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ARTICLES

LOCKEAN NEUTRALITY VERSUS RELIGIOUS ACCOMMODATION*

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From the beginning, colonists knew that they had to confront a host of questions that Europe did not always face or even see: simply because dissenters were so many and there was no secure majority, the needs of minorities assumed prominence from the beginning. What sort of liberty must a good society give to members of minorities whose religion the majority finds incorrect, or even sinful and bad? Should there be an established state church? What should be done about people who want to disobey some law applicable to all on grounds of conscience, who don't want to fight in the army, for example, or to testify in court on a Saturday, or to swear a religious oath as a condition of public office (as was typically required in Britain—no avowed atheist was seated in Parliament until 1886). What limits could a decent society impose on religious behavior?

The philosophical architects of the Anglo-American legal tradition could easily see that when peace and safety, or the equal rights of others, are at stake, some reasonable limits might be imposed on what people do in the name of religion, and that such restrictions, supported by urgent public interests, might still be compatible with a respect for equal liberty. But they grasped after a deeper and more principled rationale for these protections and limits. Significantly, they found the basis for their principles in the idea of inherent equality and equal rights, not in the idea of (mere) toleration, which they judged too thin, and compatible with the type of social hierarchy they had come to the New World to avoid. A typical, if unusually eloquent, articulation of this point is in a letter written by President George

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Washington to the Hebrew Congregation at Newport in August 1790:

> "The citizens of the United States of America have a right to applaud themselves for having given to mankind examples of an enlarged and liberal policy: a policy worthy of imitation. All possess alike liberty of conscience and immunities of citizenship. It is now no more that toleration is spoken of, as if it was by the indulgence of one class of people, that another enjoyed the exercise of their inherent natural rights. For happily, the Government of the United States, which gives to bigotry no sanction, to persecution no assistance requires only that they who live under its protection should demean themselves as good citizens, in giving it on all occasions their effectual support." [1]

Washington here associates toleration with hierarchy: a privileged group says that we will indulge you but retains the power not to do so, should it change its mind. Instead, he prefers the idea of equal inherent natural rights, rights that give people both liberty (to practice their religion) and immunity (from persecution and bigotry, but also from the state imposition of religious requirements). And he tells the Jews that the government will not ask them to worship this way or that way; it will ask them only for their support as conscientious citizens. (As we'll later see, he was so sensitive to the claims of minority religion that he did not even construe "effectual support" to require military service of people who objected to it on grounds of conscience.)

But what, more precisely, does this idea require of government? Here the philosophical tradition splits. (To return to our point about Europe, the origins of both strands of this tradition are in Europe, although they flourished primarily in the United States.) One strand, associated with the seventeenth-century English philosopher John Locke, holds that protecting equal liberty of conscience requires just two things: laws that do not penalize religious belief, and laws that are nondiscriminatory about practices, that is, the same laws must apply to all in matters touching on religious activities.[2] One example of a discriminatory law, said Locke, was the English law that made it illegal to speak Latin in a church but permitted

[1] The famous words "to bigotry . . . no assistance" and also the words "liberty of conscience and immunities of citizenship" are directly quoted by Washington from the letter addressed to him by the Hebrew Congregation at Newport, and signed by its warden Moses Seixas. Washington's letter is quoted in many places, often with minor variations in punctuation or even wording. I have checked this version against the photograph of the original in Washington's (very clear) hand. See http://gwpapers.virginia.edu/documents/hebrew/reply.html.

[2] John Locke, *A Letter Concerning Toleration* (1689; Amherst, NY: Prometheus Books, 1990).

people to speak Latin in schools.[3] Obviously the point of such a law was to persecute Roman Catholics. Another example of a persecutory law would be a law that made it illegal to immerse your body in water for the sake of baptism but allowed people to immerse themselves in water for the sake of health or recreation.[4] It's clear that the intent of such a law would be to persecute Baptists. Locke concludes, "In a word: whatsoever things are left free by law in the common occasions of life, let them remain free unto every church in divine worship. Let no man's life, or body, or house, or estate, suffer any manner of prejudice upon these accounts."[5]

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A version of the accommodationist position gradually became dominant in the colonies, as settlers tried to figure out how to live together on terms of equal respect. The colonists were familiar with a variety of problems demanding accommodation: Quakers refused to take off their hats in court; Jews refused to obey a subpoena that required them to testify on a Saturday; both Quakers and Mennonites refused military service. Roger Williams argued that the accommodationist position was the only fair position: otherwise the majority was claiming for itself a liberty much more extensive than it was prepared to grant to others. To the governors of Massachusetts and Connecticut, who imposed an established orthodoxy, he writes: "Your Selvs praetend libertie of Conscience, but alas, it is but selfe (the great God Selfe) only to Your Selves." By the time of Independence, most state constitutions provided that only extremely urgent public considerations, such as peace and safety, or protection of the rights of others, could ever be reasons to limit any person's religious liberty—the position that Williams had defended in his copious writings, although it had many sources in colonial thinking.[6]

The U.S. Constitution's First Amendment protects religious liberty in a way that does not explicitly distinguish between the accommodationist position and a weaker Lockean position: "Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof." The phrase "infringe the equal rights of conscience" appeared in several drafts but was replaced in the final version by "prohibiting the free exercise [of religion]." This change shows quite clearly that the framers intended to protect religious acts as well as beliefs: "rights of conscience" could be taken to refer only to the latter, but "exercise" clearly also

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[3] *Id*. at, 69.
[4] *Id*.
[5] *Id*.
[6] *See* Michael McConnell, "The Origins and Historical Understanding of Free Exercise of Religion," *Harvard Law Review* 103 (1990), 1409 ff.

includes the former. But we should not read the final text as meaning that the framers relaxed their focus on equality. Equality, in the former phrase, referred to rights. If the final text had said "prohibiting the equal free exercise of religion" it would have been much too weak. A law could inhibit all religions equally—for example, by saying, "No religious practice is legal in the United States"—and that would still be something we'd want to prohibit. So the absence of the word "equal" does not mean that equality was not a concern: it just means that even equal burdens on religious conscience are ruled out.

The change from "conscience" to "religion" does seem to entail that religion is legally special from the viewpoint of the Free Exercise Clause. Other forms of conscientious commitment do not get protection—at least not from that clause. As we'll see, this issue leads some people to oppose a broad accommodationist reading of the Free Exercise Clause, on the grounds that it magnified an already troubling unfairness toward nonreligious conscience.

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Even before Independence, policies were evolving in an accommodationist direction. (For example, it was understood that Jews, Quakers, and Mennonites would not remove their hats in court, and people honored this choice, while maintaining the policy of hat removal as a general matter.) Right after the War of Independence, Washington makes a major concession when he permits conscience to exempt religious minorities from a general policy of military service. Early court cases followed suit. In 1793, Jonas Phillips, a Jew, challenged the requirement to testify in court on a Saturday. In 1813, a Catholic priest, Father Kohlmann, was permitted to refuse to answer questions posed to him when he was under oath as a witness in a criminal case, when he argued that the information (about the identity of the person who had returned the stolen goods to him) came to him in the confessional.[7] The judge in the latter case, a Protestant, understood that to be required by law to violate the confessional (or, indeed, to go to jail for contempt of court for not doing so) would place a very heavy burden on Father Kohlmann and would effectively abolish the sacrament of the confessional:

> "It cannot therefore, for a moment be believed, that the mild and just principles of the common Law would place the witness in such a dreadful predicament; in such a

[7] *Stansbury v. Marks*, 2 Dall. 213 (Pa. 1793); *People v. Philips*, New York Court of General Sessions, 1813.

> horrible dilemma, between perjury and false swearing: If he tells the truth he violates his ecclesiastical oath—If he prevaricates he violates his judicial oath—Whether he lies, or whether he testifies the truth he is wicked, and it is impossible for him to act without acting against the laws of rectitude and the light of conscience.
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> "The only course is, for the court to declare that he shall not testify or act at all."

For many years, the provisions of the Free Exercise Clause were understood to be binding only on acts of the federal government, and it was not until 1940 that they were explicitly "incorporated," held to apply, as well, to the acts of state and local governments.[8] From this time on, minority requests for accommodation proliferated. Over a long period of time after "incorporation," the Supreme Court applied an accommodationist standard, holding that government may not impose a "substantial burden" on a person's "free exercise of religion" without a "compelling state interest" (of which peace and safety are obvious examples, though not the only ones).

The landmark case articulating this principle, *Sherbert v. Verner*, concerned a woman who was a Seventh-Day Adventist and whose workplace introduced a sixth workday, Saturday. Fired because she refused to work on that day, Sherbert sought unemployment compensation from the state of South Carolina and was denied on the grounds that she had refused "suitable work."[9] The U.S. Supreme Court ruled in her favor, arguing that the denial of benefits was like fining Mrs. Sherbert for her nonstandard practices: it was thus a denial of her equal freedom to worship in her own way. There was nothing wrong in principle with choosing Sunday as the general day of rest, but there was something wrong with not accommodating Mrs. Sherbert's special religious needs.

For the accommodationist (and typically for the Lockean as well), the relevant unit theoretically is the conscience of the individual. Thus, if someone has a nonstandard interpretation of his or her religion, it cuts no ice to say that the majority of that religion's members do not agree. But in practice it helps to have a track record, and the public, shared views of a group supply that. For example, though individuals who object to military service have been given exemptions without being members of a group such as the Quakers or the Mennonites, the burden of proof is high: the individuals have had to supply an extensive account of their beliefs,

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[8] The decisive case was *Cantwell v. Connecticut*, 310 U.S. 296 (1940).
[9] *Sherbert v. Verner*, 374 U.S. 398 (1963).

something that gives unfair advantages to the articulate and educated.[10] Still, the theoretical point is important for religions such as Islam that contain many different views about what is required, and its spirit is attractive: if an individual sincerely believes that wearing a *burqa* is required or that killing in war is always morally forbidden, it does no good to point out that many co-religionists disagree.

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In 1990, that tradition received a major setback in *Employment Division v. Smith,* and U.S. law reverted, in part, to the Lockean position.[11] The case is pertinent to our concern with religious fear, because its topic was the use of drugs, a topic on which Americans are very easily scared. Al Smith, a Native American, was a recovering alcoholic who worked as an alcohol and drug counselor for a variety of groups in his home state of Oregon, with considerable success. He came to believe that participation in Native-American religion was a key to his own spiritual development and to his continued recovery, and he became convinced that it would also be helpful to other Native people struggling with alcoholism. His church uses the drug peyote in its sacred ritual, which reconstructs traditional Native-American ceremonies that have roots going back over a thousand years. Peyote is a hallucinogen, but participants who use it in the ceremony describe its effect as very mild, amounting to increased concentration and focus. Smith at first abstained, because Alcoholics Anonymous (AA) philosophy forbids the use of any mind-altering drug. Eventually, however, he tried it on several occasions beginning in the 1970s and found that it did not lead him back to alcohol; in fact, he reported that he felt he had become a wiser and better person for having used it.

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Ultimately, they lost in the U.S. Supreme Court. Although a concurring opinion written by Justice O'Connor uses the *Sherbert* standard and concludes that the state has met the burden of showing a "compelling state interest," the majority opinion, written by Justice Scalia, announces that the standard to be applied henceforth (and also in the past, in a highly controversial reading of the precedents) is the Lockean standard. The question to be asked is whether the law is "a neutral law of general applicability." If it is, there is no constitutional right to an exemption. Government may not ban the performance of a physical act that is

[10] *See U.S. v. Seeger*, 380 U.S. 163 (1965), and *Welsh v. U.S.*, 398 U.S. 333 (1970).
[11] 494 U.S. 872 (1990).

generally legal when that act is performed for a religious reason (and here Scalia gives some of Locke's actual examples and others in the same vein). But the fact that some people's reason for wishing to disobey a generally applicable law is religious does not excuse them from compliance. Scalia concludes that a system of judicially administered exemptions would be tantamount to "courting anarchy."

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How should we assess these two traditions, in the light of our basic principles of equal respect for conscience and the vulnerability of conscience? The first thing we ought to notice is that the two are not exactly opponents: they differ in degree rather than in ultimate values, and they lie on a continuum. Both traditions are concerned with ample and equal liberty. The Lockean's concern for equality manifests itself in its unwillingness to permit persecutory laws, or even laws that, like the police regulation that barred Muslim beards, betray a persecutory intent that is probably not conscious, through their obtuse willingness to countenance secular but not religious exemptions. Once we reach the point of seeing that persecution may be a result of obtuseness rather than malice, we are already on the terrain of the accommodationist. Thus the police policy that denied an accommodation for the Muslim officers was not drafted with the concerns of Muslims in mind, and the exemption for the skin condition was not implicitly a denial of a religious exemption, which, very likely, nobody had thought about. So the policy is much less persecutory than the Hialeah ordinance on ritual slaughter. From here it is a short step to the drug laws that exempt a drug (alcohol) used by the majority (and ritual use of which remained legal even during Prohibition), and fail to exempt a drug (peyote) used by the minority. Probably the Oregon drug laws were not drafted with religious concerns in view, and no malice can be inferred from their failure to exempt the sacramental use of peyote. (Indeed, recall that the U.S. Congress promptly legalized this sacramental use, after *Smith,* through amendment to the Controlled Substances Act.) Nor are laws concerning workdays made in order to penalize minorities; they are made because they are convenient. But there is obtuseness in the majority's way of pursuing convenience, and this obtuseness is harsh to central concerns of minorities. That was true of the Muslim police officers, and it is true of Mrs. Sherbert and Al Smith. The difference, then, between the class of cases where Justice Scalia and his fellow Lockeans are prepared to strike down a law or policy as non-neutral and the class of cases deemed accommodations is not sharp or principled; the cases lie on a continuum. When we add to this the fact that even Justice Scalia is prepared to countenance judicial exemptions where a system of individualized exemptions is in place (as in *Sherbert),*

and that even he was willing to join a unanimous Court in *Gonzales v. O Centro Espirita—thus* restoring fairness between large and small minorities by granting the small minority a judicial exemption to match the legislative exemption the larger minority had already won—the two traditions seem to differ more in the number of such exemptions they countenance than in their type or basis. When we contrast the United States with Europe, it is revealing to see that it is in this subtle point of difference that the U.S. controversy resides, whereas European approaches often neglect even the demands of the weaker Lockean position. In that sense it might seem excessive to delve into the nuances of this debate—and yet it is revealing, for it shows how the U.S. argument has unfolded and what considerations it has taken to be essential.

Can we, nonetheless, argue that one of these traditions is more adequate to capture the idea of equal respect than the other? I believe that the accommodationist principle is superior to Locke's principle, because it reaches subtle forms of discrimination that are ubiquitous in majoritarian democratic life. All societies make choices regarding holidays, workdays, drug and alcohol restrictions, and a host of other matters touching on people's religious observances. The choices of a majority are usually supported by some type of reasoning; thus they will pass a weaker "rational basis" test, although they might not pass a "compelling state interest" test. They may, however, be extremely harsh to minorities, rendering their liberty unequal. To grant them accommodations on grounds of conscience, in areas ranging from employment to military conscription to sacramental alcohol or drug use, is to restore a standard of equal liberty.

Accommodation has its problems, however. One, emphasized by Justice Scalia, is that a system based on individualized exemptions is difficult for judges to administer. Creating exemptions to general laws on a case-by-case basis struck Scalia as too chaotic, and beyond the competence of the judiciary. Thus, although he thought that accommodations created by legislation would be permissible—such as the change in our Controlled Substances Act that legalized the sacramental use of peyote—he was opposed to granting such exemptions judicially, except where (as in *Sherbert)* a system of individualized exemptions was already in operation. To Scalia's worry about "anarchy" we can add a concern about fairness: under a system of judicial accommodations, minorities will prevail to the extent that they are both willing and able to use the legal system to their advantage. The ACLU's willingness to offer legal aid to many religious minority plaintiffs considerably reduces this concern but does not completely eliminate it. And judges may by temperament or education be more empathetic toward majority than toward minority viewpoints. The difficulty the Court has had understanding the claims of Native-American religion is a clear example of this problem.

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In short, there are strong arguments on both sides: the Roger Williams position has not yet shown that it can defeat the Lockean position. The current American state of affairs, in which RFRA prevails for federal issues and in some states, while the Lockean position prevails in other states, though with room left for legislative accommodations, reflects the complexity of the issues and the tough choices the two positions pose. It also reflects, however, the narrow gap that currently separates the two positions, in their operational form, as well as in the extent to which both positions respond to people's most serious concerns about equal respect.

THE HEALTH OF NATIONS: ECUADOR'S TWENTY YEAR CRUSADE TO ESTABLISH ENVIRONMENTAL HUMAN RIGHTS AS CUSTOMARY INTERNATIONAL LAW

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In developing governments around the world the lure of economic stimulus entices leaders to invest in projects that could relieve them of chronic poverty and set their economies on a trajectory to prosperity. These communities, consisting most often of low-income and minority demographics, suffer disproportionately from the impacts of hazardous wastes and toxic chemicals as compared to other communities across the world. In the 1960s, Texaco Petroleum began extensive exploration and extraction of crude oil in a region of the Amazon rainforest formerly inhabited solely by indigenous peoples native to northeastern Ecuador. There is no dispute the events that took place in the region in the subsequent thirty years caused an ecological disaster that permanently endangers the indigenous peoples and the once-pristine region of the Amazon. Agreement on the issues of the environmental catastrophe ends there. In 1993, a group of Ecuadorian plaintiffs filed suit on behalf of the indigenous communities harmed by Texaco's operations. Texaco argued for the removal of the case to Ecuador whose judiciary, the company argued, was perfectly capable and more suitable of resolving the dispute. In 2001, The Chevron Corporation acquired Texaco and their lengthy litigation in Ecuador. In February 2011, Ecuadorian plaintiffs obtained an 18 billion dollar judgment in an Amazon Provincial Court and suddenly the 'perfectly capable' Ecuadorian judicial system became a scapegoat and the avenue of Chevron's appeal to enjoin enforcement of the judgment. This article insists, as a general theme, that the United States address the inequities of U.S. multi-national corporations' behavior in communities where there is a substantial need for environmental and human rights protection via the Alien Tort Statute.

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I. INTRODUCTION

The environmental justice movement attempts to address the inequities of economic development in communities where there is a substantial need for environmental and human rights protection.[1] These

[1] *See* Judith Kimerling, *Indigenous Peoples and the Oil Frontier in Amazonia: The Case of Ecuador, ChevronTexaco, and Aguinda v. Texaco*, 38 N.Y.U. J. INT'L L. & POL. 413 (2006).

communities, which often consist of low-income and minority demographics, suffer disproportionately from the impacts of hazardous wastes and toxic chemicals as compared to other communities across the world.

During the 1960s, an environmental justice case developed in the Lago Agrio region of Ecuador. An American multinational corporation physically invested itself in the developing nation of Ecuador, whose government was weakened by tyranny and poverty. The American corporation befriended Ecuador's government, contracted with it to pursue fossil fuel exploration and extraction, and conducted its business pursuits without counsel or representation from the indigenous inhabitants of the region. Over the next thirty years, the population of the Lago Agrio region declined as its inhabitants suffered widespread health problems and experienced only brief periods of relief from the debilitating poverty that the government had earlier leveraged to galvanize support for partnering with the corporation.

Frequently marginalized in regard to environmental policy and regulatory enforcement, the vulnerable inhabitants of developing nations such as Ecuador are left without a voice or a vote.[2] Their fates therefore rest in the hands of their governments, which seek economic development funds by providing advantages to corporations in resource-rich areas around the world via cheap labor and limited environmental regulations.

This article argues that legitimizing the plight of exploited communities like Lago Agrio, Ecuador requires the United States to hold parties accountable for the environmental torts committed in foreign jurisdictions. Additionally, this article argues that this goal can only be effectively achieved via legal obligations, enforceable through judicial bodies, rather than relying on unenforceable frameworks driven by voluntary business agreements.[3]

The residents of Lago Agrio, who reside in a once-pristine area of the Amazon, recently began a contentious new stage of appeals in their ongoing litigation against one of the largest American corporations: the Chevron Corporation.[4] Chevron, previously willing to submit to the

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[2] Referring to the lack of informed consent by the Indigenous Peoples in Ecuador, a principle enumerated in the United Nations' Declaration on the Rights of Indigenous Peoples, discussed *infra* Part IV B (2)(b).

[3] Referring to the deregulation and lack of oversight regarding environmental practices by multinational corporations in a foreign nation and relying on the corporations themselves to "do the right thing," simply does not work. *See* Kimerling, *supra* note 1, at 419.

[4] Chevron Corporation merged with Texaco in 2001. For the purposes of this paper, the operations taking place prior to the merger will also be referred to as that of [Chevron] as the dispute of the merger divesting Chevron of liability for the prior acts is beyond the scope of this paper. For background on the dispute surrounding the merger, *see* Chevron Corp. v Naranjo, 2011 WL 4375022 (2d Cir. 2011).

jurisdiction of Ecuadorian courts, now asserts due process injustice after an Ecuadorian court's February 2011 multibillion-dollar judgment in favor of the indigenous plaintiffs.[5] The current environmental and health conditions that the plaintiffs face necessitate enforcement of the judgment and prompt environmental remediation.

Typically, when defendants default on judgment obligations stemming from tort proceedings, their assets are attached or seized to satisfy the judgment's financial obligations. Because Chevron has no assets left in Ecuador to attach to satisfy the judgment, recovery is unlikely without the judicial intervention of the United States. The United States has jurisdiction over Chevron's assets and a domestic legal framework to enforce international judgments. The Ecuadorian plaintiffs have obtained a judgment in a once-mutually accepted forum but cannot enforce that judgment due to procedural inefficiencies in the legal framework that regulates the recognition of foreign judgments. The lack of enforcement of foreign judgments creates arduous circumstances for foreign plaintiffs that have included years of litigation in the pursuit of recovery.

More than 200 years ago, U.S. legislative leaders foresaw similar situations as threats to national security and trade. They attempted to construct a framework to alleviate the quandary of domestic enforcement of international judgments altogether by providing that a U.S. District Court would serve as the forum for arbitration. In 1789, Congress enacted the Alien Tort Statute,[6] which provides foreign plaintiffs the jurisdiction of the United States. In its infancy, the nation sought to prevent disfavor that could possibly lead to military conflict by extending foreign plaintiffs a judicial forum for torts committed abroad, either in violation of a treaty of the United States or in violation of a limited list of universally condemned offenses.[7] This article contends that any tortious party operating under the laws of the United States should be held accountable for tortious environmental destruction that results in severe human rights violations because they should be included within the universally condemned offenses under the Alien Tort Statute.

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[5] *Aguinda II*, *infra* note 49.

[6] 28 U.S.C. § 1350 (2006). The Alien Tort Statute (ATS) provides, "The district courts shall have original jurisdiction of any civil action by an alien for a tort only, committed in violation of the law of nations or a treaty of the United States."

[7] Originally, the ATS included the offenses of piracy and kidnapping of ambassadors. *See* Carolyn A. D'Amore, Sosa v. Alvarez-Machain *and the Alien Tort Statute: How Wide Has the Door to Human Rights Litigation Been Left Open?*, 39 AKRON. L. REV. 593, 596 (2006); William R. Casto, *The Federal Courts' Protective Jurisdiction Over Torts Committed in Violation of the Law of Nations*, 18 CONN. L. REV. 467, 479-80 (1986).

Part I of this article discusses the Lago Agrio region of Ecuador before and after the discovery of oil in the early sixties and the environmental legacy of Chevron in Ecuador. Part II examines the two decades of litigation surrounding the misconduct of Chevron, the multibillion-dollar judgment for the plaintiffs in February 2011, and Chevron's subsequent appeals to effectively render the judgment unenforceable.

Part III analyzes pertinent case law of the Alien Tort Statute (ATS) as an alternative theory for recovery. First, non-environmental ATS cases that provide fundamental interpretations of the statute are identified. Next, case law is used to dispute the Second Circuit's decision in *Kiobel v Royal Dutch Petroleum*,[8] which held that multinational corporations are not proper defendants under the statute. This decision is inconsistent with case law and the congressional intent of the statute. Part III also evaluates pertinent environmental ATS case law that is potentially favorable to environmental human rights plaintiffs. Part IV draws on the Ninth Circuit's conclusion that the United Nations Convention on the Law of the Sea (UNCLOS) provisions meet the standard of customary international law and argues that recognizing environmental human rights as customary international law is the next step in the evolution of ATS environmental case law. Once the courts recognize environmental human rights as customary international law under the ATS, the plaintiffs in this case could prevail under this course of action.

II. PARADISE LOST: THE RAINFOREST, THE KICHWA, AND BIG OIL

A. The Significance of the Lago Agrio Region and the Kichwa

The northeast corner of Ecuador, an area roughly the size of Rhode Island, remains the home of some of the planet's most bio-diverse ecosystems as well as of thousands of indigenous peoples who have been in the region for millennia.[9] Prior to 1964, this region was entirely unexplored and inhabited only by indigenous tribes.[10] Ecuador is one of only seventeen nations known collectively as mega-diversity countries, which contain more than two-thirds of the world's biological wealth. This biological diversity is inextricably connected and essential to the existence and quality of human life, and is reflected in the wealth of life in Lago Agrio.[11] Today,

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[8] Kiobel v. Royal Dutch Petroleum, 621 F.3d 111, 149 (2d Cir. 2010). "Corporations -- in contrast to individuals -- may not be held liable under the ATS for violations of international law." *Id*. at 177.

[9] *See* ALLEN GERLACH, INDIANS, OIL, AND POLITICS: A RECENT HISTORY OF ECUADOR (2003).

[10] *Aguinda I*, *infra* note 26.

