just as it was assumed that all swans were white until the first black species was spotted in Australia during the 17th century, historical analysis is an inadequate way to judge risk.'"

Id. (quoting NASSIM TALEB, THE BLACK SWAN: THE IMPACT OF THE HIGHLY IMPROBABLE (Random House 2007)).

239 *See, e.g.*, John Taylor & John Williams, *A Black Swan in the Money Market*, (Federal Reserve Bank of San Francisco Working Paper no. 2008-04), *available at* http://www.frbsf.org/publications/economics/papers/2008/wp08-04bk.pdf (describing Credit Crisis as black swan); Bethel, *supra* note 11, at 26-27.

240 Dura Pharaceuticals v. Broudo, 544 U.S. 336, 343-44 (2005).

241 *See* Press Release, Standard & Poor's, *Home Price Declines Worsen As We Enter the Fourth Quarter of 2008 According to the S&P/Case-Shiller Home Price Indices*, http://www2.standardandpoors.com/spf/pdf/index/CSHomePrice_Release_123062.pdf (last visited Aug. 11, 2010).

242 *See* Gerardi, *supra* note 195, at 45-46 (explaining view among subprime lenders that housing prices could not fall).

243 *See* Mishkin, *supra* note 138 ("When the housing market cooled and house prices no longer rose at a rapid pace, these subprime borrowers found themselves unable to either repay their loans or refinance out of them.") .

244 *See* Gorton, *supra* note 6, at 51 ("The ability of subprime and Alt-A borrowers to sustain their mortgage payments depends heavily on house price appreciation because of the need for refinancing.

necessary for refinancing, whereas the 2006 MBS vintages did not build enough equity prepay and pass the triggers required for refinancing.[245] With rising housing prices the MBS passed its triggers and refinanced; however, when housing prices fell the MBS failed to refinance and lost the credit enhancement for which it was designed.[246] The difference between the two MBS illustrates the sensitivity MBS have towards house prices.[247] Without house price appreciation the MBS failed to trigger and became delinquent.[248] Many mortgage originators and investors took heavy losses on the subsequent credit downgrades.[249]

The ABX played an important role in informing market participants of the value in subprime MBS and related securities.[250] The ABX began to fall in 2007 as banks began to lose confidence in subprime related products. [251] Market participants started hedging their subprime risk by shorting on the ABX.[252] This only magnified the steep fall of the ABX.[253]

The housing market entered an unsustainable bubble.[254] When housing prices fell so did the value of financial instruments connected to housing.[255] The lack of information and complexity within the financial sector from securitization and credit derivatives left market participants unsure of where the risk of these suddenly toxic assets lay.[256] Greenspan states, "[i]t is clear that the levels of complexity to which market practitioners, at the height of their euphoria, carried risk-management techniques and risk-product design were too much for even the most sophisticated market players to handle prudently."[257] This loss of in-

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When housing prices did not appreciate to the same extent as in the past, and in many areas they have recently gone down, the ability of borrower to refinance has reduced.").

245 *See id.* at 34 (comparing 2005 and 2006 vintages of Ameriquest Mortgage Securities, Inc.).

246 *See id.* (noting failure of MBS when housing prices failed to rise).

247 *See id.*

248 *See id.*

249 *See* David Reilly, *Banks' Hidden Junk Menaces $1 Trillion Purge*, Bloomberg.com, March 25, 2009, http://www.bloomberg.com/apps/news?pid=20601039&sid=akv_p6LBNIdw&refer=home (Mar. (last visited Aug. 11, 2010) (detailing size of assets soured by subprime collapse).

250 *See* Gorton, *supra* note 6, at 54 (stating role of ABX in disseminating information to market on subprime risk).

251 *See id.* at 57 (describing ABX decline and subsequent conclusions).

252 *See id.* ("In fact, some of the dealer banks themselves, we now know, were shorting the index to hedge their long positions – of course so was everyone.").

253 *See id.* (discussing fall of ABX when firms hedged their subprime risk).

254 *See* TAYLOR, *supra* note 4, at 1 (blaming financial crisis on loose monetary policy).

255 *See* Gorton, *supra* note 6, at 61 (discussing connection between home values and security values).

256 *See id.* (summarizing loss of information and asymmetric information problem).

257 *See* Alan Greenspan, *We Need a Better Cushion Against Risk*, FT.com, March 26, 2009, http://www.ft.com/cms/s/0/9c158a92-1a3c-11de-9f91-0000779fd2ac.html (last visited Aug. 11, 2010) (discussing risk problem in market).

formation caused a run on SIVs.[258] Because SIVs were heavily invested in the financial sector it was unknown the amount of their exposure to subprime risk.[259] SIVs were put back onto their firm's balance sheets, restructured, or defaulted.[260] Market participants were forced to write-down the significant losses incurred by the subprime assets they held.[261] The explanation of the causes for the Credit Crisis illustrates how securities fraud does not explain the losses incurred by investors because the losses likely resulted from optimism towards housing prices and the consequences of their subsequent fall.

E. Economic Sense

The originate-to-distribute explanation of the Credit Crisis appears to be simplistic in light of the structuring of subprime securities.[262] Following the originate-to-distribute train of thought the type of crisis affecting subprime securitization would presumably affect other varieties of securitization.[263] This did not happen.[264] If the risk was successfully passed from the originator to the third-party the originator would not be forced to write down losses sustained by them in the subprime market.[265] Accordingly,

> [w]hen the majority of risk is concentrated into those bottom securities the resulting "senior-subordinate" structure dictates that the proper paradigm is not a "distribution" of risk, but a "distillation" of risk. Because of the high risk, the bottom (most risky) securities cannot typically be sold to outside investors, so they are kept on-balance sheet. Hence, the risk doesn't really leave the seller/servicer (or bank) at all.[266]

For example, in *In re New Century*, the United States District Court of the Central District of California denied defendants' motion to dismiss claims by plaintiffs about misrepresentations regarding the defendant's subprime market finan-

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258 *See* Gorton, *supra* note 6, at 57-60 (describing run on SIVs).

259 *See id.* at 59 (stating connection between SIVs and financial sector as cause for run).

260 *See id.* at 82 (listing outcomes for SIVs).

261 *See id.* at 58 ("Concurrently with the run on these vehicles, prices of subprime-related bonds began to decline. Highly levered hedged funds that held these bonds began to incur write-downs, and face margin calls. A number of hedge funds liquidated. Dealer banks began to announce write-downs.").

262 *See* Bhardwaj, *supra* note 172, at 5 ("[The originate-to-distribute explanation] appears exceptionally simplistic in the face of detailed evidence on the securitization process.").

263 *See* Gorton, *supra* note 6, at 69 (noting lack of problems in other securitization processes).

264 *See id.*

265 *See* Bethel, *supra* note 11, at 25-26 (listing losses taken by mortgage originators).

266 Joseph R. Mason, *Cliff Risk and the Credit Crisis*, November 10, 2008, http://ssrn.com/abstract=1296250 (last visited Aug. 11, 2010).

cial practices.[267] The plaintiffs purchased defendants' common stock and alleged violations of sections 11, and 20(a) of the Securities Act of 1933 and Section 10(b) and SEC Rule 10(b)-5 of the Securities Act of 1934.[268]

The New Century plaintiffs alleged misrepresentations of New Century's (1) financial statements and internal controls; and (2) loan quality and underwriting standards.[269] New Century's filings and registration statements stated that the firm's loan quality was, among other things, of "'higher credit quality,' 'improved underwriting controls and appraisal review process,' 'a strategy [of selecting borrowers with increasing credit scores],' 'strict underwriting and risk management disciplines,' and 'better credit quality.'"[270] The New Century plaintiffs associated their economic losses with bad lending practices.[271] Although the New Century case is not between participants of subprime transactions (*e.g.*, issuers and purchasers of certificates), the case is significant because the plaintiffs were investors in the common stock of companies in the mortgage business.[272] As noted by the United States District Court for the Central District of California, "[t]he investments' values depend in great part on the soundness of [the Company's] core mortgage-related operations."[273] The originator, New Century, lost money precisely because the company held onto the lower tranches of subprime MBS and suffered extreme losses.[274] Consequently, the risk was not passed from the originator to third-parties. As the mortgage market collapsed lenders, *e.g.*, New Cen-

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267 *See* In re New Century, 588 F. Supp. 2d at 1239 (C.D. Cal. 2008) ("In summary, Plaintiffs allege that Defendants, during the Class Period, misrepresented New Century's ability to repurchase defaulted loans; overvalued its residual interests in securitizations; falsely certified the adequacy of its internal controls, loan origination standards, and the quality of its loans; and failed to identify these problems in public statements, registration documents, audits, or elsewhere."). Plaintiffs to the claim comprised of persons, not including defendants, who "purchased or acquired New Century common stock, New Century Series A Cumulative Redeemable Preferred Stock ("Series A Stock"), New Century Series B Cumulative Redeemable Preferred Stock ("Series B Stock"), and/or New Century call options, or who sold New Century put options, between May 5, 2005 and March 13, 2007 (the "Class Period")." *Id.* at 1210. Defendants to the suit were "New Century officers ("Officer Defendants"), its directors ("Director Defendants"), its auditor KPMG ("KPMG"), and the underwriters of the stock offering ("Underwriter Defendants"). *Id.* Actions against New Century Financial were stayed after filed for Chapter 11 bankruptcy protection on April 22, 2008. *See id.* at 1211.

268 *See id.* (listing alleged securities violations). The 20(a) claim is not discussed herein.

269 *See id.* at 1222 (discussing section 10(b) and Rule 10(b)-5 actions).

270 *Id.* at 1225.

271 *See id.* (stating allegations).

272 *See, e.g.*, In re Countrywide Financial Corp, Sec. Litig., 588 F. Supp. 2d 1132, 1144 ("While the facts of this case are inextricably intertwined with the mortgage-backed securities ("MBS') that Countrywide sold to investment banks and other sophisticated investors, none of the actions before this Court are based on MBS purchases. Rather, the present case is brought on behalf of those who invested in Countrywide's business.").

273 *Id.*

274 *See* In re New Century, 588 F. Supp. 2d at 1239 (C.D. Cal. 2008) (describing business practices of New Century).

tury, were stuck with inferior loans to be sold off to third parties.[275] Originating MBS takes time and exposes lenders to the risk of default while the originator pools the loans.[276] The secondary market no longer had the appetite for the loans following the fall in housing prices and the originating companies were stuck with the resulting defaults.[277]

Originators of subprime MBS also retained a variety of interests in the underlying mortgages to their own detriment.[278] In *Luminent Mortgage Capital v. Merrill Lynch*, the United States District Court for the Eastern District of Pennsylvania dismissed securities fraud claims against defendants in part because defendants retained interest in the underlying loans.[279] Plaintiffs purchased MBS from defendants and alleged misrepresentations on the part of defendants.[280] Plaintiffs purchased three junior classes of MBS from defendants.[281] One class was the most junior and was paid only after the senior classes.[282] The payments on the other two classes were limited to prepayment penalties and over collateralization, respectively.[283]

Plaintiffs argued that defendants made misrepresentations on the quality and nature of the underlying mortgages as well as the due diligence performed by defendants.[284] Specifically, the plaintiffs stated that the excel spread sheet sent by defendants portraying a sampling of the underlying loans did not accurately represent the risks of the underlying loans.[285] According to plaintiffs, the loans exhibited a higher rate of default and delinquencies than the rate

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275 *See* Amiyatosh Purnanandam, *Originate-to-Distribute Model and the Subprime Mortgage Crisis* 13, (AFA 2010 Atlanta Meetings Papers, April 27, 2009), *available at* http://ssrn.com/abstract=1167786 (stating problems for originating banks following collapse of market).

276 *See id.* (discussing timing issues related to origination).

277 *See id.*

278 *See* Martin, *supra* note 65, at 9-10 (listing variety of interest retained by originators in subprime MBS).

279 *See Luminent Mortg*., 652 F. Supp. 2d at 578 (E.D. Pa. Aug. 20, 2009) (stating holding of case).

280 *See id.* (discussing nature of claim).

281 *See id.* at 579 (describing certificates purchased by plaintiffs).

282 *See id.* "Payment distributions for most of the Certificates resembled a cascade, or 'waterfall,' in which holders of the most senior class of Certificates received payments first, followed by holders of the next most senior class, and so on until holders of the most junior class of Certificates received payments." *Id.*

283 *See id.* at 579. The payments for the Class C certificates resulted from the interest left after all the senior certificates were paid and losses were accounted. *See id.* The payments for the Class P certificates resulted from the prepayment penalties on the underlying mortgage loans. *See id.*

284 *See id.* at 588 (stating allegations by plaintiffs).

