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RECONOCIMIENTOS

El Séptimo Volumen del *University of Puerto Rico Business Law Journal* (en adelante el *Journal*) se compone de veinticinco destacados estudiantes de la Escuela de Derecho de la Universidad de Puerto Rico. Durante el transcurso de este Volumen, nuestro Cuerpo Editorial demostró tener las habilidades y el ímpetu necesario para lograr cada uno de los objetivos trazados. Entre sus cualidades reflejadas se encuentran: el liderazgo, la organización, el compañerismo, la empatía, la perseverancia, la ingeniosidad, el esfuerzo, la responsabilidad y el compromiso. Además, cuentan con excelentes destrezas de redacción, edición de contenido y de citas, según el *Bluebook*. Estamos conscientes de que su desenvolvimiento en el *Journal* les servirá de gran beneficio personal y profesional, por haber contado con esta experiencia enriquecedora durante su formación como abogados.

El eficiente desempeño de nuestro Cuerpo Editorial se refleja en el contenido de ambos Números, que contienen artículos de gran calidad. Entre los temas abarcados dentro de este Volumen se encuentran: quiebras, arbitraje, economía ambiental, acciones de clase, acciones derivativas, responsabilidad vicaria, regulación tarifaria, deudas dentro del Régimen de Propiedad Horizontal, ejecución de hipotecas y otros temas corporativos. La diversidad de temas publicados en este Volumen reflejan la amplia gama de asuntos discutidos y difundidos a través de nuestra revista especializada.

Además de la publicación de los artículos, tuvimos la oportunidad de publicar un libro titulado *Congreso Internacional de Derecho Administrativo*. Este libro abarca las ponencias de los panelistas de más de veinte países de Europa e Iberoamérica, que fueron expuestas en el XIV Congreso de Derecho Administrativo celebrado en el Centro de Convenciones de San Juan, Puerto Rico. A través del mismo, se demuestra cómo los diversos países encaran la contratación, la regulación, la ética, el acceso, la participación, la política y los procesos en el ámbito público. En adición, la obra provee un mecanismo de comparación de aspectos administrativos, jurídicos y culturales para enriquecer el desarrollo efectivo de un sistema gubernamental. Más aún, tuvimos la ocasión de asistir y participar en el Congreso. Esta experiencia nos permitió intimar con expertos en la mencionada materia a nivel internacional. Por esto estamos sumamente satisfechos con las labores desempeñadas en conjunto con el Foro Iberoamericano de Derecho Administrativo (FIDA), las cuales resultaron de mucha eficacia.

A través del año, ofrecimos una serie de talleres de: edición de contenido y citas, redacción de contratos y redacción de instrumentos públicos. Estos talleres tienen el propósito de proveer un medio didáctico para la confección de escritos legales. A esto se le añade los foros de discusión que incluyeron aspectos socio-económicos relacionados a: el Negocio del Deporte, el Fraude Tributario y la Reforma Energética en América Latina. Con estas labores extra-editoriales, cumplimos con una función social al servir de medio de propagación de ideas sociales, económicas y jurídicas, a nivel nacional e internacional. Agradecemos el esfuerzo de

nuestro Cuerpo Editorial y el de la Facultad de la Escuela de Derecho de la Universidad de Puerto Rico, de quienes estamos sumamente satisfechos con su participación a través del año.

Por último, propiciamos a que nuestras labores desempeñadas a lo largo de este año contribuyan al eficiente desarrollo de nuestro sistema económico y jurídico. Confiamos en que su participación en la lectura de nuestros artículos, reseñas, noticias y su asistencia a nuestros talleres y foros de discusión les servirán de gran beneficio intelectual y práctico. Esperamos que el contenido de este Séptimo Volumen sea de su agrado y utilidad.

Cordialmente,

Junta Editorial
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THE VIRTUES OF THE DUE DILIGENCE DEFENSE FOR CORPORATIONS IN CRIMINAL CASES: SOLVING THE PROBLEMS OF A CORPORATION'S VICARIOUS LIABILITY FOR THE CRIMES OF ITS AGENTS AND EMPLOYEES

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I. INTRODUCTION

Recent events, especially those surrounding the financial crisis of 2008, have provided diverse examples of serious misconduct by large and powerful corporations. Entities as diverse as Enron, J.P. Morgan Chase, and Bank of America, among others, have been accused of violating both civil and criminal rules governing the conduct of business activities. But, on the federal level, many of these same entities have not been subject to formal criminal prosecutions. Instead, they have reached settlements with federal prosecutors that have precluded formal criminal prosecutions. Rather than face formal criminal judgments in these settlements, the corporations have paid fines and provided other remedies to the victims of their wrongful conduct.

This trend in prosecution strategy coincides with an increasing criticism of the legal structure of criminal law as it applies to corporations. That structure was first established more than a century ago when the Supreme Court held that corporations could be vicariously liable for crimes committed by their agents and employees.[1] That fundamental principle for establishing corporate criminal liability was developed to solve a particular problem in the legal context at the turn of the twentieth century; nonetheless, it has persevered ever since, even

[1] New York Cent. & Hudson River R.R. Co. v. United States, 212 U.S. 481 (1909) [hereinafter, *New York Cent.*].

though the scope and purposes of the criminal statutes applicable to corporations have greatly expanded.

This paper addresses the question of whether principles of vicarious liability should still be at the center of corporate criminal law. To do this, it begins by considering the purposes of criminal law, and the nature of corporate personhood to help identify the fundamental objectives that should be accomplished when corporations are subject to criminal prosecution. Then, the paper will examine how the principles of vicarious liability were injected into the criminal law, as applied to corporations to show what purposes those principles were designed to serve. Next, it reviews various approaches to modify the principles of corporate criminal law and determine which of them are consistent with the fundamental objectives that corporate criminal law should serve. Finally, it concludes that those objectives are best served if principles of vicarious liability are preserved while corporations are permitted to deny vicarious liability with an affirmative defense of due diligence, in which they can show that they took affirmative steps to prevent the criminal conduct of their agents and employees.

Such a modification of the current standards for corporate criminal liability would prevent corporations from being held responsible for the truly independent wrongdoing of their agents and employees. If prosecutors have declined to pursue formal criminal proceedings against corporations because they feared the principles of vicarious liability would lead to unjust results, this modification would remove a barrier to such proceedings. And if that barrier is removed, there will be more opportunities to use the instrumentalities of the criminal justice system as a formal expression of moral judgment about the conduct of some of the most powerful and influential people in the United States.

II. THE PURPOSES OF CRIMINAL LAW

Any understanding of how corporations should be regulated by the criminal law must begin with an understanding of the purposes that criminal law serves. In general, criminal law has the purpose of protecting society from wrongful conduct by establishing a moral standard for conduct —that is, distinguishing between right and wrong— and by punishing those who fail to meet that standard.[2] This broad objective is often described more specifically in terms of the concepts of *retribution* and *deterrence*.[3] Criminal law seeks to express society's moral judgments by taking retribution against wrongdoers, and it seeks to deter wrongful conduct as a means of protecting the community.[4]

Prosecution and punishment through the criminal justice system is a means of effecting retribution against those who violate the moral principles expressed through criminal statutes. "What actions are deemed to be *criminal* is a judgment by society as to what is out of bounds of acceptable societal behavior.

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[2] Henry M. Hart, Jr., *The Aims of the Criminal Law*, 23 LAW & CONTEMP. PROBS. 401, 401–11 (1958).

[3] *Id.*; *see also* Andrew Weismann, *A New Approach to Corporate Criminal Liability*, 44 AM. CRIM. L. REV. 1319, 1325–26 (2007).

[4] Hart, *supra* note 3; Weismann, *supra* note 3.

The transgression of that boundary is itself a harm that society has determined warrants its harshest condemnation."[5] In this respect, the retributive aspect of criminal law pertains to the assessment of the voluntariness and intent behind wrongful conduct.[6] That is, the criminal law directs society's retributive impulse against blameworthy decision-making —*mens rea*— as well as against harm-causing conduct.[7] Thus, the criminal law expresses a moral judgment, and establishes a standard for making moral judgments.

Of course, criminal law is about more than expressing a moral judgment of wrongful conduct; it is also about protecting the community from harmful conduct. In this respect, criminal law also aims to deter such harmful conduct. Deterrence involves both discouraging individuals from making the choice to commit crimes and protecting the community from individuals who have chosen to commit crimes, usually by restricting their liberty through criminal punishment.[8]

In this regard, the deterrence rationale for criminal law consists of two primary components: specific deterrence and general deterrence.[9] "Specific deterrence refers generally to incapacitating the criminal to prevent or dissuade future conduct in that individual. For a real person, that incapacitation comes usually in the form of imprisonment. It can also include restrictions on one's liberty and even employment during a period of supervised release."[10] General deterrence is the effect created from public awareness of the criminal penalties imposed on specific individuals.[11] This kind of deterrence is regarded to be especially important with respect to crimes requiring deliberation and calculation, as opposed to crimes of passion.[12] "General deterrence is particularly apt with respect to corporate criminal conduct, which tends to be the antithesis of crimes of passion. Corporations—through boards, inside and outside counsel, and formal deliberative processes—generally pay particular attention to precedent in determining the risks and rewards of contemplated action."[13]

III. THE NATURE OF CORPORATE PERSONHOOD

The criminal law regulates the conduct of persons. Of course, the law has long recognized that a corporation is a *person* just as an individual is.[14] This recognition leads to the conclusion that corporations are subject to the requirements of criminal law, just like any other person is. Accordingly, criminal statutes that do not specifically refer to liability for entities are governed by the

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[5] Weismann, *supra* note 3, at 1326.
[6] Id.
[7] *Id.*
[8] Id.
[9] *Id.* at 1325-26.
[10] *Id.* at 1325.
[11] *Id.* at 1325-26.
[12] Weismann, *supra* note 3, at 1325-26.
[13] *Id.* at 1325.
[14] Metropolitan Life Ins. Co. v. Ward, 470 U.S. 869, 881 (1985) (It is well established that a corporation is a 'person' within the meaning of the Fourteenth Amendment).

definitional provisions of the United States Code, which state "unless the context indicates otherwise . . . the words 'person' and 'whoever' include corporations, companies, associations, firms, partnerships, societies, and joint stock companies as well as individuals."[15]

But recognizing a corporation as a person for the purposes of criminal law is not as simple as asserting a definition. There is no doubt that corporate personhood is a unique phenomenon. The differences between the personhood of individual human beings and the personhood of disembodied business entities is important for understanding how criminal law applies to corporate persons.

Among corporate law scholars, there are three leading conceptions of the nature of the corporation: (1) as a fictional person; (2) as an entity or piece of property owned by its shareholders; or (3) as a nexus of contracts.[16] The concept of the corporation as a *person* is a legal fiction designed to convey the idea that the corporation has the authority to do things that persons do, especially to make contracts and own property. The power to own property is especially useful because it permits corporations to partition their own assets from the assets of their owners, thus insulating the owners from any liability for the corporation's debts.[17] The conception of corporations as legal entities is another way of explaining the reality of corporate existence, especially the insulation of shareholders from the corporation's own assets and liabilities. Under this conception, corporations are entities in the sense that corporate property is entirely distinct from the property of the owners and even in corporations that have a single owner, the owner, as an individual, have no standing to enforce the property rights of the corporation.[18] The *nexus of contracts* concept is useful because it effectively explains how the corporation acts through the individuals of which it is comprised, —the directors, managers, and employees. In this sense, the corporation is purely abstract, a conceptual locus for a variety of contractual relationships —contracts between the shareholders and the corporation, the employees and the corporation, the corporation and its creditors, the corporation and its customers and suppliers, and so on.[19]

Under each of these conceptions, the corporation is a *being* constituted by a set of legal rules. This set of rules has three principal elements: (1) the state statutory law that defines the framework in which it can operate; (2) its charter, by-laws, and other constitutional documents that determine how it will operate within that framework; and (3) any contractual agreements among its owners that determine their rights and duties to each other with respect to the framing of the corporate constitutional documents. These legal rules are all essential to the corporation's existence because they define the scope of agency that individual human beings have in connection with the corporation's action. These rules can

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[15] 1 U.S.C. § 1 (2012); *See also* Rowland v. California Men's Colony, Unit II Advisory Council, 506 U.S. 194, 199–200, 210–11 (1993) (noting that, as a general rule of statutory interpretation, corporations can be criminally liable unless the establishment of such liability would be inconsistent with the statutory scheme).

[16] Stephen Bainbridge, The New Corporate Governance in Theory & Practice 25–30 (2008).

[17] *Id*. at 25–26.

[18] *Id*. at 26–27.

[19] *Id*. at 28–30; *see also* William A. Klein, *The Modern Business Organization: Bargaining under Constraints*, 91 YALE L. J. 1521 (1982) (describing the corporation as a nexus of contracts).

prescribe the set of values and objectives for which the corporation's directors, managers, employees, and other agents must account in discharging their duties to the corporation. By controlling the actions of the human beings who act on the corporation's behalf, these legal rules define who the corporation is.

The legal structure that determines the framework for corporate decision-making makes corporations similar to individuals because this structure gives them an identifiable persona and the capacity to make moral judgments.[20] The fact that corporations must make decisions according to a particular set of rules, —which can be substantive as well as procedural— means that the corporation has its own independent *ethos* and is not merely the reflection of the personal preferences of its owners and managers.[21] Indeed, the independent personhood of corporations has been recognized by the Supreme Court when it has held that corporations have, among other rights, the constitutional right to freedom of speech.[22] It would not make any sense for the Court to hold that corporations had this right, if they were not capable, of expressing their own unique views that were different from their constituents.

IV. THE PROBLEM OF APPLYING THE CRIMINAL LAW TO CORPORATE PERSONS

Because corporations are abstract entities that act only through the conduct of their agents, the fundamental problem of corporate criminal liability arises in determining when the conduct and mental state of an agent of the corporation, —one of its directors, managers, or employees—, can be attributed to the corporation as corporate conduct. There is a wide spectrum of opinion on how to solve this problem. At one end of the spectrum lies the argument that it is impossible to ever attribute the criminal conduct of an agent to a corporation because the legal rules that constitute the corporation's existence make it impossible for the corporation to ever authorize criminal conduct by an agent.[23] In this connection, criminal conduct is always *ultra vires* action by the agent for which he or she alone must be responsible. At the other end of the spectrum, is the contention that a corporation must be responsible for all of the conduct and decision-making of its agents as long as such conduct and decision-making were undertaken within the ostensible scope of agency and as long as the conduct redounded to the corporation's benefit.[24] According to this viewpoint, agents must be presumed to be acting on behalf of the corporation and at its direction,

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[20] Lawrence Friedman, *In Defense of Corporate Criminal Liability*, 23 HARV. J.L. & PUB. POL'Y 833, 846 (2000).

[21] Pamela H. Bucy, Corporate Ethos: A Standard for Imposing Corporate Criminal Liability, 75 MINN. L. REV. 1095, 1099 (1991); see also Eli Lederman, Models for Imposing Corporate Criminal Liability: From Adaptation and Imitation Toward Aggregation and the Search for Self-Identity, 4 BUFF. CRIM. L. REV. 694 (2000).

[22] *See* Bank of Boston v. Bellotti, 435 U.S. 765, 787–95 (1978).

[23] *See* Michael Moore, Placing Blame: A General Theory of The Criminal Law 596-617 (1997).

[24] *See* United States v. Hilton Hotels, Inc., 467 F.2d 1000 (9th Cir. 1972), *cert. den.*, 409 U.S. 1125 (1973)). (holding that a corporation could be liable for criminal violations of the Sherman Antitrust Act that were committed by a manager, even though the manager's conduct was expressly contrary to corporate policy).

unless it can be conclusively shown that they were acting on their own, perhaps because they were violating an express directive or policy issued by management.

In the United States, the law governing corporate criminality currently stands at the latter end of this spectrum, imposing criminal liability under a theory of vicarious liability. But this approach to corporate criminal liability was developed over a century ago and served the purposes of a rather specific legal framework. Numerous fundamental changes occurring since this principle was established have raised serious questions about whether reform is warranted in the fundamental principles for determining corporate criminal liability.

V. VICARIOUS LIABILITY PRINCIPLES AND CORPORATE CRIMINAL LIABILITY

The foundational statement of the existing principles for establishing corporate criminal liability comes from the Supreme Court's decision in *New York Central & Hudson River Railroad Co. v. United States*,[25] which was decided in 1909. This was the first case in which the Court expressly held that a corporation could be liable for criminal conduct, and it concluded that such liability could be established by a theory of vicarious liability or *respondeat superior*, in which the criminal conduct of the individual agents of the corporation, such as its managers or its employees, would be imputed to the entity. Although this mode of analyzing corporate criminal conduct has persisted for more than a century, the ruling in *New York Central* was the product of several historically unique circumstances.

The question of corporate criminal liability did not arise until 1909 because, in a very real sense, there were simply no criminal statutes that a corporation could violate until the end of the nineteenth century. At that point, as the federal government made its first efforts to regulate corporate behavior, the possibility arose of using the criminal law as an aspect of the regulation of industry.[26] Thus, the imposition of criminal liability on corporations began as an instrument for supplementing the regulation of corporations through civil law.

With industrialization and the expanded use of the private business corporation during the middle and late nineteenth century came concerns about monopolistic economic behavior by corporations, especially by railroad corporations. The corporate form was especially well-suited for use by railroad enterprises, given the large capital investment that was required to pay for purchasing the property rights needed to lay lines, constructing the lines, and purchasing rolling stock, among other things.[27] Because railroads made such enormous investments in their capital stock, they were willing to slash their carriage rates to win business, even if such low rates meant operating at a loss for an extended period of time.[28] Operating losses were a relatively small price to pay for staying in business and preserving the long-term value of the company's

[25] New York Cent., 212 U.S. 481.
[26] Lawrence M. Friedman, Crime & Punishment in American History 282–86 (1993).
[27] Lawrence M. Friedman, A History of American Law 511-25 (2d ed. 1985).
[28] *Id.*

original capital investment.[29] Thus, railroads often engaged in predatory pricing, cutting their rates to levels substantially below cost, hoping to drive competitors out of business by forcing them to accept operating losses.[30] The ultimate objective of these practices was to destroy competition and obtain monopoly power in a particular geographic market, at which point, the railroad could raise prices to recoup its previous losses and earn monopoly profits going forward.[31]

The federal government sought to control these practices with legislation. As a means of controlling railroad rates, Congress enacted the Interstate Commerce Commission Act of 1887,[32] which was the first federal law to regulate private industry.[33] It prohibited price discrimination against smaller markets, such as farmers, and it required that railroad rates be "reasonable and just."[34] To enforce these regulations, it established an administrative agency, the Interstate Commerce Commission (ICC).[35] Along similar lines, in 1890, Congress sought to directly prohibit monopolistic conduct by enacting the Sherman Act,[36] which outlawed attempts to create monopolies and conspiracies to restrain commerce.[37]

After a short time, it was clear that the ICC Act and the Sherman Act were not enough, in themselves, to avoid the problems caused by monopolistic and other kinds of anti-competitive behavior. As early as 1891, the ICC recommended that Congress enact a statute imposing criminal liability on corporations, to supplement the statute creating individual criminal liability for violations of the ICC Act and Sherman Act.[38] The ICC reasoned that, according to established judicial precedent, corporations could not be classified as persons for the purpose of enforcing the criminal statutes for anti-competitive behavior.[39] It further argued that imposing criminal liability directly upon the corporations themselves was necessary for several reasons.[40] First, prosecuting individual corporate agents alone might not be effective when the violations of federal statutes benefitted only the railroad, but not the agents themselves because both jurors and the general public would oppose the punishment of individuals who did not personally gain from corporate action.[41] Second, when the corporation, that is, the real beneficiary of a criminal violation, "not only goes unpunished, but is adjudged incapable of criminal wrongdoing, the law is effectively nullified and brought into 'general discredit.'"[42] Third, even if it would be effective and just to direct prosecutions solely at individuals, it could be difficult in many cases to

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[29] *Id.*
[30] FRIEDMAN, *supra* note 26, at 282-86.
[31] Id.
[32] Interstate Commerce Act of 1887, ch. 104, 24 Stat. 379.
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[34] *Id.*, § 1.
[35] See id.
[36] Sherman Antitrust Act of 1890, ch. 647, 26 Stat. 209 (codified as 15 U.S.C.).
[37] FRIEDMAN, *supra* note 26, at 282-86.
[38] Interstate Commerce Comm'n, Fifth Annual Report, Dec. 1, 1891, S. Misc. Doc. No. 52-31 at 16 (1892).
[39] *Id.*
[40] *Id.* at 16-17.
[41] *Id.*
[42] *Id.*

identify particular persons who would be appropriate targets of prosecution because the corporation action was the joint effort of so many different individual employees or managers, many of who acted independently.[43]

While these requests lay dormant for a decade, they were revived when Theodore Roosevelt became president in 1901. Long known for his strong support of anti-trust law and commitment to controlling monopolistic practices, he called on Congress to act under the authority to regulate interstate commerce under the Commerce Clause and to enact various new statutes to control corporate conduct.[44] One such statute was the Elkins Act of 1903,[45] which created corporate criminal liability for railroads in connection with the ICC Act. It provided:

> That anything done or omitted to be done by a corporation common carrier, subject to the Act to regulate commerce and the acts amendatory thereof, which, if done or omitted to be done by any director or officer thereof, or any receiver, trustee, lessee, agent, or person acting for or employed by such corporation, would constitute a misdemeanor under said Acts or under this Act shall also be held to be a misdemeanor committed by such corporation, and upon conviction thereof it shall be subject to like penalties as are prescribed in said Acts or by this Act, with reference to such persons, except as such penalties are herein changed. . . .
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> In construing and enforcing the provisions of this section the act, omission, or failure of any officer, agent, or other person acting for or employed by any common carrier acting within the scope of his employment, shall in every case be also deemed to be the act, omission, or failure of such carrier as well as that of the person.46

The Supreme Court's decision in *New York Central*[47] arose from the prosecution of a railroad company for giving illegal rebates. The railroad had published a rate for shipping sugar from New York City to Detroit of twenty-three cents per one hundred (100) pounds. Its general traffic manager and assistant traffic manager reached an agreement with two sugar refiners to provide a rebate of five cents per one hundred (100) pounds on all sugar shipped on the railroad to the refiners' consignee in Detroit.[49] The rebate was offered to induce the refiners to ship via rail instead of by ship, up the Hudson River and across the Great Lakes.[50] The Supreme Court noted that the rebate helped the railroad respond to "severe competition with other shippers and dealers."[51] The railroad

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[43] *Id.*
[44] Theodore Roosevelt, First Annual Message to Congress (Dec. 3, 1901), http://www.presidency.ucsb.edu/ws/?pid=29542 (last visited Jan. 7, 2015).
[45] Act of Feb. 19, 1903, ch. 708, 32 Stat. 847.
[46] *Id.* at § 1.
[47] *New York Cent.*, 212 U.S. at 489.
[49] Id.
[50] See id.
[51] *Id.* at 491.

itself and its assistant traffic manager were convicted of a criminal violation of the Elkins Act.[52]

In challenging the conviction, the railroad argued that the Elkins Act was unconstitutional "because Congress has no authority to impute to a corporation the commission of criminal offenses, or to subject a corporation to a criminal prosecution by reason of the things charged."[53] The railroad made other constitutional arguments as well:

> The argument is that to thus punish the corporation is in reality to punish the innocent stockholders, and to deprive them of their property without opportunity to be heard, consequently without due process of law. And it is further contended that these provisions of the statute deprive the corporation of the presumption of innocence, a presumption which is part of due process in criminal prosecutions. It is urged that as there is no authority shown by the board of directors or the stockholders for the criminal acts of the agents of the company, in contracting for and giving rebates, they could not be lawfully charged against the corporation.[54]

The Court began its analysis of these arguments by acknowledging the long-standing authority by several prominent treatise authors that a corporation could not commit a crime. In this connection, the Court quoted Blackstone, summarizing the well-established rule that "A corporation cannot commit treason, or felony, or other crime in its corporate capacity, though its members may in their distinct individual capacities."[55]

Notwithstanding, the Court asserted that "[t]he modern authority, universally, so far as we know, is the other way."[56] The Court explained the reasoning behind this modern authority:

> Since a corporation acts by its officers and agents, their purposes, motives, and intent are just as much those of the corporation as are the things done. If, for example, the invisible, intangible essence or air which we term a corporation can level mountains, fill up valleys, lay down iron tracks, and run railroad cars on them, it can intend to do it, and can act therein as well viciously as virtuously.57

The Court also noted that several states and England had all concluded that corporations could be liable for criminal offenses, even if they could only be punished by fines or by the seizure of property.[58] And it noted that its own case law had held that corporations could be liable for torts under a theory of vicarious liability.[59]

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[52] *Id.* at 489.
[53] *Id.* at 492 (discussing the petitioner's argument).
[54] *Id.* at 492.
[55] *Id.* (quoting BLACKSTONE, COMMENTARIES, ch. 18, § 12).
[56] *Id.*
[57] *Id.* at 492–93 (quoting BISHOP'S NEW CRIMINAL LAW § 417).
[58] *Id.* at 493.
[59] *Id.* (citing Lake Shore & Mich. Southern R.R. v. Prentice, 147 U.S. 101, 109–11 (1893)).

This led the Court to conclude that the same principles of vicarious liability could also apply in criminal law as well as in tort law. As the Court explained:

> A corporation is held responsible for acts not within the agent's corporate powers strictly construed, but which the agent has assumed to perform for the corporation when employing the corporate powers actually authorized, and in such cases there need be no written authority under seal or vote of the corporation in order to constitute the agency or to authorize the act.60

The Court also pointed out that such vicarious liability was necessary to effectuate the regulation of corporate conduct.

> Applying the principle governing civil liability, we go only a step farther in holding that the act of the agent, while exercising the authority delegated to him to make rates for transportation, may be controlled, in the interest of public policy, by imputing his act to his employer and imposing penalties upon the corporation for which he is acting in the premises.61

The Court stopped short of holding that any and all criminal statutes could be applied to corporations. Rather, it concluded that the criminal liability of corporations would be limited to particular classes of offenses.

> It is true that there are some crimes, which in their nature cannot be committed by corporations. But there is a large class of offenses, of which rebating under the Federal statutes is one, wherein the crime consists in purposely doing the things prohibited by statute. In that class of crimes we see no good reason why corporations may not be held responsible for and charged with the knowledge and purposes of their agents, acting within the authority conferred upon them. 2 Morawetz on Corporations, § 733; Green's Brice on Ultra Vires, 366. If it were not so, many offenses might go unpunished and acts be committed in violation of law, where, as in the present case, the statute requires all persons, corporate or private, to refrain from certain practices forbidden in the interest of public policy.62

It also reasoned that Congress intended to impose criminal liability on corporations themselves when enacting the Elkins Act.

> It is a part of the public history of the times that statutes against rebates could not be effectually enforced so long as individuals only were subject to punishment for violation of the law, when the giving of rebates or concessions ensured to the benefit of the corporations of which the individuals were but the instruments. This situation, developed in more than one report of the Interstate Commerce Commission, was no doubt

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[60] *Id.* at 493–94 (citation omitted).
[61] *Id.* at 494.
[62] *Id.* at 494-95.

> influential in bringing about the enactment of the Elkins Law, making corporations criminally liable.63

When viewed solely within the relatively narrow context of legal efforts to prevent anti-competitive behavior, it made sense for the Court's to decide to adopt principles of vicarious liability into criminal law. The civil statutory rules prohibiting anti-competitive conduct were an extension of existing principles of tort law. And the criminal rules established by the Elkins Act essentially created a criminal penalty for the same conduct that was already prohibited by the civil statutory rules. Moreover, ruling that the Elkins Act applied only to individual agents of the corporation but not the corporation itself would have put corporations in a position to insist that their managers or employees engage in anti-competitive conduct without any fear of direct consequences to the corporation itself. Finally, as one commentator has pointed out, "[g]iven the absence of widespread public civil enforcement prior to the early 1900s, corporate criminal liability appears to have been the only available option that met both the need for public enforcement and the need for corporate liability."[64] As another commentator has noted:

> Corporate liability deters crime; it moves the risk of loss away from risk averse officers and directors toward the firm; it efficiently distributes liability risk between the firm and employees. Without significant entity liability or even shared liability, some argued, incentives would be seen as too weak to ensure an organizational commitment to law abidance.[65]

The fact that adopting principles of vicarious liability made sense in the context of the law prohibiting anti-competitive conduct does not, however, mean that vicarious liability makes sense in every context where the criminal law might be applied. As government regulation of business conduct has expanded in scope and intensity over the past century, especially in the wake of the New Deal, the legal context for imposing corporate criminal liability has changed greatly. There is a very real question of whether and under what circumstances corporations should be liable for all of the criminal acts committed by their agents within the scope of their agency. And, if such a universal application of vicarious liability principles is not warranted, a question also arises about what alternative principles can be applied to determine when corporations can and should be criminally liable.

Even now, more than a century after *New York Central*, the Court has not imposed any significant limitations on the kinds of crimes for which vicarious liability can be found. Even in *New York Central*, the Supreme Court conceded that

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[63] *Id.* at 495.

[64] V.S. Khanna, Corporate Criminal Liability: What Purpose Does It Serve?, 109 HARV. L. REV. 1477, 1486 (1996). See also Wayne A. Logan, Criminal Law Sanctuaries, 38 HARV. C.R.-C.L. L. REV. 321, 353 (2003) ("[B]y the early 1900s, legislators and judges realized that the criminal law required modification to properly account for wrongs committed by increasingly powerful and prevalent corporate collectives").

[65] William S. Laufer, *Corporate Liability, Risk Shifting, and the Paradox of Compliance*, 52 VAND. L. REV. 1343, 1364 (1999) (footnotes omitted).

there are "some crimes which, in their nature, cannot be committed by corporations," [66] but, in the decades following that statement, neither the Supreme Court nor any other federal court has imposed a significant limitation on the scope of the application of vicarious liability. In fact, corporations have been held criminally liable for a wide variety of federal offenses that require specific intent.[67] Consequently, even though the adoption of vicarious liability principles for corporate criminal law was the product of a particular regulatory context, and even though the *New York Central* Court acknowledged that the context was a dispositive factor in its decision, those principles still find universal application.

VI. THE DIMINISHING PROSECUTION OF CORPORATIONS: IS VICARIOUS LIABILITY THE PROBLEM?

In recent years, there have been many high-profile examples of corporate misconduct, especially in connection with the collapse of the mortgage-backed securities market in 2008. Even so, there have been a substantial number of prominent cases in which federal prosecutors have chosen to avoid a full-scale prosecution and trial and, instead, have entered into deferred prosecution agreements or non-prosecution agreements, or outright settlement agreements with corporations. [68] In these agreements, corporations undertake remedial measures as a substitute for criminal punishment.[69] Some have suggested that the use of such agreements is on the rise because there are increasing doubts about whether it is appropriate to impose criminal liability on corporations.[70]

The fact that settlements produce remedial measures that look like civil penalties tends to reinforce these suggestions. In many settlements, corporations accept civil liability as a substitute for criminal liability and pay fines instead of being subjected to other forms of punishment available under criminal law.[71] For example, in 2009, Pfizer Inc. and one of its subsidiaries were alleged to have engaged in health care fraud arising from the illegal promotion of certain

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[66] *New York Cent.*, 212 U.S. at 494.

[67] Kathleen F. Brickey, Corporate Criminal Liability: A Treatise on the Criminal Liability of Corporations, Their Officers & Agents § 2.09 (2d ed. 1992) (describing extension of corporate criminal liability to a variety of specific intent crimes including contempt of court and various forms of conspiracy, including conspiring to violate state and federal antitrust laws). In this three-volume treatise, Brickey discusses such subjects as corporate criminal liability for conspiracy, racketeering, various forms of fraud, foreign corrupt practices, violations of the election laws, bribery, tax offenses, currency reporting offenses, money laundering, obstruction of justice, perjury, and false statements.

[68] Gibson, Dunn Crutcher LLP, 2014 Mid-Year Update on Corporate Deferred Prosecution Agreements (DPAs) and Non-Prosecution Agreements (NPAs) (July 8, 2014), available at http://www.gibsondunn.com/publications/pages/2014-Mid-Year-Update-Corporate-Non-Prosecution-Agreements-and-Deferred-Prosecution-Agreements.aspx (last visited January 7, 2015).

[69] See id.

[70] See id.

[71] *See, e.g.*, Matthew Goldstein, *Bank of America to Pay $131.8 Million Penalty in Mortgage Deals*, N.Y. TIMES (December 12, 2013), available at http://dealbook.nytimes.com/2013/12/12/bank-of-america-to-pay-131-8-million-penalty-in-c-d-o-deals/ (last visited January 7, 2015).

pharmaceutical products.[72] As a means of settling all civil and criminal liability in connection with these allegations, Pfizer and its subsidiary agreed to pay a settlement of $2.3 billion, the largest health care fraud settlement in the history of the Department of Justice. The settlement included a fine of $1.195 billion, which was technically denominated as a criminal penalty, and the companies agreed to the forfeiture of $105 million, along with a payment of $1 billion to resolve allegations under the civil False Claims Act and provide $102 million to civil claimants.[73] Notwithstanding, the characterization of a portion of the settlement amount as a criminal fine, this agreement has all of the characteristics of a civil remedy, especially because it lacks the formal accusation of guilt and a corresponding admission or judicial finding of such guilty. While this kind of agreement may accomplish important material objectives, especially with respect to the compensation of the victims of the company's misconduct, it lacks the same kind of moral judgment that would be included in a criminal prosecution.

The increasing prevalence of this kind of outcome in cases of serious corporate misconduct could suggest that prosecutors are reluctant to initiate formal criminal proceedings against corporations because criminal liability is too forceful or too blunt an instrument. If this is the case, the perseverance of vicarious liability principles in corporate criminal law could be understood as a factor in prosecutorial reluctance to seek formal criminal sanctions against corporations. In other words, it is possible that the existing legal structure for imposing criminal liability on corporations has outlived its usefulness and that something new is required.

VII. CRITIQUES OF THE APPLICATION OF VICARIOUS LIABILITY PRINCIPLES TO CORPORATE CRIMINAL LIABILITY

There is no shortage of contemporary commentary calling for reform in the legal structure of the criminal law as it applies to corporations. Many scholars and other commentators argue that the approach to corporate criminal liability that was set forth in *New York Central* is not appropriate for many, if not most, of the circumstances in which corporations are charged with misconduct. These writers offer suggestions about how to reform the legal structure of criminal law as it is applied to corporations. Their perspectives are valuable in understanding the shortcomings of relying only on vicarious liability as a basis for corporate criminal liability.

The fundamental critique of using principles of vicarious liability to establish corporate criminal responsibility is that such liability is simply incompatible with the fundamental presumptions of criminal law.[74] This critique focuses on the assertion that an *artificial person* such as a corporation lacks the

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[72] Department of Justice, Office of Public Affairs, Justice Department Announces Largest Health Care Fraud Settlement in Its History, (September 2, 2009), available at http://www.justice.gov/opa/pr/justice-department-announces-largest-health-care-fraud-settlement-its-history (last visited January 7, 2015).

[73] *Id.*

[74] Sara Sun Beale & Adam G. Safwat, What Developments in Western Europe Tell Us About American Critiques of Corporate Criminal Liability, 8 BUFFALO CRIM. L. REV. 89, 97–98 (2004).

kind of real mental capacities that would permit it to have any of the forms of *mens rea* that are essential for the overwhelming majority of criminal offense.[75] These capacities include rationality, autonomy, and emotionality, including the capacity to choose and cause the realization of one's choice and mental states such as joy, fear, and anger.[76] Without these crucial aspects of mental capacities, corporations lack the basis for being assigned moral responsibility.[77] This critique has special resonance within the retributivist purposes of criminal law, because, to the extent that criminal law seeks to sanction morally blameworthy decision-making, the corporation does not engage in any kind of moral reasoning, much less the blameworthy moral reasoning that is the object of criminal sanctions.

This critique also engages the idea that corporate criminal liability is inappropriate because it involves imputing guilt from one person to another artificial *person*. Corporations only act through their officers and employees, making an entity vicariously liable for the conduct of its agents and employees. This idea is inconsistent with the principle that an actor is responsible only for his own conduct and, most importantly, for his own intent. This vision is extended to attack the idea of imposing any kind of punishment on corporations. According to this, the actual effect of any criminal penalty for a corporation primarily falls on innocent shareholders, and, indirectly, on innocent employees who had no connection to the criminal conduct; as well as other innocent parties, such as the entities who rely on the corporation's business and profitability, the parties with whom it contracts, and, most broadly, the community as a whole.[78]

Indeed, in a very real sense, this critique of the current approach to corporate criminal liability is not just aimed at the reliance on principles of vicarious liability but, more broadly, on any form of criminal liability for corporations. If the premises of this critique are accepted —especially the idea that corporations lack any of the mental capacities to establish *mens rea*— then it would never be appropriate to impose criminal liability on a corporation, under a vicarious liability theory or any other theory that permitted a connection between the corporation and the actions of its agents.

This critique is problematic, however, because it disregards the fact that corporate decision-making can and does have all of the characteristics necessary for moral responsibility except emotionality. This makes it less than persuasive, both in its challenge to the existing theory for imposing corporate criminal liability but also its implicit challenge to the entire concept of corporate criminal liability. By engaging in the decision-making processes specified in their organizational rules, corporations act with autonomy, make decisions according to rational methods, because the law requires them to make rational decisions in the interests of their shareholders, and have the capacity to understand the

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[75] *See* MOORE, *supra* note 23 at 596–617; see also John C. Coffee, Jr., "No Soul to Damn: No Body to Kick": An Unscandalized Inquiry into the Problem of Corporate Punishment, 79 MICH. L. REV. 386 (1981).

[76] *Id.*

[77] See id.

[78] Paul H. Robinson, *The Virtues of Restorative Process, the Vices of Restorative Justice*, 2003 UTAH L. REV. 375, 384-85 (2003) (commenting that extending criminal liability to corporations "risks obscuring the moral content of criminal liability").

decisions by issuing orders to and through managers and employees. Because corporate decision-making has so many of the attributes of individual decision-making, corporations can have the kind of *mens rea* required for the imposition of ordinary criminal liability. Moreover, making corporations morally responsible will serve the retributive purposes of criminal law because corporations do engage in decision-making processes that can be an appropriate objection of moral condemnation.

Another problem with this critique is that it utterly disregards the reality of the corporation as an independent entity with a meaningful legal existence. By assuming that the corporation is nothing more than the actions of its agents and the interests of its individual shareholders, it is premised that the corporation is a kind of empty nexus where corporate agents and shareholders somehow intersect with each other with no mediating entity between them. This idea directly contradicts foundational principles of corporate law, especially the idea that the entity creates a *veil* separating the shareholders from the parties with whom the corporation does business. If punishing the corporation really is the same thing as punishing the shareholders, then, by the same reasoning, the shareholders should not be able to escape personal liability for the corporation's debts.

Finally, critique's discussion of the collateral effects of corporate criminal liability sweeps far too broadly, unintentionally providing an argument against criminal liability for anyone. As noted above, this critique complains that punishing corporations has unwarranted ill effects on employees removed from the criminal activity, on shareholders, and on other parties who rely on the corporation in one way or another. But if this kind of argument was a reason for avoiding criminal punishment, it would apply to every defendant, whether it was a *real* or *artificial* person. Even those guilty of the most heinous crimes have connections with family members and other innocent members of the community, all of whom will suffer if the guilty are jailed or otherwise subject to criminal punishment. In the end, the absurdity of this aspect of the critique demonstrates the fundamental problem with disregarding the reality of the corporation as an independent entity and of assuming that it is nothing more than an invisible meeting ground for a collection of individuals.

The law-and-economics scholarship is the source of another critique of the current regime for imposing criminal liability on corporations. In accordance with the prevailing analytical approach of law and economics theory, this critique asserts that corporations should not be subject to criminal liability because such liability is an inefficient way of responding to corporate misconduct.[79] Because law-and-economics scholars maintain that financial incentives are the only meaningful ones —for individuals and business entities alike— they conclude that criminal liability for corporations is, at best, redundant of civil liability, creating a double liability that is simply inefficient.[80] By this reasoning, the *redundant* criminal penalty is nothing more than a symbolic gesture that imposes real costs on the corporation and others but confers no concomitant benefits.[81]

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[79] Daniel R. Fischel & Alan O. Sykes, *Corporate Crime*, 25 J. LEGAL STUD. 319, 321 (1996).

[80] *See, e.g.*, V. S. Khanna, *supra* note 61 (examining the reputational and procedural costs in the corporate context).

[81] *Id.*

Moreover, the risk of this purported double penalty may result in over-deterrence, a situation in which the corporation behaves with less than optimal efficiency because it is unduly concerned with avoiding the double penalty.[82] Also, the additional legal procedure associated with criminal prosecution as a supplement to civil litigation increases litigation expenses, a form of transaction cost.[83]

Others in the law and economics school have suggested that the risk of criminal liability is so destructive of the proper incentive structure that it can create conflicting incentives, or even perverse incentives, that lead law-abiding corporations to engage in grossly inefficient decision-making and actions.[84] In particular, these commentators contend that criminal liability for corporations will create an incentive to engage in cover-ups rather than to avoid the conduct proscribed by criminal law.[85] In addition, the risk of criminal liability may actually provide corporations with a disincentive for imposing compliance programs and conducting internal reviews or investigations to assure that such compliance programs are working.[86] In other words, these commentators conclude that the risk of criminal liability for corporations may create powerful economic incentives for those corporations to bury their heads in the sand about the actions of their own officers or employees that might be construed as criminal.[87]

Current responses to these critiques focus on the importance of understanding the corporation itself as a legally significant actor. Some have taken the position that the law must impose some criminal liability on corporations because the corporation itself is capable of engaging in criminal conduct that would not be possible for any of its agents, officers, or employees acting entirely in their individual capacities. According to this position, the actions and decisions of individual employees may be aggregated, and this aggregation can be attributed to the corporation as a whole.[88] Thus, a court may find that a corporation has knowledge of a particular fact when "one part of the corporation has half the information making up the item, and another part of the entity has the other half."[89] By this approach, the corporation may have the *mens rea* required to establish an offense even if none of its individual employees or agents would have that culpable mental state.[90] This approach has the advantage of preventing the corporation from trying to escape responsibility for a company-wide decision by compartmentalizing information in small, independent units.

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[82] Fischel & Sykes, *supra* note 76, at 321.
[83] Id.
[84] Jennifer Arlen, The Potentially Perverse Effects of Corporate Criminal Liability, 23 J. LEGAL STUD. 833, 836 (1994).
[85] See generally Jennifer Arlen & Reinier Kraakman, Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes, 72 N.Y.U. L. REV. 687 (1997).
[86] *Id.*
[87] *Id.*
[88] United States v. Bank of New England, N.A., 821 F.2d 844, 856 (1st Cir. 1987), *cert. denied* 484 U.S. 943 (1987).
[89] *In re WorldCom, Inc. Securities Litigation*, 352 F. Supp. 2d 472, 497 (S.D.N.Y. 2005) (citation and internal quotation marks omitted).
[90] *Bank of New England*, 821 F.2d at 847.

Acknowledging that the criminal justice system has an expressive function provides another reason for imposing criminal liability on corporations. In this respect, the symbolic value of criminal liability is not merely inefficiency, as argued by law and economic scholars, but rather has an important moral value, albeit one that is not quantifiable. Imposing criminal liability on corporations has the value of showing that no person, real or artificial, is above the law.[91] By contrast, when a corporation is involved in criminal conduct, relieving it of any criminal liability under any circumstances communicates the message that the wrongdoer has a greater moral value than its victims, as well as all other persons.[92] Making corporations subject to prosecution and punishment has the symbolic value of reinforcing social norms, and, in some cases, such prosecution and punishment can promote the change or evolution of those norms.[93] In addition, precluding the criminal prosecution and punishment of corporations would be the practical equivalent of giving them immunity, which would violate social norms and diminish the public perception of the legitimacy of the legal system.[94]

Preserving criminal liability for corporations serves the expressive function of the law in another way. The legal system has a unique, and pre-eminent, role in making moral judgments and in conveying their weight.[95] The punishments, including criminal sanctions imposed in connection with these moral judgments have an essential value in shaping the community's ideas of moral principles.[96] These moral judgments also have a material value in the marketplace, not just in abstract matters or moral principle. When a corporation is convicted of a crime, the market is informed that the corporation may be "flawed, unreliable, and apt to generate future harm."[97] While this information may not be capable of precise valuation in quantifiable terms, it is nevertheless an important element of market organization and economic function.

Finally, criminal liability for corporations provides a means of regulating their conduct that cannot be matched by other means. Regulating corporations through civil proceedings, often in administrative forums, may not be as effective as regulating them through criminal proceedings in the judiciary branch. Adequate administrative regulation can be undermined by regulatory capture.[98] Moreover, changes in federal securities law have made it harder for investors to assume the role of private attorneys general and impose civil sanctions on corporations through derivative suits.[99] Similarly, it can be difficult to use civil actions for breach of fiduciary duty to hold executive management or directors

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[91] Andrew E. Taslitz, *Reciprocity and the Criminal Responsibility of Corporations*, 41 STETSON L. REV. 73, 91–94 (2011).
[92] *Id.* at 94.
[93] Gregory M. Gilchrist, *The Expressive Cost of Corporate Immunity*, 64 HASTINGS L. J. 1, 49 (2012).
[94] Id.
[95] Samuel W. Buell, *The Blaming Function of Entity Criminal Liability*, 81 IND. L.J. 473, 494–497 (2006).
[96] *Id.*
[97] *Id.* at 501.
[98] Peter J. Henning, *Corporate Criminal Liability and the Potential for Rehabilitation*, 46 AM. CRIM. L. REV. 1417, 1426 (2009). For a discussion of regulatory capture, see generally Sidney A. Shapiro & Rena Steinzor, *Capture, Accountability, and Regulatory Metrics*, 86 TEX. L. REV. 1741 (2008).
[99] Christine Hurt, *The Undercivilization of Corporate Law*, 33 J. CORP. L. 361, 379 (2008).

personally responsible for directing unlawful corporate action or other forms of wrongdoing.[100] These restrictions on the availability of civil alternatives suggest a need for caution in eliminating or reducing the possibility of criminal liability.
In assessing the need for deterrence and retribution, a corporation is fundamentally different than an individual in an important and overlooked respect that warrants limiting imposition of criminal liability for the actions of employees. Companies, unlike most individuals, cannot control absolutely the people's conduct for which they can be criminally liable. It is commonplace that the criminal law's moral basis is called into question whenever individuals with no practical ability to comply with its obligations are punished for their actions. Indeed, this is one of the most basic tenets of modern theories of the insanity defense, and its logic is instructive in the corporate criminal context.[101]

Another approach to re-shaping the nature of corporate criminal liability focuses on the idea that corporations should be liable only when their alleged misconduct is the product of a deliberate decision made at the highest levels, either by the board of directors or executive management, and reflected in some kind of formal corporate policy to which the misconduct can be traced.[102] This approach seeks to cure the most significant problems with the imposition of vicarious liability while preserving the ability of the criminal law to impose moral judgments and attendant punishments directly on the corporation itself and not merely on its directors or executives in their individual capacities.

One of the first and most influential examples of this approach can be found in the Model Penal Code (MPC), which was drafted under the auspices of the American Law Institute. The MPC generally rejects vicarious liability as the dispositive principle in determining corporate criminal liability. It permits corporations to be criminally liable for the conduct of their employees and other agents on a theory of *respondeat superior* only if the offense is one outside the MPC and "a legislative purpose to impose liability on corporations plainly appears."[103] Instead of relying on vicarious liability principles, the MPC provides that corporate criminal liability can be found when "the commission of the offense was authorized, requested, commanded, performed or recklessly tolerated by the board of directors or by a high managerial agent acting in behalf of the corporation within the scope of his office or employment."[104] Given the significance of the role of these actors within the entity, the MPC concludes that it is "reasonable to assume their acts are in some substantial sense reflective of the policy of the corporate body,"[105] and shareholders are likely to be in a position to bring pressure to bear to avoid liability. The MPC also provides a defense that

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[100] Lisa M. Fairfax, On the Sufficiency of Corporate Regulation as an Alternative to Corporate Criminal Liability, 41 STETSON L. REV. 117, 117–18 (2011).
[101] Weissman, *supra* note 3 at 1327.
[102] *See* Bucy, *supra* note 21, at 1099.
[103] MPC § 2.07(1)(a). The MPC also permits liability whenever the "offense consists of an omission to discharge a specific duty of affirmative performance imposed on corporations by law." § 2.07(1)(b). This latter rule could be understood as permitting a form of vicarious liability because corporations could be liable for the criminal omissions of their agents.
[104] MPC § 2.07(1)(c).
[105] *Id.* at § 2.07 cmt. 2(c) at 339.

corporation can employ: the high managerial agent having supervisory authority "*employed due diligence* to prevent its commission."[106] Since the purpose of a corporate fine is to encourage diligent supervision, where that diligence can be shown the entity should be exculpated absent a contrary legislative purpose.[107] Although it has not been adopted by Congress, several states have drawn on the principles of the MPC to limit the scope of criminal liability for corporations, as compared to federal law.[108]

Along similar lines, some scholars have attempted to define a standard of corporate liability based on the entity's own conduct and intent, aiming to align criminal responsibility with the features of corporations that induce or inhibit criminal conduct. One example of this approach would make corporate criminal liability dependent upon specific findings about the *corporate ethos*.[109] One of the principal advantages of this approach is that it is framed with a clear recognition of the distinct nature of corporate personhood. It depends upon the assumption that, through its constitutional documents and its formal policies and practices, a corporation creates a distinct and identifiable personality for itself, one that is entirely independent of the specific individuals who control or work for the organization.[110] If corporate criminal liability were framed in terms of this approach, the government could convict a corporation only if it proved that the *corporate ethos* encouraged agents of the corporation to commit the criminal act.[111]

Another scholar has advanced a similar idea for how to assign criminal liability to corporations, one focusing on constructive corporate fault.[112] According to this scholar, the fundamental inquiry in determining corporate criminal liability should be whether "aspects of the organization, such as policies, goals, and practices, that reflect not merely the sum total of individual agents' intentions, but instead attributes and conditions of the corporation that make it possible for these agents to cooperate and collaborate in legally problematic ways."[113] Under this standard, the question is whether the primary act was authored by the corporation in a meaningful sense, such as whether the agent's acts can be fairly said to be the actions of the corporation based on objective factors such as the size, complexity, formality, functionality, decision making process, and structure of the corporate organization.[114]

Like the MPC, these proposals seek to limit corporate liability to conduct that can be attributed to the corporation's own foundational decision-making processes –its personality– but they identify a wider range of relevant factors than under the MPC. The MPC limits liability to conduct that was specifically authorized, performed, or recklessly tolerated by the board of directors or a

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[106] *Id.* at § 2.07(5) (emphasis added).
[107] *Id.* at § 2.07 cmt. 6.
[108] *Id.* § 2.07 cmt. 2(a).
[109] Bucy, *supra* note 21.
[110] *Id.* at 1099.
[111] *Id.*
[112] See William S. Laufer, Corporate Intentionality, Desert, and Variants of Vicarious Liability, 37 AM. CRIM. L. REV. 1285 (2000).
[113] *Id.* at 1309.
[114] *Id.*

member of executive management. This standard would not permit liability encouraged by clear corporate policies absent direct participation by the board or a high managerial agent. Indeed, the MPC standard may create a perverse incentive for senior managers; it encourages ignorance rather than diligence because liability attaches only if the manager was aware of and recklessly tolerated the conduct.[115]

There are, of course, problems with these approaches. Some critics have doubted that they are based on a realistic assessment of how corporations and their individual agents actually collaborate to bring about criminal conduct.[116] Under the MPC standard, which limits liability to behavior directed or recklessly tolerated by directors or executive managers, there is a perverse incentive for those in positions of corporate control to ignore criminal conduct by subordinates rather than be diligent in uncovering it.

Another way to preserve the forcefulness of the vicarious liability approach while accounting for the corporation's own efforts at due diligence can be found in the idea that corporations could assert their own due diligence as an affirmative defense to any criminal allegation arising from principles of vicarious liability.[117]Advocates of a due diligence defense contend that it can assure that corporate liability would be imposed only in cases where the corporation itself had actually engaged in wrongful conduct.[118] In addition, the availability of such a defense could provide an incentive for corporations to monitor their agents and employee's conduct, thereby preventing or at least deterring criminal acts. Finally, a due diligence defense would be consistent with fulfilling the expressive function of criminal law by preserving the ability of the criminal law to directly sanction morally blameworthy decision-making processes, regardless of whether they were made by real or *artificial* persons.[119]

VIII. CONCLUSION

In recent years, the criminal prosecution of corporations at the federal level has too often turned into another form of civil regulation, as prosecutor's substitute settlement agreements of one kind or another for actual criminal prosecutions. Because criminal law has expressive functions that are essential to establishing and confirming the community's moral standard, and because corporations are important and powerful actors in the community, corporations must be subject to criminal prosecutions to the same extent that *natural* persons are.

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[115] Bucy, *supra* note 21 at 1104–05.
[116] Buell, *supra* note 92, at 527–28.
[117] *See generally* Ellen S. Podgor, *A New Corporate World Mandates a "Good Faith" Affirmative Defense*, 44 AM. CRIM. L. REV. 1537 (2007); *see also* Ellen S. Podgor, *Educating Compliance*, 46 AM. CRIM. L. REV. 1523, 1529 n. 39 (2009) (summarizing different formulations of how a good faith defense could work).
[118] *See* Podgor, *supra* note 114.
[119] *See* Gilchrist, *supra* note 90, at 45–46 (discussing the expressive aspect of criminal law).

There are good reasons to conclude that this trend in criminal enforcement is the product of an outdated standard for imposing criminal liability, one that was set forth in a specific legal context over a century ago and that has not changed since, even though the nature and extent of the criminal laws applicable to corporations have changed greatly. This standard, first set forth in *New York Central*, makes the corporation vicariously liable for all of the criminal conduct of it agents and employees as long as they were acting within the scope of agency or employment. This standard can have the effect of making corporations criminally liable for conduct that they never knew about, much less authorized, because it sweeps so broadly. It should not be surprising if prosecutors preferred settlement agreements to formal prosecutions whenever they thought that the more-or-less independent actions of corporate agents were be unfairly attributed to the corporation as a whole.

There are a variety of proposals for modifying the legal structure of corporate criminal liability to avoid this problem. But the best of these involves preserving the basic principles of vicarious liability as established by *New York Central* while creating an affirmative defense of corporate due diligence in which the corporation would bear the burden of proving that the criminal acts of individual agents or employees were directly contrary to corporate policies and that the corporation had undertaken substantial efforts to enforce those policies and prevent individual wrongdoing. With such a defense available, it is more likely that prosecutors will seek formal criminal prosecutions against corporations and, just as importantly, that corporations will not merely accede to settlement offers in criminal cases but will defend themselves when they think they can carry the burden imposed by the due diligence defense. With this modification of the principles of criminal liability in place, wrongful conduct by corporate persons can be subjected to the moral judgments of the community, judgments that can only be conveyed through the procedures of criminal law.

NOTES FROM THE ANTITRUST SUBCONSCIOUS: HOW ATTEMPTS TO SUPPRESS COMMON LAW PRECEDENT REPLACED BY THE FOREIGN TRADE ANTITRUST IMPROVEMENTS ACT HAVE ONLY BROUGHT THE ACT CLOSER TO ITS ROOTS

ANTHONY KAKOYANNIS*

ABSTRACT

In 1982, Congress enacted the Foreign Trade Antitrust Improvements Act (FTAIA) to serve as a standard for determining when U.S. antitrust law should extend to foreign conduct. The FTAIA was designed to clarify the common law of antitrust extraterritoriality but has instead paralyzed the law's application. For years after its enactment, courts simply avoided the FTAIA. Into the late 1990s, many were still applying the common law test. More recent decisions have begun to construe the FTAIA's language, but their attempts have created more confusion than clarity. This Note argues that the dysfunction is a product of poor drafting and the resulting assumption that the FTAIA dispensed with the subjective elements of the common law test that preceded it. Understanding the FTAIA as a purely objective standard has proved unworkable. The evidence for this position comes from a close reading of FTAIA decisions, which shows that courts are implicitly relying on the subjective common law test in their analyses, even while asserting that the FTAIA test is objective. Rather than debate which circuit's interpretation of the FTAIA is better, courts should broaden their understanding of the Act to incorporate its common law roots.

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I. INTRODUCTION

Nineteen Eighty-Two was a year that seemed to want a break with the past. Michael Jackson released *Thriller* and Time Magazine gave its Person-of-the-Year Award to the computer. Possibly swept up in the tide, Congress also attempted to mark a transition from the past to the future in the realm of antitrust law, and enacted the Foreign Trade Antitrust Improvements Act (hereinafter "FTAIA" or "the Act").[1] Unlike other promising innovations of 1982, however, the FTAIA has contemporary courts and litigants yearning for the past. Although meant to clarify the common law standard used to decide when U.S. antitrust law should

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[1] The Foreign Trade Antitrust Improvement Act, 15 U.S.C. § 6a (2000). The FTAIA amended the Sherman Act and the Federal Trade Commission Act, *see* 15 U.S.C. § 45(a)(3)(2014), by using identical language. *See* Minn-Chem, Inc. v. Agrium, Inc., 683 F.3d 845, 853 (7th Cir. 2012). However, for simplicity, I refer to it as though it is a stand-alone statute.

apply to foreign conduct (i.e. when it should apply "extraterritorially"), the FTAIA "did not quite achieve that result,"[2] "introduced confusion into a regime that, before its enactment, was a modestly successful common-law scheme,"[3] "is inelegantly phrased,"[4] "has failed at its essential purpose,"[5] and "keeps getting worse and worse."[6] In summary, the FTAIA is not well liked. This article sets out to determine why the Act has been dysfunctional since its enactment and, to propose a solution.