[11] *See* KRISHNA R. DRONAMRAJU. *Biological Wealth and Other Essays*, World Scientific (2010)

the indigenous in Ecuador are searching for a sustainable way to coexist in a society that prioritizes economic development.[12]

B. The Discovery of Black Gold

Below the surface of the Amazon jungle lie reserves of crude oil and natural gas, the ever-growing demand for which threatens the environment and the indigenous communities therein. In 1964, after receiving reports of oil surfacing in the Lago Agrio region of eastern Ecuador, the Government of Ecuador invited a Texaco subsidiary, Texaco Petroleum Company (TPC), and Gulf Oil to investigate and extract the oil.[13] The following year, TPC started operating a petroleum concession for a consortium owned in equal shares by TPC and Gulf Oil Corporation.[14]

Industrial-scale natural resource extraction began in the mid-sixties.[15] Ecuador initiated a plethora of development projects aimed at relieving the nation from the bonds of chronic poverty.[16] During the early years of fossil fuel exploration and extraction, the Ecuadorian Government developed an amicable relationship with the Texaco Corporation that extended as far as allowing the company free-range of control of its operations and the building of infrastructure to achieve successful oil production and refinery.[17]

The oil company brought promises of economic prosperity to Ecuador, whose economy relied primarily on the export of bananas.[18] Poverty-relieving development and infrastructure investments fueled nationalist sentiments and as a result, the government of Ecuador created PetroEcuador, the National Ecuadorian oil and natural gas industry. The government also implemented oil-friendly legislation to continue the development of oil and to portray to foreign investors that the country as a worthy candidate for economic developments funds.[19] Although the

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[12] *See* Paul M. Barrett, *Amazon Crusader. Chevron Pest. Fraud?*, BLOOMBERG BUSINESS WEEK, (Mar. 09, 2011), http://www.businessweek.com/magazine/content/11_12/b4220056636512.htm.
[13] Republic of Ecuador v. ChevronTexaco Corp., 376 F. Supp. 2d 334, 374 (S.D.N.Y. 2005).
[14] *Id*. at 334.
[15] *Id*.
[16] Briefing Paper, Amazon Watch, Understanding Recent Developments in the Landmark Chevron-Ecuador Case (Spring 2012), http://amazonwatch.org/assets/files/Chevron-Ecuador-Briefing-Spring-2012.pdf.
[17] Megan S. Chapman, *Seeking Justice in Lago Agrio and Beyond: An Argument forJoint Responsibility of Host States and Foreign Investors before the Regional Human Rights' Systems,* 18 HUM. RTS. BRIEF 6 (2010).
[18] *Id*. at 10.
[19] Judith Kimerling , Interview with Mariana Acosta, Executive Director, Foundations For a New World in Quito, Ecuador (Mar. 3, 1994).

government procured development funds using expanded oil exploration and discovery as collateral, the promise of an exodus from poverty has never been realized. PetroEcuador became the majority owner of the Lago Agrio consortium in 1976, and Ecuador's political leaders maintained a friendly stance toward Texaco/Chevron to keep it in Ecuador.[20]

C. The Environmental Human Rights Legacy

In the United States, impact assessments and procedural protocol designed to protect the natural environment from catastrophic contamination of resources used by humans are standard practice for any oil exploration or extraction project.[21] Oil extraction typically begins with a well dug deep into the earth. Pits are created for temporary storage of wastes, such as excess oil run-off, wastewater, and toxic chemicals used with project machinery.[22] These temporary storage pits are lined with environmentally safe industrial tarps, which function as highly resistant shields that prevent the ground from absorbing any toxic contaminants. While engineers and other employees extract oil, the wastewater (or "production fluids," as it is known in the industry) is stored in these lined pits while the crude is sent to the "separation station" for the refining process. Once the project has been completed, the toxic sludge is disposed of and the wastewater is piped deep into the ground, after which the well is closed and surroundings are restored to their natural state.[23]

Evidence that the Texaco Corporation used these environmental impact protections is manifest in its U.S operations in place at the time.[24] Texaco had even patented a new reinjection technology aimed at reducing seepage of toxic wastewater, a clear demonstration of its knowledge of the dangerous outcomes of ground absorption.[25] In Ecuador, however, Texaco did not follow these procedures that were standard in the United States. Texaco directed its production fluids from its wells into open pits rather than re-injecting the toxic fluids back underground.[26] This fact is not in dispute.[27] Moreover, the sludge created from the separation process of

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[20] *Id*.
[21] Council on Envtl Quality, Executive Office of the President, *Review of MMS's NEPA Procedures Following the Deepwater Horizon Oil Spill*, *available at* http://www.whitehouse.gov/administration/eop/ceq/initiatives/nepa/mms-review (2010).
[22] *Id*. at 14.
[23] *Id*. at 15, 16.
[24] Kimerling, s*upra* note 1, at 419-422.
[25] *Id*. at 433-436.
[26] Aguinda v. Texaco, (*Aguinda I*), 945 F. Supp. 625 (S.D.N.Y. 1996).
[27] *Id*. at 535.

crude and water was not properly disposed of, resulting in mass accumulation of toxic solid waste throughout northeast Ecuador.[28]

Environmental scientists have determined that the production fluids were heavy in cancer-causing causing chemicals including benzene and polycyclic aromatic hydrocarbons (PAHs) and are responsible for present-day contamination of the regional water supply, a water supply used by the Kichwas for hundreds or thousands of years.[29] Exploration and extraction operations are estimated to have discharged twenty-six million gallons of crude oil and toxic wastewater into the surrounding environment.[30] While there has been a wide array of accusations of faulty tests, reports and scientific analyses sponsored by both the plaintiffs and defendants show a minimum of a 150% increase in cancer cases in the region since 1980. As a result, many of Ecuador's indigenous groups have suffered irreversible damage to their native lands, the erosion of their cultural heritage, and a myriad of health complications, which threaten their continued existence.[31] Damage to female reproductive organs has thinned birthrates among indigenous tribes. Chevron, while insisting that no causal link between oil operations and cancer rates can be substantiated by evidence of cancer rates increasing generally in the last thirty years, does not deny these past practices.[32]

For three decades, the oil entrepreneurs pursued and achieved unparalleled profits, partially from the Lago Agrio crude operations. Chevron's operations have left the rainforest floor stained with toxic waste pits and streams laced with verified carcinogens.[33] Local indigenous and farming communities face a public health crisis consisting of, among others, increased cancer rates, brain damage, liver and kidney damage, respiratory problems, and reproductive problems in women.[34] These human rights violations resulting from severe environmental destruction will

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[28] *Id*. at 535.

[29] PAHs occur in oil, coal, and tar deposits, and are produced as byproducts of fuel burning (whether fossil fuel or biomass). As a pollutant, they are of concern because some compounds have been identified as carcinogenic, mutagenic, and teratogenic. *See* Imre Szeman, *Crude Aesthetics: The Politics of Oil Documentaries,* 46 J. AM. ST. 442 (2012).

[30] *Aguinda II*, *infra* note 54.

[31] Richard Cabrera, Global Damages Expert for the Court of Nueva Loja, *Technical Summary Report,* (reporting on shortened life expectancy, high infant mortality rates, and uterine and ovarian genetic illnesses) *available at* http://chevrontoxico.com/assets/docs/cabrera-english-2008.pdf.

[32] Chapman, *supra* note 17, at 14.

[33] *Aguinda I*, 945 F. Supp. 625.

[34] *See* ChevronToxico, Chevron's Human Rights Record, http://chevrontoxico.com/assets/docs/chevron-human-rights-record.pdf (last visited Apr. 3, 2012).

eradicate the Kichwa unless necessary funds are immediately allocated to environmental remediation.[35]

III. LITIGATION HISTORY

A. Aguinda v. Texaco: United States not an Appropriate Forum

In 1993, a class-action lawsuit on behalf Ecuadorian citizens affected by the destruction of the Lago Agrio region was filed in the District Court for the Southern District of New York.[36] The suit sought compensatory damages for the allegedly reckless extraction operations that resulted in severe environmental contamination of the Ecuadorian rain forest between 1964 and 1992. Chevron promptly moved to dismiss the *Aguinda* action on a number of grounds, most pertinently *forum non conveniens*. Chevron argued that the Ecuadorian plaintiffs and their claims were bodies of International Law. Customary International Law demands that the plaintiffs exhaust all remedies in Ecuadorian Courts, which Chevron asserted were an appropriate forum for the litigation.[37]

The district court agreed that private citizens did have the right to recover for environmental damage to public lands and that Chevron should to submit to the jurisdiction of the Ecuadorian courts. The court dismissed the action under the *forum non conveniens* doctrine, and the Second Circuit affirmed.[38] Following this dismissal, the next decade and a half of contentious litigation in and out of United States' courts, Ecuadorian courts, and International Tribunals, fulfilled the prophecy of the drafters of the Alien Tort Statute.

Forum non conveniens allows a court, on a motion from the defendants, to defer jurisdiction to another court on matters where there is a more appropriate forum available to adjudicate the issues in dispute. [39] The grant or denial of the motion is generally committed under the court's broad discretion and the defendant bears the burden of proof on all elements of the analysis.[40] The defendant has the burden of showing: (1) the existence of an adequate alternative forum, and (2) the balance of private and public interest factors favors dismissal.[41] Colloquially referred to as the "*Gilbert* Factors," public interest factors to be considered include:

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[35] Chapman, *supra* note 17, at 10.
[36] 945 F. Supp. 625.
[37] *Id*.
[38] *Id*.
[39] Piper Aircraft Co. v. Reyno, 454 U.S. 235, 254 (1981).
[40] Flores v. S. Peru Copper Corp., 525 F. Supp. 2d 510, 2002 WL 587224 (S.D.N.Y. 2002); Torres v. S. Peru Copper Corp., 965 F. Supp. 899, 902 (S.D. Tex. 1996), *aff'd*, 113 F.3d 540 (5th Cir. 1997).
[41] *Piper*, 454 U.S. at 254; Aguinda v. Texaco, Inc., 303 F.3d 470 (2d Cir. 2002).

court congestion; the unfairness of burdening citizens in an unrelated forum with jury duty; the interest in having localized controversies decided at home; the interest in trying the case in a forum familiar with the applicable law; and the interest in avoiding unnecessary conflicts of laws.[42] However, the court's analysis is generally committed to assessing the cognizability of the suit in the proffered jurisdiction and whether or not the defendant is amenable to process.[43]

In *Aguinda I,* the court's grant of dismissal on *forum non conveniens* relied on the defendants' acceptance and acquiescence to the jurisdiction of Ecuadorian courts, and the fact that the torts were committed in Ecuador and thus more appropriately adjudicated under Ecuadorian laws. The plaintiffs argued that an Ecuadorian court would not have the means of enforcing a judgment should one be obtained. However, the court decided that, because the United States has legislation that recognizes foreign money judgments, the plaintiffs could seek redress in the United States at a later date in the event of Chevron defaulting on a judgment made by an Ecuadorian court. Thus, the merits of the dispute would be heard in an Ecuadorian court.

B. The Lago Agrio Litigation: A Brief Moment of Triumph

In 2003, the Ecuadorian plaintiffs, consisting of some *Aguinda I* plaintiffs as well as additional indigenous peoples, brought the litigation against Chevron in the Sucumbios Provincial Court in Ecuador, the epicenter of the destruction.[44] The plaintiffs' arguments were based on articles of the Ecuadorian Constitution[45] and the Environmental Management Law of 1999, which granted the right to recover damages for environmental degradation and the resulting harm to human beings and biodiversity.[46] The plaintiffs sought "elimination and removal of

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[42] Gulf Oil Corp. v. Gilbert, 330 U.S. 501 (1947).
[43] *Piper*, 454 U.S. at 255.
[44] *Aguinda II*, *infra* note 49, *aff'd*, *Aguinda III*, *infra* note 51.
[45] CONSTITUCION POLITICA DE LA REPUBLICA DEL ECUADOR arts. 23, 86-88, 90-91 (guaranteeing citizens the right to live in a healthy environment, declaring that environmental protection and the preservation of biodiversity are in the public interest, requiring public consultation and approval of decisions that affect the environment, requiring the government to regulate the production, distribution, and use of substances dangerous to human life and the environment, and placing responsibility for environmental damage occurring during the delivery of public services upon the government).
[46] Plaintiffs' Complaint Addressed to the President of the Superior Court of Justice of Nueva Loja (Lago Agrio), Aguinda v. ChevronTexaco Corp., Superior Court of Justice of Nueva Loja (Lago Agrio), No. 002-2003 (filed May 7, 2003) (Ecuador) [hereinafter Lago Agrio Complaint].

contaminating elements that persist in the region, healthcare for the inhabitants, and the repair of environmental damages."[47] In addition, the complaint sought ten percent of the cost of remediation work to be paid to Frente de Defensa de la Amazonia (The Amazon Defense Fund).[48]

On February 14, 2011, the Ecuadorian provincial court issued a comprehensive opinion adjudicating the case and entering judgment in United States dollars against Chevron. The total compensation for damages amounted to $8.646 billion, an amount that would be doubled if Chevron did not issue a statement of responsibility and regret within 90 days.[49] Chevron issued a statement via their website that stated the judgment "Is illegitimate because of documented evidence of fraud and unethical action by the plaintiffs' lawyers as well as the Ecuadorian government and judiciary."[50] Needless to say, they did not issue the apology and the judgment therefore sits at nearly $18 billion.[51] Rather than acknowledging any responsibility, Chevron filed sixteen separate lawsuits in the United States and invoked the arbitration clause of the Bilateral Investment Treaty between the U.S. and Ecuador.

Chevron immediately appealed this judgment to the Appellate Court of Sucumbíos Province, which denied their 193-page appeal. The appeal consisted of arguments surrounding a 1995 "Release" Agreement that Chevron procured from the former President of Ecuador,[52] in exchange for full remediation of the affected region.[53] Chevron also claimed that

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[47] *Id*. at 22-25. The Plaintiffs' claims with respect to "elimination and removal of contaminating elements" included requests for removal, treatment and disposition of contaminants in waste pits, the removal of contaminants from all waterways, the removal of all structures and equipment in the vicinity of closed wells and facilities, and the "clearance of the terrains, plantations, crops, streets, roads and buildings where there may still exist contaminating residuals produced or generated as a consequence of the operations directed by Texaco, including the contaminating debris deposits built as a part of the wrongly environmental cleaning tasks."

[48] *Id*. at 24.

[49] Superior Court of Nueva Loja, 14/2/2011, "Aguinda v. ChevronTexaco" (*Aguinda II*), 2003-0002 (Ecuador), *available at* http://chevrontoxico.com/assets/docs/2011-02-14-Aguinda-v-ChevronTexaco-judgement-English.pdf.

[50] The Fraudulent Case Against Chevron, *available at* http://www.chevron.com/ecuador/patternoffraud/ (last visited July 26, 2013)

[51] Provincial Court of Sucumbios, 3/1/2012, "Republica del Ecuador v. Chevron" (*Aguinda III*), 2011-0106 (Ecuador), 2012 WL 7745068, Case No. 2011-1150, *available at* http://chevrontoxico.com/assets/docs/2012-01-03-appeal-decision-english.pdf.

[52] Sixto Alfonso Durán-Ballén Cordovez, Presidente del Ecuador, 1992-96. Cordovez was an American-born Ecuadorian who became President and supported competitive markets and reducing the government's deficit. He is a well-known supporter of Chevron's presence in Ecuador. *See* Amazon Defense Coalition, *Texaco's Sham Remediation Efforts of Contamination at Well Sites* (Mar. 2011), http:chevrontoxico.com/news-and-multimedia.html (last visited Feb. 5, 2012). *See generally*, http://www.chevron.com/news/press/release/?id=2009-09-23 (last visited July 26, 2013).

[53] Republic of Ecuador v. Chevron Corp., 638 F.3d 384, 419 (2d Cir. 2011). *See also* Simon Romero & Clifford Krauss, *Ecuador Judge Orders Chevron to Pay $9 Billion*, N.Y. TIMES, Feb.

Ecuador lacked personal jurisdiction and doubted the competency of the lower judge.[54] Chevron maintains that responsibility for damage and cleanup now lies with PetroEcuador and the government. It contends that the present damage comes from PetroEcuador activities since 1990, including spills from a pipeline system built by the consortium that PetroEcuador has not maintained.[55] The damage for which Chevron has taken responsibility is mitigated, according to Chevron, by the acquisition of their enterprise by PetroEcuador.

C. Chevron's Efforts to Stay Enforcement of the Judgment

After its appeal in Ecuador failed, Chevron filed suit in the United States and internationally to stay the enforcement of the multibillion-dollar judgment obtained against them. First, Chevron filed a Racketeer Influenced and Corrupt Organizations (RICO) suit against attorney Steven R. Donziger in the United States District Court for the Southern District of New York. Second, Chevron filed with the International Arbitration Tribunal, the forum set out in a U.S./Ecuador Bilateral Investment Treaty (BIT),[56] seeking injunctive relief on grounds that corruption of proceedings tainted the entire trial and that Ecuador lacked jurisdiction in violation of International Law. In both cases, Chevron argued that the judgment should be universally enjoined.

1. *Chevron Corp v. Donziger*:[57] Chevron Appeals Enforcement Domestically

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15, 2011, at A4, *available at* http://www.nytimes.com/2011/02/15/world/americas/15ecuador.html.

[54] *Aguinda II*, No. 21101-2011-0106, at 10.

[55] *Id*. at 13.

[56] The Bilateral Investment Treaty falls under the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards ("New York Convention"), which governs agreements that are "commercial and not entirely between citizens of the United States. The New York Convention promotes the enforcement of arbitral agreements in contracts involving international commerce so as to facilitate international business transactions.

[57] Chevron Corp. v. Donziger, 768 F. Supp.2d 581 (S.D.N.Y. 2011). It is important to note that this case against Mr. Donziger was one of sixteen cases filed in Federal Courts, setting forth the same corruption, fraud, and misuse of justice system arguments to accomplish enjoining the judgment. Most are pending. *See* Santiago Cueto, *Ecuador Class Action Plaintiffs Strike Back at Chevron's Cynical Game of Musical Jurisdictions*, INT'L BUS. L. ADVISOR, Jan. 18, 2010, http://

Under U.S. law and the principles of international comity, a judgment obtained in a foreign court will be recognized in the United States on substantially identical terms without rehearing the substance of the original lawsuit.[58] Reciprocal recognition of foreign judgments provides accommodation and a predictable framework for all parties involved. After a foreign judgment is recognized, the judgment creditor can seek enforcement in the recognizing country. Monetary judgments are treated as though they were obtained in the recognizing jurisdiction meaning that the creditor has all of the enforcement remedies as one would have if the case had originated in the recognizing country. For the Ecuadorian plaintiffs, this means the fact that Chevron removed all of their assets from Ecuador does not preclude them from recovery. Chevron's assets in the United States can also be attached to satisfy the judgment.

There are limitations on this recognition under U.S. law, however. The several exceptions to the enforcement of the foreign judgments were the predicate of sixteen lawsuits filed by Chevron in the United States. The United States will not recognize judgments obtained in a variety of manners, including those obtained by fraud, in violation of due process, or when the plaintiffs agreed under contract to arbitrate similar disputes in an identified tribunal that was not the tribunal that ordered the judgment.[59] Chevron filed suit against Steven R. Donziger, the plaintiff's attorney, alleging accusations of wrongdoing and fraud, including lying to investigators and presenting false evidence by Donziger and the indigenous plaintiffs and asked the Court to enjoin the judgment.[60] Chevron, attempting to use the Act's exceptions offensively, sought mandatory injunctions globally because the judgment was rendered under a system which does not provide impartial tribunals or procedures which are

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www.internationalbusinesslawadvisor.com/2010/01/articles/international-litigation/ecuador-class-action-plaintiffs-strike-back-at-chevrons-cynical-game-of-musical-jurisdictions (last visited Oct. 5, 2012).

[58] Uniform Foreign Money-Judgments Recognition Act, 13 U.L.A. 149 (1986), §§ 1-3 [hereinafter U.M.J.R.A.].

[59] *See Id*. §4(a): "A foreign judgment is not conclusive if: the judgment was rendered under a system which does not provide impartial tribunals or procedures compatible with the requirements of due process of law; the foreign court did not have personal jurisdiction over the defendant; or the foreign court did not have jurisdiction over the subject matter." *See also* §4(b): "a foreign judgment need not be recognized if: the defendant in the proceedings in the foreign court did not receive notice of the proceedings in sufficient time to enable him or her to defend; the judgment was obtained by fraud; the cause of action or claim for relief on which the judgment is based is repugnant to the public policy of the state; the judgment conflicts with another final and conclusive judgment; the proceeding in the foreign court was contrary to an agreement between the parties under which the dispute in question was to be settled or otherwise than by proceedings in that court; or in the case of jurisdiction based only on personal service, the foreign court was a seriously inconvenient forum for the trial of the action."

[60] *Donziger*, 768 F. Supp.2d at 590.

compatible with the requirements of due process of law and because the judgment was obtained fraudulently.[61] In a press release, Chevron declared, "Lawyers falsified data and pressured scientific experts to "find contamination" where none existed," and further exerted that, "The plaintiffs' lawyers also procured the appointment of a supposedly neutral "global expert" who was recruited and paid by the plaintiffs' lawyers to pass off as his own a damages report ghostwritten by the plaintiffs' other consultants."[62]

Judge Kaplan, writing for the U.S. District Court found the evidence of fraud and deceit on the part of Donziger to be compelling and said, "Public policy weighed in favor of issuing the preliminary injunction barring enforcement.[63] The preliminary injunction prohibited residents from enforcing or preparing to enforce a potential Ecuadorian judgment against a United States corporation anywhere outside of the Republic of Ecuador. With no Chevron assets left in the country and therefore disqualifying attachment as a means of satisfying the judgment, Ecuador appealed to the Second Circuit Court of Appeals urging the necessity of recognition in the U.S.

On appeal, the Second Circuit chastised the lower court for granting a global injunction and reprimanded Judge Kaplan as well as vacated the injunction and stayed the proceedings in the District Court until further review, which came on January 26, 2012.[64] The Second Circuit concluded that judgment-debtors can challenge a foreign judgment's validity under the Recognition Act only defensively, in response to an attempted enforcement, an effort that the Ecuadorians had not yet undertaken anywhere and might never undertake in New York.[65] They formally reversed the District Court's decision, vacated the injunction, and remanded to the district court with instructions to dismiss Chevron's declaratory judgment claim in its entirety.

2. International Arbitral Tribunal Grants Interim Award Enjoining the Judgment

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[61] *Id*.
[62] *See Chevron appeals Ecuador Judgment,* http://www.chevron.com/chevron/pressreleases/article/03112011_chevronappealsecuadorjudgment.news (last visited July 26, 2013).
[63] *Id*.
[64] Chevron Corp. v Donziger, 2012 WL 858768 (2d Cir. 2012).
[65] *Id*.

Under the threat of U.S. enforcement, Chevron then sought injunctive relief again through the quasi-offensive use of an exception under the Uniform Money-Judgments Recognition Act—this time in an international forum. Since the Act can only be used defensively under U.S. law, Chevron sought an issue that could be determined elsewhere and provide a stay of enforcement that the U.S. would be required to recognize ahead of any future petition filed to recognize the judgment obtained in Ecuador.

The Uniform Money-Judgments Recognition Act states that a judgment need not be recognized if the parties previously agreed to arbitrate like disputes in an identified forum.[66] Chevron asserted that the arbitration clause in a Bilateral Investment Treaty (BIT) between the U.S. and the Republic of Ecuador governed such disputes as this. The Republic of Ecuador agreed to the arbitration, which resulted in a less favorable determination of the plaintiffs' case. On February 16, 2012, per the Bilateral Investment Treaty signed by the U.S and Ecuador, an International Arbitral body determined that the Republic of Ecuador must "Take all measures necessary to suspend or cause to be suspended the enforcement and recognition within and without Ecuador of the $18 billion judgment.[67] They also ordered the Republic not to certify the $18 billion judgment, which would permit the Ecuadorean plaintiffs to enforce it internationally.[68] The panel found procedural as well as substantive merit in Chevron's arguments that urgency exists in staying the enforcement of the judgment that Chevron alleged, "may have irreparable harm on the corporation under the veil of corruption and conspiracy charges against the Lago Agrio proceedings."[69] The panel then claimed jurisdiction over the dispute in its entirety because of the BIT between the United States and Ecuador.[70]

While the international tribunal's interim award is discouraging for the plaintiffs, it is not a death knell. It does, however, ensure the litigation will continue for many more years. The plaintiffs' next course of action will be to petition for the enforcement of the multi-billion dollar judgment, which will undoubtedly involve seeking to demonstrate the injustice of the investment treaty pursuant to which Ecuador's foreign direct investment is governed. If the plaintiffs can show that the agreement authorizing the use of an international arbitral tribunal is in violation of well-established

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[66] U.M.J.R.A., *supra* note 58, at § 4(b)(5).
[67] Chevron (U.S. v. Ecuador), Hague Ct. Rep. (Scott) 2009-23 (2012), *available at* http://www.chevron.com/documents/pdf/ecuador/SecondTribunalInterimAward.pdf.
[68] *Id*. at 1-5.
[69] *Id*. at 5.
[70] *Id*. at 6. International Arbitration is the stated dispute body of the BIT between the U.S and Ecuador.

international law, they can diminish the tribunal's award to merely an extension of that injustice. The degree of complexity and interplay between domestic and international legal principles has rendered the plaintiffs restless and underscores the importance of using the Alien Tort Statute as a possible mechanism for relief.

IV. THE ALIEN TORT STATUTE: TRIALS AND TRIBULATIONS

For almost 200 years after its passage in 1789, the Alien Tort Statute (ATS) lay virtually dormant with the exception of two cases: one maritime case adjudicating a property dispute and one child abuse case.[71] The long period of silence made interpretation of the ATS difficult and ever-evolving. To secure relief under the ATS, a plaintiff must show that a tort was committed in violation of a treaty of the United States, or in violation of the law of nations.[72] The statute does not indicate who is a proper defendant under the statute; it merely states that an alien may bring the action in U.S federal courts.[73] For the reasons discussed below, the Lago Agrio plaintiffs face significant hurdles under ATS jurisprudence.[74]

A. Forum Non-Conveniens

Forum non conveniens is a doctrine of the conflict of laws. It allows a court, on a motion from the defendants, to defer jurisdiction to another court on matters where there is a more appropriate forum available to adjudicate the issues in dispute.[75] The grant or denial of the motion is generally committed under the court's broad discretion, and the defendant bears the burden of proof on all elements of the analysis.[76] The defendant has the burden of showing: (1) the existence of an adequate alternative forum, and (2) the balance of private and public interest factors favors dismissal.[77] Known as the "*Gilbert* Factors," public interest factors to be considered include: court congestion; the unfairness of burdening citizens in an unrelated forum with jury duty; the interest in having localized

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[71] *See*, *e.g.*, Bolchos v. Darrel, 3 F. Cas. 810, 811 (D.C.D.S.C. 1795); Adra v. Clift, 195 F. Supp. 857, 865 (D. Md. 1961).
[72] 28 U.S. C. § 1350 (2006).
[73] *Id*.
[74] Justin Lu, *Jurisdiction over Non-State Activity under the Alien Tort Claims Act,* 35 COLUM. J. TRANSNAT'L L. 531, 535-37 (1997).
[75] *Piper*, 454 U.S. at 254.
[76] Flores v. S. Peru Copper Corp., 2002 WL 587224 (S.D.N.Y. July 16, 2002); Torres v. S. Peru Copper Corp., 965 F. Supp. 899, 902 (S.D. Tex. 1996), *aff'd*, 113 F.3d 540 (5th Cir. 1997).
[77] *Piper*, 454 U.S. at 254; Aguinda v. Texaco, Inc., 303 F.3d 470 (2d Cir. 2002).

controversies decided at home; the interest in trying the case in a forum familiar with the applicable law; and the interest in avoiding unnecessary conflicts of laws.[78] The court's analysis is generally focused on assessing the cognizability of the suit in the proffered jurisdiction and whether the defendant is amenable to process.[79] The Supreme Court in *Piper Aircraft Co. v Reyno* reemphasized the *Gilbert* factors and paid special attention to the "interest in having localized controversies decided at home."[80]

In *Aguinda I,* the court's grant of dismissal on *forum non conveniens* relied on the defendants' acceptance and acquiescence to the jurisdiction of Ecuadorian courts and the fact that the torts were committed in Ecuador and thus more appropriately adjudicated under Ecuadorian laws. The plaintiffs argued that an Ecuadorian court would not have the means of enforcing a judgment against the U.S. corporation should one be obtained. Chevron had no assets to levy inside of Ecuador. However, the court ruled that because the United States has legislation that recognizes foreign money judgments, in the event that Chevron defaults, Ecuador was deemed a more proper forum. The merits of the dispute would be heard in an Ecuadorian court, and the Alien Tort Statute would be of no use to them.