285 *See id.* at 582 (alleging that spreadsheet did not meet industry standards). Plaintiffs state that, "a review of the performance of the loan portfolio over time demonstrates an unusually high rate of early payment defaults, as well as unusually high rates of delinquencies." *Id.*

represented by defendants.[286] In accordance with the contract for the sale of the certificates, the defendants re-purchased or acquired the certificates as collateral from the plaintiffs.[287] The court reasoned that defendants' residual interest in the certificates negated any argument of a motive to defraud.[288] To hold otherwise would mean that defendants "'intentionally defrauded Plaintiffs to their own ultimate detriment."[289] The court, quoting the Third Circuit, stated "fraud without motive 'makes little economic sense.'" [290] This type of retained interest is not unique to this case, in *N.Y. State Teachers' Retirement Sys. v. Fremont General Corporation*, the court stated that "[d]epending upon market conditions, Fremont also securitized some of its subprime loan production and retained a required junior residual interest in the cash flows earned from the loans."[291] Thus, lenders kept a very significant interest in the loans originated.[292] Retaining these interests resulted in the originators downfall.[293]

Moreover, originators also provided several representations and warranties to purchasers of MBS, potentially to their detriment.[294] In *Lone Star Fund v. Barclays Bank*, plaintiffs purchased MBS from defendants.[295] Plaintiffs filed securities fraud claims against defendants upon learning that the underlying mortgage loans were delinquent.[296] Defendants warranted to plaintiffs in the offering documents,

> *Payments Current.* (i) All payments required to be made up to the Closing Date for the Mortgage Loan under the terms of the Mortgage Note, other than payment not yet 30 days delinquent, have been made and credited, (ii) no payment required under the Mortgage Loan has been 30 days or more delinquent at any time since the origination of the Mortgage Loan, and (iii) the first Monthly Payment was made with respect to the Mortgage Loan on its related Due Date or within the grace period, all in accordance with the terms of the related Mortgage Note.[297]

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286 *See id.* .

287 *See id.* at 589 (noting residual interest maintained by defendants on underlying loans).

288 *See id.* (discussing analysis of defendants motive for fraud).

289 *Id.*

290 *Id.* (quoting Leder v. Shinfeld 2008 U.S. Dist. LEXIS 40925, *6 (E.D. Pa. 2008)).

291 *New York. State Teachers'*, 2009 U.S. Dist. LEXIS 94241, n.3 (C.D. Cal. 2009).

292 *See Luminent Mortg.*, 652 F. Supp. 2d at 589 (describing interest held by mortgage originator).

293 *See id.*

294 *See* Lone Star Fund v. Barclays Bank, 2008 WL 4449508, *8 (N.D. Tex. 2008) (listing representations and warranties provided by MBS issuer to purchaser).

295 *See id.* at *1 (detailing transactions between plaintiffs and defendants).

296 *See id.* (stating cause of action).

297 *Id.* at *8.

If a representation or warranty is breached, "[t]he obligations of [defendants] to cure such breach or to substitute or purchase the applicable mortgage loan will constitute the sole remedies respecting a material breach of any such representation or warranty to the holders of the [Securities], the servicer, the trustee, the depositor and any of its affiliates."[298] The court held that plaintiffs were bound by the remedy provided in the offering documents.[299] This case again illustrates the retained interests originators held in MBS transactions.[300] Defaulting loans were to be purchased back by originators at their own expense according to these representations and warranties.[301]

As a result, originators faced a number of risks when securitizing mortgages.[302] Originators needed to house originated loans prior to securitization because the pool needed to be large enough before transfer to the underwriter.[303] Some banks held onto the most senior tranches of CDOs before issuing the CDOs.[304] This caused many firms to write-down massive losses sustained on the tranches they held for themselves.[305] Originators also sometimes held onto the valuable servicing rights of the loans.[306] In connection to its servicing rights, Countrywide Financial wrote-down losses totaling $830.9 million.[307] Additionally, originators provided representations and warranties to purchasers guaranteeing the underlying loan performance.[308] Finally, originating banks also bought loans from other originators.[309]

The alleged incentive of the originate-to-distribute model to service as many loans as possible regardless of loan quality makes little economic sense.[310] The retained interests and risks inherent in MBS origination clearly hinder the argument that subprime market participants intended to completely separate them-

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298 *Id.*

299 *See id.* at *11 (providing holding of case).

300 *See id.* at *8 (describing representations and warranties provided by MBS issuer to purchasers).

301 *See id.*

302 *See* Gorton, *supra* note 6, at 70 (describing risks facing subprime mortgage originators).

303 *See id.* (stating risk of housing mortgage loans prior to securitization).

304 *See id.* (discussing risks associated with CDO issuance).

305 *See id.* (reporting write-downs from firms who held onto senior tranches of CDOs).

306 *See id.* at 71 (detailing residual interests and servicing rights retained by firms).

307 *See id.* (reporting write-down of Countrywide Financial).

308 *See Luminent Mortg.* , 652 F. Supp. 2d at 589 (E.D. Pa. Aug. 20, 2009) (stating risks held by originator).

309 *See* In re Countrywide Financial Corp, Sec. Litig., 588 F. Supp. 2d 1132, 1144 (C.D. Cal. 2008) ("These operations include originating mortgages, purchasing mortgages from other originators, servicing mortgages, investing in mortgages, and packaging mortgages into MBS for resale.").

310 *Cf. Luminent Mortg.*, 652 F. Supp. 2d at 589 (discounting alleged fraud in light of economic reality).

selves from default risk.[311] Committing securities fraud, therefore, appears to be exactly what originators wanted to avoid because they were so open to the negative consequences of subprime mortgage default.[312]

V. CONCLUSION

Securitizing mortgage loans enabled "mortgage lenders and mortgage bankers to access a larger reservoir of capital, to make financing available to home buyers at lower costs and to spread the flow of funds to areas of the country where capital may be scarce."[313] Many commentators and plaintiffs blame the Credit Crisis on the securitization process via the originate-to-distribute model of banking. Several subprime securities fraud plaintiffs base their claims on the originate-to-distribute hypothesis of the Credit Crisis.[314] There are several obstacles, however, for subprime securities fraud plaintiffs.

Many defendants cautioned plaintiffs of the risks associated with subprime investing.[315] The Credit Crisis did not occur because of securities fraud. Housing entered an unsustainable bubble.[316] Securitization and re-securitization created a complex chain of financial instruments.[317] This complex chain caused a loss of information as to who held onto the risks associated with subprime lending.[318] When housing prices fell, market participants did not know where the risk lay and lending became nonexistent thereby causing a great devaluing in the financial sector.[319] Moreover, the securities fraud narrative makes little "economic sense" with what we know of securitization structuring. The risks associated with subprime lending were not passed from originators to investors as evidenced by the retained interests of originators and their subsequent downfall.

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311 *See* Mason, *supra* note 266 (explaining risks retained by originating firms).

312 *See Luminent Mortg.*, 652 F. Supp. 2d at 589 (stating problem inherent in blaming originators when they were actually incentivized to avoid fraud).

313 Securities Industry and Financial Markets Association, *Mortgage Securities: An Overview*, http://www.investinginbonds.com/learnmore.asp?catid=11&subcatid=56&id=131 (last visited Aug. 11, 2010).

314 *See, e.g.*, *Atlas*, 556 F.Supp.2d at 1149 (S.D.Cal. 2008) (blaming misrepresentations regarding companies' core business for stock inflation and subsequent devaluation); *New York State Teachers'*, 2009 U.S. Dist. LEXIS 94241, *3-4 (C.D. Cal. 2009) (stating basis for complaint).

315 *See, e.g.*, *Plumbers' Union*, 658 F. Supp. 2d at 307 (D.Mass. 2009) (stating fusillade of cautionary statements provided to plaintiffs).

316 *See* TAYLOR, *supra* note 4, at 1 ("In the recent crisis we had a housing boom and bust, which in turn led to financial turmoil in the United States and other countries.").

317 *See* Gorton, *supra* note 6, at 3 (summarizing loss of information and complexity problems in securitization process).

318 *See* Greenspan, *supra* note 257 (discussing risks in market and loss information for market participants).

319 *See* Gorton, *supra* note 6, at 76 (stating importance and consequences of housing price decline in Credit Crisis).

Therefore, the losses realized by plaintiffs are not the result of securities fraud through originate-to-distribute; rather the losses are consequence of an economic black swan.

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NOTE

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WHAT DOES IT MEAN TO THINK CREATIVELY ABOUT CREATIVE INTELLECTUAL assets in a digitally networked environment? How do we conceive of copyright law in the face of consumer cultures that expect flexibility in the use of copyrighted works and the ability to share creative digital goods? How should we approach copyright enforcement, licensing, and business designs in light of value created by users of intellectual works?

In this short essay, prepared for the inaugural issue of the University of Puerto Rico Business Law Journal, I will argue that the intuitive attitude that dominates copyright law, practice and advocacy may, in some occasions, be an obstacle to developing successful business enterprises in the creative fields. I present these views, not with specific prescriptions about how to design business models, but to generally challenge the idea that flexible and liberal views about copyright law are necessarily anathema to successful commercial ventures in the current milieu.

I. COPYRIGHT AS INCENTIVES VS. COPYRIGHT FOR ITS OWN SAKE

Traditional economic justifications for intellectual property start from the assumption that—unlike tangible property—information products are public goods subject to free riding which, consequently, risks underproduction.[1] The

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1 That is, they are non-excludable and non-rival, therefore, one could not exclude others from using an idea once made available; consumption by one does not prevent consumption by others. Because of the inability to exclude others, it is thought that a producer of intellectual works will not be able to recoup fixed costs of creation, hence, the idea will not be produced in the first place. *See* WILLIAM LANDES & RICHARD POSNER, THE ECONOMIC STRUCTURE OF INTELLECTUAL PROPERTY LAW 12-13 (2003); COOTER & ULEN, LAW AND ECONOMICS 124-42 (2008). To address this problem and incentive

copyright monopoly thus aims to maximize efficiency by providing sufficient incentives to compensate free riding while avoiding deadweight loss. But because innovation is cumulative, information is both an output and an input of the creative process.[2] In this sense, information products have social value (as inputs to downstream innovators) that exceed the private value to the first upstream creator.[3]

The scope and duration of copyright law depends on how much these innovation *spillovers*, or positive externalities, are believed to aid follow-on creators. Hence, copyright's scope depends on policy determinations about balancing incentives provided to initial creators with the innovation's social benefits.[4] This balance has been one of the laws' most celebrated goals: to incentivize creators by granting a statutory monopoly over works, while simultaneously limiting the monopoly to feed a public domain for further creators.

Nonetheless, it is well known that digital technologies have changed the landscape in which copyright law operates. They have disturbed balances previously thought to accommodate conflicting (but complementary) interests in

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production and dissemination of intellectual works, the law grants some creators monopoly rights over their works. This, consequently, may give rise to economic distortions: namely, that the copyright owner may obtain monopoly profits, and that a loss in consumer surplus (or deadweight loss) will be created (consumers who value the work at less than the monopoly price will not purchase it, although they would otherwise consume it at competitive price). Because a monopolist's marginal revenue declines as the number of copies sold increases (on account of the downward-slope in demand curve), the marginal revenue is always lower than the price (instead of equal to price as for a competitive firm) for all units sold--unless price discrimination is possible. The monopolist will maximize her profits, and consequently, will grant access to the work up until where marginal revenue equals marginal cost. Therefore, she will choose a level of output lower than one offered in a competitive market, whilst choosing a price higher than those in said competitive markets. COOTER & ULEN, *supra* at 32-36 (2008); William W. Fisher, *Reconstructing the Fair Use Doctrine,* 101 HARV. L. REV. 1659, 1700-05 (1988).

2 Innovations are the output of a first creator and an input to the second (while the first creator's input is an earlier creator's output). LANDES & POSNER, *supra* note 1, 66-67.

3 Brett M. Frischmann & Mark A. Lemley, *Spillovers,* 107 COLUM. L. REV. 257 (2007).

4 *See* Suzanne Scotchmer, *Standing in the Shoulders of Giants: Cumulative Research and the Patent Law*, 5 J. ECON. PERSP., No. 1 (1991), at 29-41. The weaker copyright protection is, the more a second author can take from previous works without paying a license and thus, the lower the second author's costs of creating new works. LANDES & POSNER, *supra* note 1 at 68. Conversely, the stronger the protection, the higher the cost of creating works for the second author. This is why copyright law must balance its incentive-producing function with a level of public access to allow for follow-up creativity. *Id*. at 69. Because these are all empirical questions, Frischmann & Lemley, *supra* note 3 at 268-71, it is not surprising that, when adhering to the incentives paradigm, the Supreme Court defers to Congress as a matter of institutional competence. Harper & Row v. Nation Enterprises, 471 U.S. 539, 558 (1985); Eldred v. Aschcroft, 537 U.S. 186 (2003) ("By establishing a marketable right to the use of one's expression, copyright supplies the economic incentive to create and disseminate ideas"); ("The Copyright Clause ...empowers Congress to define the scope of the substantive right. Judicial deference to such congressional definition is 'but a corollary to the grant to Congress of any Article I power.'"). On judicial deference in the copyright context *see* Paul Schwartz & William Michael Treanor, *Eldred and Lochner: Copyright Term Extension and Intellectual Property as Constitutional Property*, 112 YALE L. J. 2331 (2003).

incentives and public access. The ease with which digital products can be reproduced and shared at virtually no cost enabled innovative practices that concomitantly shocked a content industry whose entire revenue plan depended on the sale of physical copies.[5] With that shock came a multilayered response spearheaded by law and technology.[6]

Copyright owners' initial response to challenges posed by digital technologies is—to some extent—understandable. These technologies are after all, intensely disruptive of well established business models. Former Harvard Business School professor Debora Spar described a cycle that emerges when disruptive technologies appear where, after a period of *creative anarchy* triggered by the innovation, settled interests seek stability through the law.[7] Following an initial unregulated and disruptive period, radical technological developments, once they reach a level of maturity and commercialization, are gradually normalized and regulated (by state or private organizations). What had been a threatening technology is eventually tamed—in many cases to protect the interests of the very pioneers who brought about the innovation. In other cases, it is not pioneers who ask for rules; professor Spar contends that "sometimes it is the state, and sometimes a coalition of societal groups affected by the new technology and the market it has wrought."[8] In any case, private firms usually ask for rules when a new technology *lands* in a context that is unprepared to assimilate it.