The FTAIA governs the extraterritorial application of the Sherman Act to anticompetitive conduct occurring in foreign commerce.[7] Prior to the FTAIA's enactment in 1982, courts applied a two part *effects test*, developed by Judge Learned Hand in *United States v.Aluminum Co. of America* (hereinafter, *Alcoa*),[8] to determine whether U.S. law applied extraterritorially. Under the *Alcoa* effects test,[9]foreign conduct that: (1) was intended to affect U.S. commerce; and (2) did in fact affect U.S. commerce and was subject to U.S. law.[10] This partially subjective, partially objective, standard represented the dominant common law approach before 1982.

With the FTAIA, Congress sought to clarify the common law[11] using a slightly different two-pronged test limiting extraterritorial application of U.S. law to conduct that (1)"has a direct, substantial, and reasonably foreseeable effect . . . on [U.S. domestic commerce]," which (2) gives rise to a domestic injury.[12] Few

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[2] Makan Delrahim, *Drawing the Boundaries of the Sherman Act: Recent Developments in the Application of the Antitrust Laws to Foreign Conduct*, 61 N.Y.U. ANN. SURV. AM. L. 415, 420 (2005).

[3] Max Huffman, *A Retrospective on Twenty-Five Years of the Foreign Trade Antitrust Improvements Act*, 44 HOUS. L. REV. 285, 286 (2007).

[4] United States v. Nippon Paper Indus. Co., Ltd., 109 F.3d 1, 4 (1st Cir. 1997).

[5] Huffman, *supra* note 3, at 286.

[6] Robert D. Sowell, *New Decisions Highlight Old Misgivings: A Reassessment of the Foreign Trade Antitrust Improvements Act Following Minn-Chem*, 66 FLA. L. REV. 511, 523 n. 84 (2014) (citing Joseph P. Bauer, *The Foreign Trade Antitrust Improvements Act: Do We Really Want to Return to American Banana?*, 65 ME. L. REV. 3, 4 (2012)).

[7] 15 U.S.C. § 6a(1)(A) (covering, specifically, "trade or commerce (other than import trade or import commerce) with foreign nations").

[8] United States v. Aluminum Co. of America, 148 F.2d 416 (2d Cir. 1945).

[9] *See* Part II. As discussed below, there were several alternative effects tests applied before the FTAIA. However, I often refer to a unified "common law effects test" for simplicity, because all of the tests shared fundamental characteristics distinguishing them from the FTAIA.

[10] *Alcoa*, 148 F.2d at 443-44.

[11] H.R. REP. NO. 97-686, at 2 (1982).

[12] 15 U.S.C. § 6a(1)(A).

courts have construed the FTAIA,[13] and many courts have declined to interpret the language of the first prong, particularly the word "direct."[14] Among those that have defined it, there is considerable disagreement.[15] However, courts and scholars generally agree on one thing: although the common law approach asked whether a defendant subjectively intended its conduct to affect U.S. domestic commerce, the FTAIA does not.[16]

This strictly objective understanding of the FTAIA's first prong is inhibiting its practical application. Believing that the Act prescribes an objective test, the circuits have formulated objective definitions of its terms, and two opposing definitions of *direct* have emerged. Despite differences in the abstract, these definitions are not practically distinguishable. Both have proven to be just as ambiguous as the phrase they sought to clarify. This article Note observes that courts struggling with the Act's first prong have exhibited certain tendencies. When forced to interpret or apply the "direct, substantial, and reasonably foreseeable" standard, courts consistently weigh elements of subjective intent, purpose, and design in their analyses. References to these elements are usually subtle or implicit and most likely unintended, because most judges accept that the FTAIA disposed of the common law's subjectivity. However, a close reading of major FTAIA decisions shows how the subjective test has survived between the lines.

This article argues that courts should recognize that subjective factors — such as a defendant's intent, purpose, or design— are not irrelevant to the FTAIA's first prong. There is historical precedent for such an interpretation, both

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[13] *See* United States v. LSL Biotechnologies, 379 F.3d 672, 698678 (2004) ("Federal courts did not shower the FTAIA with attention for the first decade after its enactment. But in the last ten years, and in particular the last five years, the case reporters have steadily filled with decisions this previously obscure statute.").

[14] Turicentro, S.A. v. Am. Airlines, Inc., 303 F.3d 293, 299 (3d Cir. 2002) ("Although passed two decades ago, few federal courts have had occasion to apply the [FTAIA].").

[15] *Id.* at 298 ("Federal courts have often disagreed about the extraterritorial scope of the Sherman Act.") (citing Den Norske Stats Oljeselskap v. HeereMac Vof et al., 241 F.3d 420, 423-24 (5th. Cir. 2011) "The history of this body of case law is confusing and unsettled.").

[16] *See, e.g.*, United States v. Hui Hsiung, 758 F.3d 1074, 1083 (9th Cir. 2014) ("[T]he FTATA . . . displaced the intentionality requirement . . . ."); Animal Science Products, Inc. v. China Minmetals Corp., 654 F.3d 462, 471 (3d. Cir. 2011) ("[T]he FTAIA's effects exception does not contain a 'subjective intent' requirement."); Rene H. DuBois, *Understanding the Limits of the Foreign Trade Antitrust Improvement Act Using Tort Law Principles as a Guide*, 58 N.Y.L. SCH. L. REV. 707, 717 (2013/2014) (asserting that the FTAIA "focuses on objective criteria"); Huffman, *supra* note 3, at 316 ("[T]he FTAIA enacted an objective version of the intent requirement from *Alcoa*."). *See also* Erica Siegmund, *Extraterritoriality and the Unique Analogy Between Multinational Antitrust and Securities Fraud Claims*, 51 VA. J. INT'L L. 1047, 1055 (2011) ("It is clear the test that courts used to determine whether U.S. antitrust laws applied extraterritorially prior to the FTAIA retains significance.").

in the common law effects test and in the Act's legislative history. More practically, a purely objective standard is simply not working. The FTAIA was enacted over three decades ago, and the courts are still struggling to grasp its basic operation. Rather than debate which circuit's interpretation of *direct*, *substantial*, *and reasonably foreseeable* is better, courts, should broaden their understanding of the FTAIA's domestic effects test to expressly include the subjective elements that they implicitly rely on.

II. BRIEF BACKGROUND ON ANTITRUST STATUTES

American antitrust laws are designed to protect free and fair competition and "safeguard the competitive community against methods of trade and business that are destructive of equal opportunity in honest competition."[17] The Sherman Act[18] is broadly phrased and operates as a "comprehensive charter of economic liberty"[19] and "a blanket norm against any activity that unduly restrict competition."[20] "Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations . . ." is illegal under § 1 of the Sherman Act.[21] Presently, the Federal Trade Commission and the Department of Justice can bring enforcement actions pursuant to federal antitrust statutes.[22]

III. THE COMMON LAW OF ANTITRUST EXTRATERRITORIALITY BEFORE THE FTAIA

The question of whether U.S. antitrust laws apply extraterritorially arises when courts hear disputes involving anticompetitive activity that takes place outside the United States. The first case to define the boundaries of antitrust extraterritoriality was *American Banana Co. v. United Fruit Co.*[23] Both parties in that case were American corporations, but the complaint alleged anticompetitive conduct occurring in Costa Rica (modern-day Panama) and called for the

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[17] 1 CALLMANN ON UNFAIR COMP., TR. & MONO. § 4:1 (Louis Altman & Malla Pollack eds., 4th ed. 2014).
[18] 15 U.S.C. §§ 1–7 (2014).
[19] N. Pac. Ry. Co. v. United States, 356 U.S. 1, 4 (1958).
[20] 1 CALLMANN, *supra* note 17.
[21] 15 U.S.C. § 1 (2014).
[22] 1 CALLMANN ON UNFAIR COMP., TR. & MONO. § 4:51 (Louis Altman & Malla Pollack eds., 4th ed. 2014).2014).
[23] American Banana Co. v. United Fruit Co., 213 U.S. 347 (1909).

extension of the Sherman Act to foreign conduct.[24] The plaintiff had purchased plantations in Costa Rica and alleged the defendant had induced the Costa Rican military to seize the plots and railroads linking the plantations to trade ports.[25] The defendant's conduct, if accurately alleged, was clearly anticompetitive, but it had occurred entirely in foreign commerce. The Supreme Court declined to extend U.S. antitrust law to the defendant's activities.[26] Justice Holmes thought that applying U.S. law to wholly foreign conduct was a "startling proposition"[27] and "not within the scope of the [Sherman Act] so far as the present suit is concerned."[28] The holding appeared to create a bright-line rule exempting all conduct occurring in sovereign nations from U.S. law.[29] However, subsequent cases carefully massaged flexibility into the Court's stance, as conduct occurring outside the United States was brought within reach of the Sherman Act.[30]

A. The Predominant Common Law Approach Is Known as the *Alcoa* Effects Test

American Banana's restrictive approach was officially retired by Judge Learned Hand in *Alcoa*, when the Second Circuit sat as court of last resort.[31] In *Alcoa*, six foreign corporations had expressly agreed to restrict the supply of aluminum to the United States.[32] Considering whether § 1 of the Sherman Act applied to the agreement, the Court established what is now known as the *Alcoa*

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[24] *Id.* at 354.
[25] *Id.* at 354–55.
[26] *Id.* at 357.
[27] *Id.* at 355–56.
[28] *Id.* at 357.
[29] *See Id.* at 355–56; Sowell, *supra* note 6, at 523 n. 33 ("An important factor in the [*American Banana*] Court's limited application was that . . . a nation's laws may govern its citizens in territories lacking sovereign authority . . . ."); Huffman, *supra* note 3, at 292 ("*American Banana* generally is understood to have expressed a broad 'no extraterritorial[ity]' principle applicable to antitrust claims.").
[30] *See, e.g.*, United States v. Am. Tobacco Co., 221 U.S. 106, 182–83 (1911); United States v. Pac. & Arctic Ry. & Navigation Co., 228 U.S. 87, 90–92 (1913); Thomsen v. Cayser, 243 U.S. 66, 68–69 (1917); United States v. Sisal Sales Corp., 274 U.S. 268, 275–76 (1927) (reversing a district court holding that relied on *American Banana* to dismiss a complaint alleging anticompetitive conduct in Mexico).
[31] United States v. Aluminium Co., 322 U.S. 716, 716 (1944) (transferring the case). Several Supreme Court Justices recused from the case, and the remaining five justices fell sort of a quorum. As a result, the appeal was certified and transferred to the Second Circuit, which operated as the court of last resort.
[32] *Alcoa*, 148 F.2d 416, 424, 442 (2d Cir. 1945).

effects test: "[the agreements] were unlawful, though made abroad, if they intended to affect imports and did affect them."[33] Additionally, it specified that "[a]fter the intent to affect imports was proved, the burden of proof shifted to [the defendant]" as to whether its conduct did in fact affect U.S. domestic commerce.[34] Because the agreement openly declared the defendant corporations' intention to affect the U.S. market by restricting supply, the first element of the effects test was met.[35] On the second element, the defendants were unable to overcome the presumption that the supply restrictions drove up U.S. prices.[36] Therefore, for the first time, wholly foreign conduct was found to violate the Sherman Act and the view that "Congress chose to attach liability to the conduct outside the United States of persons not in allegiance to it" was approved.[37]

Alcoa not only negated *American Banana* in the type of conduct it declared unlawful; it moved the focus of antitrust extraterritoriality away from where conduct occurs to where its effect is felt. *American Banana* declined to consider whether there had been an effect on U.S. commerce, because the defendant's conduct occurred entirely overseas.[38] In contrast, *Alcoa* found an intended effect on U.S. commerce constituted a violation of the Sherman Act, notwithstanding the fact that it occurred entirely outside the United States.

The *Alcoa* effects test was the dominant approach to extraterritorial application in the thirty-seven years between *Alcoa* and the enactment of the FTAIA.[39] However, a plethora of modifications took hold in different circuits, most of which retained the basic *Alcoa* test but added other factors.[40] In *Timberlane Lumber Co v. Bank of America*,[41] the Ninth Circuit declared the effects test "incomplete"[42] and adopted a "tripartite analysis."[43] This expanded version of the

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[33] *Id.* at 444.
[34] *Id.*
[35] *Id.*
[36] *Id.*
[37] *Id.* at 443.
[38] *See* 1 CALLMANN, *supra* note 22, at 354.
[39] Delrahim, *supra* note 2, at 417 ("This 'effects test' has prevailed consistently since *Alcoa*."); Sowell, *supra* note 6, at 518 ("[*Alcoa*] established the 'intended-effects test,' which became the standard in determining the extraterritorial reach of the Sherman Act for years to come."); Siegmund, *supra* note 16, at 1054 ("Judge Learned Hand famously articulated the prevailing version of the effects test in [*Alcoa*].").
[40] *E.g.*, Mannington Mills Corp. v. Congoleum Corp., 595 F.2d 1287, 1297–98 (3d Cir. 1979).
[41] Timberlane Lumber Co. v. Bank of Am., 549 F.2d 597, 612 (9th Cir. 1976).
[42] *Id.* at 611–12.
[43] *Id.* at 613.

Alcoa test considered the degree of conflict between U.S. and foreign law, whether other nations were likely to enforce their laws, the significance of the effect on U.S. commerce relative to the effect on other nations, the foreseeability of the domestic effects, and whether conduct integral to a defendant's scheme occurred within the United States.[44] In 1982, the Fifth Circuit also added international comity factors to its effects test, but it expressly rejected the Ninth Circuit's contention that these factors should be used to determine subject-matter jurisdiction.[45] Despite these modifications, most courts firmly retained the intent element of the *Alcoa* test.[46]

Too much uncommon ground developed between the circuits, however, and the multiplication of effects tests following *Alcoa* created disparities in expectations about the extraterritorial application of antitrust law. Congress enacted the FTAIA in response to this confusion.[47]

IV. CONGRESS PASSES THE FTAIA, CREATING A NEW TEST

In 1982, Congress enacted the FTAIA, and the law amended both the Sherman Act and the Federal Trade Commission Act.[48] It reads:

> Sections 1 to 7 of this title shall not apply to conduct involving trade or commerce (other than import trade or import commerce) with foreign nations unless-
>
> (1) such conduct has a direct, substantial, and reasonably foreseeable effect-
> (A) on trade or commerce which is not trade or commerce with foreign nations, or on import trade or import commerce with foreign nations; or
> (B) on export trade or export commerce with foreign nations, of a person engaged in such trade or commerce in the United States; and;

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[44] *Id.*

[45] Indus. Investment Development Corp. v. Mitsui and Co., 671 F.2d 876, 884 n. 7 (5th Cir. 1982), *vacated*, 460 U.S. 1007 (1983).

[46] *Timberlane*, 549 F.2d at 612 ([The] "intent requirement suggested by *Alcoa* . . . is one example of an attempt to broaden the court's perspective."); Mannington Mills Corp. v. Congoleum Corp., 595 F.2d 1287, 1292 (3d Cir. 1979); *In re* Uranium Antitrust Litig., 617 F.2d 1248, 1253 (7th Cir. 1980).

[47] H.R. REP. NO. 97-686, *supra* note 11, at 2 (recognizing the differences among lower courts' application of the Sherman Act to foreign conduct "in their expression[s] of the proper test for determining whether U.S. antitrust jurisdiction over international transactions exists.").

[48] FTAIA, Pub. L. No. 97-290, §§ 401–403, 96 Stat. 1233 (codified as 15 U.S.C. § 6a).

> (2) such effect gives rise to a claim under the provisions of sections 1 to 7 of this title, other than this section.
>
> If sections 1 to 7 of this title apply to such conduct only because of the operation of paragraph (1)(B), then sections 1 to 7 of this title shall apply to such conduct only for injury to export business in the United States.

A. An Overview of How Each Part of the FTAIA Functions

Many years after its enactment, Justice Breyer articulated the operation of the FTAIA: "[the statute] lays down a general rule placing all (non import) activity involving foreign commerce outside the Sherman Act's reach. It then brings such conduct back within the Sherman Act's reach provided that the conduct . . . (1) sufficiently affects American commerce, . . . and (2) has an effect of a kind that antitrust law considers harmful."[49] In other words, the FTAIA is an exclusionary rule. Import commerce is subject to the Sherman Act, but purely foreign commerce is not, unless it qualifies for the domestic effects exception of the FTAIA. If a court determines a defendant's conduct is import commerce, it will not conduct an FTAIA inquiry.

1. The FTAIA Is a Substantive Limitation

The circuits have recently agreed that the FTAIA places a substantive, not jurisdictional, limitation on the extraterritorial reach of U.S. antitrust law. In 2003, the Seventh Circuit decided, en banc, that the FTAIA was jurisdictional.[50] In 2011, it reaffirmed this position in *Minn-Chem, Inc. v. Agrium, Inc.*[51] However, after the Third Circuit[52] held that the Supreme Court's decisions in *Morrison v. Nat'l Australian Bank*[53]and *Arbaugh v. Y & H Corp.*[54] had added new legal context that linked the FTAIA to the merits of an antitrust claim,[55] the Seventh Circuit reconsidered. Rehearing *Minn-Chem*, en banc,[56] the court followed the Third

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[49] F. Hoffman-LaRoche, Ltd., v. Empagran S.A., 542 U.S. 155, 162 (2004) [hereinafter, *Empagran I*], *remanded*, 417 F.3d 1267 (D.C. Cir. 2005) [hereinafter, *Empagran II*].
[50] United Phosphorus v. Angus Chem., 322 F.3d 942, 952 (7th Cir. 2003) (en banc).
[51] Minn-Chem, Inc. v. Agrium, Inc. 657 F.3d 650, 657–59 (7th Cir. 2011).
[52] Animal Science Products, Inc. v. China Minmetals Corp, 654 F.3d 462 (3d Cir. 2011).
[53] Morrison v. Nat'l Australian Bank, 561 U.S. 247 (2010).
[54] Arbaugh v. Y & H Corp, 546 U.S. 500 (2006).
[55] *Animal Science*, 654 F.3d at 467–68.
[56] Minn-Chem, Inc. v. Agrium, Inc., 683 F.3d 845 (7th Cir. 2012) (en banc).

Circuit and decided that *Morrison* had left little doubt that the FTAIA was a merit-based limitation.[57] The issue has remained settled since *Minn-Chem*.[58]

2. Overview of the FTAIA's First Prong

The first prong of the FTAIA is Congress's version of a domestic effects test.[59] Congress did not view its test as reinventing extraterritorial jurisdiction, but as offering "a simple and straightforward clarification of existing American law and the Department of Justice enforcement standards" and creating a "clear benchmark . . . for businessmen, attorneys, and judges as well as our trading partners." The Judiciary Committee recognized that the *Alcoa* effects test was the prevailing standard at the time of enactment.[60] However, it did not say whether the FTAIA codified *Alcoa* or amended it.[61] The general consensus, now, is that pre-FTAIA precedent is not binding post-enactment.[62]

Moreover, courts and scholars have since come to understand Congress's *clarification* of existing law as having removed a major element of the existing common law effects test: a defendant's subjective intent.[63] This belief is grounded in the Act's legislative history, in which it is clear Congress wanted to extend jurisdiction to cover "domestic effect[s] [that] would have been evident to a reasonable person making practical business judgments," even if not intended.[64]

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[57] *Id.* at 852.

[58] *See, e.g.*, Lotes Co., Ltd. v. Hon Hai Precision Indus. Co., 753 F.3d 395, 398 (9th Cir. 2014); *In re* TFT-LCD Antitrust Litig., 822 F. Supp. 2d 953, 959 (N.D. Cal. 2011) (expressly following *Animal Science*'s interpretation of the FTAIA post-Morrison).

[59] The FTAIA's test was technically "[d]eemed the 'domestic injury exception" but that language seems to create unnecessary confusion. *See* Sowell, *supra* note 7, at 515, 540.

[60] H.R. REP. NO. 97-686, *supra* note 11, at 5.

[61] *Id.*; Hartford Fire Ins. Co. v. California, 509 U.S. 764, n.23 (1993); *see also* United States v. LSL Biotechnologies, 379 F.3d 672, 698 (2004) ("[M]any courts have debated whether the FTAIA established a new . . . standard or merely codified the standard applied in *Alcoa* and its progeny. Several courts have raised this question without answering."); Delrahim, *supra* note 2, at 418 ("The common law standard for the reach of the Sherman Act to foreign conduct may or may not have changed with the enactment of the FTAIA in 1982.").

[62] DuBois, *supra* note 16, at 717 ("Pre-FTAIA cases . . . provide limited guidance on the limitations imposed by the conjunctive requirements of the [FTAIA] . . . ."); Huffman, *supra* note 3, at 313 ("The FTAIA codified a version of the Alcoa effects test."). *But see* Siegmund, *supra* note 16, at 1055–56 ("*Hartford Fire* thus illustrates that the effects test continues to play an important role in the Court's determination of extraterritoriality.").

[63] *See supra* note 5.

[64] H.R. REP. NO. 97-686, *supra* note 11, at 9.

However, the assumption that, if Congress wanted to add objective foreseeability to the domestic effects analysis, then it necessarily wanted to remove subjective intent from the analysis, is challenged by this article.[65]

3. Overview of the FTAIA's Second Prong

Unlike the first prong, the second prong of the FTAIA was not formally part of the *Alcoa* effects test, but its underlying principle was embodied in the common law comity analysis.[66] Section 6a(2) requires that the "direct, substantial, and reasonably foreseeable" effect described in prong one "gives rise to a claim" under the Sherman Act.[67] In a case now referred to as *Empagran I*, the Supreme Court clarified some ambiguous aspects of the second prong.[68] For example, it held that, although the effects of a defendant's conduct must be felt domestically, a foreign injury can be the basis of a Sherman Act claim and satisfy prong two of the FTAIA.

However, the Court also made two qualifications: (1) the domestic effects alleged must have been detrimental, not beneficial, to the U.S. economy; and (2) a foreign plaintiff's injury cannot be "independent" of the domestic effect proved under prong one.[69] Additionally, the Court clarified that the word "claim" in the second prong refers to the plaintiff's claim against the defendant, rejecting a broader reading that required plaintiffs to show domestic effects gave rise to a Sherman Act claim but not necessarily to theirs.[70] Importantly, the Court did not decide what causation standard should be used for the second prong.[71] It remanded this question to the D.C. Circuit (*Empagran II*), which held that a proximate cause test was appropriate.[72] The court reasoned that this standard was more respecting of international comity concerns than causation.[73] Since *Empagran II*, other circuits have also adopted proximate causation for the "gives

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[65] The legislative history is discussed in greater detail in Part VII of this article.

[66] *See* Lotes Co, Ltd. v. Hon Hai Precision Indus. Co., 753 F.3d 395, 414 (2d Cir. 2014) ("In *Empagran*, the Supreme Court [decided the meaning of] the statutory phrase 'gives rise to a claim under' . . . . [a]fter considering the legislative history and principles of international comity . . . .").

[67] 15 U.S.C. § 6a(2).

[68] *Empagran I*, 542 U.S. 155 (2004).

[69] *Id.* at 173.

[70] *Id.* ("Congress would not have intended the FTAIA's exception to bring independently caused foreign injury within the Sherman Act's reach."). The Court's holding resolved a circuit split on these issues. *See* Sowell, *supra* note 6 at 545-46.

[71] *Empagran I*, 542 U.S. at 175.

[72] *Empagran II*, 417 F.3d 1267, 1271 (D.C. Cir. 2005).

[73] *Id.*

rise to" element of the FTAIA.[74] Although there remains controversy[75] about this approach and about prong two generally, however, that is not the focus of this article.

B. Background of Congressional Intent

In addition to furthering the overarching aims of the Sherman Act[76] by "encourage[ing] the business community to engage in efficiency-producing joint conduct in the export of American goods and services,"[77] the FTAIA was intended to clarify the scattered common law of antitrust extraterritoriality.[78] The Judiciary Committee recognized that at least six distinct common law tests were being used by different courts,[79] and other sources note that even substantively similar tests often used different phraseology,[80] adding to the confusion.

Furthermore, Congress chose to cast the law as an exception to the general rule of non-liability for anticompetitive activity in foreign commerce. This may suggest an intent to limit the scope of the Sherman Act.[81] Alternatively, some scholars see this feature of the Act as a protectionist measure, "because the FTAIA permits only U.S. exporters to sue to remedy harm to competition that occurred in U.S. export commerce—giving license for U.S. exporters to engage in conduct causing harm felt only in foreign commerce."[82] Another potential reason for wanting to limit the extraterritorial application of U.S. law is international comity.[83] Surprisingly, though, Congress did not create a separate prong in the Act for comity analysis.[84]

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[74] *E.g.*, Lotes Co., Ltd. v. Hon Hai Precision Indus. Co., 753 F.3d 395, 414 (2nd Cir. 2014); *In re* Dynamic Random Access Memory (DRAM) Antitrust Litig., 546 F.3d 981, 987 (9th Cir. 2008); *In re* Monosodium Glutamate Antitrust Litig., 477 F.3d 535, 538 (8th Cir. 2007).

[75] *See, e.g.*, Sowell, *supra* note 6, at 546-47.

[76] *See supra* Part I.

[77] H.R. REP. NO. 97-686, *supra* note 12, at 2-3.

[78] *Id.* at 5 (referring to the discrepancies in "quantum and nature of effects required to create jurisdiction" developed after *Alcoa*.)

[79] *Id.*

[80] *See, e.g.*, Huffman, *supra* note 3, at 310 n. 138.

[81] 4A CALLMANN ON UNFAIR COMP., TR. & MONO. § 27:30 (Louis Altman & Malla Pollack eds., 4th ed. 2014); *see Empagran I*, 542 U.S. 155, 169 (2004) ("Congress designed the FTAIA to clarify, perhaps to limit, but not to expand in any significant way, the Sherman Act's scope as applied to foreign commerce.").

[82] Huffman, *supra* note 3, at 306.

[83] *See* Laker Airways Ltd. v. Sabena, 731 F.2d 909, 958 (D.C. Cir. 1984) (Starr, J., dissenting) (noting that the United Kingdom had enacted a law, the Protection of Trading Interests Act, in 1980 that prevented enforcement of judgments obtained under U.S. antitrust law; Judge Starr

V. HOW THE ACT AND THE FIRST PRONG HAVE BEEN AWKWARDLY APPLIED SINCE THE FTAIA REPLACED THE COMMON LAW TEST

Whether in spite of, or as a result of Congress's effort, the FTAIA has been applied awkwardly and inconsistently, particularly with regard to its first prong. Although the statute is over thirty years old, judicial interpretations of its "direct, substantial, and reasonably foreseeable" requirements are rudimentary and unstable. In part, this is because not many cases have dealt with the FTAIA since its enactment. In larger part, it is because courts have avoided construing or applying the Act's first prong. Judges have accomplished this in a variety of ways, but the overall trend of avoiding the statute is evidence that the FTAIA standard, as it stands now, is problematic.

Initially, it was unclear whether the FTAIA had changed the *Alcoa* effects test at all. The first case to address the Act reached its conclusion by relying on Alcoa's requirements of intent and actual effect and relegating the words "direct, substantial, and reasonably foreseeable" to a footnote.[85] Gradually, courts become more comfortable with the new statutory standard, and a belief solidified that, unlike *Alcoa*, the FTAIA was a purely objective standard. Despite this growing understanding, very little has been said about what the first prong meant or which facts met its objective threshold. Very recently, a flurry of cases has offered new interpretations. However, the majority of the courts have declined to rest their holdings on the first prong of the FTAIA, preferring instead to decide the domestic effects issue on the second prong or by circumventing the Act altogether.

In each of the opinions discussed below, there are clues as to what is wrong with the present understanding of the first prong and what might improve it. This article focuses on the ways in which judicial analysis has implicitly relied on subjective elements of a defendant's conduct -such as the intent, purpose or design of a conspiracy without acknowledging that these elements are part of the statutory standard.

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described that "[a] tempest has been brewing for some time among the nations as to the reach of this country's antitrust laws").

[84] The judiciary has introduced some measure of comity analysis into the existing language. *See, e.g.*, *Empagran I*, 542 U.S. 155 (2004) at 164–65 (stating generally that "this Court ordinarily construes ambiguous statutes to avoid unreasonable interference with the sovereign authority of other nations" and conducting a comity analysis).

[85] Hartford Fire Ins. Co. v. California, 509 U.S. 764, 796 n. 23 (1993).

A. Courts Are Avoiding Applying the FTAIA or Holding Under the First Prong

Less subtle than the ways in which courts have interpreted the FTAIA are the ways in which they have avoided interpreting it. The FTAIA was enacted in 1982, but the first case to mention was decided in 1993.[86] That case did not attempt to interpret the language of the Act, and neither did any other case until 2004. Since then, courts have been more willing to construe the language of the FTAIA and its first prong, but most have found that the statute's second prong offers surer footing. This article reviews a selection of major rulings and presents them as evidence that the "direct, substantial, and reasonably foreseeable" standard is unworkable as a purely objective test.[87]

B. Early FTAIA Cases Ignored the Act Altogether

After over a decade of silence on the FTAIA,[88] in 1993, the Supreme Court took a case that called for the law's application.[89] In *Hartford Fire Ins. Co. v. California*, nineteen states and several private parties brought suit against British insurance companies that had conspired to "restrict the terms of coverage of commercial general liability available in the United States."[90] Both the Northern District of California[91]and the Ninth Circuit[92]applied pre-FTAIA common law precedent. However, they came to different conclusions.[93]The Court granted certiorari ostensibly to resolve the ambiguity surrounding the application of the FTAIA, but it avoided construing the new law.[94] Rather, the Court also leaned on pre-FTAIA cases, particularly *Alcoa*.[95] Without making direct reference to the language of the FTAIA, the Court stated "it is well established by now that the Sherman Act applies to foreign conduct that was meant to produce and did in

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[86] *Id.*

[87] *See* Delrahim, *supra* note 2, at 427 ("[The first prong] has attracted less attention than the [second prong] . . . .").

[88] *Id.* at 419 ("For several years, courts seemed to avoid the FTAIA, and it attracted little attention well into the 1990s.").

[89] *Hartford Fire*, 509 U.S. 764 (1993).

[90] *Id.* at 770 (footnote omitted).

[91] *In re* Ins. Antitrust Litig., 723 F. Supp. 464, 490–91 (N.D. Cal. 1989).

[92] *In re* Ins. Antitrust Litig., 938 F.2d 919, 934 (9th Cir. 1991).

[93] *Id.*

[94] *Hartford Fire*, 509 U.S. at 796.

[95] *See* DuBois, *supra* note 17, at 713 ("*Hartford Fire* . . . returned to the broader school of thought articulated in the *Alcoa* decision.").

fact produce some substantial effect in the United States" and cited to *Alcoa* to support this rule.[96]

Recent cases have developed an alternative interpretation of *Hartford Fire*. In *Minn-Chem*, the Seventh Circuit reviewed a complaint that alleged both conduct involving import commerce and conduct occurring only in foreign commerce.[97] The court correctly recognized that conduct involving import commerce is not the type of conduct excluded from the Sherman Act by the FTAIA; the FTAIA applies only to foreign commerce.[98] Then, more controversially, it recast *Alcoa* and *Hartford Fire*, not as FTAIA cases, but as providing a jurisdictional test for conduct involving import commerce: "[*Alcoa*] held that the Sherman Act covers imports when actual and intended effects on U.S. commerce have been shown. In *Hartford Fire*, the Supreme Court confirmed this rule . . . ."[99] The Seventh Circuit thus posed *Hartford Fire* as an entirely separate, import-only test, distinct from the FTAIA's "direct, substantial, and reasonably foreseeable" domestic effects test for foreign, non-import commerce.

This view represents a perplexing inference from *Alcoa* and *Hartford Fire*. *Hartford Fire* displays a reluctance to construe the FTAIA, but the Court never claimed the statute was inapplicable because the case was about import commerce. Furthermore, in a footnote to the *Alcoa* effects test, the Court expressed uncertainty as to whether the "direct, substantial, and reasonably foreseeable" language of the FTAIA "amends existing law or merely codifies it."[100] If, as *Minn-Chem* proposed, *Alcoa* applied exclusively to import commerce, and the FTAIA does not apply to import commerce at all, then the FTAIA could not be a codification of *Alcoa*. Additionally, *Alcoa* governed both import and non-import commerce before 1982. There is no indication that the FTAIA's enactment replaced *Alcoa* with regard to non-import commerce but retained the common law test for import commerce.

As previously discussed, the Act's legislative history acknowledges *Alcoa* as the leading common law standard and described Congress's intent to "clarify" that

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[96] *Hartford Fire*, 509 U.S. at 796.

[97] Minn-Chem, Inc. v. Agrium, Inc., 683 F.3d 845, 855 (7th Cir. 2012).

[98] 15 U.S.C. § 6a ("Sections 1 to 7 of this title shall not apply to conduct involving trade or commerce (other than import trade or commerce) with foreign nations . . . ."); *Minn-Chem*, 683 F.3d at 855 ("The FTAIA does not require any special showing in order to bring these [import] transactions back into the Sherman Act . . . because they were never removed from the statute.").

[99] *Minn-Chem*, 683 F.3d at 855.

[100] *Hartford Fire*, 509 U.S. at 796 n.23.

standard with the FTAIA.[101] If *Alcoa* applied only to import commerce, then Congress would not have used it formulate a law that does not apply to import commerce. Therefore, *Minn-Chem*'s contention that *Hartford Fire* and *Alcoa* represent a test for import commerce is not supported by the language of either case or the legislative history. *Hartford Fire* applied *Alcoa*'s subjective effects test because the Court considered the FTAIA standard puzzling, not because the FTAIA did not apply.[102]

Returning to the early application of the FTAIA, in 1997, the First Circuit decided *United States v. Nippon Paper Co.*,[103] a case that relied heavily on *Hartford Fire*. In *Nippon Paper*, the Justice Department brought a criminal action against a Japanese corporation that had allegedly conspired to fix the price of paper sold in the United States.[104] The district court held that, because the defendant's activities took place entirely in Japan, a criminal antitrust prosecution was precluded.[105] The First Circuit reversed, holding that the defendant's foreign conduct had affected domestic commerce enough to warrant the extraterritorial application of U.S. antitrust law.[106] However, the court bluntly refused to use the FTAIA to make this determination, saying "[t]he FTAIA is inelegantly phrased and the court in *Hartford Fire* declined to place any weight on it . . . . [w]e emulate this example and do not rest our ultimate conclusion about Section One's scope upon the FTAIA."[107] Like *Hartford Fire*, the court instead applied the common law Alcoa effects test and declared, "the case law now conclusively establishes that civil antitrust actions predicated on wholly foreign conduct which has an

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[101] *See* Siegmund, *supra* note 16, at 1055 ("[T]he legislative history of the FTAIA suggests that Congress contemplated the effects test when enacting the statute.").

[102] It is also difficult to trace where *Minn-Chem*'s characterization of *Aloca* and *Hartford Fire* originated. The case cites to Animal Science Products, Inc. v. China Minmetals Corp., 654 F.3d 462, 470 (3d. Cir. 2011). *Animal Science* indeed supports *Minn-Chem*'s proposition and cites to Turicentro, S.A. v. Am. Airlines Inc., 303 F.3d 293, 303 (3d Cir. 2002) for support. *Turicentro*, however, does not cite *Hartford Fire* or *Alcoa* in its analysis of whether defendant's conduct constituted import commerce. *Id.* at 303-04. In fact, it cites both cases as seminal interpretations of the FTAIA. *Id.* at 304-05. This undermines the contention, in *Animal Science* and *Minn-Chem*, that *Alcoa* and *Hartford Fire* represent a different effects test for import commerce, separate from the FTAIA. *See also* Sowell, *supra* note 6, at 533 (criticizing this aspect of the *Minn-Chem* decision, because "it would seem contrary to congressional intent . . . to apply the [(*Alcoa*)] intended-effects test to import commerce that Congress specifically excluded from the FTAIA").

[103] United States v. Nippon Paper Co., 109 F.3d 1 (1st Cir. 1997).

[104] *Id.* at 2.

[105] *Id.*

[106] *Id.* at 4.

[107] *Id.*

intended and substantial effect in the United States come within Section One's jurisdictional reach."[108]

Few courts have been so explicit about their desire to avoid the FTAIA. Rather, most have taken the *Hartford Fire* route: recognizing that the FTAIA is governing law, but using the more familiar common law test as a way of understanding the Act's meaning. For example, in *United States v. Anderson*,[109] the Eleventh Circuit began its analysis by reciting the requirements of the FTAIA, including the "direct, substantial, and reasonably foreseeable" language of the first prong.[110] Additionally, the court acknowledged that the Act was meant "to limit American courts' jurisdiction over international commerce."[111] The FTAIA notwithstanding, however, the court restated the standard in common law terms: "The Sherman Act reaches conduct outside the borders of the United States, but only when the conduct is intended to and does in fact produce a substantial effect on commerce in the United States."[112]

C. Recent Cases Apply the FTAIA but Are Reluctant to Place Too Much Weight on the First Prong

The following cases, all of which were decided in the last two years, illustrate courts' increasing willingness to apply and construe the language of the FTAIA, but also their continued reluctance to hold under the first prong.

In *Lotes Co. v. Hon Hai Precision Indus. Co.*,[113] the Second Circuit elaborated, explicitly and in great detail, on its theoretical disagreement with the Ninth Circuit's interpretation of the domestic effects exception.[114] Nevertheless, the court withheld final judgment and was clearly relieved that "we need not decide the rather difficult question of whether the defendants' foreign anticompetitive conduct [satisfied the directness test] . . . . because . . . [any] effect does not 'give rise to' Lotes' claim."[115]

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[108] *Id.*
[109] United States v. Anderson, 326 F.3d 1319 (11th Cir. 2003).
[110] *Id.* at 1329–30.
[111] *Id.* at 1329.
[112] *Id.* (citing Hartford Fire Ins. Co. v. California, 509 U.S. 764, 796 (1993)).
[113] Lotes Co. v. Hon Hai Precision Indus. Co, 753 F.3d 395 (2d Cir. 2014).
[114] *Id.* at 409–412.
[115] *Id.* at 413.

In *Motorola Mobility LLC v. AU Optronics Corp.*,[116] the Seventh Circuit twice eluded the FTAIA's first prong. In his first, now vacated, opinion, Judge Posner said little about whether alleged effects on the U.S. economy were reasonably foreseeable and wondered out loud, "who knows what 'substantial' means in this context?"[117] Although he made a greater effort to elucidate the meaning of the word "direct," Judge Posner ultimately grounded the court's decision in the Act's second prong: "Motorola's claim is upended by another—and independent—requirement that must be satisfied . . . the effect . . . must 'give rise to' [the plaintiff's injury]."[118] Rehearing the case en banc, Judge Posner went into greater detail explaining the foreseeability element and was, this time, willing to say that "[w]e'll assume that the requirement of a direct, substantial, and reasonably foreseeable effect on domestic commerce has been satisfied."[119] However, the resolution of the appeal again turned on the second prong, and the difficulty of applying the first prong was neutralized: "Whether or not Motorola was harmed indirectly, the immediate victims of the price fixing were its foreign subsidiaries . . . "[120]

In *United States v. Hui Hsiung*,[121] the Ninth Circuit paid acknowledgement to the first prong of the FTAIA and Ninth Circuit precedent.[122] However, it did not base its ruling on the Act. Instead, the court reasoned that it "need not resolve whether the evidence of the defendants' conduct was sufficiently 'direct,'"[123] because all the alleged conduct could be characterized as import commerce, which automatically placed it outside the scope of the FTAIA.[124]

Minn-Chem, Inc. v. Agrium, Inc.[125] is a Seventh Circuit case seen as a bellwether decision in FTAIA interpretation.[126] One of its principle contributions was generating a proximate cause standard for measuring directness.[127] The *Minn-*

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[116] Motorola Mobility LLC v. AU Optronics Corp., 773 F.3d 826 (7th Cir. 2014) *amended and superseded by* Motorola Mobility LLC v. AU Optronics Corp., 775 F.3d 816 (7th Cir. 2015) [hereinafter, *Motorola II*], *aff'g en banc* Motorola Mobility LLC v. AU Optronics Corp., 746 F.3d 842 (7th Cir. 2014) [hereinafter, *Motorola I*].
[117] *Motorola I*, 746 F.3d at 844.
[118] *Id.* at 845.
[119] *Motorola II*, 773 F.3d at 829.
[120] *Id.* at 830.
[121] United States v. Hui Hsiung, 758 F.3d 1074 (9th Cir. 2014).
[122] *Id.* at 1094.
[123] *Id.*
[124] *Id.*
[125] Minn-Chem, Inc. v. Agrium, Inc., 683 F.3d 845 (7th Cir. 2012).)
[126] *See* Sowell, *supra* note 6, at 528 (applauding "Clarity from the Seventh Circuit" in *Minn-Chem*).
[127] DuBois, *supra* note 16, at 720.

Chem opinion described the standard in detail, assessed the facts of the complaint, and found the plaintiffs had made allegations under both prongs of the FTAIA sufficient to withstand a motion to dismiss.[128] However, the court displayed hesitance about drawing broad conclusions. It advised, "[w]e stress, however, that our evaluation throughout has proceeded exclusively on the face of the Complaint," and then carefully outlined a list of legal and factual issues upon which it was not commenting.[129] Although the Seventh Circuit cannot be accused of avoiding the FTAIA's first prong in *Minn-Chem*, its especially cautious holding is nevertheless revealing.

VI. NOW, THE FEDERAL CIRCUITS ARE DIVIDED BETWEEN DIFFERENT DEFINITIONS OF THE WORD "DIRECT" IN THE FIRST PRONG

Although these recent cases mostly avoided reaching a decision under the first prong, they did express opinions about its meaning. There is now a clear split between the circuits, with most of the conflict centered on the word "direct." One set of cases, led by the Ninth Circuit, defines a direct effect as "an immediate consequence" of an activity. Another faction, led by the Seventh Circuit, defines directness in terms of "proximate cause." This debate has subsumed the rest of the first prong, even though no meaningful explanation "substantial" and "reasonably foreseeable" has been attempted by any court.

The Ninth Circuit was the first to issue an interpretation, in *United States v. LSL Biotechnologies*, in which it defined a direct effect as one that "follows as an immediate consequence of the defendant's activity."[130] The court referred to a dictionary that defined 'direct' as 'proceeding from one point to another . . . without deviation or interruption.'"[131] Finding that an "uncertain intervening event" separated defendant's conduct from any domestic effects, the court held the standard had not been met.[132]

The Seventh Circuit later offered an alternative definition. In *Minn-Chem*, the court stated that directness was evidenced by "a reasonably proximate causal nexus" between conduct and effect.[133] Later referring to its standard simply as

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[128] *Minn-Chem*, 683 F.3d at 859.
[129] *Id.* at 860.
[130] United States v. LSL Biotechnologies, 379 F.3d 672, 680 (9th Cir. 2004).
[131] *Id.*
[132] *Id.* at 681.
[133] *Minn-Chem*, 683 F.3d at 857.

"proximate cause,"[134] the court reached its definition by analogy: "[j]ust as tort law cuts off recovery for those whose injuries are too remote from the cause of injury"[135] the FTAIA's directness test cuts off liability when domestic effects are too remote from foreign anticompetitive conduct.[136] The Second Circuit has since fallen in line with the Seventh Circuit,[137] but other circuits have not entered the fray.

A. The Seventh Circuit Created an Objective Definition of "Direct" but Prominent Cases Resort to Elements of the Common Law Test to Explain the Definition

This article asserts that both circuit's proposed definitions are inadequate, because neither considers the subjective factors -such as intent, purpose, and design- that were integral to the *Alcoa* effects test and other common law tests. In addition to court's tendency to avoid the FTAIA's first prong, or avoid the Act altogether, the primary evidence supporting this claim is that judicial analysis implicitly considers these subjective factors, even while disclaiming them from the statutory effects test. The first example is that of the Seventh Circuit.

Minn-Chem, Inc. v. Agrium, Inc. set the tone for the Seventh Circuit's position on the FTAIA and its disagreement with the Ninth Circuit. In *Minn-Chem*, "U.S. companies that [were] direct and indirect purchases of potash [a component of agricultural fertilizers], accuse[d] several global producers of price-fixing."[138] Potash "is a homogenous commodity . . . . As a result, buyers choose among suppliers based largely on price."[139] The defendant potash supplier was a Canadian conglomerate of U.S. and foreign companies[140] that conspired abroad to manipulate the U.S. market. Specifically, "[t]he cartel members used a rolling strategy: [t]hey would first negotiate prices in Brazil, India, and China, and then use those prices as benchmarks for sales to U.S. consumers."[141] Shortly after the cartel agreed to a price on foreign soil, "prices in the United States went up by precisely the same amount."[142] The court acknowledged that is strategy first

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[134] *Id.* at 859.
[135] *Id.* at 857.
[136] *Id.*
[137] *See infra*, note 214.
[138] *Minn-Chem*, 683 F.3d at 858.
[139] *Id.* at 848.
[140] *Id.* at 848–49.
[141] *Id.* at 849.
[142] *Id.*

affected countries like China and "[s]hortly thereafter, a similar price increase was implemented throughout the world."[143]

Judge Wood framed the first prong of the FTAIA as the case's central issue: "[t]he question before us is thus whether the . . . conduct . . . had a direct, substantial and reasonably foreseeable effect on domestic or import commerce."[144] The court began its interpretation of this language by finding that "the requirements of substantiality and foreseeability are easily met."[145] Interestingly, however, the court did not attempt to ascertain the meaning of these words. It was satisfied that "[w]herever the floor may be, it is so far below these numbers that we do not worry about it here."[146] It returned to the directness element, however, by rejecting the Ninth Circuit's "immediate consequence" standard as failing to understand the first prong of the FTAIA as an "integrated phrase."[147]; "[t]o demand a foreseeable, substantial, and 'immediate' consequence on import or domestic commerce comes close to ignoring the fact that straightforward import commerce has already been excluded from the FTAIA's coverage."[148] The Seventh Circuit settled on the view that "direct means only 'a reasonably proximate causal nexus.'"[149]

However, the court also made several statements that suggest subjective intent played a role in its analysis. Most notably, Judge Wood characterized the first prong as a question of "whether the allegations in the plaintiff's Complaint describe conduct that had a direct, substantial, and reasonably foreseeable effect on domestic or import commerce by, for example, setting a benchmark price *intended to govern later U.S. sales*."[150] Assuming such an intent was present and noting that there had been an effect on U.S. commerce "almost immediately," the court found it "is not a stretch to say" that the defendants' alleged conspiracy was covered by the first prong of the FTAIA.[151] Additionally, the court found the defendants' observation that several cartel members did not sell potash directly to the United States or to U.S. purchasers abroad "[does] not provide a reason to throw out the case" on FTAIA grounds.[152] In other words, a foreign supplier who

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[143] *Id.* at 850.
[144] *Id.* at 859.
[145] *Id.* at 856.
[146] *Id.*
[147] *Id.* at 857.
[148] *Id.*
[149] *Id.*
[150] *Id.* at 859 (emphasis added).
[151] *Id.*
[152] *Id.* at 860.

sold only to Chinese buyers but was involved in a conspiracy designed to raise U.S. prices is subject to the Sherman Act, because that supplier was part of a broader plan designed to affect U.S. commerce.[153] This, together with the court's framing of the legal question in terms of intentionality, suggests that the design and purpose of the defendants' plan were relevant to *Minn-Chem*'s holding.

The Seventh Circuit considered the first prong of the FTAIA again in *Motorola II*.[154] The plaintiffs in that case, Motorola and its foreign subsidiaries, alleged that the defendants, AU Optronics and other electronics manufacturers, had agreed to a price-fixing scheme that regulated the sale of liquid-crystal display (LCD) panels.[155] The defendants sold their products to Motorola and its foreign subsidiaries,[156] which incorporated them into cell phones for retail sale.[157] One percent of the price-fixed panels was sold directly to Motorola and incorporated into cellphones in the United States.[158] These transactions clearly fell within the Sherman Act and were not considered on appeal, because they constituted import commerce, which is not excluded by the FTAIA.[159] The other ninety-nine percent of the purchased panels were sold to Motorola's foreign subsidiaries.[160] Fifty-seven percent were incorporated into cellphones and sold abroad.[161] "As neither those cellphones nor their panel components entered the United States, they never became part of domestic U.S. commerce . . . [and therefore] can't possibly support a Sherman Act claim."[162] The remaining forty-two percent of the price-fixed LCD panels were incorporated into cellphones abroad by Motorola subsidiaries, then sent to Motorola and sold in the United States.[163] The court considered whether the sale of these panels satisfied the FTAIA's domestic effects test.[164]

A three-judge panel heard the case in March 2014, but their opinion was vacated and a rehearing was granted. Sitting en banc, the Seventh Circuit affirmed the district court's ruling that the defendants' sale of LCD panels to

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[153] *See Id.* at 859 (noting that one foreign defendant, Canpotex, dealt only with Chinese buyers).
[154] *Motorola II*, 773 F.3d 826.
[155] *Id.* at 827.
[156] Mainly Chinese and Singaporean. *See Motorola I*, 746 F.3d at 843.
[157] *Motorola II*, 773 F.3d at 828.
[158] *Id.*
[159] *Id.* at 827.
[160] *Id.*
[161] *Id.* at 828.
[162] *Id.*
[163] *Id.* at 828. Fifty-seven percent were sold abroad. The remaining one percent represents the (unfinished) LCD panels sold to Motorola directly by foreign manufacturers, which bypassed its subsidiaries. That one percent was not involved in the appeal.
[164] *Id.*

Motorola's subsidiaries was insulated from Sherman Act liability by the FTAIA,[165] as the three-judge panel had also found months earlier.[166] In both opinions, the court rested its holding on the Act's second prong, finding that any effects of the price-fixing scheme had not given rise to Motorola's claim.[167]

However, Judge Posner briefly analyzed the first prong in each opinion.[168] In its en banc decision, the court reasoned that "[i]f prices of the components were indeed fixed, there would be an effect on domestic U.S. commerce,"[169] which is something it had not been willing to do in its vacated opinion.[170] Additionally, the original opinion had glanced over the terms "reasonably foreseeable" and "substantial," instead opting to focus on "direct."[171] Its directness analysis was brief and centered on the fact that "[t]he alleged price-fixers are not selling the panels in the United States."[172] In its en banc decision, the court justifiably retreated from this assertion, which had inaccurately distinguished the facts of *Minn-Chem*[173] and came too close to describing import commerce. In fact, the en banc opinion reversed course entirely in its treatment of the first prong. This time emphasizing the similarities of *Minn-Chem*, the court found that AU Optronics and the other manufacturers' price-fixing scheme could have had direct effects on the United States.[174]

Furthermore, the Seventh Circuit's en banc opinion made a more definitive conclusion as to foreseeability, when it notably made reference to the defendants' subjective state of mind: "[The] effect would be foreseeable (because

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[165] *Id.* at 829.

[166] *Motorola I*, 746 F.3d at 845.

[167] *Motorola II*, 773 F.3d at 829; *Motorola I*, 746 F.3d at 845–46.

[168] The court's assumption "that the requirement of a direct, substantial, and reasonably foreseeable effect on domestic commerce has been satisfied" did not affect the outcome of the case, because, as Judge Posner emphasized, "[i]t is essential to understand that these are two requirements," and that failing to satisfy one prong of the FTAIA bars a plaintiff's claim, "[w]hether or not Motorola was harmed indirectly." *Motorola II*, 773 F.3d at 830.

[169] *Id.* at 829.

[170] *Motorola I*, 746 F.3d at 845.

[171] *Id.* at 844–45; *Motorola II*, 773 F.3d 826.

[172] *Motorola I*, 746 F.3d at 844.

[173] In *Motorola I*, the majority claimed that, in *Minn-Chem*, the defendants "sold [their] product to U.S. consumers." *Motorola I*, 746 F.3d at 844. However, this selectively ignored another part of the *Minn-Chem* opinion, which found "a Canadian entity that does not sell directly into the United States [but] restricted supply during a period of especially difficult price negotiations with China" could be liable for being "a direct —that is, proximate— cause of the subsequent price increases in the United States." *Minn-Chem*, 683 F.3d at 859.

[174] *Motorola II*, 773 F.3d at 829. ("But at the same time the facts of this case are not equivalent to what we said in *Minn-Chem* would *definitely* block liability under the Sherman Act . . . .").

defendants knew that Motorola's foreign subsidiaries intended to incorporate some of the panels into products Motorola would resell in the United States) . . . ."[175] Although brief and seemingly ad-lib, this statement reveals the organic association between a subjective factual element (a defendant's knowledge) and the calculation of domestic effects under the FTAIA's first prong. Although *Motorola* is unique in that it introduced this element in context of foreseeability, rather than directness, it fits appropriately into the pattern of courts' discreetly supplementing a reputedly objective test with subjective factors.

B. The Ninth Circuit Created an Objective Definition of "Direct" That Is Unworkable Without Considering Subjective Factors

The Ninth Circuit's decision in *United States v. LSL Biotechnologies* was the first FTAIA case to define a "direct" effect, which it characterized as "an immediate consequence of the defendant's activity."[176] This definition appears to conflict with the Seventh and Second Circuits' interpretation, but the *LSL* court's analysis raises questions about whether its definition is a workable standard of directness at all.

The government's complaint in *LSL* alleged that two agricultural companies, LSL Biotechnologies and Hazera, had reached an agreement under which Hazera was prohibited from selling long-shelf life tomato seeds in the United States.[177] The Justice Department argued the agreement eliminated a "significant competitor" from the U.S. market,[178] prevented the technological development of "better fresh-market tomatoes for United States consumers," and "may also allow defendants to charge more for their seeds."[179] The Ninth Circuit panel found these allegations insufficient to satisfy the FTAIA's first prong, because "[t]he delay of possible innovations" was too speculative to be considered a direct effect,[180] and "[t]he government has presented no evidence that LSL has or will artificially inflate the prices it charges."[181] The court

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[175] *Id.*
[176] *LSL Biotechnologies*, 379 F.3d at 680–81. (borrowing its standard from Republic of Argentina v. Weltover, Inc., 504 U.S. 607, 618 (1992), which construed "a nearly identical term in the Foreign Sovereign Immunities Act.").
[177] *LSL Biotechnologies*, 379 F.3d at 674–75.
[178] *Id.* at 675.
[179] *Id.* at 676.
[180] *Id.* at 681.
[181] *Id.* at 682.

concluded that U.S. antitrust law could not be applied to the defendants' agreement, because "[n]either of these effects is 'direct.'"[182]

Arguably, though, *LSL*'s holding was less about what constitutes directness and more about what constitutes an "effect." In the other cases discussed in this section, there was no dispute that some adverse domestic effect had occurred. In *Minn-Chem*, the price of potash in the United States rose;[183] in *Motorola*, U.S. consumers paid more for cellphones.[184] The question in those cases went to the quantum and nature of effects on the U.S. market. The *LSL* court, in contrast, was not convinced there had been any effects on the U.S. market at all. This discrepancy makes the Ninth Circuit's *LSL* holding difficult to compare with Seventh Circuit cases like *Minn-Chem* and *Motorola*, because the court did not specify how it would proceed if there had been clear domestic effects.

Judge Aldisert dissented[185] from the *LSL* majority, saying that he would use a proximate cause standard for directness —the standard later adopted by the Seventh and Second Circuits.[186] His dissent is notable, first, because it thoroughly examined how the *LSL* majority failed to consider the meaning of the FTAIA's first prong in the context of the common law, the Act's legislative history, and the federal 's interpretations. Judge Aldisert criticized the majority for selectively pulling a definition of "direct" from a dictionary when "[t]he same dictionary source contains seven main meanings . . . encompassing 31 more specific subsidiary meanings."[187] The majority's uncritical selection of the "immediate consequence" definition was arbitrary, because "[a]ll of [the dictionary's] meanings are contemporary with the FTAIA."[188] A more thoughtful approach would have acknowledged that "[d]etermining the meaning of 'direct' requires the consideration of definitions as informed by the FTAIA's context and history."[189] Judge Aldisert supported his criticism by tracing the Act's history to show that directness was always a part of the extraterritorial application of the Sherman Act and, therefore, that "the new statute merely codified existing antitrust law in the use of the word 'direct.'"[190]

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[182] *Id.* at 681.
[183] *See Minn-Chem*, 683 F.3d at 856.
[184] *Motorola II*, 773 F.3d at 833.
[185] *LSL Biotechnologies*, 379 F.3d at 683 (Aldisert, J., dissenting).
[186] *See* Lotes Co., Ltd. v. Hon Hai Precision Indus. Co., Ltd., 753 F.3d 395, 398 (9th Cir. 2014).
[187] *Id.* at 692.
[188] *Id.*
[189] *Id.*
[190] *Id.* at 684.

Paradoxically, in spite of the weight it assigns to the common law, Judge Aldisert's dissent has a complicated relationship with the subjective intent element of the *Alcoa* effects test. His dissent observed that, in enacting the FTAIA, "[w]hat concerned Congress was . . . to make explicit the requirement that the effect be 'reasonably foreseeable' rather than based on 'intent.'"[191] This statement appears to imply that Congress created a purely objective test. However, that implication would arguably undercut Judge Aldisert's central contention -that the FTAIA codified the common law- because the common law did not employ a purely objective test. In other words, if the dissent acknowledged that a major element of the common law test was obliterated by the FTAIA, then it would have difficulty arguing the Act does not represent a modification of the common law.

Additionally, Judge Aldisert's opinion argued that the Justice Department sufficiently alleged direct effects on U.S. commerce by analogy with *Hartford Fire*, in which "the Supreme Court treated the plaintiffs' allegations as satisfying both the common law and the FTAIA's tests . . . as to a conspiracy involving the market for reinsurance, particularly in London, but ultimately targeting the United States domestic market for primary insurance."[192] The dissent further points out that *Hartford Fire* highlighted effects that were "closely related—in a proximate cause sense" to a foreign conspiracy. However, he did not address how *Hartford Fire* had weighed the subjective elements of *Alcoa*.[193] Judge Aldisert may have used *Hartford Fire* as an analogy because he thought incorporating subjective elements (specifically, the defendant's "targeting" the United States) strengthened his directness analysis; or, he may have chosen it simply because the facts were similar to those of *LSL*. In either case, his dissent illustrates the difficulty of expressing any definition of *direct* that does not retain some link to the subjective elements of the common law effects test.