B. Non-Environmental ATS Litigation

1. Determining the Scope of the Statute

a. Filartiga v Pena-Irala[81]

The statute created a split of interpretations in the debate over whether the statute is purely jurisdictional or, alternatively, confers both jurisdiction and a cause of action for alleged violations of international law.[82] Debate emerged with the interpretation of the statute in *Filartiga v. Pena-Irala*,[83] in which the Court of Appeals for the Second Circuit broadened the analysis concerning actionable claims by aliens and citizens alike for damages incurred for human rights violations.[84] In this case, neither plaintiff nor defendant were U.S. citizens.

Dolly Filártiga and her younger brother Joelito lived in Asuncion, Paraguay, with their parents. Their father, Dr. Joel Filártiga, was a well-known physician, painter, and opponent of Latin America's "most durable

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[78] Gulf Oil Corp. v. Gilbert, 330 U.S. 501 (1947).
[79] *Piper*, 454 U.S. at 255.
[80] *Id*. at 249-253.
[81] 630 F.2d 876 (2d Cir. 1980).
[82] *See* Lorelle Londis, *The Corporate Face of the Alien Tort Claims Act: How an Old Statute Mandates a New Understanding of Global Interdependence,* 57 ME. L. REV. 141, 150 (2005).
[83] Filartiga, 630 F.2d at 877-879.
[84] *Id*. at 880.

dictator," General Alfredo Stroessner. In 1976, 17-year-old Joelito was abducted and later tortured to death by Americo Norberto Peña-Irala, the inspector general in the Department of Investigation for the Police of Asuncion. Dolly Filártiga was forced out of her house in the middle of the night to view her brother's mutilated body. The District Court ultimately granted Pena's motion to dismiss the complaint and allowed his return to Paraguay, ruling that, although the proscription of torture had become a universally recognized norm, the court was bound to follow appellate precedents, which narrowly limited the function of international law only to relations between states.

The Second Circuit reversed the District Court's holding, and the jurisprudential significance was two-fold. The decision held that a non-state actor could be prosecuted for a human rights violation under the ATS. In addition, the Court held that customary international law is evolving and may include violations of human rights that did not exist when the statute was written.

The decision was precedent for claims involving an increasing number of internationally recognized rights, including freedom from torture, slavery, genocide, and cruel and inhuman treatment.[85] International human rights experts in this country and abroad have embraced the decision, and since the landmark decision, courts have been awarding compensatory damages to victims of human rights abuses committed in violation of the law of nations.[86]

In the years after *Filartiga*, plaintiffs invoked the ATS in federal courts to sue persons responsible for such international human rights violations as torture, disappearances, summary execution, genocide, cruel, inhuman, and degrading treatment, arbitrary detention, and crimes against humanity.[87] There was much controversy among the circuits.[88] The Second Circuit's approach to what constituted a violation of the law of nations, under *Filartiga*, was, "not as it was in 1789 but as it has evolved and exists among the nations of the world today."

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[85] *Id*.

[86] Pauline Abadie, *A New Story of David and Goliath: The Alien Tort Claims Act Gives Victims of Environmental Injustice in the Developing World a Viable Claim Against Multinational Corporations*, 34 GOLDEN GATE L. REV. 745, 749-751 (2004).

[87] Forti v. Suarez-Mason, 672 F. Supp. 1531 (ND Cal. 1987); Estate of Rodriquez v. Drummond Co. Ltd., 256 F. Supp. 2d 1250 (N.D. Ala. 2003); Kadic v. Karadzic, 70 F.3d 232 (2d Cir. 1995); Paul v. Avril, 901 F. Supp. 330 (S.D. Fla. 1994); Hilao v. Estate of Marcos, 103 F.3d 767 (9th Cir. 1996).

[88] *See* Tel-Oren v. Libyan Arab Republic, 726 F.2d 774, 776 (D.C. Cir. 1984) (terrorist attack by PLO on Israeli bus, killing 34 and wounding 87; Court refused to apply broad analysis of *Filartiga*).

b. Sosa v. Alvarez-Machain[89]

Modern ATS applicable law was promulgated in *Sosa v. Alvarez-Machain*. Alvarez brought a claim under the ATS for arbitrary arrest and detention.[90] Alvarez had been indicted in the United States for torturing and murdering a DEA officer.[91] When the United States was unable to secure Alvarez's extradition, it paid Sosa, a Mexican national, to kidnap Alvarez and bring him into the United States.[92] Alvarez claimed that his "arrest" by Sosa was arbitrary because the warrant for his arrest only authorized his arrest within the United States.[93] The United States Court of Appeals for the Ninth Circuit held that Alvarez's abduction constituted arbitrary arrest in violation of international law.[94]

The Supreme Court reversed. The Court clarified that the ATS did not create a cause of action, but instead it merely "furnished jurisdiction for a relatively modest set of actions alleging violations of the law of nations."[95] The Court compromised broad versus constrictive by reassuring that, although the scope of the ATS is not limited to violations of international law recognized in the 18th century, "the judicial power should be exercised on the understanding that the door is still ajar subject to vigilant door-keeping," implying that *Sosa* is not meant to provide a free-for-all litigation spectacle in U.S federal courts.[96]

2. Multinational Corporations as Defendants

a. Kiobel v Royal Dutch Petroleum[97]

The Second Circuit recently interpreted *Sosa* to preclude multinational corporations from an ATS claim. In *Kiobel*, a dozen Nigerian plaintiffs claimed that Royal Dutch and two of its Shell Oil subsidiaries worked with the Nigerian government to torture and extra-judicially

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[89] 504 U.S. 655 (2004).
[90] *Id*. at 658.
[91] *Id*. at 657-660.
[92] *Id*.
[93] *Id*.
[94] *Id*. at 670.
[95] *Id*. at 662.
[96] *Id*.
[97] 621 F.3d 111 (2d Cir. 2010), *cert. granted*.

execute individuals protesting against the companies' oil exploration.[98] Judge Cabranes, writing for the majority, rejected corporate liability under the ATS because it is not recognized under customary international law. He wrote:

> We hold, under the precedents of the Supreme Court and our own Court over the past three decades, that in ATS suits alleging violations of customary international law, the scope of liability—who is liable for what—is determined by customary international law itself. Because no corporation has ever been subject to *any* form of liability (whether civil or criminal) under the customary international law of human rights, we hold that corporate liability is not a discernible—much less universally recognized—norm of customary international law that we may apply pursuant to the ATS.[99]

The court in *Kiobel* has interpreted *Sosa's* jurisdictional restraint to mean that not only is customary international law determinative of the subject-matter of the dispute giving rise to a cause of action, but it is also determinative against whom that cause of action may be brought. I believe this determination is a misapplication of current jurisprudence. *Sosa's* holding provides the guiding precedent that the applicability of the ATS in granting jurisdiction to foreign plaintiffs is driven by the content of the dispute, not in identifying who is or who is not a proper defendant under the statute.[100] Furthermore, *Sosa's* significance was that the violation of a universally recognized norm abroad creates a cause of action under the domestically governed ATS. An alien may obtain jurisdiction as a federal question under the ATS when customary international law provides the violation. The question of whether multinational corporations are liable under customary international law begins with an analysis of the tort itself, not the identity of the defendant entity.

The D.C. and Seventh Circuits also disagree with the Second Circuit.[101] In *Flomo v. Firestone Natural Rubber Co.,* Judge Posner from the Seventh Circuit rejected the Second Circuit's analysis of *Sosa* and

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[98] *Id*. at 115.
[99] *Id*. at 118.
[100] *See generally* William S. Dodge, *Corporate Liability under Customary International Law,* 43 GEO. J. INT'L L. 1045 (2012).
[101] Flomo v. Firestone Natural Rubber Co., 643 F.3d 1013 (7th Cir. 2011); Doe v. Exxon Mobil Corp., 654 F.3d 11, 40-41 (D.C. Cir. 2011).

called their approach in *Kiobel* "an outlier."[102] Judge Posner determined that *Sosa* simply did not decide that an ATS plaintiff was required to prove a customary international norm providing for civil or criminal actions against every category of ATS defendant.[103] Posner further noted that, "If a plaintiff had to show that civil liability for such violations was itself a norm of international law, no claims under the Alien Tort Statute could ever be successful, even claims against individuals: only the United States, as far as we know, has a statute that provides a civil remedy for violations of customary international law."[104]

Similarly, the D.C Circuit Court of Appeals determined the issue of corporate liability under the ATS in *Doe v Exxon Mobile Corp*. The Court held that "neither the text, history, nor purpose of the ATS supports corporate immunity for torts based on heinous conduct allegedly committed by its agents in violation of the law of nations" and therefore concluded that Exxon's objections to justiciability were "unpersuasive."[105]

b. Abdullah v. Pfizer, Inc.[106]

The Second Circuit ruled that the prohibition on nonconsensual medical experimentation on human beings constituted a universally accepted norm of customary international law, and consequently an alleged violation thereof fell within the jurisdiction of Alien Tort Statute.[107] The case arose because Pfizer had been testing new antibiotic drugs on children and adults in Nigeria without their consent.[108] After the district court dismissed the action for lack of subject-matter jurisdiction and forum non conveniens, the Second Circuit reversed and remanded.[109] The majority stated clearly that because the plaintiffs sufficiently alleged a violation of customary international law and because Pfizer's profit from experimentations on unwilling subjects in developing nations would result in significant anti-American animus, the plaintiffs could claim a human rights violation under the jurisdiction of the ATS.[110] While there is not a point of unanimous agreement, a growing consensus seems to be emerging from judicial opinions and scholarship that multinational corporations have responsibility for torts committed abroad.

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[102] *Flomo*, 643 F.3d at 1017.
[103] *Id*. at 1019.
[104] *Id*.
[105] *Doe*, 654 F.3d at 40.
[106] 562 F.3d 163 (2d Cir. 2009).
[107] *Id*. at 201.
[108] *Id*. at 199.
[109] *Id*. at 170-180.
[110] *Id*. at 177.

C. Environmental ATS Litigation

Achieving jurisdiction under the Alien Tort Statute is difficult for any type of claim, but it has proven especially difficult for claims involving environmental human rights. This de facto doctrine of avoidance is spelled out in a few recent decisions concerning the impact that destructive environmental practices have on human beings.

1. Environmental Abuse proves too vague to support ATS action

a. Amlon Metals, Inc. v. FMC Corp.[111]

In 1991, the District Court for the Southern District of New York became the first court presented with a class of plaintiffs claiming jurisdiction under the ATS for human rights violations resulting from flawed environmental practices.[112] Amlon, an American corporation specializing in the acquisition of metal residues, and its United Kingdom affiliate, Wath, filed suit against FMC Corporation, a chemical manufacturing company headquartered in Pennsylvania, over allegations that FMC shipped hazardous material to the United Kingdom.[113] The business affiliates functioned such that Amlon acquired various metal residue and then transported this material to Wath for washing and processing.[114] FMC Corporation treated copper residue for reclamation purposes, with the understanding that the material would be shipped back to the U.K. free of impurities.[115] When a noxious smell revealed that xylene,[116] hydrogen 7,[117] and dioxin[118] were found in large amounts, Amlon, et al sued. The District Court examined The Resource Conservation and

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[111] 775 F. Supp. 668 (S.D.N.Y. 1991).
[112] *Id*.
[113] *Id*. at 669.
[114] *Id*. at 670.
[115] *Id*.
[116] Xylene is an EPA-listed hazardous waste. *See* U.S. Dep't of Health & Human Servs., Toxicological Profile for Xylene 1 (Aug. 1995).
[117] *See Amlon*, 775 F. Supp. at 670 ("7-hydrogen is an allegedly carcinogenic pesticide intermediary").
[118] *Id*. Chlorinated phenols may form dioxin when exposed to heat and a catalyst. Tests on laboratory animals indicate that dioxin is the most potent carcinogen known. Exposure to dioxin can cause a serious skin disease called chloracne. Tests on laboratory animals also indicate that exposure may result in a rare form of cancer called soft tissue sarcoma. *See* Michael Grough, *Dioxin: Perceptions, Estimates, and Measures*, in PHANTOM RISK 249, 249-260 (Kenneth R. Foster et al. eds., 1983).

Recovery Act (RCRA)[119] as well as Principal 21 of the Stockholm Declaration.[120] The court dismissed the RCRA claim for lack of jurisdiction on the ground that RCRA cannot be applied extraterritorially, as it would be a violation of international comity.[121] In other words, since the waste was entirely located within the territory of the U.K., a sovereign nation, it is not the U.S. judiciary's business to enforce U.S laws outside the United States.

Next, and most pertinent for this discussion, the court in *Amlon* evaluated Stockholm Principle 21 regarding the violations of FMC Corp as under customary international law, which would grant jurisdiction under the ATS.[122] The court found that although Principle 21 is applicable to this case, it is not a source of international law that is specific or universal enough to be considered a part of customary international law.[123] The court found Principle 21's responsibility measures to simply be a guiding tool that countries should reach to achieve and that it could not be used to bind the United States under customary international law. While the court assessed what does not meet the standard for customary international law, it did not say what does. *Amlon* did not result in the much-needed guidance as to the standard to be met in order to sufficiently allege a violation of customary international law on the grounds of human rights and the environment.

b. Beanal v. Freeport-McMoran, Inc[124]

Beanal is another notable case in which environmental human rights victims sought redress in the United States via the ATS. The suit was initiated by plaintiff Beanal, who alleged that a U.S. multinational corporation, Freeport, was liable for cultural genocide, environmental torts, and human rights abuses committed against his Amungme tribe in their operations of mines in Indonesia.[125] Beanal, a resident of a small mining village in Indonesia, alleged that, "Freeport's activities caused destruction,

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[119] *Id*. at 669; 44 U.S.C. §§ 6901-6992 (1985).
[120] UN Conference on the Human Envt, Stockholm, Sweden, June 1972. Principle 21 states: "States have, in accordance with the Charter of the United Nations and the principles of international law, the sovereign right to exploit their own resources pursuant to their own environmental policies, and the responsibility to ensure that activities within their jurisdiction or control do not cause damage to the environment of other States or of areas beyond the limits of national jurisdiction."
[121] *Amlon*, 775 F. Supp. at 670. International Comity and the Act of State Doctrine are used interchangeably.
[122] *Id*.
[123] *Id*. at 722.
[129] Beanal v. Freeport-McMoran, 969 F. Supp. 362 (E.D. La 1997), *aff'd*, 197 F.3d 161 (5th Cir. 1999).
[125] *Id*. at 369.

pollution, alteration, and contamination of natural waterways, as well as surface and ground water sources; deforestation; destruction and alteration of physical surroundings."[126] He invoked three principles of international law as the basis for obtaining jurisdiction in the United States under the ATS: (1) the Polluter Pays Principle,[127](2) the Precautionary Principle,[128]and (3) the Proximity Principle.[129]

The court rejected all three principles explaining that, "the principles relied on by the Plaintiff, standing alone, do not constitute international torts for which there is universal consensus in the international community as to their binding status and their content."[130] In addition, the court further noted that the principles invoked by the plaintiff pertained only to members of the international community and not to non-state actors, such as the Freeport-McMoran Corporation.[131] The court concluded that a treaty must exist to bind non-state actors and hold them responsible for torts under international law.

Moreover, Beanal alleged that, through the environmental destruction, Freeport-McMoran had committed cultural genocide to the indigenous peoples inhabiting Tamika, Indonesia. The court rejected this claim noting that, "genocide requires the destruction of a group, not a culture." When claiming the destruction of culture by means of genocide, the court reasoned that much more clarity is necessary and that Beanal's complaint fell short of being sufficiently specific. In affirming the district court's dismissal of the case, the Court of Appeals for the Fifth Circuit found Beanal's complaint to be general and vague and advised other courts to operate with caution when adjudicating environmental claims under the purview of another nation's laws.[132] Like the decision in *Amlon Metals,* the

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[126] *Id*.

[127] *See* PHILLIPE SANDS, PRINCIPLES OF INTERNATIONAL ENVIRONMENTAL LAW I: FRAMEWORKS, STANDARDS, AND IMPLEMENTATION 213-217 (1995) "This principle states that the costs of pollution are to be borne by the polluter."

[128] "Where there are threats of serious or irreversible damage, lack of full scientific certainty shall not be used as a reason for postponing cost-effective measures to prevent environmental degradation." *See* Rio Declaration Prin.15, UN Conference on Envt and Development, Rio De Janeiro, June 3-14, 1992, *available at* http://www.unep.org/Documents.multilingual/Default.asp?DocumentID=78&ArticleID=1163 (last visited July 27, 2013).

[129] The proximity principle suggests that hazardous waste should be disposed of in the state of its creation, to the extent that such disposal is reasonable. Sands, *supra* note 127 at 217.

[130] *Beanal*, 969 F. Supp. at 384.

[131] *Id*. at 370 (citing RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW OF THE UNITED STATES §§ 601-602).

[132] *Id*. "If Beanal in fact means that Freeport is destroying the Amungme culture, then he has failed to state a claim for genocide. On the other hand, if Beanal intended to state that Freeport is

Fifth Circuit warned of violating international comity by becoming involved in the affairs of other sovereign nations.

The *Beanal* decision left the human rights community disappointed and restless. The courts involved cautioned against finding an allegation of environmental human rights as cognizable under customary international law so as to grant jurisdiction under the ATS. The decision therefore left the international community wondering if there even existed a threshold for achieving the definiteness required to transform broad principles into concrete legal structures. Beanal was seen as a squandered opportunity to challenge ATS jurisprudence, scuttled due to poor planning and execution despite a perfect set of facts, and created an enormous amount of frustration among environmental human rights advocates.[133]

c. Flores v. Southern Peru Copper, Corp.[134]

Echoing the Fifth Circuit's repudiation of general environmental principles as sufficiently definite to attach customary international law status, the Second Circuit rejected the use of the right to life, health, and sustainable development, three fundamental principles of environmental justice, to gain recognition under the ATS. In this case, the plaintiffs brought suit against the corporation for instances of fatal lung disease allegedly resulting from its copper mining, refining, and smelting operations.[135] The Peruvian class action plaintiffs claimed that pollution from the operations undertaken by the defendant violated their right to life, health and sustainable development—principles that the plaintiffs argue have risen to the level of customary international law.[136] The District Court found that the plaintiffs' reliance on non-binding sources of international law failed to meet the universally recognized standard set forth in ATS jurisprudence.[137] The Second Circuit affirmed, stating that the right to life and health, as far as a sustainable environment provided by the government, is concerned[138] come from the "clear and unambiguous" standard promulgated by the *Filartiga* Court.[139]

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committing acts with the intent to destroy the Amungme group, i.e. its members, then he has failed to make this allegation sufficiently explicit."

[133] *See generally* Jean Wu, *Pursuing International Environmental Tort Claims under the ATCA:* Beanal v. Freeport-McMoran, 28 ECOLOGY L. Q. 487, 498 (2001).

[134] 253 F. Supp. 2d 510, 514 (S.D.N.Y. 2002), *aff'd*, Flores v. S. Peru Copper Corp., 414 F.3d 233 (2d Cir. 2003).

[135] *Flores*, 414 F.3d 233.

[136] *Id*. at 240.

[137] *Id*. at 237.

[138] *Id*. at 244. Plaintiffs dropped sustainable development for review by the Second Circuit.

[139] *Id*. at 255; *Filartiga*, 630 F.2d 876. *See also* Ulrich Beyerlin, *Different Types of Norms in International Environmental Law*, *in* OXFORD HANDBOOK OF INT'L ENV'L L. 425, 425-26 (Daniel Bodansky et al. eds., 2007).

Flores is especially notable because it was the first case to directly plead the link between human rights and the environment.[140] Plaintiffs in the case attempted to distinguish their case from the failed *Amlon* and *Beanal* cases by emphasizing a human rights approach as their primary basis for obtaining jurisdiction under the ATS.[141] The Second Circuit did not see distinguishable facts here and found that, "labels plaintiffs affix to their claims cannot be determinative."[142]

2. Using UNCLOS as Vehicle for International Recognition

a. Sarei v. Rio Tinto PLC[143]

The foregoing case law has demonstrated the challenges of recognizing environmental torts as customary international law and thus affected the plaintiffs' ability to establish jurisdiction in a U.S. court for an ATS claim alleging environmental harm. The *Sarei* decision, while unsuccessful, has illuminated the first viable path to success for environmental justice plaintiffs.[144]

In *Sarei,* the defendant, Rio Tinto PLC, operates an international mining group on the island of Bougainville, in Papua New Guinea.[145] The plaintiffs are current or former residents of the island of Bougainville.[146] They brought this case under the ATS, alleging among other claims that the intentional dumping of hazardous material into the community's river system caused environmental destruction and harm to the island.[147] In a lawsuit substantively equivalent to the *Flores* case, the plaintiffs here alleged that the actions of Rio Tinto PLC violated their right to life, health, and sustainable development, and they stressed that these rights are

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[140] *See* Natalie L. Bridgeman, *Human Rights Litigation under the ATCA as a Proxy for Environmental Claims*, 6 YALE HUM. RTS. & DEV. L.J. 1, 23 (2003).
[141] *Flores*, 253 F. Supp. 2d at 510
[142] *Id*. at 510-514.
[143] 221 F. Supp. 2d 1116 (C.D. Cal. 2002), *aff'd in part*, *vacated in part* (*Sarei II*), 456 F.3d 1069 (9th Cir. 2006), *aff'd in part*, *vacated in part*, *reversed in part* (*Sarei III*), 487 F.3d 1193 (9th Cir. 2007), *en banc rehearing granted*, 499 F.3d 923 (9th Cir. 2007), *heard on exhaustion of remedies* (*Sarei IV*), 650 F. Supp. 2d 1004 (C.D. Cal. 2009).
[144] Christopher M. Kozoll, *Poisoning the well: Persecution, the Environment, and Refugee Status,* 15 COLO. J. INT'L ENVTL. L. & POL'Y 271 (2004).
[145] *Sarei*, 221 F. Supp. 2d at 1120.
[146] *Id*.
[147] *Id*. at 1121-1126. For the purpose of this paper, I have omitted the plaintiffs' additional claims accusing the defendants of war crimes, crimes against humanity, and racial discrimination committed during a long-lasting internal conflict in Papua New Guinea in which many died. These *jus cogens* violations are still pending before the Ninth Circuit.

sufficiently specific and universally recognized to meet the *Sosa* standard.[148] Counsel for the plaintiffs referred to the same international documents used by the plaintiffs in *Flores*.[149] However, in *Sarei,* the plaintiffs also claimed that the intentional dumping of toxic waste violated two provisions of the United Nations Convention on Law and the Sea (UNCLOS).[150]

The District Court refused to give merit to the plaintiffs' claims emanating from violations of right to life, health, and sustainable development, ruling that that they were insufficient in definiteness to rise to the level of customary international law.[151] In fact, the District Court, eventually affirmed by the Ninth Circuit, went one step further. It pronounced that even if the right to life and health were a part of customary international law, harm to the environment as the catalyst for the deprivation of these broad rights is certainly not a specific, universal, and obligatory norm.[152] In regards to the sustainable development claim, the courts refused to accept the international documents as obligatory instruments that could bind the United States to their declarations.[153]

While the decision failed to negotiate access to environmental justice by way of international human rights in U.S federal courts, the District Court held that the allegations of UNCLOS violations met the requirements of *Sosa*.[154] The Ninth Circuit affirmed on this count and held that while the United States is not a party to UNCLOS, the binding legal instrument is specific enough in its provisions, obligatory among the 162 nations party to it, and universally recognized as customary international law.[155] This revelation has provided the international environmental justice community and future plaintiffs with strategies to create a sufficient nexus between environmental human rights damages and access to redress.

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[148] *Sarei*, 221 F. Supp. 2d at 1120.

[149] Plaintiffs referred to the International Covenant on Civil and Political Rights, the Universal Declaration of Human Rights, the American Declaration of the Rights and Duties of Man, the American Convention on Human Rights, the European Convention for the Protection of Human Rights and Fundamental Freedoms, the African Charter of Human and Peoples' Rights, and the Charter of Fundamental Rights of the European Union. *Id*. at 1156.

[150] *Id*. at 1160. U.N. Convention on the Law of the Sea, *entered into force* November 16, 1994, 1833 U.N.T.S. 397 (1982) [hereinafter UNCLOS]. Widely regarded as the "Constitution of the Sea," UNCLOS has been ratified by 162 countries. Plaintiffs cited Article 194, which says, "states take all measures . . . that are necessary to prevent, reduce and control pollution of the marine environment that involves hazards to human health, living resources and marine life through the introduction of substances into the marine environment," and Article 207 which states that, "States adopt laws and regulations to prevent, reduce, and control pollution of the marine environment caused by land-based sources."

[151] *Sarei*, 221 F. Supp. 2d at 1140-1150.

[152] *Id*. at 1158.

[153] *Id*. at 1156.

[154] *Id*. at 1161.

[155] *Sarei II*, 456 F.3d at 1078.

Unfortunately, even though a cognizable claim was found in the UNCLOS violations, the Ninth Circuit ultimately dismissed the case under the ATS due to international comity concerns similar to those in *Amlon Metals*.[156] The Court sitting *en banc* found the actions of Rio Tinto PLC to be closely related to the actions of the nation of Papua New Guinea, and not within the purview of the United States' judiciary.[157] This facet of the case underscores the procedural hurdles to obtaining jurisdiction under the ATS. It seems that even when all of the puzzle pieces fit together convincingly, environmental justice via the ATS remains an illusion.

b. Environmental Victims Deserve a Remedy

After analyzing the seemingly infinite obstacles to achieving jurisdiction under the ATS, one might consider using an established norm of customary international law as a route to circumvent these barriers. The Ninth Circuit Court provided the possibility of such recovery in a short section of its opinion in *Sarei*.[158] The Court distinguished the UNCLOS claims from the remaining claims the plaintiffs brought, which included violations of the laws of war and racial discrimination.[159] After it was determined that the prudential interests of international comity preempted the UNCLOS claims, the court implicitly suggested that had the plaintiffs asserted what the Court defined as "*jus cogens*"[160] offenses of racial discrimination and violations of war, the result of dismissal would have been different because these very serious offenses are not trumped by prudential concerns.[161] Asserting existing *jus cogens* offenses as a route to environmental justice, in lieu of the environmental atrocities as *jus cogens* violations themselves, is not the answer.

For indigenous communities like the Kichwa of Ecuador, the Korubo and Urarina of Peru, and the Amungme Tribe of Indonesia, the

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[156] *Id*. at 1193. Previously, the court had declined to dismiss on the basis of the *forum non conveniens* doctrine after deeming that private interests favor retaining jurisdiction and that public interests were neutral. *Id*. at 1175.
[157] *Id*. at 1176-77.
[158] *Id*. at 1165-72.
[159] *Id*. at 1172.
[160] Markus Petsche, *Jus Cogens as a Vision Of The International Legal Order*, 29 PENN ST. INT'L L. REV. 233, 258 (2010) ("Jus cogens is based on the idea that the international legal system recognizes, or should recognize, a set of fundamental values.").
[161] *Sarei II*, 456 F.3d at 1165-75. "Only the other claims assert *jus cogens* violations that form the least controversial core of modern day ATCA jurisdiction." *Sarei III*, 487 F.3d 1193, *en banc hearing granted*, 499 F.3d 923 (9th Cir. 2007) ("A different outcome would only have been possible if the invoked UNCLOS norms were part of *jus cogens*.").

environment is the lynchpin of posterity. The indigenous peoples involved in these cases are not the only victims here. Future generations of indigenous peoples, if in existence at all, are relegated to adapting to a new way of life and compromising their cultural heritage. Over time, this effectively results in the extinction of the tribes, or at least the way of life that they know. Obtaining the equitable relief necessary to fix this threat of eradication must, then, be found in environmental claims themselves, and financial recovery must go to environmental remediation for the sake of the indigenous identity.