This is exactly what happened when digital technologies *landed* in an analog world. Both legal and technological responses to these technologies were put into place. In the process, copyright protection stopped being regarded instrumentally, *i.e,* as a means to an end (to provide innovation incentives), and was replaced by a view of copyright as an end in itself (that is, copyright protection

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5 For an interesting example of how the content industry has reacted to these new business models see the conflicting positions of the music industry and the startup MP3.com over the new entrant's impact on the incumbent's potential (yet unexplored) market *in* UMG Recordings v. MP3.com, Inc., 92 F. Supp.2d 349 (S.D.N.Y. 2000). *Cf.* Perfect 10, Inc. v. Amazon.com, Inc., 487 F.3d 701 (9th Cir. 2007) (displaying a more permissive attitude toward the market entrant where, as in that case, use of copyrighted content is *transformative* under fair use analysis—even when making exact copies of the original work, albeit for different purposes—since transformative uses cannot be inferred to produce a market harm to copyright owner absent a showing of such harm).

6 As is the case of the employment of DRMs and the enactment of the anti-circumvention provisions of the Digital Millennium Copyright Act. Pub. L. 105-304, 112 Stat. 2863 (1998), 17 U.S.C.A. §§ 1201-05.

7 *Creative anarchy* refers to a phase in the life of a disruptive innovation when, together with commercialization of the innovation, an unregulated *anarchic* market emerges spawning a host of competitors and innovators. Here, many innovations emerge from both enthusiasts (such as free and open software) and commercially minded enterprises. The technology, at this stage, appears unruly and undomesticated (e.g. Napster in the late 1990s), but in fact, it eventually is (e.g. MGM Studios, Inc. v. Grokster, Ltd. 545 U.S. 913 (2005)) (sometimes at the behest of initial innovators, and sometimes at the insistence of interests affected by the technology). DEBORA L. SPAR, RULING THE WAVES: FROM THE COMPASS TO THE INTERNET, A HISTORY OF BUSINESS AND POLITICS ALONG THE TECHNOLOGICAL FRONTIER 15 (2001).

8 *Id.* at 18.

for its own sake). This view promotes absolute protection of works regardless of copyright's incentivizing promise. We can see how his paradigm got settled by examining some of the technological and legal responses to the impact of digital technologies on copyright law.

Technological responses are well known; I have discussed them in other writings.[9]

> The very same features of the digital age that empower ordinary individuals also lead business continually to expand markets for intellectual property and digital content. Yet as businesses do so, they must deal with features of the digital age that empower consumers and give them new abilities to copy, distribute, and manipulate digital content.[10]

Thus, in an effort to control and monetize particularized uses of content, we have witnessed the emergence of Digital Rights Management systems or Technological Protection Measures (these are "technological method[s] intended to promote the authorized use of digital works.")[11]

As a consequence, through these technologies content owners today are capable of controlling their works well beyond legitimate claims of copyright by limiting fair uses; affecting—otherwise protected—personal non-commercial use of content;[12] regulating works in the public domain;[13] or impeding the exercise of rights that a user would otherwise have according to the first sale doctrine.[14] In some cases, as with the music industry, consumer demand for interoperability and flexibility in the use of digital goods has pressured content owners to provide works with less rigorous protection.[15]

On the legal side, these technological responses are reinforced by the Digital Millennium Copyright Act (DMCA), which severely punishes efforts to circum-

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9 Hiram A. Meléndez-Juarbe, *DRM Interoperability,* 15 B.U. J. SCI. TECH. L. 181 (2009).

10 Jack Balkin, *Digital Speech and Democratic Culture: A Theory of Freedom of Expression for the Information Society*, 79 N.Y.U. L. REV. 1, 14 (2004).

11 Ian Kerr, Alana Maurushat & Christian Tacit, *Technological Protection Measures: Tilting at Copyright's Windmill*, 34 OTTAWA L. REV. 7, 13 (2002-2003). *See generally,* EBERHARD BECKER, ET AL. (EDS.), DIGITAL RIGHTS MANAGEMENT: TECHNOLOGICAL, LEGAL AND POLITICAL ASPECTS 3 (2003); JOAN VAN TASSEL, DIGITAL RIGHTS MANAGEMENT: PROTECTING AND MONETIZING CONTENT (2006).

12 Sony v. Universal Studios, 464 U.S. 417 (1984); Pamela Samuelson, *Copyright And Freedom Of Expression In Historical Perspective*, 10 J. INTELL. PROP. L. 319, 331 (2003); L. Ray Patterson & Christopher M. Thomas, *Personal Use In Copyright Law: An Unrecognized Constitutional Right*, 50 J. COPYRIGHT SOC'Y U.S.A. 475 (2003).

13 Timothy Armstrong, *Digital Rights Management and the Process of Fair Use,* 20 HARV. J. L. & TECH. 49 (2006); Dan Burk & Julie Cohen, *Fair Use Infrastructure for Rights Management Systems,* 15 HARV. J.L. & TECH. 41, 57 (2001).

14 17 U.S.C. § 109(a) ("the owner of a particular copy . . . is entitled . . . to sell or otherwise dispose of the possession of that copy . . . .").

15 Meléndez-Juarbe, *supra* note 9 at 218.

vent DRMs' access-control mechanisms.[16] Section 1201(a) of the DMCA prohibits the circumvention of a "technological protection measure that effectively controls access to a work,"[17] while section 1201(b) addresses the manufacture, distribution or traffic technologies primarily designed to circumvent a DRM "that effectively protects a right of the copyright owner."[18] Courts have found that the DMCA's anti-circumvention provisions are independent from the fair use defense, finding liability even if such defense is available.[19]

These legal and technological developments can be said to create a new legal right to control how we *access* copyrighted works, even if we legitimately own specific media (e.g., a DVD) containing such work (e.g., a movie).[20] These reactions emerged late in the twentieth century in the context of an unprecedented amplification of the copyright monopoly, both procedurally and substantively, as explained at the margin.[21]

While it is true that digital technologies unsettled the underlying terrain that supported a balance between incentives and public access, current copyright protection (both through law and technological protection measures) has redrawn previous balances and strengthened the copyright monopoly well

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16 It also prohibits or the manufacture or distribution of such technology. *See* 17 U.S.C. §§ 1201-1205.

17 17 U.S.C. § 1201(a).

18 17 U.S.C. § 1201(b).

19 Realnetworks, Inc. v. Streambox, Inc., 2000 WL 127311 (W.D. Wash. 2000); Universal City Studios v. Reimerdes, 111 F. Supp. 2d 294 (S.D.N.Y. 2000). *But see* Lexmark v. Static Control Components, 387 F.3d 522 (6th Cir. 2004); Chamberlain v. Skylink, 381 F. 3d 1178 (Fed. Cir. 2004) (requiring that the protection against circumvention technology under 1201(a) be related to copyrighted work).

20 "Every act of perception or of materialization of a digital copy requires a prior act of access. And if the copyright owner can control access, she can condition how a user apprehends the work, and whether a user may make a further copy." Jane Ginsburg, *From Having Copies to Experiencing Works: The Development on an Access Right in US Copyright Law,* 50 J. COPYRIGHT SOC'Y U.S.A. 113, 115 (2003).

21 Since 1976, many of the formal requirements required to protect works have been eliminated, moving copyright protection away from the positive law paradigm. For example, it is no longer required that a work be published prior to protection. 17 U.S.C. § 102(a) ("copyright protection subsists . . . in original works of authorship fixed in any tangible medium of expression . . . ."). Requirements such as notice, 17 U.S.C. § 401(a), deposit, 17 U.S.C. § 407(a), registration, 17 U.S.C. § 408(a), and term renewal, 17 U.S.C. § 304, have been eliminated. Today a work is protected by default since its creation and fixation in a tangible medium of expression, 17 U.S.C. § 102(a), for the life of the author plus seventy years, 17 U.S.C. § 302(a), instead of the shorter and fragmented periods that predated the 1976 Act. The term of copyright protection has been extended several times during the last century delaying the entrance of works into the public domain (sometimes even reverting their public domain status and reestablishing their protection). Eldred v. Ashcroft, 537 U.S. 186 (2003). Furthermore, copyright protection today is not limited to reproduction rights since it includes, for instance, the right to make derivative works. 17 U.S.C. § 101, 106(2). Additionally, infringement is subject to steep statutory damages, costs and attorney's fees, 17 U.S.C. § 504(c), 505, while the litigation costs to individual users remain notoriously prohibitive.

beyond the basic economic incentives justification. The literature excited by this contemporary reality comes from all sides of the ideological spectrum.[22]

In all, the expansive shape of current copyright law and practice cannot be supported by the traditional incentives rationale. It is, however, sometimes justified from other perspectives. For example, both in rhetoric and legal argumentation, strong protections are sometimes favored through a moral argument about what is fair or just: an argument about property rights over information with a whiff of Lockean natural right over one's creations—forgetting that the metes and bounds of the copyright monopoly are just that: a policy-oriented, state-created monopoly.[23] On other occasions, the expansive view of copyright deploys an economic logic unrelated to the provision of incentives. Some favor a regime of *absolute protection*[24] through a set of *ex post* economic justifications.[25] Contrary to traditional incentives theory that considers copyright's potential incentives *ex ante* (that is, copyright as a *precondition* for innovation), *ex post* advocates argue that absolute and strong intellectual property rights give the first creator (and only him or her) efficient incentives to innovate across time and improve over an existing work.[26] According to this controversial (yet, increasingly popular) view, strong protection prevents overuse, or tragedy of the commons, avoiding a decrease in the value of intellectual property rights.[27] In

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22 *See, e.g.*, LANDES & POSNER, *supra* note 1; WILLIAM W. FISHER III, PROMISES TO KEEP: TECHNOLOGY, LAW AND THE FUTURE OF ENTERTAINMENT (Stanford University Press 2004); BOYLE, THE PUBLIC DOMAIN: ENCLOSING THE COMMONS OF THE MIND (2009); NEIL NETANEL, COPYRIGHT'S PARADOX 34-35 (Oxford University Press 2008); LAWRENCE LESSIG, FREE CULTURE: HOW BIG MEDIA USES TECHNOLOGY AND THE LAW TO LOCK DOWN CULTURE AND CONTROL CREATIVITY (2004); YOCHAI BENKLER, THE WEALTH OF NETWORKS: HOW SOCIAL PRODUCTION TRANSFORMS MARKETS AND FREEDOM 29 (YALE UNIVERSITY PRESS 2006).

23 *See* JOHN LOCKE, SECOND TREATISE OF GOVERNMENT ¶¶ 25-52. On Locke, see generally JEREMY WALDRON, THE RIGHT TO PRIVATE PROPERTY 137- 252 (1988). On its relation to copyright law see Dianne Leenheer Zimmerman, *Information Goods as Speech, Information as Goods: Some Thoughts on Marketplaces and the Bill of Rights*, 33 WM. & MARY L. REV. 665, 675-77 (1992); Roberta Rosenthal Kwall, *Inspiration and Innovation: The Intrinsic Dimension of the Artistic Soul*, 81 NOTRE DAME L. REV. 1945, 1979 (2006).

24 Anne Barron, *Copyright Infringement, 'Free Riding' and the Lifeworld*, 8 (LSE Working Papers 17/2008, 2008), *available at*, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1280893.

25 Mark Lemley, *Ex Ante versus Ex Post Justifications for Intellectual Property*, 71 U. CHI. L. REV. 129 (2004).

26 *See e.g.*, Randal C. Picker, *Fair Use v. Fair Access*, 16 (U. Chi. L. & Econ. Olin Working Paper No. 392, 2008), *available at*, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1104764 (arguing that the initial author is in a better position to "take advantage of the information that we know will be forthcoming to make the second-stage investment decision").

27 LANDES & POSNER, *supra* note 1 at 222 (discussing congestion externalities that they argue are applicable to copyright law):

> One purpose of giving the owner of a copyright a monopoly of derivative works is to facilitate the scope and timing of the exploitation of the copyrighted work—to avoid, as it were, the 'congestion' that would result if once the work was published anyone could make and

this sense, the argument ceases to be about initial incentives and morphs into an argument about absolute copyright protection at all costs as an end in itself and for its own sake (about protecting the copyright owner well after creation and well beyond what's necessary for innovation).

The shape of copyright law has increasingly been influenced by these *ex-post* justifications, although recent judicial decisions, especially in the realm of *fair use*, have begun to pull back a bit.[28] Content industries, their lawyers, and counsels sometimes believe that absolute protection and strong copyright enforcement are the only way to grapple with the perceived threat of digital technologies. The centralization of *all copyright monopoly facets* in the hands of the owner is seen as the only efficient way to use that creative good. That belief usually comes armed with its own supply of rhetorical devices about *piracy*, *theft*, *fairness*, and, as described by Google's Senior Copyright Counsel William Patry, a host of overblown metaphors that contribute to a moral panic about quotidian engagement with digital works.[29]

Sometimes, as the music industry has learned in recent years, creative industries are forced to modify absolute protection strategies because of their alienating effects on consumer demand or difficulty with practical enforcement.[30] But in the main, businesses, as well as their strategists and attorneys, have a hard time conceiving the protection of their intellectual assets through something other than the *ex post*, absolute protection paradigm. Although there are a million reasons why as a matter of social or constitutional policy these inclinations might be unwise, my aim is not to explore them here.[31] The question here is different: whether these inclinations make sense in cases where user creativity and flexibility in the use of digital works create value. In such cases we must ask whether it makes more sense to embrace, rather than reject or attack, the disruptive features of digital technologies. Businesses may be able to capture value created by public access practices and make such capture the premise of creative business models in our digital era. This is the challenge to which I turn next.