Seven years after *LSL*, the Northern District of California applied the Ninth Circuit's interpretation of the FTAIA and carefully analyzed the circumstances that contribute to a direct effect.[194] In *In re TFT-LCD (Flat Panel) Antitrust Litigation*, a class of retail consumers who purchased products containing LCD panels brought a Sherman Act suit against global producers of the panels, the six largest of which controlled more than eighty percent of the world market.[195] The plaintiffs alleged the manufacturers had conspired to fix the prices

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[191] *Id.* at 690.
[192] *Id.* at 694 (emphasis omitted).
[193] *Id.*
[194] *In re* TFT-LCD Antitrust Litigation, 822 F. Supp. 2d 953 (N.D. Cal. 2011).
[195] *Id.* at 955.

of the panels, which resulted in a higher cost to consumers.[196] The defendants manufactured all of their panels outside of the United States, and the majority of these panels were sold to foreign companies that incorporated them into finished products in foreign manufacturing facilities.[197] Thus, U.S. retailers rarely purchased the price-fixed panels directly from the defendants.[198]

Apparently conceding the substantiality and foreseeability components of the FTAIA's domestic effects test, the defendants asserted that "the only 'direct' effects of the conspiracy occurred overseas and that the effects on the U.S. economy are at most 'ripple effects.'"[199] The plaintiffs responded by arguing "that defendants' conduct had a direct effect on the United States economy because the conspiracy was deliberately targeted at the United States."[200] To substantiate this argument, they presented a wealth of evidence that the "primary purpose" of the conspiracy was to affect U.S. prices, such as admissions by corporate executives that their agreement specifically targeted the U.S., evidence that products were tailored for U.S. consumers, and records showing the defendants' monitored U.S. prices.[201] Fundamentally, the plaintiffs grounded their theory of "direct effects" in the design of the conspiracy, "regardless of how the LCD panels ultimately found their way into the United States."[202]

The Northern District of California held for the plaintiffs,[203] saying "[t]he Court agrees with plaintiffs' construction of the 'domestic injury' exception."[204] Fully acknowledging Ninth Circuit precedent (namely, *LSL*), the court held "the effect is an 'immediate consequence'. . . . because the effect of defendants' anticompetitive conduct did not change significantly between the beginning of the process . . . and the end."[205] It reasoned that, unlike in *LSL*, where a chain of events separated conduct and effect, "[n]o intervening events interrupted [the effect's] journey."[206] Of course, there were, literally speaking, several events separating the illegal pricing of LCD panels and consumer purchases in the United States; most notably, price-fixed panels were sold to foreign

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[196] *Id.*
[197] *Id.* at 959–60.
[198] *Id.* at 960.
[199] *Id.* at 962.
[200] *Id.*
[201] *Id.* at 962–63.
[202] *Id.* at 963.
[203] *Id.* at 967.
[204] *Id.* at 963.
[205] *Id.* at 964.
[206] *Id.*

intermediaries before being sold to U.S. retailers.[207] However, the intended effect of the defendants' anticompetitive agreement —that prices for products containing their panels in the United States would rise, proceeded uninterrupted. Put simply, everything went according to plan.

TFT-LCD stands as an example of courts' recognition that the intent or purpose of a foreign conspiracy is a relevant factor in determining the directness of domestic effects. Importantly, the court never explicitly said that intent is an element of directness, and it did not consider whether the plaintiff's design-oriented theory comported with the apparently objective nature of the FTAIA's domestic effects test. It simply recited the evidence presented, noting how clearly it demonstrated the defendant's intent to affect U.S. commerce, and then held that the plaintiff's arguments were persuasive on the directness element.[208] Therefore, like the other cases discussed thus far, *TFT-LCD* did not openly challenge the objectivity of the FTAIA, but it nevertheless relied on theories and evidence which undermined that objectivity.

A limited number of other cases have been more explicit. For example, another Northern District of California judge, in *In re Static Random Access Memory (SRAM)*,[209] agreed with a plaintiff's theory that "transactions have a domestic effect because Defendants targeted purchasers in the United States." As authority, the *SRAM* court cited a Third Circuit case, *Turicentro v. American Airlines*,[210] in which the court declared "[t]he geographic target of the alleged anticompetitive conduct matters greatly."[211] However, neither *SRAM* nor *Turicentro* offers much help in dissecting the application of the FTAIA's first prong, because both opinions rested their holdings on other grounds before reaching the directness of the defendants' conduct.[212] Still, these cases are

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[207] *See Minn-Chem*, 683 F.3d at 856, 859.

[208] "In this case, of course, there are no similar 'twists and turns' in plaintiffs' theory of domestic effect. Plaintiffs argue that defendants colluded to increase the prices of LCD panels, a major component in electronic products that are imported into the United States. The increased price of the components caused the prices of the finished products in the United States to increase. If this effect is not 'direct,' it is difficult to imagine what would be." *TFT-LCD*, 822 F. Supp. 2d at 966.

[209] *In re* Static Random Access Memory (SRAM) Antitrust Litigation, 2010 WL 5477313 at *7 (N.D. Cal. 2010).

[210] Turicentro, S.A. v. AmericanAm Airlines, Inc., 303 F.3d 293 (3d Cir. 2002).

[211] *Id.* at 305.

[212] The court in *SRAM* decided to allow the plaintiffs more time to present evidence of the defendants' intent to increase prices in the U.S., finding the existing evidence insufficient. *SRAM*, 2010 WL 5477313 at *7-8. In *Turicentro*, the plaintiffs' claim did not properly allege any domestic effect had resulted from the defendants' conduct, so their complaint was facially insufficient. *Turicentro*, 303 F.3d at 305.

valuable, because they show some courts' willingness to introduce subjective elements into analysis under the FTAIA.

C. The Second Circuit Adopted the Seventh Circuit's Definition but Has Only Hinted at How It Might Be Applied

In *Lotes Co., Ltd. v. Hon Hai Precision Indus. Co., Ltd.*,[213] the Second Circuit adopted the Seventh Circuit's proximate cause standard for the first prong of the FTAIA.[214] However, because it held under the second prong,[215] it said very little about how it would apply that standard. The court only opined that the modern economy, with its many and fragmented layers, should not

> [R]ender[] any and all domestic effects impermissibly remote and indirect. Indeed, given the important role American firms and consumers play in the global economy, we expect that some perpetrators will design foreign anticompetitive schemes for the very purpose of causing harmful downstream effects in the United States.[216]

This statement suggests that otherwise remote or indirect effects could be deemed "direct" if a defendant intended its conduct to impact the United States. It is uncertain, however, whether the Second Circuit would reach this conclusion if it was presented with, and had to rule on, a conspiratorial design like the one it hypothesized.

VII. THE LEGISLATIVE HISTORY AND THE FEDERAL AGENCIES' POSITION DO NOT RULE OUT THE POSSIBILITY THAT CONGRESS INTENDED TO RETAIN SOME ELEMENTS OF THE SUBJECTIVE COMMON LAW TEST

The legislative history of the FTAIA is important, because the notion that the Act's standard is purely objective originated in scholarly and judicial interpretations of the history. In a subsection entitled "Addition of the Requirement That Effects 'Reasonably Foreseeable,'" the Judiciary Committee

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[213] Lotes Co., Ltd. v. Hon Hai Precision Indus. Co., Ltd., 753 F.3d 395 (9th Cir. 2014).
[214] *Id.* at 398.
[215] *Id.*
[216] *Id.* at 413.

explained: "The subcommittee chose a formulation based on foreseeability rather than intent to make the standard an objective one . . . ."[217] This approach was favored, because "[a]n intent test might encourage ignorance of the consequences of one's actions, which in this context would be an undesirable result."[218] Admittedly, this suggests that Congress wanted to remove the intent element of the *Alcoa* effects test and replace it with foreseeability to a "reasonable person making practical business judgments."[219]

However, other parts of the legislative history complicate the issue. For example, one subsection quotes a policy statement from the Department of Justice that articulated the agency's version of an appropriate effects test:

> United States antitrust laws should be applicable to an international transaction 'when there is a substantial and foreseeable effect on the United States commerce,' and that it . . . would be a miscarriage of congressional intent to apply the Sherman Act to 'foreign activities which have no direct *or intended effect* on United States consumers . . . .[220]

The legislative history does not explicitly say that Congress adopted Justice Department's position, but the final language of the Act is very close to the above-quoted phrase, as well as similar formulations found in the agency's guidelines.[221] Additionally, the Department's 1977 antitrust enforcement guidelines continue to be regarded as the Act's prototype,[222] and the legislative history cites them approvingly in several other instances.[223] Still, it is difficult to ascertain which parts of the agency interpretation were retained by the FTAIA and which were excluded.

The federal agencies' understanding of the FTAIA post-enactment has evolved with the law itself and is likewise mired in complexity and contradiction.

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[217] H.R. REP. NO. 97-686, *supra* note 11, at 9.
[218] *Id.*
[219] *Id.*
[220] *Id.* at 5 (emphasis added).
[221] Huffman, *supra* note 3, 62at 315.
[222] Foreign Trade Antitrust Improvements Act: Hearings on H.R. 2326 Before the Subcomm. on Monopolies and Commercial Law of the H. Comm. on the Judiciary, 97th Cong. 69 (1981), (statement of former Assistant Attorney General for Antitrust, John Shenefield) (recommending that Congress "bring the bill . . . into line with *Alcoa* and the Antitrust Guide for International Operations, published by the Justice Department"); Am. Bar Ass'n, Sec. of Antitrust Law, Report to Accompany Resolutions Concerning Legislative Proposal to Promote Export Trading 29-30 (1981) ("[The Act] is intended, without changing the law substantively, to use the 1977 Justice Department Guide's wording to clarify the 'effects' test . . . ."); Huffman, *supra* note 3, at 315 ("Congress's formulation most closely approximates that of the Department of Justice . . . .").
[223] *See supra* note 119.

The most recent policy statement is embodied in the 1995 enforcement guidelines that the Department of Justice and the Federal Trade Commission[224] (collectively, "the agencies") issued jointly.[225] Although the agencies' litigation strategy may sometimes suggest otherwise,[226] their guidelines strongly imply a connection between the directness element of the FTAIA and a defendant's subjective intent, purpose, or design.

This view is not stated outright, because the substance of the guidelines is contained in a series of illustrative examples. For instance, Example C presents two hypothetical situations.[227] In one situation, a group of manufacturers form an agreement that "clearly indicates that sales in or into the United States are not within the scope of the agreement."[228] In the other situation, the "agreement specifically provides that cartel members will set agreed prices for the U.S. market."[229] According to the guidelines, only the latter situation falls within the domestic effects exception of the FTAIA, because it contains "[t]he critical element of a foreign price-fixing agreement with direct, intended effects in the United States."[230] Similarly, in Example D, an agreement between two companies "would clearly have a direct and reasonably foreseeable effect on U.S. export commerce, since it is aimed at a U.S. exporter."[231] In Example E, an agreement is declared both direct and foreseeable, because "[the] arrangement appears to have been created with particular reference to competition from the United States."[232]

The guidelines' repeated reference to the intent, design, and purpose of anticompetitive schemes is not semantic or accidental, but represents a considered policy position. The foundation of this policy is that

> [T]he essence of any [Sherman Act] violation . . . is the illegal agreement itself—rather than the overt acts performed in furtherance of it,' [therefore,] the Agencies . . . focus on the potential harm that would

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[224] *See supra* note 1.
[225] U.S. DEP'T OF JUSTICE & THE FED. TRADE COMM'N, ANTITRUST ENFORCEMENT GUIDELINES FOR INTERNATIONAL OPERATIONS (1995) [hereinafter, "1995 Guidelines"].
[226] Delrahim, *supra* note 3,, at 429-30 ("In the Division's view, the correct interpretation of 'direct' in the FTAIA is a reasonably proximate causal nexus.") (citing *In re* Linerboard Antitrust Litig., 305 F.3d 145 (3d Cir. 2002)).
[227] *Id.* § 3.121.
[228] *Id.*
[229] *Id.*
[230] *Id.*
[231] *Id.* § 3.122.
[232] *Id.*

> ensue if the conspiracy were successful, not on whether the actual conduct . . . had in fact the prohibited effect.[233]

The agencies may have taken this position to avoid the messy factual questions that arise from trying to trace imported goods through the complicated avenues of global trade.[234] Alternatively, they may have simply assumed that the elements of the *Alcoa* test and the 1977 Department of Justice guidelines[235] were not altered by the FTAIA. Regardless of the agencies' motivations, their interpretation of the Act clearly considers a defendant's subjective intent relevant, if not critical, to analysis under the first prong of the FTAIA.[236]

VIII. CONCLUSION

This final observation of the agencies' stated position exemplifies the aim of this Note, which focuses less on how courts, legislators, and scholars express their interpretations of the FTAIA, and more on what their analyses of particular facts reveal. It is entirely possibly, maybe even likely, that Congress intended to make the first prong of the FTAIA a purely objective test. It is equally possible, or likely, that none of the judges writing the opinions surveyed in this Note intended to incorporate any subjective elements in their analysis. The same can be said, and has been said, for the agency position. However, the fact remains that references to intent, purpose, design, and other subjective factors consistently appear in all of these sources. Even if their influence is not invited, it is undeniably present.

Therefore, although the objective "immediate consequence" and "proximate cause" definitions of "direct" both have strengths and weaknesses, Judge Aldisert observed correctly that "[i]t would be arbitrary simply to pick one definition and declare it the 'plain meaning' in the abstract."[237] For thirty-seven

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[233] *Id.* § 3.121 (footnote omitted).

[234] For example, avoiding the analysis the *LSL* court performed in order to determine whether an effect had actually been felt in the United States. *See Minn-Chem*, 683 F.3d at 856; *Motorola II*, 773 F.3d at 833; *LSL Biotechnologies*, 379 F.3d at 683 (Aldisert, J., dissenting).

[235] I refer to these as "DOJ guidelines" rather than "the Agencies' guidelines," because FTC was not given enforcement authority under the Sherman Act until the FTAIA was enacted. *See supra* note 1.

[236] *See also* Am. Bar Ass'n, Sec. of Antitrust Law, *Report to Accompany Resolutions Concerning Legislative Proposal to Promote Export Trading* 29-30 (1981) ("[T]here is, with rare exception, no *significant* inconsistency between judicial precedents and the Justice Department's view of the 'effects' test.").

[237] United States v. LSL Biotechnologies, 379 F.3d 672, 692 (2004) (Aldisert, J., dissenting).

years, *Alcoa* governed antitrust extraterritoriality with a test that was one half subjective. Without analyzing the merits of that test, this Note suggests that such a long-standing precedent may not have been completely extinguished from antitrust jurisprudence by a new statute and new interpretations. Furthermore, it argues that incorporating subjective elements that continue to be relevant to the FTAIA would be more productive than attempting, unsuccessfully, to suppress them.

A CASE STUDY ON THE POLITICS BEHIND SUSTAINABLE ENERGY POLICY: GERMANY'S "ATOM-MORATORIUM" AND "ENERGIEWENDE"

RICHARD J. SCHELL

I. INTRODUCTION

Nuclear power has been of particular importance to European countries due to its low cost and atmospheric emissions that are almost inexistent when compared to fossil fuels. However, the dangers of a possible Chernobyl or a Fukushima like incident occurring in Germany—a country slightly larger than New Mexico—have also been a part of the discussion surrounding this particular energy source. Alongside this is the fact that, although nuclear energy does produce cleaner emissions, power plants produce more hazardous waste in depleted radioactive material that cannot be disposed easily. As a result of these

difficulties, pro-environment groups question the role of nuclear power in European economies.[1]

Although anti-nuclear forces have enjoyed marked recent success, this has not always been the case. The movement was unable to garner a majority of people to support the abolition of nuclear power, even as the Chernobyl disaster spread radioactive material throughout Europe. It took the meltdown in Fukushima to spur the following generation—one much more environmentally conscious—to call for the closing of nuclear plants.[2] Following intense political discussion, both on the merits of the issue and on the German government's own role in executing policy, Chancellor Merkel announced a nuclear moratorium: the "Atom-Moratorium."[3] Declaring that closing down every nuclear plant would be too costly, the German government avowed that older plants' closings would be accelerated and that no new nuclear plants would be built.[4]

Although the German government made plans to increase exploitation of alternative energy sources, particularly, renewable energy sources, it had not planned for the immediate closing of seven nuclear power plants. These were originally intended to be phased out during the latter half of the 2010s.[5] The government, therefore, recurred to massive investments, both short and long-term in order to shore up its energy productions. These actions have been called the "Energiewende" within and outside of Germany.[6] In hindsight, the German government's decision to invest in renewable energy and to shut down nuclear power plants has been vindicated in the sense that the infrastructure is already in place for a sustainable energy economy, demonstrable by the country becoming a net energy exporter now in comparison to its neighbors, who are particularly reliant on fossil fuels like coal, oil, and particularly, Russian gas.[7]

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[1] Joachim Radkau, *Eine kurze Geschichte der deutschen Antiatomkraftbewegung*, BUNDESZENTRALE FÜR POLITISCHE BILDUNG (Nov. 10, 2011), http://www.bpb.de/apuz/59680/eine-kurze-geschichte-der-deutschen-antiatomkraftbewegung?p=all.

[2] Cristoph Twickel, *Deutsches Anti-AKW-Gefühl: Im Land der Mahnbürger*, DER SPIEGEL (Mar. 15, 2011, 5:18 p.m.), http://www.spiegel.de/kultur/gesellschaft/deutsches-anti-akw-gefuehl-im-land-der-mahnbuerger-a-750990.html.

[3] Sebastian Fischer & Philipp Wittrock, *Schwarz-gelbe Atomwende: Die neue Anti-AKW-Bewegung*, DER SPIEGEL (Mar. 15, 2011, 7:13 p.m.), http://www.spiegel.de/politik/deutschland/schwarz-gelbe-atomwende-die-neue-anti-akw-bewegung-a-751078.html.

[4] *Schwarz-gelbe Wende: Merkel klemmt sieben Reaktoren ab–vorerst*, DER SPIEGEL, (Mar. 15, 2011, 11:52 a.m.), http://www.spiegel.de/politik/deutschland/schwarz-gelbe-wende-merkel-klemmt-sieben-reaktoren-ab-vorerst-a-751039.html.

[5] *Id.*

[6] *Introduction*, AGORA ENERGIEWENDE, http://www.agora-energiewende.de/en/die-energiewende/introduction/.

[7] *Deutschland exportierte auch 2012 mehr Strom als es importierte*, STATISTISCHES BUNDESAMT (Apr. 2, 2013), https://www.destatis.de/DE/PresseService/Presse/Pressemitteilungen/2013/04/PD13_125_51pdf.pdf?__blob=publicationFile.

The purpose of this paper is to examine the nature of the debates surrounding the implementation of public policy, specifically within the energy sector utilizing the Moratorium and Energiewende as a case study for such a purpose. Hopefully, it will serve as a roadmap to others seeking to further a similar conversation within their own society. In doing so, these participants would be able to view the debate within a factual framework and be able to understand the intricacies involved in a debate of such magnitude and to tailor their own political strategies with such complications in mind.

II. THE ESTABLISHMENT OF NUCLEAR POWER PLANTS AND THE ORIGINS OF ANTI-NUCLEAR ACTIVISM

In order to begin ascertaining the reasons behind the German public's antipathy towards nuclear energy, we must first head back to the 1970s when nuclear power plants now subject to the Moratorium were built. These developments were initially perceived as a way to stave off the oil crisis that had occurred earlier in the decade.[8] With the rising price of fossil fuels due to the formation of OPEC, the need to use other energy sources was paramount to the continued economic expansion of West Germany. Construction of these nuclear power plants began in the 1970s and continued into the 1980s and the present.[9] The development and operation of power plants proceeded uninterruptedly, with the older plants running concurrently with the new, up to the Atom-Moratorium.[10]

At the time when nuclear power came in vogue, environmentalist began to worry about the possible repercussions of a nuclear disaster and began to coalesce into non-partisan grassroots movements.[11] Their fears included the possibility of a reactor meltdown scarring the environment for generations and the disposal of radioactive energy.[12] Unlike the United States, where radioactive waste can be safely locked in the middle of the desert, Europe is much more densely populated and lacks such open places. Consequently, a fault or defect in waste disposal would negatively affect many more people forcing them from their homes and denying the use of already developed land. Other concerns stemmed from a more political dimension. Some of the movement's participants, influenced by Marxist thought, clamored for a more equitable and fair political

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[8] *Ölkrise und Kernkraft*, DIE ZEIT (May 8, 1987), http://www.zeit.de/1987/20/oelkrise-und-kernkraft.

[9] *Kernkraftwerke in Deutschland*, KERNENERGIE.DE, http://www.kernenergie.de/kernenergie/themen/kernkraftwerke/kernkraftwerke-in-deutschland.php.

[10] *Der Einstieg zum Ausstieg aus der Atomenergie*, DEUTSCHER BUNDESTAG (2012), https://www.bundestag.de/dokumente/textarchiv/2012/38640342_kw16_kalender_atomaustieg/208324.

[11] Radkau, *supra* note 1.

[12] Brian Martin, *Opposing Nuclear Power: Past and Present*, 26 SOC. ALTERNATIVES (NO. 2) 43 (2007), http://www.bmartin.cc/pubs/07sa.pdf.

environment.[13] They began to see the establishment and enshrinement of big energy developments as a means through which a bourgeois establishment was allowed to maintain itself.[14]

Although these people engaged in massive and highly visible protests against nuclear power,[15] they were unsuccessful in curbing the use of nuclear power.[16] Economic considerations won out due to the lack of alternate energy sources to substitute nuclear power. Interest in these movements plateaued, but they were able to maintain a lasting presence within the socio-political argument. The Chernobyl incident helped keep these movements relevant and spurred the creation of the Federal Ministry for the Environment, Nature Conservation, Building and Nuclear Safety.[17] The thought of nuclear waste contaminating farmland became one of the narratives behind which environmentalists began to rally. Not only did this allow environmentalists to secure their position in national politics, but to also consolidate and join forces with other political movements, particularly those on the left.[18]

In tandem with the grassroots movement, new political parties began to spring up around Europe focused on an environmental message. These "green" parties made environmentalism the core tenet of their manifestos. The abolishment of nuclear power, alongside other hot-button issues like reducing carbon emissions, global warming, and conservationism, became one of their chief concerns and most visible causes.[19] In Germany, however, the Green party has been unable to cement itself as a leading political voice at the national level.[20] Since reunification, aside from the Gerhard Schröder government of 1998 to 2005, in which the Greens participated as junior coalition partner, Germany has been

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[13] *Id.*

[14] *Die Zertrümmerung der Anti-AKW-Bewegung in bunte Teilchen*, 23 MARXISTISCHE STUDENTEN ZEITUNG (1978), http://msz1974-80.net/AntiAKW.html.

[15] One of the most notorious of these protests was the 1977 protest in Hamelin, Lower Saxony, where protesters bloodily, yet unsuccessfully, protested against the construction of Grohnde Nuclear Power Plant. *Böses Massaker*, DER SPIEGEL (March 28, 1977), http://www.spiegel.de/spiegel/print/d-40941633.html. Another such incident was the 1981 protest in Brockdorf, Schleswig-Holstein, where protesters sought to bring awareness to the problems of nuclear waste disposal. Twenty-two were reported injured. John Tabliabue, *West Germans Clash at Site of A-Plant*, THE NEW YORK TIMES (March 1, 1981), http://www.nytimes.com/1981/03/01/world/west-germans-clash-at-site-of-a-plant.html.

[16] This is exemplified by the construction of the protested reactors, including the one at Grohnde.

[17] *Bundesministerium für Umwelt, Naturschutz und Reaktorsicherheit*, PRESSEAUSWEIS.DE, http://www.presseausweis.de/service/bundespolitische-organe/bundesministerium-fuer-umwelt-naturschutz-und-reaktorsicherheit/geschichte.

[18] This is very nicely exemplified with the history of the Green Party in Germany (Die Grünen), which is actually the merger of three different political parties: Die Grünen, the Grünen Aktion Zukunft, and the East German Bündnis 90.

[19] In Germany, one of the more notable manifestos is the Grünen Aktion Zukunft's (GAZ) *Das Grüne Manifest*, published in 1978. The GAZ would later merge into Die Grünen.

[20] Serkan Agci, *Geschichte*, BUNDESZENTRALE FÜR POLITISCHE BILDUNG (Feb. 22, 2010), http://www.bpb.de/politik/grundfragen/parteien-in-deutschland/42151/geschichte.

ruled by either center-right or center coalitions led by Christian Democrats Helmut Kohl and Angela Merkel. The Greens have had greater success in state elections, where they have been junior coalition members in multiple regional governments.[21]

III. THE FUKUSHIMA DISASTER & THE ATOM-MORATORIUM

A. Catastrophic Nuclear Meltdown

The Fukushima Disaster was the result of a cataclysmic earthquake-tsunami event that crippled the Fukushima Daiichi Nuclear Power Plant. An earthquake initially ravaged the power plant, leaving it in a state of vulnerability to a rapidly approaching tsunami that flooded five of six reactors. As a result of these events, the plant's electrical systems completely blacked out. This left the reactors without any means of regulating their internal temperatures, and they only grew hotter.[22] Workers were unable to cool down the reactors through alternative means, which resulted in an unavoidable nuclear meltdown, far worse than Chernobyl in terms of gross nuclear material.[23] Land surrounding the power plant had to be evacuated due to the high levels of radiation. Ground water in certain regions was also affected by the contamination, being deemed undrinkable and not fit for human use otherwise. Additionally, radioactive material was spewed into the Pacific, much of which contaminated the local wildlife, including fisheries. This nuclear material has also coalesced into a plume that is currently on its way to the United States' West Coast, although the possibility of harm this last case has been deemed negligible.[24]

Much of the post-mortem reports dealt with the plant's security measures and its preparedness for natural disasters. Examples of mismanagement include not heeding warnings on tsunami preparedness, malfunctioning electrical equipment, and poorly built infrastructure that was prone to flooding.[25]

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[21] Die Grünen are currently junior coalition partners in the governments of Lower Saxony, Bremen, Thuringia, North Rhine-Westphalia, and Rhineland-Palatinate. They are the senior coalition partner in Baden-Württemberg.

[22] *Timeline for the Fukushima Daiichi nuclear power plant accident*, OECD-NEA (Mar. 7, 2012), https://www.oecd-nea.org/press/2011/NEWS-04.html.

[23] *Id.*

[24] James Conca, *Radioactive Fukushima Waters Arrive at West Coast of America*, FORBES (Mar. 16, 2014), http://www.forbes.com/sites/jamesconca/2014/03/16/radioactive-fukushima-waters-arrive-at-west-coast-of-america/.

[25] *Fuel storage, safety issues vexed Japan plant*, REUTERS (Mar. 22, 2001) http://uk.reuters.com/assets/print?aid=UKL3E7EM23620110322; *Operator of Fukushima Nuke Plant Admitted to Fake Repair Records*, HERALD SUN (Mar. 20, 2011, 6:33 p.m.), http://www.heraldsun.com.au/news/special-features/operator-of-fukushima-nuke-plant-admitted-to-faking-repair-records/story-fn858jk3-1226024977934?nk=023977a3dbb45ab8ed0a7f123c0f7917; *Japan, TEPCO ignored atomic accident risks due to 'myth of nuclear safety': Report*, NEWSTRACK INDIA (July 23, 2012),

Additionally, many in the public—when comparing the Fukushima incident to the geographical conditions in Germany—do not take into account the geographical placement of the plant. Due to its location in the Ring of Fire, the Fukushima reactor was much more prone to extreme tectonic activity than any building located in Central Europe and its location on the coastline also makes it more vulnerable to tsunamis.

B. The Reaction within Germany and the Adoption of the Moratorium

As a result of this mounting political pressure, Angela Merkel and her cabinet ordered the closure of every one of Germany's nuclear power plants.[26] During their closures, they were investigated by government officials, who evaluated the plants' risk status. This was quantified by evaluating the condition of the plants' infrastructure and also evaluating these plants' vulnerabilities to outside forces, such as possible terrorist attacks—including 9/11 style airplane attacks—and natural catastrophes—ranging from a mild heatwave to an earth-shattering quake.[27] The conclusions led to the closing of the seven oldest power plants, which lacked the baseline safeguards as measured in the inspections.[28] The other plants, however, were allowed to resume operations. These newer nuclear reactors will be indefinitely shut down by 2022, though kept in a state of limbo as possible reserve energy sources in the event that they are needed again.[29]

Another development included the establishment of an ethics commission to decide on the future of the German energy industry, with particular emphasis on renewables and the risks posed by the continued operation of nuclear power plans.[30] Although the commission did not opine as to whether nuclear energy developments ought to be encouraged or not, it did produce some worry in nuclear power supporters. It stated that nuclear power is a rational course of acting when handled and that there are particular safeguards in place that ought to be followed and, where possible, nuclear power producers ought to also

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http://www.newstrackindia.com/newsdetails/2012/07/23/330-Japan-TEPCO-ignored-atomic-accident-risks-due-to-myth-of-nuclear-safety-Report.html.

[26] Fischer & Wittrock, *supra* note 3.

[27] *AKW-Experten machen sich auf die Suche nach dem Risiko*, DIE ZEIT (Mar. 31, 2011), http://www.zeit.de/politik/deutschland/2011-03/roettgen-reaktorsicherheitskommission-moratorium.

[28] *Merkels Atom-Moratorium: Sieben Kernkraftwerke gehen vorerst vom Netz*, FRANKFURTER ALLGEMEINE ZEITUNG (May 15, 2011, 4:46 p.m.), http://www.faz.net/aktuell/wirtschaft/unternehmen/merkels-atom-moratorium-sieben-kernkraftwerke-gehen-vorerst-vom-netz-1613287.html.

[29] *Einigung im Kanzleramt: Atomausstieg bis 2022*, FRANKFURTER ALLGEMEINE ZEITUNG (May 30, 2011, 12:00 p.m.), http://www.faz.net/aktuell/2.2032/einigung-im-kanzleramt-atomausstieg-bis-2022-1637930.html.

[30] *Deutschlands Energiewende — Ein Gemeinschaftswerk für die Zukunft*, ETHIK-KOMMISSION SICHERE ENERGIEVERSORGUNG (May 30, 2011), http://www.bmbf.de/pubRD/2011_05_30_abschlussbericht_ethikkommission_property_publicationFile.pdf.

always adopt the safest course possible in conducting their business.[31] Moreover, it placed particular emphasis on the fact that nuclear fallout and contamination can become an international problem due to weather patterns, as was the case with Chernobyl. In such instances, energy producers must also conduct themselves responsibly and with particular care to prevent another international catastrophe.[32]

The commission also opined as to fossil fuels and their place in a non-nuclear world. Although the commission agreed that they are readily available energy sources, it took issue specifically with coal. The report claims that coal is in itself a naturally inefficient fuel source, and that the carbon emissions produced by clean coal are unsustainable.[33] As a result, the report points towards renewable energy as the ideal future, identifying wind and hydroelectric energy as the most efficient and desirable sources thereof.[34]

IV. THE POLITICAL DEBATE SURROUNDING THE MORATORIUM

A. Whether the Government Could Unilaterally Impose the Moratorium

Right-wing politicians deemed the German government's actions unconstitutional because it lacked the consent of parliament.[35] They argued that Merkel's decision was also extrajudicial because the parliamentary majority previously voted down legislation of the same nature and Merkel contravened the legislative body's will.[36] Additionally, given that the German Atomic Law only allows for closure of a power plant for an illegal act or in the face of a pressing state interest, the German government would have been legally barred from acting, as these politicians saw neither element proven at the time of enacting the moratorium.[37] There were also additional constitutional issues involved regarding Germany's federalist structure—nuclear power supporters argued that the

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[31] *Id.*
[32] *Id.*
[33] *Id.*
[34] *Id.*
[35] *Lammert zweifelt an Rechtmäßigkeit*, SÜDDEUTSCHE ZEITUNG (Apr. 27, 2011), http://www.sueddeutsche.de/politik/bundestagspraesident-vs-bundeskanzlerin-lammert-zweifelt-an-rechtmaessigkeit-des-atom-moratoriums-1.1072637.
[36] *Id.*
[37] *See* Gesetz über die friedliche Verwendung der Kernenergie und den Schutz gegen ihre Gefahren [AtG] [Act on the Peaceful Use of Nuclear Energy and Protection against its Dangers], Dec. 23, 1959, BUNDESGESETZBLATT Teil I [BGBL. I] at 59 814 (Ger.) http://www.gesetze-im-internet.de/bundesrecht/atg/gesamt.pdf. *See also* Gesetz zur geordneten Beendigung der Kernenergienutzung zur gewerblichen Erzeugung von Elektrizität [AtomG 2002] [Act on the Orderly Termination of the Use of Nuclear Energy for the Commercial Generation of Electricity], Apr. 22, 2002, BUNDESGESETZBLATT Teil I [BGBL. I] at 26 1351 (Ger.).

different German states ought to have had the exclusive power to decide whether the power plants should be closed or not.[38]

Additionally, the power plants' private operators were distraught at what they deemed an act that impaired existing contractual obligations. They saw the government's actions in closing the plants pending investigation and also closing the older plants as an unjust and unlawful taking of a proprietary interest.[39] Two power plant operators sued, and—although they were not allowed to reopen and recommence their plant's operations—the courts held that they were entitled to legal damages.[40] The Federal Administrative Court, which is the court of last instance for this particular claim, held that the German government, in ordering the closure of these plants, while the operators were still operating them, had interfered with their existing contractual rights and impaired their proprietary interest in the power plants.[41]

Supporters of the German government's position argued in the contrary, that the measures imposed by Merkel were themselves grounded upon the law, notwithstanding the opposition's concerns that the Atom Law required an amendment before being able to act. In this case, the Fukushima disaster, coupled with the public concern over nuclear power plants, was enough to demonstrate that there was a pressing state interest justifying intervention. On top of this—although the possibility of damaging private property interests was high—the necessity of acting and putting the public's concerns at ease was enough to justify state action.

B. Whether this Decision Was Just a Political Move by the Government

Merkel was criticized by many of her opponents for deciding to impose the moratorium with regional elections approaching.[42] At that point in time, regional elections for some of the German states were one to two weeks away. Given that the absolute majority of the populace supported a stop to nuclear power generation, many interpreted Merkel's actions as pandering.[43] This is particularly so because the ruling coalition had previously vetoed legislation from the opposition that attempted to do exactly what she had done on her own. Allegations of hypocrisy were thrown at the government.

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[38] *Lammert zweifelt an Rechtmäßigkeit*, *supra* note 35.
[39] Bundesverwaltungsgericht [BVerwGE] [Federal Administrative Court], Dec. 20, 2013, 7 B 19.13, http://www.bverwg.de/entscheidungen/verwandte_dokumente.php?ecli=201213B7B19.13.0.
[40] *Id.*
[41] *Id.*
[42] Lena Jakat & Oliver Das Gupta, *Regierung geht in Deckung, Opposition frohlockt*, DIE SÜDDEUTSCHE ZEITUNG (Apr. 27, 2011, 8:03 p.m.), http://www.sueddeutsche.de/politik/bruederle-das-moratorium-und-der-wahlkampf-regierung-geht-in-deckung-opposition-frohlockt-1.1076659.
[43] *Id.*

C. Whether the Moratorium Would Lead to Increases in Energy Costs and on Dependency on Energy Imports

The other important aspect argued by the opposition was that, in enacting the moratorium, energy prices would soar due to decreased production and that such decreased production would force Germany to acquire energy from other markets.[44] In fact, politicians and economists warned that the moratorium itself would exacerbate the domestic energy market as long as it was in effect and that increased prices would continue to be present as a result of that initial shortfall. Germany would, consequently, be forced to spend €93.5 billion in fossil fuel imports in 2012.[45]

Additionally, warnings were also issued as to possible legal liability for closing down the plants without a pressing state interest. Putting forward that a State act based on nebulous legal foundations would directly harm private enterprises, opponents of the moratorium warned that any action could result in protracted litigation that would conclude with the State having to pay damages to the affected power plants. In fact, this is precisely what has occurred with regards to a couple of these power plants.[46]

Proponents of alternative energy would argue that price is not as high of an issue as traditional energy supporters would argue it to be because, in calculating energy prices, one is directly comparing the upfront cost of establishing an entirely new economic model compared to one that is fully realized. The costs are much lower for exploiting a coal dig, given that the equipment to mine the coal, and the skills required are already available, compared to creating a windfarm, where the requisite turbines are much newer technology and there are less qualified people to operate them by virtue of their novelty. Furthermore, renewable energy supporters like to argue that finite resources like fossil fuels have a price based on the supply and demand. On the topic of energy independence, supporters of the moratorium like to point out that the moratorium did not significantly harm German interests. In fact, a year after the moratorium went into effect, reports came out stating that Germany had become an energy exporter.[47] This is especially significant considering that they

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[44] Stefan Schultz, *Ökostrom-Umlage: Netzagentur kritisiert Entlastungen für Industrie*, DER SPIEGEL (May 15, 2012), http://www.spiegel.de/wirtschaft/netzagentur-kritisiert-verguenstigungen-fuer-stromintensive-unternehmen-a-833299.html.

[45] Frank-Thomas Wenzel, *Abhängig von Öl und Kohle*, BERLINER ZEITUNG (Sep. 20, 2013), http://www.berliner-zeitung.de/wirtschaft/energiewende-abhaengig-von-oel-und-kohle,10808230,24386982.html.

[46] Bunesverwaltungsgericht [BverwGE] [Federal Administrative Court], Dec. 20, 2013, 7 B 19.13, http://www.bverwg.de/entscheidungen/verwandte_dokumente.php?ecli=201213B7B19.13.0.

[47] *Deutschland exportierte auch 2012 mehr Strom als es importierte*, STATISTICHES BUNDESAMT (Apr. 2, 2013), https://www.destatis.de/DE/PresseService/Presse/Pressemitteilungen/2013/04/PD13_125_51pdf.pdf?__blob=publicationFile.

dealt with the 2012 Cold Wave, in which temperatures across Europe plummeted, forcing people to spend more on heating.

V. ENERGIEWENDE

Even before the Fukushima disaster, the Federal Government had already been planning a sustainable energy platform. In order to continue to foster economic growth within the country, policymakers reasoned that Germany had to detach itself from continued reliance on finite energy sources. The Fukushima disaster, however, forced their hand. Whereby the plan was to slowly phase out existing energy sources, it had to be altered as a result of the moratorium because nuclear power did not factor into the initial economic plans to phase out the usage of fossil fuels. In fact, this circumstance would lead to the increase in fossil fuel consumption in the short term. According to the AG Energiebilanzen, a dependence of the Deutsches Institut für Wirtschaftsforschung, nuclear energy production went from 10.8% to 7.7% of total energy production from 2010 to 2013. At the same time, black coal, brown coal, and natural gas consumption rose to substitute the shortfall. Renewable energy also had a slight rise.[48]

A. Short-Term Fossil Fuel Exploitation

As a result of the sudden shut down of nuclear reactors, Germany found itself strained in terms of energy.[49] As a short-term solution, the exploitation of fossil fuel developments was continued.[50] This included building new natural gas pipelines to Eastern Europe and establishing a closer relationship with Russia, the European Union's greatest energy trading partner. However, this merely provided an abatement of the current energy shortage and was not a means towards sustainable development, thus forcing the government to extend its efforts elsewhere.[51]

In any case, environmental protection efforts have not been entirely ignored through the expansion of fossil fuel usage. Much of these efforts were focused on expanding natural gas production because it is a much cleaner fossil fuel than coal. Moreover, an interesting particularity arises when evaluating these events. Although the government had been investing more in fossil fuels, the amount of coal used, specifically, the dirtier brown coal, did not significantly increase as a result of the moratorium.

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[48] *Auswertungstabellen zur Energiebilanz Deutschland*, AG ENERGIEBILANZ E.V., (Sep. 15, 2014), http://www.ag-energiebilanzen.de/index.php?article_id=29&fileName=ausw_10092014_05112014_ov.pdf.

[49] Henning Gloystein & Jackie Cowhig, *Analysis: German nuclear U-turn means jump in emissions*, REUTERS (Apr. 4, 2011), http://www.reuters.com/article/2011/04/04/us-germany-energy-coal-idUSTRE7331BF20110404?feedType=RSS&feedName=everything&virtualBrandChannel=11563.

[50] *Id.*

[51] *Id.*

B. Long-Term Renewables Strategy

Due to environmental and economic reasons, continued reliance on fossil fuels has been regarded as unsustainable.[52] Increasing carbon emissions has become an almost taboo action in the European Union, while the continent as a whole lacks worthwhile reserves of fossil fuels. Because of this, the Federal Government has adopted policy advocating for the development of a sustainable energy market through the adoption of renewable energy sources.[53]

Among the problems facing this movement is the associated cost involved. In much the same way as the transition to nuclear energy necessitated large amounts of capital investments for building power plants, the infrastructure needs for renewable energy are also apparent.[54] Although the maintenance and upkeep of renewable energy infrastructure is most definitely not entirely similar to the burden suffered by power plant operators, there is still a large upfront cost involved in the initial construction of such infrastructure.

Other considerations involve the oft-unreported harm caused by renewable energy sources. Wind farms are particularly relevant to this situation. These are necessarily placed in regions through which wind currents run. Given their placement in such areas and that many birds actually fly through these same currents, the birds end up getting mauled by wind farms.[55] Another factor to consider is land use. Wind farms also have to be of a certain size in order to produce enough energy to meet society's demands. Unlike a power plant, which is a relatively compact building, these have to be spread out, providing each wind turbine sufficient access to aeolic forces.[56] These same concerns apply when dealing with solar panels, which has led to their installation in more creative ways such as on the roofs of buildings or making roads built of solar panels.

In any case, the German government has seen fit to hedge its bets with this secondary model. In claiming that the issue was not entirely about cost, other key words have sprung up. One of the most important of these is innovation. The government is hoping that, as it invests in renewable energy, luring inventors and researchers to Germany, it can also foster a new technological boom within the

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[52] *Deutschlands Energiewende – Ein Gemeinschaftswerk für die Zukunft*, *supra* note 30.

[53] Annalena Baerbock, *Ran an die Kohle*, DIE ZEIT (Sep. 25, 2014), http://www.zeit.de/2014/40/fossile-energien-klimaschutz.

[54] *See* Evan Jones & Joseph Eto, *Financing End-Use Solar Technologies in a Restructured Electricity Industry: Comparing the Cost of Public Policies*, LAWRENCE BERKELEY NAT'L LAB. (Sep. 1997), http://emp.lbl.gov/sites/all/files/REPORT%20lbnl%20-%2040218.pdf, at 41-50.

[55] Rose Eveleth, *How Many Birds Do Wind Turbines Really Kill?*, SMITHSONIAN (Dec. 16, 2013), http://www.smithsonianmag.com/smart-news/how-many-birds-do-wind-turbines-really-kill-180948154/.

[56] Darren Quick, *Less is more for cost-efficient wind farms*, GIZMAG (Jan. 23, 2011), http://www.gizmag.com/less-is-more-for-more-cost-efficient-wind-farms/17659/.

country.[57] Another important keyword would be sustainability. The government is not merely looking at what would be an easy way to invest money; rather it is foreseeing a long-term development plan, such that by investing in renewable energy henceforth, it could also establish a long-term based system almost entirely on renewable energy.[58] Furthermore, the externalities associated with a system based on renewable energy are definitely recognized in this system, such that value is accorded to comforts such as a cleaner environment and energy independence instead of simply focusing on the bottom line.

C. The "Erneubaren-Energien Gesetz" of 2014[59]

This particular law establishes the German government's policy towards the development of renewable energy sources. This policy is exemplified by a series of milestones related to the production of renewable energy. Renewable energy should be about 40–45% of Germany's total energy by 2025, 55–60% by 2035, and 80% by 2050. Additionally, carbon emissions should be less than in 1990. In order to reach that goal, this law has a series of curious provisions, such as section 37, paragraph 2 of the law. This piece stipulates a charge of €0.0624/kWh to all consumers during 2014.[60] The proceeds from this fee would then be pooled together and utilized to subsidize and incentivize the development of renewable energy production. Section 41 of the law establishes a procedure through which private enterprises may petition to be exempted from these fees. Another provision, which ties into this scheme of incentives, is an energy resale scheme within the law. Consumers who produce more energy than consumed—particularly with the aid of renewable resources—are allowed to either resell the energy at a fixed rate or they are allowed to participate in a type of energy exchange, through which they can set their own prices. This last measure is particularly important to the small entrepreneur and to the common citizen simply looking to make some money on the side. Yet, while they may earn profits, they are also doing so through the adoption of environmentally sound activities that also propagate an environmentally-conscious message.

D. Corporations Shift to Renewable Energy

One of the most unlikely standard bearers for the German government's efforts is E.on, an energy production company that operates multiple nuclear

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[57] *Ziele der Energiewende*, BUNDESMINISTERIUM FÜR BILDUNG UND FORSCHUNG, http://www.buergerdialog-bmbf.de/energietechnologien-fuer-die-zukunft/300.php.

[58] *Id.*

[59] Erneubare-Energien-Gesetz [EEG 2014] [Renewable Energy Act], July 21, 2014, BGBL. I at 1066 (Ger.) http://www.gesetze-im-internet.de/bundesrecht/eeg_2014/gesamt.pdf.

[60] *Energielexikon: Was ist die EEG-Umlage und wie funktioniert sie?*, BUNDESNETZAGENTUR (May 6, 2013), http://www.bundesnetzagentur.de/cln_1411/DE/Sachgebiete/ElektrizitaetundGas/Verbraucher/Energielexikon/energielexikon-node.html.

reactors and employs approximately 40,000 people within Germany.[61] The company, seeing the financial incentives available through clean energy initiatives, plans to cut its nuclear power enterprises and focus solely on natural gas and on renewable energy. The reasoning for this is that the energy market will greatly change throughout the next years and the older power plants do not fit into the new model that is much more consumer driven.[62] However, their departure from the traditional market is also creating additional complications. One of the biggest questions is what to do with the now-abandoned power plants, and, if they are to be demolished or repurposed, who would be asked to finance such an undertaking: consumers, the government, or E.on?[63]

However, this corporate shift is not merely restricted to domestic enterprises. International enterprises are also taking advantage of the renewables-friendly climate. The Australian energy firm Ceramic Fuel Cells, which has invented a novel electrical generator that could dramatically reduce household electricity consumption, has also recently migrated to Germany.[64] This company left Australia because Germany had made €16 billion available in commercial subsidies, while Australia lacked a similar program.

E. Democratizing the Energy Debate

Another aspect of the Energiewende, dating from the origins of the anti-nuclear movements, is the desire to have a more democratic discussion of the relevant issues. Examples of this include establishing a locally-owned wind farm. Compared to a multinational oil corporation, this would definitely make the people closer to those who are influential in crafting policy. Individual-driven reforms, such as placing solar panels on the roof of one's house would also help to include the citizenry as an active participant in the reform. In fact, the EEG considers this latter step specifically in that it authorizes the creation of shared energy communities, powered by solar panels.[65]

Furthermore, the government charging a fee to each end consumer ensures financial barriers are eased by distributing risk through the populace, instead of concentrating the gatekeeping to traditional financial institutions. In fact, these developments that allow smaller entities to participate in the energy

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[61] *Strategiewechsel bei E.on: Die Angst vor der atomaren Bad Bank*, DER SPIEGEL (Dec. 1, 2014), http://www.spiegel.de/wirtschaft/unternehmen/gruene-warnen-e-on-vor-atomarer-bad-bank-a-1005932.html.

[62] *Id.*

[63] *Id.*

[64] Emily Stewart, *Germany's Renewable Energy Incentives and Regulations Attracting Australian Companies*, THE BUSINESS (Oct. 28, 2014, 10:58 p.m.), http://www.abc.net.au/news/2014-10-28/australian-green-energy-company-forced-offshore/5849082.

[65] Burghard Flieger, *Mit Bürgerengagement zur Energiewende*, DEUTSCHER NATURSCHUTZRING (Oct. 2011), http://www.dnr.de/publikationen/umwelt-aktuell---archiv-2011/102011/mit-buergerengagement-zur-energiewende.html.

reform are also changing the means to finance these projects. Given the financial incentives from generating surplus electricity from renewable sources, these lesser participants are now allowed to finance their undertakings through the energy market itself, without needing to recur to traditional sources of funding like a commercial loan.[66] Consequently, the barriers of entry in the industry are significantly reduced.

F. Opposition

The opposition to the Energiewende is composed of those who are in favor of a more laissez-faire perspective on energy matters. They refuse regulation on energy products claiming that doing so would be more harmful to economic development than simply letting the market run its course. In an interview with *Der Spiegel*, former Shell CEO Jeroen van der Veer argued that the increased use of renewables will not eclipse traditional fossil fuels.[67] He also argued that new technological advances will arise that will enable us to burn coal and oil cleaner.[68] Additional advances in technology would enable companies like Shell to more easily access previously unapproachable oil deposits, such as the Canadian Oil Sands. He dismissed current efforts to switch to renewables, specifically emphasizing that solar technology is not nearly efficient enough to be widely adopted and requires continued refinement.[69]

On the other side of things, others argue that the switch to renewables is being disproportionately shouldered by the people who contribute about ten times more to subsidies than larger businesses.[70] This has also resulted in a disproportionate number of industries seeking to be exempted from paying the subsidy, which weakens the program's liquidity.[71] As a result, rates would have to go up to cover for the now-exempted parties. Another criticism has been levied at

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[66] Henrik Paulitz, *Dezentrale Energiegewinnung - Eine Revolutionierung der gesellschaftlichen Verhältnisse*, IPPNW, http://www.ippnw.de/atomenergie/energiewende/artikel/b93f91816b/dezentrale-energiegewinnung-eine-r.html.

[67] Matthias Streitz & Daniel Puntas Bernet, *Ölmulti Shell: "Die klassische Solartechnik ist eine Sackgasse"*, DER SPIEGEL (June 6, 2007), http://www.spiegel.de/wirtschaft/oelmulti-shell-die-klassische-solartechnik-ist-eine-sackgasse-a-486715.html.

[68] *Id.*

[69] *Id.*

[70] Stefan Schultz, *Ökostrom-Umlage: Netzagentur kritisiert Entlastungen für Industrie*, DER SPIEGEL (May 15, 2012), http://www.spiegel.de/wirtschaft/netzagentur-kritisiert-verguenstigungen-fuer-stromintensive-unternehmen-a-833299.html.

[71] Manfred Schäfers, *Abschlag auf die Stromrechnung*, FRANKFURTER ALLGEMEINE ZEITUNG (Aug. 30, 2012), http://www.faz.net/aktuell/politik/energiepolitik/erneuerbare-energien-abschlag-auf-die-stromrechnung-11873749.html. *See also* Johannes N. Mayer & Bruno Burger, *Kurzstudie zur historischen Entwicklung der EEG-Umlage*, FRAUNHOFER ISE (July 14, 2014), http://www.ise.fraunhofer.de/de/downloads/pdf-files/data-nivc-/kurzstudie-zur-historischen-entwicklung-der-eeg-umlage.pdf.

the regressive nature of the fee itself. Being a flat fee, it affects the poor more than the rich.[72]

VI. CONCLUSION

As a case study on the political process, the Moratorium and Energiewende are absolutely fascinating. This is one of those few instances where one can see a very clear meshing of different disciplines including science, economics, political science, and law coming together and interacting in a way that makes them almost indistinguishable from each other in the sequence of events. In a way, these events are indicative of the need for multiple perspectives in an area as controversial and as multi-disciplinary as economic development and policy, even more so when taking into account environmental concerns.

In fact, that multi-perspective analysis is quite well realized in the interaction between the many different parties to this tale. At the very least, here in America, it is almost unthinkable for a right-wing government to adopt environmentally friendly measures that are—when taking only the bottom line into account—hurtful to consumers. However, the ability to see beyond the bottom line and take into account economic externalities, while also seeking to establish an economically sound developmental strategy, demonstrates the intelligence of adopting, reconciling, and implementing seemingly contradictory points of view. It is with this perspective in mind that Germany is poised for a great future. It is also with such an open mind and a desire to reach for economic progress that we must emulate their audacity and take the plunge to succeed on our own merits.

[72] Thiemo Heeg, *Arme zahlen mehr für die Energiewende*, FRANKFURTER ALLGEMEINE ZEITUNG (Apr. 24, 2012), http://www.faz.net/aktuell/politik/energiepolitik/erneuerbare-energien-arme-zahlen-mehr-fuer-die-energiewende-11729060.html.

THE FEASIBILITY OF A THIRD-PARTY FUNDING MARKET FOR ARBITRATION CLAIMS IN PUERTO RICO

FÉLIX M. GONZÁLEZ NIEVES

I. INTRODUCTION

Arbitration has become an increasingly desired mechanism for dispute resolution for its "quicker, less expensive, and more private alternative to litigation."[1] Therefore, businesses turn to binding arbitration to lower costs and time of claims. However, it seems to be that even arbitration cannot offset the risks associated with the costs of pursuing or defending from claims. Hence, recurring to market investors to bring solvency to the legal claim industry could prove a viable solution to reduce the cost and accessibility to dispute resolution. Third-Party Funding (hereinafter "TPF") is a type of financing for legal claims that has taken a rise in recent years. TPF occurs when an unrelated party to a legal claim provides financial support to a party related to the case. In exchange the TPF receives a portion of the proceedings of the claim if successful.[2] If the claim is unsuccessful and no favourable outcome is rendered, then the TPF receives nothing.[3] The party to the claim being funded is transferring all or part of the financial risk of pursuing the claim to the TPF. TPF may rise in litigation and arbitration claims, however, this paper is focused in arbitration claims only.

This article contemplates how the interaction of TPF and arbitration could form a powerful mix in providing effective legal claim resolution to parties,

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[1] Murray S. Levin, *The Role of Substantive Law in Business Arbitration and The Importance of Volition*, 35 AM. BUS. L.J. 105, 106 (1997).

[2] *See* Jennifer A. Trusz, *Full Disclosure? Conflicts of Interest Arising from Third-Party Funding in International Commercial Arbitration*, 101 GEO. L.J. 1649, 1653-54 (2013).

[3] *Id.*

specifically businesses. It has been noted that "the use of third-party funding in major arbitration cases is a development that is here to stay[4]," and Puerto Rico should, if possible, capitalize in this growing international trend. It is expected that TPF will continue with the tremendous growth it has shown in the past decade and will likely play a large role in transnational legal claims.[5] Puerto Rico may offer an untapped market for established TPF companies looking to expand internationally.[6] Cassandra Robertson argues that "[o]utside funding can also affect forum choice, potentially offsetting the traditional magnet effect in the U.S. and making it easier to maintain suit in other countries."[7] By developing a TPF market, Puerto Rico can become a magnet forum for transnational cases. The parties in international disputes may choose a country as a dispute resolution forum, based upon whether arbitration financing is available. The end result may translate into greater business development and foreign investments, as Puerto Rico becomes a dispute resolution headquarter.

TPF is a great opportunity to examine arbitration from a multidisciplinary perspective. This paper undertakes the examination of the current arbitration framework as a variable in the risk assessment functions of financial-economy theories. TPFs' investments depend on an evaluation of financial risk, which requires the use of financial models and economic theories to grasp its extent. An important variable of such a model is legal risk. Therefore, this paper will not follow traditional legal analysis, because arbitration claims will be evaluated as assets, and arbitration's legal environment as a variable of the risk assessment of TPF's investment analysis.

The purpose is to provide a framework to evaluate the feasibility of a TPF market in Puerto Rico. To achieve such a framework, it is necessary to determine the factors that affect the valuations performed by TPF on arbitration claims. TPFs are looking for a fair return on their risky investment. It is my contention that if arbitration law and jurisprudence is too hostile for parties using arbitration to solve disputes, the value of arbitration claims in Puerto Rico will be reduced, and a TPF market will not surge. By identifying the factors that affect the valuation of an arbitration claim, a hospitable legal environment can be created for a TPF market to grow. In determining such factors, I use a real options valuation approach to determine how current arbitration doctrines would increase or decrease the valuation that TPF performs. However, before entering to discuss the profitability and surge of a TPF market in Puerto Rico, it is necessary to examine whether such type of legal claim financing is legal in our jurisdiction.

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[4] *Id.*

[5] Cassandra Burke Robertson, *The Impact of Third-Party Financing on Transnational Litigation*, 44 CASE W. RES. J. INT'L L. 159, 168 (2011).

[6] *Id.* (The author argues that "countries such as Spain, Brazil, Mexico, Argentina, Bulgaria, Latvia, and Estonia may offer an untapped market for established companies looking to expand out of Australia, the U.K., or the U.S.").

[7] *Id.* at 163.

II. LEGALITY OF TPF IN COMMON LAW JURISDICTIONS

Australia and the United Kingdom have significant experience in the TPF market.[8] Australia was the first jurisdiction to develop a TPF market for litigation and arbitration claims.[9] However, these common law jurisdictions faced a hostile legal environment, which prevented the surge of a TPF market, based upon the *maintenance* and *champerty* doctrines. These doctrines are the primary barriers for the development of TPF in common law jurisdictions. "Champerty is . . . 'an agreement to divide litigation proceeds between the owner of the litigated claim and a party unrelated to the lawsuit that supports or helps enforce the claim' . . . ."[10] The maintenance doctrine refers to "assistance in prosecuting or defending a lawsuit given to a litigant by someone who has no bona fide interest in the case."[11] These doctrines proscribe investors with no relation to the claim from funding and obtaining a share of the rendered award if successful. In the U.S., "while a minority of states have abandoned champerty restrictions, the majority of states retain and enforce the prohibition with varying degree of zeal."[12]

In their origins, the "maintenance and champerty were a crime, any contract to maintain an action was therefore illegal and unenforceable. Furthermore, maintenance and champerty were tortious acts giving rise to an action for damages under the common law."[13] TPF can be traced to feudal England, were TPF for lawsuits was prohibited.[14] It was considered "detrimental to the developing legal system with little offsetting benefit.[15]" "According to Blackstone, champerty thereby 'perverted the process of law into an engine of oppression'."[16] Since "feudal lords often took an interest in the real property at issue in the litigation, using their funding agreements to expand their holdings and ultimately to consolidate land wealth in fewer hands."[17] "Restrictions on champerty and maintenance traveled with English common law into the U.S."[18] England embraced TPF through the Criminal Law Act of 1967, which "abolished criminal and civil liability for champerty."[19] Another important development for

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[8] Dr. George R. Barker, *Third-Party Litigation Funding in Australia and Europe*, 8 J.L. ECON. & POL'Y 451 (2012).
[9] *Id.* at 452.
[10] Maya Steinitz, *Whose Claim Is This Anyway? Third-Party Litigation Funding*, 95 MINN. L. REV. 1268, 1286 (2011).
[11] *Id.* at 1287
[12] *Id.* at 1289.
[13] Barker, *supra* note 8, at 460.
[14] Robertson, *supra* note 5, at 164.
[15] *Id.*
[16] *Id.* at 164 (citing Thallhimer v. Brinckerhoff, 3 Cow. 623 (N.Y. Sup. Ct. 1824) (internal quotations omitted)).
[17] *Id.*
[18] *Id.*
[19] Steinitz, *supra* note 10, at 1280.