The Ninth Circuit's interpretation of UNCLOS will be helpful for future environmental victims. The concepts of the right to life, to health, and sustainable development are amorphous indeed, and the instruments that contain such rights are only binding, if at all, for the nations who voluntarily assent to be bound by them. The Ninth Circuit's finding of sufficient definiteness in UNCLOS violations suggests that another court, with the right set of facts, could find pollution on the level of severity akin to that of the Ecuadorian plaintiffs, worthy of customary international law status via UNCLOS.

V. CONNECTING THE DOTS: RECOVERY FOR ENVIRONMENTAL TORT PLAINTIFFS

A. Achieving Jurisdiction via the Alien Tort Statute

To prevail in an environmental ATCA claim, a plaintiff must: (1) overcome the motion to dismiss on forum grounds, and (2) prove that the defendant's actions and the resulting damage are in violation of, "Norms of international character accepted by the civilized world and defined with a specificity "comparable to the 18th century paradigms." [162] that the *Sosa* Court required.

1. Clearing the *Sosa* Hurdle

Of the three prongs of the *Sosa* test,[163] specificity is the primary hurdle in every environmental ATS claim. Traditionally, the consensus among the circuits has insisted that the "right to life" and the "right to health" are vague concepts that do not meet the standards set in *Sosa*.[164] In *Flores*, for example, the Second Circuit stated that the rights to life and to

[162] Sosa v. Alvarez-Machain, 542 U.S. 692, 724 (2004).
[163] *Amlon*, 775 F. Supp. 668; *Beanal*, 969 F. Supp. 362; *Flores*, 253 F. Supp. 2d 510.
[164] Sarah M. Morris, *Intersection Of Equal And Environmental Protection: A New Direction for Environmental Alien Tort Claims After* Sarei *and* Sosa, 41 COLUM. HUM. RTS. L. REV. 275 (2009).

health are too indeterminate to constitute a cause of action under the ATS.[165]

Transcending this interpretation and including environmental human rights violations is, for the first time, a conceivable path. Two years after *Flores*, the United States District Court for the Northern District of California held that, "The limits of a norm need not be defined with particularity to be actionable; rather, the norm need only be so defined that the particular acts upon which a claim is based certainly fall within the bounds of the norm."[166] In *Doe v. Qi*, that court stated, "The fact that there may be doubt at the margins—a fact that inheres in any definition—does not negate the essence and application of that definition in clear cases."[167] The dispute among the circuits concerning what exact parameters should be assessed to customary international law status is a misinterpretation of *Sosa*.[168]

Furthermore, the court also described how to determine what actions should be excluded as an international norm, holding that, "The actions alleged should be compared with actions that international adjudicatory bodies have found to be proscribed by the norm in question."[169] The *Doe* Court gave deference to decisions by institutions such as the Human Rights' Committee, the European Court of Human Rights, and the African Commission on Human Rights to elucidate international consensus.

Facts comparable to the Chevron/Ecuador case demonstrate a level of specificity that U.S. courts should regard as adequate. The evidence of the harmful actions taken by the defendants, or actions they knowingly failed to take, is clear and overwhelming.[170] Their operations in Ecuador were carried out in a tortious manner for thirty years, resulting in relentless environmental decay. The evidence shows that there were responsible disposal methods available and that Texaco utilized them in its United States operations but not in Ecuador.[171] Evidence also shows that even after the first action was filed against Texaco in 1993, no sincere remediation efforts were made and the very same destructive practices persisted.[172] The "totality of the circumstances" evaluation used in *Doe* is the most equitable

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[165] *Flores*, 414 F.3d at 247.
[166] *Doe v. Qi*, 349 F.Supp. 2d 1258 (N.D. Cal. 2004).
[167] *Id*. at 1266.
[168] *Sosa*, 504 U.S. 655; 28 U.S.C. § 1350 (2006).
[169] *Doe*, 349 F. Supp. 2d at 1261-62.
[170] *See* Paul M. Barrett, *Amazon Crusader. Chevron Pest. Fraud?*, BLOOMBERG BUSINESS WEEK (Mar. 9, 2011), http://www.businessweek.com/magazine/content/11_12/b4220056636512.htm.
[171] Aguinda v Texaco, Inc. 945 F.Supp. 625 (1996).
[172] *Id*. at 627.

approach possible and should be used in evaluating the Chevron/Ecuador case as well. To refuse to hear a case on its merits in the face of blatant violations and misconduct committed abroad effectively vitiates the vision and intent of the ATS.[173]

The universal component required under the *Sosa* analysis is the least contentious element in ATS controversy. Something is not customary international law if it is not a standard to which the vast majority of countries adhere. Both the *Filartiga* and *Sosa* cases, from which the foundational principles of ATS analysis emanate, declare that customary international law is an evolving body of law that includes norms that emerge when "conduct, or the conscious abstention from certain conduct, of states … becomes in some measure a part of the international legal order."[174] Very simply stated by a note from the Third Restatement of the Law of Foreign Relations of the United States, "practice builds law."[175]

The conduct of Chevron in Ecuador is universally condemned.[176] There is well-established, universal consensus that the rights of sovereignty and the ability to exploit one's own natural resources exist in every nation. When the ability to capture those resources is lost due to the tortious conduct of another, international consensus that a remedy should be afforded to such victims exists.

Moreover, it is universally agreed that a significant purpose of the ATS was to "ensure that the United States complied with its obligations under international law by providing redress for certain violations of the law of nations."[177] The obligatory element of the *Sosa* framework is a qualifier of the specificity requirement and a limitation on the universal component. The general rule is that to be recognized as customary international law, the violations committed must present a binding obligation on the U.S.[178] Concepts that are not of binding character are determined not sufficiently specific, and even if the concepts are universally condemned, they are not enough to rise to the level of customary international law. I, along with others, find strict adherence to a narrow definition of "obligatory" antiquated and not in line with the intent of the ATS.[179] The Second Circuit in *Abdullah v Pfizer, Inc*.[180] determined

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[173] *Id*.
[174] HENRY J. STEINER & PHILIP ALSTON, INT'L HUMAN RIGHTS IN CONTEXT: LAW, POLITICS, MORALS 224 (2008).
[175] RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE U.S. § 102.
[176] *Aguinda III*, 2012 WL 7745068.
[177] Bradley & Goldsmith, *The Current Illegitimacy of International Human Rights Litigation*, 66 FORDHAM L. REV. 319 (1997).
[178] *Sosa*, 504 U.S. at 660.
[179] Bradley & Goldsmith, *supra* note 177, at 330-331. The authors attack the obligatory element on the grounds that "The modern position claim that CIL is to be applied as federal common law thus compensates for the abstinence of the United States vis-a-vis ratification of international

that medical experimentation on persons without their consent is universally censured, and while the Court used the Nuremberg trials in Germany only as persuasive material, their focus was the anti-American animus that would abound if we failed to hold Pfizer accountable.

Moreover, requiring a binding document to obligate U.S. courts to establish customary international law is counterintuitive to the ATS. If it were meant to be a requirement, the statute would only have extended jurisdiction for torts committed in violation of a U.S. treaty with no mention of those committed in violation of the law of nations. Binding documents are produced from a legislative process in which complex political systems have to work in tandem to agree on something. Requiring that a violation either be enumerated in a binding document to which the U.S. assents or the decision of a court the U.S. chooses to validate, presupposes that the legislative branch is a corollary of the judicial branch, which it is not.[181] The two are separate branches of government designed to keep a "check" on one another. The ATS is a jurisdictional statute, and the question of what constitutes customary international law under the statute is a legal question. Thus, by logical extension, allowing the defiance of environmental human rights' policy by American legislators to dictate the parameters of the ATS is logically flawed. The obligatory requirement is a technicality and should only be used as a persuasive factor—not as a requirement.

2. Using the UNCLOS analysis from *Sarei v. Rio Tinto PLC*

The bane of the Kichwa in Ecuador was thirty years of mass pollution to the environment, resulting in widespread illness and resource degradation.[182] Significant funds will be necessary to repair the environment to a livable habitat. The Ninth Circuit's recognition of UNCLOS provisions in *Sarei,* as customary international law, opened the door to recovery for environmental human rights victims.[183]

The Ninth Circuit affirmed the District Court's determination that the two provisions of UNCLOS had risen to the level of an international norm, primarily because of the wide acceptance and adherence by the

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human rights treaties. It permits federal courts to accomplish through the back door of CIL what the political branches have prohibited through the front door of treaties."

[180] 2005 U.S. Dist. LEXIS 16126 (S.D.N.Y. Aug. 9, 2005.)

[181] *See* Geoffrey R. Stone, *Precedent, the Amendment Process, and Evolution in Constitutional Doctrine*, 11 HARV. J. L. & PUB. POL'Y 67 (1988).

[182] *Id.*

[183] *Sarei II*, 456 F.3d 1069.

nations of the world to the prohibition of willful marine pollution.[184] This signals a very important benchmark in the evolution of ATS jurisprudence and is enormously important for environmental human rights plaintiffs. What this effectively does is recognize that international norms exist independently of the obligatory requirement under *Sosa*. Until this case, no treaty provision rose to the level of binding customary international law for ATS purposes without ratification by the United States government. This decision establishes the precedent that specific violations of universally recognized pollution standards are actionable under the ATS.

B. Dispelling the Act of State Doctrine

The final hurdle any environmental plaintiff must overcome is the Act of State Doctrine. This doctrine provides that a nation is sovereign within its own borders, and its domestic actions may not be questioned in the courts of another nation.[185] As seen in the *Sarei* decision, even if the requirements of customary international law are met, U.S. federal courts have established a precedent of non-intervention on matters that straddle foreign affairs and the law. The threshold inquiry is the degree of interplay between the government in which the tort takes place and the tortfeasors. If the developing nation's government is knowingly contributing and allowing the cause of the damages, U.S. courts will very likely determine that the dispute belongs within the courts of that nation.

Although not required under international legal principles,[186] the doctrine aims both to protect other nations' sovereignty by intervention from the U.S. and to protect the U.S. Executive's broad foreign affairs powers from being usurped by a decision issued from the judiciary.[187] If a federal court made a determination of law that ran afoul of the executive's foreign policy, the authority of the executive would be diminished.

In 1964, the Supreme Court upheld the Act of State Doctrine to the chagrin of Congress and American investors in *Banco Nacional de Cuba v Sabbatino*.[188] In that case, the Court maintained that the Act of State Doctrine barred recovery for American investors in Cuba's sugar production after the government nationalized the sugar industry and refused

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[184] UNCLOS, 1833 U.N.T.S. 397 (1982).
[185] Underhill v. Hernandez, 168 U.S. 250 (1897).
[186] Neither customary international law nor treaty law. *See* RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES § 403 (1987). The Restatement maintains that a domestic court possessing adjudicatory jurisdiction may exercise that jurisdiction if it is reasonable to do so. It asserts that the principle of reasonableness is based on customary international law.
[187] *See*, Deborah Azar, *Simplifying The Prophecy Of Justiciability In Cases Concerning Foreign Affairs: A Political Act Of State Question*, 9 RICH. J. GLOBAL L. & BUS. 471 (2010).
[188] Banco Nacional de Cuba v. Sabbatino, 376 U.S. 398 (1964).

to compensate the shareholders.[189] The Court held that Cuba's sovereign right to control its domestic affairs is beyond the scope of the federal judiciary's adjudicative authority.[190] Congress responded with the Hickenlooper Amendment,[191] which balances the interests of foreign affairs and justice by allowing the United States Executive to decide, on a case-by-case basis, when the Court should invoke the doctrine.[192] The President of the U.S. will invoke the doctrine when intervention in such affairs does not belong in the purview of the judicial branch.

In *Sarei,* the Rio Tinto company's operations were found to be attributable to the sovereign Papua New Guinea government due to the state-sanctioned violence and torture of opposition to the company.[193] Even though the *Sosa* elements were met, the Act of State Doctrine precluded the extension of jurisdiction for prudential reasons. In contrast, plaintiffs in the Chevron/Ecuador litigation would likely not face preclusion under doctrine. The Ecuadorian Government fully supports its indigenous peoples and condemns the actions of Chevron. The Ecuadorian government's involvement with Chevron is no longer a matter of state policy, and intervention by a U.S. adjudicative body would pose no threat to the foreign affairs' policy of the U.S.

Chevron has argued that because Ecuador's oil and natural gas industry is nationalized, there is a sufficient connection between the actions of Chevron and the Ecuadorian Government, thus transforming the dispute into a political question under the Act of State doctrine. This argument is flawed. For the Act of State Doctrine to apply, it must be shown that the government of Ecuador either affirmatively took steps to suppress justice, as in the case of *Sarei*, or entirely acquiesced. With a favorable judgment in Ecuador and the support of that nation to enforce it, neither is present.

VI. CONCLUSION

The plaintiffs affected by the tortious conduct of the Chevron Corporation are entitled to a remedy. Unfortunately, by the time a remedy materializes, it may be too late to save their cultural lands and ensure the continuation of their indigenous identity. For more than twenty years, the

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[189] *Id*. at 410.
[190] *Id*. at 417.
[191] 22 U.S.C. § 2370(e)(1) (1964).
[192] *See*, Frances X. Hogan, *The Hickenlooper Amendments: Peru's Seizure of International Petroleum Company As a Test Case*, 11 B.C. L. REV. 77 (1969).
[193] *Sarei II*, 456 F.3d at 1165.

plaintiffs have journeyed through one procedural hoop after another, and it appears that there is no end in sight.

For future plaintiffs of environmental human rights violations, U.S. federal courts should use the Chevron litigation as a motivator to apply the Alien Tort Statute as it was intended: as a deterrent to such convoluted, expensive, and time-consuming litigation. Accountability measures should be imposed on multinational corporations' actions abroad to protect indigenous communities from tortious environmental misconduct occurring on a level that will cause great damage to their lands and people. Under the Alien Tort Statute, such measures have existed for more than two centuries to provide relief from extrajudicial murder, medical experimentations on non-consenting persons, torture, genocide, and other offenses. With the favorable determination from the Ninth Circuit that UNCLOS pollution provisions rise to the level of customary international law, the natural evolution of ATS jurisprudence includes human rights violations resulting from tortious environmental degradation.

REEVALUATING THE IMPORTANCE OF CIVICS EDUCATION

MARCUS ALEXANDER GADSON**

In the effort to reform American education, civics has received little attention. To spur efforts to improve the civics education that students receive, four congressmen introduced the Sandra Day O'Connor Civics Education Act. This article argues that while the legislation may provide some marginal benefits, it is unlikely to have a great impact on civics education. The article then proposes ideas on what additional measures such legislation might take to genuinely improve civics instruction for students around the country. The article concludes by explaining the necessity of reforming civics education and laying out the benefits of implementing the proposed changes.

I. BACKGROUND

Much of the focus of educational policy in the past decade has been on raising student achievement in "core" subjects such as reading, math, and science: the essence of the "No Child Left Behind" Act. President George W. Bush's signature education initiative was signed into law on January 8, 2002, and required states that received federal funding to administer annual standardized tests to students. The law required states to define what adequate yearly progress (AYP) should look like for all students, and then more specifically for students from disadvantaged groups and who had limited English proficiency. The law also prescribed certain remedies for schools that failed to achieve AYP. Schools that failed to do so two years in a row would have to devise a l-year improvement plan

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I would like to dedicate this article to all of the social studies teachers I worked with who did everything they could to make sure that students in the Mississippi Delta, many of whom came from disadvantaged backgrounds, received an education that would prepare them to be active, engaged citizens. I would also like to dedicate it to my former students, so many of whom inspired me with their love of learning and their persistence in climbing the mountain to and through college.

for the subject in which students at the school were struggling and also give them the option to transfer to a higher-performing school in their district if one existed.[1] Every subsequent year that AYP was not met would lead to more serious steps, until the sixth year of failure when the school would be restructured.[2] Some ways this may have been accomplished were closing the school, turning it into a charter school, or having the state run it directly.

Since the Obama administration has taken office, it has attempted to grant states more flexibility from the rigid requirements, but few question the underlying objectives. What has been scarcely mentioned in discussions about how to reform education is how little graduating students know about civics, a subject directly relevant to their ability to vote in elections in which they will soon be able to participate. By taking civics classes, student are supposed to learn about how government works at the local and national level, gain an understanding of important principles of the US political order, acquire some background in important policy questions, and develop a working knowledge of the political parties and their issue positions, enabling them to vote intelligently one day. Unfortunately, only 24 percent of 12th graders were proficient on the 2010 National Assessment of Educational Progress (NAEP) for Civics, and a scant 4 percent knew enough to be classified as "advanced.[3]" To provide some context, the 2011 NAEP showed that 35 percent of eighth graders were proficient and 8 percent were advanced in math. Such numbers are routinely taken as evidence that the US needs to do much more to strengthen math education.[4]

Introduced in November of 2011 and referred to the Subcommittee on Early Childhood, Elementary, and Secondary Education in March of 2012, the Sandra Day O'Connor Civics Education Act is a much less heralded attempt to improve American students' civics knowledge. The most important part of the act is essentially a grant program designed to fund effective civics instruction programs so that school districts can learn from each other's successes. The act authorizes the Secretary of Education to work with entities that develop civics educational programs. The grants can be given to applicants who demonstrate any of the following[5]:

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[1] Erin Dillon and Andrew Rotherham, *States' Evidence: What It Means to Make "Adequate Yearly Progress" Under NCLB*, *available at* http://www.educationsector.org/sites/default/files/publications/EXPAYP.pdf.
[2] *Id*.
[3] *Civics: Grade 12 National Results*, The Nation's Report Card, http://nationsreportcard.gov/civics_2010/g12_national.asp.
[4] Fawn Johnson, *Parsing the Nation's Report Card*, National Journal Education Experts Blog, Nov. 7, 2011, http://education.nationaljournal.com/2011/11/parsing-the-nations-report-car.php.
[5] Sandra Day O'Connor Civic Learning Act of 2011, H.R. 3464, 112th Cong. (2011) *available at* http://thomas.loc.gov/cgi-bin/query/z?c112:H.R.3464.

1. Increase equity, meaning (A) programs that meet the needs of students with different learning styles, students of different racial and socioeconomic backgrounds, and students who are English language learners; and (B) resources for serving student populations that have not traditionally received opportunities for high quality, engaging civic learning, with a special emphasis on inner-city and rural underserved students.
2. Foster innovation through design, settings, and delivery, including service learning, interactive on-line programming, and other approaches to engaging students in active learning and civic participation.
3. Provide scalability through broad, cost-effective implementation and institutionalization, including use of the latest technology, addressing relevant national and state standards, and low cost ways of expanding the number of teachers and students.
4. Demonstrate accountability for student assessment results, including independent research and evaluation of student knowledge and skills gained, identifying techniques that reach different students, and evaluation of the teachers' content knowledge and teaching ability.

The bill would provide $23,500,000 over the next five years and, interestingly enough, has bipartisan potential. The main sponsor, Mike Honda (D-California) is a Democrat, as are two of the cosponsors. But the third cosponsor is none other than Tom Cole (R-Oklahoma), who was recognized by the American Conservative Union as one of the most conservative members of Congress.[6] It includes themes that should appeal to both liberals and conservatives: widening educational access and a focus on the history and the system of government that makes America unique. Furthermore, the cost of doing so is essentially negligible in proportion to the entire federal budget. In terms of specific educational concerns, it does not establish any national standards or provide for a larger federal role in civics education; it is much more like the concept of the Race to the Top program, which both liberals and conservatives have supported.[7]

Officially, the bill has been spawned by the efforts made by retired Supreme Court justice Sandra Day O'Connor to promote quality civics instruction. After years of receiving complaints about her decisions that she found quite misdirected—she said the complaints could have been more appropriately directed at other branches of government—she decided

[6] *Cole Named One of Congress' Most Conservative Members*, United States Congressman Tom Cole (May 11, 2012), http://cole.house.gov/press-release/cole-named-one-congress-most-conservative-members.

[7] Frederick M. Hess & Andrew P. Kelly, *A Federal Education Agenda,* American Enterprise Institute (Sept. 24, 2012), http://www.aei.org/article/education/k-12/a-federal-education-agenda/.

something had to be done.[8] When she left the court in 2006, she started a program called iCivics that promotes interactive civics instruction to reach younger generations of students.[9] iCivics allows students to play simulations focusing on the different branches of government to increase their civics knowledge. Two states, Florida and Kentucky, have passed civics education bills named after her.

II. ASSESSING THE BILL'S LIKELY IMPACT

Though likely to have some beneficial effect on civics education, the bill is hardly a panacea. The grants will no doubt encourage some local districts to develop stronger civics programs using new platforms and technology to reach younger generations, and its focus on closing the achievement gap between minority students and white students will be welcome. Eventually, a "best practices" trend may develop that the Department of Education can encourage in schools nationwide.

There are however three fundamental problems. The first is that the legislation is not large enough to have the desired impact. Leaving a mere $5,700,000 per year means that only a few grants of substantial size can be awarded each fiscal year. It is easy to imagine five major school districts taking the grant money to develop civics instructional programs that implement new technology, train teachers, and develop curriculum. Leaving only a limited number of school districts and educational entities working on civics instruction would make it difficult to really develop an idea of what the best practices should be going forward. Moreover, with such a comparatively small amount of grant money available, many students will not even reside in the districts that can take advantage of the money. To understand how little money this bill allocates, consider how much funding No Child Left Behind provided for Math and reading instruction. In 2006, over $1 billion was allocated for reading first grants, and $182 million was allocated just for math and science partnerships for the space of one calendar year. [10]

Second, there is not enough of a focus on expanding access to civics education for those who do not currently receive it. As it stands now, there are still eleven states in which students do not even have to take a course in civics or government to graduate high school. [11] Before focusing on how to reach students of different racial backgrounds or improving cost

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[8] Donna Krache, *Sandra Day O'Connor Champions Civics Education*, CNN (July 19, 2012), http://schoolsofthought.blogs.cnn.com/2012/07/19/sandra-day-oconnor-champions-civics-education/.

[9] *Id*.

[10] *No Child Left Behind Act Funding*, New America Foundation (Apr. 4, 2012), http://febp.newamerica.net/background-analysis/no-child-left-behind-funding.

[11] Nora Fleming, *Few States Test Students on Civics*, Education Week (Oct. 11, 2012), http://www.edweek.org/ew/articles/2012/10/11/08civics.h32.html.

control, it is critical that students in these eleven states are exposed to a civics courses. Only then will districts in those states see the need for grants to modernize their curricula and integrate new technology.

Third, there is no emphasis on accountability in the legislation. Under the No Child Left Behind Act, schools had a deadline of 2014 to raise student achievement in math and reading, and schools unable to do so would be labeled as failing. Even with President Obama's waivers, states that want relief from certain provisions must adopt "college and career-ready" academic standards and rigorous teacher evaluation systems.[12] Moreover, they must still administer yearly tests in math and reading and release the results to the public,[13] imposing at least a publicity penalty for schools that do not raise achievement in these subjects. A good start would be to require schools to test annually in civics and release the data, including information about how students from different racial groups performed.

III. HOW TO STRENGTHEN AMERICAN CIVICS EDUCATION

Many states are working on promising approaches to strengthen civics education. One example is Florida, which actually passed a Civics Education program of its own in 2010.[14] In middle school, all students in Florida must pass a civics class in order to be promoted to the next grade. Moreover, schools must administer a civics end-of-year assessment, the results of which must be included in the school's overall report card.[15] It will be hard to know whether students in a given school are doing better than they did before 2010, but at least schools will now have data on how much students actually learn from year to year in civics classes.

At the high school level, students in only two states, Ohio and Virginia, must pass tests in civics to graduate.[16] That is why increased accountability is so critical. It sends the helpful message that civics classes are actually important. As it stands, the fact that so much more energy and resources is spent on "core" subjects such as math, reading, and science implies to students that social studies is less important than their other subjects. Requiring students to pass a civics test tells them and their parents that society takes civics as seriously as it does those other subjects. Civics should not be seen as a vacation from the rigors of normal school or a subject with no consequences for the student. Moreover, if No Child Left

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[12] Sam Dillon, *Obama to Waive Parts of No Child Left Behind*, N.Y. Times, Sept. 23, 2011, at A19 *available at* http://www.nytimes.com/2011/09/23/education/23educ.html.
[13] *Id*.
[14] Civics Education, H.B. 105, 2010 Leg., (FL. 2010), *available at* http://www.myfloridahouse.gov/sections/Bills/billsdetail.aspx?BillId=42220.
[15] *Id*.
[16] Nora Fleming, *supra* note 11.

Behind is a guide, even if many people do not like such rigid accountability, Florida's approach will at least start a conversation about how to raise student achievement in civics and shine a light on an achievement gap between minority and nonminority students that is even more daunting than the one in math. Such awareness will help facilitate the discussions happening in education circles about how to raise reading and math scores for particular students.

In addition, there needs to be a discussion about standardizing civics curricula across states and localities. Common core standards for math and English provide a helpful precedent. The states came together to formulate common standards so that they would have an idea of how students were doing relative to a national measuring stick. One might think that this model will not work because civics is a more subjective subject than math or English, but such standards would not mandate a favorable or unfavorable portrayal of certain policies. Instead, they would describe basic principles and content that every student in the country should know—things like the fact that checks and balances and federalism are important parts of our constitutional and political framework. On contentious policy questions like whether the federal government should administer a national healthcare program, common core standards could ensure that students nationwide are exposed to both liberal and conservative perspectives. This means that students who live in areas of the country where one party is dominant will have a chance to understand crucial debates from the side of the debate they hear from least in their communities.

Many of the criticisms leveled against the common core standards and standardized testing in math and English might be applied to putative standards in civics. One such criticism is that pressure to prepare students for standardized tests will lead to "drill and kill" instructional methods[17] where students memorize content which they will forget as soon as they have bubbled in their answer sheets. Teachers and administrators feeling pressure to produce strong test results could likely see no alternative. While this is certainly a valid concern, it should not deter educators from developing civics standards and then testing students on them. Two solutions seem particularly promising.

One would be to create a civics standardized test that requires higher level thinking in order to pass. For example, students could answer a document-based question where they are given opinion polls or examples of political cartoons or ads and asked to write a coherent essay of the sort that students see on AP History exams. Even multiple choice questions can be tailored to require more than simple regurgitation. Students could be

[17] Valerie Straus, A Tough Critique of Common Core on Early Childhood Education, Washington Post, January 29, 2013, *available at* http://www.washingtonpost.com/blogs/answer-sheet/wp/2013/01/29/a-tough-critique-of-common-core-on-early-childhood-education/.

given a table of racial demographic groups in a particular area and asked to predict the partisan affiliation of the representatives that it would send to Washington. In order to correctly answer such a question, a student would have to know the typical partisan affiliations of racial groups in an area and consider the likely voting outcome of an area with certain percentages of each racial group.