> sell translations, abridgements, burlesques, sequels, versions in other media from that of the original . . . or other variants without the copyright owner's authorization.

Id. at 226.

28 Bill Grahm Archives v. Dorling Kindersley, 448 F.3d 605 (2d Cir. 2006); Perfect 10 v. Visa, 494 F.3d 788 (9th Cir. 2007); Perfect 10 v. Amazon, 508 F.3d 1146 (9th Cir. 2007) (displaying a more permissive attitude toward the market entrant where, as in that case, use of copyrighted content is *transformative* under fair use analysis—even when making exact copies of the original work, albeit for different purposes—since transformative uses cannot be inferred to produce a market harm to copyright owner absent a showing of such harm).

29 WILLIAM PATRY, MORAL PANICS AND THE COPYRIGHTS WARS (2009).

30 Meléndez Juarbe, *supra* note 9 at 216-17.

31 *See* Hiram Meléndez Juarbe, Creative Commons y la Agenda de Contenido Abierto, 69 REV. COL. ABOG. P.R. 151 (2008); Meléndez Juarbe, *supra* note 9; LESSIG, *supra* note 22; NETANEL, *supra* note 22; BOYLE, *supra* note 22; FISHER, *supra* note 22.

II. THINKING CREATIVELY: TRANSCENDING THE LOCKSMITH

Not all businesses think creatively about their intellectual property. They should; but they don't.

Diane Zimmerman observes four types of reactions by businesses in the creative fields to the interaction between copyright law and digital technologies.[32] These are: *Naysayers*, *Locksmiths*, *Subverters*, *and Explorers*. The first conforms a minority breed that stays away from digital distribution channels while embracing traditional legal protections. For instance, for a long time copyrights holders over *The Beatles'* musical compositions were *Naysayers*, refusing almost all forms of online digital distribution.[33]

Explorers, at the other extreme, abandon copyright laws altogether, seeking profits from services connected to their creative works while experimenting with innovative business models. These "are individuals and entities interested in disseminating their own expressive materials—and who may well hope to profit directly or indirectly from doing so—but without help from the formal legal regime set out in the Copyright Act."[34] Musicians (such as the band Radiohead), authors (like Stephen King), and many others sometimes benefit from innovative distribution and payment schemes such as voluntary pricing, honor systems or mixed schemes where hard copies are sold and digital copies are not.

In the middle of the spectrum we find *Locksmiths* (those who rely on copyright and other alternative measures to aggressively enforce their interests, such as DRMs) and *Subverters* (who employ copyright law's mechanisms to serve non-enclosure ends, and hence subverting it, such as businesses relying on Free and Open Source Licenses like Creative Commons and GNU Public License). The interaction between *Explorers, Locksmiths and Subverters* is at the center of current and future arrangements for the distribution of creative works.[35]

Locksmith attitudes are reflected in the absolute protection (or *ex post*) paradigm previously described, and conform a complex reaction to the effect of digital "disruptive technologies"[36] on settled interests. In the current milieu, a driver behind this attitude may be what Harvard Business School's Clayton Christensen calls the *Innovator's Dilemma*.[37] According to this view, incumbent businesses are inclined to reject disruptive technologies since—rationally—it is

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32 Diane L. Zimmerman, *Living without Copyright in a Digital World*, 70 ALB. L. REV. 1375 (2007).

33 *Id.* at 1378.

34 *Id.* at 1382.

35 *Id.* at 1383, 1388.

36 Disruptive technologies are those that, contrary to *sustaining* technologies that "improve the performance of established products", they "bring to the market a very different value proposition that had been available previously." CLAYTON M. CHRISTENSEN, THE INNOVATOR'S DILEMMA xviii (2000).

37 CLAYTON M. CHRISTENSEN, THE INNOVATOR'S DILEMMA (2000).

in their best interest to invest in sustaining innovations (especially those that only improve existing innovations) and not invest in (thus resisting) those radical technologies that may challenge their place in the market.[38]

Although this account has much explanatory value, it is not always the case that things play out that way. Disruptive technologies are not always seen as threatening. One cannot ignore more complex *Subverter* and *Explorer* attitudes that embrace those disruptive features of digital technologies. For instance, as mentioned, we see emerging business strategies in the music industry that experiment with both open and proprietary products,[39] and allow vendors such as iTunes to release DRM-free music.[40] Increasingly, we see a more subtle world of *Subverters* and *Explorers* or what Lessig calls *hybrid economies*, where "either a commercial entity . . . aims to leverage value from a sharing economy, or . . . a sharing economy . . . builds a commercial entity to better supports its sharing aims."[41]

Classic examples of native-born hybrids are Slashdot.org, Flickr, Youtube, Craigslist and Google: companies that are able to capture the value created by sharing activities by users and build business models that mix the free (free as in *freedom to do things*, and not necessarily free as in *cost-free*) with the proprietary. These companies are able to see and recognize the value that free usage of intellectual resources has to consumers and can earn substantial revenues from it. Some openness—in copyright lingo—does not necessarily contradict economic success.

What is more, we increasingly encounter crossovers into these hybrids. MIT's Eric Von Hippel describes how companies sometimes find it in their best interest to forego some IP enforcement in order to benefit from user innovation.[42] The *Lego Mindstorms* project presents a famous example. Lego initially resisted how individuals hacked and repurposed computerized and motorized Lego figures on IP grounds, only to later learn the value that had been created *by users* in being able to share their modifications and innovations. Lego leveraged this spontaneously-formed, networked community of user innovators, and harnessed its value. Today, we find in their website user created designs and mod-

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38 *See* LAWRENCE LESSIG, THE FUTURE OF IDEAS 89-90 (2001); WILLIAM PATRY, MORAL PANICS AND THE COPYRIGHT WARS 40-41 (2009) (Oxford).

39 *See e.g.*, Jon Fine, *Radio Head's Business Head*, BUSINESSWEEK, Oct. 1, 2007, http://www.businessweek.com/innovate/FineOnMedia/archives/2007/10/radioheads_busi.html.

40 Jesús Díaz, *iTunes Gets DRM Free, New Prices, Purchase Over 3G*, Jan. 6, 2009, http://i.gizmodo.com/5124588/itunes-gets-drm-free-new-prices-purchase-over-3g. Since 2007 Apple had been selling songs from EMI's entire music catalog without DRMs. *See* Apple, *DRM-Free Songs from EMI Available on iTunes for $1.29 in May*, Apr. 2, 2007, http://www.apple.com/pr/library/2007/04/02itunes.html.

41 LAWRENCE LESSIG, REMIX: MAKING ART AND COMMERCE THRIVE IN THE HYBRID ECONOMY 177 (2008).

42 ERIC VON HIPPEL, DEMOCRATIZING INNOVATION (2005).

ifications to their products; innovations embraced by a company that crossed over to a hybrid economy,[43] moving from a *Locksmith* attitude to an *Explorer* or *Subverter* one.

Other less-known examples exist. The Center for Technology and Society of the Fundação Getulio Vargas Law School in Brazil and the Young Foundation in London, host the *Open Business* project,[44] a repository showcasing hundreds of businesses based on hybrid economies. Examples range from music,[45] fashion,[46] digital design,[47] and software development,[48] to film,[49] and consulting services.[50] Lessig's *Remix: Making Art and Commerce Thrive in the Hybrid Economy* describes at length powerful examples.[51]

These commercial initiatives emerge, in part, thanks to a measure of disintermediation in human interaction observable in a digitally connected world; the democratization and cheapening of computing power; the irreversible fact that distribution of digital works is virtually costless; the distributed and granular nature of online creativity; and the fact that digital technologies allow communities of users to emerge imposing their creative energies into the works they acquire.[52] It is not a world of passive *consumers* but, more broadly, a world of active *users* engaged creatively adding value to the works and to the communities they belong to.[53] Spillovers of digital creative works are not necessarily used more efficiently if they are controlled by a single entity or person.[54] In a digitally connected world, sometimes positive externalities of intangible works are better left to the hands of users who are capable of adding value through their use, which can—in turn—form the basis for creative businesses.

As with everything else in a competitive capitalist economy, some of these endeavors are bound to be more successful than others. But some are. And all are based on business models that are not blind to the value created by users and by the very features of digital technologies that are seen as threatening by some. Sometimes—and this is the point I want to drive home—when these entrepre-

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43 *See* LEGO.com MINDSTORMS: Home, http://mindstorms.lego.com/ (last visited June 3, 2010).

44 OpenBusiness, http://www.openbusiness.cc/ (last visited June 3, 2010).

45 Magnatune: we are not evil, http://magnatune.com/ (last visited June 3, 2010).

46 Custom Dress Shirts, http://www.blank-label.com/ (last visited June 3, 2010).

47 99 designs.com, http://99designs.com/ (last visited June 3, 2010).

48 The Apache Software Foundation, http://www.apache.org/ (last visited June 8, 2010); Canonical Homepage, http://www.canonical.com/ (last visited June 3, 2010).

49 Remixing Cinema, http://aswarmofangels.com/ (last visited June 3, 2010).

50 Brain Candy LLC, http://braincandyllc.com/ (last visited June 3, 2010).

51 LESSIG, *supra* note 41.

52 YOCHAI BENKLER, THE WEALTH OF NETWORKS (2007).

53 Yochai Benkler, *From Consumers to Users: Shifting the Deeper Structures of Regulation Toward Sustainable Commons and User Access*, 52 FED. COMM. L. J. 561 (2000).

54 *See* Frischmann & Lemley, *supra* note 3.

neurs consciously forego opportunities for copyright enforcement or adopt open and free licenses such as Creative Commons,[55] they employ alternative *Explorer* or *Subverter* attitudes toward the interaction between intellectual property and the digital environment. In short, they think creatively about copyright for their creative businesses. In doing so, these entrepreneurs consciously or unconsciously challenge the *absolute protection*/*Locksmith*/*ex-post* paradigm.

What is more, when they think creatively about copyright in a digital era, these entrepreneurs challenge the artificially-created polarity between, on one hand, advocating for reasonable copyright regimes that sensibly target the incentives goal and, on the other, successful commercial ventures deployed in our contemporary information economy.

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55 Puerto Rico - Creative Commons, http://creativecommons.org/international/pr/ (last visited June 3, 2010).

LITIGATING THE GRAY MARKET: AN INTELLECTUAL PROPERTY APPROACH TO CURTAILING PARALLEL IMPORTS

NOTE

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I. INTRODUCTION

GRAY GOODS ARE PRODUCTS BEARING A VALID TRADEMARK WHICH ARE SOLD by unauthorized distributors in contravention of commercial arrangements. Also referred to as parallel imports, these products are usually obtained abroad and not intended to be resold in the United States.[1] Gray marketers take advantage of existing price differentials between countries and benefit from the goodwill and reputation that the authorized dealer has developed in a particular market. Gray goods are generally understood to be legal, although, to some, they may appear to be unethical. If the gray goods are identical to the authorized products and they are being offered at a lower price, then there is the presumption that the consumer is not being harmed, and therefore, trademark law cannot be applied to bar the sale of these goods. Gray goods are not to be confused with counterfeit products, since they are genuine products, usually produced under a valid license, yet intended for a different market than the one where they are being sold. They also differ from counterfeit products because they are identical or very similar to the authorized products and bear a registered trademark.

Distributors of authorized goods are those most interested in litigating and curtailing the sale of gray goods, since these products compete with theirs and cause them to lose huge profits. The gray market has been described as a multi-billion dollar industry which competes with the authorized distribution system,

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1 Lisa A. Nester, *Keywords, Trademarks, and the Gray Market: Why the Use Is Not Fair*, 7 MARQ. INTELL. PROP. L. REV. 235, 242 (2003).

eating away at its profits.[2] In 2007, for example, the sale of gray market Information Technology products had an average impact on the profits of technology companies of between $8 and $10 billion dollars.[3] Although it may seem as if consumers benefit from gray products, since they are able to purchase the same products for a lower price, the truth is that gray market goods can potentially harm consumers in many ways.

Firstly, consumers may be confused or deceived as to the source or affiliation of the products they are buying. At times, trademark holders confer licenses to producers in foreign countries allowing them to manufacture and sell products under the existing trademark for sale exclusively in that country or region. In such cases, the foreign source of the gray product is not the same as the domestic source whom the consumer associates with the trademark. Furthermore, gray products may not meet the same quality standards with which authorized products are required to comply. When consumers buy gray products, they may be relying on the quality that they know and trust and which they associate with the product's trademark. However, they may instead find themselves with products that were mishandled or damaged as they were exported and imported on multiple occasions, and in the end cause dissatisfaction in the consumer. Additionally, consumers may subsequently find that the products they purchased, because they are unauthorized, are not covered by the manufacturer's warranty. Gray products may also get mixed with counterfeit products or be tampered with in some way. Finally, although gray goods are not counterfeit, there may be small variations, as products intended to be marketed in different regions are usually slightly modified, possibly resulting in incompliance with U.S. safety, ingredient, or labeling requirements.[4] These scenarios not only harm consumers, but also wear down the authorized distributors', as well as the manufacturers', hard-earned goodwill and reputation.