TPF in England occurred in 2005. In *Arkin v. Borchard Lines Ltd*,[20] the English Court of Appeal "held that, while third-party funding is acceptable and even desirable as a way of increasing access to justice, the funder does not control the management of the litigation."[21]

Initially, Australian courts, like many common-law jurisdictions, had prohibited Third Party Funding of legal claims for many years.[22] The hostility towards TPF in Australia changed with two landmark cases[23] that resulted in the acceptance of TPF "with the funder having broad powers to control the litigation."[24] The *Fosfit* decision was a result of a growing in the demand of legal claim funding in Australia.[25] Through the years, Australians had demanded a greater access to justice, met by allowing TPF to fund legal claims.[26] In 2009, "the Australian High Court interpreted its decision in *Fostif* to be a ban on any general rule prohibiting the funding of litigation for reward."[27]

III. LEGALITY OF TPF IN PUERTO RICO

Civil law jurisdictions as Puerto Rico, deal with the common law figure of *champerty* in a unique fashion.[28] In Puerto Rico, if a plaintiff sells all or part of his claim, "the defendant may extinguish the claim by redeeming it from the purchaser for the price he paid plus interest and costs." [29] This right surges from Article 1425 of Puerto Rico's Civil Code, which establishes that:

> When a litigated credit is sold, the debtor shall have the right to extinguish the same by reimbursing the assignee for the price the later paid for it, the judicial costs incurred by him, and the interest on the price from the day on which the same was paid.
>
> A credit shall be considered as litigated from the day the suit relating to the same has been answered.

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[20] 2005 EWCA (Civ) 655 (Eng.).
[21] Steinitz, *supra* note 10, at 1281.
[22] Steinitz, *supra* note 10, at 1279.
[23] Campbells Cash and Carry Pty. Ltd. v. Fostif Pty. Ltd. (2006) 229 CLR 386 (Austl.) (recovery in the tobacco industry); Mobil Oil Australia Pty Ltd. v. Trendlen Pty. Ltd., (2006) 229 ALR 51 (recovery in the petroleum license fee).
[24] Steinitz, *supra* note 10, at 1279.
[25] Campbells v. Fostif (2006) 229 CLR 386.
[26] *Id.*
[27] Steinitz, *supra* note 10, at 1280 (citing Jeffery & Katauskas Pty. Ltd. v. SST Consulting Pty. Ltd. (2009) 239 CLR 75, 92 (Austl.) (addressing the issue of indemnity for costs by litigation funders.)
[28] Ari Dobner, *Litigation for Sale*, 144 U. PA. L. REV. 1529, 1552 (1996).
[29] 31 L.P.R.A. § 3950. (translation by the autor).

> The debtor may make use of his right within nine (9) days, counted from the day the assignee should demand payment of him.[30]

This legal approach to *champerty*, favours debtors/defendants by giving them the capability of extinguishing the claim by reimbursing the price plus cost and interest to the investor, but it is still less restrictive than the total restriction imposed by the *champerty* doctrine in common law jurisdictions. Therefore, in Puerto Rico, "the investor will at least get his money back, plus interest and costs."[31] Whereas in common law jurisdiction with *champerty* restrictions "a champertous agreement may be held invalid, and the investor may lose all of his money."[32]

In *Consejo de Titulares v. C.R.U.V.*,[33] the Supreme Court of Puerto Rico had the opportunity to examine the extent and applications of Article 1425. The Court defines litigated credit as one that cannot come into existence until a court's ruling confirms it.[34] As a condition for Article 1425 to apply, the litigation must be centered upon the existence of the credit and not merely about its consequences.[35] The Court went as far as to limit the sale of litigated credits based upon mental anguish to interested parties, and also stating that only the price plus cost and interest can be recovered.[36] The Court argued that such limitation precludes speculation on the suffering and misfortunes of others.[37] In the same way, *Pritzker v. Yari*[38] is an example of TPF in Puerto Rico and the application of Article 1425. The case was a highly litigated breach of contract suit "between Paul S. Dopp and Jay A. Pritzker (the D/P Litigation) concerning the ownership of two hotels, situated on approximately 1,000 beachfront acres, in the Commonwealth of Puerto Rico."[39] Dopp, in order to finance the high cost of litigation, assigned "various portions of the anticipated proceeds of the D/P Litigation to third parties," in exchange of funding.[40] In response, Pritzker tendered payment to the investors, pursuant to Article 1425, and sought extinguishment of the litigated credit. The controversy presented was whether the financing agreement entered by Dopp to finance its litigation was subject to Article 1425. In its conclusions, the First Circuit Court categorized Article 1425 as "a very unusual animal", and expressed that its purpose "is to prevent the illegal trade of litigious credits which were purchased for a price below their

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[30] *Id.* (translation by the autor).
[31] Dobner, *supra* note 28, at 1553.
[32] *Id.*
[33] Consejo de Titulares v. C.R.U.V., 132 D.P.R. 707, 132 P.R. Offic. Trans. 707 (1993).
[34] *Id.* at 726.
[35] *Id.*
[36] *Id.* at 735.
[37] *Id.*
[38] Pritzker v. Yari, 42 F.3d 53 (1st Cir. 1994).
[39] *Id.* at 57.
[40] *Id.* at 58.

actual value, and then the actual price was recovered from the debtor and big profits reaped."[41] The Court concluded "that the financing agreements [entered by Dopp with third parties] fall squarely within the purview of article 1425."[42] The facts in *Pritzker* draw the traditional TPF agreement. As the case shows, TPF is permissible as long as the debtor/defendant's right under Article 1425 is not undermined. The other important limitation to TPF, established in *Consejo de Titulares*, is that the sale of litigated credits, based upon mental anguish, is restricted to interested parties and that only the price plus cost and interest can be recovered.

In Puerto Rico, *champerty* transcends the typical common law prohibition towards litigation financing and, in its quest to deter such practice, a rule of law that has the potential to effectively price claims and induce settlements has surged. From a practical perspective, Article 1425 uses a financial deal entered among parties for a litigated credit, in order to force a settlement. Its novelty surges from the fact that it uses the financial agreement between the funder and the plaintiff to price the claim and afterwards, gives defendant the opportunity to settle the case for such price. The reasoning behind the Article is that if a plaintiff is willing to part from his claim for *X amount*, then such amount should be the settlement between the parties, therefore pricing the claim. In fact, Article 1425 achieves such results. If a TPF buys the totality of the claim from a plaintiff, the defendant could pay the funder the price paid plus cost and interest, and extinguish the claim. Therefore, the result is that the claim can be settled by the defendant for the amount paid by the TPF.

Even though, Article 1425 can be considered an ingenious policy to deal with *champerty* and settlements, it is not favorable to TPF. Before undertaking any investment in legal claims, a TPF must undergo an extensive due diligence in order to decide whether the investment is worth it. The riskiness inherent to legal claims makes such endeavor difficult, and the TPF will have to use its resources extensively to identify ideal claims to invest in. Therefore, TPF will not embark in such a journey if a defendant can easily pay them back their investment and leave them with no returns. The legal structure of *champerty* in Puerto Rico leaves certain questions unanswered in regards to its application to arbitration. Two fundamental questions are to be raised: (1) whether Article 1425 applies to arbitration claims and (2) whether the parties, through an arbitration agreement, preclude its application. These questions will not be addressed for being outside the topic's scope.

[41] *Id.* at 65 (citing Consejo de Titulares, 132 D.P.R. 707 (internal quotations omitted)).
[42] *Id.* at 66.

IV. FACTORS AFFECTING THE PREVALENCE OF A TPF MARKET: A VALUATION APPROACH

There is still the question whether TPF would invest in Puerto Rico as a forum for international and domestic arbitration claims. The answer to this question lies in the valuation of arbitration claims, and whether such valuations show a desirable return for investment. An "investor in an economic venture seeks to maximize profit and minimize loss and risk."[43] "The market convention is that one should undertake risk only if there is a commensurate prospect of increased return."[44] In an arbitration claim, as in the stock market, risk will surge from two broad sources of uncertainty. The first risk arises from the legal environment that has been formed through doctrines that regulate arbitration. For example, if arbitration doctrines do not permit Courts to effectively enforce an arbitration's award, then this translate to a risk for a TPF, which profits depend on that award. This type of risk is analogous to the market risk that comes from conditions in the general economy.[45] As with market risk, the risk that arises from legal doctrines that regulate arbitration, cannot be diminished through a diversified portfolio of distinct legal claims. Such a systemic risk might only be reduced or transformed through new judicial doctrines, legislation or arbitration agreements. The second risk arises from the specific facts of the case. As investors reduce firm specific risk through diversification,[46] a TPF can devise a diversification strategy through a wider portfolio of legal claims. These two types of risk will be determinant in the pricing of arbitration claims, and the profiting of TPF.

TPF "have an obvious stake in the question of how to price legal claims."[47] TPF not only put their "capital on the line but also solicit capital from investors based on a business model that presumes that funders can – and are good at – assessing the value of the investments they purchase for investors."[48] Scholar Maya Steinitz has raised two important questions in regard to pricing legal claims: (1) "whether they [TPF] can price the claim with some degree of confidence in the soundness of their prediction regarding the claim value, and, if not, [(2)] how to devise an 'incomplete contract' that allows them to reprice with minimum transaction costs."[49] She proposes that a practical solution for pricing legal claims "lies with *staged funding* in a manner similar to the funding of start-ups by venture capitalists."[50] She argues that "[w]hen the pricing of legal claims is

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[43] Robert J. Rhee, The Effect of Risk on Legal Valuation, 78 U. COLO. L. REV. 193, 197 (2007).
[44] *Id.*
[45] Investopedia, Types of Investment Risks, INVESTOPEDIA, http://www.investopedia.com/exam-guide/finra-series-6/evaluation-customers/types-investment-risks.asp?header_alt=b
[46] *Id.*
[47] Maya Steinitz, *How Much Is That Lawsuit in the Window? Pricing Legal Claims*, 66 VAND. L. REV. 1889, 1892 (2013).
[48] *Id.* (remarks in regard to litigation funding firms).
[49] *Id.* at 1903.
[50] *Id.* at 1893.

adjusted using staging to accommodate for fluctuations in transaction costs and the value of asset and option, efficiency and fairness are maximized for both claimants and the financier."[51] Therefore, she is presenting a contractual approach to reduce the risk that comes from the specific facts of the case. Steitnitz's proposition should become the norm regarding the financial agreement between TPF's and claimants. Since, "litigation financing contracts are confidential"[52], which precludes an analysis of the current contractual norm used by TPF, it will be assumed that TPF use an incomplete contract to be able to re-price the claim as new information becomes available.

A. Analyzing TPF of Arbitration Claims through a Real Options Approach

Analyzing TPF investment from the perspective of an incomplete financial agreement that may re-price the value of the investment through new information requires departing from traditional financial valuation methods.[53] Traditionally, in finance, "value is the sum of the risk-adjusted cash flows."[54] The generally used technique for asset valuation is the discounted cash flow method (hereinafter "DCF"), which discounts the expected future cash flow "by the cost of capital, a measure of the firm's risk."[55] In the investment world, however, valuation analysis through DCF has "been supplemented by 'real options' approach."[56]

"Real options" surge as a response to the incapability of the DCF to capture, in its valuation, new and unexpected developments.[57] The traditional DCF "assume[s] a fixed commitment to full investment at the outset, real option theory models the investment process as a series of decision points at which investors have the option of adjusting their investments in response to new information."[58] Following the assumption that TPF agreements are incomplete contracts that permit a reevaluation of the investment with an embedded option to discontinue the funding, real options are a better fit than the traditional DCF to assess the value of TPF investments in legal claims. A real options model allows new information and the option of abandonment to be taken into consideration in the

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[51] *Id.* at 1895.

[52] Maya Steinitz & Abigail C. Field, *A Model Litigation Finance Contract*, 99 IOWA L. REV. 711, 719 (2014).

[53] Rhee, *supra* note 43, at 195 ("By analogizing lawsuits to investments, scholars view legal valuation not from the perspective of standard cost-benefits analysis, which ideally requires information completeness, but from the perspective of risk management, which assumes that uncertainty is the governing condition.").

[54] *Id.* at 203.

[55] *Id.*

[56] Joseph A. Grundfest & Peter H. Huang, *The Unexpected Value of Litigation: A Real Options Perspective*, 58 STAN. L. REV. 1267, 1273 (2005)(internal quotations omitted) (emphasis added).

[57] *Id.*

[58] *Id.* at 1273-74.

valuation of the claim. Therefore, I will use a real options valuation approach to identify the factors that affect the potential returns of TPF in arbitration claims in Puerto Rico. Steinitz herself asserts that "[m]ultistage or sequential investment decisions are an important class of real options with embedded managerial flexibility."[59] The use of a financial valuation model for the developed framework is for determining how distinct arbitration doctrines can affect the valuation performed by a TPF, and ultimately, its returns.

It is not the first time that real options are used to understand a variety of legal themes.[60] "Modern option pricing theory traces its roots to the Black-Scholes model of the value of an option to buy common stock."[61] An option derives its value from an underlying asset.[62] In finance, "a call option, you get the right to buy the underlying asset at a fixed price, called a strike price."[63] Since the holder has the right and not the obligation to buy the underlying asset, the option is exercised only if the value of the underlying asset exceeds its strike price.[64] Applying the option approach to arbitration, leads to the examination of the claim as if it were the underlying asset and the TPF as the holder of the option.[65] A TPF pays a claimant the cost of pursuing the arbitration claim in exchange of a percentage of the claim. The TPF has the option of not continuing to fund the case if he expects that no award will be rendered or that the proceedings from the outcome will be less than the cost.[66] This would be the equivalent of not exercising the option and letting it expire. The TPF will lose the funds that, up to that point, were invested in the claim. On the other hand, the TPF has the option of continuing to fund the arbitration claim if he expects that the proceeds from the rendered award exceed the funding costs. Therefore, the decision of a TPF in continuing funding the claim can be mathematically expressed as follow:

$$FC * (1+RR) < AW * (P)$$

- FC: Expected funding costs
- RR: Required rate of return

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[59] Steinitz, *supra* note 47, at 1897.

[60] *See* Bradford Cornell, *The Incentive to Sue: An Option-Pricing Approach*, 19 J. LEGAL STUD. 173 (1990) (introduces a model using real options that "produces several intuitive predictions regarding the relation between legal procedure, legal practice, and the incentive to sue".); William J. Blanton, *Reducing the Value of Plaintiff's Litigation Option in Federal Court: Daubert v. Merrell Dow Pharmaceuticals*, Inc., 2 GEO. MASON L. REV. STUDENT ED. 159 (1995) ("[I]n this comment, option pricing theory is used to evaluate the effects of the Daubert decision on a plaintiff's incentive to litigate.").

[61] Blanton, *supra* note 59, at 159.

[62] Rhee, *supra* note 42, at 204.

[63] ASWATH DAMODARAN, APPLIED CORPORATE FINANCE 294 (3d ed. 2010).

[64] *Id.*

[65] *See* Steinitz, *supra* note 47, at 1903 ("The claim is the asset in which a funder is purchasing 'shares' (and thus equivalent to a company that is issuing stock).").

[66] *See id.* at 1902 (describing a third-party funding agreement, which allows the investor "to exit the investment and, therefore, to control risk.").

- AW: Expected monetary award
- P: The percentage of the award belonging to the TPF

Three variables, "FC," "RR," and "AW," depend on information regarding how well the arbitration claim is going. Since information is constantly flowing in an arbitration claim, especially during the discovery phrase, the formula's result is constantly changing. The 'P' variable, however, is predetermined in the TPF agreement, thus it does not change with the flow of information. Therefore, when analyzing new case law, new regulation or arbitration agreements, the effects they might have on the presented variables have to be taken into account when analyzing the feasibility of a TPF market, in order for the formula to identify high return claims.

A "real options model" also sheds light to an important variable in identifying profitable claims: variance. Variance is one of six variables that determine the value of an option.[67] In financial economics, variance is defined "as the statistical mean squared deviation from the expected value, which is the risk of an expected return [or] . . . as the measure of one's belief about the possible deviations of a judgment from expectation . . . ."[68] In the valuation of options, increasing the variance of the underlying asset increases the value of the option. The reasoning behind such assertion is that "the holder of options can never be forced to exercise an option, which protects them against downside risk but preserve upside potential."[69] As a holder of a call option, a TPF's down-risk is limited to the amount that has been invested in the funding of the claim. Its maximum down-risk is limited to the expected total amount of funding needed to fulfill the arbitration claim. However, the upside for recovery is not limited. TPFs have a right to a percentage of the claim and, therefore, the higher the award is the higher will be the return for the investor. Since a TPF's risk is limited to the amount invested in funding the arbitration claim, it will intend to maximize its profit without worrying if such initiative increases risk. In such scenario, the question a TPF will confront is how to maximize the potential upside of the investment. The option pricing theory answers this by asserting that the value of the option will increase with an increase in the variance of the underlying asset's value.

In order to apply this financial principle to arbitration claims, a fundamental question has to be answered: how can the variance of an arbitration claim be increased in order to increase its value? I argue that variance is maximized in the arbitration agreement, when in such contracts the parties do not choose a substantive law to be applied by the arbitrator. In such case, arbitrators would not be bound to resolve the controversy on legal grounds and may use principles of equity to reach a solution. This is not to say that arbitrators

[67] DAMODARAN, *supra* note 62, at 294.
[68] Rhee, *supra* note 42, at 199.
[69] DAMODARAN, *supra* note 62.

are completely free to reach any determination they feel appropriate. However, arbitrators will have a greater scope to reach its decision if no law is chosen in the arbitration agreement. If the agreement requires for a substantive law to apply, and the arbitrator departs from such law, then the rendered outcome may be vacated on the grounds that the arbitrator exceeded its power. A greater variance in the possible outcomes of the arbitration awards is reached when the parties do not establish a substantive law in the arbitration agreement and, therefore, arbitrators can apply principles in equity to reach a solution. Since under the option valuation approach, a greater variance results in a higher valuation, then TPF will want to invest in claims in which no applicable law has been chosen.

The aforementioned argument leads to the conclusion that a TPF market will be more prone to develop in jurisdictions were arbitrators have a greater scope of grounds to make its ruling. Some jurisdictions in the U.S. permit a scope beyond the applicable law, in which an arbitrator can make its determination. The Supreme Court of Alaska has expressed that "[t]he general rule in both statutory and common law arbitration is that arbitrators need not follow otherwise applicable law when deciding issues properly before them, unless they are commanded to do so by the terms of the arbitration agreement."[70] In New York, it has been established that "[a]bsent provision to the contrary in the arbitration agreement, arbitrators are not bound by principles of substantive law or rules of evidence."[71]

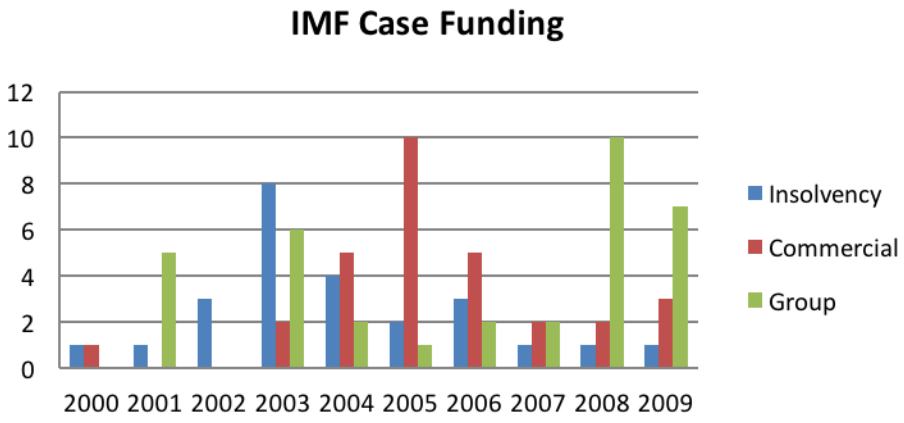
B. Understanding TPF through Venture Capital Funds

Steinitz's analogy between litigation funders and venture capitalists is an important starting point in developing an effective framework to understand how a TPF market develops. Litigation funders and venture capitalists "have a similar risk profiles: they invest in high risk assets with the hope that, even if many of their investment fail, a handful will be wildly successful."[72] Understanding TPF from a venture capitalist perspective requires departing from the standard market conceptualization of risk and its primary management tool, diversification. Peter Thiel, founder of PayPal, states that "[t]he biggest secret in venture capital is that the best investment in a successful fund equals or outperforms the entire rest of the fund combined."[73] He states that venture capitalist must "only invest in companies that have the potential to return the value of the entire fund."[74] This pronouncement is sustained by the venture capitalist market data; even though "total venture capitalist investments account for less than 0.2% of the GDP", "ventured back companies generate an outstanding 21% of the GDP."[75] Applying this rule to TPF leads to a departure from diversification techniques, to reduce

[70] University of Alaska v. Modern Construction, Inc., 522 P.2d 1132, 1140 (1974).
[71] Lentine v. Fundaro, 278 N.E.2d 633, 635 (1972).
[72] Steinitz, *supra* note 53, at 723.
[73] PETER THIEL, ZERO TO ONE 87 (2014).
[74] *Id.*
[75] *Id.* at 89-90.

risk towards the few legal claims that can be catalogued as overwhelmingly valuable. The rule also supports the aforementioned variance principle, that TPF will prefer arbitration claims with a greater variance because they present greater profit potential, even though uncertainty is also increased.[76]

Data collected from a TPF's investment sustains the venture capitalist analogy used to build the proposed framework. IMF Bentham is a listed public company in Australia, which offers funding for litigation claims with a claim value of at least AUD$5 million, and for arbitration claims, from AUD$10 million[77]. As part of their investments practices, "IMF Bentham looks to fund international commercial arbitration and investment treaty claims" with a claim value in excess of AUD$10 million.[78] A look at the historical trends of IMF's portfolio sheds light on how TPF invest and the type of cases they undertake. Dr. George R. Barker[79], using information provided by Malcolm Stewart[80], presents insightful data regarding the amount of cases funded by IMF and its segmentation by case type. Here is his data using a bar graph[81]:



The graph illustrates two important aspects of IMF's portfolio: (1) the relatively few cases funded yearly, and (2) that funded cases come from three case categories. "In total there is a reasonably even spread of cases by category, with group actions most common at 39%, commercial actions next at 33%, and

[76] *See* Grundfest, *supra* note 55, at 1276 (From a litigation perspective, "[i]n the real options framework, variance is a critical determinant of a lawsuit's settlement value because the larger the variance, the more dramatic and potentially valuable the information waiting to be disclosed [...] and the larger the value of the plaintiff's option to continue or to abandon the litigation in response to that information.").

[77] IMF Bentham, *About Us*, IMF BENTHAM, https://www.imf.com.au/about-us (last visited Dec. 25, 2015).

[78] IMF Bentham, *Arbitration*, IMF BENTHAM, https://www.imf.com.au/funding/arbitration (last visited Dec. 25, 2015).

[79] Barker, *supra* note 8.

[80] Paul Fenn, Neil Rickman & Malcolm Stewart, Third Party Funding of Commercial Disputes: A Framework for Comparative Analysis, (unpublished manuscript) (2011).

[81] The data includes both litigation and arbitration claims.

insolvency actions at 28%."[82] Unless integrated to a group action, cases involving recoveries for mental anguish are not typically funded by TPF. Therefore, the decision of Puerto Rico's Supreme Court in *Consejo de Titulares*, which prohibits the selling of litigated credits involving mental anguish, has a very limited impact in the investment opportunities of TPF. The reason for such case preference surges from the fact that "[f]unding commercial proceedings are considered less risky, as the award is more easily quantifiable by reference to the financial loss suffered by the claimant."[83] Also, proceedings involving personal injury "are generally considered too risky for funders that are engage in proper due diligence, particularly when success is less certain."[84]

V. LEGAL ENVIRONMENTS AND THIRD PARTY FUNDING

A. Market Determinants Model

From the aforementioned analysis, a simple model can be deduced from which new case-law, regulations and arbitration agreements may be analysed to determine their positive or negative effects on the development of a TPF market. The model I present is a reformulation of the supply and demand framework presented by Dr. George R. Barker.[85] My model integrates the presented real options valuation approach into a TPF supply function. The model can be expressed as:

$$TPF\ S = F\ ((-)\ RR, (+)\ PR, (-)\ AC, (+)\ CF, (-/+)\ \alpha)$$

- **RR: Required Return**- It shall be measured as a function of the riskiness of the arbitration legal environment. A primary factor to measure such a risk would be the proclivity of courts to vacate rendered arbitration awards.
- **PR: Potential Return**- It can be described as the variance of the arbitration claim's expected return. Also, be measured through the ability of an arbitrator to depart from substantive law, and apply equity principles or commercial practices to reach a determination.
- **AC: Arbitration Cost**- It can be measured as the investment provided by the TPF to finance the arbitration claim.
- **CF: Category Frequency**- Level of arbitration cases that can be categorized as insolvency claims, commercial claims and class actions.

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[82] Barker, *supra* note 8, at 481.
[83] *Id.* at 478.
[84] *Id.*
[85] *Id.* at 455-56 (he draws his model upon the work of Paul Fenn, Neil Rickman, and Malcolm Stewart, Third-Party Funding of Commercial Disputes: A Framework for Comparative Analysis (2011) (unpublished manuscript) (paper presented to the European Association of Law and Economics Conference 2011)).

- **α: Alpha**- Includes all future regulations that can be imposed to TPF. It also compiles the effect of lesser variables.
- (+): Represents a Direct Relation
- (-): Represents an Inverse Relation

These variables have to be examined through three different spheres: (1) international arbitration, (2) federal arbitration, and (3) domestic arbitration. An example would be looking to the enforceability of arbitration award, an important determinant of risk in arbitration claims, from the proposed three legal environments. This examination will give an insight as to the required return variable of the presented model.

B. International Arbitration Perspective

The New York Convention on the Recognition and Enforcement of Foreign Arbitration Awards[86] (hereinafter "Convention") "seeks to provide common legislative standards for the recognition of arbitration agreements court recognition and enforcement of foreign and non-domestic arbitral awards." The Convention assures the effectiveness of arbitration claims in an international context. Article V of the Convention establishes seven legal grounds in which the recognition and enforcement of the award may be refused. Professor David M. Helfeld[87] recognizes that two of them will have a greater weight in convincing a court to vacate the rendered arbitration award. These are Article V-2:

> (a) The subject matter of the difference is not capable of settlement by arbitration under the law of that country; or
>
> (b) The recognition or enforcement of the award would be contrary to the public policy of that country.[88]

Through these subsections, the Convention gives ample leeway for a country's law or public policy to determine whether the award is to be sustained or vacated. Therefore, even in the international stage, the country's legal environment regarding arbitration will play a vital role in the final judgment of the arbitration claim. TPF will have to take into consideration the laws and policies of the country where recognition and enforcement of an arbitration award is sought, in order to have a better measurement of the risks that the

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[86] Convention on the Recognition and Enforcement of Foreign Arbitral Awards with respect to the United States, June 10, 1958, 10 U.S.C. § 201 (2012).
[87] David M. Helfeld, *La Jurisprudencia Creadora: Factor Determinante en el Desarrollo del Derecho de Arbitraje en Puerto Rico*, 70 REV. JUR. U.P.R. 1, 45 (2001) (translation by the autor).
[88] *Id.*

award may be vacated. This analysis will affect the required return variable, since it is a valuation of the level of risk the international arbitration claim faces.

The application of the aforementioned discussion can be examined in *Mitsubishi Motors v. Soler Chrysler-Plymouth*,[89] which is a leading case in Internal Commercial Arbitration. A car distribution company from Puerto Rico (hereinafter "Soler") entered into distribution and sales agreements with Mitsubishi, a Japanese car manufacturer. The sales agreement contained a clause providing for arbitration by the Japan Commercial Arbitration Association, for disputes that may arise from the agreement. After a dispute surged, Mitsubishi brought an action seeking to compel arbitration, and Soler countered claimed causes of actions under the Sherman Act. One of the controversies was whether a Sherman Act claim could be subject to arbitration in an international forum. The United States Supreme Court solved the controversy in the affirmative expressing, among other reasons, that:

> Having permitted the arbitration to go forward, the national courts of the United States will have the opportunity at the award-enforcement stage to ensure that the legitimate interest in the enforcement of the antitrust laws has been addressed. The Convention reserves to each signatory country the right to refuse enforcement of an award where the "recognition or enforcement of the award would be contrary to the public policy of that country." Art. V(2)(b), 21 U.S.T., at 2520.[90]

A look at *Mitsubishi* through the lens of the proposed framework raises a red flag in the decision. The Court's aforementioned expression expands the scope for judicial review to the merits of an award, in order to assure that the interests of national antitrust laws are addressed. It is well known that "[t]he enforcement of awards is critical to the viability of the arbitral process. If arbitrator determinations were not enforceable at law, there would be little, if any, incentive to proceed with arbitration."[91] *Mitsubishi* exponentially increases the required rate of return for TPF financing a claim, because it increases the risk that the rendered award could be vacated by exposing the award to judicial review in its merits. "Soler never got to arbitrate the case due to lack of economic resources."[92] A TPF could have financed Soler's claims in arbitration. However, after *Mitsubishi*, a TPF will hardly be incentivizing to finance such a case because it runs the risk of a Court finding the award rendered by the Japanese arbitrators inconsistent with the policy of the Sherman Act. Such a result would increase another variable in the presented model arbitration costs, since a TPF would be forced to continue financing through litigation or lose the investment.

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[89] Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, 473 U.S. 614 (1985).
[90] *Id.* at 638.
[91] THOMAS E. CARBONNEAU, ARBITRATION LAW AND PRACTICE 34-35 (West 2012).
[92] Helfeld, *supra* note 86, at 48 (translation by the author).

C. Federal Arbitration Perspective

The aforementioned analysis demonstrates the influence that federal statues and case law have in the feasibility of the development of a TPF market in Puerto Rico. Therefore, an examination of the effects of the FAA and federal case law is indispensable. I will use Mastrobuono v. Shearson Lehman Hutton[93] to illustrate the application of another variable in my model: potential returns. In *Mastrobuono*, the plaintiffs had signed a standard client's agreement, which included an arbitration clause providing for the application of New York law to the agreement. Thereafter, an arbitral tribunal awarded $400,000 in punitive damages to the plaintiffs. Shearson, the defendant, appealed arguing that under the Garrity rule[94] arbitrators are prohibited from awarding punitive damages. The United States Supreme Court faced the question "whether a contractual choice-of-law provision may preclude an arbitral award of punitive damages that otherwise would be proper."[95] The Court held in the negative, establishing that, unless the contract specifically precluded punitive damages, they would be allowed. First, it established "that if contracting parties agree to include claims for punitive damages . . . , the FAA ensures that their agreement will be enforced according to its terms even if a rule of state law would otherwise exclude such claims from arbitration."[96] It also held that if a similar contract, without the choice of law provision, had been signed, "punitive damages would be allowed because, in the absence of contractual intent to the contrary, the FAA would pre-empt the Garrity rule."[97] With regards to the facts of the case, the Court reasoned that the choice of law "provision might include only New York's substantive rights and obligations, and not the State's allocation of power between alternative tribunals."[98] Therefore, it can be concluded from *Mastrobuono* that the powers of an arbitrator have to be limited expressly in an arbitration agreement and not through the choice of law provision, since such provision can be interpreted as to only cover substantive rights.

Mastrobuono undoubtedly increases the potential return variable of my model, and would favour TPF investments. It increases the potential returns of a claim by permitting punitive damages, and establishing that, unless expressly established in the arbitration agreement, the FAA would pre-empt the Garrity rule. Under the FAA, the TPF will have the certainty that if in the arbitration agreement is no expression of punitive damages, the arbitrator can grant them. Punitive damages are a substantial part of a plaintiff's potential monetary return. In *Mastrobuono*, punitive damages represented 71% of the total monetary award

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[93] Mastrobuono v. Shearson Lehman Hutton, Inc., 514 U.S. 52 (1995).
[94] *See* Garrity v. Lyle Stuart, Inc., 353 N.E.2d 793 (N.Y. 1976).
[95] Mastrobuono, 514 U.S. at 55.
[96] *Id.* at 58.
[97] *Id.* at 59 (emphasizes added).
[98] *Id.* at 60.

rendered. Therefore, TPF have a greater certainty in the potential returns it can obtain from a claim, and a greater earnings potential through punitive damages, thus increasing the feasibility of a TPF market.

To illustrate the category frequency variable, I will analyse the Supreme Court decision in *AT&T Mobility LLC v. Concepcion*.[99] The ATT service agreement with Concepcion "provided for arbitration of all disputes, but did not permit class-wide arbitration."[100] When a dispute surged and ATT filed a motion to compel arbitration, the Concepcion's opposed. They argued that the "arbitration agreement was unconscionable and unlawfully exculpatory under California law because it disallowed class wide procedures."[101] The Supreme Court had to decide "whether § 2 [of the FAA] pre-empts California's rule classifying most collective-arbitration waivers in consumer contracts as unconscionable", known as the *Discover Bank* rule[102]. The Court held that:

> [t]he overarching purpose of the FAA, evident in the text of §§ 2, 3, and 4, is to ensure the enforcement of arbitration agreements according to their terms so as to facilitate streamlined proceedings. Requiring the availability of classwide arbitration interferes with fundamental attributes of arbitration and thus creates a scheme inconsistent with the FAA.[103]

AT&T Mobility severely affects the probabilities of class-wide arbitration and class action litigation to surge. Therefore, it adversely impacts the category frequency variable of the model presented. This variable was deduced from data regarding case distribution by category from IMF Bentham. TPF have category preferences regarding legal claim type, from which class actions are the most common. By limiting class-wide arbitration and permitting class action waiver in arbitration agreements under the FAA, the Supreme Court limited the potential market for TPF. The decision directly affects Puerto Rico under the Supremacy Clause. "When state law prohibits outright the arbitration of a particular type of claim, the analysis is straightforward: The conflicting rule is displaced by the FAA."[104] The Supreme Court goes beyond the limits of the case's facts and expresses that "[a]rbitration is poorly suited to the higher stakes of class litigation."[105]

An important aspect of *AT&T Mobility* is that the facts of the case surge from an adhesive arbitration agreement. In consumer arbitration such contracts

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[99] AT&T Mobility LLC v. Concepcion, 563 U.S. 333 (2011).
[100] *Id.*
[101] *Id.* at 337-338.
[102] *Id.* at 340.
[103] *Id.* at 344.
[104] *Id.* at 341.
[105] *Id.* at 350.

are necessary from a cost and economics perspective, but to also permit a waiver from class actions seems to be far extended. In an analysis of *Mitsubishi*, Professor Heldfeld points out that parties of an arbitration agreement are not in a position of equal strength and, therefore, there will be favourable terms in the self-interest of one of the contracting parties. It has to be remembered that parties in a weaker position are usually those most in need of TPF.

VI. Conclusion

This paper introduces a framework based upon a valuation perspective, in which new arbitration case-law and regulation can be examined, and in order to determine how they may impact the development of a TPF market. The framework is simplified into a market determinants model composed of six variables that interact with the supply of TPF in the market. It provides a new vision on arbitration, as it promotes the idea to analyse arbitration claims as an asset that can be priced. Through new case-law and regulation, the legal environment changes the market for arbitration claims and, therefore, its value for Third Party Funders. It is also necessary to keep an eye on the evolution of legal financing regulation that can change the Third-Party Funding's landscape.

An examination of three normative arbitration cases through the market determinants model shed light into how it works, with some compelling results. The presented cases raise a red flag to the development of a TPF market. Could parties from a position of economic strength structure arbitration agreements as to prevent TPF of future controversies? The case analysis seen from the proposed framework seems to give an affirmative answer. A party in a position of power will exclude punitive damages and waive class actions, adversely affecting the potential return variable and the category frequency variable of my model and therefore, limiting TPF market supply. Also, *Mitsubishi* increases the riskiness of arbitration in the international context by increasing the chances that the rendered award could be vacated. The case-law examined is just a small sample of what is necessary to have a complete understanding of the interaction of the legal environment with a Third-Party Funding. Nonetheless, the propose framework will permit others to add a new perspective into the examination of the law and new developments in Third-Party Funding.

PRINCIPLES ABOUT A FUTURE U.S. NATIONAL LAND RECORDING SYSTEM: IS IT REALLY NECESSARY TO CONTINUE EXISTING M.E.R.S.?

ARTURO MATHEU DELGADO[1]

ABSTRACT

This article deals with the weaknesses of the current American Land Recording System and the lack of a nationwide federal regulation involving all the subjects on Recording Land Acts, taken from the point of view of Professor Matheu's experience, as teacher of Real Estate Law in the University of La Laguna at Spain. He proposes a new Federal Act that includes a full regulation on recording deeds, land titles, encumbrances, all kind of burdens, liens and mortgages notes, to give certainty to any buyer/seller or borrower/lender. The article explores the Spanish and Italian experience on digitally recording land acts. It also explores the idea of taking the I.C.T. new tools and Graphical Geobase data to give full certainness to the registration system. Matheu also makes an in-depth analysis of several duties concerning recording land titles, such as the chain of title doctrine, and proposes several main principles to the future Federal Land Recording Act, to be able to enforce the land titles covered by the protection of a public registry office. He also makes a draft of a new American Public Registry System, rather than the actual local and State's county clerks offices. Matheu faces the problems of the actual Mortgage Electronic Recording System, a private system created by the bank industry that has not given any transparency to legal transactions on real estate property.

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I. AN INTRODUCTION TO THE MORTGAGE RECORDING PROBLEMS IN U.S.A.

The following article criticizes the lack of an American Land Recording System, not only for mortgages, but also for all real estate transactions, from the point of view of a comparative study of the Spanish Land Registration System. In this position, the truth is that following the aftermaths of the subprime mortgage crisis in early 2007, the bank industry failed to foreclose many of their loans. Not only due to the lack of money of borrowers and grantees, but also due to the fact that the Recording Systems failed to provide the correct information related to the real owner of the land and the real record of the mortgage note describing the property. What usually happened was that when a bank, an owner or a holder of a mortgage tried to foreclose, the mortgage had already been transferred to another bank. If the initial one had gone to the secondary mortgage market, or even the land, the lot or the property actually didn't belong to the real debtor, because the chain of title had been broken in the local office of the Registration System.

This article pretends to take the weaknesses and strengths of all U.S.A. land recording systems all over the different states and local offices, to make possible a new federal system. A system more accurate and more transparent to the bank industry as lenders, to the customers as borrowers, and also for all operators involving real estate transactions, buyers, sellers, holders of any burdens or conveyances, and financial operations dealers. This article doesn't propose to draft a new regulation for a nationwide land recording system, as some scholars and academic have done in past years.[2] What we want is to draft the main aspects and outlines to be considered towards the issue of a Federal Land Regulation Act by Congress. I want to give academics and politicians a new vision taken from other legal systems, like Spain and others in the European Union that come from the Roman law tradition, rather than common law which is used by the American and the English.

II. THE WEAKNESSES OF AMERICAN MORTGAGE REGISTRATION SYSTEMS

The main issue related to the recording land title system is how to get a system that gives the real estate operators the accurate data taking from its

[2] Dale A. Whitman, *A Proposal for a National Mortgage Registry: MERS done right*, 78 MO. L. REV. 1 (2013).

publicly main target.[3] That also gives the real and on line information about all subjects, such as the land description, boundaries, prior owners, and mayor burdens or liens to a specific parcel or lot, regardless of fact of the variety of assignments that happened all over the past time. The fundamental thing is that, if we don't want to break the real chain of the title, we must have all the information related to a parcel described in the recording system, that allows customers (borrowers and lenders) to know in real time what happened with the property to be purchased, mortgaged or taking any conveyances. This lack of information muddles transactions, because people living in one part of the country that want to acquire a property located in another state far from where they are, need to know all the information. Regardless of the fact that they have never seen that parcel or they don't even know all the information about prior conveyances.

A federal national recording land registry would give such information in real time. We shouldn't need to visit the County Clerk's Office to search the necessary information or to make an assignment on it, if we could use the modern information technology systems. When the antiquated local title recording system failed to meet the needs of national lenders, a private and limited access system to record the residential mortgage assignments was created. The Mortgage Electronic Recording System Inc. (MERS), created by the bank industry in 1993,[4] provides an electronic processing and tracking of mortgage ownership and transfers. Nonetheless, MERS's main target in the beginning was profitable, but then failed because recording laws differ from State to State, and indexing practices can differ over time in the same county or municipality. Even we can say that land recording is not required for purchasers to take possession of property or for deeds to be effective[5], purchasers must search diligently for prior recordation in their chain of title, to ensure they are receiving a good title. That's why the failure of such a private parallel system had played an important role in most of the foreclosures cases in the United States. The need of a Plan of

[3] The system of publicly recording land title documents originated in the Playmouth and Massachusetts Bay Colonies, in the U.S. (1640). *See* JESSE DUKEMINIER, ET AL., PROPERTY 559 (2006).

[4] MERS was created by the Mortgage Bankers Association, Fannie Mae, Freddie Mac, The Government National Mortgage Association, The Federal Housing Administration and the Department of Veterans Affairs. *See* Tanya D. Marsh, *Foreclosures and the Failure of the American Land Title Recording System*, 111 COLUM. L. REV. 19, 26 (2011).

[5] Rather, recording deeds protects subsequent purchasers who take title without notice of prior conveyances that are either recorded in a manner that doesn't impart adequate notice, or aren't recorded at all, Emily Bayer-Pacht, *The Computerization of Land Records: How Advances in Recording Systems Affect the Rationale Behind Some Existing Chain of Title Doctrine*, 32 CARDOZO L. REV. 337, 346-357 (2010).

Modernization of the American Land Title Recording System[6] is a real need and an urgent measure, for the lenders/mortgagees and the borrowers/mortgagors.

Conveyances in real estate are normally recorded with a county recorder or a register of deeds. For locating a mortgage and identifying the lender, you must look at the chain of title of the real property in question and find the name. Such work is not easy if all of the data related to conveyances or the parcel description hasn't been recorded correctly, nor contains all the agreed and trading information. To achieve such a goal, modern technology provides a full and complete variety of tools based on information systems, like data-search programs and indexing functions, rather than focusing on the digital submission or recorded documents.[7] The old ancient systems based on written books and notes must be substituted for another one based on recorded data, PDF files and information accessible to anybody using a personal computer, and connecting to a server with all the land information processed. In the 21th century this aim should be easily achieved with modern technologies, because machines don't think and therefore must be people to qualify the deeds, titles and all the land information prior to be technically processed or scanned, to match with legal requirements. This target must be made by future public officials in local or State registries of land titles. The goal is to make the systems safe and accurate between the recorded titles, the database containing the land information (the owners and holders too) and real life.

III. THE STRENGTHS AND POSSIBILITIES OF A NEW RECORDING SYSTEM FOR U.S.A.

All land title offices allow on-site searches, but they work with no coordination, because every State has their own rules related to the recording system. If we take a combination of transparency and clear priority in title recording processes, it will create lots of security in land interest and strengthen the confidence of investors who seek to purchase real estate and banks or financial corporations hoping to lend money secured by the real estate properties. We have more than 3,000 local recording systems all over the U.S. In the beginning, deeds, mortgages and leases were hand-transcribed into books. Now we have the possibility of making such transcriptions into e-books and computerized data books that let lose the old lack of inaccuracy.

We need to take advantage of such technological and information system tools, because the static indexing system couldn't account for changing legal descriptions of property parcels. The ancient systems used traditional boundary descriptions to identify parcels of land. New systems assign a parcel

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[6] Marsh, *supra* note 4, at 19.

[7] Gerald Korngold, *Legal and Policy Choices in the Aftermath of the Subprime and Mortgage Financing Crisis*, 60 S.C. L. REV. 727, 741-742 (2009). *See also* Dale A. Whitman, *Digital Recording of Real Estate Conveyances*, 32 J. MARSHALL L. REV. 227 (1999).

identification number, but it is a number related to a tax or zoning map, it does not offer the real information about a parcel of land. MERS recording system is acting solely as a nominee for lender and lender's successors. The information is held only by MERS and its Servicer Identification System.[8] Such a technically developed system could be drawn upon to: (1) create the real, perfect and best Federal Recording System;[9] (2) to spread all the information to real estate title land, wherever you are located in the U.S. and whenever you want to make a purchase; or (3) to make a conveyance or a mortgage to any parcel or property. This could be possible because the actual status of MERS holds no beneficial interest in the property, and that position is irreconcilable with the mortgage laws.

MERS's only right is the right to record the mortgage, but doesn't qualify as a mortgagee pursuant to our foreclosure statute[10]. The wellness of drawing a new Federal Land Recording System not only for mortgages, but also for any kind of burdens, conveyances or liens related to real estate property, would give us the security and accuracy that would make the U.S. transfer of property legal system one of the best in the world. There have been some attempts on drafting a statute to create such federal system[11], but authors fail to create the mainframe before creating the federal regulation on how to record a mortgage or the note related to it. What I propose in this article is to outline the main principles, in order to create a Federal Registration System, taken from the experience of Spain legal principles that have several centuries of background and thousands of cases resolved in court of land assignments and mortgages questions. This is what I will explain in the next pages.

IV. THE MAIN PRINCIPLES TO INSPIRE THE FUTURE U.S. RECORDING SYSTEM

In the following pages, rather than making or proposing a statute[12], I will try to outline the main principles that a pure recording land system should have,

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[8] MERS Servicer ID, *The Mortgage Industry's Utility*, MERS SERVICERID, http://www.mers-servicerid.org/sis/.

[9] Australia's registration system is among the best, often referred to as the "Torrens System", a tribute to its earliest, most effective designer and advocate, Robert Richard Torrens, appointed Registrar-General of the State of South-Australia in 1852. *See* DOUGLASS J. WHELAN, THE TORRENS SYSTEM IN AUSTRALIA 12 (1982). *See also* John L. McCormack, *Torrens and Recording: Land Title Assurance in the Computer Age*, 18 WM. MITCHELL L. REV. 61 (1992).

[10] *See* Christopher L. Peterson, Foreclosure, Subprime Mortgage Lending and the Mortgage Electronic Registration System, 78 U. CIN. L. REV. 1359, 1380-86 (2010).

[11] *See* Whitman, *supra* note 2.

[12] To face mortgage recording problems, see *id*.

taken from the Spanish law experience[13]. I will call them *registration principles*. The chain of title doctrine will be analyzed at the end of the present article. It basically states that a deed related to a property cannot be recorded unless it is previously recorded on the parcel or land, or the previous assignments and liens related to such a piece of land[14]. These mortgage recording principles are law and real regulation on recording systems. That means that, regardless of the fact that there is not a federal regulation over them, those principles must be enforced by judges and public authorities, and must be taken for local, regional or state regulations wherever the property is located.

A. The Registration/Recording Principle

This principle comes from German Law,[15] and it means that recording a deed is a necessary requirement to an existing change of status of any property. Either way, you could say that only a note or deed would be necessary to create a debt, a mortgage, a lien or any burden without recording them. But if you want to enforce them, what gives the legal security and accuracy is the recording status at a Public Land Recording System. Therefore, the changes of real estate status can happen in real life, regardless of the fact that such changes are being recorded. These changes exist for law, judges, particulars, etc. But the existence of the change of property status only has the protection of law to be enforced, if the deeds are recorded in a public registry.

B. The Agreed Principle

The following principle states the need of an agreed act to be recorded in such a future recording system. What it means is that no act should be recorded by any public clerk if such an act does not come from an agreement from parts of a note or from a judicial statement. But you can question that when someone enforces a foreclosure they are not really making an agreed act. You may also say that such judicial statement came from an initial agreed act and the foreclosure is only the subsequent aftermath, or an initial agreement that becomes a note or deed breach. Therefore, the root of an enforced recording act must be an agreement, so that any act recorded in a public system must have a background from an agreement.

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[13] The main work related to such a matter in Spanish Law belongs to JOSÉ LUIS LACRUZ BERDEJO ET AL., ELEMENTOS DE DERECHO CIVIL III, DERECHO INMOBILIARIO REGISTRAL (1984) with several following editions.

[14] On chain in title doctrine it is important to see Coco v. Ranalleta, 733 N.Y.S. 2d 849 (Sup. Ct. 2001) and Federal Natl. Mtge. Assn v. Levine-Rodriguez, 579 N.Y.S. 2d 975 (1991). *See also* Bayer-Pacht, *supra* note 5.

[15] This is known in German as *Eintragungsprinzip*.

C. The Publicity Principle

According to this principle, we can have two different points of view: (1) that publicity gives us accuracy and security on private transactions on real estate, and only what it is recorded in a public system, could have a presumption of *bona fide* and accuracy; and (2) that the recording system must be available to the public, that is to anyone who searches for land information. So that people, banks or investors, who want to know the real owner of a property and/or the real characteristics of a lot or a parcel, must have full access to the recording system wherever the real estate is located. This principle would give full transparency on any transaction, would make them less expensive and may help avoid future foreclosures, because investors have the full information before the deed is signed by the parts of such transaction. When you are buying a vehicle, you must go to the Department of Motor Vehicles (D.M.V.) and a quick search of their computerized data would enable you to know who owns the car and whether it is subject to a loan[16]. The same fact should happen if you are searching for data of any property in a public registry.

D. The Standing or Legitimation Principle

The holder of a recorded note or mortgage[17] should be considered the real owner, rather than one that has not recorded his note. It is enough for him to show the recorded note, to prove that he is the real owner and such a title gives him all the enforcement power to go to trial court. One that only holds a non-recorded note should record his note before he goes to court. Even more, there will be a possession presumption for the recorded one that he is in possession of any real estate or property. This destroys the presumption for the non-recorded one, so this last one is not in possession of the property. Either way, if you cancel the records of any parcel in the registry, it will be a legal presumption that the rights have disappeared for such recorded one. Also, for preserving the records in the public registry systems, the Courts will take a lot of care not to cancel any record that is not due to a trial or a judicial case involved to it. Therefore, not only the County Clerk Officials will take care of the records, but also, the judges will not allow any cancellation of a recording data, unless it is due from a foreclosure

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[16] For this comparative example, *see* GEORGE LEFCOE, REAL ESTATE TRANSACTIONS, FINANCE AND DEVELOPMENT 244 (6th ed. 2009).

[17] About becoming a non-holder who has the rights of a holder, *see* American Law Institute and the National Conference of Commissioners on Uniform State Law, *Report of the Permanent Editorial Board for the Uniform Commercial Code, Application of the Uniform Commercial Code to Selected Issues Relating to Mortgage Notes* (November 14, 2011), http://www.uniformlaws.org/Shared/Committees_Materials/PEBUCC/PEB_Report_111411.pdf. *See also In re* Veal v. American Home Mortgage Servicing Inc., 450 B.R. 897, 911–12 (9th Cir. 2011), which it recognizes the rights of a holder status, but states that it did not exist in the absence of possession of note.

case or based on a statement or a judicial act. That's why only the standing holder of a recorded note (a bank or any owner holding a right) will have the legal right to go to courts to enforce his rights from a recorded act.

E. The Public Faith or Confidence Principle

This one is the outcome of the publicity principle and the key of all the Recording System. It means that if a person gets or buys a property from the second person who appears at the recording system with *bona fide*, he will be held in his possession when acquired with a valid deed, even if later the title of the seller is repealed or cancelled by any judge. This is due to the fact that the owner acquired in good faith thinking that the seller had the real property protected by public faith on the Registration Recording Land System. In cases of a double sale or purchase by one seller and two buyers at the same time, the public system will always protect the first one to record his deed in the Recording Land System or Public Registry, even if he is the second one to buy in time. Therefore, the first person who bought will only have the right to recover the money he paid against the seller, but he will not have the right to record his deed. The second buyer or holder recorded his title first and is protected by the public faith principle, due to the confidence in the public registry recorded deed.

This principle ensures the transactions concerning the variety of title insurance companies that make thousands of title insurance notes before the closing dates. So they can make sure that their titles are ensured, valid, that there are no doubts of their authenticity and that there is a real and valid deed and title that is marketable[18].

F. The Priority Principle

This principle comes from a Roman law that says: *prior tempore, potior iure*. It means the first in time is the first in right and the key is to know which title is the first in time. For this priority principle, the answer is that the first in law[19] is the one that first records his deed in the public system. So that law will protect whoever had access to the registry, even if his deed is later on time than the other that signed before, but who has not recorded his title in the Registry. That's why, regardless of the fact that a buyer or mortgagee has a note that recognizes his purchase or his debt, the first to enforce will be the one who firstly recorded his,

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[18] Condell Private Letter, *If Title Insurance Didn't Exist Today We'd Have to Invent It*, (May 15, 2000), http://condell.com/pdf/titleinsurance,pdf.

[19] To an explanation about that the first in law is declared first in right, *see* Ralph W. Aigler, *The Operation of the Recording Acts*, 22 MICH. L. REV. 405 (1924). In the specific case of mortgage, *see* Union Central Life Ins. Co. v. Cates et al., 137 S.E. 324 (N.C. 1927), as quoted in Household Realty Corp. v. Lambeth, 656 S.E.2d 336, 339–40 (N.C. Ct. App. 2008).

but that doesn't mean that the second one could not get his deed to access to the public registry. Not at all, the second owner or mortgagee could also record his title, for not to break the chain of title, but he has the sole right to enforce his after the first who recorded has done it. That's the meaning of priority principle.

So if there are many burden titles recorded (for example, mortgagee number one, bank note holder number two, investor who bought the initial burden with number three, etc.) the priority will be for the first who recorded his deed regardless of the date of the title. He will have a prior right and the following holders will have to wait for the firstly recorded to enforce theirs. This is valid unless there is a judicial statement that cancels the initial recording title due to a false or forgery document, or in the case of a claimant fully protected, in order to preserve their priority before any later adverse claims[20].

G. The Starting Praying Principle

Changes in the public recording systems might happen if somebody asks for them with a valid right, or holding a valid title (even a judge). What I mean is that, even if the public employee or the official clerk from the public recording office have notice about a deed, a conveyance or assignment, not only by hearing about it, but also if he has seen the title or the deed, only can have access such a title to the public registry, if somebody (a private , a bank or a judge) makes all the arrangements to record such deed in the recording system, but not if we have notice from a conveyance[21] or an investors will. There must be a real will from somebody with a legal interest (usually a party of the agreement or the assignment) or a due warrant to record a deed from a judicial court, regardless of the level (i.e. state, local or Supreme Court). For that reason it will be very important that the future officials and employees from the Registration Public Office will be selected and appointed with special requirements of law knowledge, because of the full responsibility to record only the titles that should be legally recorded, without a reasonable doubt of the validity of the deed submitted to record.

H. The Legality Principle

The Land Registry is not a mere library or digital library held by a Public Official to record deeds, notes or agreements. Due to the fact that the public registry gives such an accuracy and certainly related to land, all the recorded deeds must be according to laws in Real Estate, giving the true related to land,

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[20] Illustrating the risks of not promptly recording a deed, *see* Robert J. Bruss, *Uncle Invalidated Quitclaim Deed*, LOS ANGELES TIMES (Feb. 13, 2005).

[21] *See* Dale A. Whitman, *Digital Recording of Real Estate Conveyances*, 32 J. MARSHALL L. REV. 227, 230 (1999).

and his owners or burden holders. To gain such a target, the county clerk office employees must have special knowledge in laws involving real estate, transactions and land financing. Also, due to that special education, they must demand recorders, even if he is a judge with his statements, all the legal requirements. The public officials must, not only record a deed, but also see the previous deeds recorded on the same parcel or property, so they don't break the chain of title, even with the privilege of *res judicata* for the recorded files on each property, as equal as if it were a non-appealable judicial statement.

I. The Speciality Principle

This last principle means that a mortgage must be a guarantee of a particular debt, a kind of an assurance for it, with a determined sum or amount of debt by a particular borrower to a bank lender of such amount, with a principal amount, an interest rate, a term of years to pay it and the currency used. All the data must be specified and can't bring any doubt of forgery or mistake. The principle of specialty or determination of the recorded subject, must be transferred to all items to be registered, that are: the subjects in the relationship (owner, mortgagee, mortgagor, owner of a burden, holder of the note, etc.), the property characteristics (parcel, size of it, lands around it, boundaries, etc.), the real estate rights created over it, etc. It also refers to a kind of determination of every data that is being recorded. If public registry gives us accuracy and full faith of any data previously recorded, to gain such a goal, all the data must be specified and determined without gaps or doubts.

V. A SIMPLE RECORDING SYSTEM OR A TAX RECORDING SYSTEM: IS IT POSSIBLE SUCH A COMBINATION?

The banks invented MERS because the land title system failed to meet the needs of a modern real estate industry. However, imagine how easy it would be to search in a public recording system, spread all over the nation, with the same characteristics of searching and ease of access. There should be uniformity and consistency in the rules governing the form and substance of documents eligible for being recorded, and this system should be public, not a private one like MERS[22]. We should change from the paper-based system to a computer system with documents to be seen on the internet and in PDF format, downloadable documents, with the accuracy and faithfulness of the old paper-based systems. You must also imagine integrating property tax records, subdivision plats and recorded documents with a dynamic map with the Geographical Information

[22] *See* Carson Mullen, *MERS: Tracking Loans Electronically*, MORTGAGE BANKING (2000) *available at* http://www.thefreelibrary.com/MERS%3A+Tracking+Loans+Electronically.-a063975145. *See also* Michael Powell & Gretchen Morgenson, *MERS? It May Have Swallowed Your Loan*, THE NEW YORK TIMES, March 5, 2011.