Second, an assessment of subject-matter mastery could include more than just one high-stakes test. High school students, for example, could be asked to write a research essay about an area of civics that interests them. Working in consultation with a teacher, students could develop a topic, find sources to help them answer the question, and then craft a thesis. Such a system would obviously pose challenges. One would be ensuring uniform grading. A useful example here is the international baccalaureate program's extended essay. Assessors are given a rubric with a range of criteria including quality of the research question, quality of argument, and knowledge and understanding of the topic studied.[18] Another concern would be cost. Hiring essay graders for millions of students would certainly consume a great deal of resources and be particularly tough during a time of fiscal austerity. To mitigate the fiscal cost, the federal government could provide grants to help develop and grade such an assignment.

A second related criticism is that developing such standards would decrease teacher discretion, but this begs the question of how much discretion teachers should have in determining which kinds of basic content to teach. As stated earlier, students should have to learn about important constitutional values such as separation of powers and the Bill of Rights. Teachers should, however, retain considerable discretion over *how* to teach to the standards. In one classroom, students might best learn about Congress by doing a simulation where they take on roles of legislators and attempt to form consensus on a bill to pass. In another, students might respond better to watching a documentary about Congress and discussing what they learned as a group. Still another group of students might do best by completing assigned reading and then participating in a Socratic lecture. In all cases, teachers should be able to use their reasoned judgment and experience to determine the most effective means of instruction.

Lastly, one might worry that state and local governments would be better situated than the national government to set civics standards. Given their knowledge of the local population and how politics have played out in their state, the argument goes, they are best able to craft a relevant curriculum. There are two compelling responses. First, states would be free

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[18] International Baccalaureate Organization, *International Baccalaureate Extended Essay Guide*, *available at* http://www.fcps.edu/RobinsonSS/ib/pdf/Extended%20Essay%20Subject%20Guidelines.pdf.

to create separate standards regarding instruction on local and state politics that would take into account their unique histories and political arrangements. They could even impose a requirement of passing a state civics test in order to graduate high school or be promoted to the next grade. National civics standards would function as a floor, not a ceiling. Second, an important function of national civics standards is to make sure that students get exposure to ideas that make up the core of the US political order, as well as ideas that may differ from those most popular in their area. The only way to develop standards that accomplish these objectives is to work with educators, historians, and politicians from across the nation and political spectrum, and this would be best done at the national level.

IV. WHY IMPROVING CIVICS EDUCATION IS SO IMPORTANT

That such measures are not currently offered by this legislation or seriously considered in educational circles suggests a lack of urgency surrounding civics and history. This likely has to do with the perception that subjects such as math, science, and reading have a more immediate economic impact. The jobs of the future, after all, require facility with technology. Many of the job openings available are going unfilled for want of applicants who have the requisite skills.[19] Yet, the fact that students are actually doing worse in civics is equally damaging, even if less immediately apparent. There is evidence, for example, that there is a link between the quality of civics education that a student receives and the likelihood that he or she will vote. A study by the Center for Information and Research on Civic Learning and Engagement (CIRCLE) found that voters in the 18-29 age-groups who lived in states that had strengthened civics or government requirements were more likely to vote than those who lived in states who had weakened such requirements. [20] While it is of course possible to point to other factors for increased voting in such states, the study makes intuitive sense. Citizens who have a solid grounding in civics are better situated to actually understand campaigns and their issues and perhaps to perceive a greater stake in the outcome.

This takes on even more importance in the current political and economic climate where important decisions on entitlement spending and taxes will be made that could have consequences for the type of social contract between government and the upcoming generation. For example, in the next year or so, it is likely that structural changes to Medicare and

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[19] Darren Dahl, *A Sea of Job-Seekers, but Some Businesses Aren't Getting Any Bites,* N.Y. Times, June 28, 2012, at B7 *available at* http://www.nytimes.com/2012/06/28/business/smallbusiness/even-with-high-unemployment-some-small-businesses-struggle-to-fill-positions.html?pagewanted=all.

[20] *Did Civic Education Laws Affect Youth Turnout in 2012?*, The Center for Information & Research on Civic Learning and Engagement (Nov. 28, 2012), http://www.civicyouth.org/did-civic-education-laws-affect-youth-turnout-in-2012/.

Social Security will be considered, if not enacted, as well as changes in the tax code used to pay for them. If young voters do not vote or do not have enough information to cast their votes meaningfully, politicians will pay less attention to their generation. As a result, these momentous changes may well be skewed in a direction young Americans come to rue when they do pay more attention to politics later. Simply put, a quality civics education is imperative from the perspective of generational fairness.

The focus of discussions about the achievement gap is usually on math and reading test scores. What has almost never been mentioned is that the gap between minority and white students, as well as students from well-off backgrounds and disadvantaged ones, in civics and US history is sometimes even greater than the one present in the subjects that are usually the focus of educational reform efforts. For example, in 2010 just 8% of black high school seniors were proficient in civics, and 1% advanced, compared to 30% of whites who were proficient, and 5% who were advanced.[21] If basic reading and math skills are a prerequisite to a quality job in the 21st century, then basic civics knowledge is a prerequisite to true citizenship. That black students on average are leaving schools unable to participate in the political process to the same extent as their white counterparts should worry us as much as the disparity in reading and math scores.

Perhaps most significantly, doing more to promote quality civics instruction is important because it is the one subject that holds out the genuine possibility of a shared experience for America's students. Reading and math are greatly stratified with some high school seniors taking AP Calculus and others struggling with Algebra II. But in civics, we can make sure that students from different backgrounds all get a firm basis in the information they need to engage in the democratic conversation that our country desperately needs. Crucially, doing so holds open the prospect that students from different backgrounds will have a chance to develop a common source of knowledge and common assumptions about important questions of public policy and law that will allow them to transcend the status quo where Americans of different political persuasions get their knowledge from completely different sources. Spending more money and devoting already-strained educational resources to civics education may seem like a luxury in an era of austerity. In reality, it is a necessity.

[21] *Supra* note 3.

CREDIT DEFAULT SWAPS: HOW SHOULD THEY BE REGULATED?

STEVEN A. SIBO**

With the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (hereinafter Dodd-Frank) there has been much debate about the effectiveness of this piece of legislation. One of the largest concerns legislators addressed in Dodd-Frank was how the credit default swap market ballooned to astronomical proportions and how these financial derivatives were abused by "Too Big to Fail" financial institutions. This article examines how credit default swaps played a role in the financial crisis and addresses the debate as to whether or not credit default swaps are a form of insurance, while examining the effectiveness of Dodd-Frank in addressing the problems created by the interconnectedness and abuse of the financial instrument. The article concludes by offering suggestions for legislators and scholars to consider and recommends additional measures for enactment which were not previously a component to the legislation.

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I. INTRODUCTION

With the lingering effects of the 2008 financial crisis, there continues to be much discussion about what went wrong and who is to blame for the serious impact it had on the global economic environment. Much of the blame game has resulted in finger pointing between counter parties throughout the entire web that makes up the financial system. One argument made for what triggered the financial calamity points to the federal government's policies - specifically, the policies created by the Federal Reserve backing Fannie Mae and Freddie Mac, the Department of Housing and Urban Development, and the Federal Housing authority to require lending institutions to make risky loans to under-qualified buyers.[1] Another argument made for the causation of the financial crisis is the federal government's lackadaisical attitude toward regulation of the financial markets. In other words, financial deregulation was what set the stage for the proverbial fuse to the financial bomb.[2]

As for other critics of the financial crisis, some point their fingers directly at CDSs, making the financial derivative out to be a "financial weapon of mass destruction" (as Warren Buffet once opined.)[3] CBS's 60 Minutes once did a piece on credit default swaps, calling them "The Bet that Blew up Wall Street", while George Soros and other hedge fund managers have argued that over-the-counter credit default swaps should be banned as a whole.[4]

This article will begin with a discussion of how the credit default swap market grew to the enormity it reached (which will be explored in section two), and provide some general information about credit default swaps and the entities involved in the significant growth of the credit default swap market. Section three will examine two instances of calamity involving credit default swaps, while section four will dig into a discussion of whether or not credit default swaps should be regulated as insurance or as a financial derivative. Finally, section five will review the Dodd-Frank Financial Reform legislation that was enacted to address the problems pertaining to credit default swaps and the financial markets, and section six will conclude the article with some suggestions for amending legislation

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[1] *See* Lawrence H. White, *How Did We Get into This Financial Mess?*, Cato Inst., 7 (Nov. 18, 2008),
http://www.cato.org/sites/cato.org/files/pubs/pdf/bp110.pdf.

[2] *See* Brian Quinn, *The Failure of Private Order and the Financial Crisis of 2008*, 5 N.Y.U. J.L. & BUS. 549, 593 (2009).

[3] *See* Chris Wallace, *Europe's Ticking Time Bomb: Credit Default Swaps*, Fortune, Jan. 2012, at 11.

[4] Rene M. Stulz, *Credit Default Swaps and The Credit Crisis*, National Bureau of Economic Research, 2 (September 2009),
http://www.nber.org/papers/w15384.pdf.

passed to address credit default swap issues.

II. THE RISE OF THE CREDIT DEFAULT SWAP MARKET

CDSs are financial derivatives that are traded between two parties which allow one party to pass risk to another party. This section first discusses the creation of the CDS market by detailing what a CDS is and how a transaction takes place. A discussion of the International Swaps and Derivatives Association will follow in order to highlight an additional feature on how CDSs are created and to elaborate on the ISDA's Master Swap agreement that essentially streamlines the creation of CDSs. The section will then conclude by discussing the series of events that took place, as well as the changes in regulation that gave rise to the booming CDS market post the year 2000 up to the 2008 financial crisis.

A. What Are Credit Default Swaps?

A credit default swap is one of several financial derivative products where two parties enter into a private contract to allocate risk.[5] For example, Party A wishes to purchase protection from Party B. In this case, Party A is the protection buyer and Party B is the protection seller.[6] The protection buyer will agree to pay premiums to a seller of protection on a fixed schedule over the course of the agreement, which is most often five years.[7] In return for the premium payments that Party A will make to Party B, Party B agrees to pay the buyer an amount of loss that is created by a "credit event".[8] A credit event is related to an underlying asset, which is oftentimes a bond or a loan that Party A will have purchased from a debtor.[9] It is important to note that each individual agreement can be customized to specify what constitutes a "credit event" and what specific assets are at issue.[10] With the risk of a credit event occurring, Party A will likely request that collateral be placed in a trust to mitigate Party B's risk of default. Party A may request that that Party B post 100% collateral should a credit event occur if the risk of default is high.[11] Likewise, in return for

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[5] *See* Richard R. Zabel, *Credit Default Swaps: From Protection to Speculation*, PRATT'S J. BANKR. L, SEPT. 2008, available at http://www.rkmc.com/Credit-Default-Swaps-From-Protection-To-Speculation.htm.
[6] *Id*.
[7] *Id*.
[8] *Id*.
[9] *Id*.
[10] *Id*.
[11] *See* Peter J. Wallison, *Everything You Wanted to Know about Credit Default Swaps – but Were Never Told*, Am. Enterprise Inst. For Pub. Pol'y Res., Fin. Services Outlook, 3 (December 2008), http://www.aei.org/files/2008/12/31/20090107_12DecFSOg.pdf.

protecting against a greater risk of default, Party B will frequently demand a higher premium payment from Party A to offset Party B's risks in case of a credit event.

Credit default swaps in this very simple example appear be like a form of insurance and, in a way, they began analogously by allowing one party to transfer risk to another party in return for the payment of a premium. This analogy is, however, a false perception that many will make without understanding the differences between insurance and credit default swaps. For example, a CDS does not have the same form of underwriting and actuarial analysis as does a typical insurance product. Rather, the value of the contract is openly negotiated by the two parties' analysis of the financial strength of the underlying credit asset.[12] In addition, insurance companies are subject to regulatory capital requirements, whereas parties engaging in CDS transactions are not.[13]

Credit default swaps are not regulated, but are sold in the "over-the-counter" derivatives market, meaning that arms-length transactions can be entered into freely by Party A and Party B without the need of an exchange or a clearinghouse. The "over-the-counter" market often involves a "broker" who brings together the two sides of a CDS contract and collects a fee for its services.[14] This role was originally performed by commercial banks; however, investment banks became ever more popular in brokering CDS transactions: as a market for CDS blossomed on the scene in which corporate bonds, municipal bonds and structured investment vehicles were becoming underlying assets in CDS transactions, this phenomenon significantly increased.[15]

B. The International Swaps and Derivatives Association (ISDA)

The ISDA is a trade association for over-the-counter derivatives dealers and other market participants.[16] The majority of ISDA's activities focus on the market for privately negotiated swaps contracts.[17] The ISDA to date is composed of more than 800 member institutions from 55 countries, which are classified into three categories described in the Association's by-laws.[18]

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[12] *See* Zabel *supra* note 5.
[13] *Id*.
[14] *Id*.
[15] *See id*.
[16] Sean M. Flanagan, *The Rise of a Trade Association: Group Interactions within The International Swaps and Derivatives Association*, 6 HARV. NEGOTIATION L. REV. 211, 228 (2001).
[17] *Id*.
[18] *Bylaws*, ISDA, October 18, 2011, https://www.isdadocs.org/membership/mem_nav.html.

The three categories of member institutions are 1) Primary (dealer firms), 2) Associate (service providers) and 3) Subscriber (end-users).[19] According to the Association's by-laws, every investment, merchant or commercial bank or other corporation, partnership or other business organization that, directly or through an affiliate, as part of its business (whether for its own account or as agent), deals in derivatives is eligible for election to membership in the Association as a Primary Member, provided that no person or entity participates in derivatives transactions solely for the purpose of risk hedging or asset or liability management.[20] The ISDA's Associate Membership category is designed for service providers- for example, brokers, law firms, accounting firms, consulting firms, exchanges and software providers- who are active in the privately negotiated derivatives business. Associate Membership provides a forum for these industry participants to stay abreast of and contribute to important developments and initiatives.[21] The ISDA's Subscriber Membership category is designed for corporations, financial institutions, government entities, and others who use privately negotiated derivatives to better manage financial risks. Subscriber Membership provides a forum for these industry participants to stay abreast of and contribute to important developments and initiatives.[22]

The ISDA corresponds with and appears before regulatory and legislative bodies in the United States and abroad to promote the over-the-counter derivatives industry and the interests of ISDA members.[23] The ISDA also has an educational role: it conducts conferences around the world and works with developing countries to structure financial markets in order to accommodate over-the-counter derivatives trading.[24]

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[19] *Id*.

[20] *Primary Membership*, ISDA, https://www.isdadocs.org/membership/primary.html (Primary members from the United States include several large institutions such as AIG, Bank of America, Merrill Lynch, Citigroup, Goldman Sachs, and Wells Fargo & Company, as well as others.

[21] *Associate Membership*, ISDA, https://www.isdadocs.org/membership/associate.html (United States associate members include the Chicago Board Options Exchange, Deloitte LLP, Ernst & Young LLP, Katten Muchin Rosenman, Kirkland & Ellis, KPMG LLP, McDermott Will & Emery LLP, and Pricewaterhouse Coopers).

[22] *Subscriber Membership*, ISDA, https://www.isdadocs.org/membership/subscriber.html (United States subscribers include American Express Company, Ameriprise Financial, Inc., Chevron Corporation, Commonwealth of Pennsylvania (Public School Employees' Retirement System), The Dow Chemical Company, Freddie Mac, Fannie Mae, Fifth Third Bank, Ford Motor Credit Company, GMAC Inc., Intel Corporation, John Hancock Financial Services, McDonald's Corporation, New York Life Insurance Company, Paulson & Co. Inc., Sallie Mae, and U.S. Bancorp).

[23] *See* Flanagan *supra* footnote 16 at 229.

[24] *Id*.

C. ISDA Master Agreements

One of the greatest accomplishments of by the ISDA was the development of standard form documentation for the over-the-counter derivatives industry.[25] This came by way of what the industry knows as the ISDA Master Agreement.[26] The significant impact of the Master Agreement is that it is more than just a simple contract between parties in one transaction; rather it provides the parties with the opportunity to engage in multiple transactions over a long period of time.[27] The Master Agreement sets out all terms and conditions (representations and warranties, obligations, definitions, events of default, etc.) that the parties would like to include in any future transactions between them as indicated by the parties in the schedule portion of the agreement.[28] Once the Master Agreement is signed, the parties need only send a confirmation (a mini-contract) spelling out what is being exchanged, at what price, in what currency, and on what date, along with any desired variances from the standard terms of the Master Agreement for the specific transaction being confirmed.[29]

With the Master Agreement in place and numerous transactions between two parties, should the parties wish to settle their contracts with one another, the Master Agreement sets forth a policy of "cross-transaction payment netting", which allows the parties to net their differences in a settlement of all contracts with one lump sum.[30] The net result of "cross-transaction payment netting" has been a reduction in transaction costs by eliminating the time and resources needed to settle each individual "mini-contract."[31] With these particular benefits of the Master Agreement, the speed and informality that define the vast transnational market in CDSs has yielded multimillion-dollar deals that were consummated over the telephone in a matter of minutes.[32]

D. The CDS Market from Creation to Boom

From their genesis in the mid-1990s, credit default swaps, although not technically an insurance contract, have been considered by many to be

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[25] *Id.*
[26] *Id.*
[27] *Id.* at 230.
[28] *See id.*
[29] *Id.* at 231.
[30] *See id.*
[31] *Id.*
[32] *See* Anna Gelpern, *Domestic Bonds, Credit Derivatives, and The Next Transformation of Sovereign Debt*, 83 CHI.-KENT L. REV. 147, 171 (2008).

a form of term insurance on the notional value of an outstanding bond.[33] By entering into a CDS, a commercial bank was able to shift its risk to a third party, and this shifted risk did not count against the bank's regulatory capital requirements.[34] In the late 1990s, several banks began selling CDSs to bond owners in order to mitigate the risks assumed for purchases of corporate bonds and municipal bonds.[35] As it turns out, JPMorgan was the first bank to make a big bet on CDSs, as it hired young math and science wizards from schools like MIT and Cambridge to create and market these complex financial instruments.[36] Since its inception, the CDS market has experienced dramatic growth, doubling in size each year between 2002 and 2007 - when it reached a peak of $62 trillion..[37]

Once the beast was created, banks like JP Morgan Chase had little use for CDSs, as Glass-Steagall[38] had only allowed 5% of revenues to be derived from investment banking activities such as dealing in CDS.[39] However, it was a very short time after the creation of CDSs when in 1996 the Federal Reserve reinterpreted Glass-Steagall to allow commercial banks to derive up to 25% of revenues from investment banking activities, allowing the proverbial floodgates of CDS trading to crack even further.[40] Three years later, the floodgates were blown wide open with the passage of the Gramm-Leach-Bliley Act,[41] which repealed the portion of Glass-Steagall that separated commercial banking, investment banking and insurance industries.[42] This congressional deregulation resulted in the

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[33] *See* Robert A. Jarrow, *The Economics of Credit Default Swaps*, The Johnson School Research Paper Series #31-2010, (Oct. 28, 2010) (unpublished manuscript), http://ssrn.com/abstract=1646373; *see also* Zabel *supra* footnote 5.
[34] *See* Zabel *supra* footnote 5.
[35] *Id*.
[36] *See* Matthew Philips, *The Monster That Ate Wall Street: How 'credit default swaps' – an insurance against bad loans – turned from a smart bet into a killer*, Newsweek, Sept. 2008, *available at* http://www.newsweekdailybeastreprints.com.
[37] Jeremy C. Kress, *Credit Default Swaps, Clearinghouses, and Systemic Risk: Why Centralized Counterparties Must Have Access to Central Bank Liquidity*, 48 HARV. J. ON LEGIS. 49, 54 (2011). The $62 trillion notional value of the CDS market almost matched Global GDP of $63 trillion according to World Bank estimates, available at http://siteresources.worldbank.org/DATASTATISTICS/Resources/GDP.pdf.
[38] The Banking Act of 1933 codified at 12 U.S.C. § 227 (upon its origination, Glass-Steagall prevented commercial banks from generating revenues from any investment bank activities).
[39] *See* Matthew Sherman, *A Short History of Financial Deregulation in the United States*, Ctr. for Econ. And Pol. Res., 9 (July 2009), http://www.cepr.net/documents/publications/dereg-timeline-2009-07.pdf, (noting that the Fed had reinterpreted Glass-Steagall to allow banks to derive up to 5 percent of gross revenues in investment banking business).
[40] *Id*.
[41] 15 U.S.C. §§ 6801-6809 (repealed a portion of the Glass-Steagall Act that drew lines of demarcation between commercial banking, investment banking, and insurance allowing for the creation of megabanks which can transact in any one of these industries).
[42] *Id*. at 10.

creation of megabanks and removed the lines of demarcation between the varying types of financial institutions. Banking, securities, and insurance operations could now all be merged, and there was no cap on the volume of trades that commercial institutions could make in the CDS market.[43]

The stage was now set for the CDS boom to take place, as numerous new parties became involved in the CDS market through the development of a secondary market for both the sellers and buyers of protection.[44] With the creation of the secondary market, speculation was beginning to run rampant. CDS buyers and sellers no longer were performing transactions that resembled insurance; rather, they were using the instrument to essentially "bet" on whether or not a credit event would occur on numerous different assets.[45] Another impact from a large influx of players in the secondary market was that some CDS contracts were believed to have passed through a chain of 10-12 different parties whose financial strength was undetermined. In some instances this resulted in an interconnected web that was very difficult to untangle upon the happening of a credit event.[46] As CDSs are typically customized between two parties in the ISDA Master Agreement Schedule, certain transactions were difficult to interpret. A common issue that occurred was trying to determine who would pay out the CDS protection when a credit event occurred, as risk was passed through several parties down the chain of CDS transactions involving the underlying asset.[47]

III. CAUSES FOR ALARM IN THE CREDIT DEFAULT SWAP MARKET

With the complexity of passing risk further down the chain, there runs greater risk of events with respect to fraud and mismanagement. Two particular events that led to the overwhelming concern about credit default swaps arose from transactions by two of the United States' largest financial institutions. The first of the two was orchestrated by New York based investment bank Goldman Sachs Co. (Goldman) and the second involved American International Group (AIG), whereby the "too-big-to-fail" insurance company realized over a $99 billion dollar loss in net income at the year-end of 2008.[48] .[49] These two events are clear examples of why

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[43] *Id*. at 10-11.
[44] *See* Zabel *supra* footnote 5.
[45] *Id*.
[46] *Id*.
[47] *See Aon Financial Products, Inc. v. Societe Generale,* 476 F.3d 90, 102 (2d Cir. 2007) (concluding that "[a]s a matter of law and under the unambiguous language of the Aon/SG CDS contract, no Credit Event occurred thereunder and SG therefore did not breach that agreement by declining to pay Aon thereunder", reversing the judgment of the district court and entering judgment in favor of SG).
[48] *See* American International Group, Inc., Annual Report (Form 10-K) (March 2, 2009) at 36.

credit default swaps must be placed in the purview of the public eye so they can be scrutinized for the possibilities of systemic contagion.

A. The SEC v. Goldman Sachs: Fraudulent CDS Activity[50]

In early 2007, U.S.-based Goldman Sachs (Goldman) created and sold ABACUS 2007-AC1 (ABACUS), a synthetic collateralized debt obligation (CDO) that was tied to the performance of residential subprime mortgaged-backed securities.[51] In 2006, Paulson & Co. Inc. (Paulson), a New York-based hedge fund, approached Goldman to discuss an investment strategy whereby both Goldman and Paulson would significantly benefit.[52] Paulson contacted Goldman after conducting its own research on Triple B-rated residential mortgage-backed securities (RMBS) that they believed would experience credit events.[53] In a lawsuit alleging fraud, the SEC claimed that Paulson and Goldman discussed creating a CDO that would allow Paulson to participate in selecting a portfolio of reference obligations and then short the portfolio by entering into a CDS with Goldman to buy protection on the CDO's capital structure.[54]

The SEC alleged that Goldman knew it would be difficult to sell a synthetic CDO if they disclosed that a short investor played a significant role in selecting the portfolio.[55] Goldman thereafter approached ACA Management LLC (ACA), an independent third-party expert in mortgage backed securities, and proposed it serve as the Portfolio Selection Agent for a CDO transaction that was to be sponsored by Paulson.[56] ACA met with Paulson and Goldman and selected a portfolio of 90 RMBSs that would comprise the ABACUS offering.[57] Throughout this time, the SEC alleged, neither Goldman nor Paulson had disclosed Paulson's intent to short the portfolio created.[58] According to the SEC, Goldman instead led ACA to believe that Paulson was to share an equity interest in the portfolio and was thus taking a long position along with the other ABACUS investors.[59]

The ABACUS portfolio was approved by ACA's Commitments Committee on February 12, 2007, naming ACA as the Portfolio Selection Agent in ABACUS.[60] Goldman thereafter continued developing marketing

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[49] *See* American International Group, Inc., Annual Report (Form 10-K) (March 2, 2009) at 36.
[50] *S.E.C v. Goldman Sachs & Co.*, 790 F. Supp. 2d 147, 150 (S.D.N.Y. 2011).
[51] *Id.*
[52] *Id.*
[53] *Id.*
[54] *Id.*
[55] *Id.*
[56] *Id.* at 151.
[57] *Id.*
[58] *Id.*
[59] *Id.*
[60] *Id.*

materials for the ABACUS RMBS portfolio, again failing to name Paulson as a party to the portfolio selection.[61]

In the following months, Goldman approached IKB, a German commercial bank, to whom they sold $150 million worth of ABACUS notes.[62] Within months of the closing, the ABACUS notes were worthless, and IKB allegedly lost almost all of its $150 million investment. The SEC claimed that most of this money ultimately went to Paulson by virtue of a CDS that a Paulson-affiliate entered into with a Goldman-affiliate.[63] In addition to IKB, Goldman had solicited numerous other institutional accounts to participate in the purchase of ABACUS.[64] The SEC alleged that IKB and other institutional investors would not have purchased ABACUS if they had known that Paulson participated in the portfolio selection process and was shorting the CDO via a CDS.[65]

In April 2007, ACA Capital Holdings, Inc. (ACA Capital), ACA's U.S-based parent company, purchased $42 million worth of ABACUS from Goldman.[66] These notes were also worthless within months, according to the SEC.[67] Furthermore, ACA Capital decided to take a long position on the ABACUS portfolio, selling $909 million of protection in a super senior tranche[68] of ABACUS.[69] At the same time, a Paulson-affiliate allegedly entered into a CDS with a Goldman affiliate to short the super senior tranche in ABACUS.[70] ACA Capital, just like ACA, was apparently unaware of Paulson's participation in the ABACUS portfolio creation, and the SEC alleged that ACA Capital would not have written the protection on the super senior tranche of ABACUS had it been aware that Paulson assisted in its development and took a short position on the CDO.[71]

The super senior transaction with ACA Capital was intermediated

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[61] *Id*. at 152.
[62] *Id*. at 153.
[63] *Id*.
[64] *Id*.
[65] *Id*.
[66] *Id*.
[67] *Id*.
[68] The Super Senior Tranche is a category of CDOs that consists of high quality financial paper with a very low risk exposure and the three credit rating bureaus typically rate this category as AAA. A Mezzanine Tranche is a category of CDOs that consists of financial paper that has middle risk exposure but generates a higher premium of return for greater risk assumed by the holder than the Super Senior Tranche category. Mezzanine Tranches are typically rated AA to BB by the three credit rating bureaus. The Equity (Junk) Tranche is a category of CDOs that the highest risk that commands a higher premium than the Mezzanine Tranche for the most risk assumed for the purchase of a CDO in this category. The Equity Tranche is rated the lowest of all tranches by the three credit rating bureaus. *See* Investorpedia, *available at* http://www.investopedia.com/articles/07/cdo-mortgages.asp#axzz1sG0Qvklo.
[69] *Id*.
[70] *Id*. at 154.
[71] *Id*.

by ABN AMRO Bank N.V. (ABN), a European bank.[72] Through a series of CDSs between ABN and a Goldman affiliate and between ABN and ACA Capital, ABN assumed the risk associated with the $909 million super senior portion of ABACUS's capital structure in the situation that ACA Capital became unable to pay.[73] Therefore, when ABACUS went bust, a Paulson-affiliate would collect from a Goldman-affiliate, Goldman's affiliate would collect from ACA Capital, and ACA Capital would collect from ABN, who was left with the ultimate obligation to fulfill the CDS payout.