Gray goods also have effects on the market in general. The presence of gray goods causes an increased supply, which, in turn, lowers the price that consumers are willing to pay for the product because it is widely available. This result, if seen in a simplistic manner, may appear as a positive effect of gray goods. However, the long-term effect is that, since profits for manufacturers diminish they may need to lower costs, and consequently begin producing lower quality products. In the end, the consumer is confronted with a decline in the quality of the products, triggered by the presence of gray goods in the market.[5]

The problem with gray goods is clear. Yet, the solutions available to manufacturers and distributors of authorized products who are being affected by

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2 *Id.*

3 KPMG AND AGMA GLOBAL, KPMG/AGMA SURVEY PROJECTS GLOBAL 'GRAY MARKET' OF $58 BILLION FOR INFORMATION TECHNOLOGY MANUFACTURERS (2008), http://www.agmaglobal.org/press_events/12-11-08%20KPMG%202nd%20release%20for%20WP.pdf.

4 Nester, *supra* note 1, at 243.

5 *See* Christopher A. Mohr, *Gray Market Goods and Copyright Law: An End Run Around K Mart v. Cartier*, 45 CATH. U. L. REV. 561, 572-573 (1996).

the sale of gray goods are not clear. Although gray marketing is generally understood to be legal, there are several creative approaches that are being taken in order to curtail it, such as litigating the case under certain intellectual property laws.

II. The Trademark Approach

Trademarks are words, phrases, symbols, designs, images, sounds, smells, and colors, among other traits, that distinguish the products of a particular source from those of another. Unlike copyrights and patents, which are constitutionally based,[6] trademarks derive from legislation.[7] Trademark law has a dual purpose: on the one hand, it protects consumers from confusion or mistake about the source of a product or service in the market, while, on the other hand, it protects the reputation and goodwill of the trademark owners, thus, creating an incentive to maintain the quality and consistency of their products.[8] Several trademark law arguments have been used in cases regarding gray goods.

Section 32(1)(a) of the Lanham Trade-Mark Act (the Lanham Act) prohibits and imposes civil liability for the sale, offer for sale, distribution, and advertisement of counterfeit or imitation products due to the likelihood of confusion or deception that it may cause in consumers.[9] Section 32 clearly takes care of counterfeit and imitation products; however, it is not an adequate solution for gray products. Since, as discussed before, gray market products are usually identical or extremely similar to the authorized products, consumer confusion is unlikely, hence, making Section 32 inapplicable to gray products.

Case law has been consistent in holding that trademark law does not protect the unauthorized sale of genuine goods bearing a true mark.[10] This general principle is inapplicable, however, when the "genuine, but unauthorized, imports differ materially from the authentic goods authorized for sale in the domestic market."[11] The reasoning behind this so-called "material differences" standard lies in that differences in products bearing the same name and mark

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6 *See* U.S. CONST. art. I, § 8, cl. 8.

7 *See* Lanham Trade-Mark Act, 15 U.S.C. §§ 1051 *et seq.*; *see also* Puerto Rico Trademark Act, Act Num. 169 of December 16, 2009, 11 L.P.R.A. §§ 171 *et seq.* (2010).

8 *See, e.g.,* Societe des Produits Nestle, S.A. v. Casa Helvetia, Inc., 982 F. 2d 633, 636 (1st Cir. 1992).

9 Lanham Trade-Mark Act § 32, 15 U.S.C. § 1114 (2009) ("(1) Any person who shall, without the consent of the registrant--(a) use in commerce any reproduction, counterfeit, copy, or colorable imitation of a registered mark in connection with the sale, offering for sale, distribution, or advertising of any goods or services on or in connection with which such use is likely to cause confusion, or to cause mistake, or to deceive; or [...]shall be liable in a civil action by the registrant for the remedies hereinafter provided").

10 *See* NEC Electronics v. CAL Circuit Abco, 810 F. 2d 1506, 1508-1509 (1987). *See also* Shell Oil Corp. v. Commercial Petroleum, Inc., 928 F. 2d 104, 107 (4th Cir. 1991).

11 *Nestle*, 982 F. 2d at 638.

contravene Section 32 of the Lanham Act because they "confuse consumers and impinge on the local trademark holder's goodwill."[12] There is no particular standard for determining what are understood to be "material differences," since this analysis depends on the nature of the products. Material differences are thus determined on a case-by-case basis.[13] Section 32 of the Lanham Act may be of help in curtailing some very limited cases of gray market products. However, this approach does not provide a solution for addressing the majority of gray products, which are not materially different from the authorized products.

Another section of the Lanham Act that has been invoked by those trying to restrict the sale of gray products is Section 42,[14] which prescribes that:

> *no article of imported merchandise which shall copy or simulate the name of any domestic manufacture*, or manufacturer, or trader, or of any manufacturer or trader located in any foreign country which, by treaty, convention, or law affords similar privileges to citizens of the United States, *or which shall copy or simulate a trademark registered in accordance with the provisions of this chapter* or shall bear a name or mark calculated to induce the public to believe that the article is manufactured in the United States, or that it is manufactured in any foreign country or locality other than the country or locality in which it is in fact manufactured, *shall be admitted to entry at any customhouse of the United States*.[15]

Section 42 does not distinguish between genuine products and copies or simulations. However, the statute's purpose is, as mentioned above, to protect the consumer from confusion, and no such confusion exists when the two products, the imported and the domestic one, are identical. Again, we are confronted with a statute that only affords protection against counterfeit and imitations and, in rare cases, to gray products.

Trademark law can only afford protection against gray market products if material differences are present to such an extent that they are likely to cause confusion in the consuming public.[16] For this reason, trademark approaches to curtailing gray market products have proved ineffective in most cases. This, in turn, has required more creative theories from lawyers defending domestic manufacturers and distributors from competing parallel imports.

III. CUSTOMS REGULATIONS: THE TARIFF ACT

The United States Tariff Act of 1930 has a clear disposition that bars the importation of goods bearing a valid U.S. trademark without the written

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12 *Id.*

13 *See id.*

14 Lanham Trade-Mark Act § 32, 15 U.S.C. § 1124 (2009).

15 *Id.* (emphasis added).

16 *See, e.g., Nestle,* 982 F. 2d at 640.

authorization of the U.S. trademark holder.[17] However, Customs regulations have created broad exceptions to this rule, allowing goods bearing a valid U.S. trademark to enter the country without the trademark holder's consent if: "(1) the United States and the foreign trademark are owned by the same entity; (2) the United States and the foreign mark holders are subject to 'common control'; or (3) the goods bear a mark applied 'under authorization of the U.S. owner.'"[18]

These regulations were specifically interpreted by the U.S. Supreme Court in *K Mart v. Cartier*[19] which distinguishes between three separate scenarios of gray imports, of which only in one may Customs allow the parallel importation. The first situation is where a company purchases the right to use a foreign mark within the U.S. and registers said mark in the U.S. Registry. If the foreign manufacturer tries to import goods bearing that mark into the U.S., taking advantage of the reputation that the company has built in the U.S. for the mark, the importation can be barred, according to the U.S. Supreme Court. If, however, the company that registers the foreign mark in the U.S. is an affiliate of the foreign company, then the importation is allowed because, in the Court's opinion, the U.S. distributor, due to its ties with the foreign producer, is in a position to prevent the importation if it is in fact harming it. The third situation that the court considers is when a U.S. manufacturer, with a registered mark, sells to a foreign company the right to use and sell the mark abroad, with the restriction that it may not import the products bearing the mark into the U.S. If the foreign company breaches the agreement, the U.S. manufacturer and mark holder may require Customs to prevent the importation of the goods. Therefore, the *K Mart* decision is solely based on the type of relationship existing between the U.S. and the foreign mark holders and makes no reference to material differences, as do court decisions made pursuant to trademark law. In conclusion, the Tariff Act may prove useful in certain situations; yet, Customs regulations have created loopholes for gray goods and in the case of goods where the foreign importer and the domestic mark bearer are subject to common ownership, the Tariff Act cannot be applied to prohibit the parallel importation.

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17 Tariff Act of 1930 § 526, 19 U.S.C. § 1526(a) (2009) ("Except as provided in subsection (d) of this section, it shall be unlawful to import into the United States any merchandise of foreign manufacture if such merchandise, or the label, sign, print, package, wrapper, or receptacle, bears a trademark owned by a citizen of, or by a corporation or association created or organized within, the United States, and registered in the Patent and Trademark Office by a person domiciled in the United States, under the provisions of sections 81 to 109 of Title 15, and if a copy of the certificate of registration of such trademark is filed with the Secretary of the Treasury, in the manner provided in section 106 of said Title 15, unless written consent of the owner of such trademark is produced at the time of making entry.").

18 Mohr, *supra* note 5, at 574.

19 K Mart Corporation v. Cartier, Inc., et al., 108 S. Ct. 1811 (1988).

IV. Copyright Law: A More Effective Tool

The trademark and tariff approaches described above provide solutions for a variety of scenarios involving the importation of gray goods into the U.S. market. However, there remains still one scenario where neither of these approaches results helpful to the trademark owner trying to prevent the sale of gray goods. This is the case where the goods "perfectly mirror[ ] those sold in the United States and [bear] a United States trademark owned by a United States affiliate of a foreign trademark registrant."[20] For these cases, litigants have come up with the novel solution of utilizing copyright law to circumvent the affiliate exception created by *K Mart*.

Copyrights provide protection to "original works of authorship fixed in any tangible medium of expression."[21] Copyright protection is automatic: as long as the work is fixed in a tangible medium of expression, it is not necessary to register the copyright in order to acquire the rights and protections. Registration, however, does provide additional rights and is a prerequisite for upholding an infringement suit. Some of the works covered by copyright law are: literary works, musical works, dramatic works, *pictoral, graphic, and sculptural works*, motion pictures, and architectural works. Obviously, goods subject to a trademark are not automatically protected by copyright law. In order to attain copyright protection for a trademarked good, the good must also meet the requirements for works covered under copyright law. The trademark owner may ensure copyright protection of its goods by making the product, or some part of it, such as the label of packaging, copyrightable. For it to be copyrightable "the work must be in writing or other tangible form from which it can be reproduced [and] it must also be original and involve an appreciable amount of creative effort."[22]

The purposes of copyright protection vary greatly from those of trademarks. Firstly, consumer confusion is generally irrelevant to copyright law. The main goal of copyrights is to allow authors to control the use and sale of their works. This is what makes copyright law particularly attractive as a weapon for fighting gray marketing. The material differences standard does not apply to copyrights, on the contrary, the more identical the infringing goods are to the authorized goods, the more applicable copyright law becomes. Additionally, the existence of an affiliation between the foreign importer and the domestic copyright owner does not act as a restriction that prevents the importation of the infringing goods. According to section 602(a) of the Copyright Act "[i]mportation into the United States, without the authority of the owner of [the] copyright under this title, of copies or phonorecords of a work that have been acquired outside the United States is an infringement of the exclusive right to distribute copies or

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20 Mohr, *supra* note 5, at 586.

21 Copyright Act of 1976, 17 U.S.C. § 102(a) (2009).

22 Donna K. Hintz, *Battling Gray Market Goods with Copyright Law*, 57 ALB. L. REV. 1187, 1191-92 (1994).

phonorecords."[23] The Copyright Act does not authorize Customs to bar the entrance of copyrighted works that contravene Section 602(a), hence, it is up to the U.S. copyright owner to initiate a private infringement suit. The copyright owner's exclusive right to control the distribution of its works is limited, however, by the "first sale doctrine," which arises from section 109(a) of the Copyright Act.[24]

A. First Sale Doctrine

The First Sale Doctrine limits the copyright owner's right to control the resale or subsequent transfers of the copyrighted work after the first sale. This statutory limitation is not clearly drafted, and consequently, has been subject of multiple and diverse interpretations by different courts. Section 109(a) indicates that,

> [n]otwithstanding the provisions of section 106(3) [which gives the copyright owner the exclusive right to do and authorize the distribution of copies of the work], the owner of a particular copy or phonorecord *lawfully made under this title*, or any person authorized by such owner, is entitled, *without the authority of the copyright owner*, to sell or otherwise dispose of the possession of that copy or phonorecord.[25]

The phrase "'[l]awfully made' refers to goods made without violating any laws; for example, goods manufactured with permission as opposed to counterfeit goods."[26] The controversy that has been analyzed by the courts is whether a first sale abroad "of legally manufactured foreign goods which are eventually imported without permission into the United States [in direct contravention to section 602(a)] . . . prevents [the] United States copyright owner from using copyright law to prohibit the importation."[27] The issue is to determine whether the first sale doctrine, embodied in section 109(a), limits section 602(a)'s prohibition of importing unauthorized copyrighted material acquired abroad.

The court decisions regarding this matter can be arranged into two major groups: the first group of cases has prohibited the importation of unauthorized copyrighted works, while the second has allowed it. The main factor that has inspired these decisions is whether the goods were manufactured domestically or abroad. In most cases, the goods produced abroad, even under a valid license, and later imported, were declared as infringing, while those manufactured domestically, sold abroad, and subsequently imported were permitted.

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23 17 U.S.C. § 602(a)(1) (2009).

24 17 U.S.C. § 109(a) (2009).

25 *Id.* (emphasis added).

26 Hintz, *supra* note 22, at 1211.

27 *Id.* at 1187-88.