System (G.I.P.) technology,[23] and such a system bringing up all the data in the records pertaining to a particular parcel of land.[24] A type of Land Registry Graphical Database, consisting of layers of spatial information that have been created using digital technologies (orthophoto, drawing tools, computerization, links to juridical information, etc.), would make searching for lawyers a much easier feat to handle.

Even in Spain some land recorders in every county office or registry have developed ICT applications for the processing of the graphical database with the following outcome. They will enable coordination between registered properties and graphical database, and that will let recorders to include the data related to town planning, the environmental aspects and the administrative affairs. Why don't to the same in a future Federal Recording Land System in the U.S. with the same ICT applications to all county offices of registry? MERS don't do it actually and only gives bank industry limited mortgage information. That's not enough at all because we need to make a step towards, like Spanish recorders have done[25].

One solution should be to centralize the land title system at the state level, much like the registration system used by article 9 filings under the Uniform Commercial Code. Nevertheless, I think that a better step would be to create a federal system of recording titles. In the state of New York, for example, there is a Tax Map where every land, parcel, condominium or any property have a *tax number*, which is the same number that is registered at County Clerk's office. Therefore, we have the two elements for achieve the most complete description of a parcel. One of them, the public recording system at County Clerk office, where there are the total backgrounds of the property. The second one should be that we have a tax map that controls every property, for the income and revenue tax purposes for public governments.

The combination of these two elements gives us the full control of real estate conveyances and financial transactions based upon them. All mortgage deeds must pay a kind of mortgage tax, thus the tax map has the information to any property assigning a number to every parcel. Thereby, every time such a number suffers a conveyance or an encumbrance, the data system will record what is going on with such a parcel. That should be a well profit for the State

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[23] In Spain, for such a purpose, have a new system called "Geobase Project", which consists in using ICT tools to geographically translate or render the properties that have already been registered in the land registry by literally description.

[24] In Spain and Italy, most of the research work on database upon GDI, has been made by Elena Sánchez Jordán & Cesare Maioli, *The Role of the Land Registry within the INSPIRE Directive* (2009) http://www.gsdi.org/gsdiconf/gsdi1 l/papers/pdf/104.pdf; Elena Sánchez Jordán & Cesare Maioli, *Towards a Reliable Parcel Identification System: The Spanish Land Registry Graphical Bases System*, INSPIRE (2010) http://inspire.jrc.ec.europa.eu.events/conferences/inspire_2010/conf_skd_conference.cfm.

[25] Elena Sánchez Jordán & A. Falcinelli, *The new European Infrastructure for Spatial Data: The implementation of the INSPIRE Directive in the UK* (2009), http://www.academia.edu/21496570/The_ role_of_the_Land_Registry_within_the_INSPIRE_Directive.

Treasury Departments and also for the Federal. It should be almost impossible to avoid paying taxes to any real estate selling or mortgaging act or any real estate transaction. Servicers,[26] at land registries, would have easier to handle with all the money from loans, fees and taxes.

VI. THE NECESSARY ELEMENTS FOR A PUBLIC RECORDING SYSTEM

A perfect recording system should have clearly defined what kind of data must be recorded. This should mainly be: the land, parcel or property; the holder of a note or the owner of it; and all the acts related to the relationship between them.

A. The Land, Parcel or Real Estate Property

1. The Description

The first and most important data to be recorded is the land or property. We must define what kind of data, related to it, are the most important and necessary to have a full description.[27] These data are mainly the following:

- The nature of the property: (1) if it is private or public property, or belonging to any non-governmental organization; (2) if it is a building, condominium, a loft, a farm, etc.; and (3) if it is an urban land located inside a city or a ground land dedicated to such purposes as agriculture goals, forest exploitation, etc.
- The situation: describing where it is located. For example, the town, street, the number of house or the floor, etc.
- Surface size in square meters or yards, feet, or any admitted measure.
- The boundaries to north, south, east and west describing who the adjacent neighbors are.
- Finally, the parcel will be given a number that should be the same in the tax map, and also a reference to be found in any other searching data.

2. Access to Registry

Once we have the full description of the property and there is no doubt concerning it, even with a recorded document with a dynamic map, photos or

[26] *See* Whitman, *supra* note 2, at 57.

[27] The description delineates a specific piece of land and cannot be applied to any other, MARY RANDOLPH, THE DEEDS BOOK: HOW TO TRANSFER TITLE TO CALIFORNIA REAL ESTATE 6; 15-16 (1987).

pictures of it,[28] we are able to make the record of such a parcel of land, and all the following acts concerning it. The future Federal Land Recording Act should describe the kind and number of documents necessary to make a full description of a parcel of land. Without them the record should be uncompleted and not able to give us the accuracy that we need from any successfully public registry.

3. Changes or Assignments

Such a property is like a living object, it should change its status. Land changes, roads are vacated, rivers move, condominiums are established and building are demolished, so the future federal recording system should be able to monitor and record such changes of the status of the land. The registry must change all the assignments on land, recording the new legal situations: new buildings, new boundaries, and any changes of measure of parcels, any construction built over a lot, an extension of measure or a decrease of building. You must also record any parcel joining, or the opposite, when you segregate a whole parcel in different parts.

4. The Acts That Have Access To Registry

All acts related to a property should have full access to the Recording System. The first act to be recorded is the initial description of the land and who was/is the first owner.[29] This is so because land cannot exist without an owner, even if it belongs to government, a church, corporation or even a non-governmental organization. Therefore, any deeds covenants should go to a registration system, no matter which one it is, even if it is a simple agreement not changing any recording status. Recording system must offer full information of all data in life of any property. Its tax number and value should be recorded with a kind of automatic update system, to make its value as close to market as it is possible. That would let lenders to know which the maximum amount they can offer a borrower is.

B. The Holder of a Note or a Mortgage

As the land description, the second main element to be recorded is the owner of the property. Also every holder of a note or a mortgage note,[30] or any

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[28] Or a *Graphical Database* as the new Spanish and Italian systems based on INSPIRE Directive from U.S. drafted on 2007. Directive 2007/2/EC, of the European Parliament and of the Council (March 14, 2007) (Official Journal of the European Union L/108/1-14, published on April 25, 2007).

[29] The chain of title must begin based certainly on an initial real estate act.

[30] *See* RMS Residential Properties, LLC v. Miller, 32 A.3d 307, 314 (Conn. 2011) ("[A] holder of a note is presumed to be the owner of the debt, and unless the presumption is rebutted, may foreclosure the mortgage).

lien, burden or encumbrance, such as servitudes,[31] must be recorded. People can also be designated in the registry system, according to different rules: by a single nomination or by reference to, for example, a corporation. This always has to be with all the relevant data regarding who is the final headline holder, to avoid getting anonymous parcels that are figurehead hiding the real owner or holder. In the case of a disabled person, his legal guardian must be mentioned, and if he or she doesn't have one, the name of the Governmental Social Service official, who holds and handles his/her case, must be appear. Transparency must be one of the most important values of a full credit public recording system, and what gives us full faith and confidence on such a registration system.

C. The Recording And Registration Process

First of all, we must be clear about both terms: "recording a deed" *versus* "registering a title,"[32] because the distinction is important to know what we have to do. Recording must be referred to the technical automatic process, that historically was a manual process and still is in many counties, but today it is made with computerized or electronic sources and ICT tools, to gain or take notice of any property act or deed covenant. Recording is just one of several steps in the registration process and will probably be the last step. Though not necessarily, registration refers to the whole process concerning taking public notice of a real estate act. It begins with a kind of informal qualification of the deed or note, to know if such an act must be recorded or not. This is followed by a formal analysis of a paper, to see if it includes all the legal formalities to be taken in a good notice by the public registry. That is one of the reasons why the servicers and employees at public registration offices must have a special qualification concerning real estate law. They must be skilled at analyzing legal requirements of acts and deeds to be able to discriminate which act or title is recordable, and which one is to be returned to his initial holder to be amended.

Nevertheless, recording a deed or note must be the final activity after we have depurated a legal act. It is a simple operation, by a technological skill in a public record, to take notice of an act or deed related to a real estate transaction. This simple technical operation must have all the requirements to give us all the information on a particular parcel of land. The record must contain almost the full content of the deed, or at least the main aspects, so there will be no place for interpretations that could confused the holder and/or the owner of what really

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[31] For cases upon servitudes doctrine, *see* Witter v. Taggart, 78 N.Y.S.2d 338 (1991) and Ammirati v. Wire Forms Inc., 82 N.E. 2d 789 (1948). *See also* Kenneth L. Gartner, *Witter v. Tuggart and Ammirati v. Wire Forms. Inc.: The Potential Ramifications of New York's Newly Restrictive Definition of "Chain of Title" and Newly Expansive Definition of "Easement by Necessity"*, 5 HOFSTRA PROP. L.J. 101 (1992).

[32] *See* Tim Hanstad, *Designing Land Registration Systems for Developing Countries*, 13 AM. U. INT'L L. REV. 647, 649 (1998). *See also* BARLOW BURKE, REAL ESTATE TRANSACTIONS: EXAMPLES & EXPLANATIONS 221 (4th ed. 2006).

happened in the life of such a property. Interpretation of a legal deed would be the opposite of accuracy and confidence in a public recording system. The legal principle runs on "the less interpretation is the better legal accuracy."

1. Constitutive or Declarative Recording For the Mortgage Note?

Advice in mortgage notes is necessary to record one and to be effective? This question is based on constitutional or declarative doctrine on recording acts. This subject would help us to demystify MERS as a private recording system.[33] If we considered it is not necessary to record a mortgage note, then it should be a declarative act. That does not mean a mortgage is not effective or that one cannot enforce it, because the mortgage really exists, but it lacks the investment of a public record, making it more difficult to enforce it in court. Instead, it only means that one must go to trial to give knowledge to the party that one is going to sue for a breach of the debt amount or the due obligation. The other party should recognize his signature in a mortgage document, in order to avoid problems and for one will be able to enforce directly his mortgage note. If the other party does not give assurance of his signature, then one will have to go to court as a plaintiff to gain a judicial statement giving the right to sue for a breach of contract. Then one will be able to enforce the mortgage agreement or foreclosure, if the other party fails to pay.

On the other hand, if you consider the recording act and/or the mortgage note as a constitutive act, they lack the power to be enforced. That means the note does not exist lawfully until it is recorded in a public registry. This theory would bring problems because it would be possible that the same bank lender could sign different mortgage notes, for example, on the same day, but at different times and places with different borrowers. Also it could happen when the second or the third person to sign the mortgage note, goes to record his note before the one who signed before in time. In this case the law could give the power to enforce the mortgage to who really was the last in time, against the law principle: "the first in time is the first in law."

That's why I prefer the declarative doctrine, even giving us a kind of insecurity and a lack of collateral, because we must respect the times of signing any document, regardless of the fact that a doctrine makes us face more arrangements and force us to go to court at least twice, to enforce a mortgage note.

Even the declarative theory is in the way of assignment real estate, the property is transferred regardless that the conveyance is recorded in a public registry, only taken possession of the land you become the owner, if any deed is signed with all the legal requirements. You don't need to record your deed to take

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[33] *See* Christopher L. Peterson, *Two Faces: Demystifying the Mortgage Electronic Registration System's Land Title Theory*, 53 WM. & MARY L. REV. 111, 143-55 (2011). *See also* PETERSON, *supra* note 10.

legal possession of a land that has been bought with all the legal requirements. You are the owner to real property regardless of the fact that the deed is recorded or not, since you cannot prove your ownership against the person who records a better title, regardless of the fact that he is or not a *bona fide* purchaser[34].

2. The Defense of Recording Acts

For defending the recorded acts, the future recording system should create a civil action that should be called the "recording act civil action"[35]. This action is to be used not only by the real owner of any property, but also by any holder of a note or a mortgage note, to give effectiveness of his recorded act. Even, if he only has the sole possession of a parcel. The target should be the defense of any recorded act. Thus the action is to be sued in court to get a judicial statement, telling that the recorded act has a legal presumption of accuracy and truthfulness. This action is to be sued against anybody who holds a note that could controvert the one recorded in the registry, but also against anyone who appears in a registration note but is not the real owner, or even against somebody who has a greater right to be recorded rather than him, for example, due to a simple error, mistake or even forgery.

3. Presumption of Accuracy

The presumption of accuracy means that any recorded act belongs to whom appears as the owner in the public registry, in the same way that it is described in the public records. Also means that he has the effective possession of such a piece of land. These records are saved by court decisions or decrees, and can be changed only by a judicial statement or by an agreement made by the person who appears as the holder in the public registry. This legal presumption of accuracy can be destroyed or rebutted only by opposing evidence.[36] Therefore if one shows any proved evidence that the recorded is a mistaken act, or based on forgery, that presumption will definitively fall.

4. The Possession Presumption

This presumption lets us know that someone who has a recorded note, has the real, *bona fide*, public and peaceful possession of the land, without any

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[34] *Bona fide purchaser* is also commonly referred by academics as "*BFP*" in most works.

[35] Similar to the *eminent domain action*, a government forfeiture proceeding, a quiet title action or an action to enforce a zoning, housing code, or building code infraction. The federal government may maintain a "criminal forfeiture" action pursuant to 18 U.S.C. § 982 and 21 U.S.C. § 881 against property used in the commission in certain crimes. The title to real estate so forfeited "relates back" to the date of the first commission of illegal activity. *See* 21 U.S.C. § 881(h). *See also* United States v. Schecter, 251 F.3d 490, 497 (4th Cir. 2001).

[36] This is called in latin the "*iuris tantum* presumption."

interruption in time made by the previous owners and while the recorded act was published at the public registry. Therefore, the public recording title system not only gives us a possession presumption, but also a public possession that shows everyone who is the real owner of the land and the legal description of such a parcel or lot. This presumption also admits any opposing evidence, so if you are the real possessor of a piece of land, that possession destroys the legal presumption of possession in his note or deed recorded at a public registry. In this case, you would have to go to court to sue based on your evidence of such a possession presumption, and you will have to pay some money for trail and lawyers. You will most certainly win the case.

5. The Action to Enforce or Defend a Recorded Act

A new recording act civil action should be drafted. This action should be useful, not only for the holder or owner, but also for the banks, investors and for anybody who wants to enforce a recorded act against anybody who deals with a forged or simple mortgage note, that are in contradiction with previously recorded data. A complete regulation of such action should be addressed with the proposed statute for a new National or Federal Mortgage Registry Act, and it should contain the terms for using it for the following objectives:

a) To make a defense of a recorded act when somebody is threatening against it, for example with an illegal possession of land against the real owner according to registry;
b) To attack a recorded act when somebody holds a signed note or a deed that indicates he is the real owner or holder of a legal mortgage note, if the recorded data seems to be another person;
c) To claim the legal possession of land when somebody holds it without a recorded act that shows notice of his right;
d) To know who has the standing to sue it, or who has to be the defendant as holder of any passive legitimation*;
e) To find what kind of evidence must be taken in trial to prove the legal possession or ownership of a recorded land, or what kind of legal evidence should be enough to destroy the legal presumption of accuracy of a recorded act;
f) Finally, a Future Federal Registry Act should include the procedure to sue, the terms of claiming and the closing dates[37] to gain security and collateral for insurance title companies.[38]

[37] *See* K.F. BOACKLE, REAL ESTATE CLOSING DESKBOOK: A LAWYER'S REFERENCE GUIDE & STATE-BY-STATE SUMMARY (2d ed. 2003).

6. Effectiveness of a Recording Act

The main effect of a recorded act has to be the protection of the holder or owner mentioned in the recorded books. This protection must be understood as a legal protection against any third party that disputes this recorded act, or who disagrees with the notice that the records seem to notice anybody, for example, if any boundary size or measures are not specified as in real life, or if it's not a coincidence between both of them, even if the owners of boundary lands aren't the ones specified in the registry. Therefore, registry must give us full accuracy about what's happening in real life. Only a *bona fide* holder with a valid deed, but not recorded, could destroy a legal presumption, if his conveyance is based on a valid agreement that does not breach the chain of title.

The *bona fide* principle establishes a requirement for the effectiveness of a valid recorded act. But what means *bona fide*? Basically, we must describe *bona fide* as the personal belief that your title is a valid one, without any mistaken data. It is the belief that the person, who took the note, gave it to you and made the transfer of ownership by a conveyance or an assignment, was in fact the real and legal owner, without any thoughts of breach of chain of title. Thus, *bona fide* must be the absolute lack of any doubt about the legality of an agreement and the ownership of the holder of a note or deed. *Bona fide* can be lost if you find evidence of such a lack of belief about the real data and owner. You can sue to prove the absence of *bona fide*[39] by any evidence which destroys the legal presumption of it.

7. Preventive Annotations

To gain security or collateral in real estate agreements, it should be possible to make a temporary preventive recording act, to ensure the future conveyance or mortgage note. To gain legal security in such a future Federal Land Title System as a nationwide registry, you must record an insurance record made by a Title Insurance Company, so that makes sure to all parties during the complicated process of a buying/selling or lending/borrowing agreements, that should even last a long time. This temporary preventive annotation in land registry should be cancelled on records, when the final agreement is arranged or closed, or even if the closing date finishes with an agreement or not. If you have a trial over property ownership, conveyances or about a mortgage question, it should be a profit to record the suit, claim or foreclosure by the plaintiff. Ensure

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[38] *See* Tammy L. Ortman, *Title Insurance- A Comprehensive Look into the World of Title Insurance Today*, 34554 NBI-CLE 27 (2006).

[39] *Bona fide* means "genuine or good faith" in latin and a *bona fide* purchaser in notice states, is one that prevails against the holders of prior unrecorded interest. *See* LECFOE, *supra* note 16 at 261, taking the sense of the U.C.C. art. 8 (revised).

the final judicial statements, decrees, aftermaths and deeds, do not have access to the recording system, unless the trial has finished with a non-appeal statement.

These preventive annotations act as a warrant or a seizure measure that give accuracy to the registry system, without jeopardizing the property. It should take the way of an edge annotation in the parcel sheet, if we are talking about a registry based on paper. But if we are achieving a digital system with ICT tools, it should be submitted by a kind of a footnote or a digital note where the record is scanned in the database. In this case, we should avoid suspicious circumstances or contradicting facts.[40]

8. Cancellations

Cancellation of a recorded act or note should be easy or difficult, depending of what kind of act we want to remove from the registry. It will not be a single operation deleting a data, and we must keep the whole background of a land and his owners or holders. If we are talking about deleting an encumbrance, burden, a lien or a mortgage, the process would be quite difficult because we are going to delete a data that could affect somebody interested in such a burden and have consequences over his rights. If we are talking about deleting a single sell, trading act or assignment, it should be easy to erase an agreement, but always keeping the original data in the registry. You just delete it from the final sheet of the recording book and therefore do not breach the chain of title. Cancel the whole history of a building could happen only if the building is destroyed or knocked down, and the whole property disappears to anybody. You must face the fact that the lot or parcel will exist in real life and it will have an owner. So, deleting all the data is absolutely impossible to happen. You can delete or cancel any data of a demolished building or a condominium, but the land will always exist, maybe with a different owner, but it will always have a real existence.

Cancellations should happen by a judicial statement or an agreement among the parties involved. If it happens against the owner's will, he must be notified so he can make a defense of his recorded act. Cancellations must be taken due to the time, either if a term has gone or if any agreements or trading acts have lasted their agreed term. Cancellation of a recording act can be used if the initial right has gone beyond its expiration or closing date.

9. Errors and Mistaken Rectifications

When a recorded file in the public registry has a data error or mistaken information, we should begin a procedure to make a legal correction or

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[40] *See* Pepe Coin Laundries v. Catovest Int'l Inc., 820 So. 2d 947 (Fla. Dist. Ct. App. 2002). For suspicious facts theory, *see* 14 RICHARD POWELL, POWELL ON REAL PROPERTY §§ 82.01–82.04 (Michael Allan Wolf ed., 2015).

amendment, to fix the reality into the registry. This could happen by a mistaken data on measure, names, due to the description of land or if the bounds have changed for another trading act. This process should take notice by a corrective deed[41] in recording registry, because we are not changing the reality of life of land and we are not making any arrangement or agreement over real estate. The only thing that we are doing is adjusting the recorded data to the reality. That's why this process should be accessible to anybody with evidence based on documents, deals, contracts or judicial statements. This procedure should be easy to handle, because we are not disputing the recorded rights of owners or holders, but making a material operation to fix a better recording data according to the reality. We are not taking nullity of the recorded deeds or rights, neither changing any legal status. We are only matching the registry data with real life.

Therefore, corrective acts[42] should happen by a judicial statement or a decree taken from a trial suit, which could also be made by the parties involved in the mistaken data with a corrective deed. But if it happens against the owner's will he must be taken in notice to make a defense of his recorded rights due to his legal note or deed. This is an aftermath of the presumption of accuracy we talked about before, and its effects takes off from the real date the initial act was recorded by the first time in the registry system[43].

10. Inscription Procedure

A recording procedure must be drafted because individuals, financial institutions, investors and bank lenders need to know the legal process. Since a person asks for a particular record, until the official recorder gives him a notice of a proved recorded act, many questions can be asked by particulars and banks. All these questions must have an answer and a legal regulation to solve them, because most of them involve a legal question that needs a legal answer.

The inscription process is a kind of *tertium genus*, a third type or procedure. It is not a jurisdictional process nor administatrive, but an extrajudicial process. It is a process that involves recording acts and that must be enforced by the public officials working at the public office of recording land titles. But what can you do if the public registry denies you a recording act? You must go to court to get a judicial statement to search for that recording act warrant or decree.

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[41] *See* Stacy O. Kalmanson and Jerry Morris, *Five Tips Every Real Estate Practitioner Should Know About Defective Deeds*, 82 FLA. B.J. 37 (2008).

[42] Most states have Curative Acts which function, essentially, as statutes of limitations. These laws bar challenges to documents, because of technical irregularities after they have been on record for the prescribed statutory period. *See* POWELL, *supra* note 40. *See also e.g.* CAL. CIV. CODE § 1207 (West 2016). A Bankruptcy Court interpreted the Pennsylvania Curative Act as curing only minor defects, not major defects such as the notary never having met the party giving the acknowledgment. In re Rice, 133 B.R. 722 (E.D. Pa. 1991).

[43] Some acts cleanse all defects in instruments recorded before a certain date. These laws needs to be reenacted periodically, *e.g.* 21 PA. CONS. STAT. § 281.1 (2016).

The first thing to do when a deed is presented to the public registry is the qualification process done by a public official at the registry with a especial qualification in real estate law. Anyone could present a title, but not all should get a recorded act or title from the registry. The holder or owner of a valid land title should be the only allowed doing it, with a valid legitimate right. When you submit a title to the registry, you must receive a proved ticket, receipt or note. With that you can get a proved document of your title, until the qualification process has finished. Immediately after you submit your deed, the public official must make a presentation record at the recording books, e-books or database, so that any document submitted after that date, can be taken notice from the registry. The last document submitted to the registry won't have any priority towards the first one presented, until the final recording process is done, over or if the recording act is denied with a valid justification.

One can desist at any time a withdrawal from the document presented before, that can only be made before the final recording is done. After the deed or note is recorded, you cannot desist, because the title has been legally recorded and that legal fact cannot ever disappear from the registry and from the law. Although you can delete documents, you cannot make the law or the acquired rights from real estate disappear, unless an assignment is done by an agreement or by judicial statement. According to the legality principle, you must make the legal qualification of the title you submit to the registry. To do so, the public official must look the previous titles recorded to not breach the chain of title. You must also watch inside the title, deed or note, to see if the legality is enforced. I mean that the qualification process is not only a procedure to check if the chain of title is not broken, but it's a legal process to enforce the law in real estate. For achieving such a target, not only you must use de pre-recorded data and the recorded backgrounds, but you must bear in mind the real estate regulations, cases and all documents you are taking notice before the Registry. You must take all the time needed, because the recording act must give us accuracy of legal requirements. You can make a preventive record to ensure your rights, if the recording process is complicated and taking a lot of time.

After you make all the qualification process, the public official must record the act or deny it. The denial must be done with proof or evidence that the title is not according to the real estate law or to previous titles that can break the chain of title. If the fault in the title submitted is minor you can correct it in a short period of time. After that happens, without taking a corrective deed, the rejection will become non-appealable. Then, you can only go to trial to get a judicial statement to gain a recording warrant or decree. These are the main outlines on the recording process to be drafted in the future Federal Recording Land Act. Much of the experience from previous judicial cases should be taken to make such regulation.

VII. THE PUBLIC GOVERNMENTAL ORGANIZATIONS

A. The Future U.S. National Registraton System And Its Officials And Employees

Actually, most of the public registries over the country are taken in county clerks offices. The future U.S. Land Recording Title System should be a National Federal Agency spread all over the States, without local control (states and town offices). This Federal Agency would substitute every local office, and the officers should be appointed with special requirements and according to their knowledge of real estate law. Actually, there are over 3.600 recording systems where holders of an interest in real estate can register that interest.[44] However, it is a fact that all these local offices would be extremely difficult to dismantle. Nowadays, the American Recording System is in the hands of thousands of elected officials, and many of them hold offices established in their State's Constitutions. Eliminating them would be impossible, but we cannot give up the idea of creating a Federal Agency for recording land titles due to such a problem. This is one of the main problems we considered to gaining our target. We should make a change in the structure of local and state offices, mixing today's officials with the future ones well versed in real estate law, to attain our purpose, that is accuracy in all land titles over the nation.

The federal government should create an alternative recording system that includes the features we mentioned above. This federal recording system should be able to digitalize new records and maintain the indexes, although some smaller county clerk offices continue using physical books for indexing, until they finally disappear in a couple of years[45]. These manuscript book systems should be changed for a new one based on ICT tools. The new information technologies' and tools allow us to obtain the information we need to know in less time and with more accuracy, and also find the location of the documents and its content. Change will not be easy to handle, but it's possible and desirable. The real need for the new times to come in the field of information technologies is to gain the main target in a public system, confidence and accuracy.

This future Federal Recording System should be located as a spread agency in the actual local offices, but with an official headquarter leaded by federal authorities, to give all of them common instructions to record the titles and deeds, and to gain homogeneity. A leading official should be a manager or director of every local or county office. The whole system should be connected with ICT, receiving general outlines to record any act from the main headquarter, leaded by lawyers with a notorious and high level of knowledge in real estate local and state regulations. A kind of a pyramidal system that gives general

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[44] LECFOE, *supra* note 16, at 248.

[45] Tanya D. Marsh, *The limits of constructive notice: a call to reform Indiana's recording statutes*, 46 RES. GESTAE 20 (2002).

instructions from the top to the ground level, and to give unanimous criteria to recording deeds or land titles. Every local office of registry should be connected to a database network all over the country. Should be an internet registry that tell us, in real time, all the information about a property or about an owner, lender, borrower or anyone who is taken notice in a deed or land title. A kind of electronic book, like a virtual library with PDF documents scanned, that should be accessible to anybody with a legal interest. Only public official should be able to record or deny the inscription in such database.

This measure ensures the chain of title so that, only one data belonging to a certain property can be introduced at the same time, even from different places around the country, like with airlines reservation systems. Only one person can have access to a land file. The next person to introduce a data on the same parcel, dated at least a second after the first, thus the chain of title is not breached at all and respects the principle that the first in time is the first in right. Of course, it should be a paid system, so that these fees should finance the salaries, the buildings and all the arrangements for such a Federal Agency. Maybe such fees make the real estate transactions more expensive at the beginning, but accuracy and security in property assignments is worth it. Later the whole federal system will become economically sustainable by itself.

B. The Future of the Actual Mortage Electronic Recording System

A uniform state law would allow a parcel of real estate or property to permanently migrate out of the local recording system into the new federal system. Then, why it's still necessary for MERS to continue existing[46]? MERS is a separate corporation that is acting solely as a nominee for lenders, lender's successors and assigns. When a mortgage is sold, the conveyance information is registered in MERS, but no assignment is recorded. I really need to know who I am paying my mortgage to, which company actually owns my mortgage if it has been sold in the secondary market[47], what is the name of the trust of investors that bought it, even if such a company is not to be considered a lender, and also the name of the servicer I have to pay my debt to. Even if I receive a foreclosure notice, I could not consult the county clerk office to verify who is threatening foreclosure and owns the debt of my property. Such information is only held by MERS that created a service information system, giving to the homeowner the identity of the servicer and the investor that owns the loan. This step promotes

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[46] *See* Patrick Pulatie, *Is the Current Recording Process Sufficient for Today's Complex Financial Instrument? Can MERS Resolve the Issues?*, ML-EXPLODE.COM (Nov. 2002) http://ml-explode.com/2011/11/mers-and-recording-past-present-and-future-pt-1/ (outlining other deficiencies in the public recording system).

[47] *See* Dale A. Whitman, *How Negotiability Has Fouled Up the Secondary Mortgage Market, and What to do About It*, 37 PEPP. L. REV. 737, 747–48 (2010).

transparency[48], but is not enough. We must even say that MERS is irreconcilable with mortgage law due to such a lack of transparency.[49]

The future Federal Land Title Recording System should let us avoid all the questions and problems that MERS cannot solve, mainly the transparency. If we were to have a public land title registry that does all the work that MERS does for the banking industry, why should MERS continue being an alternative land title recording system? Only for banking industry purposes and for keeping the lack of transparency that does not let us know who has bought our mortgage in the secondary mortgage market[50]. Such a dual system is not necessary, if one of them gives us all the information we need to know. What better solution than a public system with the governmental law blessings? Even, this public system would let us index land title records in different methods: (1) a track index that gives us a legal description of the relevant land, and (2) a grantor/grantee or lender/borrower system index using the names of the parties to a conveyance. MERS does not give us all the information we should have available to make a real estate transaction. It only gives us the information that MERS has recorded because of its interests, and that is not all the information necessary for a financial agreement, involving real estate. MERS is only a mortgage recording system, but not a full real estate recording system. MERS gives us the data related to a given mortgage, but there are more encumbrances besides it, e.g. servitudes, etc. There are more facts involving real estate than a simple mortgage or loan. Property is eternal and a lot of changes could happen along its long life. That is the reason why a full information system should be preferred by investors than a simple mortgage database system.

Even more, in the future it could happen that the private system involving MERS[51] will end up being at odds with this Federal Public System, and courts would have to decide which one gives the full faith or the real legal situation of a single parcel or lot. That would increase court disputes, which is not good for the judicial system. The dichotomy "public versus private recording system" is served. I surely prefer a public recording land title system, with the accuracy and wealth of information it could give us.

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[48] For transparency on MERS, you can see Whitman, *supra* note 2, at 58.

[49] Marsh, *supra* note 4, at 23.

[50] For further information on secondary mortgage market you can see David Reiss, *Reforming the Residential Mortgage-Backed Securities Market*, HAMLINE L. REV. (2012), Brooklyn Law School, Legal Studies Paper 275 (2012).

[51] Even it could have to face federal agencies as the Federal Reserve Board, *see* 12 C.F.R. § 208 (2012); the Office of Comptroller of the Currency, *see* 12 C.F.R. § 1.1; the Department of Housing and Urban Development, *see* 24 C.F.R. §§ 200.1, 300.3; the Federal Housing Finance Agency that supervises Fannie Mae, Freddie Mac and The Federal Home Loan Banks, *see* 12 C.F.R. § 1282.1; and the new Consumer Financial Protection Bureau created by the Dodd-Frank Act, Public Law 111-203, *see* 12 C.F.R. § 1282.1. Anyone of these Agencies would have disputes with MERS, when the Federal Agency was created, or any of them would assume the goal of it.

VIII. OTHER QUESTIONS RELATED TO A RECORDED MORTAGE

A. The Chain Of Title Doctrine

One of the main principles in real estate recording law is the chain of title doctrine.[52] The chain of title consists of an analysis of all legally relevant documents, transferring interests in a particular parcel of land, from the earliest to the most recent. Basically, it means that the successive deeds concerning a piece of land must be recorded, so that we can have the chronological background of every parcel or lot. Also, you cannot record any deed regardless of the last recorded deed, with the last recorded owner or holder of the note, and description of the property. Therefore, you will have recorded all the background history of any property with a chronological order, so you can get any information from the registry according to the last events that happened in a real estate property. This principle will let buyers and lenders handle the last information on any parcel, so they will not be dispossessed from their notes by anyone who claims a better right, as they are the real legal last holder or owner. Therefore, anyone can sell a property, unless you have recorded your property of your ownership as the last owner or holder. Thus, anyone who wants to buy a property, will be ensured that people holding the last note and going to sell or make a mortgage trade, is the real last recorded owner or holder of a mortgage note. It could happen that the real owner or note holder, who is in legal possession of any property, is not the last recorded one. The future Federal Recording Act should have different sources to protect this legal owner, so he can record his legal possession to get the chain of title back in legal real life, according to recorded data.

These different sources to not breach the chain of title should prevent cases, such as the "wild deed doctrine."[53] According to this doctrine, a purchaser is allowed to gain the protection of the recording by acting against a prior purchaser who has recorded his own deed, but whose chain of title includes an unrecorded deed. In this case, the holder of a wild deed will prevail in a title dispute. Also the "mother-hubbard problem,"[54] a clause also known as a general assignment, conveys all the grantor's property in a given area, without identifying which parcels it conveys or where the parcels are located. This clause does not identify the property's location, so there is no way for a county records' office to

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[52] The legal relevance of a document depends on whether it could be located in a conventional search of the public records, *see* LECFOE, *supra* note 16 at 243.

[53] *See* Emily Parker-Pacht, *supra* note 5. *See also* Board of Education of Minneapolis v. Hughes, 136 N.W. 1095 (Minn. 1912), Morse v. Curtis, 2 N.E. 929, 931 (Mass. 1885) and Anthony J. Fejfar, *The Wild Deed and Real Property Law* (2007) *available in* http://www.scribd.com/doc/210501/The-Wild-Deed-and-Real-property-Law.

[54] Luthi v. Evans, 576 P.2d 1064 (Kan. 1978).

index the deed properly. The recorded land federal system would let the purchaser know what property the deed conveyed, without examining every deed to and from its grantor. The purchaser would need to go through numerous books (which are in chronological order, so one volume does not contain all the records pertaining to a particular grantor). That problem would be solved with a Federal Recording System with scanned digitalized documents in a database, making the purchase search easier and faster, using new ICT technologies.

Finally, another theory concerning the breach of chain of title should be "The Spring Lakes v. O.F.M. Co. Rule."[55] This states that a subsequent purchaser is not on constructive notice of restrictions not contained within the subsequent purchaser's own chain of title, but instead contained within the deed to an adjacent lot conveyed by a common grantor. Such restrictions did not impart constructive notice even through the subsequent purchaser's deed referenced restrictions.

B. Denying a Recording Act

Denying a registration should be a restrictive act that should happen in a few cases, if the deed was correctly done and the chain of title has been respected. Before denying a recording act, the deed should be able to be corrected or amended if possible. For that process, the registry office must give everyone the opportunity to make all the amendments to a deed, giving a reasonable period of time to make a corrective deed[56]. In many cases it should just be a simple correction, but in many other cases the process for changing a deed requires more time and more arrangements, because you have to take notice to all parties again, draft a new agreement text, and maybe send the corrective deed to a public notary again. This means more money to pay, more time to get collateral, and a plenty of subjects to get? That is sometimes not easy as we desire. The denying act attempts to gain the accuracy in recording acts and the security in real estate transactions. Public officials do not deny a recording act easily, because it must be the result of a qualified procedure after examining the whole deed or note, and taking notice of all the legal requirements.

The same agreement will have to get to the registry twice and it is not worth doing the same job twice. Thus, denying a recording act is a complicated solution and must be taken unless there is a big error or fault in the proposed recording act. If you cannot agree with the registry denying act, you should be able to sue at local or state courts to get a judicial statement, to gain the recording

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[55] Spring Lakes Ltd. v. O.F.M. Co., 467 N.E.2d 537, 540 (Ohio 1984) ("[I]n order for a purchaser of real property to be charged with constructive notice of an encumbrance contained in a prior recorded instrument, the prior instrument must be recorded in the purchaser's chain of title.").

[56] *See* LACFOE, *supra* note 16, at 358. *See also* Kalmanson and Morris, *supra* note 41.

warrant or decree. This procedure should be legally fixed or regulated in the future Federal Land Title Recording Act or in a Denying Procedure Act.

C. The Release of Encumbrances and Resume of Chain of Title's Breach

One important question to be regulated is the release of any burden, liens or encumbrances recorded in the public registry. This action should not be easy to handle, neither impossible to achieve. Any encumbrance or burdens recorded have a target, mainly to get a kind of lien over a real estate property. Anyone who obtains information from a registry can know all the encumbrances upon a parcel of land, and the legal holder or owner could begin a judicial action to protect his rights. This is true, unless the final term is gone. If the period for a legal encumbrance has reached its end, it should be easier to delete such a data from the recording books. For example, a kind of servitude over a land for the crossing of people or animals should have a final term, and once this term is over, it should be easier to remove such an encumbrance from the recording books. Then, the registry should be able to certify that the property is "free of burden." Otherwise, in a mortgage, once all the debt has been repaid to the bank by the borrower, an additional act (a deed of cancelation of the loan) should be needed to facilitate the cancellation of a burden from the registry. There an additional requirement: a formal deed or note with the agreement of the grantor/grantee, that the entire amount of principal and interest is paid, and therefore, the mortgage note could be canceled from the public registry. This recording act should let such a recorded real estate appear to the public as "free of any burden."

Therefore, depending of the kind of encumbrance, it should be easier or more difficult to release the recorded burden from registry. But what must appear to be easier to handle, is the resume of chain of title's breach. It is a goal of any public registry to respect the chain of title doctrine, so purchasers are on constructive notice of recordation pertaining to the property they wish to purchase and regardless of whether a recordation is recorded late or out of order. In addition, purchasers of lots in a subdivision are on constructive notice of restrictions contained in the deeds to adjacent lots, as well as other lots in the same subdivision. That's why a subsequent purchaser must be a *bona fide* purchaser who records after a prior purchaser, because if he (*i.e.* subsequent purchaser) records before this last one purchaser (*i.e.* the prior one), we should be in front of a race-notice, rather than a notice.[57]

[57] The distinction is clear: In a *race* all conveyances of real property are void, except between the parties to the conveyance, but form the time of recordation, regardless of when the conveyance was executed, sealed or delivered. In a *notice*, no conveyance of real property shall be valid against subsequent purchasers without notice, unless the conveyance is recorded. In a *race-notice*, every conveyance of real property which is not recorded is void as against any subsequent purchaser, in

IX. CONCLUSION

After having discussed all the above subjects, we must conclude that a new regulation for American Land title recording system is urgently needed. Such a regulation must be enforced by Congress, rather than States or local authorities, if we really want to achieve a nationwide act that brings us homogeneously to the land recording system all over the U.S. We must quit the idea of each State regulating its particular recording system of real estate. That is not a fine solution for real estate problems. We are in the 21st century and new ICT technologies can provide us all the skills to leave the ancient books system based on manuscript data. New database systems and internet programs should let us share all the information related to every parcel of land or lot, wherever you and the land are located. The information should be available all the time and to all peoples, should need to make a real estate transaction, finance operation or trade anytime, anywhere with anyone.

New communication technologies should let us to get such information, and that new system should provide all the accuracy and safety in the land, trade deeds and agreements, to all parties involved. Collateral is the correct word and the target to achieve in real estate transactions. It should even be good evidence in courts, based on public registry data. It would make full faith of the recorded land information according to real life, and the facts involving the data should be in a full coincidence or match. All real estate operators will be grateful and thankful for such a new recording system. It would allow them faster transactions by obtaining all the information of the proposed trade or agreement, nevertheless that we are making a common selling, a loan note with a formal mortgage, or a simple conveyance or burden with a lien.

This new U.S. Land Recording System, created as a Federal Agency, would make all the trades and agreements less expensive, regardless of the payment of fees to make the future Federal Agency economically sustainable. What is going to be a problem is the training of thousands of current local and state public officials in county clerk or municipalities' offices, to provide them the land law knowledge needed to handle all such land information. This should be a progressive process to educate them in land regulations and in technical database tools to be able to scan and make PDF files of submitted recording proposed deeds or mortgages notes. Such a goal should be achieved during several years, even renewing the older officials after their retirement, and electing new officials to be well prepared in such ICT skills, land title acts and regulations.

The challenge can be possible to achieve, but not impossible. We only need to carry on with it. We have only drafted the general outlines to achieve it. Now the governmental authorities and politicians have to make their steps to

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good faith, of the same real property, whose conveyance is first recorded. *See* LECFOE, *supra* note 16, at 262 for more examples.

create an efficient alternative to the private system MERS. It is up to them to craft a future federal recording land title system to gain the security and accuracy in all real estate transactions all over the nation. Do not miss this opportunity. Countries with modern land recording systems have gained this goal and their legal systems could be found as the best in the world, like Spain, Italy and most European Union countries have done. The U.S. deserves one, and should take the experience of European land registering systems and their mistakes and successes, to enact its own land recording law, as the newest one, should be the most perfect in the world.

ACCIÓN DE CLASE DE CONSUMIDORES DE BIENES Y SERVICIOS: ANÁLISIS DE LA JURISPRUDENCIA DEL TRIBUNAL SUPREMO DE PUERTO RICO Y LAS SENTENCIAS DE LOS TRIBUNALES ESTATALES Y FEDERALES

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I. INTRODUCCIÓN

Imagine percatarse —al cabo de tres años de recibir servicio telefónico— de que la compañía proveedora le sobrefacturó un total de $80.00 a lo largo de ese periodo de tiempo. A pesar de haber traído la anomalía a la atención de la compañía el asunto, esta se rehúsa a corregir retroactivamente las facturas, citando los términos de vencimiento para realizar una revisión administrativa. Usted contacta a un conocido que trabajó en dicha compañía, quien le dice que la compañía conoce sobre sus errores de facturación desde hace años, pero le aconseja que se olvide de eso. Este le recuerda que aún cuando podría reclamar la facturación inapropiada judicialmente, usted tendrá que contratar representación legal, a lo que se añade el costo de presentación del pleito, reproducción,

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búsqueda y recopilación de información, los gastos de expertos, entre otras costas. Un sencillo cálculo aritmético arrojará que para obtener sus $80.00, tendrá que invertir una cantidad excesiva y desproporcional, por lo que ignora la posibilidad del pleito. La compañía, por su parte, continúa con su patrón de sobrefacturación. Pero, ¿si en lugar de ser usted solamente quien reclama sus $80.00, hubiese 15,000 otras personas a quienes la misma compañía ha sobrefacturado? En ese caso, se podría distribuir entre 15,001 personas el costo del peritaje, presentación del pleito, representación legal, entre otros. Además, los costos de representación legal podrían ser asignados, por operación de ley, a su compañía de servicios de telefonía, de resultar perdidosa. Este segundo escenario es mucho más atractivo que el primero, y es una opción que vale la pena considerar.

Esto justamente es lo que ofrece la Ley Núm. 118 de 25 de junio de 1971[1] (en adelante, "Ley 118"): la posibilidad de instar una acción de clase en beneficio de consumidores. Este escrito pretende explorar el contenido de la Ley 118, los enmiendas que ha sufrido tan recientemente como en el 2013, la jurisprudencia interpretativa del Tribunal Supremo de Puerto Rico, así como analizar las posibilidades y visiones que nos ofrecen las sentencias de los tribunales estatales y federales respecto a dicha ley. Asimismo, se pretende estudiar y analizar la jurisprudencia del Tribunal Supremo de los Estados Unidos respecto al acuerdo de cláusulas de arbitraje y renuncia a la presentación de pleitos y arbitrajes de clase, y las implicaciones que ello tiene sobre el desarrollo de los pleitos de clase en Puerto Rico, específicamente sobre las acciones de clase en beneficio de los consumidores.

II. ASPECTOS GENERALES DEL PLEITO DE CLASE

Nuestro ordenamiento procesal civil ofrece varios mecanismos mediante los cuales partes pueden acumularse para reclamar bajo un mismo pleito reclamaciones comunes. Ello propende al descongestionamiento judicial, así como a lograr la agilidad, la justicia y la economía procesal que sirven como zapata a todo el ordenamiento procesal civil.[2] Ejemplo de ello son las Reglas 16 y 17, cuales permiten la acumulación de partes dentro de un pleito. Estas "van dirigidas a asegurar que las partes que reclamen sean las que poseen el derecho reclamado".[3] Vemos, pues, que la Regla 16.1, relativa a la acumulación obligatoria de partes, exige que aquellas personas que se encuentran "tan directamente relacionadas con la causa de acción tienen que ser incorporadas al proceso so pena de desestimación".[4] Esta regla está alineada al precepto constitucional de que

[1] 32 LPRA §§ 3341–3344 (2014).
[2] R.P. Civ. 1, 32 LPRA Ap. V, R. 1 (2014); JAVIER ECHEVARRÍA VARGAS, PROCEDIMIENTO CIVIL PUERTORRIQUEÑO 139 (1era ed. rev. 2012).
[3] ECHEVARRÍA VARGAS, *supra* nota 2, en la pág. 139.
[4] *Id.*

ninguna persona debe ser privada de su propiedad sin el debido proceso de Ley.[5] Asimismo, "[l]a obligatoria acumulación de partes sirve el propósito de evitar que personas puedan ser declaradas responsables estando en ausencia del pleito . . . [y] evita que se pueda llegar a un dictamen que no tenga la consecuencia de proveer un remedio completo".[6]

A su vez, la Regla 17.1 permite la acumulación permisible de partes en un pleito, sea como demandantes o demandados:

> [S]i reclamaren o se reclamare contra ellas mancomunada, solidariamente, o en la alternativa cualquier derecho a un remedio relacionado con, o que surja de la misma transacción, evento, o serie de transacciones o eventos siempre que cualquier cuestión de hecho o de derecho, común a todas, hubiere de surgir en el pleito. No será requisito que un demandante o demandado tenga interés en obtener o defenderse de todo el remedio solicitado.[7]

Sin embargo, en ocasiones, las reglas antes mencionadas resultan insuficientes para ~~al~~ la adecuada tramitación de un pleito, particularmente cuando el número de partes involucradas, ya sea en calidad de demandantes o demandados, es muy numeroso para acumularlas en el pleito.[8] Para ello, nuestras Reglas de Procedimiento Civil proveen la herramienta del pleito de clase en la Regla 20.[9] Nuestro Tribunal Supremo define el pleito de clase como "una forma especial de litigación representativa que permite a una persona o grupo de personas demandar a nombre propio y en representación de otras personas que se encuentran en una situación similar a la suya pero no se encuentran ante el Tribunal".[10] Así pues, la Regla 20, "impostada entre lo sustantivo y lo procesal . . . viabiliza reivindicaciones que de otra forma y por consideraciones prácticas no serían viables".[11] Asimismo, esta regla:

> [A]mplía dramáticamente el ámbito de la legitimación, restringido por el principio de que todo pleito se presentará por aquellos directamente interesados, al permitir que un pequeño número de los interesados represente al colectivo con todas las consecuencias jurídico-procesales

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[5] *Id.* (citando Municipio de S. Juan v. Bosque Real, 158 DPR 743, 756 (2003) (citando CONST. P.R. art. II, § 7)).
[6] *Id.*
[7] *Id.* en la pág. 142 (citando R.P. Civ. 17.1, 32 LPRA Ap. V, R. 17.1; Meléndez v. Levitt & Sons of P.R., Inc., 106 DPR 437, 439 (1977)).
[8] *Id.* en la pág. 146.
[9] 32 LPRA Ap. V, R. 20.
[10] Guzmán Matías v. Vaquería Tres Monjitas, Inc., 169 DPR 705, 714 (2006) (citando Cuadrado Carrión v. Romero Barceló, 120 DPR 434, 445–46 (1988)).
[11] RAFAEL HERNÁNDEZ COLÓN, PRÁCTICA JURÍDICA DE PUERTO RICO: DERECHO PROCESAL CIVIL § 1005 (5ta ed. 2010).

> incluyendo las de la cosa juzgada para cada uno de los integrantes del colectivo.
>
> [M]ás que un tema de acumulación de lo que se trata es de legitimar a los comparecientes para representar a la clase a través del cumplimiento de los requisitos de la Regla 20: numerosidad, comunidad, tipicidad, adecuada representación, etc., de modo que la relación jurídico-procesal se establezca en torno a la clase como tal con todas las consecuencias para los integrantes de la misma como si estuvieran compareciendo individual y personalmente al litigio.[12]

Nuestro Tribunal Supremo tuvo, además, ocasión de enumerar los beneficios que presenta el pleito de clase. Este:

> (1) [F]omenta la economía judicial en la medida que disminuye el número de casos que deben resolver los tribunales al permitirles adjudicar de una vez todas las cuestiones comunes a varios litigios. Además, evita la posibilidad de reclamaciones múltiples y repetitivas; (2) permite hacer justicia a personas que de otra manera no la obtendrían, especialmente cuando las sumas individuales en controversia no son cuantiosas y, por lo tanto, las personas agraviadas no se sienten motivadas a litigar, y (3) protege a las partes de sentencias inconsistentes.[13]

Ahora bien, al observar detenidamente la Regla 20, se nota que se bifurca conforme al desarrollo del pleito. Las Reglas 20.1 y 20.2 establecen los requisitos necesarios para que un pleito de clase pueda sobrevivir el proceso de certificación. La Regla 20.1 establece los requisitos indispensables del pleito de clase, es decir, presenta un listado de cuatro (4) requisitos sin los cuales, no puede certificarse un pleito como uno de clase. Ello debido a lo siguiente:

> [Q]uienes representan la clase tienen la gran responsabilidad de defender los intereses de aquellos miembros de la clase que no estén presentes, y para los cuales la sentencia que recaiga en su día será vinculante, claro está, salvo para el que opte por excluirse del pleito cuando ello es factible.[14]

Estos cuatro (4) requisitos son:

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[12] *Id.* (citas omitidas).
[13] HERNÁNDEZ COLÓN, *supra* nota 11, § 1005 (citando *Cuadrado Carrión*, 120 DPR en la pág. 446); ECHEVARRÍA VARGAS, *supra* nota 2, en la pág. 147.
[14] Matías Lebrón v. Depto. de Educación, 172 DPR 859, 873 (2007).

> (1) que la clase sea tan numerosa que la acumulación de todos los miembros resulte impracticable, es decir, *numerosidad*; (2) que existan cuestiones de hecho o de derecho comunes a la clase, o sea, *comunidad*; (3) que las reclamaciones de los representantes sean típicas de las reclamaciones de la clase, o sea, *tipicidad*, y (4) que los representantes protejan los intereses de la clase de manera justa y adecuada.[15]

Respecto al primer criterio, *numerosidad*, el Tribunal Supremo expresó que aun cuando la regla no ofrece un número particular "[e]xiste consenso en que el número de personas que pueden componer una clase no es decisivo en la determinación de 'impracticabilidad'; se trata de una cuestión por resolver caso a caso según las circunstancias . . .".[16] Asimismo, el Tribunal expresó que la impracticabilidad no es sinónimo de imposibilidad.[17] Basta con demostrar "que tal proceder le crearía serios inconvenientes y obstáculos en la tramitación del caso"[18]. Teniendo lo anterior presente, el Tribunal Supremo ofreció el siguiente listado —no exhaustivo— para guiar la consideración de certificar un pleito como uno de clase:

> Además del factor numérico, existen otros factores que ayudan al análisis, a saber, la dispersión geográfica . . . la posibilidad de que los miembros de la clase puedan ser identificados para propósitos de la acumulación . . . la naturaleza del pleito . . . la cuantía de la reclamación . . . y la habilidad de cada miembro para hacer valer sus derechos de forma individual . . . .[19]

Es meritorio destacar el siguiente aspecto sobre el elemento de la numerosidad:

> [N]o puede descansar en la mera especulación y el peso de la prueba recae sobre el promotor de la certificación, la parte demandante no tiene que alegar ni probar el número exacto de miembros de la clase. Es

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[15] *Guzmán Matías*, 169 DPR en ~~*supra*~~ la pág. 724; Arce Bucetta v. Motorola, 173 DPR 516, 531 (2008); García Rubiera v. Asociación, 165 DPR 311, 318 (2005); ECHEVARRÍA VARGAS, *supra* nota 2, en la pág. 147 (citando *Cuadrado Carrión*, 120 DPR en la pág. 458; R.P. Civ. 20.1, 32 LPRA Ap. V, R. 20.1). *Véase además* HERNÁNDEZ COLÓN, *supra* nota 11, § 1007a; JOSÉ A. CUEVAS SEGARRA, TRATADO DE DERECHO PROCESAL CIVIL 739 (2da ed. 2011).

[16] *Guzmán Matías*, 169 DPR en la pág. 728 (citando *Cuadrado Carrión*, 120 DPR en la pág. 449 (citando R.P. Civ. 20.1, 32 LPRA Ap. V, R. 20.1)).

[17] *Id.* en las págs. 728–29 (citas omitidas). *Véase además* ECHEVARRÍA VARGAS, *supra* nota 2, en las págs. 147–48; HERNÁNDEZ COLÓN, *supra* nota 11, § 1007a.

[18] *Guzmán Matías*, 169 DPR en la pág. 729 (citas omitidas). *Véase además* ECHEVARRÍA VARGAS, *supra* nota 2, en la pág. 147; HERNÁNDEZ COLÓN, *supra* nota 11, § 1007a; Liana Fiol Matta, *La Acción de Clase del Consumidor*, 36 REV. COL. ABG. PR 683, 697–98 (1976).

[19] *Cuadrado Carrión*, 120 DPR en la pág. 450. *Véase además* ECHEVARRÍA VARGAS, *supra* nota 2, en la pág. 147; HERNÁNDEZ COLÓN, *supra* nota 11, § 1007a.

> suficiente con presentar alguna prueba o estimado razonable del número potencial de individuos representados.[20]

El siguiente aspecto a considerar es la *comunidad*. Este requisito exige que "exista una cuestión de hecho o de derecho común a la clase"[21] mas, sin embargo, tal cuestión común no tiene que surgir del "mismo acto, omisión o evento".[22] A tal aseveración, Cuevas Segarra añade que "[p]otenciales reconvenciones no derrotan la certificación de la clase".[23] Esta determinación es de carácter cualitativo, no cuantitativo.[24] Además, "se requiere tan sólo que lo reclamado requiera resolver una cuestión de hecho o de derecho común a los representados".[25] "[L]a existencia de particularidades —sobre todo en relación con las defensas que son oponibles a cada miembro— no derrota el cumplimiento de este requisito".[26]

El requisito de *tipicidad*, por su parte, "atiende a la cuestión de si existe una relación entre las reclamaciones de los demandantes y las de la clase que se intenta representar".[27] "[E]ste requisito también está relacionado con el hecho de que quienes representan a la clase deben defender adecuadamente los intereses de sus miembros".[28] Hernández Colón expresa respecto a este particular que "[d]onde hay tipicidad tiene que haber comunidad, pero donde hay comunidad no tiene que haber tipicidad porque los representantes pueden tener acciones comunes en un aspecto pero atípicas en otros".[29]

Finalmente, la Regla 20.1 requiere que la clase goce de una *adecuada representación*. Ello busca proveer la protección de un debido proceso de ley tanto a los miembros presentes como los ausentes al momento de tramitar el pleito de clase.[30] El Tribunal expresa lo siguiente respecto a este particular:

> Sólo la adecuada representación de los intereses de los miembros ausentes evita que la acción de clase sea inconstitucional al asegurar que se cumpla con el debido proceso de ley. Sin duda, ante el principio

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[20] *Cuadrado Carrión*, 120 DPR en la pág. 450. *Véase además* García Rubiera v. Asociación, 165 DPR 311, 319 (2005); CUEVAS SEGARRA, *supra* nota 15, en la pág. 742.

[21] *Cuadrado Carrión*, 120 DPR en la pág. 451 (citas omitidas). *Véase además* ECHEVARRÍA VARGAS, *supra* nota 2, en la pág. 148; HERNÁNDEZ COLÓN, *supra* nota 11, § 1007a.

[22] *Cuadrado Carrión*, 120 DPR en pág. 451; CUEVAS SEGARRA, *supra* nota 15, en la pág. 747.

[23] CUEVAS SEGARRA, *supra* nota 15, en la pág. 743 (citando Davis v. Cash for Payday, Inc., 193 F.R.D. 518, 521–22 (2000)).

[24] *Guzmán Matías*, 169 DPR en la pág. 726 (citando *Cuadrado Carrión*, 120 DPR en la pág. 451).

[25] *Id.*

[26] *Cuadrado Carrión*, 120 DPR en la pág. 451 (citas omitidas). *Véase además* HERNÁNDEZ COLÓN, *supra* nota 11, § 1007a.

[27] *Cuadrado Carrión*, 120 DPR en la pág. 453.

[28] *Guzmán Matías*, 169 DPR en la pág. 732.

[29] HERNÁNDEZ COLÓN, *supra* nota 11, § 1007a (citando Matías Lebrón v. Dpto. de Educ., 172 DPR 859 (2007)).

[30] *Id.* (citando *Cuadrado Carrión*, 120 DPR en la pág. 455–56). *Véase además* CONST. P.R. art. II, § 7.