With respect to the course of events above, the SEC brought charges against Goldman for securities fraud on April 16th, 2010. The first count of the SEC complaint alleged that Goldman violated Section 17(a) of the Securities Act[74] by (1) knowingly, recklessly, or negligently misrepresenting in the marketing, offering, and sale of ABACUS securities and security-based swap agreements that ACA selected the reference portfolio without disclosing Paulson's significant involvement in the selection process; and (2) knowingly, recklessly, or negligently misleading ACA into believing Paulson was investing in the equity of ABACUS, when in fact Paulson was taking a short position.[75] The second count of the SEC complaint alleged that those same acts by Goldman also violated Section 10(b) of the Exchange Act[76] and SEC Rule 10b-5.[77] The last count alleged that Fabrice Tourre, the executive who worked with Paulson to orchestrate all of the ABACUS transactions, aided and abetted Goldman's violations of Section 10(b) and Rule 10b-5 based on the same allegations in the second count.[78] [79]

Immediately after the SEC filed its complaint against Goldman, Goldman moved to dismiss the SEC's complaint in the ABACUS matter. The Southern District of New York began its analysis of the motion to dismiss by reviewing the second and third counts with respect to a violation of the Securities Exchange Act. The Court reviewed Goldman's interactions with IKB and ABN and found that the purchase and/or sale of ABACUS or the CDSs could not definitively have been made in the United States, and that the Exchange Act Section 10b and Rule 10b-5 do not apply

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[72] *Id*.
[73] *Id*.
[74] Securities Act of 1933, ch. 38, 48 Stat. 74 (current version at 15 U.S.C. § 77a (1982)).
[75] *Id*.
[76] The Securities Exchange Act of 1935, codified at 15 U.S.C.A. § 78j(b)(2011).
[77] *Id*.
[78] *Id*.
[79] Tourre was charged with all 3 counts; however, Goldman is held liable for Tourre's conduct under a theory of respondeat superior. *See generally* Restatement (Third) of Agency, § 7.03 (2006).

extraterritorially.[80] The Court, however, did deny the motion to dismiss with respect to ACA Capital, noting that the SEC had plead sufficient facts to charge Goldman and Tourre with violations of section 10b of the Securities Exchange Act and Rule 10b-5 for omitting the fact that Paulson was a party to the ABACUS selection process. The court noted that the SEC had displayed sufficient evidence to show that Paulson was shorting the ABACUS portfolio and held that Tourre had a duty to inform ACA Capital of Paulson's interests.[81]

As for the first count alleging violation of section 17(a) of the Securities Act, the court found that even though IKB and ABN did not definitively complete a transaction within the United States, the statute still applies to "offers" inside the United States.[82] The court granted the motion to dismiss with respect to IKB and ABN for "sales", but found sufficiently plead facts by the SEC with regard to the offers made to IKB and ABN to purchase the ABACUS CDO or CDSs. Section 17(a), therefore, still applied to these transactions.[83] The court denied the motion to dismiss the section 17(a) violations regarding both offers and sales between Goldman and ACA Capital.[84]

The net result of this litigation was a $550 million settlement that Goldman Sachs agreed to pay. Of this amount, $300 million was paid in a fine to the United States Treasury, $15 million was paid in disgorgement of profits, and the remainder went to compensate the injured parties.[85] The settlement was considered one of the largest ever in the history of the SEC.[86] Goldman refused to settle the case if the judicial order barred it from committing intentional fraud in the future under federal securities laws.[87] This case illustrates why an eyebrow should be raised with respect to parties engaging in CDSs. There would be much less incentive to defraud players in the market if the CDS market were subject to a regulatory body. A regulatory body could have made Paulson's CDSs public and provided greater transparency to the happenings concerning the ABACUS portfolio. With greater transparency of CDS transactions, Paulson would have been exposed to ACA Capital, IKB, and ABN when he shorted the ABACUS portfolio, as this information would have been made public. ACA Capital, IKB, and ABN would then likely have not

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[80] 790 F. Supp. 2d 158-161; *see also Morrison v. National Australia Bank Ltd.*, 130 S. Ct. 2869, 2881 (2010).
[81] 790 F. Supp. 2d at 166.
[82] 790 F. Supp. 2d at 164.
[83] 790 F. Supp. 2d at 166.
[84] *Id.*
[85] Sewell Chan & Louise Story, *Goldman Pays $550 Million to Settle Fraud Case*, N.Y. Times, July 15, 2010.
[86] *Id.*
[87] *Id.*

purchased the ABACUS CDO or held a long CDS position on the portfolio and this would have avoided a cause for alarm with respect to fraudulent behavior in CDSs transactions.

B. The American International Group (AIG) Bailout

On February 28, 2008, AIG,[88] then the largest insurance company in the United States, announced earnings of $6.20 billion.[89] Several months thereafter, AIG was on the edge of bankruptcy, and the United States government bailed out AIG with an $85 billion loan.[90] A primary reason for the "too-big-to-fail" bailout was AIG's interconnectedness throughout the financial markets.[91] AIG's CDS business had exposed it to risks unknown to AIG in its economic models, leading to a major cash crunch as AIG found itself unable to meet its CDS obligations, among other obligations.[92]

AIG conducts its CDS business through subsidiaries - AIG Financial Products Corp. and AIG Trading Group, Inc. - and their respective subsidiaries, all of which cumulatively make up AIGFP.[93] AIG guarantees all present and future payment obligations and liabilities of AIGFP arising from transactions entered into by AIGFP.[94] AIGFP's CDS business consisted primarily of selling credit protection on "super senior" risk tranches of diversified pools of loans and debt securities when AIG first entered the CDS market.[95] The financial assets that made up these asset-backed securities usually consisted of commercial loans, residential mortgages, credit card receivables, student loans, and other similar assets.[96] The super senior tranche was rated AAA by the different credit rating agencies and was perceived to be a very safe investment for any investor,

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[88] *See* William K. Sjostrum, Jr., *The AIG Bailout*, 66 WASH. & LEE L. REV. 943, 945 (2009). (AIG is a holding company which, through its subsidiaries, is engaged in a broad range of insurance and insurance related transactions in the United States and overseas. AIG operates in over 130 countries and almost half of its revenues are from foreign transactions. Its principal business units are General Insurance, Life Insurance & Retirement Services, Financial Services, and Asset Management).

[89] Press Release, American International Group, Inc., AIG Reports Full Year and Fourth Quarter Results (Feb. 28, 2008), available at http://idea.sec.gov/Archives/edgar/data/5272/000095012308002282/y5050exv99w1.htm.

[90] *See* Credit Agreement Between American International Group, Inc. and Federal Reserve Bank of New York § 4.12 (Sept. 22, 2008), available at http://www.sec.gov/Archives/edgar/data/5272/000095012308011496/y71452exv99w1.htm.

[91] *See* Press Release, The Federal Reserve Board (Sept. 16, 2008), *available at* http://www.federalreserve.gov/newsevents/press/other/20080916a.htm (elaborating on the need for federal intervention to avoid systemic chaos).

[92] *Id*.

[93] *See* Sjostrum *supra* footnote 88 at 952.

[94] *Id*.

[95] *Id*.

[96] *Id*. at 953.

especially because the senior tranche was always the first to be paid and the last to suffer a loss.[97]

AIG defined the "super senior" tranche "as the layer of credit risk senior to a risk layer that has been rated AAA by the credit rating agencies, or if the transaction is not rated, equivalent thereto."[98] On December 31, 2007, AIGFP had a booked net notional value of $527 billion of protection on outstanding super senior securities backed by the asset types mentioned above.[99] Interestingly enough, $379 billion of AIGFP's protection portfolio was written to provide European lenders "regulatory capital relief".[100] Apparently, the European lenders were skirting international regulations known as the Basel Accords,[101] which required lenders to have certain amounts of cash on hand to cover potential losses. These lenders used CDSs to give the appearance that they had off loaded the risk to AIG, and the cash requirements turned into additional lending assets within the Basel framework.[102]

Unbeknownst to AIG, AIGFP honestly believed that their CDS investment risk model was a "Golden Goose" that was cranking out golden eggs at a remarkable rate. One former AIGFP senior executive characterized writing CDSs as "gold" and "free money", because AIGFP's risk models indicated that the underlying securities were never going to default; ergo, the company would simply collect premium payments and would never have to pay a CDS settlement.[103] This behavior is indicative of the bullishy long position AIG took in CDS transactions that would eventually almost burn the organization to the ground.

In an effort to accumulate even higher premiums, AIG decided to further leverage its AAA credit rating and trillion dollar balance sheet and entered into long position CDSs on multi-sector CDOs classified as "high grade" and mezzanine tranches, where the risks were greater.[104] AIG

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[97] *Id*. at 954.
[98] *Id*. at 955.
[99] *See id*.
[100] *See id*. at 956.
[101] *See* Joe Larson, *The Basel Capital Accords*, The Univ. of Iowa Ctr. for Int'l Fin. & Dev., 1-2 (2011), http://ebook.law.uiowa.edu/ebook/sites/default/files/Basel%20Accords%20FAQ.pdf (The Basel Committee on Bank Supervision (BCBS), entrusted with the role as international advisor on bank regulation, has promulgated guidance on issues critical to ensuring health in the banking systems across the world. One such issue, and one that played an important role in the recent global financial crisis, is the regulation of bank capital. Addressing this issue has been an ongoing process for the BCBS over the past twenty years, and has resulted in the promulgation of capital adequacy standards that national regulators can implement. These standards are known collectively as the Basel Accords, named after the city in Switzerland where the BCBS resides).
[102] *See* David Henry et al., *A Lethal Loophole at Europe's Banks*, Business Week, Oct. 23, 2008.
[103] *See* Carrick Mollenkamp et al., *Behind AIG's Fall, Risk Models Failed to Pass Real-World Test*, Wall Street Journal, Nov, 2008.
[104] *See* Sjostrum *supra* Footnote 88 at 959.

unfortunately had $61.4 billion in net notional CDS value on its books when the subprime market fell apart, and these "high grade" and mezzanine tranches turned out to consist of multiple CDO's that had consumed the subprime toxic pill.[105] In September of 2008, the phone began to ring from counterparties and the cash crunch was soon to follow.[106] AIGFP was obligated to post more and more cash collateral as the CDO values tanked, and AIGFP at first complied.[107] With the next round of calls from counterparties for more collateral, however, AIG was staring down the barrel of bankruptcy.[108]

Shortly thereafter, the credit rating agencies took action and downgraded AIG's long-term debt rating. S&P knocked AIG down three rungs, and Moody's and Fitch reduced its rating by two.[109] With the credit downgrade, AIG was now forced to post an additional $20 billion dollars in additional collateral because the CDSs took into account AIG's credit rating as well.[110] The day after the downgrade, AIG made a last ditch effort to raise additional financing with other local financial institutions - namely, Goldman Sachs, J.P. Morgan, and the New York Federal Reserve. The parties discussed the possibility of putting together a $75 billion loan in which each would take part.[111] The effort was to no avail, and as a result, the federal government interceded with the "too-big-to-fail" bailout.[112]

Federal Reserve Banks do not ordinarily lend money to institutions that are non-depository.[113] In this instance, the Federal Reserve acted under its section 13(3) powers granted under the Federal Reserve Act,[114] which allows the Fed to lend to non-depository institutions in "unusual and exigent circumstances".[115] Prior to the AIG bailout, no such lending had occurred since the 1930s.[116] Explaining the need for federal intervention, the Wall Street Journal noted that "AIG's tentacles were spread throughout the financial system, making it almost impossible to be certain about the impact of a collapse other than to know it was potentially catastrophic."[117]

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[105] *See id*. (Toxic pills are assets within CDOs that carry low to moderate risk whereby the asset's value significantly drops and the overall value of the CDO drops with the asset).
[106] *See* Carol J. Loomis, *Derivatives: The Risk that Still Won't Go Away*, CNN Money, June 24, 2009, *available at* http://money.cnn.com/2009/06/22/news/economy/derivatives_regulation_risks.fortune/index.htm.
[107] *Id*.
[108] *See id*.
[109] *See* Sjostrum *supra* footnote 88 at 962.
[110] *Id*.
[111] *Id*. at 963.
[112] *Id*.
[113] *See* Sjostrum *supra* footnote 88 at 976.
[114] 12 U.S.C. § 248(r)(2)(A)(ii)(I)(2011).
[115] *Id*.
[116] *Id*.
[117] Monica Langley et al., *Bad Bets and Cash Crunch Pushed Ailing AIG to Brink*, Wall Street Journal, September 18, 2008.

Another immense concern was that AIG was one of the 10 most widely held stocks in 401(k) retirement plans. Its collapse could potentially cause a run on mutual funds.[118] No one could predict how far the bottom was for the financial system if AIG filed for bankruptcy, but what was certain was that the federal government was not willing to assume the risk of a financial calamity that could possibly result in the utmost systemic failure.

IV. SHOULD CREDIT DEFAULT SWAPS BE REGULATED AS INSURANCE?

"If it looks like a duck, swims like a duck, and quacks like a duck, then it probably is a duck" seems to be a test that would resemble what most think of when they refer to CDSs as insurance. If only the world of finance were simple enough that the "duck test" would apply. This is not the case, however, and this section will address scholars' vigorous debate over whether or not CDSs are indeed a form of insurance. The distinguishing characteristics between CDSs and insurance discussed in this section are critical to understand as regulatory bodies create laws and allow for the sale and purchase of the different instruments in completely different ways.

A. Arguments for Credit Default Swaps to be Regulated as Insurance

The portion of Glass-Steagall Act separating commercial banking, investment banking and insurance was repealed and Gramm-Leach-Bliley merged these industries creating megabanks. Under these circumstances, it is prudent to examine whether or not CDSs are or should technically be classified and regulated as insurance. Regardless of whether or not CDSs are classified as investment banking derivatives or insurance contracts, the megabanks would still be able to partake in CDS transactions; however, the regulatory impacts are quite significant.

Black's Law Dictionary defines insurance as "[a] contract by which one party (the insurer) undertakes to indemnify another party (the insured) against the risk of loss, damage or liability arising from the occurrence of some specified contingency, and to defend the insured or to pay for a defense regardless of whether the insured is ultimately found liable."[119] The principal argument in favor of treating CDSs like insurance is that contracts can create moral hazard similar to traditional insurance, and should thus be regulated as such.[120] Moral hazard can be defined as

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[118] Eric Dash & Andrew Ross Sorkin, *Throwing a Lifeline to a Troubled Giant*, N.Y. Times, Sept. 18, 2008.

[119] *Black's Law Dictionary* 870 (9th ed. 2010).

[120] Arthur Kimball-Stanley, *Insurance and Credit Default Swaps: Should Like Things Be Treated Alike?,* 15 CONN. INS. L.J. 241, 246 (2008).

activity that reduces incentives to protect against loss or minimize the cost of loss.[121] Insurance was created to counter moral hazard and aims to do nothing more than reimburse.[122] If a buyer of insurance could collect more than the property's worth, that additional amount would not be based on an insurable interest[123] and the moral hazard doctrine attempts to avert that which would not be fully mitigated.[124]

Financial products that transfer wealth in the event of a loss give the buyer an incentive to bring about that loss, often in spite of external societal costs.[125] A CDS potentially creates such an incentive or moral hazard since it creates rewards when bad things such as bankruptcies or foreclosures occur.[126] University of North Carolina Professor Thomas Lee Hazen posed a very important question essentially asking whether CDSs should be excluded from insurance regulation when it is difficult to understand that insurance be regulated as it is while CDS are unregulated - but both cause moral hazard?[127] Professor Hazen noted that the disparity between what insurance is and what a CDS is should be narrowed, and suggested that there is good reason to treat CDSs more like insurance because there are greater risks of moral hazard if CDSs are unregulated.[128]

In a 2003 article, The National Association of Insurance Commissioners (NAIC) weighed in on the topic of treating weather derivatives (another form of derivative, but the logic can be extended to credit default swaps) like insurance contracts.[129] The NAIC study noted that businesses that accept risk transfers for a fee are generally known as *insurers*, and the fee paid by the entity seeking to transfer risk is comparable to an insurance premium.[130] The NAIC opined that many parties that are engaged in derivatives trading go to great lengths to avoid using language in their contracts that would suggest that they are offering and selling insurance.[131] The NAIC's contribution to the debate suggests that the parties transacting in derivatives such as CDSs in fact know that

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[121] *Id*. at 258.
[122] *Id*. at 260.
[123] *See Black's Law Dictionary*, 886 (9th Ed. 2010) (A legal interest in another person's life or health or in the protection of property from injury, loss, destruction, or pecuniary damage).
[124] *Id*.
[125] *Id*.
[126] *Id*.
[127] *See* Thomas Lee Hazen, *Disparate Regulatory Schemes for Parallel Activities: Securities Regulation, Derivatives Regulation, Gambling and Insurance*, 24 ANN. REV. BANKING & FIN. L. 375, 426 (2005). (Professor Hazen also discussed the ability for individuals to circumnavigate insurance regulation by entering into CDSs in an unregulated market in the alternative to purchasing an insurance contract).
[128] *Id*.
[129] *See* Kimball-Stanley *supra* footnote 120 at 250.
[130] *Id*.
[131] *See id*. (For example, many traders of CDSs refer to monthly or quarterly payments for CDS protection as fees rather than premiums in their CDSs).

they are buying and selling insurance, but are skirting regulation by carefully crafting their agreements.

Assuming for the sake of argument that CDSs do in fact have a moral hazard effect, what are some of the moral hazard implications that have or do occur when parties trade in CDS contracts? As previously discussed, the case of SEC v. Goldman[132] is a resounding example that illustrates a moral hazard issue. Goldman and their accomplice Paulson, who was never named in the original complaint, (nor, to the author's knowledge, has the SEC filed a complaint against Paulson or his hedge fund Paulson & Co.), teamed together to create, offer and sell what they allegedly knew were toxic securities to market players. Both SEC and Goldman also allegedly made millions of dollars in fees and by shorting the investments that the two organizations colluded to create.[133] The moral hazard created in the case derives from the underlying behavior that both Goldman and Paulson demonstrated in order to make profits on the losses of not only the parties buying the securities and the parties trading credit default swaps, but also of the market as a whole.

The net result was market-wide injury, resulting in a lack of confidence in the products bought and sold by investment banks as well as the specific monetary damages suffered by ABN, IKB, and ACA Capital.[134] In theory, Paulson would have had no incentive to short ABACUS if CDS were sold as insurance contracts, as it would have been unable to make profit on the loss suffered from the tanking investment portfolio. Hence, he would never have approached Goldman to create the toxic ABACUS, and moral hazard would have been avoided.

Another example of how moral hazard could be avoided if CDSs were considered and regulated as insurance is when truck frame supplier Tower Automotive declared bankruptcy in 2005.[135] Although not certain, there was some evidence to suggest that hedge funds that purchased Tower's debt (so Tower would avoid bankruptcy) were likely speculating with CDS transactions that Tower would fail and were profiting off short CDS positions on a Tower bankruptcy.[136] The hedge funds denied Tower any additional capital infusion and, without any additional loans, Tower was forced to file for Chapter 11 bankruptcy.[137] Hedge funds are private companies that do not have to file SEC reports so long as they have no more than one hundred investors and do not engage in making public offers of their securities;[138] therefore, it is difficult to determine whether or not

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[132] *See supra* IIA.
[133] *See* discussion *supra*.
[134] *Id*.
[135] Kimball-Stanley *supra* footnote 120 at 253.
[136] *Id*.
[137] *Id*.
[138] *See* 15 U.S.C. § 80a-3(3)(c)(1)(2010).

these hedge funds refused to extend additional credit in order to profit on back-end CDSs. However, it is relevant to point out that many bankruptcy judges have witnessed strange courtroom behavior with respect to creditors such as the hedge funds in Tower's case, as some creditors have complained of the bankruptcy estate as being valued "too high", preventing a creditor from collecting a settlement on a short CDS contract that specified a valuation limit for the bankrupt as the reference entity.[139] Although the moral hazard in Tower's case cannot technically be placed upon the hedge funds' actions, suffice it to say that the facts do at least signal the moral hazard issue with respect to their denial of additional lending and risking a nominal return on their purchase of Tower's debt in bankruptcy.

These two situations raise the question: should CDSs exist as derivatives at all, or should they find a home under the guise of insurance? The doctrine of insurable interest invalidates insurance contracts in which buyers have no interest in the insured entity.[140] If moral hazard doctrine were applied to CDSs and CDSs became an insurance product regulated by the insurance industry, falling under state insurance laws, therein lies a strong argument for the prevention of negative economic interests and the elimination of the potential profit from the destruction of value to the market and society as a whole.[141] Purchasers of CDS contracts would no longer be able to influence the default of the underlying asset and any activity that would lead to such a result would be considered fraudulent under state insurance law.

B. Arguments Against Credit Default Swaps to be Regulated as Insurance

There are many arguments as to why CDSs are unlike and are not, in fact, insurance, but merely possess certain characteristics that are synonymous with what we know as insurance. As it stands, with the passage of the Gramm-Leach-Bliley Act, if a credit default swap relates only to loan or other debt obligations, then it qualifies as a non-security-based swap agreement.[142] Furthermore, so long as CDS agreements are drafted to avoid 1) being characterized as contingent options on debt securities and 2) physical delivery of securities, they will fall under the exemption for security-based swap agreements and remain free from SEC regulation.[143]

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[139] *Id*. at 254.
[140] *See* Kimball-Stanley *supra* footnote 120 at 258.
[141] *See id*. at 261.
[142] Robert F. Schwartz, *Risk Distribution in the Capital Markets: Credit Default Swaps, Insurance and a Theory of Demarcation*, 12 FORDHAM J. CORP. & FIN. L. 167, 172 (2007).
[143] *Id*.

The first consideration that must be paid to the debate for CDSs to remain a derivative and not fall under insurance regulation is that over-the-counter CDSs do not necessarily go unregulated. Rather, they are in fact self-regulated by market participants who have banded together to create the ISDA.[144] When issues occur in the CDS market, the ISDA responds to issues through publication of its protocols.[145] These protocols are ISDA-written contract amendments that allow Master Agreement adherents to respond to market disturbances in a unified way.[146] The ISDA also produces CDS Index Protocols, whereby a protection buyer and protection seller can determine the appropriate terms of their agreement if the reference entity is a company listed on a credit derivatives index. This allows for a price discovery function between the parties and for the reduction in settlement issues.[147]

With respect to state insurance law, on October 19, 2004, New York's legislature adopted an amendment to the state's insurance laws declaring that: "the making of [a] credit default swap does not constitute the doing of an insurance business.[148] The New York legislature went on to define what a CDS contract is:

> "An agreement referencing the credit derivative definitions published from time to time by the [ISDA] or otherwise acceptable to the superintendent, pursuant to which a party agrees to compensate another party in the event of a payment default by, insolvency of, or other adverse credit event in respect of, an issuer of a specified security or other obligation; provided that such agreement does not constitute an insurance contract and the making of such credit default swap does not constitute the doing of an insurance business."[149]

As the New York statute implies, CDS are not insurance – a notable affirmation in that the vast preponderance of CDS contracts indicate New York as the juridiction.

So what characteristics differentiate CDSs from insurance? Author Robert Schwartz identifies several major differences.[150] The first is in

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[144] *See supra* at III; *see also* Schwartz *supra* footnote 143 at 171.
[145] *See* Schwartz *supra* footnote 143 at 180.
[146] *Id*.
[147] *Id*.
[148] *See* Kimball-Stanley *supra* footnote 143 at 252.
[149] *See* Schwartz *supra* footnote 143 at 183; *See also* N.Y. Ins. Law § 6901(j-1); 2004 N.Y. Sess. Laws Ch. 605 (S. 6679-A) (approved and effective Oct. 19, 2004).
[150] *See* Schwartz *supra* footnote 143 at 199-200.

regard to the property for which the contract can extend coverage. Insurance covers the property of someone that has incentive to protect from risk of loss, destruction, or pecuniary damage subject to an insurable interest, while CDSs can only extend coverage on the reference entity that is not subject to an insurable interest.[151] The second difference is the extent to which the contract purchaser can transfer the contract. In asymmetrical negotiations, insurance contracts are typically non-transferrable unless, in seldom cases, the insurer approves the transfer, while in symmetrical negotiations between parties CDS traders can easily transfer the contract upon novation by the parties.[152]

A third line of demarcation lies wherein insurance contracts require that an actual loss must occur in order for the insured to recover, while CDSs stipulate only that a credit event must occur while no actual loss to the protection purchaser is required to recover under the contract.[153] As for how recovery takes place, insurance requires a two-step process whereby the insured must provide 1) a notice of loss, followed by 2) a proof of loss; in contrast, all that is needed to recover under a CDS contract is a Credit Event Notice, which is sent to the protection seller counterparty.[154] With regard to the measure of recovery, insurance must apply the principle of indemnity, and the actual cash value, original price paid or replacement value is used to compensate the insured for the loss. CDSs are not subject to the principle of indemnity and the recovery is the amount specified in the settlement terms, valuation metrics, deliverable obligations and all are in relation to the reference entity.[155] Lastly, in the asymmetrical realm of insurance, no market makers and indices exist to serve both buyers and sellers, whereas the opposite is true for parties to a CDS.[156]

To conclude the argument for why CDSs should not be subject to insurance laws, observers note that the capital markets are often very efficient at distributing risk. Insurance companies are more often targeting ordinary consumers to purchase insurance products. In the case of CDS contracts, the two parties of the agreement are sophisticated market players. The latter have the capacity and the resources to perform proper valuations and due diligence on the reference entity to know how much collateral should be posted and what CDS spread to assume.

As the issue stands, neither the federal government nor many States consider CDSs to be insurance contracts. If they were considered insurance contracts, several changes would be required, such as mandating that

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[151] *Id*.
[152] *Id*.
[153] *Id*.
[154] *Id*.
[155] *Id*.
[156] *Id*.

traders be issued a license, subjecting protection sellers to meeting certain regulatory capital requirements, and, in the case of a recovery by the protection buyer, subjecting the protection seller to State insurance regulatory oversight.[157] Such a paradigmatic shift would most certainly cause calamity in the CDS market, especially for speculators who make "side bets" with other parties. Speculators would no longer be able to short a reference entity without being a party with an interest in the underlying asset, as insurance doctrine mandates.