B. First Sale Doctrine Copyright Case Law

The first gray goods case litigated under copyright infringement was *Nintendo of America v. Elcon Industries*.[28] In this case, Nintendo of America, an affiliate of the Japanese company, owned the U.S. copyright for the game Donkey Kong. Nintendo of America manufactured, sold, and marketed the Donkey Kong arcade video game in the U.S. The Japanese company had authorized Falcon to manufacture and distribute a similar Donkey Kong game, under the Nintendo brand, exclusively in Japan. Falcon, however, apparently violated the agreement, importing the video game consoles into the U.S. Elcon bought the consoles from a U.S. company who had purchased the unauthorized products and began distributing them in the U.S. Nintendo of America sued Elcon under copyright infringement and unfair competition, and requested a preliminary injunction. The district court concluded that Elcon was benefitting from Nintendo of America's goodwill and was causing harm to the latter, and that Nintendo of America proved its likelihood of success on the merits, consequently granting the requested injunctive relief. In its analysis the court does not consider the first sale doctrine, which must lead to the conclusion that in the court's opinion, a first sale abroad does not prevent the copyright owner from banning the importation of copyrighted work, pursuant to section 602(a).

One year after *Nintendo, Columbia Broadcasting v. Scorpio Music,*[29]—one of the most cited gray goods copyright cases—followed. Here, Columbia sued Scorpio for copyright infringement over records for which Columbia was the U.S. copyright holder. The records acquired by Scorpio had been manufactured and sold under a valid, yet limited, license in the Philippines. The Philippine records had made their way into the U.S. and were bought by Scorpio who began distributing them in the U.S. without Columbia's authorization. Scorpio raised the first sale defense and argued that the first sale of the records made in the Philippines prevented Columbia from claiming that Scorpio's sale of the records in the U.S. constituted copyright infringement.

The district court held that section 602(a) was not limited by the first sale doctrine and consequently, that section 109(a) "grants first sale protection to the third party buyer of copies which have been legally manufactured and sold within the United States and not to purchasers of [foreign manufactured] imports such as are involved here."[30] The court's reasoning relied on the principle that U.S. legislation generally does not have extraterritorial application and therefore, the statutorily created first sale doctrine cannot be applied to sales made outside the U.S. borders, absent express Congressional intent. Additionally, the court stated that since section 602(a) was enacted more recently than section 109(a), the effect of interpreting that section 109(a)

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28 Nintendo of America, Inc., v. Elcon Industries, Inc., 564 F. Supp. 937 (D.C. Mich. 1982).

29 Columbia Broadcasting System, Inc. v. Scorpio Music Distributors, Inc., 569 F. Supp. 47 (D.C. Pa. 1983) (affirmed without opinion by 738 F. 2d 424 (3rd Cir. 1984)).

30 *Id.* at 49.

supersedes section 602(a)'s restriction on importation would be that section 602(a) would be rendered virtually meaningless.[31] Such construction of the statute would mean that "[t]hird party purchasers who import phonorecords could thereby circumvent the statute, in every instance, by simply buying the recordings indirectly."[32] This would violate the principle that no part of a statute should be interpreted in a way that makes any other part of the statute superfluous. For the reasons stated, the circuit court granted Columbia's request for summary judgment.

Following the *Columbia Broadcasting* decision, the District Court for the Northern District of California decided in *Hearst v. Stark*[33] that section 109(a) cannot be construed to limit the application of section 602(a) because section 602(a) was enacted after section 109(a), yet, it makes no reference to section 109(a). If Congress intended for section 602(a) to be limited by the first sale doctrine, it would have made this intent explicit within the statute. Therefore, after analyzing the legislative history of these dispositions, the court decided that "section 602 clearly provides that it is an infringement of United States copyrights for books that have been acquired outside the United States, however lawfully, to be imported into the United States."[34] The Ninth Circuit followed this same reasoning in deciding *BMG Music v. Perez*.[35]

Another case that decides against the importation of legally manufactured copyrighted goods produced abroad is *Parfums Givenchy v. C & C Beauty Sales,*[36] yet in this case the court bases it decision in a different rationale. The court agrees with the outcome of the Ninth Circuit in *BMG Music*, to which it is bound. However, it understands that the basis for the decision should be different. As opposed to the cases discussed above, the court here interprets "that the phrase 'lawfully made under this title' clarifies what constitutes a 'first sale' for purposes of the first sale doctrine; it makes no reference to the location of the manufacture or sale of the goods."[37] Instead, the court focuses its discussion on its understanding that "the [section] 106(3) distribution right, the first sale doctrine of [section] 109(a), and [section] 602(a) all work together to enable the copyright owner to realize the 'full value' of each copy sold."[38] In order for a first sale to take place, a valid sale must be made, and according to

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31 *Id.*

32 *Id.*

33 Hearst Corporation v. J. Ben Stark, and J. Ben Stark Books, Inc., 639 F. Supp. 970 (N.D. Cal. 1986).

34 *Id.* at 975.

35 BMG Music v. Perez, 952 F. 2d 318 (9th Cir. 1991) (holding that the first sale doctrine does not provide a defense for infringement under section 602(a) when the infringing copies are manufactured abroad).

36 Parfums Givenchy, Inc. v. C & C Beauty Sales, Inc., 832 F. Supp. 1378 (C.D. Cal. 1993).

37 *Id.* at 1387.

38 Hintz, *supra* note 22, at 1203.

the court, a valid sale only takes place when the owner receives the full value for its product. Therefore, only those who purchase the copy for the full value are afforded the protection of the first sale doctrine. With gray imports, copyright owners are prevented from attaining the full value to which they are entitled; therefore, gray goods violate Copyright law. This argument is one of the strongest that can be made in favor of prohibiting gray imports and hence proves that copyright law is a very useful tool against gray goods.

Parfums Givenchy, however, indirectly renders section 609(a) inapplicable to copies manufactured in the U.S., exported for sale abroad, and later imported back into the U.S. without the authorization of the U.S. copyright owner. The reason for this is because once the copy is sold within the U.S. for the full value, the copyright holder loses the right to control further sales. This leads us to the second group of cases, which have allowed the unauthorized copyrighted work to be imported into the U.S. if it was manufactured in the U.S. and then sold abroad. In *Cosmair v. Dynamite Enterprises*[39] the court decided not to issue the requested preliminary injunction that would have barred the sale of unauthorized imports. The reasoning was that Cosmair was unable to prove its likelihood of success on the merits because if *Nintendo* and *Columbia* were applied to the facts of this case they would render the goods as covered under the first sale doctrine. Here the copies were manufactured in the U.S. and later imported back into the U.S. market without the authorization of the copyright owner. Therefore, the court concluded that section 602 was inapplicable as the first sale had taken place domestically. In *Neutrogena v. United States*[40] the court followed the *Cosmair* decision in denying Neutrogena's request for preliminary injunction because the goods were manufactured in the U.S.

The copyright approach to gray goods received a hard blow with the Third Circuit's decision in *Sebastian v. Consumer Contacts*.[41] In this case the circuit court ruled that the copyright owner lost all rights to control the importation after the first sale was made. The court failed to recognize any conflicts between sections 109(a) and 602(a), consequently applying the first sale doctrine to both foreign and domestically manufactured goods. Additionally, the court concluded that sections 109(a) and 602(a) are separate dispositions and that the first sale doctrine, embodied in section 109(a), applies in all cases of unauthorized importation. This Third Circuit decision is what motivated the Supreme Court to sort out this issue for good.[42]

In 1998, in *Quality King v. L'anza*,[43] the Supreme Court finally decided whether the first sale doctrine is applicable to imported copies, pursuant to

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39 Cosmair, Inc. v. Dynamite Enterprises, Inc., 226 U.S.P.Q. (BNA) 334.

40 Neutrogena Corp. v. United States, 7 U.S.P.Q.2d (BNA) 1900 (1988).

41 Sebastian International, Inc. v. Consumer Contacts (PTY) Ltd., 847 F. 2d 1093 (2nd Cir. 1988).

42 *See* Quality King Distributors, Inc. v. L'anza Research International, Inc., 523 U.S. 135, 140 (1998) ("Because its decision created a conflict with the Third Circuit, see *Sebastian Int'l, Inc. v. Consumer Contacts (PTY) Ltd.,* 847 F.2d 1093 (1988), we granted the petition for certiorari.").

43 *Id.*

section 602(a). L'anza is a manufacturer and distributor of hair care products and affixes copyrighted labels to its products. L'anza distributes its products in the U.S. to select retailers, such as beauty salons and barber shops because its studies have revealed that U.S. consumers were not willing to pay high prices for hair care products if they were sold along with cheaper brands in supermarkets and pharmacies. L'anza has invested considerable effort and money into advertising its products and creating a brand image in the U.S. Outside the U.S., however, L'anza sells its products to distributors at prices significantly lower than in the U.S., in great part because it does not engage in extensive marketing efforts abroad as it does in the U.S. Some products manufactured by L'anza and sold abroad made their way back into the U.S. and were sold by unauthorized retailers who purchased the products from Quality King Distributors.

The Supreme Court explains that sections 109(a) and 602(a) are separate provisions that apply to different situations and that although they may both apply in some situations, the interpretation that one limits the other is not necessary.

> The argument that the statutory exceptions to [section] 602(a) are superfluous if the first sale doctrine is applicable rests on the assumption that the coverage of that section is coextensive with the coverage of [section] 109(a). But since it is, in fact, broader because it encompasses copies that are not subject to the first sale doctrine-*e.g.,* copies that are lawfully made under the law of another country-the exceptions do protect the traveler who may have made an isolated purchase of a copy of a work that could not be imported in bulk for purposes of resale. As we read the Act, *although both the first sale doctrine embodied in § 109(a) and the exceptions in [section] 602(a) may be applicable in some situations, the former does not subsume the latter; those provisions retain significant independent meaning*.[44]

In its decision, the Supreme Court also establishes that the purpose of section 602(a) is to prevent the unauthorized importation of copies manufactured abroad under the laws of a foreign country. In such a case the first sale doctrine does not apply because the wording of section 109(a) provides that the first sale restriction concerns copies "lawfully made under this title" and the copies made abroad, although lawfully made, are not made pursuant to the U.S. Copyright Act.

Quality King confirms the approach taken by most district courts and reverses the Third Circuit's decision in *Sebastian*. The current state of law after the Supreme Court's interpretation in *Quality King* is that copyright holders may initiate and prevail in an infringement action against gray goods manufactured abroad and imported without the authorization of the U.S. copyright owner. Domestically manufactured goods remain, however, without protection when they find their way back into domestic markets, albeit lacking authorization

44 *Id.* at 148-149 (emphasis added).

from the U.S. copyright owner. This result is due to the applicability of the first sale doctrine embodied in section 109(a) of the Copyright Act.

V. Conclusion

As demonstrated by the outcomes of the cases discussed above, there is a variety of approaches that may be taken in order to battle gray market goods. Firstly, there is the obvious trademark approach. Under the Lanham Act, if the trademark owner can demonstrate that the unauthorized goods exhibit material differences when compared to the authorized products, which will most likely cause confusion in the consuming public, then there is great chance of prevailing. If such is the case, the trademark holder may enjoin the importation of the unauthorized goods or sue for trademark infringement, or both. A wise recommendation for producers of trademarked goods that sell in different countries at different prices is to make sure that the goods have slight, yet tangible differences in each regional market. This will ensure that if they enter the U.S. as gray goods, the trademark holder will be able to support a trademark infringement suit.

If the trademark approach is not available because the goods do not bear material differences that may confuse the consumers, the copyright approach is available in most cases. In order to have a copyright case the manufacturer has to make sure that at least some part of its product, or the packaging, is copyrightable. In copyright cases there need not be material differences; in fact the product should be an identical copy of the copyrighted work. The only limitations in copyright cases are that the copyright owner may not control the distribution of a copy beyond the first sale, and that therefore, domestically manufactured copies that are sold abroad and subsequently make their way back into the U.S. are not protected by the Copyright Act. This exception does not apply, however, to copies produced abroad, even under a valid license, and imported into the U.S. without authorization. Therefore, a recommendation to manufacturers that desire to sell their goods abroad at lower prices than those used domestically, is that they grant licenses that contemplate the production, distribution, and sale abroad, instead of manufacturing the products domestically and then selling them abroad. If the product is manufactured abroad and enters the U.S. market without authorization of the U.S. copyright owner, even if that owner granted a license for use of the copyright abroad, the owner may sue those distributing the unauthorized good for copyright infringement, regardless of how many times the goods have changed hands, because the first sale doctrine never applies to these situations.

Additional methods of battling gray market goods include labeling the products as unauthorized, demarking or removing trademarks from the goods before importation, or raising prices abroad to decrease any incentives for importing.[45] Contractual clauses are also an effective tool, but they usually only provide an action for breach of contract, which does not provide as many remedies as those available in an infringement suit. However, a more creative approach to drafting the contracts may lead to the inclusion of clauses where the parties agree that certain remedies, such as those provided statutorily for trademark or copyright infringement, will apply in the case of unauthorized distribution in violation of the contract. A clause may, for example, establish that distributing the products through unauthorized channels will entail automatic impounding and disposal of the infringing articles by the manufacturer, without having to obtain a protective order or an injunction from a court. As long as these remedies do not contravene any laws and are not immoral, the drafters may include clauses that make it extremely unattractive for the other party to engage in parallel importation.

In conclusion, there are many remedies available for addressing gray marketing and its negative effects for manufacturers, distributors, and consumers. Depending on the nature and characteristics of the products, one may consider a trademark approach, a copyright approach, or a contractual approach in order to deal with the unauthorized distribution of goods. Before initiating an infringement suit, there needs to be an analysis of the good, its appearance, composition, packaging, and country of origin or manufacture, among other characteristics, in order to determine which approach is most desirable.

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45 This last approach may not always be defensible. In the case of expensive products where the consumer invests a considerable amount of money and is subsequently affected, because of the quality of the gray product or inapplicability of a warranty, for example, artificially raising the price of the product in a foreign market may be favored. However, in the case of certain products (i.e. hair care products) where the consumer's investment is not as significant, if the consumer is not satisfied with the product she may dispose of it and never buy it again. In this case, although the producer or distributor and their goodwill are still being harmed, it may not be defensible to hold that artificially raising prices abroad is a feasible solution. The harm to consumers who buy such gray products is not as clear as the potential harm to consumers and the market caused by artificially raising prices.