> sacramental que exige que toda persona cuyos derechos estén en controversia tengan su "día en corte", y que nadie pueda ser afectado por una sentencia *in personam* en un procedimiento en el cual no ha sido parte . . . acción de clase constituye, desde el punto de vista conceptual, una anomalía.[31]

El análisis predominante en la actualidad respecto a la adecuada representación se basa en dos postulados principales, a saber: "(1) la ausencia de conflicto, y (2) las garantías de litigación agresiva y vigorosa".[32] Respecto a ello el Tribunal Supremo se expresó como sigue:

> [E]l requisito de una representación adecuada está ligado íntimamente al de tipicidad, ya que sólo se asegura una representación adecuada cuando ambos, la clase y el representante, tienen un fin común. Así, no deben existir conflictos sustanciales entre los intereses del representante y el de los miembros ausentes que impidan que el representante asegure una litigación agresiva y vigorosa a favor de los miembros de la clase. Ello incluye la contratación de un representante legal competente.[33]

A esto, el Tribunal añade lo siguiente:

> Cuando las reclamaciones o defensas de los representantes no son típicas de las reclamaciones o defensas de la clase, existe un problema inherente de conflicto, ya que no se cumple con el requisito mínimo de adversariedad que caracteriza nuestro derecho adjudicativo. Es decir, no hay garantía de que los intereses de los ausentes se verán en controversia. Ausente el requisito de tipicidad, no hay adecuada representación de una clase y, por lo tanto, no hay garantía de cumplimiento con el debido proceso de ley. Formulada la cuestión en términos positivos, satisfecho éste se aminoran los peligros que en estos casos confronta el debido proceso.
>
> Cuando no existe el peligro mencionado, el análisis de tramitación vigorosa enfatiza las características del abogado de los representantes de la clase.
>
> En cuanto a la competencia de la representación legal de la parte demandante, tradicionalmente se han tomado en cuenta, entre otros factores, la experiencia del abogado en ese tipo de casos y la calidad de los escritos y argumentos presentados en las etapas iniciales del caso, si el abogado ha mostrado puntualidad, capacidad y diligencia en el trámite

[31] *Cuadrado Carrión*, 120 DPR en las págs. 454–55 (cita omitida).
[32] *Id.* en la pág. 455.
[33] *Matías Lebrón*, 172 DPR en la pág. 873.

> judicial que abarca desde la presentación de la demanda —o su rápida contestación— el uso de los mecanismos de descubrimiento de prueba y el cumplimiento con las órdenes del tribunal, etc. A falta de prueba específica de lo contrario, la competencia del abogado se presume.
>
> Dada la naturaleza del pleito de clase, el foro primario debe asegurarse de que la representación legal reúna los requisitos de calidad, objetividad y carácter requeridos para proteger adecuadamente los intereses de la clase. En este tipo de litigios los tribunales deben estar particularmente atentos a cualquier posibilidad de conflicto ético, a saber, si la representación de un cliente en un asunto puede afectar el interés de otro cliente anterior, si el abogado al aceptar una representación legal adelanta sus propios intereses como miembro de la clase o si, en el mismo plano ético, la tramitación del pleito de clase no persigue otro propósito que el proporcionar al abogado un aumento en sus honorarios.
>
> Cuando ocurren conflictos irreconciliables entre la representación legal y la clase, las reglas ofrecen varios recursos procesales: subclasificación, intervención, redefinición o limitación de la clase, etc. En especial, el enfoque sobre la subclasificación requiere que los tribunales participen activamente en la supervisión de los pleitos de clase. Estos deben ir más allá de meramente responder a las subclasificaciones propuestas por los demandantes; deben también tomar la iniciativa y elaborar las subclases adecuadas. Los abogados de los demandantes a veces no tienen incentivo para proponer la certificación de subclases. Una división de la clase usualmente implica una división del control sobre el litigio y una división de los honorarios de abogado. Además, el abogado de los demandantes puede simplemente no tomar en consideración la posibilidad de presentar un esquema de subclasificación. En tal circunstancia, el tribunal puede adelantarse y definir las subclases.[34]

Cumplir con los (4) requisitos antes mencionados es indispensable para que e pleito se clasifique como uno de clase, mas no es suficiente. Nuestro Tribunal Supremo estableció que "no basta con el cumplimiento de los cuatro requisitos de la Regla 20.1 de Procedimiento Civil . . . sino que, *además*, es necesario que se satisfaga, *al menos*, uno de los requisitos adicionales establecidos por la Regla 20.2 . . . ".[35] Estos requisitos pueden resumirse de la siguiente manera:

> (1) la tramitación individual de los pleitos crearía un riesgo de adjudicaciones inconsistentes o variadas con respecto a miembros

[34] *Cuadrado Carrión*, 120 DPR en las págs. 455–57 (citas omitidas).
[35] *García Rubiera*, 165 DPR en la pág. 318.

> individuales; o, que sea susceptible de adjudicaciones que puedan representar cosa juzgada o empeorarían los intereses de los miembros individuales que no sean parte de la acción judicial;
>
> (2) resulte apropiado conceder un remedio interdictal o sentencia declaratoria en contra de una parte que ha rehusado actuar por razones aplicables a la Clase en general; o,
>
> (3) el tribunal determina que el Pleito de Clase es el mejor mecanismo para la más justa y eficiente adjudicación de la controversia.[36]

La Regla 20.3 establece el modo como se tramitará un pleito de clase:

> (a) Tan pronto como sea factible, luego del comienzo de un pleito traído como pleito de clase, el tribunal, previa celebración de vista, determinará si se mantendrá como tal. La resolución bajo este inciso podrá ser condicional y podrá ser alterada o enmendada antes de la decisión en los méritos.
>
> (b) En cualquier pleito de clase mantenido bajo la Regla 20.2(c) de este apéndice, el tribunal dirigirá a los y las miembros de la clase la mejor notificación posible dentro de las circunstancias, incluyendo la notificación individual a todos(as) los(las) miembros que puedan ser identificados(as) mediante esfuerzo razonable, excepto cuando por ser tan oneroso dificulte la tramitación del pleito en cuyo caso el tribunal dispondrá la forma de hacer tal notificación. La notificación avisará a cada miembro que:
>
> > (1) El tribunal lo excluirá de la clase en una fecha específica si él o ella así lo solicita;
> >
> > (2) la sentencia, sea favorable o no, incluirá a todos(as) los(las) miembros que no soliciten la exclusión, y
> >
> > (3) cualquier miembro que no solicite la exclusión podrá, si así lo desea, comparecer a través de su abogado o abogada.
>
> (c) La sentencia en un pleito tramitado como pleito de clase bajo el inciso (a) o (b) de la Regla 20.2 de este apéndice, sea o no favorable a la clase, incluirá y describirá a aquellos(as) a quienes el tribunal determine

[36] ECHEVARRÍA VARGAS, *supra* nota 2, en la pág. 149 (citando R.P. CIV. 20.2, 32 LPRA Ap. V, R. 20.2).

> que son miembros de la clase. La sentencia en un pleito tramitado como pleito de clase bajo la Regla 20.2(c) de este apéndice, sea o no favorable a la clase, incluirá y especificará o describirá a aquellos(as) a quienes fue dirigida la notificación dispuesta en la Regla 20.3(b) de este apéndice, que no han solicitado la exclusión, y quienes el tribunal determine que son miembros de la clase.
>
> (d) Cuando sea apropiado, un pleito podrá ser presentado o tramitado como pleito de clase con respecto a cuestiones específicas, o una clase podrá ser dividida en subclases y cada subclase tratada como una clase, y las disposiciones de esta regla serán entonces interpretadas y aplicadas de conformidad.[37]

Respecto a este inciso, es menester señalar varios asuntos. La *notificación* debe efectuarse de la mejor manera posible. Ello permite que si se identifican los miembros de la clase, puedan notificarse individualmente, pero si dicha identificación no es posible, entonces podría recurrirse a otros métodos de notificación, como por ejemplo, los edictos.[38] Le corresponde a la parte promovente afrontar los costos de la notificación.[39] El aviso contenido en esa notificación debe "ser neutral y objetivo . . . recitar de manera imparcial la materia de la demanda, informar a los miembros que sus derechos son objeto de litigación, alertarlos sobre los pasos apropiados para que sus intereses están protegidos"[40]. Asimismo, la jurisprudencia federal ha determinado que la notificación y los costos relacionados a ella deben ser afrontados por la parte promovente, aclarando que el hecho de que los mismos resultasen altos no era eximente de este requisito.[41] Respecto a este particular, Fiol Matta nos ilustra —interpretando lo expresado por el Tribunal de Apelaciones de los Estados Unidos en el caso anterior— que la falta de compensación monetaria no constituye una falta de beneficio sustancial, sino que, el castigo que se le impone al que viole la ley poder ser considerado un beneficio sustancial.[42] Posteriormente, el mismo Tribunal Supremo de los Estados Unidos concedió cierta y limitada flexibilidad a la facultad de los tribunales de menor jerarquía para adjudicar los costos de la notificación.[43]

Asimismo, respecto al contenido de la notificación, vimos que la regla no es muy abarcadora respecto a ese particular. Hernández Colón sugiere —a

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[37] R.P. CIV. 20.3, 32 LPRA Ap. V, R. 20.3.
[38] HERNÁNDEZ COLÓN, *supra* nota 11, §1009 (citas omitidas).
[39] *Id.* (citando Eisen v. Carlisle & Jacquelin, 417 U.S. 156 (1974)).
[40] CUEVAS SEGARRA, *supra* nota 15, en la pág. 761 (citando Macarz v. Transworlds Systems, Inc., 201 F.R.D. 54, 57 (2001)).
[41] *Eisen*, 417 U.S. en las págs. 171–72.
[42] Fiol Matta, *supra* nota 18, en la pág. 699.
[43] CUEVAS SEGARRA, *supra* nota 15, en la pág. 761 (citando Oppenheimer Fund Inc. v. Sanders, 437 U.S. 340, 350, 359 (1978)).

nuestro entender, acertadamente— que además de lo requerido por la regla, la notificación contenga un "estimado de las cantidades que se pretenden recuperar . . . los costos que implica el litigo, . . . la forma en que puede solicitar la exclusión para que no le afecte"[44].

Respecto a la tramitación del Pleito de Clase, la Regla 20.4 reza como sigue:

> En la tramitación de pleitos a los cuales aplica esta regla, el tribunal podrá dictar órdenes apropiadas para:
>
> (a) Determinar el curso de los procedimientos o adoptar medidas para evitar la repetición o complicación indebida en la presentación de evidencia o argumentación;
>
> (b) exigir, para la protección de los y las miembros de la clase o para la justa tramitación del pleito, que se notifique a algunos(as) o a todos(as) los(las) miembros de la clase, en la forma que el tribunal ordene, de cualquier actuación en el pleito, o del propuesto alcance de la sentencia o de la oportunidad de los y las miembros para indicar si consideran la representación justa y adecuada para intervenir y presentar reclamaciones o defensas, o para unirse al pleito en cualquier otra forma;
>
> (c) imponer condiciones a los(las) representantes o interventores(as);
>
> (d) requerir que las alegaciones sean enmendadas con el propósito de eliminar aseveraciones en cuanto a la representación de personas ausentes, y que el pleito prosiga de conformidad;
>
> (e) dictar reglas especiales para el procedimiento y los términos a seguir para el descubrimiento de prueba, o
>
> (f) resolver asuntos similares de procedimiento.
>
> Las órdenes podrán ser combinadas con una orden bajo la Regla 37 de este apéndice y podrán ser modificadas o enmendadas de tiempo en tiempo, según sea conveniente.[45]

Como podemos apreciar "[l]os principios esbozados en esta Regla tienen el objetivo de atender cada Pleito de Clase según sus propias características para

[44] HERNÁNDEZ COLÓN, *supra* nota 11, §1009.
[45] REG. PROC. CIV., 32 LPRA Ap. V, R. 20.4.

disponer las órdenes que sean necesarias para lograr la solución justa, rápida y económica de la controversia".[46] Asimismo, debemos considerar al momento de utilizar esta regla, lo contenido en las Reglas para Casos Civiles de Litigación Compleja.[47]

Respecto a la desestimación o transacción del pleito, una vez certificado el pleito como uno de Clase, necesitará la autorización del tribunal para cualquiera de las antes mencionadas acciones.[48] La regla no impone ni establece criterios al tribunal para aprobar una transacción, sino que se limita a disponer que puede aprobar o rechazar el acuerdo.[49] De hecho "no alcanza a imponer un acuerdo que las partes no consienten".[50] "Si el tribunal se convence de que el desistimiento o la transacción es producto de una colusión entre las partes, no permitirá la transacción o desistimiento si hay objeción de otras partes interesadas".[51] Cabe destacar que, ante la posibilidad de una transacción o desistimiento, "[a]ntes de que el tribunal preste su consentimiento, los miembros de la clase deben ser adecuadamente notificados del propuesto desistimiento o transacción. La adecuacidad de esta notificación requiere que esos miembros obtengan información sobre la naturaleza del acto de desistimiento o transacción[,] así como de sus consecuencias".[52] El Tribunal evaluará la propuesta a la luz de los mejores intereses de la clase.[53]

Por último, es meritorio señalar que al momento de presentar la solicitud de certificación de un pleito como uno de Clase, los términos prescriptivos se detienen en tanto se decida la petición,[54] en beneficio de todos los miembros o posibles miembros de la clase.[55] Si se denegare la petición, el término prescriptivo comenzará a correr nuevamente, desde la fecha de la denegatoria de la certificación.[56]

III. ASPECTOS GENERALES DE LA ACCIÓN DE CLASE DE CONSUMIDORES

La Acción de Clase de Consumidores de Bienes y Servicios[57] provista por ley surge como respuesta a la necesidad de proteger e incentivar a los

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[46] ECHEVARRÍA VARGAS, *supra* nota 2, en la pág. 140.
[47] Reglas para Casos Civiles de Litigación Compleja, 4 LPRA Ap. XVII.
[48] ECHEVARRÍA VARGAS, *supra* nota 2, en la pág. 140 (citando R.P. CIV. 20.5, 32 LPRA Ap. V, R. 20.5).
[49] CUEVAS SEGARRA, *supra* nota 15, en la pág. 775 (citando Evans v. Jeff D., 475 U.S. 717, 726 (1988)).
[50] *Id.*
[51] *Id.* en la pág. 776.
[52] ECHEVARRÍA VARGAS, *supra* nota 2, en las págs. 140–41.
[53] HERNÁNDEZ COLÓN, *supra* nota 11, §1010a.
[54] Arce Bucetta v. Motorola, 173 DPR 516, 543–44 (2008) (citando González Natal v. Merck, 166 DPR 659, 683–84 (2006)).
[55] *Id.* en la pág. 544.
[56] *Id.* (citando *Rivera Castillo v. Mun. de San Juan, 130 DPR 683 (1992)).*
[57] Ley Núm. 118 de 25 de junio de 1975, 32 LPRA §§ 3341–3344 (2014) (en adelante, Ley 118).

consumidores a presentar acciones de clase frente a las deficiencias que tenía la antigua Regla 20 de Procedimiento Civil.[58] La clase denominada como *espuria* — no tan robusta como en la actualidad— no ofrecía en aquel entonces las ventajas y protecciones disponibles para otros tipos de pleitos de clase. Ello teniendo en consideración lo siguiente:

> La mayoría de los casos que conciernen al consumidor y que son significativos en términos sociales se refieren a personas que por la poca cantidad envuelta, por los altos costos del litigio, por ignorancia de sus derechos o por otras consideraciones, no acudirán al tribunal individualmente. Sin embargo, nuestro Tribunal Supremo . . . exige su presencia como partes si han de obtener algún beneficio.[59]

Con lo anterior, se le otorga "a los consumidores un instrumento amplio y efectivo para proteger sus derechos; aunque similar a la Regla 20, permite conceder unos derechos adicionales, entre éstos, el interdicto, y le reconoce el derecho a los consumidores de entablar una acción bajo la Ley de Monopolios".[60] Como expresa Hernández Colón "se viabiliza de esta manera la implantación judicial de la política pública para proteger los derechos, bien de los consumidores, o bien de los grupos cuyos derechos civiles han sido violados . . .".[61] Así las cosas, la Ley Núm. 118 se aprobó "para que los consumidores puedan instar un Pleito de Clase en contra de proveedores de bienes y servicios. Esto es de patente utilidad para la protección de los consumidores contra prácticas dolosas".[62] Asimismo, y acorde con lo establecido por el Tribunal Supremo, la Ley Núm. 118:

> [P]retendió . . . extender el alcance de la Regla 20 al superar las limitaciones impuestas sobre la llamada clase espuria, y por el otro, autorizar a los consumidores a acudir directamente al tribunal para vindicar sus derechos sin necesidad de ser socorridos por una agencia gubernamental. En ese sentido su objetivo es eliminar todos los obstáculos legales que dificultarían a los consumidores el acudir al Tribunal.[63]

Sin embargo, es menester recalcar que "La Ley 118 no creó una forma de acción de clase distinta a la establecida por la Regla 20, sino que extendió los remedios disponibles para los consumidores de bienes y servicios".[64] Ante esto, debemos

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[58] CUEVAS SEGARRA, *supra* nota 15, en la pág. 731 (citando *Guzmán Matías*, 169 D.P.R. en la pág. 722).
[59] Fiol Matta, *supra* nota 18, en la pág. 695.
[60] CUEVAS SEGARRA, *supra* nota 15, en las págs. 731–32.
[61] HERNÁNDEZ COLÓN, *supra* nota 11, §1005.
[62] ECHEVARRÍA VARGAS, *supra* nota 2, en la pág. 141.
[63] *Guzmán Matías*, 169 DPR en las págs. 720–21.
[64] *Id.* en la pág. 723.

tener claro que para poder utilizar el procedimiento habido en la Ley Núm. 118, es necesario cumplir con los requisitos expuestos en la Regla 20 de procedimiento Civil. Nuestro Tribunal Supremo expresó lo siguiente:

> En términos de los requisitos aplicables para certificar una clase de consumidores de bienes y servicios, debemos enfatizar los requisitos de "predominio y superioridad" y "comunidad" los cuales, aunque presentes en la Regla 20, son los únicos expresamente dispuestos en la Ley Núm. 118. Esto significa que cuando se presenten acciones de clase al amparo de esta ley debemos atender primeramente a estos dos requisitos para determinar si una alegada clase es acreedora de los remedios que allí se establecen. Una vez se satisfacen los requisitos de "preponderancia y superioridad" y "comunidad", es necesario examinar si entonces se cumplen los demás requisitos supletorios de la Regla 20, o sea, numerosidad, tipicidad y adecuada representación. Sin embargo, al aplicar estos requisitos estamos llamados a interpretarlos con el espíritu de liberalidad e inclusión que inspiró la Ley Núm. 118.[65]

Pasando al contenido de la Ley Núm. 118, la §3341 establece la política pública del Estado respecto a la defensa del consumidor. Este inciso destaca que:

> Se reconoce el derecho de los consumidores de bienes y servicios y/o al Estado Libre Asociado de Puerto Rico, por sus agencias, dependencias e instrumentalidades en su carácter de *parens patriae*, a instar un pleito de clase a nombre de dichos consumidores por razón de daños y perjuicios así como acciones de *injunction* bajo la Regla 57 de procedimiento civil de 1958 para el Tribunal General de Justicia, según enmendadas.[66]

Esta política pública responde a la realidad de que muchas veces, por desconocimiento o por elementos de índole económico, las personas no presentan reclamaciones contra aquellos comerciantes quienes han violado sus derechos. Tal como reseña Hernández Colón:

> [L]a justicia no es gratis y los procesos judiciales implican para las partes gastos y esfuerzos de considerable magnitud. Los mismos no se justifican para atender reclamaciones de pequeño valor económico ante los tribunales de justicia. Al permitir agrupar todas las reclamaciones de una clase, bajo un solo pleito, se hace económicamente el litigio.

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[65] *Id.*
[66] 32 LPRA § 3341.

> Y, al encaminar múltiples-a veces millones- de reclamaciones a través de una sola demanda, se maximiza la eficacia del sistema judicial y se cumple con el objetivo de una justicia rápida, económica y eficaz . . . .[67]

Asimismo lo considera la exposición de motivos de la Ley Núm. 118 al establecer:

> Usualmente las acciones de los consumidores envuelven sumas de dinero tan pequeñas que no justifican un pleito individual; es más económico y justo el que reclamaciones esencialmente idénticas sean instadas en un solo pleito de clase a nombre de todos los consumidores defraudados o engañados . . . . Este tipo de acción compensa la inhabilidad del consumidor individual de litigar pérdidas pequeñas individuales al permitir el que uno o más representantes de un grupo de consumidores con daños similares puedan instar el pelito a nombre de la clase [....] Estas están obligadas a considerar no solamente la pérdida económica directa del pleito de clase, sino también la publicidad y reacción del público con la consiguiente pérdida de tiempo, nombre o prestigio. En el interés de desalentar la conducta impropia y engañosa de los suplidores de bienes y servicios para los consumidores, la Asamblea Legislativa de Puerto Rico considera de imperiosa necesidad establecer el pleito de clase para los consumidores . . . .[68]

Cabe destacar que la §3342 reafirma la política pública antes mencionada y provee herramientas adicionales para proteger los derechos de los consumidores. La misma establece que "[s]e reconoce el derecho a los comerciantes, a los consumidores de bienes y servicios y al Estado Libre Asociado de Puerto Rico a instar un pleito de clase a nombre de dichos comerciantes o consumidores basado en las secs. 257 a 274 del Título 10".[69] Es decir, se amplían las herramientas que tienen los reclamantes a su haber, concediendo "derechos adicionales, entre éstos, el interdicto, y le reconoce el derecho a los consumidores de entablar una acción al amparo de la Ley de Monopolios".[70]

La próxima sección establece la jurisdicción exclusiva del Tribunal de Primera Instancia (en adelante TPI) así como la concesión de compensación y honorarios de abogado. La misma lee:

> El Tribunal de Primera Instancia tendrá jurisdicción primaria exclusiva en los pleitos de clase presentados en virtud de este capítulo. A tales efectos, queda investido con autoridad para prevenir, evitar, detener y castigar acciones en perjuicio de los consumidores y/comerciantes independientemente de la cuantía envuelta, y durante el

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[67] HERNÁNDEZ COLÓN, *supra* nota 11, §1005; *Véase además* Fiol Matta, *supra* nota 18, en la pág. 695.
[68] *Guzmán Matías*, 169 DPR en la pág. 720 (citando la Exposición de Motivos de la Ley 118).
[69] 32 LPRA § 3342.
[70] CUEVAS SEGARRA, *supra* nota 15, págs. 731–32; Fiol Matta, *supra* nota 18, en la pág. 696.

> procedimiento, antes de recaer fallo final, el tribunal podrá emitir órdenes restrictivas y prohibitivas, según lo crea justo y equitativo, en cuanto al acto que produjo la acción.
>
> El Tribunal de Primera Instancia en su resolución o sentencia impondrá *una cantidad igual a los daños determinados* en concepto de liquidación de daños y perjuicios, *más una cantidad razonable según lo determine el tribunal en concepto de honorarios de abogado*, más los intereses legales desde el momento de la comisión del daño en los casos de temeridad; y las costas del procedimiento. Cualquier acción o pleito judicial instado por parte particular podrá transigirse mediante la intervención del Departamento de Asuntos del Consumidor, o de la Junta Reglamentadora de Telecomunicaciones de Puerto Rico cuando se trate de un servicio de telecomunicaciones, cable televisión o televisión por satélite 'DBS' bajo la jurisdicción de la Junta según provee la 'Ley de Telecomunicaciones de Puerto Rico', secs. 265 et seq. del Título 27, la cual tendrá treinta (30) días desde que le es notificada la transacción por el tribunal para que exprese su posición en torno a la misma.[71]

En relación a este inciso hay que considerar dos elementos importantes. El primero es que se establece la jurisdicción primaria y exclusiva del TPI para atender este tipo de pleitos. Inicialmente, y como veremos más adelante, esto resultó problemático cuando se le concedía jurisdicción primaria a alguna agencia administrativa, tal como la Junta de Telecomunicaciones.[72] Ello se subsanó mediante los artículos 1(3) y 3 de la Ley Núm. 118-2013, que enmendaron la Ley de Telecomunicaciones de Puerto Rico de 1996[73] y la Ley 118, confiriéndosele jurisdicción para este tipo de pleitos al TPI, vía acción legislativa.[74] El segundo elemento a considerar es que la ley originalmente concedía un 25% respecto a honorarios de abogado.[75] Con la Ley 118-2013 se modificó el lenguaje para conferirle al Tribunal discreción para imponer honorarios de abogados, basado en el criterio de razonabilidad.[76] Otro aspecto relevante de este inciso es la concesión de una doble compensación en daños.[77]

Finalmente, la § 3344 establece aquellas cuestiones relacionadas a la notificación y la transacción del pleito de clase de consumidores. El texto lee como sigue:

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[71] 32 LPRA § 3343 (énfasis suplido).
[72] *Véase* Román Román v. Puerto Rico Tel. Co., KLAN201000259, 2010 WL 2885647 (TA PR 28 de mayo de 2010).
[73] 27 LPRA §§ 265–272.
[74] Ley Núm. 118-2013, arts. 1(3), (3).
[75] *Guzmán Matías*, 169 DPR en la pág. 734. *Véase además* HERNÁNDEZ COLÓN, *supra* nota 11, §1005; Fiol Matta, *supra* nota 18, en la pág. 696.
[76] 32 LPRA § 3343.
[77] *Id.*

> Cuando se inicie una acción de clase de acuerdo a lo provisto por esta sección, el tribunal deberá, tan pronto como sea posible, determinar si existe una cuestión común de hecho o de derecho y que la acción de clase es superior a otros medios disponibles para la adjudicación justa y eficiente de la controversia.
>
> El tribunal notificará a los miembros de la clase de la manera más práctica posible bajo las circunstancias. Se notificará personalmente a aquellos miembros de la clase que puedan ser identificados mediante un esfuerzo razonable.
>
> La notificación indicará que:
>
> (1) El tribunal excluirá a cualquier miembro de la clase si éste lo solicita específicamente.
>
> (2) La sentencia incluirá a todos los miembros que no soliciten exclusión.
>
> (3) Cualquier miembro de la clase que no solicite exclusión podrá, si así lo desea, comparecer por medio de su abogado.
>
> Un pleito de clase iniciado bajo esta sección no será desistido o transigido sin la aprobación del tribunal. Deberá notificarse la solicitud de desistimiento o transacción que se interese a todos los miembros de la clase en la forma que el tribunal dispusiere.[78]

Es necesario reseñar que este inciso resulta similar a la Regla 20 de Procedimiento Civil respecto a los requisitos de la notificación. Igualmente, mediante enmienda, se añade como requisito el que se debe notificar al TPI dentro del período de 30 días si se llega a algún acuerdo transaccional con alguna de las agencias administrativas enumeradas en la ley.[79]

IV. JURISPRUDENCIA INTERPRETATIVA

A. Tribunales Estatales

1. Tribunal Supremo de Puerto Rico

[78] *Id.* § 3344.
[79] Ley Núm. 118-2013, art. (3).

Aun cuando el Tribunal Supremo de Puerto Rico ha discutido ampliamente los requisitos del pleito de clase amparado en las Reglas de Procedimiento Civil —en particular las reglas 20.1 y 20.2— sólo ha aborado el pleito de clase de consumidores creado en la Ley 118 en una ocasión.[80] En este caso se alegó que las compañías elaboradoras de leche tenían o debían tener conocimiento de que existía una práctica de adulterar la leche, añadiéndole sal y agua.[81] Los peticionario intentaron certificar el pleito como uno de clase bajos las disposiciones de la Ley Núm. 118, a lo que tanto el TPI como el Tribunal de Apelaciones de Puerto Rico (en Adelante, "Tribunal de Apelaciones") se negaron. El Tribunal lo resume del siguiente modo:

> [L]os peticionarios indican que el tribunal recurrido cometió un grave error de derecho al fundamentar su determinación en que se desconocía "si otros ciudadanos hubiesen solicitado intervención como parte representada en la acción de clase" . . . . Igualmente rechazan la contención del Tribunal de Apelaciones en cuanto a que para cumplir con el requisito de numerosidad los demandantes tenían que: (a) presentar un estimado razonable de los consumidores que representan; (b) presentar evidencia relacionada al número potencial de individuos representados que ingirieron leche adulterada; (c) cualificar el número de consumidores de leche que hay en Puerto Rico y cuántos de éstos consumieron leche adulterada desde 1994 hasta 1998, y (d) demostrar los hábitos de consumo de leche fresca de los miembros de la clase.[82]

También alegaron que presentaron su causa de acción bajo la Ley 118, la cual establecía un estándar más flexible para definir una clase y, en la alternativa, que cumplían con los requisitos de la Regla 20 vigente al momento.[83]

Luego de repasar el trasfondo y evolución de aquello que dio pie a la formulación de la Ley Núm. 118, el Tribunal establece que además de los requisitos esbozados en dicha ley, se debe también cumplir con aquellos descritos en la Regla 20 de Procedimiento Civil:

> [n]o hay duda de que está dentro del amplio marco de discreción del Tribunal de Primera Instancia el determinar si un pleito debe constituirse como acción de clase. Esto comúnmente significa que los tribunales revisores no deben intervenir con esa decisión, a menos que se demuestre que el foro de instancia ha abusado de su discreción . . . . No obstante, como señalamos anteriormente, en el caso particular de la acción de clase de los consumidores de bienes y servicios, dicha discreción está limitada por el interés público en favor de los

[80] *Guzmán-Matías*, 169 DPR 705.
[81] *Id.* en la pág. 711.
[82] *Id.* en la pág 713.
[83] *Id.*

> consumidores según plasmado en la Ley Núm. 118. No actuar de esta manera iría en contra de una clara y reiterada intención legislativa.
>
> La Regla 20.1 . . . establece cuatro requisitos para que pueda incoarse un pleito de clase: (1) que la clase sea tan numerosa que la acumulación de todos los miembros resulte impracticable, es decir, numerosidad; (2) que existan cuestiones de hecho o de derecho comunes a la clase, o sea, comunidad; (3) que las reclamaciones de los representantes sean típicas de las reclamaciones de la clase, o sea, tipicidad, y (4) que los representantes protejan los intereses de la clase de manera justa y adecuada.
>
> Además, para que proceda la certificación de un pleito como una acción de clase es igualmente necesario que se satisfaga, al menos, uno de los requisitos de la Regla 20.2 de Procedimiento Civil. De entre estos requisitos alternativos, la propia Ley Núm. 118 exige que se cumpla específicamente con el requisito de "predominio y superioridad" contenidos en la Regla 20.2(c). De forma muy similar al lenguaje utilizado para definir la desaparecida acción de clase espuria, este inciso (c) define una clase sostenible como aquella en la cual "cuestiones de hechos o de derecho comunes a los miembros de la clase predominan sobre cualesquiera cuestiones que afecten solamente a miembros individuales".[84]

Comienza el Tribunal describiendo los requisitos de *comunidad*, *predominio y superioridad*. Respecto a ellos —en conjunto— expresa:

> El requisito de que exista una cuestión de hecho o de derecho común a la clase es similar a lo que se requiere para la acumulación e intervención en las Reglas 17 y 21 de Procedimiento Civil [de 1979] con la diferencia de que la Regla 20 no exige que las cuestiones de hecho o de derecho surjan del mismo acto, omisión o evento. Además, este requisito está presente en la Ley Núm. 118 en su Sec. 4, en donde se dispone que "el tribunal [...] determinar[á] si existe una cuestión común de hecho y de derecho y que la acción de clase es superior a otros medios disponibles para la adjudicación justa y eficiente de la controversia.[85]

Sobre el concepto de *comunidad*, el Tribunal expone que se trata de un concepto "cualitativo y no cuantitativo[86] que comprende sólo que "lo reclamado requiera resolver una cuestión de hecho o de derecho común a los

[84] *Id.* en las págs. 724–25.
[85] *Id.* en las págs.725–726.
[86] *Id.* en la pág. 726.

representados"[87]. Dichas cuestiones de hecho o de derecho deben predominar, y no ser las únicas o ser idénticas.[88] Asimismo es necesario establecer que la acción de clase sea el "medio superior para adjudicar la controversia"[89]. Respecto a este requisito de superioridad, el Tribunal lo define de la siguiente forma:

> [E]l interés de los miembros de la clase en controlar individualmente la tramitación o defensa de pleitos separados; la naturaleza y alcance de cualquier litigio relativo a la controversia ya comenzado por o contra miembros de la clase; la deseabilidad de concentrar o no el trámite de las reclamaciones en el foro específico; las dificultades que probablemente surgirían en la tramitación de un pleito de clase.[90]

El Tribunal también define el concepto de *numerosidad* esbozado en la Regla 20 de Procedimiento Civil. Primeramente establece que, aunque no existe una definición concreta de lo que constituye numerosidad, "'[e]xiste un consenso en que el número de personas que pueden componer una clase no es decisivo en la determinación de 'impracticabilidad"; se trata de una cuestión por resolver caso a caso'"[91]. A su vez, la impracticabilidad a la que se hace referencia bajo este criterio no es sinónimo de imposibilidad.[92] Sin embargo, el número a ofrecerse para establecer la numerosidad no puede ser uno especulativo, aunque tampoco se requiere que sea un número exacto. Basta con que el promovente -quien tiene el peso de la prueba- provea un estimado razonable del número sustancial de posibles representados.[93]

Por último, el Tribunal discute el requisito de adecuada representación y expresa que el mismo es de génesis constitucional. Respecto a ello añade:

> [e]ste último requisito goza de especial relevancia ya que tiene su génesis constitucional en el debido proceso de ley. Después de todo, "[s]ólo la adecuada representación de los intereses de los miembros ausentes evita que la acción de clase sea inconstitucional al asegurar que se cumpla con el debido proceso de ley"[...] Este requisito subsana la exigencia de que toda persona tenga su " 'día en corte', y que nadie pueda ser afectado por una sentencia in personam en un procedimiento en el cual no ha sido parte". . . . .

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[87] *Id.*
[88] *Id.* en las págs. 726; 732.
[89] *Id.* en la pág. 726.
[90] *Id.* en la pág. 727.
[91] *Id.* en la pág. 728 (citando *Cuadrado Carrión*, 120 DPR en la pág. 449).
[92] *Id.* en la pág. 728.
[93] *Id.* en la pág. 729 (citando *Cuadrado Carrión*, 120 DPR en la pág. 449).

> En la actualidad, los factores primordiales y notas diferenciales del análisis de "adecuada representación" se concentran en torno a: (1) la ausencia de conflicto, y (2) las garantías de litigación agresiva y vigorosa . . . .
>
> Cuando las reclamaciones o defensas de los representantes no son típicas de las reclamaciones o defensas de la clase, existe un problema inherente de conflicto, ya que no se cumple con el requisito mínimo de adversariedad que caracteriza nuestro derecho adjudicativo . . . . Cuando no existe el peligro mencionado, el análisis de tramitación vigorosa enfatiza en las características del abogado de los representantes de la clase.[94]

Acorde con lo expresado por el Tribunal, lo que se busca al momento de garantizar la adecuada representación es ese efecto de confrontación que garantice una defensa vigorosa de los intereses de aquellas parte que, aunque vinculadas por el resultado final de la acción, no estarán presentes durante el proceso ni tendrán su día en corte, tal como exige nuestra Constitución.

2. Tribunal de Apelaciones de Puerto Rico

El Tribunal de Apelaciones ha discutido más ampliamente las disposiciones de la Ley 118 y se ha enfrentado a unos retos particulares relacionados a la aplicación de dicha ley. Asimismo, las sentencias emitidas sirven para clarificar ciertos asuntos que el Tribunal Supremo de Puerto Rico aún no ha discutido. Teniendo presente que las sentencias y resoluciones del Tribunal de Apelaciones no son vinculantes, sino meramente persuasivas, consideramos de vital importancia discutirlas, pues sirven de barómetro respecto a futuras controversias que pudieran llegar a la consideración del Tribunal Supremo de Puerto Rico.

En *Mayesa v. Autoridad de Energía Eléctrica de Puerto Rico*[95] el Tribunal de Apelaciones, mediante resolución, evaluó si a raíz de una consolidación de dos pleitos habidos en el TPI –en la Sala Superior de Utuado y la Sala Superior de San Juan- procedía autorizar un descubrimiento de prueba en aras de corroborar que la clase en cuestión continuaba estando adecuadamente representada.[96] Las clases consistían en abonados que alegadamente habían sido sobrefacturados en sus facturas de consumo de energía eléctrica.[97] La Autoridad de Energía Eléctrica (en adelante AEE) solicitó la consolidación de los pleitos en el TPI de San Juan, lo cual no le fue concedido, pues ese mismo Tribunal ordenó que se consolidaran los

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[94] *Id.* en las págs. 732–33.
[95] Mayesa v. Autoridad de Energía Eléctrica de Puerto Rico, KLCE-05-00619, 2005 WL 2755925 (TA PR 13 de junio de 2005).
[96] *Id.* en la pág. *1.
[97] *Id.*

pleitos en el Tribunal de Utuado.[98] Ello sin embargo fue posterior a que el TPI –entendemos que el de San Juan- certificara el pleito como uno de clase y emitiera una orden para notificar por edicto a los miembros de la clase.[99] En lo que se efectuaban los traslados y se atendían mociones de reconsideración correspondientes, presentadas por las partes, la AEE solicitó al Tribunal comenzar con el proceso de descubrimiento de prueba, donde entre otras cosas, se depusieron a los demandantes.[100] Posterior a ello, la AEE solicitó autorización al Tribunal para deponer personas adicionales, a lo cual los peticionarios se opusieron y solicitaron una orden protectora.[101] El TPI autorizó las deposiciones solicitadas y denegó la orden protectora.[102] Los peticionarios solicitaron reconsideración y la aplicación de las Reglas para Casos Civiles de Litigación Compleja[103]. Ante una aparente falta de respuesta del TPI, los peticionarios recurrieron al Tribunal de Apelaciones mediante *certiorari*, aduciendo que el TPI erró al denegar la orden protectora y permitir las deposiciones.[104] El Tribunal de Apelaciones resuelve, luego de discutir los requisitos del pleito de clase según las Reglas de Procedimiento Civil y la Ley 118 que "[l]a Ley confiere jurisdicción primaria exclusiva al Tribunal de Primera Instancia para entender en este tipo de casos y le faculta para emitir órdenes restrictivas y prohibitivas según lo crea justo y equitativo, en cuanto al acto que produjo la acción"[105]. Asimismo indica que "se reconoce la procedencia de realizar descubrimiento de prueba en torno a una solicitud de certificación de un pleito de clase"[106]. Finalmente, el Tribunal de Apelaciones dispuso que no entendía que la determinación del TPI fuera un abuso de discreción ya que el (1) descubrimiento de prueba autorizado estaba relacionado con la controversia y (2) el mismo no resultaba demasiado oneroso.[107]

Otro caso que atiende el asunto de los pleitos de clase de consumidores lo es *Miguez Balseiro v. Sedeco-Servicios de Descuento en Compra, Inc.*[108]. En este caso, la señora Miguez demandó a Sedeco, alegando que el contrato de servicio suscrito entre ambos era nulo, pues Sedeco no contaba con la autorización del Comisionado de Seguros para expedir el mismo, conforme se requería en Derecho.[109] La señora Miguez intentó presentar el pleito como uno de clase en representación de todas las personas que habían adquirido *algún contrato de*

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[98] *Id.* en la pág. *2.
[99] *Id.* en la pág. *1.
[100] *Id.* en las págs. *2–*3.
[101] *Mayesa*, 2005 WL 2755925 en la pág. 3.
[102] *Id.*
[103] Reglas para Casos Civiles de Litigación Compleja, *supra*.
[104] *Mayesa*, 2005 WL 2755925 en la pág. *3.
[105] *Id.* en la pág. 8 (citando 32 LPRA § 3343).
[106] *Id.* en la pág. *10 (citas omitidas).
[107] *Id.*
[108] Miguez Balseiro v. Sedeco-Servicios de Descuento en Compra, Inc., KLAN-06-00556, 2006 WL 3253549 (TA PR 2006).
[109] *Id.* en la pág. *1.

servicios.[110] El TPI se negó a certificar la clase dado que (1) la *mención de miles de consumidores* no constituía un estimado razonable ni probado de las personas afectadas, (2) la señora Miguez no estaba cualificada para representar a la clase, toda vez que no cumplía con los requisitos de tipicidad ni comunidad y (3) no se había evidenciado que el pleito de clase era el vehículo más efectivo para llevar el pleito.[111] El Tribunal de Apelaciones confirmo la determinación del TPI al estipular que (1) la señora Miguez no demostró que había sufrido daño concreto y real alguno por lo que podía "representar adecuadamente [...] a los demás miembros de la clase que podían reclamar individualmente por sus daños"[112]. También se expresó respecto al particular de que ni el primer pliego de interrogatorios ni el requerimiento de admisiones presentado junto a la demanda, habían sido contestados al momento del TPI emitir su sentencia.[113] El Tribunal de Apelaciones entendió que el interrogatorio y los requerimientos de admisiones iban dirigidos a establecer si la señora Miguez cumplía con el requisito de numerosidad, y que aun cuando lo cumpliera, estando ausente el requisito de tipicidad y representación adecuada, la certificación como pleito de clase no prosperaría.[114] Finalmente, el Tribunal de Apelaciones determinó que sólo podía concederle un remedio a la señora Miguez, pues era sobre quien único ostentaba jurisdicción, ya que al no certificarse el pleito como uno de clase, no había jurisdicción sobre los otros potenciales miembros de la misma.[115]

Un caso a nuestro entender de particular relevancia se presentó en *Román Román v. Puerto Rico Telephone Co*.[116] Aquí, se estableció un pleito contra Puerto Rico Telephone Co. (en adelante P.R.T.C.) por ésta última facturar y activar unilateralmente los servicios de internet inalámbrico en sus unidades móviles sin el consentimiento de los clientes. La controversia principal relacionada con el pleito de clases del consumidor estribaba en determinar a quién le corresponde la jurisdicción sobre el caso cuando existe una ley especial que atiende el asunto de los pleitos en el área de servicios de comunicaciones, incluidas las reclamaciones de clase de consumidores[117], o si se puede utilizar el vehículo provisto por la Ley 118. Dicho de otro modo, ¿corresponde a la Junta de Telecomunicaciones, organismo administrativo, atender el pleito de clase de los consumidores o le corresponde al TPI atender el pleito bajo la Ley 118?. Respecto a este asunto, el Tribunal de Apelaciones razona:

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[110] *Id.* (énfasis suplido).
[111] *Id.* en la pág. *2.
[112] *Id.* en la pág. *7.
[113] *Id.* en las págs. *7–*8.
[114] *Miguez Balseiro*, 2006 WL 3253549 en la pág. *8.
[115] *Id.*
[116] Román Román v. Puerto Rico Telephone Co., Inc., KLAN-2010-00259, 2010 WL 2885647 (TA PR 28 de mayo de 2010).
[117] *Véase* Ley de Telecomunicaciones de Puerto Rico, 27 LPRA §§ 265–272 (2014).

> [L]a Ley 138 expresamente le otorgó jurisdicción primaria exclusiva a la Junta Reglamentadora para atender las reclamaciones de daños y perjuicios incoadas por los usuarios o consumidores contra las compañías de servicios de telecomunicación, incluidas las que se refieran a sobrecargos en la facturación y a todas las prácticas asociadas con este resultado.
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> En el caso de autos, el Tribunal de Primera Instancia desestimó la demanda incoada por Román al concluir que era la Junta Reglamentadora de Telecomunicaciones la que tiene jurisdicción para atender las tres causas de acción incluidas en la demanda. Procede confirmar la sentencia dictada por el tribunal *a quo*.
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> [U]n examen cuidadoso de la demanda nos lleva a concluir que el Tribunal de Primera Instancia actuó correctamente al declararse sin jurisdicción para atender las dos reclamaciones. Esa prerrogativa de determinar su jurisdicción le corresponde exclusivamente al foro judicial. La impresión o el juicio emitido por la Junta sobre la jurisdicción del D.A.Co. o el Tribunal de Primera Instancia para ventilar las acciones derivadas de la Ley 118 no determinan esa jurisdicción *si los hechos específicos que el tribunal tiene ante sí le impiden asumir esa autoridad.*
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> [E]l tribunal sentenciador concluyó correctamente que el hecho de que Román hubiese incoado una demanda de clase, al amparo de la Ley de Acción de Clase para Consumidores de Bienes y Servicios, no priva a la Junta de su jurisdicción primaria y exclusiva para dilucidar cualquier pleito de clase presentado *por consumidores que, a su vez, son usuarios de servicios de telecomunicaciones.* El Artículo 12–A de la Ley 138 así lo dispone, con el efecto de excluir "ese conjunto de consumidores-usuarios de celulares" del "universo de consumidores ordinarios de otros servicios y bienes diversos".[118]

En este escenario, el Tribunal de Apelaciones, de forma implícita, reconoce que la Ley 118 puede ser y será desplazada por una ley especial que pueda atender un pleito de clase de consumidores. Sin embargo, como vimos anteriormente en la parte II de este artículo, esto fue aclarado por la Ley Núm. 118-2013, Art. 1(3),

[118] *Román Román*, 2010 WL 2885647 en las págs. *12–*15.

donde se confirió la jurisdicción para este tipo de pleitos al TPI, vía acción legislativa.[119]

En otra instancia, el Tribunal de Apelaciones se expresó en *Ryder Health Plan, Inc. v. Corporación del Fondo del Seguro del Estado*[120] respecto al efecto que tiene la academicidad en los pleitos de clase. En este pleito un grupo de patronos demandó a la Corporación del Fondo del Seguro del Estado (en adelante CFSE) por unos pagos en exceso que le efectuaron a dicha corporación.[121] Posteriormente, la CFSE solicitó la desestimación del pleito dado que ya se le había reembolsado a los demandantes las cantidades pagadas en exceso. Los demandantes, entre otras cosas, se opusieron a la solicitud de desestimación alegando que la controversia no tenía visos de finalidad y podía repetirse. Además, solicitó que se tramitara el pleito como uno de clase, bajo la Ley 118. El TPI dictó sentencia parcial en la que desestimó el pleito por académico y no certificó la clase.[122] Inconformes, los patronos presentaron mediante apelación los argumentos de la inexistencia de academicidad y la procedencia de la certificación del pleito de clase en la apelación. El Tribunal de Apelaciones determinó que el TPI resolvió correctamente. Respecto al asunto de la academicidad expresó:

> No obstante haber sido satisfechos en su reclamación de pago, los apelantes pretenden representar en un pleito de clase a los patronos que aún no han sido resarcidos. En ello fundamentan también su contención de que el caso no es académico. Nuevamente, parten de la premisa hipotética y especulativa de la posibilidad de que el Fondo incumpla su deber de acreditar a estos patronos el dinero que pueda adeudarles por concepto de primas pagadas en exceso. No hay forma en que se pueda cuestionar el carácter permanente de los pagos efectuados por el Fondo a los apelantes. La posibilidad de que el Fondo incumpla en un futuro su deber de pagar lo cobrado en exceso, es una especulación que no activa la excepción invocada a la doctrina de academicidad.[123]

En relación a la aplicación de la Ley 118, el Tribunal establece que al no existir causa de acción "la aplicabilidad de la referida Ley y los remedios que entraña, son inmateriales e inaplicables"[124]

Por otra parte, en *Toro Díaz v. Autoridad de Acueductos y Alcantarillados*[125], el Tribunal de Apelaciones se enfrentó a otro pleito relacionado

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[119] Ley Núm. 118-2013, art. 1(3).
[120] Ryder Health Plan, Inc. v. Corporación del Fondo del Seguro del Estado, KLAN-2010-00199, 2011 WL 7842594 (TA PR 14 de diciembre de 2011).
[121] *Id.* en la pág. *1.
[122] *Id.*
[123] *Id.* en la pág. *5.
[124] *Id.* en la pág. *6.

a sobrefacturación de servicios básicos. Aquí cuatro personas incoaron una acción de clase, pero el TPI consideró que sólo dos cumplían con los requisitos para representar la clase. Los dos restantes no estaban relacionados con los las alegaciones del caso. El TPI certificó la clase y la Autoridad de Acueductos y Alcantarillados (en adelante AAA) recurrió al Tribunal de Apelaciones alegando que los recurridos no habían cumplido con los requisitos estatutarios ni jurisprudenciales. El Tribunal de apelaciones, luego de discutir las reglas, leyes y jurisprudencia aplicable, determinó que los requisitos se habían cumplido.[126] Asimismo añadió que el desinterés de algunos miembros de la clase de llevar el pleito respondía a lo pequeño de la cuantía a recobrar, y que era por ello que el pleito de clase resultaba el mecanismo idóneo para resolver este pleito.[127]

Finalmente, en *Trilla Piñero v. Chevron de Puerto Rico, LLC*[128], se resolvió que tanto el texto de la Ley 118 como la intención legislativa relacionada, claramente establecían que la doble compensación se aplicaba al monto concedido en daños y perjuicios conforme a la ley. Es decir, aquella cuantía en daños concedida se duplicará al momento de emitir la sentencia.[129]

B. Tribunales Federales[130]

El Primer Circuito del Tribunal de Apelaciones de los Estados Unidos se expresó respecto a la Ley 118 en *Díaz-Ramos v. Hyundai Motor Co*.[131]. En este caso se pretendía establecer, amparado en una causa de acción privada, un pleito de clases de consumidores bajo la §259 de la Ley Antimonopolística[132]. Dicha sección faculta a la Oficina de Asuntos Monopolísticos a crear reglamentos, presentar acciones administrativas y judiciales para detener y/o disuadir prácticas injustas y engañosas tanto en la competencia como en los negocios.[133] Siendo esta la interpretación tanto del Primer Circuito del Tribunal de Apelaciones de los Estados Unidos como del Tribunal Federal del Distrito de Puerto Rico, quedó establecido que la parte demandante, en este caso el señor Díaz-Ramos, estaba impedido de presentar una causa de acción privada bajo la § 259 de la Ley

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[125] Toro Díaz v. Autoridad de Acueductos y Alcantarillados, KLCE-2014-00628, 2014 WL 4957136 (TA 2014).
[126] *Id.* en las págs. *1–*7.
[127] *Id.* en la pág. *7.
[128] Trilla Piñero v. Chevron de P.R., LLC, KLAN-2011-00007, 2011 WL 6710641 (TA PR 25 de octubre de 2011).
[129] *Id.* en la pág. *39.
[130] Por tratarse de pocas controversias resueltas al amparo de la Ley Núm. 118, discutiremos la jurisprudencia y sentencias federales de manera integrada.
[131] Díaz-Ramos v. Hyundai Motor Co., 501 F.3d 12 (1st. Cir. 2007), *cert. denegado*, 553 U.S. 1018 (2008).
[132] Ley Antimonopolística, 10 LPRA § 257–276 (2014).
[133] §§259(a)–259(j).

Antimonopolística.[134] El Primer Circuito razona entonces que la Ley 118 depende de la existencia previa de una causa de acción para utilizar el mecanismo provisto por la ley para llevar un pleito de clases de consumidores.[135] Estando ausente el señor Díaz-Ramos de una causa de acción, era imposible entonces que pudiera entablar una reclamación bajo la Ley 118.[136]

Posteriormente, el Tribunal Federal para el Distrito de Puerto Rico resolvió en que la Ley 118 no creaba por sí una causa de acción sustantiva.[137] En este caso la parte demandante alegó que había ingerido un medicamento el cual prometía (1) un tratamiento efectivo para la depresión, la ansiedad y otras condiciones de salud mental y (2) un proceso de liberación de los ingredientes activos en un proceso prolongado.[138] Eventualmente logró probarse que el medicamento no cumplía con estas dos promesas, por lo que Simonet demandó por varias causales, cuales incluían anuncios engañosos, producto defectuoso, violación a los términos de la garantía, entre otras cosas. Respecto a Ley 118, Simonet alegó que dicha ley confería una causa de acción sustantiva en protección del consumidor. El Tribunal, por su parte, interpretando los casos de *Díaz-Ramos*[139] y *Guzmán-Matías*, así como la Ley 118, colige: (1) que la mencionada ley no confiere una causa de acción sustantiva, sino que provee un esquema procesal para manejar pleitos de clase de consumidores y (2) el caso de *Guzmán-Mejías*, nada dispone sobre si la Ley 118 provee una causa de acción en sí, sino que versaba sobre si éste era el vehículo apropiado para atender la controversia planteada.[140]

V. EL ARBITRAJE Y SU POSIBLE EFECTO SOBRE LA LEY

A. Jurisprudencia

El Tribunal Supremo de Puerto Rico, a la fecha, no se ha expresado en torno a las implicaciones de las cláusulas de arbitraje en contratos que afectan a consumidores y, muy particularmente, a casos que además no permiten a los consumidores entablar un pleito de clase, obligándolos a instar acciones individuales. Ello significa muchas veces que los costos para vindicar los derechos del consumidor son muy superiores al beneficio real obtenido de resultar victorioso en el mismo. Sin embargo, el Tribunal Supremo de los Estados Unidos de América (TSEUA) sí se expresó respecto a ello en *Stolt-Nielsen S.A. v.*

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[134] *Díaz-Ramos*, 501 F.3d en la pág. 17. *Véase además* Díaz-Ramos v. Hyundai Motor Co., 431 F.Supp. 2d 209, en las págs. 212–13 (D.P.R. 2006).
[135] *Díaz-Ramos*, 501 F.3d en la pág. 16. *Véase además Díaz-Ramos*, 431 F.Supp. 2d en la pág. 213.
[136] *Díaz-Ramos*, 501 F.3d en la pág. 17. *Véase además Díaz-Ramos*, 431 F.Supp. 2d en la pág. 213.
[137] Simonet v. SmithKline Beecham Corp., 506 F.Supp. 2d 77, 91 (D.P.R. 2007).
[138] *Id.* en las págs. 81–82.
[139] 431 F.Supp. 2d 209.
[140] *Simonet*, 506 F.Supp. 2d en la pág. 91.

Animalfeeds International Corp.,[141] *AT&T Mobility LLC v. Concepción*[142] y *American Express Co. v. Italian Colors Restaurant, et als.*[143].

En *Stolt-Nielsen* una compañía de distribución de alimentos y productos al por mayor es demandada en un pleito de clase debido a que se descubrió que, luego de ser encontrada responsable de prácticas monopolísticas, también era responsable de la fijación de precios del mercado, y de consecuencia, una alegada sobrefacturación por sus servicios.[144] Durante el proceso de la demanda las partes acordaron entrar en un proceso de arbitraje. Sin embargo, en la cláusula de sumisión nada se decía sobre el proceder en un arbitraje de clase, por lo que se confirió a los árbitros la determinación de si se podía llevar ante ellos un pleito de clases.[145] Lo árbitros determinaron que, aunque no estaba explícitamente en el acuerdo de sumisión, el pleito de clase podía llevarse en el foro arbitral. Sin embargo, detuvieron el proceso para que las parte buscaran revisión judicial.[146] La corte de Distrito del Distrito sur de Nueva York determinó que los árbitros ignoraron completamente las leyes aplicables, dado que no realizaron un análisis respecto a la selección del foro. De haber efectuado dicho análisis hubieran encontrado que existía una regla relacionada a la ley marítima federal que requiere que los contratos sean interpretados de acuerdo a los usos y costumbres.[147] La Corte de Apelaciones revocó, aduciendo que nada había en la ley marítima federal que contraviniera el uso del arbitraje en este tipo de controversias.[148] El TSEUA determinó que el panel de árbitros impuso su propio criterio respecto a la política relacionada al arbitraje en clase.[149] Respecto a este particular el TSEUA añade:

> But the panel had no occasion to "ascertain the parties intention" in the present case because the parties were in complete agreement regarding their intent. In the very next sentence after the one quoted above, the panel acknowledged that the parties in this case agreed that the Vergoilvoy charter party was "silent on whether [it] permit[ted] or preclude[d] class arbitration," but that the charter party was "not ambiguous so as to call for parole evidence."
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[141] Stolt-Nielsen S.A. v. Animalfeeds Int'l Corp., 559 U.S. 662 (2010).
[142] AT&T Mobility LLC v. Concepción, 563 U.S. 333 (2011).
[143] Am. Express Co. v. Italian Colors Restaurant, 133 S.Ct. 2304 (2013).
[144] *Stolt-Nielsen*, 559 U.S. en las págs. 1764–65.
[145] *Id.* en la pág. 1766.
[146] *Id.*
[147] *Id.*
[148] *Id.*
[149] *Id.* en la pág. 1769.