Considering both how large the CDS market is today as well as the actual benefits the CDS can provide (for example, additional liquidity in the primary market for those who would have a difficult time finding a creditor whom would assume the risk to lend without credit default swaps), a complete overhaul from unregulated derivatives to insurance is unwarranted. This is not to say that some of the insurance regulatory requirements would not be beneficial in maintaining a more stable CDS market (i.e. licensing or capital requirements). Some will argue that implementing these requirements will increase transaction costs and drive players out of the market. Others will argue that these requirements will result in the removal of liquidity from the financial system. However, these simple remedial tools can have significant benefits to the CDS market with greater confidence in CDS trades, more transparency to players in the market and a better understanding of systemic risks for greater sustainability.

V. DODD-FRANK AND CDS MARKET CHANGES

After the bankruptcy at Lehman Brother's and AIG's "too-big-to-fail" bailout,[158] public outrage cried for additional forms of regulation of Wall Street Financial institutions. The Dodd-Frank Act[159] encompasses numerous statutory requirements that are to be placed upon Wall Street, most of which are far beyond the scope of this article. However, Dodd-Frank enacted some legislation regarding CDS trading, however, Dodd-Frank does not go far enough.

A. Dodd-Frank CDS Regulatory Reform

Title VII of the Dodd-Frank Act has impacted the CDS market in the following ways: 1) all major players are required to have adequate capital to enter the market to sustain their potentially huge obligations; 2) almost all CDSs are required to be collateralized by the counterparties; 3)

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[157] *See* Kimball-Stanley *supra* footnote 120 at 251; *see also* Zabel *supra* footnote 5.
[158] *See supra* at IIIB.
[159] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 (2010).

almost all CDSs must be guaranteed and properly margined by clearing facilities, which in turn, are subject to strict federal regulation and oversight; 4) all CDS transactions must be publicly recorded and in most cases traded on a public exchange or in an exchange-like environment; and 5) the CFTC, the SEC, and the members of the Financial Stability Oversight Council collectively impose full transparency on CDSs, with an eye open to the potential for systemic failure.[160]

Additional oversight measures enacted in Dodd-Frank place the Federal Reserve Board of Governors in primary control over the trading institutions in the CDS market.[161] The Financial Stability Oversight Council (FSOC), created by Dodd-Frank, is the Congressional body charged with the responsibility of overseeing the Federal Reserve's operations. The FSOC offers its recommendations to the Federal Reserve Board of Governors regarding CDS activity and the Board of Governors must supply a report to the FSOC to keep the Council apprised of CDS regulatory activity.[162]

Dodd-Frank also created a new threshold for non-banking and banking entities to enter the CDS market. The legislation has set a floor of $50 billion of capital on hand to participate in CDS trading activity.[163] The $50 billion threshold will now also take into account any off balance sheet activities that a CDS trading financial institution conducts for the purposes of determining capital on hand.[164] The Board of Governors has the right to request reports from CDS trading institutions called "stress tests" to determine whether such companies have the capital, on a total consolidated basis, necessary to absorb losses as a result of adverse economic conditions.[165] These stress tests are created by several federal agencies, including the Board of Governors, the CFTC, the SEC, and the Federal Depository Insurance Corporation.[166] In an effort to provide greater transparency, the Board of Governors is required to make public its findings under the stress tests conducted.[167]

One of the more stringent requirements Dodd-Frank will place on financial institutions in regard to CDS trading is a limitation on credit exposure to any unaffiliated company that exceeds 25% of all capital stock

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[160] Implementing Dodd-Frank: A Review of the CFTC's Rulemaking Process Before the H. Comm. on Agric. Subcomm. on Gen. Farm Commodities and Risk Mgmt, 112th Cong. 3 (2011) (Testimony of Michael Greenberger, Law Professor, University of Maryland School of Law).
[161] 12 U.S.C. § 5465(a)(2010).
[162] 12 U.S.C. § 5325(a)(2010).
[163] 12 U.S.C. § 5325(a)(2)(B)(2010).
[164] 12 U.S.C. § 5365(k)(1)(2010).
[165] *See* 12 U.S.C. § 5365(i)(1)(A)(2010). (CDS protection selling is considered a form of credit exposure, therefore, CDS trading financial institutions cannot sell an unaffiliated company CDS protection greater than 25% of its capital stock and surplus).
[166] 12 U.S.C. § 5365(i)(2)(C)(2010).
[167] 12 U.S.C. § 5365(i)(1)(B)(v)(2010).

and surplus.[168] This level can be lessened by the Board of Governors at any time should the Board see fit.[169] Dodd-Frank defines credit exposure so as to include all guarantees, acceptances, or letters of credit (including endorsement or standby letters of credit) issued on behalf of the CDS trading company and all purchases of or investment in securities issued by the company.[170] CDSs, whether on the books or off the books, no longer will be hidden from the purview of the public and will be factored into the Board's considerations on capital requirements.

As previously noted, one of the biggest changes Dodd-Frank makes in the over-the-counter CDS market is the requirement that CDSs be traded through centralized counterparties (CCP) or clearinghouses.[171] This requirement changes the current operation of CDS contracts, whereby two parties enter into a bilateral agreement, by adding a third party (the CCP) who acts as a middleman. The CCP enters into two separate contracts with each of the counterparties.[172] This mechanism is believed to reduce systemic risk by netting offsetting exposures and mutualizing counterparty risk among all the members of the CCP.[173] This method centralizes the credit exposure to the single entity, which is the CCP and disperses the risk throughout its membership.[174] Only the member firms of the CCP are able to trade and should a non-member firm wish to enter into a CDS trade, it would have to have the trade cleared through a member firm.[175] CCPs also have very strict collateral requirements, where even AAA-rated trading firms will be required to post significant amounts of capital. In the bilateral agreement system, by contrast, they were in some cases not required to post any collateral at all.[176]

Although the CCP mandate promises benefits of reductions in counter-party risk through netting and loss mutualization, there are some potential drawbacks to consider. Using a CCP will, for example, lead to greater centralization, raising concern of centralized systemic risk.[177] If the CCP were to fail, there would be immediate and severe consequences to the

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[168] 12 U.S.C. § 5365(e)(2)(2010).
[169] *Id*.
[170] 12 U.S.C. § 5365(e)(3)(C-D)(2010).
[171] *See* 12 U.S.C. § 5464(a)(1)(A)(2010).
[172] *See* Jeremy C. Kress, *Credit Default Swaps, Clearinghouses, and Systemic Risk: Why Centralized Counterparties Must Have Access to Central Bank Liquidity*, 48 HARV. J. ON LEGIS. 49, 61 (2011).
[173] *Id*. (In the event that a default should occur and a CDS transaction is under-collateralized, the CCP can pay out the total amount of the protection seller's contract even though the protection seller does not have the capital to cover the contract settlement. This is done by charging fees to all members in the CCP to start a fund for default settlements and aggregating the risk of default settlement among the members via this mechanism).
[174] *Id*. at 62.
[175] *See id*. at 63.
[176] *See id*.
[177] *See id*. at 71.

financial system.[178] This classifies the CCP as a "too big to fail" banking institution, which was the issue at hand when Dodd-Frank was drafted.[179] This issue comes into play when considering the number of CCPs that would be available for members to join and engage in transactions. If CCPs were to compete with one another to attract additional members to increase the volume of trades, then the risk of competition may very well lead to reductions in collateral requirements, default fund contributions, and the acceptance of lower margins that would take away from net operating income.[180] If a CCP decides to run too thin in any of these areas, then it is at greater risk of defaulting in CDS transactions. Therefore the problem of systemic risk (which was the underlying premise for the CCP mandate) is imminent and a bailout from the Federal Reserve will most likely ensue.[181]

Although the Dodd-Frank Act has been passed and enacted, the above mentioned regulations will not have any effect on CDSs in existence before the statute was passed or on those CDSs that were executed prior to the final rules promulgated by the CFTC.[182] Currently, there has been little change that has taken place in the CDS market from the 2008 financial crisis and the same systemic risks related to CDSs still linger as they previously did right before the "great recession".

B. Does Dodd-Frank Go Far Enough?

As mentioned, Dodd-Frank has not changed the CDS market significantly. Therefore, Dodd-Frank, has not fulfilled its purpose of protecting market players and the public at-large from the systemic risks associated with the CDS trading behaviors that led to the panic and crisis in 2008. Upon its passage on July 21, 2010, Dodd-Frank should have mandated several steps that could be accomplished within the two years after its passage. By July 21, 2012, a licensing requirement should have been developed and imposed on the traders in CDSs transactions. In an interview with, James Fadel, a Certified Financial Analyst (CFA) and Senior Investment Manager at the Marco Consulting Group, for example, Mr. Fadel used an analogy to help explain the magnitude of risk when trading CDSs, stating, "When dealing in credit default swaps, the transaction needs to be handled much like that of handling a firearm, because if used properly it can offer security in times when it is most needed, however, if abused, it can lead to catastrophic results and kill an

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[178] *Id*. at 72.
[179] *See id*.
[180] *See id*. at 74.
[181] *See id*.
[182] *See* Greenberger Testimony *supra* footnote 160 at 4.

innocent bystander or the individual himself."[183] AIG most certainly mishandled the firearm and would have certainly slain itself if not for Dr. Bernanke and the Federal Reserve using taxpayer dollars to perform emergency surgery on the flailing giant.[184]

Licensing offers an educational requirement at the very level that needs it most and that is with traders themselves. The systemic risks of poor transactions can be brought to the forefront by mandating this requirement and traders will be forced to at least consider the possibility of moral hazard that is associated with mishandling their transactions.

Another point where Dodd-Frank fails is that it does not address the increased systemic risk concerns with CCPs, as CCPs maintain their own capital requirements and margins. As previously noted, CCPs may run margins too thin or lower sustainable capital requirement, resulting in in a bailout in the course of a serious default of large member institutions. The increased interconnectedness CCPs will have with their member institutions may have a greater detrimental impact to the financial system should these phenomena occur. Dodd-Frank should have also developed a tax structure built into trading that sets up a fund in cases of emergency so as to avoid the need for additional taxpayer dollars to bail out the CCP in a case of "unusual or exigent circumstances".[185] Why should American tax payers pay the tax for the security of those who want to make CDS trades, when it is the players in the game that are the ones want the game to exist?

As a simplistic analogy, a young boy Timmy wants to play little league baseball (become a trader of CDSs) with his local Little League Baseball affiliate (CCP) and he knows there are costs that are associated with playing in the league. (CCP membership fees, transaction fees, taxes, etc.) Should the American tax payer have to pay for little Timmy to play Little League baseball or in the alternative should it be his parents ("Too Big to Fail" Financial Institutions) that foot the bill for his wonderful boyhood experience (Profits made from CDS transactions) on the baseball diamond (in the CDS market)? The example illustrates a simplistic and free-market theory of "Pay to Play" and the big financial institutions with deep pockets should be footing the bill and paying taxes on the transactions they make to fund the CCP in times of emergency. Moreover, the fund could be separated into two separate buckets (one for the CFTC and one as a rainy day fund) that would fund not only an emergency, but also assist the CFTC in hiring much needed resources for sufficient oversight of the CCP, the proper promulgation of rules and regulations for more CDS market efficiency and prevention of moral hazard.

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[183] Telephone interview with James Fadel, C.F.A., Senior Investment Manager, The Marco Consulting Group (Mar. 14, 2012).
[184] *See supra* section IIIB.
[185] *See* Federal Reserve Act § 13(3), 12 U.S.C. § 343(3)(2010).

VI. CONCLUSION

If we have learned anything from the calamity of the financial crisis in relation to CDSs it should be that large financial institutions require strict compliance with licensing requirements, a tax structure to finance the regulatory bodies, and prompt execution in order to keep certain irresponsible behavioral activities at bay. As the CDS market still operates currently as it did in the over-the-counter market, no change to address these behaviors has taken place. These irresponsible behaviors place not just the market players at greater levels of risk, but society as a whole is jeopardized by the decisions of these "Too Big to Fail" financial institutions such as those mentioned in this article (Goldman Sachs and AIG).

Dodd-Frank, although in theory has some beneficial aspects of greater transparency and risk elimination while allowing for free market efficiency to continue, is a failure with respect to CDS regulation to date. The Act also fails to address an additional licensing requirement, and it fails to provide additional resources to the entities that most need them to assure the proper economic outcome it seeks. It should be amended to include these suggestions and more immediate action should be taken.

When originally created and as referenced in general discussions, CDSs have elements of beneficial "insurance" contracts. However, as it stands they are not insurance and will not be regulated as such. There is no need to consider them insurance however to regulate the CDS market. Dodd-Frank certainly continues to consider CDSs as a credit derivative and provides a regulatory framework, albeit not as complete as it should be. With the American economy as frail as it is today, our legislators should reconsider that framework and add a licensing requirement, a tax for emergency funding and for the CFTC, and push action to take place in a more expeditious fashion. These simple remedial measures are critical to the overall success of legislation that reduces the risk for another 2008 financial crisis.

PROXY ACCESS AND THE SEC'S CONTINUED QUEST FOR SHAREHOLDER EMPOWERMENT

JAMES HENNESSY[**]

As a response to perceived weak shareholder voting rights in U.S. corporate law, many normative debates have been waged over the concept of granting shareholders universal access to the corporate proxy. After many unsuccessful attempts at regulating proxy contests at the Federal level, the Dodd-Frank Act finally authorized the SEC to require publicly traded companies allow shareholders the opportunity to place board nominees onto the corporate proxy. Although the D.C. Circuit promptly invalidated a corresponding SEC rulemaking, the proxy access debate is not over. The SEC decided not to appeal the decision, yet the Commission has affirmed that proxy access is still a central focus. The question then remains how exactly should the SEC pursue its goals of enhanced shareholder democracy.

This Note argues that instead of making findings or otherwise addressing court defects, the SEC would be wise to rely on a system of private ordering in facilitating an effective shareholder voting system. Under SEC Rule 14a-8(i)(8), shareholders may put forward proposals to amend issuer bylaws so as to permit the inclusion of shareholder nominees on the proxy card. Although this rule does not yield a mandatory, comprehensive scheme like the one which the D.C. Circuit struck down, its potential to enable proxy access in a gradual, individualized manner makes it a viable alternative for the time being. Although issuer specific experimentation may not represent the ideal proxy access procedure to the SEC, it might produce experiential data that can, at a minimum, assist further informed governance decisions. Upon facing heightened judicial scrutiny, the SEC should avoid unnecessary costs and abandon its emphasis on comprehensive proxy access and instead rely on private ordering in pursuing its ends of increased shareholder empowerment.

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I. INTRODUCTION

A. Shareholder Voting

The proxy process is the principal means by which shareholders of a publicly traded corporation elect the company's board of directors.[1] This process is facilitated through two key instruments: the proxy statement and the proxy card. The purpose of the proxy statement is to "promote the free exercise of the voting rights of shareholders by ensuring that proxies would be solicited with explanation to the shareholder of the real nature of the questions for which authority to cast his vote is sought."[2] The proxy card, on the other hand, enables shareholders to vote for or against nominees without attending the actual meeting.[3] Before an annual corporate meeting, a company places information about each nominee in its proxy materials, which are then distributed to all shareholders.[4] A proxy statement is thus filed in advance of the annual meeting, and a shareholder who wishes to nominate a different candidate may separately file his own proxy statement and solicit votes from shareholders, thereby initiating a proxy contest.

However, many shareholders view this voting mechanism as ineffective. Currently, investors have the right to put forth a "short slate," or limited number of candidates for a board election at their own expense.[5] Shareholders who seek to shake up boards must wage campaigns and foot the bill for distributing their own ballots to shareholders. On average, these costs range from $100,000 at the low end to millions of dollars at the high end.[6] Indeed, various practical and legal impediments to shareholder control make it difficult, maybe even impossible in certain circumstances, to hold directors accountable.

Levin v. MGM, a seminal federal proxy case, demonstrates the broad playing field between insurgents and incumbents.[7] In *Levin*, the plaintiffs intended to nominate a slate of directors at the defendants' annual meeting. In addition to seeking aid from corporate employees, the defendants responded by using company funds to hire outside help to

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[1] *Bus. Roundtable v. S.E.C.*, 647 F.3d 1144, 1146 (D.C. Cir. 2011).
[2] *Mills v. Elec. Auto-Lite Co.*, 396 U.S. 375, 381 (1970) (*quoting* H.R. REP. NO. 73-1383, at 14 (1934); S.
REP. NO. 73-792, at 12 (1934)).
[3] *Id.*
[4] *Id.*
[5] *What is Shareholder Proxy Access?,* US SIF: The Forum for Sustainable and Responsible Investment, (October 21, 2003),
http://www.csrwire.com/press_releases/23226-What-Is-Shareholder- Proxy-Access.
[6] Marc Weingarten, *Reimbursement of Proxy Contest Expenses for Incumbents and Insurgents*, Schulte Roth & Zabel LLP. (Fall 2006),
http://www.srz.com/Weingarten_Activist_Investing_Proxy_Contest_Reimbursement_Six_Flags.
[7] *Levin v. Metro-Goldwyn-Mayer, Inc.*, 264 F. Supp. 797 (S.D.N.Y. 1967).

promote their candidates, including attorneys, a public relations firm, and proxy soliciting organizations. Determining that the payments were not excessive, however, the court found no problem with the defendants soliciting proxies through the use of corporate resources. The court reasoned that no statute prohibited the solicitation practice and the hiring of a public relations firm, among others, was neither "unusual nor unreasonable." *Levin* illustrates the uphill battle faced by insurgents in proxy contests.

The substantial costs of proxy contests have created a major disincentive for unsatisfied shareholders. To some, the death of contested elections in publicly traded firms has provided evidence that the current system is broken.[8] Between 1996 and 2005, only eight contested elections with rival slates existed among companies with a market capitalization of over $200 million.[9] Without access to the proxy, shareholders who disagree with a company's direction must engage in expensive and time-consuming campaigns against incumbent boards, resulting in a substantial majority of director slates running unopposed. Board incumbents spend substantial amounts of the company's money with fewer restrictions, whereas losing insurgents receive no such reimbursement. Winning is difficult, and the benefits of winning are attenuated enough to make shareholders feel disenfranchised.

In response, displeased shareholders have sought the right to propose board candidates to strengthen the independence and responsiveness of corporate boards.[10] Although shareholders elect the board of directors, in most cases they do not participate in the nomination process.[11] This discrepancy largely stems from the fact that without the ability to effectively utilize the proxy process, shareholder nominees do not have a realistic probability of being elected.

The concept of proxy access has emerged as a response to weak shareholder voting rights by seeking to alleviate the practical barriers to proxy contests. Proxy access allows dissatisfied shareholders an opportunity to nominate candidates onto the company proxy card. Such a system allows shareholders to print the names of candidates for corporate boards of directors directly onto company ballots, creating a meaningful opportunity to nominate directors. Because proxy access would cover costs traditionally covered by the shareholder in the process, its implementation

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[8] J.W. Verret, *Defending Against Shareholder Proxy Access: Delaware's Future Reviewing Company Defenses in the Era of Dodd-Frank,* 36 J. Corp. L. 391, 395 (2011).
[9] Lucian A. Bebchuk, *The Myth of the Shareholder Franchise,* Harvard John M. Olin Discussion Paper Series, *available at:*
http://www.law.harvard.edu/programs/olin_center/papers/pdf/Bebchuk_565.pdf.
[10] US SIF: The Forum for Sustainable and Responsible Investment, *supra* note 6.
[11] Jill E. Fisch, *The Destructive Ambiguity of Federal Proxy Access*, 61 EMORY L.J. 435, 436 (2012).

would mark a significant milestone in shareholder suffrage—but not without controversy.[12] Indeed, for reasons that will soon be discussed, proxy access is often regarded as the SEC's most controversial rule-making initiative.[13]

B. Arguments in Favor of Proxy Access

Generally, proponents of strong shareholder democracy claim that proxy access can enhance empowerment by improving director accountability, increasing investor confidence, and generating wealth. In theory, the principal way shareholders hold boards accountable and influence matters of corporate policy is through the nomination and election of directors.[14] This process can lower agency costs by making boards of directors accountable to their owners. Strengthening the voting process is intended to help make boards more accountable for the risks undertaken by the companies they manage.[15] Furthermore, proponents urge shareholders to monitor the corporate board. Proxy access makes it easier and more logical for shareholders to take an active role in monitoring managers and the incumbent board by the threat of replacement.[16] Proponents of proxy access further point to the fact that the United States is one of the few developed countries which does not give shareholders access to the proxy and that proxy access has not lead to "enormous dislocations" in other countries.[17] Improving accountability and increasing investor confidence through the proxy system could yield substantial benefits.

C. Arguments Against Proxy Access

Alternatively, those who oppose proxy access believe it promotes inefficiency and diminishes wealth. Stephen Bainbridge, a leading supporter of director primacy, has consistently argued that proxy access will not result in improved board performance.[18] Although shareholder wealth maximization is the ultimate goal, Bainbridge argues that

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[12] Stephen Bainbridge, *Proxy Access Invalidated on APA Grounds,* (July 22, 2011), http://www.professorbainbridge.com/professorbainbridgecom/2011/07/proxy-access-invalidated-on-apa- grounds.html.
[13] Fisch, *supra* note 11.
[14] Securities and Exchange Commission, 17 C.F.R. Parts 200, 232, 240 and 249, http://www.sec.gov/rules/final/2010/33-9136.pdf.
[15] Mary Schapiro, *Statement by SEC Chairman Mary L. Schapiro on Proxy Access Litigation*, (September 6, 2011), Washington D.C, http://www.sec.gov/news/press/2011/2011-179.htm.
[16] Verret, *supra* note 8.
[17] Charles M. Nathan, *The Battle for Shareholder Access: The Current State of Play*, The Harvard Law School Forum on Corporate Governance and Financial Regulation, May 30, 2009.
[18] Bainbridge, *supra* note 12.

managerial oversight belongs to the *managers* of the company.[19] Proxy access might further add to corporate problems by creating divided and dysfunctional boards.[20] In contrast, director discretion currently promotes efficient decision making because board members are experts and knowledgeable about their corporation. With proxy access, shareholders might conflict in their desires, creating countless election contests which boards may have a duty to defend. This process is not cheap and would impose substantial costs upon the company.

Another significant worry for those against proxy access concerns the pursuit of private interests at the expense of the shareholder collective. Many executives fear that certain shareholders may bring their own political agenda to the voting process, which could generally detract from the business at hand at the expense of other shareholders.[21] Another fear is that institutional investors would be the only ones using proxy access, and these investors would launch contests unrelated to wealth maximization. Indeed, certain institutional investors—namely union pension funds and state and local government pension funds—might use proxy access as leverage to extract private gains at the expense of other shareholders.[22] Union pressure to maximize employment or push for "socially responsible policies" may be greater than their interest in share value.[23] Moreover, employee benefit funds may impose costs upon companies by using proxy access as leverage to gain concessions, such as additional benefits for unionized employees, unrelated to shareholder value.[24] There is indeed reason to fear that proxy access will lead to the pursuit of these alternative ends.

Furthermore, other avenues of director accountability may already exist. Financial markets sufficiently impose costs on underperforming managers, especially given that boards oust managers convicted of wrongdoing almost without exception. Shareholders can also withhold capital as a mechanism for protecting their interest or sell shares if they are dissatisfied. Proxy access dissidents claim that the system is accountable as is, and that any alternative would shift too much power to certain shareholders, inhibiting a company's ability to generate wealth.

II. LEGAL DEVELOPMENTS

On several occasions, the Securities Exchange Commission

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[19] Verret, *supra* note 8 (emphasis added).
[20] Nathan, *supra* note 17.
[21] No. 2 Andrews Corp. Off. & Directors Liab. Litig. Rep. 17.
[22] Bainbridge, *supra* note 13.
[23] *Bus. Roundtable v. S.E.C.*, 647 F.3d 1144, 1146 (D.C. Cir. 2011).
[24] *Id.* at 1146. (Petitioners used this argument against Rule 14a-11).

("SEC") has tried, unsuccessfully, to regulate proxy contests at the federal level. As early as 1942, the SEC proposed a rule that would have required issuers to include shareholder nominated candidates in their proxy statements.[25] The SEC also considered rules to grant shareholders access to the corporate proxy in 2003 and 2006 but ultimately voted not to implement either proposal.[26] The SEC understood that investors wanted direct access to the company ballots and often tried to give shareholders the ability to place nominees onto the corporate ballot; their authority to do so, however, has been traditionally uncertain.

In 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd- Frank") finally clarified the SEC's role in regulating proxy access. When Dodd-Frank passed, the U.S. and its markets were experiencing a serious crisis, leading many to question whether boards of directors truly were being held accountable to shareholder interests.[27] In response, Dodd-Frank gave the SEC express authority to require boards to give shareholders access to the corporate proxy. Dodd-Frank Section 971 states that the SEC may include "a requirement that a solicitation of proxy, consent or authorization by an issuer include a nominee submitted by a shareholder to serve on the board of directors of the issuer."[28] This legislation encouraged the SEC to enact rules that would rein in directors of banks and corporations who approved inordinate fiscal risk-taking and executive compensation.[29] In doing so, the legislation arguably went further than the federal government has ever gone before in regard to shareholder voting rights.[30]

On August 25, 2010, just a few weeks after Dodd-Frank became law, the SEC adopted Exchange Act Rule 14a-11. The SEC recognized that "the financial crisis the nation and markets experienced heightened the serious concerns of many shareholders about the accountability and responsiveness of some companies and boards of directors to shareholder interests, and that these concerns resulted in a loss of investor confidence."[31] The SEC raised concerns over appropriate management oversight, whether boards were focused on shareholder interests, and whether boards needed to be more accountable for their decisions regarding

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[25] Fisch, *supra* note 12, at 436.
[26] Verret, *supra* note 9, at 447.
[27] Securities Exchange Commission. *SEC Votes to Propose Rule Amendments to Facilitate Rights of Shareholders to Nominate Directors* (May 20, 2009), http://www.sec.gov/news/press/2009/2009- 116.htm.
[28] Dodd–Frank Wall Street Reform And Consumer Protection Act, Pub. L. No. 111-203, §124 (2010) Stat. 1376.
[29] Proxy Access Rule No Curb of Corporate Free Speech, Law Profs Say. 2011 WL 684192 (WJCODL).
[30] Verret, *supra* note 9, at 447.
[31] SEC Final Ruling, *supra*.

issues such as compensation structures and risk management.[32]

In promulgating Rule 14a-11, the SEC ruled that companies would be required to include shareholder-nominated candidates for director in company proxy materials.[33] Specifically, the rule required "a company's proxy materials to provide shareholders with information about and the ability to vote for candidates for director nominated by long-term shareholders or groups of long-term shareholders with significant holdings."[34] Thus, under certain circumstances and subject to certain limitations, public companies would be required to provide shareholders with information about nominees for director and include nominees on the proxy voting card. With 14a-11, the SEC created a comprehensive and mandatory proxy access scheme, applicable to all U.S. public companies.