ABANDONED AND UNCLAIMED PROPERTY LAW IN PUERTO RICO: POTENTIAL IMPACT ON BUSINESSES

COMMENT

FRANCISCO J. RODRÍGUEZ BERNIER*

I. INTRODUCTION

I RECENTLY RESEARCHED AND PREPARED A MEMORANDUM ON WHETHER OUTstanding checks could be considered abandoned property and whether their issuer, a non financial institution, was required to report, and subsequently transfer such property to the Office of the Commissioner of Financial Institutions (the OCFI). This legal question at first seemed odd to me, doesn't OCFI only regulate financial institutions?

In addition, in order to determine whether non financial institutions have this obligation in Puerto Rico, the nature of the asset is also relevant. At first, outstanding checks did not seem to be the type of asset for which their issuers are required to report and transfer to OCFI. I was skeptical because all businesses are expected to have outstanding checks at the end of any accounting period as part of their regular operations.

Based on the research I conducted and a web seminar I attended, named "State Unclaimed Property Laws: Best Practices for Compliance" (the Web Seminar),[1] I became convinced that this is a subject of importance to general businesses in Puerto Rico and that there are necessary steps that should be taken by

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1 American Law Institute | American Bar Association, *State Unclaimed Property Laws: Best Practices for Compliance* (Ref. Num.: TSRGC07, performed on October 20, 2009). Seminar was dictated by Kendall L. Houghton, Esq. from Baker & McKenzie LLP and by Weiyen M. Jonas, Esq. Vice President and Associate General Counsel of FMR LLC Legal Department, Fidelity Investments.

businesses to be properly protected against any non-compliance risk associated to Puerto Rico Law.

II. GENERAL ESCHEAT LAW IN PUERTO RICO

All of the 50 states and territories of the United States, including Puerto Rico, have some type of Escheat Law.[2] There have been efforts to uniform these laws among states and territories of the United States through the Uniform Unclaimed Property Act (the UUPA).[3] The majority of these jurisdictions have used versions of the UUPA as base for their Escheat Laws.[4]

The purpose of Escheat Laws in these jurisdictions, including Puerto Rico, is "to ensure the protection of abandoned property until the rightful owner is located" and it is "intended to prevent a windfall to the holder of unclaimed property."[5]

Puerto Rico's Escheat Law is the Abandoned or Unclaimed Money and Other Liquid Assets Act (the Act),[6] which provides that "money and other liquid assets abandoned or unclaimed by their . . . owners [whose last known address is in Puerto Rico] [be transferred] . . . to the Commonwealth of Puerto Rico."[7] Pursuant to the Act every financial institution, or holder (Holder) of money or other liquid assets belonging to another person, shall publish a notice annually of money or other liquid assets presumed abandoned or unclaimed and transfer such property to the Commissioner of Financial Institutions.[8]

As noted, the Act rules over financial institutions or Holders (i.e., non financial institutions); therefore it applies to any business in Puerto Rico. To be a Holder, in the course of its business, an entity must have in custody money or

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2 Escheat Law is the name commonly given to a general unclaimed and abandoned property law.

3 The National Conference of Commissioners of Uniform State Laws issued the 1954 Uniform Disposition of Unclaimed Property Act, which was amended on 1966. A complete revision was made in 1981 when the Uniform Unclaimed Property Act was published. The 1981 Act was superseded by the 1995 Uniform Unclaimed Property Act . *See* THE UNIFORMED UNCLAIMED PROPERTY ACT, the Uniform Law Commission, (1995). *See also* Lori Furguson-Keney, *Perils of Unclaimed Property*, The CPA Journal, *available at* http://www.nysscpa.org/ cpajournal/2003/0403/features/f043403.htm (last visited, February 26, 2010).

4 Furguson-Keney, *supra* note 3.

5 American Law Institute, *supra* note 1.

6 Act No. 36 of July 28, 1989, P.R. LAWS ANN. tit. 7, §§ 2101-2109 (2009).

7 *Id.* Statement of Motives. The Act was amended on September 2, 2000 (clarifying the "custody" nature of the Commonwealth of Puerto Rico possession of these assets). Section 3 of Act 346 of September 2, 2000, P.R. LAWS ANN. tit. 7, § 2103 (2009), (Spanish Version) (the Act rules over these assets if the last known address of the respective owners is in Puerto Rico). *See* Sec. 4(e).

8 Sec. 6 of the Abandoned or Unclaimed Money and Other Liquid Assets Act, P.R. LAWS ANN. tit. 7, § 2105 (2008). Money or other liquid asset is presumed abandoned after 5 years in possession. *Infra* note 17.

other liquid assets belonging to another person.[9] The complete definition for Holder is:

> [A]ny person that in the course of his business has in his custody money or *other liquid assets* belonging to another person, with the obligation of returning or paying them to said other person, his beneficiaries, heirs or successors in law, on a specific date or one to be determined, or when a certain or contingent event occurs, whether foreseeable or not. (emphasis added)[10]

The matter as to when an entity becomes a Holder is critical since the Act specifies that Holders have reporting obligations, even when there is still no presumed abandoned property.[11]

The Act considers "other liquid assets" to be:

> [A]ssets that can be changed into money easily or within a term less than one (1) year with no loss or with a loss that does not exceed fifty percent (50%) of its value, and includes checks, certified checks, certified money orders, bank, postal, or other money orders, travelers checks, pass books, certificates of deposit, stocks, shares, promissory notes, bonds, dividends, escrow funds, sureties, credits and other similar assets.[12]

This "other liquid assets" definition includes "credits" and "other similar assets," which are open ended terms that lack specificity. The danger of this definition is that the Act could be applied to any asset that is "similar" to the ones described, as it could also be applied to outstanding checks.

For an indication as to what OCFI considers "other similar assets" in "custody," I reviewed the property reports that the agency requires. According to their Addendum to the Final Report on Abandoned or Unclaimed Money and Other Liquid Goods as of June 30,[13] among the "miscellaneous" assets to be reported by Holders in Puerto Rico to OCFI are:

1. Payment for goods and services (identifying number = MS04)
2. Unrefunded overcharges (identifying number = MS07)
3. Accounts Payable (identifying number = MS08)
4. Other outstanding checks (identifying number = MS16)[14]

According to this form, and the Act, any business in Puerto Rico that, as the result of its regular operations has accounts payable, credits due to customers, or outstanding checks, among other items (i.e., in possession of assets belonging to

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9 Sec. 2 (f) of the Act, P.R. LAWS ANN. tit. 7, § 2101 (f) (2009).

10 *Id.*

11 *Infra* note 18.

12 Sec. 2(d) of the Act, P.R. LAWS ANN. tit. 7, § 2101(d) (2009).

13 Office of the Commissioner of Financial Institutions, *Form INPR-IFA* (E), *available at* http://www.ocif.gobierno.pr/unclaimedeng/infoholders.aspx (last visited February 26, 2010).

14 *Id.*

a third party), could become a Holder. In other words, according to the Act, all businesses that operate in Puerto Rico may be considered Holders.

To be a Holder the entity must have the custody of an asset "in the course of its business,"[15] a phrase not defined by the Act. Nonetheless, the reasonable inference is that its possession should be the natural and expected result of its regular course of business.

In order to be a Holder, assets need to be "in custody," another term not defined by the Act. Being in possession of an asset belonging to another party should not automatically (i.e., per se) convert its possessor into a Holder; however, the Act is silent as to this matter. It is more reasonable to conclude, that if the purpose of the Act is "to ensure the protection of abandoned property until the rightful owner is located,"[16] a possessor will become a Holder (i.e., in "custody") if it holds an asset belonging to a third party for a period of time longer than what is considered reasonable for its type of business.

Will a check issued and not immediately paid by a bank be an outstanding check, and therefore, make of its issuer a Holder? Will any accounts payable recorded in the accounting books of a business immediately convert that business into a Holder?

We must look asset by asset to determine under which circumstances an entity in possession of assets belonging to another party becomes a Holder. As to outstanding checks, the most reasonable threshold for an issuer to become a Holder will be when the check has been outstanding for more than six (6) months after its issuance date. This period of time is contained in the Commercial Transaction Act (i.e., a special statute), and its purpose is to terminate the obligation of a bank as to paying a check after certain time has elapsed since its date of issuance.[17] As to accounts payable, for a debtor to become a Holder, any amount that remains unpaid (i.e., check not issued) beyond the agreed upon payment term (e.g., Net 30) could be determinant.

In other words, credits, or any similar assets belonging to another person, that are in possession of a business beyond a standard and customary period of time, according to its type of business, or beyond any period of time established as "reasonable" by any special statute, should make of its possessor a Holder. On the other hand, any person that in the course of its business possesses assets belonging to another person within a standard or a reasonable period of time, according to its type of business, or within a period of time established as "reasonable" by any special statute, should not be considered a Holder. However,

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15 Sec. 2(f) of the Act, P.R. LAWS ANN. tit. 7, § 2101(f) (2009).

16 P.R. LAWS ANN. tit. 7, §§ 2101-2109 (2009). *See also* Statement of Motives of the Act.

17 Sec. 3-404 of the Puerto Rico Commercial Transaction Act, P.R. LAWS ANN. tit. 19, § 954 (2009).

there is no case law that ascertains this, and the Regulation (Regulation)[18] issued on this matter by OCFI does not clarify this point.

The potential application to all businesses in Puerto Rico is real, and the Act needs serious consideration because of the penalties that can be imposed for not complying with the obligations it imposes, which are:

1. To submit annual reports of assets in custody and presumed abandoned (i.e., unclaimed for more than 5 years);[19]

2. If no presumed abandoned property, to file an annual report indicating so;[20]

3. To publish an annual notice in a newspaper of general circulation of the presumed abandoned property and its last known owner;[21] and

4. By the 10th of December of each year, to transfer the presumed abandoned property to OCFI.[22]

It is worth noting that one of the obligations requires Holders to submit annual reports, even if there is no presumed abandoned property. Not rendering this report is a breach of the Act.

There is no limitations period in the Act. The Regulation, on the other hand, gives the owner of the property as much as ten (10) years after property is transferred to OCFI to claim it,[23] after which it will become the property of the Commonwealth of Puerto Rico. This means that OCFI could go after abandoned property in Holders' possession with no limitations period.[24]

Businesses not complying with these obligations are subject to a $5,000 administrative fine per each noncompliance of any of its obligations, according to the Act,[25] in addition of being required to transfer presumed abandoned property to OCFI, which could represent a significant amount of money.

III. ESCHEAT LAW AS APPLIED IN THE STATES

The Act does not create a tax; instead, it creates an obligation to report, to give notice of, and to transfer abandoned assets. As any other obligation, prop-

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18 Office of the Commissioner of Financial Institutions, Regulation to Implement Act No. 36 of July, 28 1989, Regulation 4706 (June 3, 1992), *available at* http://www.cif.gov.pr/documents/4706.pdf.

19 Sec 5 of the Act P.R. LAWS ANN. tit. 7, § 2104 (2008). *See also,* Sec. 4 of the Act, P.R. LAWS ANN tit. 7, § 2103 (2008).

20 *Id.*

21 Sec 6 of the Act, P.R. LAWS ANN tit. 7, § 2105 (2008).

22 Sec. 6 (c) of the Act, P.R. LAWS ANN. tit. 7, § 2105(c) (2008).

23 Art. 9 of the Regulation, *supra* note 18.

24 Even though this is an obligation to the Commonwealth of Puerto Rico, it can be claimed that the Statute of Limitations of the Act is 15 years, because there is no stated limitations period. *See* Art. 1864 of the Civil Code of Puerto Rico, P.R. LAWS ANN. tit. 31, § 5294 (2009).

25 Sec. 9 of the Act, P.R. LAWS ANN. tit. 7, § 2108 (2008).

erty in custody should be accrued as a valid liability and should be reported in the financial statements.[26]

As in Puerto Rico, Escheat Laws in the States includes under their scope some sort of "other liquid assets." One of the speakers in the Web Seminar shared an experience she had with one of her clients who happened to manage inventory. This entity was imputed with abandoned properties in its possession whose origin were credits due to suppliers. These credits were generated from differences from quantity received over quantity billed by suppliers. In other words, excess of quantity received over quantity billed was considered a credit to suppliers, and therefore, credits became assets in custody of the entity, making it subject to the Escheat Law. This illustrates the extent to which Escheat Laws are being applied in U.S. jurisdictions.

As to its enforcement, because of the current economic slowdown, it is expected that the states and territories will be more aggressive in applying their Escheat Law since, after a specified period of time, the title over assets presumed abandoned will be conveyed to them.

Some U.S. jurisdictions have already significantly increased their unclaimed property "collections." As an example, Delaware's collections on this matter increased from $125.7 million in 1999 to $392.1 million in 2009.[27] In this state these types of collections are handled by the Bureau of Unclaimed Property, under the Division of Revenue of the Department of Finance of the State of Delaware. For Fiscal Year 2010, this bureau was assigned a $1,500,500 budget, and 14 full time public servants.[28]

An effort that is being applied by jurisdictions to increase the "collections" of "escheat property" is the performance of audits. In some states these audits are performed by state auditors, in others, there are third party auditors, paid on a contingent fee based on the assessment issued to Holders of unclaimed property as a result of the audit.[29] In some cases, for years when no records were kept, these audits extrapolate unreported escheat property found in the years audited to those years without records.[30]

This third party audit is the preferred strategy for jurisdictions that are not willing to dedicate more (or any) public servants and budget to this matter. In

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26 *See generally* RESEARCH AND DEV. ARRANGEMENTS, Statements of Fin. Accounting Standards NO. 68 § 32 (Fin. Accounting Standards Bd. 1982) (explaining the Generally Accepted Accounting Principles).