> In sum, instead of identifying and applying a rule of decision derived from the FAA or either maritime or New York law, the arbitration panel imposed its own policy choice thus exceeded its power [...][150]

Sobre el aspecto procesal de la arbitrabilidad, el TSEUA expresa:

> We think it is also clear form our precedents and the contractual nature of arbitration that parties must specify *with whom* they choose to arbitrate their disputes.
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> . . . .
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> Thus, we have said that "procedural" questions which grow out of the dispute and bear on its final disposition' are presumptively not for the judge, but for an arbitrator to decide... "[w]hen the parties to a bargain sufficiently defined to be the contract not agreed with respect to a term which is essential to a determination of their rights and duties, a term which is reasonable in the circumstances is supplied by the court.
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> . . . .
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> An implicit agreement to authorize class-action arbitration, however, is not a term that the arbitrator may infer solely from the fact of the parties agreement to arbitrate. This is so because class-action arbitrations changes the nature of arbitration to such degree that it cannot be presumed the parties consented to it by simply agreeing to submit *their* dispute to an arbitrator.[151]

Luego de esto, el TSEUA hace hincapié en la existencia de un problema respecto a la adecuada representación de las partes ausentes en un proceso de arbitraje, entre otras cosas, debido a la muy limitada posibilidad de revisión de las laudos arbitrales, la falta de publicidad del laudo y el proceso, y la falta de consentimiento de las partes no suscribientes.[152]

Otra controversia se vio en *Concepción*, donde un grupo de consumidores presentó una reclamación contra AT&T por alegadas prácticas engañosas, anuncios engañosos y fraude.[153] La misma consistía en ofrecer unidades móviles gratis, pero luego las mismas eran cobradas a los clientes.[154] Otro aspecto relevante era que el contrato permitía a AT&T hacer enmiendas al mismo

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[150] *Stolt-Nielsen*, 559 U.S. en la pág. 1770.
[151] *Id.* en las págs. 1774–75 (énfasis suplido).
[152] *Id.* en la pág. 1776.
[153] *AT&T Mobility LLC*, 563 U.S. en la pág. 336.
[154] *Id.*

unilateralmente- lo que hizo en varias ocasiones-, disponía que los clientes renunciaban a su derecho de presentar un pleito de clase y establecía que las controversias se verían mediante arbitraje, de manera individual.[155] Concepción alegó que dichas disposiciones no eran válidas toda vez que iban en contra de la política pública del Estado de California, donde se invalidaban los contratos en donde los consumidores renunciaban a llevar procesos de arbitraje colectivos o a escala inválidos.[156] El Tribunal dispone que para que una cláusula de arbitraje pueda invalidarse, debe ser una cláusula que invalide la totalidad de cualquier tipo de contrato. No puede prosperar una causa de invalidez contractual que busca limitar el alcance del arbitraje o que interfiera con la razón de ser del *Federal Arbitration Act*.[157] Asimismo, el Tribunal razona que el permitir procesos arbitrales de clase contraviene el propósito del *Federal Arbitration Act*. Ante ello expone:

> First, the switch from bilateral to class arbitration sacrifices the principal advantage of arbitration—its informality—and makes the process slower, more costly, and more likely to generate procedural morass than final judgment. "In bilateral arbitration, parties forgo the procedural rigor and appellate review of the courts in order to realize the benefits of private dispute resolution: lower costs, greater efficiency and speed, and the ability to choose expert adjudicators to resolve specialized disputes . . . . But before an arbitrator may decide the merits of a claim in classwide procedures, he must first decide, for example, whether the class itself may be certified, whether the named parties are sufficiently representative and typical, and how discovery for the class should be conducted. A cursory comparison of bilateral and class arbitration illustrates the difference . . . .
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> Second, class arbitration *requires* procedural formality. The AAA's rules governing class arbitrations mimic the Federal Rules of Civil Procedure for class litigation… And while parties can alter those procedures by contract, an alternative is not obvious. If procedures are too informal, absent class members would not be bound by the arbitration. For a class-action money judgment to bind absentees in litigation, class representatives must at all times adequately represent absent class members, and absent members must be afforded notice, an opportunity to be heard, and a right to opt out of the class… At least this amount of process would presumably be required for absent parties to be bound by the results of arbitration.
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[155] *Id.*
[156] *Id.* en la pág. 341.
[157] *Id.* en la pág. 343.

> Third, class arbitration greatly increases risks to defendants. Informal procedures do of course have a cost: The absence of multilayered review makes it more likely that errors will go uncorrected. Defendants are willing to accept the costs of these errors in arbitration, since their impact is limited to the size of individual disputes, and presumably outweighed by savings from avoiding the courts. But when damages allegedly owed to tens of thousands of potential claimants are aggregated and decided at once, the risk of an error will often become unacceptable. Faced with even a small chance of a devastating loss, defendants will be pressured into settling questionable claims. Other courts have noted the risk of "in terrorem" settlements that class actions entail . . . and class arbitration would be no different.
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> Arbitration is poorly suited to the higher stakes of class litigation. In litigation, a defendant may appeal a certification decision on an interlocutory basis and, if unsuccessful, may appeal from a final judgment as well. Questions of law are reviewed *de novo* and questions of fact for clear error. In contrast . . . allows a court to vacate an arbitral award *only* where the award "was procured by corruption, fraud, or undue means"; "there was evident partiality or corruption in the arbitrators"; "the arbitrators were guilty of misconduct in refusing to postpone the hearing … or in refusing to hear evidence pertinent and material to the controversy[,] or of any other misbehavior by which the rights of any party have been prejudiced"; or if the "arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award . . . was not made."[158]

Finalmente, el TSEUA dispone que la cláusula que presentaba AT&T- la cual ofrecía el pago de no menos de $7,500.00 y el doble de los honorarios de abogados si el resultado del arbitraje era mayor que la última oferta transaccional de AT&T- era razonable y suficiente para motivar a los agraviados a buscar individualmente su remedio. A raíz de ello se declaró válida la cláusula de arbitraje y la renuncia a llevar procesos de arbitraje de clases.

Finalmente, en *Italian Colors Restaurant* varios dueños de establecimientos comerciales entablaron una acción de clase contra American Express por alegadas prácticas monopolísticas, debido a un sobrecargo por el procesamiento de pagos electrónicos. American Express, por su parte, solicitó la puesta en vigor de la cláusula de arbitraje —la cual había sido suscrita por las partes— así como la renuncia de los peticionarios a poder presentar una acción de clase.[159] *Italian Colors Restaurant* se opuso bajo el fundamento de que el costo del peritaje necesario para presentar el pleito era de cientos de miles de dólares por caso y ello era desproporcional al monto obtenido si el caso se llevaba

[158] *Id.* en las págs. 348–51.
[159] *Am. Express Co.*, 133 S.Ct. en la pág. 2308.

individualmente, el cual oscilaba entre $17,850.00 y $32,549.00.[160] El TSEUA estableció que el hecho de que el costo del peritaje sea desproporcional a la cuantía que se puede obtener de un pleito no es impedimento para que una parte pueda vindicar sus derechos. Es decir, es diferente alegar que el costo de presentar una petición para arbitraje es excesivamente alto y hace el remedio impráctico- lo cual *podría* dar paso a que se invalide la utilización del arbitraje en un caso- a que los costos de peritaje de un pleito sean altos en comparación con el remedio.[161] A raíz de ello el TSEUA declaró validó tanto la cláusula de arbitraje como la renuncia a presentar pleitos de clase a los peticionarios.

VI. Conclusión

Como vimos anteriormente, la Ley Núm. 118 es realmente un complemento a la Regla 20 de procedimiento civil, que ofrece unos incentivos, opciones y protecciones adicionales a los consumidores de bienes y servicios. Sin embargo, pudimos apreciar que la misma adolece de varias deficiencias que pueden minar tanto su efectividad como lo práctico de su utilización.

La primera deficiencia que pudimos apreciar era respecto a la jurisdicción donde se atenderían dichas reclamaciones. En un inicio, las herramientas provistas por esta ley se tornaban inoperantes, pues su único foro lo constituía el TPI y cuando una agencia administrativa intervenía, muchas veces adquiría jurisdicción de los pleitos de clase presentados ante sí. Ello redundaba en que el caso se atendía ante la agencia como un pleito de clase ordinario y no como una acción de clase de consumidores. Por suerte, esta deficiencia fue subsanada mediante la Ley Núm. 118-2013, que le confirió jurisdicción exclusiva al TPI, sin importar si una agencia administrativa estaba llamada a atender los pleitos de consumidores, particularmente el Departamento de Asuntos del Consumidor y la Junta de Telecomunicaciones.[162] Sin embargo, no todas las enmiendas realizadas por la referida ley fueron positivas. Dicha ley modificó el lenguaje de la §3343 para otorgarle mayor discreción al TPI al momento de otorgar honorarios de abogados, eliminando así el mínimo de 25% que se concedía originalmente.[163] Entendemos que dicho cambio puede resultar disuasivo al momento en los abogados consideren representar consumidores en este tipo de pleito, ya que el elemento de seguridad respecto a los honorarios fue eliminado y se suma a la incertidumbre de que el pleito resulte favorable para sus representados. Sin embargo, entendemos que esto puede resolverse de modo similar a como se resolvió la omisión de la cuantía de los honorarios de abogado bajo la Ley de Indemnización de Despido Sin Justa Causa[164]. El Art. 11(b) de dicha ley, en su redacción original, establecía

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[160] *Id.*

[161] *Id.* en las págs. 2310–11. Parte del razonamiento es que la parte podría recobrar los costos del peritaje al final del proceso. *Id.* en la pág. 2312.

[162] Ley Núm. 118-2013, *a*rts. 1(3), (3).

[163] *Id.*

[164] Ley Núm. 80 de 30 de mayo de 1976, 29 LPRA §§ 185a–185m (2014).

un mínimo de 15% de honorarios de abogados a ser pagados por el patrono cuando el empleado resultare victorioso. Sin embargo, una enmienda a dicho estatuto descartó dicho porcentaje.[165] El Tribunal Supremo de Puerto Rico, mediante opinión, estableció que el lenguaje del artículo mencionado estaba incompleto y, evaluando la intención legislativa y junto a su lenguaje, reinstaló el 15% como mínimo a ser concedido respecto a la partida de honorarios de abogados.[166] Reconocemos que las circunstancias que rodean estas disposiciones son diferentes. El Lenguaje del Art. 11(b) de la Ley 80 denota que la eliminación del porcentaje correspondiente a los honorarios de abogados respondió a una omisión involuntaria. La enmienda realizada a la §3343 no presenta tal cosa, sino una ampliación a la discreción judicial del TPI. No empero, consideramos que el proceder habido para con el Art. 11(b) antes mencionado podría afianzar cierta seguridad tanto a los consumidores como a los abogados e incrementar el interés que podrían tener ambos para llevar este tipo de acción.

Otro factor de suma importancia respecto a la Ley Núm. 118 es el efecto que tendrán las decisiones recientes del TSEUA respecto al arbitraje y renuencia a presentar pleitos de clase y acciones de clase en arbitraje por parte de los consumidores. Dichas opiniones del Tribunal Supremo tienen el efecto de destruir la figura del pleito de clase dentro de nuestro ordenamiento y cancelar totalmente las ventajas que ofrece la Ley Núm. 118 respecto a la doble compensación. Además, el retirar las controversias de consumidores al foro arbitral tiene un efecto disuasivo cuando los costos de presentar el pleito y probarlo en el foro arbitral son desproporcionalmente altos comparados con la cuantía que puede obtenerse de resultar victorioso. También destruye el incentivo existente en los pleitos de clase de dividir costas y gastos entre un número amplio de personas, así como aumenta la posibilidad de resultados totalmente inconsistentes en pleitos que hayan surgido de una misma cadena de eventos. El arrancar del foro judicial los pleitos de clase para integrarlos como acciones individuales ante árbitros menoscaba la justicia que se le puede ofrecer a los consumidores. Asimismo, la falta de un mecanismo regulador en beneficio del consumidor propende a que se derrote el propósito principal de la ley de brindar un mecanismo de control a los comerciantes que incurrían en conductas desleales y monopolísticas.

La Ley Núm. 118 es una herramienta que tenía un potencial enorme tanto para hacer justicia a los consumidores como para regular la conducta de los diferentes integrantes del mercado de bienes y servicios. Sin embargo, enmiendas recientes han restado un tanto los incentivos que ofrecía la misma para que los consumidores buscaran presentar sus reclamaciones. Asimismo, los desarrollos recientes en tema de las cláusulas de arbitraje y renuncia a la presentación de pleitos de clase realmente está destruyendo los beneficios del pleito de clase así

[165] § 185k.
[166] Hernández Maldonado v. Taco Maker, 181 DPR 281, 296 (2011).

como de los incentivos ofrecidos por la Ley Núm. 118, ya que obligan al consumidor a acudir a un foro donde tienen que asumir una mayor cantidad de gastos, eliminan la posibilidad de dividir el impacto económico ante un grupo amplio de personas al momento de probar su causa de acción y reducen geométricamente, a tal punto de hacerlo virtualmente imposible, la posibilidad de revisar las determinaciones respecto a su pleito.

REFORMING MUNICIPAL BANKRUPTCY: LESSONS FROM PUERTO RICO

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I. INTRODUCTION

Domestically and abroad, governmental bankruptcy is on the rise.[1] Reasons why abound and vary, but a few broad trends stand out. First of all, as populations age, pension and healthcare liabilities increase. For another reason, debt financing has become a more common practice for cities, states and countries alike. Meanwhile, reverberations from the recession continue to reduce revenues. Intergovernmental lending has been reduced, and taxes have declined along with salaries and employment rates.[2]

Governmental insolvency is costly and inefficient. Where there is no relevant bankruptcy law, the debtor can become mired in litigation, as in Argentina's decade-long war with its hedge fund creditors.[3] The traditionally stable municipal bond market has become increasingly volatile, discouraging ordinary investors and raising the cost of borrowing.[4] And negative externalities abound when the debtor is in the business of providing crucial public services.

Where insolvency law does apply to a public debtor, as with Detroit, the legal procedure offers little comfort to creditors.[5] History has seen few filings under Chapter 9, U.S. bankruptcy law's proceeding for governmental debt adjustment. The lack of precedent prevents lenders from anticipating *ex ante* the outcome of their claims. As a result, municipal bonds are not optimally priced, and overall lending is inefficiently restricted.

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[1] Jeffrey B. Ellman & Daniel J. Merrett, *Pensions and Chapter 9: Can Municipalities Use Bankruptcy to Solve Their Pension Woes?*, 27 EMORY BANKR. DEV. J. 365, 365–66 (2011).

[2] *See* STATE BUDGET CRISIS TASK FORCE, FINAL REPORT (2014), http://www.statebudgetcrisis.org/wpcms/wp-content/images/Report-of-the-State-Budget-Crisis-Task-Force-Full.pdf.

[3] Daniel Cancel, *Topsy-Turvy Bond Market Means No Default Pain: Argentina Credit*, BLOOMBERG BUS. (Dec. 29, 2014, 8:00 PM), http://www.bloomberg.com/news/articles/2014-12-30/topsyturvy-bond-market-means-no-default-pain-argentina-credit.

[4] Michael J. Casey, *Argentina's Default Is a Warning to Frothy Government Bond Markets*, WALL ST. J. (Aug. 3, 2014, 5:33 PM), http://blogs.wsj.com/moneybeat/2014/08/03/argentinas-default-is-a-warning-to-frothy-government-bond-markets/.

[5] Steven Church, *Muni Mutual Fund Exposure to Detroit Falls on New Analysis*, THE BOND BUYER (July 29, 2013, 4:12 PM), http://www.bondbuyer.com/issues/122_145/muni-mutual-fund-exposure-to-detroit-falls-on-new-analysis-1054176-1.html; Bloomberg News, *Detroit bankruptcy teaches muni bond investors painful lessons*, CRAIN'S DETROIT BUS. (NOV. 7, 2014, 5:52AM), http://www.crainsdetroit.com/article/20141107/NEWS01/141109896/detroit-bankruptcy-teaches-muni-bond-investors-painful-lessons.

Expansion and reform of Chapter 9 could turn the law from a foe to a friend of investors. Expansion would enhance predictability, a premium goal in lending law. With reforms, Chapter 9 could serve rather than stymie economics.

Bankruptcy law is legally, economically, and ethically complex. As scholarship on municipal bankruptcy acknowledges, additional complexities arise when the debtor is a government. Legally, a host of additional balance-of-power issues arise on top of typical federalist bankruptcy issues. Financially, a bankruptcy judge must assess projections of future financial performance, which involve future tax collection predictions when the debtor is a government. Ethically, additional issues arise when the debtor is in the business of providing public services.

This article provides an in-depth case study of Puerto Rico, a governmental debtor that is currently in financial crisis, to propose efficiency-enhancing reforms for Chapter 9. Because of Puerto Rico's unique status as a U.S. Commonwealth, the island provides a useful lens through which to examine legal issues affecting insolvent states, cities, and countries alike.

Recent legal scholarship on Chapter 9 surveys the various political, legal, and structural problems complicating governmental insolvency. This article fills a gap by, first of all, allowing the reader to consider legal solutions upon a foundation of in-depth, practical and financial understanding of a representative governmental debtor. Secondly, the article draws recent scholarship to its relevant conclusion by proposing concrete amendments to municipal insolvency law.

II. CHAPTER 9 AND THE PUERTO RICO EXCLUSION

When a borrower cannot pay back his creditors in the amount or time they originally agreed upon, it may appeal to federal law to scale back its obligations. If the borrower is a private firm, the relevant law is outlined in Chapter 11 of Title 11 of the U.S. Code.[6] If the borrower is a government, the relevant law is in Chapter 9.[7]

Though corporations, individuals, banks and railroads located within Puerto Rico may appeal to federal bankruptcy law just like corporations, individuals, banks or railroads located within any of the fifty states of the U.S., neither Puerto Rico nor any of its political subdivisions, public agencies, or *instrumentalities* may amend their debt obligations under the Code. When read in conjunction, two statutory provisions exclude Puerto Rico from Chapter 9: municipality is defined as a "political subdivision or public agency or instrumentality of a State"[8] whereas "the term 'State' includes the District of

[6] 11 U.S.C. §§ 1101–1174 (2015).
[7] §§ 901–946.
[8] § 101(40).

Columbia and Puerto Rico, except for the purpose of defining who may be a debtor under chapter 9 of this title."[9]

Why did Congress choose to treat Puerto Rico differently under bankruptcy law in this limited way? Neither the statutory language nor legislative history provides a reason. Congress passed the modern Bankruptcy Code in 1978.[10] The Act included an identical version of what is now 11 U.S.C. § 109(a), which specifies that "only a person that resides in the United States . . . or a municipality may be a debtor under this title,"[11] and defining municipality as a "political subdivision or public agency or instrumentality of a State."[12] The 1978 version of the act did not define *State* or mention Puerto Rico at all. Then, as now, Puerto Rico was not a state but a Commonwealth.

The legislative history of the Bankruptcy Code from 1978 is utterly silent concerning Puerto Rico. The first time Congress considered the Commonwealth while legislating on bankruptcy was to include Puerto Rico under the Code so that it would not be distinguishable from a state. In 1981, Congress introduced the Bankruptcy Amendments Act with the purpose of clarifying and correcting technical errors in the 1978 Act. The Act added the definition of *State* that the modern law includes in § 101(52) and explained the amendment as follows:

> This amendment amends the definition of "state" to include the District of Columbia and Puerto Rico. These governmental units were inadvertently left out of the definition of 'state' during the passage of the Reform Act . . . .
>
> This amendment adds a rule of construction for the term "United States" when used in a geographical sense. The effect of this addition . . . is to clarify that the Reform Act applies to those who reside, have a domicile, or have property in the Commonwealth of Puerto Rico, the District of Columbia or the territories or possessions of the United States. Absent the amendments made by this subsection and subsection (c) of the bill, the Reform Act could be construed as not applying to those areas and debtors residing there could not seek relief in the bankruptcy courts.[13]

The original purpose, then, of the modern Code provision defining *state* was to include Puerto Rico under the law in order to ensure that Puerto Ricans could file for federal bankruptcy. The legislative history did not explain the final

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[9] § 101(52).
[10] Pub. L. No. 95-598, 92 Stat. 2549 (1978).
[11] *Id.* at § 109(a).
[12] 11 U.S.C. § 101(29).
[13]

clause of § 101(52), excluding Puerto Rico from the *state* in the narrow context of determining who may be a Chapter 9 debtor.

A subsequent 1983 hearing provides limited insight into the amendment. Congressman Frank R. Kennedy consulted with famed bankruptcy scholar Vern Countryman and included the following comment in the legislative history: "I do not understand why the municipal corporations of Puerto Rico are denied by the proposed definition of 'State' the right to seek relief under Chapter 9, but the addition of the definition of 'State' is useful."[14] Congress never addressed Countryman's question, and the 1981 definition of *state*, explicitly including Puerto Rico under the Code in general and explicitly excluding Puerto Rico from Chapter 9, stands today.

Because Puerto Rico is a governmental unit, it cannot file under Chapter 11[15] or any other Code provision.[16] As a result, the Commonwealth, its municipalities and its public corporations may not restructure their debt under federal law.

The Northern Mariana Islands, a U.S. territory and Commonwealth, like Puerto Rico, dealt with a similar situation in 2013. The U.S. District Court held that the public retirement fund could not file under Chapter 11 because it was a governmental unit. Judge Robert J. Faris acknowledged that federal law, under this interpretation, left the petitioner "caught between an irresistible force . . . and an immoveable object."[17] However, he reasoned,

> Congress did not intend that the Bankruptcy Code could solve all problems, least of all the financial problems of governmental units. The dismissal of this case will leave the Fund and its beneficiaries at the mercy of the Commonwealth government, but Congress intended that the local government, rather than a federal court, should address such problems.[18]

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[14] S. Hrg. 98-574, 326 (1983).

[15] Like Puerto Rico, the Northern Mariana Islands constitute a U.S. territory and Commonwealth, and are thus excluded from Chapter 9 as well as Chapter 11 for amending their own debt obligations. *See In re* Northern Mariana Islands Retirement Fund, No. 12-00003, 2012 WL 8654317, at *3 (D. N. Mar. I. June 13, 2012) (holding that the Northern Mariana Islands Retirement fund could not file for bankruptcy under Chapter 9 because it was a municipal instrumentality).

[16] Within Title 11, there are five different types proceedings available depending on the type of debtor: (1) Chapter 7 proceedings, which are available to individuals and most private corporations; (2) Chapter 13 proceedings, which are available only to individuals; (3) Chapter 11 proceedings, which are available to individuals, private corporations, and railroads; (4) Chapter 12 proceedings, which are available to family farmers and fishermen; and (5) Chapter 9 proceedings, which are only available to municipalities. 11 U.S.C. § 109.

[17] *In re N. Mar. I. Ret. Fund*, 2012 WL 8654317, at *3.

[18] *Id.*

In effect, Puerto Rico took Judge Faris' advice and passed its own governmental restructuring law in June of 2014. The Public Corporation Debt Enforcement and Recovery Act permitted certain public corporations to modify their debt obligations by creditor approval or judicial enforcement.[19] Modeled on Chapter 11, the P.R. Recovery Act aimed to protect creditors and stabilize the bond market while allowing debtor agencies to provide essential power, highway, water and sanitation services[20] and incorporated federal Bankruptcy Code case law as precedent.[21]

However, in February 2015 the P.R. Recovery Act was struck down the on federal preemption grounds.[22] The decision leaves Puerto Rico with no legal avenue to restructure its debt obligations and lawmakers devoid of power to change this untenable situation.

III. PUERTO RICO'S CURRENT ECONOMIC STATE

Puerto Rico is financially distressed. As of the island's most recent operating report, the island's total outstanding public service debt was $71.435 billion, equivalent to 101% of its gross national product for 2013.[23] The Commonwealth's general fund budget has generated deficits for decades, which it covers primarily with further debt financing.[24] Between 2007 and 2011, the gross national product contracted every year; its subsequent growth has been minimal.[25] The population decreased by 2.2% from 2000 to 2010 and an additional 3% from 2013, due largely to emigration. The average age of the population is increasing.[26] Employment has declined steadily each year since 2000, and unemployment currently averages 14.3%.[27]

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[19] *See* Puerto Rico Public Corporation Debt Enforcement and Recovery Act, 2014 P.R. Laws 371 [hereinafter P.R. Recovery Act]. *See also* GOV'T DEV. BANK FOR P.R., THE FACTS ABOUT PUERTO RICO'S PUBLIC CORPORATIONS DEBT ENFORCEMENT AND RECOVERY ACT, http://www.gdb-pur.com/documents/FactsAbout DebtEnforcementAndRecoveryAct.pdf.

[20] P.R. Recovery Act §§ 101, 128–137, 2014 P.R. Laws 395, 420–28. *See also* Lorraine McGowen, *Summary of Puerto Rico Public Debt Enforcement and Recovery Act*, ORRICK, HERRINGTON & SUTTCLIFFE LLP: RESTRUCTURING ALERT (July, 2014), http://s3.amazonaws.com/cdn.orrick.com/files/Puerto Rico.pdf.

[21] P.R. Recovery Act § 103(p), 2014 P.R. Laws at 406.

[22] Franklin Cal. Tax-Free Trust v. Puerto Rico v. García-Padilla, 85 F. Supp. 3d 577, 583 (D.P.R. Feb. 6, 2015).

[23] GOV'T DEV. BANK FOR P.R., COMMONWEALTH OF PUERTO RICO: FINANCIAL INFORMATION AND OPERATING DATA REPORT 14 (2014), http://www.gdbpr.com/documents/CommonwealthReport-October302014.pdf [hereinafter P.R. Fin. Rep.].

[24] *Id.* at 15.

[25] *Id.* at 23.

[26] *Id.* at 24.

[27] *Id.* at 48.

Future balanced budgets are unlikely, given higher debt service and pension funding obligations beginning in 2016.[28] In March and October 2014, the Commonwealth issued $900 million of new notes at high interest rates.[29] The bonds have dispersed claimholders and short maturities, and thus could be called "dangerous debt" because of the burdens they place on the island.[30] Reflecting this high risk of default, all three major credit-rating agencies rate these bonds as non-investment grade.[31]

An additional source of debt crippling Puerto Rico is its public pension system, which is nearly insolvent.[32] In 2014, the government contributed $98.6 million less to its pension plan than promised the prior year, increasing unfunding ratios to roughly 15%. In December 2013, Puerto Rico introduced legislation scaling back its unsustainable pension obligations to the Judiciary and to the Teachers' Retirement Systems. Merely days thereafter, Puerto became embroiled in litigation with the pensioners. On appeal to the Puerto Rico Supreme Court, the government lost the suit to its teachers,[33] and won the suit with the Judiciary, but only for judges taking office on or after December 24, 2013.[34] Despite its legislative attempts, these cases have significantly limited Puerto Rico's hope of a statutory solution to its impending pension debt crisis.

A. Market Effect

Despite Puerto Rico's weak economy, investors snatched up its most recent bond issuances. High trading levels drove up prices, reflecting the market's opinion that the island's IOU's were meaningful or reliable.[35]

Why would investors take Puerto Rico's payment promises seriously, given the island's history of unbalanced budgets and present state of financial

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[28] *Id.* at 33, 45–46.

[29] On October 10, 2014, the Government Development Bank for Puerto Rico—the Commonwealth's fiscal agent and financial advisor—issued $900 million of notes backed by the Commonwealth, scheduled to mature by June 30, 2015. *Welcome Message*, GOV'T DEV. BANK FOR P.R., http://www.gdb-pur.com/about-gdb/welcome.html (last visited March 5, 2016); P.R. Fin. Rep., *supra* note 23, at 7. *See also* Mike Cherney, Al Yoon, & Matt Wirz, *Investors Flip for Puerto Rico's Debt Offering*, WALL ST. J. (March 12, 2014, 8:24 PM), http://online.wsj.com/news/articles/SB10001424052702304914904579 435191727908068.

[30] Patrick Bolton & David A. Skeel, Jr., *Inside the Black Box: How Should A Sovereign Bankruptcy Framework Be Structured?*, 53 EMORY L.J. 763, 774 (2004) (arguing that the issuance of dangerous debt increases the risk of debt crisis and the cost of restructuring).

[31] Maria Armental, *Fitch Downgrades Puerto Rico General Obligation Bonds*, WALL ST. J. (July 9, 2014, 8:11 PM), http://www.wsj.com/articles/fitch-downgrades-puerto-rico-general-obligation-bonds-1404 951069.

[32] Robert Slavin, *Puerto Rico Falters on Pensions*, BOND BUYER (Sep. 26, 2014, 12:28 PM), http://www.bondbuyer.com/news/regionalnews/puerto-rico-falters-on-pensions-1066492-1.html.

[33] Asocn. de Maestros de P.R. v. Sis. de Ret. para Maestros de P.R., 190 P.R. Dec. 854 (2014).

[34] Germán J. Brau v. ELA, 190 P.R. Dec. 315 (2014).

[35] *See* Cherney et al., *supra* note 29.

distress? An optimistic reason is that some investors believe in the government's economic overhaul plans. Governor Padilla has undertaken major spending cuts and economic development plans, some of which have already seen moderate success. Thus borrowing would currently be underpriced because investors are betting that the Commonwealth will create more value going forward.

A more skeptical reason is that investors are betting on a bailout from the federal government. One reason bailouts create marketplace inefficiencies is their unpredictability. Investors price debt according to the likelihood of timely payment. The more that timely payment would require an uncertain external bailout, the higher the chance is of mispricing. In Puerto Rico's case, a bailout is even less predictable than usual because of the island's convoluted and unstable relationship with the federal government. The Obama administration has issued explicit and contradictory statements both that it would and would not bail out Puerto Rico.

Given federal income tax policy, such as triple tax-free status and recently enacted excise taxes on U.S. manufacturing companies operating in Puerto Rico, which Forbes criticized as a "backdoor bailout,"[36] investors predicting federal assistance would not be off base.

Puerto Rico's bond are triple-tax free, meaning that bondholders residing anywhere in the United States do not have to pay state, local or federal taxes on interest or maturity payments. In contrast, most other municipal bonds are only exempt from local taxes in the geographical area where they are issued. All else held equal, Puerto Rican bonds are more valuable to, for example, a New York-based resident than bonds from another U.S. city or state, because the New York investor would not discount Puerto Rican payments by his tax rate.

As a result of federal tax preferences for Puerto Rican bonds, many large U.S. mutual funds hold Puerto Rican bonds. This means that, although Puerto Rico is a tiny island far off in the Atlantic Ocean, a default on its municipal bonds will ripple back to the mainland and make waves throughout the national bond market.

Puerto Rico's bond market resembles the pre-Dodd Frank residential mortgage market. In both situations, the federal government did not merely fail to regulate unsustainable lending, but worse, encouraged over-lending through tax law. In the case of pre-financial crisis mortgage lenders, federal income tax policy incentivizes mortgage borrowing and home ownership. In the present case of Puerto Rico's over-issuance, triple-tax-free status subsidizes the island's bonds relative to those from other issuers. So long as current tax policy persists, Puerto Rico will continue borrowing at unsustainable levels; investors will continue buying the debt at artificially low rates; and U.S. taxpayers will bear the burden, if not directly through a bailout, then indirectly through tax policies.

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[36] Martin Sullivan, *The Obama Administration's Backdoor Bailout Of Puerto Rico*, FORBES: TAXES (Jan. 28, 2014, 9:35 AM), http://www.forbes.com/sites/taxanalysts/2014/01/28/the-obama-administrations-backdoor-bailout-of-puerto-rico/#5a94585f182e.

B. Reasons for Puerto Rico's Financial Distress

This section discusses four primary reasons for Puerto Rico's financial distress:

(A) rational fiscal irresponsibility by politicians, (B) municipal structure, (C) issues specific to individual public corporations, and (D) dependence on the U.S. To be sure, this is an oversimplification. These categories overlap with one another, and there is a fine line between cause and effect when there is a downward spiral. I focus on these reasons because they are high on the cause-effect chain. This is useful because the best legal solutions address root causes rather than mere effects.

Additionally, I focus on what public administration scholars would call internal factors as opposed to external factors. External factors are, by definition, outside of the local government's control, and as such cannot be solved by local legal regime.[37] Internal factors, on the other hand, are a good place for lawmakers to focus their attention.

C. Rational Fiscal Irresponsibility of Politicians

Like most states, Puerto Rico legally requires politicians to balance the budget. The Commonwealth's Constitution mandates that "the appropriations made for any fiscal year shall not exceed the total revenues estimated for that fiscal year," and holds the governor, his executive branches, and the legislature responsible for doing so.[38]

The statutorily mandated budget-making process also requires budgetary balancing. Each year, governmental agencies petition the Office of Management and Budget [hereinafter OMB], a governor-appointed wing of the executive branch, for funds. The OMB evaluates the requests and, based on the Department of Treasury's revenue estimates and Government Development Bank's [hereinafter GDB] lending margin, works with the governor to create a budget. The governor then submits the budget to the legislature, which holds hearings where the agency heads defend their funding requests. The legislature may amend the budget but must allocate existing or raise additional funds if their amendment would otherwise create a deficit. The governor then may sign the amended budget if and only if it is balanced. He may reduce but not increase spending at this point.[39] He also has the power to veto the budget wholesale, which the legislature may override by two-thirds majority vote.

The government has issued high levels of debt, which it uses to fund its basic operations. Puerto Rico's constitution limits long-term, Commonwealth-

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[37] Keeok Park, *To File or Not to File: The Causes of Municipal Bankruptcy in the United States*, 16 J. PUB. BUDGETING, ACCT. & FIN. MGMT. 228, 241 (2004).

[38] P.R. Const. art. VI, § 7.

[39] *Id.* art. III, § 20.

guaranteed debt to 15% of average internal revenues of the two preceding fiscal years. The average is 13.7%, which will increase.[40] The Constitutional requirements address the current fiscal year and do not monitor such long-term debt.

Puerto Rico does not lack legal requirements, as balanced budget provisions abound throughout Commonwealth law. But the island does lack sufficient enforcement mechanisms. The politicians are not effective self-monitors because their personal interests conflict with the interest of the island as a whole. Political office holders only internalize the short-term costs and benefits of their decisions. The citizens will feel long-term effects, such as bonds with long-term maturity dates, after the politician has left office. This misalignment of interests creates an agency cost. The politicians in charge of budget-making are agents who manage taxpayers' money. When politicians use taxpayer dollars in a way that enhances politicians' reputations but ultimately costs taxpayers to a greater extent, inefficiency arises known as agency cost.

Monitoring can reduce agency costs. But Puerto Rico, like many governmental entities, lacks effective monitors. The politicians are not effective monitors of one another because the theoretical checks and balances in place are, in practice, weak. Although the budget-making process involves various agencies, all of them are executive branch members that the government appoints and oversees. The legislature's role, holding hearings and making some amendments, is limited, and the judiciary is absent from the process.

Empirical evidence shows that citizens have not effectively monitored their representatives either. Puerto Rico failed to enact a balanced budget for the last 14 years, from 1999 to 2013.[41] The government's budgetary predictions have been consistently and significantly inaccurate. As of early January 2015, revenues were already $36 million below projected and expenses were significantly higher than projected for the first quarter of 2015.[42]

D. Municipal Structure and Interdependence of Public Corporations

At an area of 3,515 square miles, Puerto Rico is smaller than Connecticut, but has a labyrinthine economic and political structure more appropriate for a larger geographical entity. The Commonwealth is divided into 78 municipalities, each electing its own mayor and dividing further into barrios. The executive branch of the Commonwealth owns 51 public corporations as well as 15 executive departments, several of which are further divided into agencies and sub-agencies. The public corporations are funded by revenues from service rates, subsidies

[40] P.R. Fin. Rep., *supra* note 23, at 16.

[41] Danica Coto, *Puerto Rico Presents First Balanced Budget In Over A Decade*, HUFFINGTON POST (April 30, 2014, 9:35 AM), http://www.huffingtonpost.com/2014/04/30/puerto-rico-balanced-budget_n_5239509.html.

[42] P.R. Fin. Rep., *supra* note 23, at 15–16.

from the Central Government, and publicly issued bonds. The governor appoints most of the public corporations' board members, subject to senate approval.

In Puerto Rico, the Commonwealth, public entities, and municipalities have separate operating budgets and issue their own bonds. But the Commonwealth's General Fund subsidizes the public corporations' basic operational budgets. The GDB, a public corporation that borrows from public markets, serves as financial adviser and fiscal agent to the Commonwealth, and finances the public corporations, General Fund, and municipalities. When any of these entities have been unable to meet their expenses, the GDB has extended them financing and in this way has functioned as a lender of last resort.[43] The legally separate governmental entities are, in practice, highly integrated. When one public corporation in Puerto Rico suffers, credit ratings agencies downgrade bonds issued not only by that corporation, but also by the other corporations and by the General Fund.[44]

When legal identities do not match practical realities, inefficiencies ensue. Creditors of the General Fund, or of a public corporation or municipality, will be unable to predict *ex ante* exactly to whom they are lending. From an economic perspective, this is problematic because lenders will not be able to price interest accurately. From a fairness perspective, unclear boundaries undermine the parties' and judges' ability to respect creditors' *ex ante* expectations. It is difficult to honor lending agreements when it is unclear exactly who the borrower is.

Some of the island's political subdivisions may still be useful, to the extent that the public corporations and municipalities have separate issues and therefore benefit from specialized management. But intra-governmental loans erode any clarity to investors that the subdivisions could provide.

E. Issues Specific to Individual Public Corporations

The financial troubles of the individual public corporations mirror and contribute to the financial troubles of the Commonwealth overall. As of 2013, the combined deficit for the corporations was $800 million and their combined debt totaled $20 billion.[45] Ratings agencies downgraded most of the corporations to

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[43] *See* ARTURO C. PORZECANSKI, AM. U., THE GOVERNMENT DEVELOPMENT BANK: AT THE HEART OF PUERTO RICO'S FINANCIAL CRISIS 2 (2014), http://auapps.american.edu/aporzeca/www/The%20GDB%20at%20the%20Heart%20of%20Puerto%20Ricos%20Financial%20Crisis.pdf (arguing that "[t]he GDB facilitated the decade-long borrowing binge that paved the road to the Commonwealth's current fiscal crisis").

[44] The P.R. Recovery Act only applied to some of the governmental corporations, explicitly excluding other governmental issuers, *e.g.*, the general fund, sales tax-backed bond, and the University of Puerto Rico. However, ratings agencies downgraded the all issuers alike. Aldo Ceccarelli, *Puerto Rico—Restructuring and Downgrading Debt*, WELLS FARGO ASSET MGMT.: ADVANTAGEVOICE (July 17 , 2014). https://blogs.wellsfargo.com/advantagevoice/2014/07/ puerto-rico-restructuring-and-downgrading-debt-excerpt/.

[45] P.R. Recovery Act, Statement of Motives, 2014 P.R. Laws at 373.

below investment grade in mid-2014.[46] Interest rates and bond yields decreased, which has restricted the public corporations' access to private lenders as well as to the capital markets. Puerto Rico relies on debt financing to cover its basic operating expenses and capital needs, so the public corporations have not been able to finance their operations.[47]

The three large public corporations with outstanding debt attributable to tax-exempt securities which the government's rehabilitation efforts and this paper focus on are: (1) Puerto Rico Highways and Transportation Authority ("PRHTA"), (2) Puerto Rico Electric Power Authority ("PREPA"), and (3) Puerto Rico Aqueduct and Sewer Authority ("PRASA").[48]

1. Puerto Rico Highway and Transportation Authority ("PRHTA")

The Puerto Rico Highways and Transportation Authority builds, operates and maintains the island's roads and mass transportation facilities. The corporation endured net operating losses of $530.8 million in 2010, $511.8 million in 2012, and $567.7 million in 2013,[49] and accumulated operational losses of $349 million between 2010 and 2013.[50] Borrowing from the GDB to cover operations added over $2 billion to PRHTA's liabilities between 2009 and 2012.[51]

As of its most recent financial reports, released in March 2014, total operational expenses, from payroll, highway, train, and bridge administration and maintenance, utilities, and the mass transportation system totaled $168,980,000, exceeding operational revenues, which totaled $130,253,000 (derived from tolls, train fares, and "other income"). [52] Non-operational revenues, though, coming from gas taxes, cigarette taxes, investment income, and vehicle licensing fees, totaled $411,420,000.[53] Promisingly, many of these non-operational revenues

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[46] *Id.* at 374.

[47] *See id.* at 375.

[48] The P.R. Recovery Act applies solely to governmental corporations, other than the following: the Children's Trust; the Employees Retirement System of the Government of the Commonwealth of Puerto Rico and its Instrumentalities; Government Development Bank for Puerto Rico and its subsidiaries, affiliates, and any entities ascribed to it; the Judiciary Retirement System; the Municipal Finance Agency; the Municipal Finance Corporation; the Puerto Rico Public Finance Corporation; the Puerto Rico Industrial Development Company, the Puerto Rico Industrial, Tourist, Educational, Medical and Environmental Control Facilities Financing Authority; the Puerto Rico Infrastructure Financing Authority; the Puerto Rico Sales Tax Financing Corporation (CoFInA); the Puerto Rico System of Annuities and Pensions for Teachers; and the University of Puerto Rico. P.R. Fin. Rep., *supra* note 23, at 40.

[49] *Id.* at 167.

[50] P.R. Recovery Act, Statement of Motives, 2014 P.R. Laws at 378.

[51] *Id.*

[52] P.R. HIGHWAYS & TRANSP. AUTH., FINANCIAL RESULTS AND DEBT COVERAGE CALCULATION (2014), http://www.bgfpr.com/spa/investors_resources/documents/05-15-14-ACT-QuarterlyInfMar2014.pdf.

[53] *Id.*

increased due to new legislation passed by the government in 2013[54]. Even so, ratings were downgraded to below investment grade in 2014, and the agency is facing a liquidity crisis.

A major reason for PRHTA's financial distress is an unprofitable contractual relation that it is locked into. PRHTA's revenues from tolls have declined significantly since PRHTA transferred operation and income of two large toll plazas to Goldman Sachs and Albertis Infrastructure under a public-private partnership agreement entered into on September 22, 2011.[55]

Governor Padilla has defended the deal, arguing that the private operators will make badly needed highway improvements. But the Commonwealth will lose out on $90 to $95 million of toll revenues that the roads generate annually, which Albertis and Goldman will now collect. PRHTA entered the agreement out of urgency. The corporation needed the upfront payment to pay down its debt, which exceeded $6 billion at the time. Contracts entered out of financial desperation are often not the best deal for the distressed party in the long run. However, breaking the contract without a special legal mechanism would incur substantial damages fees for PRHTA.

2. Puerto Rico Electric Power Authority ("PREPA")

PREPA generates and distributes the island's electric power.[56] This public corporation has been operating at a deficit since June 2011.[57] As of the Authority's most recent fiscal report, total assets were $10,157,253 in 2013, down from $10,253,852 in 2012. Total liabilities for 2013 were $10,948,638, up from $10,157,253 in 2012. PREPA operated at a net deficit of $791,385 in 2013, up from a $515,686 deficit in 2012 and a $169,495 deficit in 2011.[58]

Thus, PREPA's expenses are rising, and revenues are falling. Global oil prices, a classically external problem, are at the root of many of these problems. The island's reliance on oil, though, results from internal policies. Puerto Rico's energy industry and infrastructure are outdated, which in turn results in the hike in expenses and a high opportunity cost from non-existent energy technology. The Commonwealth's dependence on oil and obsolete energy policy have made

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[54] Act 31-2013 increased the petroleum product tax from $3.00 to $9.25 per barrel. It also increased the cigarette excise tax revenues by $20 million. Act No. 30-2013, in turn, transferred the Commonwealth's General Fund motor license fees to PRHTA, increasing PRHTA's revenues by around $80 million in FY2014. P.R. Fin. Rep., *supra* note 23, at 4.

[55] ERNST & YOUNG PUERTO RICO LLC, AUDITED FINANCIAL STATEMENTS, REQUIRED SUPPLEMENTARY INFORMATION AND SUPPLEMENTAL SCHEDULES 16 (2013), http://www.gdb-pur.com/investors_resources/financial_statements/PRHighways-AFS-6-30-2013-FINAL.pdf, at 16.

[56] *PREPA Is...*, P.R. ELEC. POWER AUTH., http://www.prepa.com/aeees_eng.asp (last visited March 5, 2015).

[57] PREPA Report, at 5.

[58] *Id* at 8.

investors reluctant to loan to PREPA.[59] Further, investors lack faith in PREPA because the public corporation is overly leveraged.[60] PREPA's long-term debt totaled $8.895.7 billion in 2013, $8,935.5 billion in 2012, and $8,089.0 billion in 2011.[61] The dwindling population, both a result from and continuing cause of the island's larger economic problems, has reduced demand for power, and thus reduced PREPA's revenues from rates.

PREPA has managed to buy itself some time by renegotiating contractual obligations with individual creditors. On August 14, 2014, PREPA entered into forbearance agreements with 60% of its creditors that extended PREPA bonds' maturity dates to March 31, 2015. The forbearance agreements posed several new costs and inefficiencies to PREPA's already strained budget. First of all, PREPA incurred additional costs for itself, paying an additional $1.4 million forbearance fee, $500,000 to bank lenders and $1 million to bondholders every month until the new maturity date.[62] Secondly, PREPA encountered inefficiencies arising from legal inconsistencies under said forbearance agreement. Under the contracts' terms, the forbearance agreement is governed by New York law whereas the amendments to the bond agreement are to be governed by Puerto Rico law. The Commonwealth of Puerto Rico court and the United States District Court for Puerto Rico were both granted jurisdiction to hear disputes arising under the new agreements.[63] Additionally, the agreements introduced conflicting deadlines for PREPA to introduce a restructuring plan and amended priority in a manner inconsistent with federal bankruptcy law, introducing further uncertainty.

3. Puerto Rico Aqueduct and Sewer Authority ("PRASA")

PRASA owns and operates the Commonwealth's water and wastewater systems. The corporation operates at a continually increasing deficit, with net losses of $39.6 million in 2011, $136.8 million in 2012, and $291.9 million in 2013.[64] Between 2012 and June of 2013, operating revenues decreased by $77.4 million to $735.7 million, while operating expenses increased by $77.7 million to $1.027.6 billion, respectively.[65] Moody's downgraded its ratings of PRASA's

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[59] *See* P.R. Recovery Act, Statement of Motives, 2014 P.R. Laws at 379.

[60] P.R. Fin. Rep., *supra* note 23, at 164.

[61] PREPA Report, *supra* note 53 at 15.

[62] Matt Wirz, *Puerto Rico Paying $9 Million for Power Bond Forbearance*, WALL ST. J.: MONEYBEAT (Aug. 15, 2014, 3:55 PM), http://blogs.wsj.com/moneybeat/2014/08/15/puerto-rico-paying-9-million-for-power-bond-forbearance.

[63] Robert Slavin & Kyle Glazier, *PREPA Pacts Reinforce Banks' Priority Over Bondholders*, THE BOND BUYER (Aug. 27, 2014, 11:37 AM), http://www.bondbuyer.com/news/regionalnews/prepa-pacts-reinforce-banks-priority-over-bondholders-1065640-1.html.

[64] P.R. Fin. Rep., *supra* note 23, at 166.

[65] ERNST & YOUNG LLP, AUDITED FINANCIAL STATEMENTS: PUERTO RICO AQUEDUCT & SEWER AUTHORITY, YEARS ENDED JUNE 30, 2013 AND 2012 4 (Dec. 31, 2013), https://www.acueductospr

Commonwealth-guarantee revenue bonds by one notch, to BB, and of PRASA's revenue bonds from BB+ to BB- in June 2014.

The ratings agency attributed the June 2014 downgrade largely to general skepticism of the Commonwealth's business climate and was more hopeful about PRASA's economic health than other public corporations.[66] PRASA raised its water rates steeply in 2013, which ratings agency Standard and Poor's [hereinafter S&P] found hopeful for establishing PRASA's financial independence from the central government's budget, and giving PRASA capital to invest in potentially lucrative projects.[67] PRASA has also cut personnel and energy costs in a manner S&P considered "credit positive."[68] PRASA's capital structure is basically sustainable, with sufficient liquidity so that, unlike PREPA, the corporation does not urgently need to amend its debt obligations.

F. Dependence on Capricious U.S. Funding

Puerto Rico relies on funding from the federal government: Congress provides both direct federal aid in addition to substantial tax breaks to incentivize business in Puerto Rico.[69]

Over the last few decades, the U.S. federal government has weaned Puerto Rico from some other federal support. Most significantly, Congress repealed the possessions tax credit, which incentivized American corporations to do business in Puerto Rico.[70] § 936, a federal income tax exemption for U.S. companies operating in Puerto Rico, was ultimately repealed in 2006 following a 10-year phaseout.[71]

Before the credit was repealed, U.S. corporations' possessions claiming tax credits comprised most of Puerto Rico's manufacturing sector and employed many Puerto Ricans. With the repeal of § 936, the largest employers left the island, taking jobs and corporate tax dollars with them, from which the

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.com/INVESTORS/download/Financial%20Statements/2013%20PRASA%20Audited%20Financial%20Statements%20FINAL.pdf [hereinafter PRASA Report].

[66] "The lower SACP is because we view the current climate surrounding all Puerto Rico obligations as creating adverse business conditions for PRASA." STANDARD & POOR'S RATINGS SERVICES, PUERTO RICO AQUEDUCT & SEWER AUTHORITY; GENERAL OBLIGATION EQUIVALENT SECURITY; WATER/SEWER 3 (July 14, 2014), http://www.gdb-pur.com/investors_resources/documents/SPDowngradePRASAJul142014.pdf.

[67] *Id.* at 3.

[68] *Id.*

[69] For a complete overview of federal aid programs to Puerto Rico, *see* Alexis Z. Tejeda Marte, *Los Fondos Federales en Puerto Rico: Un Affair con los Estados Unidos*, 80 REV. JUR. U. P.R. 493 (2011).

[70] The tax credit was phased out in a ten-year period ending in 2006. U.S. GEN. ACCT. OFF., GAO 06-541, PUERTO RICO: FISCAL RELATIONS WITH THE FEDERAL GOVERNMENT AND ECONOMIC TRENDS DURING THE PHASEOUT OF THE POSSESSIONS TAX CREDIT (2006), http://www.gao.gov/assets/160/157687.pdf.

[71] U.S. GEN. ACCT. OFF., GAO/GGD 93-109, TAX POLICY: PUERTO RICO AND THE SECTION 936 TAX CREDIT (1993), http://www.gao.gov/products/GGD-93-109.

Commonwealth has not recovered. Manufacturing has declined by two thirds since the repeal.

New industries have not arisen to offset the decline. Puerto Rico's tax base has declined significantly since 2006, leaving the island with reduced revenues from which to meet debt obligations, most significantly to public employee pension holders and bondholders. Puerto Rico thus built its economy around low-tech jobs, and low-wage manufacturing, service and tourism sectors.[72] Once § 936 was repealed, though, Puerto Rico could not compete with lower-wage assembly plants in Latin America, whose doors had opened during the course of § 936.[73]

In this way, federal assistance provided an obfuscatory band-aid, hiding the deeper wounds festering beneath from investors' and voters' eyes. Federal funds have been a nostrum, cushioning Puerto Rico from the rock bottom it would otherwise hit if it had to face its unsustainable economy lacking a sufficient revenue base for the social services it must provide on its own. Until 2008, the government was the largest employer on the island. Government payroll still exceeds all sectors in employment, with the next largest sector, trade, totaling 156,500 as of 2014, and all other sectors below 100,000.[74] Disproportionate dependence on the U.S. economy opens the island up to unnecessary levels of risk. In 2014, 71.8% of Puerto Rico's exports were shipped to the mainland United States, and 47.2% of Puerto Rico's imports came from the mainland United States. Just like an individual investor may minimize risk by diversifying his portfolio, a country stands well to diversify risk by putting its eggs in multiple baskets. Since Puerto Rico's eggs are all in the U.S's basket, any economic problems on the mainland leave the island reeling. Also, Puerto Rico relies heavily on debt financing with high deficit levels. A business that employs itself with money borrowed under empty promises is not generating value, and as such is unsustainable.

Although § 936 has been repealed, the hydra of capricious federal funding through tax benefits has reared another head in the form of Puerto Rico Act 154 of 2010 [hereinafter Act 154].[75] This "backdoor bailout," enacted in 2010, imposes

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[72] For an investor's view on the subject, see Richard P. Larkin, *Puerto Rico's Worst Case Scenario: R-E-C-O-V-E-R-Y*, HJ SIMS (Oct. 10, 2013), http://www.hjsims.com/news-views/puerto-ricos-worst-case-scenario-recovery/#.VKrQ4WTF_-U.

[73] *See Can Puerto Rico Reinvent Itself as a Global Competitor*, KNOWLEDGE @ WHARTON (Aug. 22, 2012), http://knowledge.wharton.upenn.edu/article/can-puerto-rico-reinvent-itself-as-a-global-competitor/.

[74] For a comprehensive set of statistical data on the topic, see GOV'T DEV. BANK FOR P.R., STATISTICAL APPENDIX 2015, http://www.gdb-pur.com/economy/documents/ApendiceEstadistico2015.pdf.

[75] 2010 P.R. Laws __.

an excise tax on multinational corporations doing business in Puerto Rico.[76] Proceeds go to the Commonwealth.[77] In return, the multinational corporations receive federal tax credit. Puerto Rico relies heavily on Act 154 proceeds. In 2012, 2013 and 2014, Act 154 revenues accounted for 21.6%, 19.7%, and 20.3% of Puerto Rico's general fund revenues, respectively.[78] Riskily, only six corporations account for 75% of the Act 154 payments. Repeating history, Act 154 is scheduled to expire in 2017, leaving investors uncertain about their money and citizens uncertain about their jobs.

Puerto Rico relies on a number of unreliable federal grants to fund essential governmental services, including education and healthcare.[79] The U.S. has historically cut such funding with little warning. Additionally, the U.S. allocates funds on a per capita basis. Thus as Puerto Rico's population continues to declines, U.S. funding will decrease. Population decline does not necessarily correspond to declining demand for social services, especially when, as in Puerto Rico, the people leaving the island are relatively young and well-educated, compared to those who stay behind.

U.S. capriciousness in granting funds creates risk and uncertainty for investors interested in Puerto Rico. Like any risk, federal reliance increases the cost of investing in the island, undermining economic self-sufficiency and vitality. U.S. capriciousness is a quasi-external factor resulting from Puerto Rico's not-quite political status *vis à vis* the mainland. Not quite a state, Puerto Rico only has half the power to determine its own status,[80] because admitting the Commonwealth as a mainland state would require both majority support from Puerto Ricans as well as majority support from Congress plus presidential approval.[81] As of the last Puerto Rican plebiscite on the matter in 2012, 50% of Puerto Ricans favored statehood.[82] Because Puerto Ricans are perceived as overwhekmingly Democratic,[83] Congress is unlikely to approve statehood so long

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[76] For an in-depth analysis of the effect of Act 154 on Puerto Rico's economy, see Felipe Rodríguez Lafontaine, *Puerto Rico Act 154: The Beginning of the End? Effects of Act 154 on Future Economic Development*, 2 U. P.R. Bus. L.J. 216 (2011).

[77] C. W. London, *Bail-out By the Back Door*, THE ECONOMIST (Jan. 29, 2014, 12:52) http://www.economist.com/blogs/freeexchange/2014/01/puerto-rico.

[78] P.R. Fin. Rep. *supra* note 23, at 18.

[79] *Id.* at 19.

[80] I am borrowing the language of "not quite" statehood from President Clinton in a different context. "Not quite a State, not quite a city, not quite independent, not quite dependent," President Clinton described D.C. in remarks that would apply equally well to Puerto Rico. U.S. GEN. ACCT. OFF., GAO-96-126, DISTRICT GOVERNMENT; INFORMATION ON ITS FISCAL CONDITION AND THE AUTHORITY'S FIRST YEAR OF OPERATIONS 7 (1996).

[81] U.S. CONST. art. IV.

[82] P.R. S. Con. Res. 24, 17th Legis. Assembly (2013).

[83] Steve Mufson, *Puerto Rican debt crisis forces its way onto presidential political agenda*, WASH. POST: BUS. (July 8, 2015), https://www.washingtonpost.com/business/economy/puerto-rican-debt-crisis-forces-its-way-onto-presidential-political-agenda/2015/07/07/40ea8aae-1ffe-11e5-aeb9-a411a84c9d55_story.html.

as Republicans control Congress.[84] So long as the island remains a territory, federal policy regarding the island will be unpredictable. Congress is unrestrained by federal law in how it chooses to fund and how not to fund Puerto Rico. Territory status means Puerto Rico elects a non-voting member of Congress and does not vote for president, leaving the island unrepresented in federal fund allocation decisions.

Puerto Rico's dependence on the U.S. costs the island in several ways. First of all, the federal government is capricious, which injects further risk into Puerto Rican projects for potential investors. Secondly, the band-aid effect infantilizes the island, holding it back from forming a modern economy to compete in the global marketplace. Third, and most broadly, Puerto Rico's unique, undefined, and ever-evolving status creates uncertainty. Uncertainty is costly in and of itself, as investors raise risk premiums they charge for unpredictable projects. And uncertainty leads to litigation, such as the various Supreme Court cases that hammer out, amendment by amendment, which Constitutional clauses apply to Puerto Rico.[85]

IV. SOLUTIONS OTHER THAN STATUTORY RESTRUCTURING

In this section, I describe the options available to an insolvent sovereign debtor other than statutory restructuring: (1) out-of-court restructuring through negotiations with individual debt holders, (2) defaulting, and (3) economic development. Puerto Rico serves as a case study for examining the pros and cons of these alternatives.

A. Out-of-Court Restructuring through Creditor Negotiations

Bonds are voluntary contractual agreements. If both parties consent, they are free to change their obligations by entering into a new contract. This voluntary process, called a bond exchange, is available to the Commonwealth.[86] PREPA's forbearance agreements are akin to bond exchanges. They represent new agreements with existing credit holders, and ease the debtor's unsustainable obligations by buying it some time.

A bond exchange is a partial solution at best.[87] One reason is that it is unlikely to happen at all. The only reason that a debtor would initiate

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[84] Jason Koebler, *Despite Referendum, Puerto Rico Statehood Unlikely Until At Least 2015*, U.S. NEWS & WORLD REP. (Nov. 7, 2012, 4:52 PM), http://www.usnews.com/news/articles/2012/11/07/despite-referendum-puerto-rican-statehood-unlikely-until-at-least-2015.

[85] *See generally* David M. Helfeld, *Understanding United States-Puerto Rico Constitutional and Statutory Relations Through Multidimensional Analysis*, 82 REV. JUR. U. P.R. 841 (2013).

[86] For an overview of sovereign debt terms, see Molly Ryan, *Sovereign Bankruptcy: Why Now and Why Not in the IMF*, 82 FORDHAM L. REV. 2473, 2479–82 (2014).

[87] For a discussion of the benefits and drawbacks of collective action clauses, see Bolton & Skeel, *supra* note 30, at 772 –77.

negotiations would be to give its creditors less favorable terms. Investors are free to disapprove bond exchanges and retain their initial agreements. It takes not only a long-sighted, but also a generous investor, to voluntarily agree to worse terms (and in economic terms, a synonym for "generous" is "irrational"). Although it may be in the collective best interest of all creditors to renegotiate terms so that the debtor can actually meet its obligations rather than default, it is in the interest of individual creditors to hold onto their initial, more favorable agreements, so long as they have the resources to litigate and enforce their original payment terms. In PREPA's case, 40% of creditors did not agree to forbearance agreements and can be characterized as holdouts.[88]

Non-bankruptcy law awards first in time, first in right, which perversely incentivize creditors to race to sue the debtor when it breaches a contract. This destroys value and impedes fairness in two ways. First of all, creditors are rewarded based on their litigation resources and tactics rather than their *ex ante* agreements. Secondly, litigation diverts resources away from operations. In litigation, a firm might dry up revenues that it could otherwise use to get back on its feet, which would create value for creditors as well as for shareholders.