The rule did, however, outline some limitations. To be eligible, a nominating shareholder or group would be required to satisfy a continuous ownership threshold of at least 3% of the voting power of a company's securities.[35] Rather than simply attempting to limit proxy access to larger shareholders, the thresholds were created as a result of competing considerations between enhancing the election process and avoiding any potential practical difficulties. In its final rule, the SEC stated that it balanced the considerations of "facilitating shareholders' ability to participate more fully in the nomination and election process against the potential cost and disruption of the proxy system."[36] The SEC clearly feared a deluge of proxy proposals from minority stakeholders. Additionally, these thresholds limited the amount of shareholders who would have access to the proxy and reflected the SEC's acknowledgement of the fact that companies could be negatively affected if shareholders used the rule to promote narrow interests at the expense of other shareholders. Yet the SEC reasoned that these potential costs would be limited because the ownership and holding requirements would "allow the use of the rule by only holders who demonstrated a significant, long-term commitment to the company, and who would therefore be less likely to act in a way that would diminish shareholder value."[37] A further limitation was created so a shareholder would not be able to use the rule to take over the company. Shareholders were limited to putting forward a short slate consisting of at least one nominee or up to 25% of the company's board of directors, whichever was greater.[38] The rule did not apply if state law or a company's governing documents "prohibit[ed] shareholders from nominating a

[32] *Id*.
[33] *Id*. at 10.
[34] *Id*.
[35] *Id*. at 24.
[36] *Id*.
[37] *Bus. Roundtable v. S.E.C., supra* note 24, at 1146.
[38] SEC Final Ruling, *supra*.

candidate for election as a director."[39]

Shortly after the SEC's final ruling, the U.S. Chamber of Commerce and Business Roundtable sued to overturn the Rule 14a-11. The Roundtable argued that the SEC "promulgated the rule in violation of the Administrative Procedure Act because the Commission failed adequately to consider the rule's effect upon efficiency, competition, and capital formation."[40] Furthermore, the Roundtable claimed the SEC acted arbitrarily and capriciously because it neglected its statutory responsibility to determine the likely economic consequences of Rule 14a-11 and to connect those consequences to efficiency, competition, and capital formation.[41]

The D.C. Circuit agreed with the Business Roundtable's arguments to invalidate Rule 14a-11. In *Business Roundtable v. SEC*, the Court recited federal law which requires federal agencies to demonstrate that their regulations are not capricious and have been weighed carefully against any economic costs.[42] Criticizing the SEC for not doing its legwork, the Court cited a general failure for lack of evidence before the SEC in assessing the rules.[43] In further reasoning that the SEC is required by law to study the effects of its rule on efficiency, competition, and capital formation, the Court found that the Commission inconsistently and opportunistically framed the costs and benefits of the rule.[44] The Court stated that the idea of directors choosing not to oppose shareholder nominees had no basis beyond mere speculation as the SEC presented no evidence that such forbearance was ever seen in practice.[45] Furthermore, the Commission apparently: 1) failed to adequately quantify the certain costs or to explain why those costs could not be quantified, 2) neglected to support its predictive judgments, 3) contradicted itself, and 4) failed to respond to substantial problems raised by commenters.[46] This holding has been considered a monumental win for those who believe in the board-centric model and dominance of state law in regulating corporate governance.[47]

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[39] *Id*. at 262.
[40] *Id*. at 261.
[41] *Id*. at 263.
[42] *Bus. Roundtable v. S.E.C.*, *supra* note 24, at 1146.
[43] Steven M. Davidoff, *The Heated Debate Over Proxy Access*. NEW YORK TIMES, November 2, 2010,
http://dealbook.nytimes.com/2010/11/02/the-heated-debate-over-proxy-access.
[44] *Bus. Roundtable v. S.E.C.*, *supra* note 24, at 1147.
[45] *Id*. at 265.
[46] *Id*. at 264.
[47] Bainbridge, *supra* note 12.

III. WHERE DOES THE SEC GO FROM HERE?

A. Has the door to proxy access closed?

The proxy access debate is not over, as is suggested by the Court's decision. Importantly, nowhere in the decision does the Court expressly prevent the SEC from rewriting the rule. Indeed, the crux of its holding centers upon the Commission acting "arbitrar[ily] and capricious[ly] in promulgating Rule 14a-11."[48] The Court's language does not mention any support for the idea that the SEC did not have proper authority that the rule itself was improper, or that proxy access is generally disfavored. Instead, most of the Court's language pertains to evidence and findings, such as "neglected to quantify,"[49] and "failed to consider."[50] As one commenter concludes, much depends on the SEC's own decisions with respect to proxy access from here, but it is unclear what action the agency will take.[51]

In a somewhat surprising decision, the SEC formally announced it would not seek immediate review.[52] This is an interesting move by the SEC, not only because the agency shelved its longstanding pursuit of proxy access, but also because some commentators remain uncomfortable with the D.C. Circuit's "dramatically inconsistent" level of review exhibited in *Business Roundtable*.[53] James Cox, a leading scholar on securities regulation, has rebuked the holding. He states that the standard Congress prescribed for courts reviewing SEC Rules has been beaten down by the D.C. Circuit, requiring much more than Congress intended.[54] Cox writes that when enacting the National Securities Markets Improvement Act of 1996, Congress did not explain what level of consideration the SEC had to give in the rulemaking process.[55] Furthermore, although there is much more at stake than getting the D.C. Circuit's approval, greater goals of investor confidence and the public interest depend on surviving this type of

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[48] *Id*.
[49] *Business Roundtable v. S.E.C.*, 647 F.3d 1144 (D.C. Cir. 2011).
[50] *Id*. at 1148.
[51] *SEC Walks Away from Part of New Proxy Access, Faces Imminent Deadline on Remainder*, Proskauer, (September 9, 2011), *available at* http://www.proskauer.com/publications/client-alert/sec-walks-away-from-part-of-new-proxy-access-faces-imminent-deadline-on-remainder/.
[52] *Statement by SEC Chairman Mary L. Schapiro on Proxy Access Litigation, U.S. Securities and Exchange Commission* (September 6, 2011), *available at* http://www.sec.gov/news/press/2011/2011-179.htm, (explaining that the Commission will "'learn from the Court's objections,'" indicating that the Commission took the court's harsh criticisms as final and would not seek review).
[53] James D. Cox and Benjamin J.C. Baucom, *The Emperor Has No Clothes: Confronting the D.C. Circuit's Usurpation of SEC Rulemaking Authority*, 90 TEXAS LAW REVIEW 1811, *available at* http://www.texaslrev.com/wp-content/uploads/Cox-Baucom-90-TLR- 1811.pdf.
[54] *Id*. at 1824.
[55] *Id*. at 1819.

challenge to its rule.[56] This decision has created a great deal of uncertainty regarding *any* SEC rulemaking, thereby complicating SEC initiatives moving forward and making the Commission's decision not to appeal all the more surprising.

Regardless, amid this confusion and debate as to whether the *Business Roundtable* was rightly decided, the SEC has decided not to appeal the decision. Yet the Commission has made it apparent that proxy access is still a central aim.[57] In a formal response to the ruling, the SEC stated that it is "committed to finding a way to make it easier for shareholders to nominate candidates to corporate boards"[58] and that the Commission would "learn from the court's objections to determine the best path forward."[59] The SEC remains concerned about a continued loss of investor confidence in the capital markets, and it will continue to enhance the director election process.[60] Moreover, proxy access is still considered a major goal of institutional investors and has strong support from Democrats in Congress and the left-leaning members of the Commission.[61] The SEC has also indicated that it remains deeply committed to making it easier for shareholders to nominate board candidates, and that its staff would review both the court decisions as well as interested party comments.[62] The only question remaining is exactly how the SEC plans to achieve proxy access in the future.

B. Change the rule?

Of course, the SEC could simply go back to the rule-making process and try again.[63]

Former Chairman Mary Schapiro suggested the agency might rewrite the regulation after consideration of the outcome of the litigation.[64] The difficulty with revising the rule, however, may be that the D.C. Circuit

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[56] *Id*. at 1847.
[57] Although Chairman Schapiro has recently stepped down, arguments that this will not significantly change the course of action for the SEC under the present administration can be found at the following: *White House Vets New SEC Chairman Contenders,* The Wall Street Journal (November 26, 2012), *available at* http://online.wsj.com/article/SB10001424127887324784404578143612714469292.html, and Mark Memmott, *SEC Chief Schapiro is Leaving; New Chairman Chosen*, Wall Street Journal (November 26, 2012), *available at* http://www.npr.org/blogs/thetwo-way/2012/11/26/165912745/sec-chief-schapiro-is-leaving.
[58] Schapiro, *supra* note 15.
[59] *Id*.
[60] No. 2 Andrews Corp. Off. & Directors Liab. Litig., *supra* note *21*.
[61] Bainbridge, *supra* note 12.
[62] *SEC Walks Away*, *supra* note 51.
[63] Bainbridge, *supra* note 12.
[64] *SEC Walks Away*, *supra* note 51.

did not explicitly identify its flaws.[65] In pursuing a rule change, the SEC might consider enhancing shareholder limitations to accessing the proxy or increasing the thresholds for shareholder participation. The problem with changing the regulation is that the rule itself has been considered "presumptively reflecting a fair and balanced approach."[66] The SEC rule already recognized 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.[67] Indeed, the SEC already considered the importance that investors nominating directors through a proxy contest have the company's long-term success in mind.[68] The rule itself might indeed have been satisfactory because the D.C. seemed to primarily take issue with its presentation and the process by which it was established.

C. Address defects of the rulemaking process?

Instead of simply rewriting the rule, the SEC might address the court's defects by making findings and performing a cost benefit analysis. If the SEC appraises costs associated with proxy contests, it would seem to address what the court primarily focused on. The main difficulty here is that much evidence exists to support both sides of the classic shareholder empowerment debate, as asserting the costs and benefits for *any* regulatory initiative can be problematic.[69]

As the SEC pointed out in its final ruling, many studies have shown that proxy access has resulted in significant economic benefits. In particular, one event study, which used the Business Roundtable's challenge to the SEC's proxy access rule, showed that financial markets placed a positive value on shareholder access.[70] This study found that firms

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[65] Fisch, *supra* note 11 at 435.

[66] *Corporate Governance Commentary: Proxy Access and Advance Notice Bylaws in the Wake of Invalidation of the SEC's Proxy Access Rule: An Approach to Private Ordering*,. Latham & Watkins, LLP (November 2011), *available at* http://www.lw.com/globalSearchPage.aspx?searchText=Proxy+Access.

[67] Nicholas D. Harken, *2009 Sec Proxy Amendments: A Problematic Solution to Shareholder Director Nomination*, 1 U.P.R. BUSINESS LAW JOURNAL 65, 79 (2010), *available at* http://www.uprblj.com/wp/wp-content/uploads/2010/08/1-UPRBLJ-65-Harken-ND2.pdf.

[68] *Id*.

[69] Cox, *supra* note 53 at 1840.

[70] Bo Becker, Daniel B. Bergstresser, and Guhan Subramanian, *Does Shareholder Proxy Access Improve Firm Value? Evidence from the Business Roundtable Challenge*, *Harvard Business School Finance Working Paper No. 11-052*, *Harvard Business School NOM Unit Working Paper No. 11-052*; *Harvard Law and Economics Discussion Paper No. 685* (January 19, 2012), *available at* http://ssrn.com/abstract=1695666 or http://dx.doi.org/10.2139/ssrn.1695666.

that would have been most vulnerable to proxy access, as measured by institutional ownership and activist institutional ownership, lost value when the SEC unexpectedly announced it would delay implementation of the Rule in response to the Business Roundtable challenge. The study further found intra-day returns and that the value loss occurred just after the SEC's announcement. Similar results were found in July of 2011, when the D.C. Circuit ruled in favor of the Business Roundtable.[71] Additionally, in its defense, the Commission relied on a favorable hybrid board study,[72] as well as a study concerning proxy contests in general, upon shareholder value, both of which indicated an increase in value.[73]

Other such findings indicate the opposite result. One study has shown that companies which would have been most vulnerable to proxy access declined significantly in value compared to companies that would have been more insulated from the rule after controlling for market movements and other factors.[74] In his dissent to 14a-11, SEC Commissioner Paredes admitted that the Commission's treatment of the economic studies was "not evenhanded."[75] The Commission even acknowledged the numerous studies submitted by commenters that reached the opposite result and admitted the limitations of the very studies they proposed.[76] Further research has shown that when dissident directors win board seats, those firms underperform peers by 19-40% over the two years following the proxy contest.[77] The court also raised the idea of boards being compelled by fiduciary duties to make an appropriate effort to oppose the nominee, as boards now do in traditional proxy contests,[78] which will likely cause companies to incur costs even when a particular nominee is unlikely to be elected.[79] Furthermore, if these contests arise from investors with a special interest, self-interested objectives rather than the goal of

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[71] *Id*.
[72] *Business Roundtable v. S.E.C*. 647 F.3d 1144, 1146 (D.C. Cir. 2011).
[73] Chris Cernich,, et al., *IRRC Inst. for Corporate Responsibility, Effectiveness of Hybrid Boards*, IRRC Institute (May 2009), *available at* www.irrcinstitute.org/pdf/IRRC_05_09_ EffectiveHybridBoards.pdf, and J. Harold Mulherin & Annette B. Poulsen, *Proxy Contests & Corporate Change: Implications for Shareholder Wealth,* 47 JOURNAL OF FINANCIAL ECONOMICS 279 (1998), *available at* http://econpapers.repec.org/article/eeejfinec/v_3a47_3ay_3a1998_3ai_3a3_3ap_3a279-313.htm.
[74] Elaine Buckberg, and Jonathan Macey, *Report on Effects of Proposed SEC Rule 14a–11 on Efficiency, Competitiveness and Capital Formation*, *NERA Economic Consulting* (August 17, 2009), *available at* www.nera.com/upload/Buckberg_Macey_Report_FINAL.pdf.
[75] James Morphy, *Proxy Access Proposals: Review of 2012 Results and Outlook for 2013*, The Harvard Law School Forum on Corporate Governance and Financial Regulation, *available at* http://blogs.law.harvard.edu/corpgov/2012/06/28/proxy-access-proposals-review-of-2012-results-and-outlook- for-2013.
[76] *Business Roundtable v. S.E.C*., 647 F.3d 1144, 1146 (D.C. Cir. 2011).
[77] Buckberg, *supra* note 74.
[78] *Id*. at 264.
[79] Bainbridge, *supra* note 12.

maximizing shareholder value will win the day.[80]

As of right now, limited evidence provides a basis for definitively determining the impact of proxy access on value either way.[81] Obviously, The D.C. Circuit was less than convinced, and Commissioner Paredes added that the mixed empirical results did not support the Commission's decision.[82] Furthermore, the D.C. Circuit found that the SEC relied exclusively and heavily upon only two relatively unpersuasive studies.[83] Findings are also complicated because of the variability among companies. Shareholder proxy access may be a terrific idea for companies that have not adequately pursued shareholder interests, but not for those who are more responsive.

Moreover, according to Cox, none of this should matter because of the inherent inability to conclude on *any* such federal rulemaking. Instead, Cox offers up a suggestion that the SEC simply frame its argument differently, and instead of trying to be an "econometrician or empiricist," the SEC should act more like a "lawyer" in its rulemaking process.[84] Opining that the SEC blindly walked into a trap trying to frame economic justifications, Cox thinks the Commission should construct its argument based on the factors of the relevant review standard.[85] Yet in spite of Cox's suggestions, even he appears pessimistic that his proposals would result in a different outcome. After all, much uncertainty exists surrounding every SEC rulemaking. There is no telling whether the D.C. Circuit will relinquish its evolved role in the review process, no matter how opposed it is to the one Congress prescribed.

To add to the SEC's complex problem, other defects mentioned by the court need to be addressed. The SEC was called to estimate the frequency with which proxy access would be used and address the possibility that unions and pension funds would use the rules as a bargaining chip in unrelated negotiations. These too would likely be scrutinized as speculative. Indeed, even SEC Commissioner Kathleen Casey pointed out that Rule 14a-11 favored activist investors who may seek to use the new access rights to engage in private rent seeking.[86] By treating certain shareholders who do not represent the interests of other shareholders as a proxy for all, Casey noted that the Commission "betrayed its mission" with increasingly federalized corporate governance

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[80] *Id*.
[81] Davidoff, *supra* note 43.
[82] Bainbridge, *supra* note 12.
[83] *Business Roundtable v. S.E.C.*, 647 F.3d 1144, 1146 (D.C. Cir. 2011).
[84] Cox, *supra* note 53 at 1840.
[85] *Id*.
[86] Stephen M. Bainbridge, *Dodd Frank: Quack Federal Corporate Governance Round II*, *UCLA School of Law, Law-Econ Research Paper No. 10-12* (September 7, 2010), *available at* http://ssrn.com/abstract=1673575.

requirements.[87] There is simply no telling when the SEC's alleged defects would be sufficiently accounted for.

Evidently, making findings or otherwise solving the cost-benefit problem would not necessarily guarantee a favorable D.C. Circuit response to the Commission's reasoning.[88] Given the court's flat disdain for the rule, making findings and otherwise addressing defects could be costly. The D.C. Circuit ruling is considered "an unqualified rejection of a high-profile initiative which had been roughly 70 years in the making."[89] As Bainbridge remarks, the SEC received a "serious spanking from a court that was not amused." Indeed, given the Court's language,[90] the SEC appears to have a difficult road ahead in revisiting the rule.

D. Change Directions?

The SEC would be wise to rely on a system of private ordering as facilitated by Rule 14a- 8. Currently, Rule 14a-8's stay on effectiveness has expired because the litigation in the DC Circuit only involved Rule 14a-11.[91] *Business Roundtable* did not involve amendments to Rule 14a-8, which permits shareholders to submit proxy access proposals on a company-by-company basis, subject to state law.[92] Importantly, recent economic work examining proxy access specifically suggests that the results are not uniform[93] as the net effect of proxy access would seem to vary based on a company's particular characteristics and circumstances.[94] Indeed, Meredith Cross, the Director of the SEC's Division of Corporate Finance, stated that the SEC was considering its options going forwards and highlighted that the amendments to Rule 14a-8 were unaffected, and which implies that the stay on these might be lifted.[95]

In short, the SEC amended Exchange Act Rule 14a-8(i)(8) in an effort to narrow a company's ability to exclude shareholder proposals relating to the election of directors.[96] The SEC originally adopted 14a-8(i)(8) under the Securities Exchange Act of 1934 to allow companies to

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[87] *Id*.
[88] Stephanie L. Parker, *The Folly of Rule 14a-11: Business Roundtable v. SEC and the Commission's Next Step*, 61 AM. U. L. REV. 715, 717 (2012), *available at* http://www.aulawreview.org/pdfs/61/61-3/Parker.pdf.
[89] Fisch, *supra* note 11, at 435.
[90] *Bus. Roundtable v. S.E.C.*, 647 F.3d 1144, 1146 (D.C. Cir. 2011). (stating that the SEC "Once again failed"; "Opportunistically assessed evidence"; "Contradicted itself.").
[91] Schapiro, *supra* note 15.
[92] *SEC Walks Away*, *supra* note 51.
[93] Bainbridge, *supra* note 12.
[94] *Id*.
[95] *SEC Votes to Propose Rule Amendments*, *supra* note 27.
[96] Bainbridge, *supra* note 12.

exclude shareholder proposals that related to the nomination or election of directors from their proxy materials.[97] Indeed, the old Rule 14a-8(i)(8) allowed exclusion of a shareholder proposal intended to set up a proxy access mechanism or to nominate a particular person for a board seat.[98] With the amendment, however, shareholders may request that proxy access be added to a particular company's bylaws. Specifically, Rule 14a-8(i)(8) prohibits the exclusion of certain shareholder proposals "seeking to establish a procedure in the company's governing documents for the inclusion of one or more shareholder director nominees in the company's proxy materials."[99] Because the amendments to Rule 14a-8 were intertwined with rule 14a-11, the SEC voluntarily stayed the amendments to Rule 14a-8 during litigation over the proposed universal shareholder access Rule 14a-11.

Under this regulation, shareholders who want proxy access may put forward proposals under Rule 14a-8 to amend the issuer's bylaws thereby permitting shareholder nominees to be included on the proxy card.[100] The main difference between Rule 14a-8 and 14a-11 is that the former allows shareholders the opportunity to establish proxy access standards on an individualized basis. As Delaware stated, the main problem with Rule 14a-11 was that it "[took] away choice."[101] Rule 14a-8 amendments give shareholders the flexibility to propose amendments that would establish proxy access standards on an individualized basis, rather than the "one-size-fits-all" approach as provided in Rule 14a-11.[102] This process, often referred to as private ordering, offers a more flexible mechanism for maintaining equilibrium in the allocation of power between shareholders and managers[103] and can shape to a company's particular circumstances.[104]

To rely on Rule 14a-8 for proxy access may concede the Federal government's role in regulating a comprehensive, national proxy system. Some claim that the separation of ownership from control in the modern large corporation justifies extending the reach of federal regulation of companies.[105] Yet although the SEC asserts that "there is nothing novel

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[97] *SEC Walks Away*, *supra* note 51.
[98] *Id*.
[99] *Rule 14a-8 Amendments Allowing Shareholder Proposals on Proxy Access to Go into Effect Shortly*, Akin Gump Newsletters & Alerts (September 16, 2011), *available at* http://www.akingump.com/communicationcenter/newsalertdetail.aspx?pub=2839.
[100] *SEC Walks Away*, *supra* note 51.
[101] "Proxy Access Rule No Curb of Corporate Free Speech, Law Profs Say." 2011 WL 684192 (WJCODL).
[102] *Rule 14a-8 Amendments Allowing Shareholder Proposals*, *supra* note 99.
[103] Fisch, *supra* note 11, at 435.
[104] Schapiro, *supra* note 15.
[105] Verret, *supra* note 8, at 393.

about mandated limitations on private ordering in corporate governance,"[106] some feel that the core of the problem with 14a-11 is that federal regulation is poorly suited to regulating corporate governance.[107] Indeed, in his dissent of the 14a-11 final ruling, Commissioner Paredes remarked that the rule marked a considerable displacement of state corporate law by Federal securities regulation.[108] He further stated that "Rule 14a-11's immutability conflicts with state law. Rule 14a-11 is not limited to facilitating the ability of shareholder to exercise their state law rights, but instead confers upon shareholders a new substantive federal right that runs counter to what state corporate law otherwise provides."[109]

The SEC and proponents of Rule 14a-11 might claim that proxy goals cannot be realized fully under a system of private ordering because of individual proxy barriers to companies. Indeed, the SEC rejected Delaware's approach of private ordering because letting each company decide what rights of access are available to future shareholders is unfair and impractical.[110] Furthermore, "many companies impose impediments such as supermajority requirements, restrictions on shareholders' ability to amend or propose bylaws, and board repeal of shareholder-adopted bylaws."[111] Rule 14a-8, however, boasts lower thresholds than does 14a-11. Moreover, shareholder proposals submitted under Rule 14a-8 will have lower company thresholds for proxy access than will those imposed by Rule 14a-11.[112] Many institutional investors have favored a lower ownership threshold at larger-cap companies and a one or two year holding period,[113] both of which are lower than the measures under Rule 14a-11.

There are also concerns about state law preemption of proxy access; some companies may still take the position that such proposals are not permitted under state law.[114] Accordingly, the SEC rejected proposals to let each company's board or a majority of its shareholders decide whether to incorporate Rule 14a-11 in its bylaws, stating that "exclusive reliance on private ordering under state law would not be as effective and efficient" in facilitating shareholders' right to nominate and elect directors."[115] The rule does not apply if applicable state law or a company's governing documents "prohibit shareholders from nominating a candidate

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[106] *SEC Votes to Propose Rule Amendments*, *supra* note 27.
[107] Fisch, *supra* note 11, at 435.
[108] Bainbridge, *supra* note 12.
[109] *Id*.
[110] "Proxy Access Rule No Curb of Corporate Free Speech, Law Profs Say." 2011 WL 684192 (WJCODL).
[111] *Id*.
[112] *Rule 14a-8 Amendments Allowing Shareholder Proposals*, *supra* note 99.
[113] *Id*.
[114] *SEC Walks Away*, *supra* note 51.
[115] *Bus. Roundtable v. S.E.C.*, 647 F.3d 1146 (D.C. Cir. 2011).

for election as a director."[116]

Delaware, however, has already amended its laws to permit proxy access mechanisms.[117] In an *amicus* brief in support of the Business Roundtable, Delaware argued that it already had amended its corporate laws to allow companies to modify their bylaws to establish a right of access.[118] The Delaware legislature adopted Section 112 of the Delaware General Corporation Law, which explicitly authorizes, but does not require, bylaws granting shareholders access to the corporation's proxy materials to nominate directors.[119] Section 113, which also is enabling, permits a bylaw providing for the corporate reimbursement of shareholders soliciting proxies for the election of directors.[120] This amendment therefore gives stockholders the ability to decide whether and when stockholders would be granted such a right of access.[121]

Although issuer specific experimentation may not produce the perfect proxy access procedure, it—unlike the SEC's regulatory process—is likely to produce experiential data that, at a minimum, can facilitate more informed governance choices.[122] It would be costly, from a time and money standpoint, to address the court's defects. Instead, using private ordering as a way for experimentation might mean that findings would take care of themselves. Empirical evidence might inevitably emerge, which will either help or hinder the goal of universal proxy access. Indeed, some evidence of shareholder proposals through Rule 14a-8 has already appeared. Since the Rule 14a-8 amendments, Hewlett Packard preliminarily approved proxy access for shareholders who hold 3% of the company's shares for three years, limiting them to 20% of the board seats.[123] Additionally, Nabors has approved access to the proxy with a threshold of at least 3% of shares for three years, with the right to nominate 25% of the board.[124] Importantly, these are the same exact thresholds as those proposed by the SEC in Rule 14a-11.[125] We may see more examples of individualized proxy access over time. Governance standards could very well emerge along with a richer

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[116] *Id*. at 1145.
[117] *SEC Walks Away*, *supra* note 51.
[118] "Proxy Access Rule No Curb of Corporate Free Speech, Law Profs Say". 2011 WL 684192 (WJCODL).
[119] *SEC Walks Away*, *supra* note 51.
[120] *Id*.
[121] "Proxy Access Rule No Curb of Corporate Free Speech, Law Profs Say". 2011 WL 684192 (WJCODL).
[122] Fisch, *supra* note 11, at 500.
[123] Matt Orsagh, *Shareowners Gain Leverage Through Proxy Access At Nabors Industries, Chesapeake Energy*, Seeking Alpha (June 14, 2012), http://seekingalpha.com/article/658491-shareowners-gain-leverage-through-proxy-access-at-nabors-industries-chesapeake-energy.
[124] *Id*.
[125] *Id*.

sample size of evidence, and—fortunately for the SEC—*these* findings will be free.

IV. CONCLUSION

The SEC still intends to regulate proxy access, but for the time being, mandatory, comprehensive proxy access by federal regulation seems unlikely. In the meantime, the best way of effectuating investor confidence through access to the proxy is to abandon its potentially costly efforts at justifying comprehensive proxy access. Instead the SEC should rely on the framework of Rule 14a-8. Indeed, rather than battles for mandatory proxy access at the federal level, permissive proxy access at the state level, as seen in Delaware, should suffice and may actually prove favorable to the SEC's goal of enhancing shareholder empowerment.