27 State of Delaware, Financial Department, *Delaware Fiscal Notebook 2009 Edition, State General Fund, Revenue by Category, available at* http://finance.delaware.gov/publications/fiscal_notebook_09/Section02/sec2page23.pdf (last visited March 2, 2010).

28 *See* Fiscal Year Appropriations Act, House Bill No. 290 (June, 29 2009), *available at* http://budget.delaware.gov/fy2010/hb290.pdf.

29 American Law Institute, *supra* note 1.

30 *Id.*

some jurisdictions interests are assessed on the value of the property that is not transferred on time to the appropriate governmental authority.[31]

There is no indication that Puerto Rico will become more aggressive with its Escheat Law enforcement, however, the Act is enforceable, and could be implemented accordingly.

In addition to potential administrative fines and the obligation to transfer presumed abandoned assets to OCFI, there is also a risk for over-escheatment, which can cause lawsuits by owners whose property was allegedly wrongfully escheated. There is also the risk for the Holder to lose its indemnification because of reports submitted that are considered not in good faith.[32]

IV. BEST PRACTICES

Compliance with the Escheat Law can be complex because of the different types of liquid assets that can be in custody under the Act. This is why all businesses in Puerto Rico need to establish unclaimed property procedures and formats to ensure compliance. This should include definition of roles for employees handling these issues and a well thought segregation of duties. There needs to be accountability and people responsible to ascertain there is compliance with the Act. In most states, the corporate departments that are generally responsible for Escheat Law compliance are Tax, Risk/Compliance, Accounts Payable, Treasury, and General Accounting.[33]

These internal controls should be properly documented, including their compliance. Records shall be retained and be available in case there is an audit on unclaimed property.

The role of counsel and consultants will be to assist in the drafting and implementing of policies and procedures, to understand and communicate industry-specific best practices, and to represent Holders in audits and filings.

V. CONCLUSION

Puerto Rico has its Unclaimed and Abandoned Property Act, which rules over financial institutions as well as any non financial institution that is consider a "holder." Any entity doing business in Puerto Rico that, as part of its regular operations generates, among other items, outstanding checks or records accounts payable that remain outstanding for a period of time that exceeds what is reasonable for its type of business, or exceed a period of time stated as "reasonable" pursuant to any special statute, is a Holder pursuant to the Act.

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31 *Id.*

32 *Id*. In Puerto Rico the Holder will not be liable for property properly transferred to OCFI under the ACT. P.R. LAWS ANN. tit. 7, § 2105(d) (2009).

33 American Law Institute, *supra* note 1.

Businesses in Puerto Rico need to be aware of this and should establish an appropriate system of internal controls to protect themselves from any potential audits by OCFI or other state-empowered entity. Risk of noncompliance with the Act includes the imposition of administrative fines by OCFI and transfer to them of the escheat property. Furthermore, an understatement in corporate books of liabilities generated from unclaimed property in possession of a Holder, if considered material, could place business executives of such Holder at risk of non-complying with their diligent duty to disclose accurate financial statements.

PUERTO RICO SUPREME COURT ISSUES OPINION ON TAXATION OF SEVERANCE PAYMENTS – TREASURY ISSUES RELATED GUIDANCE

COMMENT

JUAN LUIS ALONSO*

ON DECEMBER 18, 2009, THE PUERTO RICO SUPREME COURT ISSUED A 57-page opinion (excluding two concurring opinions) in the case of *Orsini García v. Secretario de Hacienda*.[1] In *Orsini*, the Supreme Court held, that severance payments made to discharged employees pursuant to Puerto Rico's Unjust Dismissal Act (Act No. 80)[2] are not subject to Puerto Rico income tax, and as such, not subject to Puerto Rico income tax withholding.

I. THE FACTS

After several years of employment, in 2003, Orsini was discharged by his Employer and was offered an amount in exchange for signing a release agreement, which Orsini accepted. Following applicable guidance from the Puerto Rico Treasury Department (PR Treasury), the Employer withheld Puerto Rico income tax from the payment and reported the payment and tax withheld to the PR Treasury.

Orsini originally included the payment in his Puerto Rico income tax return as taxable wages. He subsequently filed an amended tax return to exclude said amount from income and to request a refund of the tax withheld, on the basis that the severance payment did not constitute taxable income. The PR Treasury denied the refund request

Orsini filed a claim against the PR Treasury before the Puerto Rico Court of First Instance alleging that the amount received did not constitute taxable in-

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1 Orsini García v. Secretario de Hacienda, 2009 TSPR 190, 177 DPR ___ (2009).

2 Puerto Rico Unjust Dismissal Act, Act No. 80 of May 30, 1976, 29 L.P.R.A. §§ 185a-185m (2009).

come, as it was not remuneration for work performed or services rendered, nor was it a substitute for his salary. Orsini argued that the payment was for damages, and as such, it is excluded from the definition of gross income under Section 1022(b)(5) of the Puerto Rico Internal Revenue Code (PR Code).[3] At the time of the dismissal, this section excluded from its definition of gross income, payments made on account of damages, including mental anguishes. On the other hand, the PR Treasury alleged that the payment was not made under Act No. 80, but instead, as a separation or severance payment and, as such, it was a payment of wages subject to Puerto Rico income tax.

Eventually, the matter reached the Supreme Court. The Supreme Court concluded that the separation payment received by an employee as a result of a dismissal is not subject to Puerto Rico income tax because the purpose of said payment is to compensate for the damages caused to the employee by the loss of employment. Specifically, the Court determined that payments received under a separation agreement that provides a release of unjust dismissal claims under Act No. 80 are to be presumed, despite express contractual language to the contrary, a payment for unjust dismissal under Act No. 80. Further, the Court held that payments made on account of unjust dismissal, under Act No. 80, are intended to compensate for the emotional and physical damages caused by the loss of employment. Lastly, the Court concluded that payments for emotional and physical damages are excludable from gross income, pursuant to Section 1022(b)(5) of the PR Code,[4] and thus, exempt from Puerto Rico income taxation. The Supreme Court took into account the fact that the amount received by Orsini was the same amount as the severance payment he would have received had there been a wrongful discharge under Act No. 80.

With this opinion, the Supreme Court appears to be reversing PR Treasury's Administrative Determinations 05-02[5] and 07-01 [6] which provide guidance regarding the specific content of settlement agreements and the various Puerto

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3 Internal Revenue Code of Puerto Rico, Act No. 120 of October 31, 1994, 13 L.P.R.A. **§** 8001 *et seq.* (2009).

4 It is worth mentioning that the severance payment in *Orsini* was made prior to the amendment of the PR Code Section 1022(b)(5), which, effective on July 4, 2006, included the word "physical" in the exclusion from gross-income for amounts received on account of physical injury or physical illness.

5 PR Treasury, Adminstrative Determination No. 05-02 (2005) *available at* http://www.hacienda.gobierno.pr/ (follow "Publicaciones" hyperlink; then follow "Determinaciones Administrativas" hyperlink; then follow "05-02" hyperlink) (on the tax treatment of payments made pursuant to an extrajudicial settlements).

6 PR Treasury, Administrative Determination No. 07-01 (2007), *available at* http://www.hacienda.gobierno.pr/ (follow "Publicaciones" hyperlink; then follow "Determinaciones Administrativas" hyperlink; then follow "07-01" hyperlink) (on the Tax Treatment of Income Pursuant to the Award of an Action for an Employment-Related Damage or an Unjust Employment Termination).

Rico income tax consequences of severance and settlement payments, respectively.

II. AND NOW, WHAT?

On March 8, 2010, the PR Treasury issued Informative Bulletin 10-08 providing that *Orsini* does affect PR Treasury's Administrative Determinations 07-01, 08-04 and 08-13, regarding the taxability of Act No. 80 severance payments, the tax exemption of payments for emotional damages resulting from a physical injury, and the tax exempt treatment for certain voluntary special payments for discharge with just cause under Act No. 80, as amended by Act No. 278,[7] respectively.[8] The PR Treasury concludes that after amendments to PR Code Section 1022(b)(5), effective July 4, 2006, only severance payments made on account of a *physical* injury or *physical* illness are exempt from Puerto Rico income taxes (*i.e.*, that PR Code Section 1022(b)(5), as amended, includes non-physical damages). In light of the foregoing, and assuming that a severance payment is not made on account of physical injury, it might be advisable for employers to report payments for unjust dismissal, under Act No. 80, as taxable wages in a form 499R-2/W-2PR for Puerto Rico income tax purposes; although no Puerto Rico income tax withholding would be made.[9]

On the other hand, Informative Bulletin 10-08 does not address the Supreme Court's position that payments made pursuant to separation or settlement agreements, which mention Act No. 80 within their general release provisions, even if expressly rejecting the commission of any actions covered under Act No. 80, will be presumed to be payments covered under Act No. 80. Thus, PR Treasury Administrative Determination 05-02 seems to have been rendered inapplicable in such situations.

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7 *See* 19 L.P.R.A. §§ 185b(d)-(f), as amended by Act No. 278 of August 15, 2008. (which provides tax-free treatment for Puerto Rico income tax purposes to certain payments made to discharged employees to the extent the discharge is due to, among others, full, temporary or partial closing of operations of the establishment, changes in the design or nature of the product or in the services rendered by the employer, or a reduction of volume of production, sales or profits).

8 *See* PR Treasury, Informative Bulletin No. 10-08 (March 8, 2010), *available at* http://www.hacienda.gobierno.pr/ (follow "Publicaciones" hyperlink; then follow "Boletines Informativos" hyperlink; then follow "10-08" hyperlink).

9 It remains unclear if the same treatment applies to a payment under a separation or settlement agreement which includes a payment in lieu of a payment for unjust dismissal under Act No. 80.

III. WHAT ABOUT FICA?

Although *Orsini* cited the Supreme Court´s decision in *Alvira v. SK & F Laboratories*,[10] it did not specifically address whether the payment is subject to withholding of the Social Security and Medicare tax (collectively, FICA). At least two decisions have been issued by the U.S. District Court for Puerto Rico (District Court) after *Alvira* holding that payments under Act No. 80 are wages for FICA tax purposes.[11] Absent clear and binding guidance as to FICA tax, it is advisable to report a payment under Act No. 80 (or a waiver or settlement payment for such claim) (including, if applicable, a *gross-up* of the employee portion of the FICA tax) as taxable wages in a form 499R-2/W-2PR for FICA tax purposes. The employer will have to decide whether to *gross-up* the FICA tax withholdings on a payment under Act No. 80. The decision to *gross-up* the special payment is a determination that should be based on the employer's position regarding the need to pay the total Act No. 80 payment for unjust dismissal with no withholdings, after *Orsini*, and not on the taxable or tax-free nature of the payment.[12]

IV. REDUCTION IN FORCE PROGRAMS AFTER *ORSINI*

Generally, payments made under a reduction in force program (RIF) are within the scope of severance payments for dismissals with just cause.[13] Special Payments are, by law, and irrespective of the decision in *Orsini*, not subject to Puerto Rico income tax, and must be reported in a form 480.6D for Puerto Rico income tax purposes. Such severance payments are subject to FICA tax withholdings and must be reported in a form 499R-2/W-2PR for FICA tax purposes.

If, for labor and employment law reasons, it is decided that the amount of the Special Payment to be made under a RIF will be equivalent to, and should be treated as, the amount payable for unjust dismissal under Act No. 80 (*mesada* payment), then the employer will have to decide whether to *gross-up* the FICA tax withholdings. Whether the employee must receive the total Act No. 80 payment for unjust dismissal with no withholdings in order to comply with Act No. 80 seems an issue still subject to debate after *Orsini*. The decision to *gross-up*

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10 Alvira v. SK & F Laboratories, 142 D.P.R. 803 (1997) (concluding that payments for unjust dismissal under Act No. 80 constitute payments for damages which may not be subject to any withholdings).

11 *See* Cancio de Jesus v. Phillips Puerto Rico, Civil No. 98-1147; *see also* Rivera v. Baxter, Civil No. 02-228; *see also* IRS Regulation on Employment Taxes and Collection of Income Tax at Source,26 C.F.R. 31.3401(a)-1 (b)(4) (2010).

12 It is noteworthy that the U.S. District Court for the Western District of Michigan recently concluded that severance payments "made because of the employees' involuntary separation from employment which resulted directly from a reduction in force or the discontinuance of a plant or operation" are not taxable for purposes of FICA taxes. *See* In re Quality Stores, Inc., *et al.,*105 A.F.T.R. 2d 2010-1110 (W.D. Mich. 2010).

13 *See* Puerto Rico Unjust Dismissal Act, 29 L.P.R.A. § 185b(d)-(f) (2009).

the special payment is a determination that should be made by the employer on the basis of that need.

V. Conclusion

Orsini and Informative Bulletin 10-08 may seriously impact the negotiation and management of separation payments, severance programs, settlement agreements, and the withholding and reporting obligations under various statutes. Employers should revise all severance, separation, and settlement agreements to include specific language as to the nature of the payment(s) being made, the applicable tax withholdings and reporting requirements, and include a *hold-harmless* provision in favor of the employer regarding these matters.