A creative approach to dealing with the collective action problem in the absence of collective legal proceedings is to insert modification clauses into bond indentures. Modification clauses empower a majority of bondholders to alter the terms of all outstanding bonds. If the majority of bondholders agree to an amendment, the amendment binds all creditors of that issuance. The most popular type of modification clause is the collective action clause ("CACs").[89] A related clause is the "exit consent," where investors who agree to an exchange offer must pledge their vote to amend the original bond terms as a condition of participating in the exchange.[90]

Modification clauses are of only limited power to counteract collective action problems. For one reason, these clauses do nothing to overcome the initial hurdle of convincing the first creditors to participate in a bond exchange, but only solve the problem of later holdouts.[91] Additionally, CACs and exit consents are only useful if they are actually present in the original bond agreements. Even then, they are limited because they are binding only upon bondholders of that issuance. Some governments have begun to include modification clauses in their bonds,[92] but many, including Puerto Rico, have not.[93]

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[88] *See, e.g.*, Lee C. Buchheit & G. Mitu Gulati, *Sovereign Bonds and the Collective Will*, 51 EMORY L.J. 1317, 1320 (2002).

[89] Stephen J. Choi, Mitu Gulati & Eric A. Posner, *The Evolution of Contractual Terms in Sovereign Bonds*, 4 J. LEGAL ANALYSIS 131, 140 (2012).

[90] Jill E. Fisch & Caroline M. Gentile, *Vultures or Vanguards?: The Role of Litigation in Sovereign Debt Restructuring*, 53 EMORY L.J. 1043, 1091 (2004).

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[92] *See, e.g.*, Matina Stevis and Katy Burne, *Greek Legal Maneuvers Raise Fears of Euro-Zone Debt Fallout*, WALL ST. J. (Feb. 23, 2012, 4:54 AM), http://blogs.wsj.com/eurocrisis/2012/02/23/greek-legal-maneuvers-raise-fears-of-euro-zone-debt-fallout/.

Bond exchanges can have negative market externalities. If the debtor asks individual creditors to renegotiate, the creditors in general will become nervous about the possibility of default. They will rush to sell their bonds, driving down prices and exacerbating the financial state of a debt-reliant borrower like Puerto Rico.

A separate problem with bond exchanges arises from the fact that politicians would be the ones negotiating on behalf of the borrower. Politicians will rationally behave in a way that benefits their constituents, even if it harms bondholders. Especially in the case of triple tax-free Puerto Rico, investors are likely to be nonlocal and therefore have no voice in electing the politicians who make decisions that affect them. Additionally, politicians' interests are short term, spanning the length of their time in office, whereas bond obligations are long term.

Giving politicians decision-making power with regards to debt issuance is problematic from a broader social welfare perspective, as politicians' interests align with only a small portion of the population. Taking on debt provides liquidity so the government can function today, signaling the politician's aptitude to his constituents and the sovereignty's economic health to the market. But the risk of false signaling is high. Politicians will rationally impose unrealistic future restrictions on the sovereignty to improve the government's reputation today at the expense of realistic obligations tomorrow.

B. Defaulting

The sovereign may opt for default and simply refuse to pay creditors the money they are owed, which would amount to a breach of contract.[94] For example, Argentina defaulted on its public and private debt obligations in 2001.[95]

There are several problems with the default option. First of all, legally, default is not a solution at all. The debtor in default still has the same contractual obligations to creditors, plus, depending on the agreement terms, any additional obligations triggered by default. Creditors could also sue for breach of contract. Litigation would create additional expenses for the debtor. Default leaves the insolvent borrower worse than where it started.

Secondly, legal uncertainty surrounding default inefficiently discourages lending in the long-term and broader marketplace. Argentina's situation provides a glimpse into Puerto Rico's future if the island were to take the default route. The country came to a repayment agreement with most creditors, but some hedge funds held out and began decade-plus-long litigation against the country

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[93] To examine Puerto Rico's bond agreements, see *Tax-Exempt Securities*, GOV'T DEV. BANK FOR P.R., http://www.gdb-pur.com/investors_resources/exempt-securities.html.

[94] For a historical overview of sovereigns in default and economic discussion thereof, see Hal S. Scott, *A Bankruptcy Procedure for Sovereign Debtors?*, 37 INT'L LAW. 103, 108 (2003).

[95] Christina Marie Wilson, *Argentina's Reparation Bonds: An Analysis of Continuing Obligations*, 28 FORDHAM INT'L L.J. 786, 798–800 (2005).

to demand payment in full.[96] In 2012, the Southern District of New York shocked the markets by holding that a boilerplate clause in the debenture, the *pari passu* clause, entitled the holdout creditors to full payment.[97] The Second Circuit affirmed,[98] and the Supreme Court has denied multiple writs of certiorari.[99] Argentina remains entangled in costly litigation, strapped for cash, and effectively shut out of the international bond market.[100]

Regardless of the outcome on the specific legal questions in Argentina's case, default damages the issuer's credibility. In the realm of bond creditors, lack of credibility increases the cost of and ultimately restricts lending by increasing risk premiums. For Puerto Rico, which, like many developing nations, uses debt financing to fund essential governmental services, restricted access to the credit markets translates into reduced public services.

As the Argentina cases illustrate, uncoordinated litigation by individual creditors wastes resources and creates perverse incentives. The decisions for the bondholders award the most litigious creditors and dis-incentivizes bargaining in the name of the collectivity. For these reasons, default is a costly and flawed alternative.[101]

C. Economic Development: Raising Revenues and Decreasing Liabilities

If the borrower raises enough money and reduces spending, it will not need to cut down its existing debt obligations because it will be able to service them. This is often politicians' preferred plan, and, analogously, management's plan in many an optimistic private context. Puerto Rico is no exception. The materials that the island presents to investors focus on the governor's plans to increase revenue and, to a lesser extent, cut costs. The 2015 budget assumes a revenue increase of $528 million in 2015 over 2014. The government is more conservative but also less reliable in its expense predictions. It projected expenditures of $9.565 billion, which represent an increase over the actual 2014 expenditures of $9.245 billion, but a decrease in the predicted 2014 expenditures

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[96] Kathy Gilsinan, *65 Words Just Caused Argentina's $29-Billion Default*, THE ATLANTIC, (Jul. 31, 2014, 11:59 AM), http://www.theatlantic.com/international/archive/2014/07/65-words-just-caused-argentinas-29-billion-default/375368/.

[97] NML Capital, Ltd. v. Republic of Argentina, 2012 WL 5895650, at *3 (S.D.N.Y. Nov. 21, 2012).

[98] NML Capital, Ltd. v. Republic of Argentina, 727 F.3d 230 (2d Cir. 2013).

[99] Republic of Argentina v. NML Capital, Ltd., 134 S. Ct. 201 (2013) (mem.), Republic of Argentina v. NML Capital, Ltd., 134 S. Ct. 2819 (2014) (mem.).

[100] Matt Wirz and Christopher Whittall, *Plan to Sell Argentine Debt Collapses*, WALL ST. J. (Feb. 26, 2015, 6:56 PM), http://www.wsj.com/articles/argentina-planned-bond-sale-dropped-1424973179.

[101] For an empirical study of the costs of default, see Eduardo Borensztein & Ugo Panizza, *The Costs of Sovereign Default*, 56 IMF STAFF PAPERS 683, 690–97 (2009).

of $9.770 billion.[102] The government passed an emergency austerity law in June of 2014, and also counts the P.R. Recovery Act amongst its cost cutting measures.[103]

Investors should take these optimistic projections with a grain of salt. Many of the government's predictions rely on shaky assumptions and risky undertakings.

For example, the 2015 revenue predictions assume increased tax collections, from $4.847 billion in total income tax collections in 2014[104] to $5.313 billion in 2015.[105] Magically, the government also plans to reduce both individual and corporate marginal tax rates while still increasing collections to the tune of roughly $460 million.

Further, the island depends on the unreliable U.S. tax subsidies for its revenue predictions. The Act 154 excise tax is one of Puerto Rico's most significant revenue sources. For the past three years, revenues from Act 154 comprised 20% of the Commonwealth's General Fund revenues. A large portion of Puerto Rico's corporate tax revenues comes from just a handful of taxpayers. Only six corporate taxpayers paid 75% of these collections last year. If any one were to leave the island, tax revenues would decrease significantly and unexpectedly. Not only are the revenue collection sources risky, but also, they are temporary. Act 154-2010 is set to expire in 2017.[106]

On the individual income tax side, the government is proposing a massive, fundamental overhaul of tax policy, switching from a U.S. style tax on salary to a European style tax on consumption.[107] Like on the corporate side of tax collection, the island's revenue eggs are currently in too few taxpayer baskets. 78% of individual income tax collections last year came from less than 10% of all tax filers.[108]

As Puerto Rico illustrates, the economic development option is the best alternative in terms of minimizing pain, but the worst option in terms of feasibility. It is rational for politicians in a distressed public entity to

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[102] P.R. Fin. Rep. at 7.
[103] *Id.* at 39.
[104] *Id.* at 100. The Government of the Commonwealth of Puerto Rico Special Fiscal and Operational Sustainability Act, 2014 P.R. Laws 273, aims to reduce spending by (i) freezing and reducing public labor compensation and benefits, (ii) reallocating some public corporations' savings into General Fund treasuries, (iii) freezing allocations to the University of Puerto Rico, Judicial Branch, Legislative Assembly, and municipalities, (iv) reducing rates that the government would pay for its own water and services, (v) implementing a payment plan for legal judgments, and (vi) strengthens oversight of the executive branch by the OMB.
[105] OFF. OF MGMT. & BUDGET, PROPOSED BUDGET 2014–2015: NET REVENUES TO THE GENERAL FUND 2, http://www2.pr.gov/presupuestos/PresupuestoAprobado2014-2015/Informacin%20de%20Referencia/Ingresos%20Consolidados%20del%20Estado%20Libre%20Asociado%20de%20Puerto%20Rico.pdf.
[106] P.R. Fin. Rep. at 19.
[107] COMMONWEALTH OF P.R., UPDATE ON FISCAL AND ECONOMIC PROGRESS 49 (2014). http://www.gdbpr.com/documents/FY15Q1UpdateOnFiscalAndEconomicProgressWebcast103014.pdf.
[108] *Id.* at 46.

overestimate future revenue streams. Term limits misalign politicians' incentives with the long-run health of the economy. An estimate of future revenue increases, to the extent creditors believe them, allows the borrower to live well today and suffer tomorrow, when payment becomes due. By the time tomorrow rolls around, the politicians will have left office.

V. LESSONS FROM PUERTO RICO

This section considers statutory legal solutions to Puerto Rico's problems, which represent the inefficiencies that plague insolvent governments in general. It (1) argues that a statutory scheme for bankruptcy would be more efficient than non-statutory alternatives; and (2) suggests specific amendments to Chapter 9, several of which are inspired by the P.R. Recovery Act, to improve federal bankruptcy law economically.

A. Efficiency of Bankruptcy Law Over Non-Statutory Alternatives

As the Puerto Rico case study illustrates, contractual mechanisms are inefficient solutions to insolvency.[109] Default is not a solution but rather a new problem. And economic development solution is ideal in theory but unlikely in practice.

Bankruptcy law has the potential to minimize costs, both in terms of dollars and in terms of welfare more broadly. Lending transactions will not always go as planned. When the pie is too small to feed everyone, some parties will be disappointed. Complex debtors and multiple creditors are involved in large public debt issuances, each of whom wants as much of the pie for himself as possible.

Article I, § 8—delegating to Congress the authority to establish "uniform laws on the subject of bankruptcies throughout the United States"—is the Founders' attempt to balance these interests.[110] The clause reflects James Madison's idea that uniform bankruptcy laws were essential to a healthy national economy, with vibrant intra- and international lending. As he wrote, "[t]he power of establishing uniform laws of bankruptcy is so intimately connected with the regulation of commerce, and will prevent so many frauds where the parties or their property may lie or be removed into different States that the expediency of it seems not likely to be drawn into question."[111] In the words of astronaut and former Eastern Airlines CEO Frank Borman, bankruptcy law is to

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[109] *See* COMM. ON INT'L ECON. POLICY & REFORM, REVISITING SOVEREIGN BANKRUPTCY 20 (2013), http://www.brookings.edu/~/media/research/files/reports/2013/10/sovereign-bankruptcy/ciepr_2013_revisitingsovereignbankruptcyreport.pdf (arguing that "contracts as interpreted by judges have proven inadequate to mediate the tension between the lack of enforcement and the impossibility of discharge in sovereign debt.").

[110] U.S. CONST. art. I, § 8, cl. 4.

[111] THE FEDERALIST NO. 42 (James Madison) http://www.constitution.org/fed/ federa42.htm.

capitalism what hell is to Christianity. In order for commercial transactions to occur at the outset, most rational parties need a reliable plan B for when things don't go as planned. Bankruptcy law represents over 200 years of judges and legislators formulating a plan B that is as fair and reliable as possible to all the parties involved.[112]

Underlying and enabling rehabilitative provisions of the law is the ingenious, optimistic idea that the parties' interests will cease to conflict if they focus on growing the pie rather than on snatching pieces for themselves. This rehabilitative concept is original to U.S. law, though has begun to catch on abroad in governments that traditionally focus on liquidation.[113]

Leaving aside the detailed provisions of U.S. bankruptcy law and Chapter 9, bankruptcy law generally poses a solution over the non-statutory alternatives by simply existing. To paraphrase Woody Allen, 80% of a successful bankruptcy law is just showing up.[114] When creditors know at the outset of a transaction that, in the worst case scenario, they will be dealt with by federal law, which seeks to maximize their payout and treat them fairly, they will be more comfortable lending at the outset. In economic terms, comfortable means having enough information to price the loan accurately, so the interest rates reflect the chance of a diminished outcome in a plan B scenario. The more predictable outcomes are, the more comfortable each individual creditor will feel. The more comfortable each individual feels, the healthier the credit market will be overall. In a healthy credit market, Puerto Rico would be able to borrow money to fund infrastructure projects and individuals will be able to borrow money to pay for new homes and cars. If the creditor thinks that the chance the borrower will be unable to repay is high, the creditor will charge high interest rates initially, and the borrower may or may not choose to take the loan. Unchanging, uniform bankruptcy law sets the stage for a healthy credit market. The more predictable the Plan B outcome is to creditors at the outset of a transaction, the safer lending is. Federal statutes are more predictable than contract and common law because they change less frequently, both over time and between jurisdictions.

Municipal bankruptcy law has only existed in the United States since the 1930s.[115] Throughout history, there have been far fewer Chapter 9 filings than Chapter 11 filings. In this way, municipal creditors have a less reliable plan B than corporate creditors. But the Chapter 9 plan B is still more predictable than the non-statutory alternatives. Although there is some variation from one Chapter 9 case to another, each one is a unified legal proceeding, overseen by a neutral

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[112] *See* Charles Jordan Tabb, *The History of the Bankruptcy Laws in the United States*, 3 AM. BANKR. INST. L. REV. 5 (1995) (for a history of U.S. bankruptcy law).

[113] Manfred Balz, *The European Union Convention on Insolvency Proceedings*, 70 AM. BANKR. L.J. 485, 498 (1996).

[114] Susan Braudy, *He's Woody Allen's Not-So-Silent Partner*, N.Y. TIMES, Aug. 21, 1977, at 83.

[115] For a history of municipal bankruptcy law in the U.S., see Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 427–42 (1993).

arbiter,[116] that imposes an automatic stay,[117] and requires creditor plan approval.[118] The judge as neutral arbiter monitors the debtor's managers, easing the agency costs of rationally irresponsible politicians at play in Puerto Rico, such as unrealistic budgetary promises and unsustainable debt issuances.

The automatic stay freezes actions against the debtor and prevents creditors from racing one another to the courthouse. The debtor can focus on growing the pie rather than on duplicative legal proceedings like Argentina. The creditors can rest easy that a situation in which quicker creditors to the courthouse would be paid first and drain the debtor's assets will not occur. In Puerto Rico, the automatic stay would have barred both a teachers' suit against the government for modifying public pensions[119] as well as the hedge funds' suits against the government for passing debt reform legislation, which eventually led to the P.R. Recovery Act being overturned. It would have also obviated PREPA's need to negotiate with creditors individually for forbearance agreements, which incurred additional direct costs as well as litigation expenses upon the island.

Creditor voting provisions under the Code divide creditors into classes according to the types of claim. For the plan to be approved, both a majority of creditors within each class and a majority of the classes must sign on. Judicial approval depends partly on whether the plan pays creditors according to a statutorily determined order. Under the absolute priority requirement, junior creditors may not be paid before senior creditors are paid in full. Whether a creditor is senior or junior depends in significant part on the creditors' initial contractual expectations. For example, creditors are senior to equity holders, which preserves the parties' ex ante expectations about who would get paid first. The creditor voting provisions delicately balance the goals of protecting all creditors, minimizing the power of holdouts, and ensuring that the debtor pays until it hurts. In a governmental bankruptcy, creditor voting could be valuable as a symbolic stamp of approval that the debtor's plan going forward serves the interest of creditors. For example, in Puerto Rico, fiscal stringency measures that the government took outside of bankruptcy involved reducing pension payments to public employees. This resulted in the costly litigation by judges and teachers. Had the fiscal stringency measures been imposed through a bankruptcy plan rather than emergency law, the symbolic stamp of approval from other creditors would quell costly litigation and protest from unhappy creditors. A plan that involved cutting governmental services such as public pension payments would be unpopular even if it would be in the long-term interest of the economy. A creditor vote in its favor could signal to voters the necessity of an unpopular plan,

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[116] 11 U.S.C. § 921(b).

[117] *Id.* at § 901 (making the § 362 *automatic stay* available for Chapter 9 proceedings).

[118] *Id.* (making § 1122 applicable to Chapter 9 cases).

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so citizens would not vote responsible parties out of office for taking responsible stringency measures.[120]

For these reasons, a Chapter 9 creditor is in a better position than a creditor of a municipality in default, pursuing ad hoc negotiations, or relying on economic development plans without a statutory restructuring scheme. With every new Chapter 9 case that follows existing precedent that sets clear, well-reasoned precedent going forward, the municipal creditor's position becomes more predictable and efficient. In this way, every time an insolvent municipality does not file under Chapter 9, it creates an opportunity cost. The municipal credit market misses out on a chance to make Chapter 9 more reliable and valuable.

By barring Puerto Rico from the Code and leaving the island to resort to non-statutory measures for debt adjustment, Congress imposes an opportunity cost on the municipal credit market at large. The cost will be especially high because the Commonwealth, with its quasi-state, quasi-city, and quasi-sovereign status, would have set relevant precedent for a wide variety of types of Chapter 9 debtors. Additionally, because of Puerto Rico's triple tax-free status and the resultant ubiquitousness of its debt, investors in every state will feel the effects of the exclusion in the short-term.

B. Suggested Code Amendments Inspired By the P.R. Recovery Act

The P.R. Recovery Act provided two mechanisms for public corporations to restructure their debt: Chapter 2 and Chapter 3. Chapter 2 essentially facilitated out-of-court workouts. The section provided a framework for negotiations, with minimal judicial participation but with provisions in place to minimize collective action problems. In effect, Chapter 2 retroactively added CACs to debt contracts, and in so doing overcame the initial collective action hurdle inherent to contractual solutions: that it is never in a creditor's best interest to renegotiate for less favorable terms than he had initially.

Although a stand-in for Chapter 9, the P.R. Recovery Act improves upon federal law from an economic perspective. The Commonwealth law incorporated innovations from legal scholarship and Chapter 11 into a governmental bankruptcy in a way that Chapter 9 could adopt.

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[120] For an overview of bankruptcy law's policy goals, see 1 COLLIER ON BANKRUPTCY P1.01 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2011). *See also* the legislative history of the current municipal bankruptcy law, describing the law's purpose, "to provide a forum where distressed cities, countries and minor political subdivisions . . . of their own volition, free from all coercion, may meet with their creditors under the necessary judicial control and assistance in an effort to effect an adjustment of their financial matters upon a plan deemed mutually advantageous." H.R. REP. NO. 73-207 (1933); H.R. REP. NO. 94-686 (1976). For an overview of bankruptcy law theories, see also Yaad Rotem, *What Is Missing in Corporate Bankruptcy Theories? Revisiting the Efficiency Rationale*, 39 ISR. L. REV., no. 3, 2006, at 190.

1. Clarification of Intragovernmental Boundaries and Central Bank Role

A major concern of would-be Chapter 9 filers is damage to the credit ratings of related governmental entities and on the municipal credit market as a whole. For example, in August, 2011, the governor of Alabama urged Jefferson County commissioners not to file because "it could ripple out and hurt the credit of the whole state."[121] Ensuring that a Jefferson County would, indeed, affect Alabama creditors, Governor Robert Bentley offered to back the county's newly issued debt with the city's moral authority. As a result, the county dragged its feet, but eventually filed two months later.[122]

A similar ripple effect occurred when PRASA's credit was downgraded along with the rest of the island's debt. Although PRASA itself was financially healthy, credit agencies downgraded the public corporation because it was interconnected with the remainder of the Puerto Rican government. The reason for this downgrade was the fuzzy boundaries and open-ended intra-governmental loans that characterize Puerto Rico's government. The Commonwealth's Central Bank, which one economist described as acting "as the government's 'piggy bank[,]'"[123] enables the broad gaps between distinct legal identities and blurred economic realities of the Commonwealth government's corporate structure. In PRASA's case, the interconnectedness represented an inefficiency. The corporation's ratings were needlessly lowered below the level of actual risk to investors investing in the corporation, because of Puerto Rican creditors' general inability to tell exactly which entity they are lending to due to the blurred intragovernmental boundaries.

The P.R. Recovery Act addresses the root of the ripple effect problem by clarifying the role of the central bank and establishing strict boundaries around the separate public corporations' budgets.[124] The public corporations are distinct legal entities from the GDB and Commonwealth's general fund, and the P.R. Recovery Act intends to bring practice in line with legal reality. Specifically,

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[121] Mary Williams Walsh, *A County in Alabama Puts Off Bankruptcy*, N.Y. TIMES, Aug. 12, 2011, http://www.nytimes.com/2011/08/13/business/jefferson-county-alabama-puts-off-bankruptcy-decision.html?_r=0.

[122] Mary Williams Walsh, *Alabama Governor Fails to Prevent County's Record $4 Billion Bankruptcy Filing*, N.Y. TIMES, Nov. 9, 2011, http://www.nytimes.com/2011/11/10/us/alabama-governor-fails-to-prevent-jefferson-countys-record-4-billion-bankruptcy-filing.html.

[123] Porzecanski, *supra* note 43, at 3.

[124] The P.R. Recovery Act is part of a larger plan by Governor García-Padilla to spin off the public corporations' budgets from the general fund and GDB. For example, P.R. Pub. L. 24-2014, 2014 P.R. Laws 60, required public corporations to identify sources of repayment in order to secure GDB loans. The Government of the Commonwealth of Puerto Rico Special Fiscal and Operational Sustainability Act, P.R. 2014 P.R. Laws ___, declares a state of fiscal emergency and requires public corporations to cover their operational expenses with revenues rather than loans and debt refinancing. For a full description of other measures that Puerto Rico took during 2014 to reorganize the island's public corporations and scale back debt levels, see P.R. Recovery Act, Statement of Motives, 2014 P.R. Laws at ___.

a public corporation reorganizing its debt under the P.R. Recovery Act must commit to a recovery program that allows the entity to become financially self-sufficient, rather than dependent upon the General Fund and Government Development Bank.[125] The GDB must approve this plan.[126]

Whereas the P.R. Recovery Act acknowledges the interconnectedness of its governmental entities and takes steps to address resulting inefficiencies, Chapter 9 does little to clarify intragovernmental boundaries to creditors. A state must authorize a filing by one of its subdivisions but is free to extend any or no financial assistance to creditors of the debtor. Governor Bentley was right to be concerned that a Jefferson County filing would affect Alabama's credit rating. But instead of employing a sensible way to counteract the chance of contagion by assuring creditors as to the separateness between the county's and state's budgets, he took the opposite approach, backing the county's budget with the state's authority. In the long run, blurring boundaries between state and municipal budgets will confuse creditors and thwart *ex ante* attempts to price municipal bonds accurately. Lenders will not be able to valuate their loans when it is unclear whether they are creditors of Jefferson County, the entire state of Alabama, or some ever-changing combination of the two. Chapter 9 does nothing to address this fundamental inefficiency inherent to governmental lending on the front end and budget blurring on the back end during times of insolvency.

This deficiency is characteristic of U.S. bankruptcy law overall. U.S. law generally upholds formalistic legal entity structures and does not address corporate groups as such. For example, the Bankruptcy Code is silent on parent liability for subsidiaries' liability.[127] Some case law has arisen in the absence of statutes that deal with corporate groups. In bankruptcy, the common law doctrine of substantive consolidation allows judges to treat separate corporate entities as one. The court's substantive consolidation power derives from its general equitable powers under § 105(a) of the Bankruptcy Code, permitting the judge "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions" of the law.[128] Not only does substantive consolidation lack a specific statutory basis, but also, U.S. courts have failed to establish consistent case law for determining when substantive consolidation is appropriate. Like veil piercing, the substantive consolidation test is fact-specific

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[125] *See* P.R. Recovery Act, Statement of Motives, § 202(b) (mandating that "[i]n connection with a consensual debt relief transaction, an eligible obligor must prepare and commit itself…to a recovery program that—(a) allows the eligible obligor to become financially self-sufficient based on such financial and operational adjustments as may be necessary or appropriate to allocate the burdens of consensual debt relief equitably among all stakeholders."). Further, the program may include interim milestones and performance targets to improve margins, increase revenues, and reduce expenses. P.R. Recovery Act § 202(c).

[126] P.R. Recovery Act § 202(b).

[127] Marcus Lutter, *Limited Liability Companies and Private Companies*, *in* INT'L ENCYCLOPEDIA OF COMP. L. 13, ch. 2, § 203, at 102 (1998).

[128] 11 U.S.C § 105(a) (2010).

and varies from one jurisdiction to another. The Third Circuit[129], Second Circuit,[130] and D.C. Circuit[131] have all announced vague, differing approaches to substantive consolidation.

As a result, creditors of multi-entity groups in the United States cannot determine *ex ante* exactly which assets they would have a claim upon in the event of default. The lack of statutory guidelines addressing corporations collectively leaves a good deal of discretion in individual judges' hands, which undermines creditors' ability to predict their fate at the outset and price lending optimally.

2. Refocus of Authorization Requirements Towards Boundary Transparency

The eligibility requirements in Chapter 9 of the Bankruptcy Code illustrate the conflicts between federalism and efficiency. U.S. municipal debtors must meet four initial eligibility requirements in order to file under Chapter 9.[132] Of these, provisions § 109(c)(5)(A) and (B) further efficiency goals. To meet requirements (A) or (B), the prospective debtor must take a long, hard look at its financials, determine a realistic plan to meet its debt obligations as completely and promptly as possible, so as to be likely to obtain creditor approval, and attempt to bargain with creditors out of court. Pre-filing planning protects creditors and debtors alike from a bankruptcy preceding that is more trouble than it is worth, as bankruptcy is costly and disruptive. As the judge explained in In re Sullivan County, a foundational Chapter 9 case, "some sort of comprehensive plan is required as one of the 'screening factors' to avoid a too early and rapid resort to the bankruptcy courts by municipalities."[133] Right off the bat, the Code catalyzes negotiations, transparency, and sound financial planning.

The eligibility requirement under § 109(c)(2), on the other hand, derives from federalist concerns and undermines efficiency. This provision requires that a Chapter 9 debtor be "specifically authorized, in its capacity as a municipality or by name, to be a debtor under such chapter by State law, or by a governmental officer or organization empowered by State law."[134] The purpose of the

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[129] *See*, *In re:* Owens Corning, 419 F. 3d 195 (3d Cir. 2005).
[130] *See*, In re Augie/Restivo Baking Co., Ltd., 860 F.2d 515 (2d Cir. 1988).
[131] *See*, In re Auto-Train Corp., Inc., 810 F.2d 270 (D.C. Cir. 1987).
[132] 11 U.S.C.A § 109(c)(5) (2010), requires the debtor to either (A) present the creditors with a plan for debt adjustment and obtain the agreement of each impaired class agrees to; (B) attempt in good faith but fail to present creditors with a plan and obtain agreement from the majority of each impaired class; (C) be unable to negotiate with creditors because doing so would be impracticable; or (D) reasonably believe that a creditor may attempt to obtain a transfer that is voidable under § 547.
[133] *In re* Sullivan County Regional Refuse Disposal District, 165 B.R. 60, 78 (Bankr. D.N.H. 1994) (citing 4 COLLIER ON BANKRUPTCY ¶ 900.03 (15th ed.); 6 NORTON BANKRUPTCY LAW & PRACTICE § 136.25 (1993)).
[134] 11 U.S.C.A § 109(c)(2) (2010).

requirement is balancing the federal power to enact bankruptcy laws with the Tenth Amendment, which reserves contract power to the states. Together with § 903, which provides, "this chapter does not limit or impair the power of a State to control, by legislation or otherwise, a municipality of or in such State in the exercise of the political or governmental powers of such municipality,"[135] § 109 "allows states to act as gatekeepers to their municipalities' access to relief under the Bankruptcy Code."[136]

The specific authorization requirement has been the topic of extensive litigation and statutory deliberation around the country. For example, in In re Timberon Water & Sanitation Dist., Timberon, a New Mexican municipal water and sanitation district, was denied access to Chapter 9 for failing to meet the § 109(c)(2) state authorization requirement, despite a state law empowering the district "to sue and be sued and to be a party to suits, actions and proceedings"[137] as well as a resolution by the district's governing body declaring the district insolvent and declaring its intent to file under Chapter 9.[138] In the case, In re New York City Off-Track Betting Corp., after extensive deliberation, the Bankruptcy Court ultimately held that the debtor met the requirement after the governor issued an executive order that authorized the filing.

Many of the Code's inefficiencies arise from federalist concerns. Chapter 9 struggles to balance the Tenth Amendment, which protects state jurisdiction over contract law, against Article I, Section 8, which delegates bankruptcy power to Congress.[139] Throughout the history of bankruptcy law, Congress has spent a good deal of time, litigation, and taxpayer money juggling Tenth Amendment state authority against Article I, section 8 federal bankruptcy authority. The first version of Chapter 9 was passed in May of 1934 as "Chapter IX," as tensions escalated between the late Lochner-era court, which prioritized contracts, and the Depression era population, who desperately needed a way to scale back debt obligations.[140] The drafters took great care to obviate Commerce Clause and Tenth Amendment challenges, stating in Section 80 that the statute should not

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[135] 11 U.S.C.A § 903.

[136] *In re* City of Vallejo, 403 B.R. 72, 75 (Bankr. E.D. Cal. 2009).

[137] *In re* Timberon Water & Sanitation Dist., 2008 WL 5170581, at 1.

[138] *Id.*, at 2.

[139] Federal jurisdiction of bankruptcy law is necessary because the federal government has broader authority to impair contracts, including lending agreements, than state governments. *See* ERWIN CHEMERINSKY, CONSTITUTIONAL LAW: PRINCIPLES AND POLICIES 646–55 (4th ed. 2011) (citing U.S. CONST. art. I, § 10 (mandating that "no State shall . . . pass any . . . law impairing the Obligation of Contracts") as prohibiting only state behavior, not federal behavior).

[140] Between the late 19th Century and 1937, the Court embraced *laissez-faire* politics and restricted both state and federal legislative powers by narrowly defining Congress' interstate commerce powers, as in United States v. E.C. Knight, 156 U.S. 1(1895), interpreting the Tenth Amendment as substantively protecting a zone of state powers into which the federal government could not intrude, as in Hammer v. Dagenhart ("the Child Labor Case"), 247 U.S. 251 (1918), and prohibiting governmental interference with the freedom to contract as violative of economic substantive due process, as in Lochner v. New York, 198 U.S. 45 (1905). *Id.* at 252–53, 630–31.

"be construed to limit or impair the power of any state to control, by legislation or otherwise, any political subdivision thereof in the exercise of its political or governmental powers."[141] Nonetheless, the pre-Roosevelt era court struck down Chapter IX just two years later, in a 5-4 decision in Ashton v. Cameron County Water Improvement District.[142] Even were a state to agree to Chapter IX, the Ashton court held, federal jurisdiction over municipal bankruptcy would still violate federalist principles. The Ashton court advanced two separate reasons for the judiciary's role in preserving federalism: (1) to protect the states' freedom from federal tyranny,[143] and (2) to preserve separate spheres of state and federal activity as a goal unto itself, as an optimal balance of powers.[144] Since then, the authorization requirement has been amended and amended again to reach a balance between state and federal power. Most recently, the law was amended in the mid-1990s to require specific authorization by the state rather than general authorization for its municipalities to file under Chapter 9.

Anyone seeking to preserve Tenth Amendment concerns is up for a lot of work by way of wasteful transaction costs and uncertain outcomes. Tenth Amendment jurisprudence is in a confused state in general. The Court vacillates over whether the Tenth Amendment is "but a truism"[145] or a more meaningful clause.[146] Specifically in the bankruptcy context, the Code and courts alike are unclear as to the proper role of states and Congress in lawmaking.

Under the P.R. Recovery Act, a public corporation seeking debt adjustment under Chapter 2 or 3 must receive authorization from the GDB, which the governor can request or the GDB can provide independently. Unlike Chapter 9, which gives free reign to states in determining whether to authorize municipal bankruptcy, and why or why not to do so, the P.R. Recovery Act's authorization requirement has a clear purpose. As § 202 and the Statement of Motives discusses, the purpose of the P.R. Recovery Act is disentangling intra-governmental lending and leaving the public corporations self-sufficient. GDB authorization is intended to ultimately give the filer greater financial autonomy.

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[141] 11 U.S.C.A. § 903. (Section 80(k) of the 1934 Bankruptcy Act).

[142] Ashton v. Cameron Cty. Water Improvement Dist., 298 U.S. 513 (1936).

[143] For example, the *Ashton* court cautions: "If obligations of states or their political subdivisions may be subjected to the interference here attempted, they are no longer free to manage their own affairs." *Id.* at 896.

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[145] The phrase *but a truism* comes from a 1941 Supreme Court decision—expressing the Court's view from the New Deal era until the 1990s—that the Tenth Amendment was not, itself, a restriction on Federal power, but merely a restatement of balance of power principles outlined throughout the Constitution. United States v. Darby, 312 U.S. 100, 124 (1941).

[146] Additionally complicating matters is the interplay between Tenth Amendment and Commerce Clause jurisprudence. If the Tenth Amendment is not "but a truism," but a more meaningful restriction on Congressional ability to legislate outside of its enumerated powers, the scope of Congressional enumerated powers becomes a critical question for determining whether Tenth Amendment violations exist.

This will result in clearer budgetary boundaries, increasing informational transparency to creditors and ultimately making lending more efficient.

The authorization requirement can be valuable by legitimizing the proceeding in the eyes of creditors. The debtor must demonstrate fiscal emergency in order to receive GDB authorization. The fiscal emergency requirement ensures that public corporations will not resort to the P.R. Recovery Act to restructure obligations merely because they are unfavorable. As such, the authorization requirement would theoretically legitimize the procedure in investors' eyes, assuaging them that debtors will not abuse the Act by filing to seek an unfair advantage.

Chapter 9 would benefit from clarifying the goal of the authorization requirement, and refocusing the goal towards informational transparency for creditors. The authorization requirement could require a clear statement from the state about the financing role it intends to play in the bankruptcy going forward. This would clarify budgetary boundaries to creditors and allow efficient pricing. It would also reduce transaction costs by giving courts a clear sense of the purpose of the authorization requirement. The courts in Timberon and New York City Off Track Betting spent a significant amount of time and money determining the debtors' authorization. A clear statement of Congressional intent would mitigate these costs. These amendments would reduce the inefficiencies that derive from the authorization requirement without sacrificing Tenth Amendment state authority.

A clearer statement of authorization requirement purpose from Congress would inspire more consistent authorization laws at the state level. Currently, state legislatures have responded disparately to the state authorization requirement. For example, in California, a state statute broadly authorizes all municipal filings in advance; Connecticut municipalities wishing to file under Chapter 9 must receive specific approval from the governor, and a Georgia municipality is statutorily prohibited from filing.

One of the main reasons federal rather than state bankruptcy law makes sense from a law and economics perspective is having uniform law from state to state. Giving creditors certain, consistent treatment from state to state incentivizes them to lend at lower rates, benefitting the economy overall by allowing capital to flow more freely, at more efficient prices. This is one reason that the Constitution delegates bankruptcy authority to the federal government and contains a uniformity requirement.[147] In other words, the more consistent treatment that creditors could expect among the states, the more willing creditors would be to lend in the first place, and the more easily the government could ensure creditors' fair treatment.

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[147] *See generally*, Judith Schenck Koffler, *The Bankruptcy Clause and Exemption Laws: A Reexamination of the Doctrine of Geographic Uniformity*, 58 N.Y. U. L. Rev. 22 (1983). Professor Koffler argues that state exemption laws render the uniformity requirement meaningless and nullify the power of federal bankruptcy jurisdiction as intended by the Founders.

Uniform bankruptcy laws benefit debtors as well.[148] Before ratification, inconsistent bankruptcy laws amongst the states meant that a debtor's obligations could be discharged in one colony and still remain binding next door. Debtor's prisons were especially miserable, squalid quarters, where, unlike ordinary prisons, inmates had to pay for their own food and lodging while in prison. While bankrupt municipalities cannot literally be sent to debtor's prison, endless litigation is a prison of its own, as Argentina can attest. But the Tenth Amendment limitations on Chapter 9 work at crosshairs with the goal of uniformity.

3. Use of Financial Advisors

The Puerto Rico Act statutorily empowers a judge to appoint a special commissioner who "must be a person of recognized expertise in financial matters, including insolvency proceedings."[149] Chapter 9, on the other hand, does not make use of financial advisors. As the Collier monograph notes, "failing to retain a qualified financial advisor with significant experience in municipal finance is likely to be penny-wise and pound-foolish."[150]

Chapter 9 would benefit if, like the P.R. Recovery Act, the law anticipated or even required the judge to consult with a financial adviser. The judge's role in an insolvency proceeding is to ensure the plan's feasibility. Essentially, a restructuring plan is in one half a valuation of the debtor's business, which involves estimates of future cash flows, and in the other half a blueprint for dividing those future cash flows. The judge's initial approval of the plan thus hinges half on the judge's sense of whether these predictions are realistic, and, in the other half, a determination of whether the proposed division is fair.

Assessing whether predictions about future cash flows are realistic is the job description of a financial advisor, not a judge. Judicial determination of plan feasibility at the outset is an especially more important protection of creditors' rights in a governmental proceeding.[151] In a corporate bankruptcy, creditors have greater legal and market recourse against a debtor who ends up unable to fulfill his plan obligations. In a governmental bankruptcy, creditors' remedies against a debtor who, after plan approval, does not fulfill his obligations are more limited.

4. Enforcement

Chapter 9's only means of executing a reorganization plan is § 943(b)(7), which requires a Chapter 9 plan to be "in the best interests of creditors" and "feasible." But the Code neither defines "feasible," nor provides relevant factors

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[148] This is incidental because the Founders were not concerned with the treatment of debtors, which has become a central policy concern of modern bankruptcy law.

[149] Recovery Act § 109(b).

[150] 1-Monographl COLLIER ON DEBT ADJUSTMENT FOR MUNICIPALITIES § 4.

[151] *See* discussion, *supra*, under Enforcement.

for a judge to consider in a feasibility analysis. The lack of statutory guidance creates ambiguity for creditors, debtors, and judges, increasing transaction costs. For example, the bankruptcy court in the Colorado Chapter 9 case In re Mount Carbon Metro discussed the meaning of *feasibility* at length, delving into the legislative history and history of the Code in general.[152] The thorough judicial opinion concluded with a definition of feasibility resembling that in § 363(g) of the Puerto Rico Act. Had the U.S. legislature included a similar provision in the statute, the actual costs of litigation as well as indirect costs arising from uncertainty would have been avoided.

Not only does the vagueness of the feasibility requirement under U.S. law create transaction costs by parties uncertain about *feasibility*'s meaning, but also, the vagueness speaks to the lack of enforcement provisions in place for Chapter 9 plans, robbing them of potential value. Chapter 9 lacks any means of ensuring that a debtor actually implement a plan, other than the vague feasibility standard, which the judge determines prior to confirmation.

The P.R. Recovery Act, on the other hand, contains actual enforcement mechanisms. The Act creates an independent commission to oversee compliance with the plan.[153] The public corporation must report to the commission every six months. If the corporation fails to meet statutorily specified milestones, the commission will inform the governor and the public. The Commission may make recommendations for curing non-compliance, which may "include the replacement of some or all of the management or the governing body of the eligible obligor."[154]

The P.R. Recovery Act is an inspirational model in that it merely contains an enforcement mechanism at all. Further, its particular enforcement mechanism is effective because it addresses root causes of the fiscal crisis: misaligned incentives between politicians' relatively short-term interests in their careers, and the Commonwealth's long-term interest in the health of its economy, and insufficient monitoring to reduce resulting agency costs. The Commission itself monitors politicians and also facilitates public monitoring of politicians. The Commission may even suggest firing politicians, which voters have the power to do.

Chapter 9, on the other hand, refrains from interfering in the political process. § 904, limitation on jurisdiction and powers of court, states: "Notwithstanding any power of the court, unless the debtor consents or the plan so provides, the court may not, by any stay, order, or decree, in the case or otherwise, interfere with—(1) any of the political or governmental powers of the

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[152] *See, e.g.*, *In re* Mount Carbon Metro. Dist., 242 B.R. 18, 31–42 (Bankr. D. Colo. 1999) (discussing the lack of statutory language or case law defining the *feasibility* requirement, and discussing the requirement at length).

[153] Recovery Act § 203.

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debtor; (2) any of the property or revenues of the debtor; or (3) the debtor's use or enjoyment of any income-producing property."

The purpose of § 904 is respecting the Tenth Amendment. But in doing so, the law neuters its effectiveness by refusing to deal with a fundamental cause of municipal insolvency: because politicians internalize short-term costs to the government's economy as reputational damages, and do not internalize long-term costs to the government because political terms are limited, politicians' interests are *per se* misaligned with the economic health of the government they represent.

So long as democratically elected representatives are responsible for making budgets, this conflict will persist and motivate unwise financial decision-making. A truly effective municipal bankruptcy law must address this endemic and ubiquitous agency cost.

The Puerto Rico law takes further steps to ensure that plans are actually put into practice. § 363(g) requires that "the petitioner shall be able to make all mandatory payments provided by the plan and perform public functions." § 363(h) mandates that "confirmation of the plan is not likely to be followed by the need for further financial reorganization of the petitioner," a requirement mimicking the § 1129(a)(11) for Chapter 11 confirmation, which references liquidation and is not incorporated into Chapter 9.[155]

Chapter 3 debtors must undertake fiscal stringency measures. § 315(o) requires for confirmation that "the petitioner shall have proved to the Court that it undertook...a reasonable program of cost reductions and income enhancements to try to maximize its repayment of affected debt under the plan." Chapter 3 thus offers an additional way for the court to oversee elected officials' budgetary decisions, and ensure that they prioritize economic efficiency over popular appeal. If they do not, the Commission will make their non-compliance known to the public, who may punish wayward officials by firing them through the voting process. By contrast, Chapter 9 lacks a statutory fiscal stringency requirement.

Not only must the Puerto Rico judge determine feasibility of the plan prior to confirmation, and in a well-defined way, but also, once the plan is put into place, in independent commission oversees compliance. A statutory bankruptcy has the potential to create value by introducing predictability for creditors into what would otherwise be an uncertain, risky environment. But without enforcement, predictability and therefore value of the proceeding in creditors' eyes is watered down.

5. DIP Period Judicial Monitoring

In both Chapter 9 cases and hypothetical P.R. Recovery Act cases, the government has a good deal of power to manage its own business affairs during

[155] 11 U.S.C. § 1129(a)(11) requires that "confirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor or any successor to the debtor under the plan, unless such liquidation or reorganization is proposed in the plan."

the course of the proceeding. Like § 363 in Chapter 11 of the Bankruptcy Code, § 307 of the P.R. Recovery Act provides a shortcut for the debtor to sell "all or substantially all" of its assets before plan confirmation. Both provisions require judicial approval.

Under current federal law, § 363 does not apply to Chapter 9 cases.[156] Chapter 9 does not incorporate § 363 because Congress wanted to give municipalities freedom to make budgetary decisions. To preserve the federalist balance of powers, insolvent municipalities do not need court approval to sell significant assets outside of the ordinary course of business.

However, a judicial approval requirement has benefits that Chapter 9 debtors miss out on. A judicial approval requirement protects creditors' interests and legitimizes the debtor's decisions. This is especially important for a debtor in possession [hereinafter DIP].[157] During the DIP period of a bankruptcy, legitimization benefits the debtor because managers of an insolvent entity *per se* lack legitimacy. Their prior decisions are responsible for the business's mess.

Legitimization enhances public and investor confidence. In Puerto Rico, the governor's decision to partially privatize the public corporation PRHTA in 2011 was akin to a DIP decision without judicial approval. The government decided to transfer operation and income of its two large toll plazas to Goldman Sachs and Albertis Infrastructure.[158] Creditors and citizens were concerned that the arrangement was a poor deal for the Commonwealth in the long run, designed to save political face and pay off debts with a short term cash infusion.[159]

If PRHTA had conducted the transfer under § 307, the court would have evaluated whether the transfer was a good business decision for both the agency in the long run as well as for its creditors. Court approval would ease creditors' and citizens' concerns that the transfer was made by incompetent or unscrupulous managers. The judicial stamp of approval would restore faith in the government's budgetary decisions in the eyes of citizens and creditors alike, rehabilitating the economy.

Because Chapter 9 lacks judicial approval requirements for significant DIP sale, creditors will be less likely to trust municipal debtors' business decisions. Although under federal law, the municipal DIP has the power to make these decisions whether the creditors like them or not, the debtor's interests are met

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[156] *See* 11 U.S.C. § 901 (cross-listing applicable statutes to Chapter 9).

[157] Under federal law, the debtors' managers may apply to run the firm during the bankruptcy proceedings. The period after filing and before plan confirmation is known as the DIP period. 11 U.S.C. § 1107.

[158] PRESS OFFICE OF THE GOVERNOR OF P.R., PUERTO RICO TO GET $1.4 BILLION IN ITS FIRST P3 TOLL ROAD DEAL (June 20, 2011), http://www.app.gobierno.pr/wp-content/uploads/2011/06/News-Release-ENG.pdf.

[159] *See* Alan Schankel, *PR Highway and Trans: A Bumpy Road*, JANNEY FIXED INCOME STRATEGY (June 13, 2013), http://www.janney.com/File%20Library/Fixed%20Income/prhta-a-bumpy-road.pdf; Carlos Márquez & John Marino, *First Phase of Highways PPP Underway*, CARIBBEAN BUS., (July 26, 2010, 12:00 AM), http://www.caribbeanbusinesspr.com/prnt_ed/news02.php?nw_id=3744&ct_id=0.

better when creditors have faith in its economy. In a broad sense, creditor faith encourages lending overall. In a more immediate sense, creditor distrust will inspire litigation.

For example, Detroit, when in Chapter 9, considered selling the city's artwork collection, valued between $2.8 and $4.6 million, to pay pension debts.[160] As a matter of law, Detroit was free to make this decision without creditor or judicial approval. But the Detroit Institute of Art, despite being owned and financed by the city, threatened to "fight and litigate every piece of art that the city would sell…in order to make it a very lengthy and painful piece of litigation" for the City.[161]

Had the sale received judicial authorization, the museum would not have wasted its time challenging the sales in court. Under § 363, a judge would have considered the costs and merits *ex ante*, and obviated costly and unnecessary litigation on the back end.

The Puerto Rico procedure for § 307 sales puts a good deal of power in the court to protect creditors and assess the debtor's business decisions.[162] Chapter 9 would do well to permit § 363 sales, which can be an important means of increasing estate value, with significant judicial oversight to legitimize the process. Puerto Rico provides an inspirational model in this regard.

6. DIP Period Creditor Monitoring

Chapter 9 formally incorporates the portions of Chapter 11 that empower creditor committees.[163] But in practice, the role of creditors' committees is more

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[160] Matthew Dolan, *Detroit Museum Raises Nearly $27 Million to Help Stave Off Sale*, WALL. ST. J. (July 16, 2014, 1:14 PM), http://www.wsj.com/articles/detroit-museum-raises-nearly-27-million-to-help-stave-off-sale-1405530845.

[161] Brent Snavely & Matt Helms, *Orr Says Settlement With DIA Averted Costly Legal Fight*, DETROIT FREE PRESS (*Oct. 2, 2014, 7:28 PM*) http://www.freep.com/story/news/local/detroit-bankruptcy/2014/10/02/bankruptcy-preview-day/16562469.

[162] "No transfer shall be approved unless the petitioner, or GDB on behalf of the petitioner, or GDB on behalf of the petitioner, shall have included in its request for approval the reasons why such proposed transfer is reasonably likely to maximize value for creditors, in the aggregate, consistent with enabling the continued carrying out of the petitioner's public functions and the Court shall have found such reasons plausible." P.R. Recovery Act § 307.

[163] In Chapter 11 proceedings, creditors' committees step in to monitor debtors as they run their business during the debtor-in-possession period. § 1102 requires the U.S. Trustee to appoint an unsecured creditors' committee in Chapter 11 cases, and permits the court to appoint creditor committees in cases under other chapters, including Chapter 9, on request of a party in interest and if necessary to ensure adequate representation of creditors or shareholders. § 1103 empowers creditor committees to hire lawyers and accountants, and lists the duties of committees as follows:

> A committee appointed under section 1102 of this title may
>
> > (1) consult with the trustee or debtor in possession concerning the administration of the case;

limited in a Chapter 9 case than in a Chapter 11 case. For one reason, the Chapter 11 debtor must pay creditor committees' attorney fees. In a Chapter 9 case, however, the debtor will not necessarily pay creditors' committees fees.[164] For Tenth Amendment reasons, it is outside the power of bankruptcy law or courts to require municipal debtors to make these payments.[165] Doing so would violate 11 U.S.C. § 904, which provides that "unless the debtor consents or the plan so provides, the court may not . . . interfere with any of the political or governmental powers of the debtor; any of the property or revenues of the debtor; or the debtor's use or enjoyment of any income-producing property."

In a Chapter 11 case, creditor committees play an important monitoring role during the critical, risky DIP period. During the DIP period, the fox is guarding the henhouse. Debtor's management continues to make all business decisions and does not even need court approval for decisions in the ordinary course of business. This is risky for two reasons. First of all, assuming the debtor is insolvent, management has already gone a long way towards proving its incompetence in making business decisions. Secondly, when a firm is in the zone of insolvency, managements' interests in saving their jobs and reputations diverge from shareholders' and creditors' interests. This increases potential costs and the need for monitoring.[166]

> (2) investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and the desirability of the continuance of such business, and any other matter relevant to the case or to the formulation of a plan;
> (3) participate in the formulation of a plan, advise those represented by such committee of such committee's determinations as to any plan formulated, and collect and file with the court acceptances or rejections of a plan;
> (4) request the appointment of a trustee or examiner under section 1104 of this title; and
> (5) perform such other services as are in the interest of those represented.

§ 1109 gives creditor committees standing to raise and hear "any issue in a case under this chapter." Chapter 9 incorporates § 1102, § 1103, and § 1109. Creditor committee appointment is required in a Chapter 11 case, but optional in a § 1102 case. Chapter 9 does not incorporate § 1104, so § 1103(c)(4)—empowering the creditors' committee to request appointment of a trustee or an examiner—is moot in a Chapter 9 case.

[164] Rather, the debtor itself must propose paying creditor committees' expenses, because only the debtor may propose a plan. The court will propose the debtor's proposal if it is reasonable. *See, e.g.*, *In re* Castle Pines N. Metro. Dist., 129 B.R. 233 (Bankr. D. Colo. 1991) (requiring the Chapter 9 debtor to pay the creditors' committee's reasonable attorney fees as an administrative expense).

[165] The Tenth Amendment limits the bankruptcy court's power under § 904. 6-901 COLLIER ON BANKRUPTCY P 901.04; United States v. Bekins, 304 U.S. 27 (1938).

[166] For a thorough discussion of this point, see N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92 (Del. 2007).

Creditors' committees have the potential to increase welfare by monitoring a wasteful debtor in possession.[167] In Chapter 9, the Tenth Amendment demands even broader deference to the debtor-in-possession's decisions. But here, the Tenth Amendment demands such excessive judicial deference to the debtor-in-possession's decisions. The limited role of creditors' committees in Chapter 9 exemplifies the Tenth Amendment's interference with an economically efficient restructuring regime.

In contrast, under the P.R. Recovery Act, the court must appoint a creditors' committee in any Chapter Three proceeding.[168] The P.R. Recovery Act debtor must reimburse as administrative expenses the creditors' committee for at least two law firms' and a financial advisor's fees.[169] This makes more sense than the Chapter 9 approach, which exclusively empowers the debtor to appoint its own monitor--or not. Under Puerto Rico's law, in contrast, the power to monitor the debtor ultimately lies with the creditors, as granted by statute and executed by the court, and with the court, whose decisions regarding creditors' committee membership are not appealable.[170]

If Puerto Rico had filed under its own Recovery Act, the combination of judicial and creditor monitoring provided for by the law could have restricted the government's dangerous debt issuances. To the extent that the government did issue new debt, markets would have had the assurance of a stamp of approval from the judge and existing creditors. Greater monitoring would have increased the chance of optimal, efficient debt pricing.

7. *Executory Contracts*

The P.R. Recovery Act improves upon both Chapter 9 and Chapter 11 by statutorily defining which contracts the debtor may choose to reject after filing. Executory contracts are some of the most commonly litigated issues in federal bankruptcy.[171] For a large business or municipal debtor with many contractual

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[167] Michelle M. Harner & Jamie Marincic, *Committee Capture? An Empirical Analysis of the Role of Creditors' Committees in Business Reorganizations*, 64 VAND. L. REV. 749 (2011).

[168] P.R. Recovery Act § 318(c).

[169] §§ 318(h), 319(a), 333.

[170] § 318(g).

[171] Under § 365 of the Code, which applies in both Chapter 9 and Chapter 11 cases, a debtor may assume or reject executory contracts, subject to court approval, during the period between filing and plan confirmation. "Assumption" and "rejection" are bankruptcy law synonyms for "performance" and "breach." If the debtor chooses to assume an executory contract, the agreement continues uninterrupted, unless the debtor has already breached, in which case the code requires he compensate the other party in order to assume the contract. If the debtor rejects an executory contract during a bankruptcy proceeding, the event of rejection is effectively backdated and treated as a pre-petition breach. As such, the debtor will only need to pay a pro-rata portion of the claim. The effect is that, while executory contractual counterparties' "claims are calculated in full under state law . . . their actual relief, the payment of the claims, can be thought of as being in little tiny Bankruptcy Dollars, which may be worth only ten cents in U.S.

relationships, the executory contract determination is a matter of huge amounts of money. But the Code fails to define executory contracts.

Traditionally, courts have applied Professor Countryman's definition of an executory contract, *i.e.*, a contract where both parties have material obligations outstanding.[172] However, as many courts and commentators have pointed out, this definition is of limited use.[173] Once a contract ceases to be executory, it no longer exists. Additionally, the Countryman definition is difficult for courts to apply. Due to significant differences from one contract to another, judges struggle to determine whether there are material issues outstanding, driving up litigation costs and reducing predictability.[174]

Unsatisfied with the statutory language and Countryman interpretation thereof, some courts have implemented a functional definition of executory contracts that involves a business judgment test. The purpose of the functional test is to give effect to the Congressional intent behind § 365, which is to enhance the value of the estate. The functional test permits the debtor in possession or trustee to reject contracts that are net liabilities to the estate and assume contracts that are net assets to the estate. A functional executory contract provision maximizes the welfare of the collective, at least when limiting the universe to the parties directly involved in the bankruptcy. An enhanced estate increases payments to creditors, and thus sets the debtor closer to a fresh start.

In 1997, the National Bankruptcy Review Commission recommended that Congress eliminate the "executory" definition from § 365 and leave courts free to

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dollars." This provision gives the debtor a powerful tool; as Professor Jay Lawrence Westbrook explained, "these results suggest that the trustee somehow is not bound to the contract, yet can bind the Other Party, a consequence that seems almost magical to the legal mind." If a contract is not executory, a debtor's breach during the pendency of the case will not be backdated. Rather, the contractual counterparty will have a post-petition claim, which is not dischargeable in bankruptcy and which the debtor must hence pay in real dollars rather than tiny Bankruptcy dollars. Theoretically, then, determining whether a particular contract is executory or not could be very important to the debtor in possession or trustee as he tries to minimize liabilities for the estate. However, as Westbrook pointed out,

It is obvious that a contract must be executory to be assumed or rejected, if the term is used in its ordinary sense to mean merely that aspects of the contract were not fully performed or satisfied on Bankruptcy Day. But if executoriness had such a simple meaning, the requirement would be trivial. The trustee need not, and could not, assume or reject a contract fully performed a year before bankruptcy—nor would anyone dream of doing so. Speaking of a 'nonexecutory' contract in that sense is like discussing a sunset after dark.

The meaning of *executory* has spawned reams of litigation, and led to a labyrinth of case law such that the definition of executory is anything but intuitive. Jay Lawrence Westbrook, *A Functional Analysis of Executory Contracts*, 74 MINN. L. REV. 227, 253, 243 (1989).

[172] "[A] contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other." Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 Minn. L. Rev. 439, 460 (1973).

[173] *In re* Jolly, 574 F.2d 349, 350 (6th Cir. 1978).

[174] 3-365 COLLIER ON BANKRUPTCY P 365-02.

adopt the functional approach.[175] But the politicized bankruptcy reform bill inspired by the 1997 recommendations died by Clinton's veto. However, many courts today use the functional definition, which the 11th Circuit has affirmed on appeal. Others still use the Countryman test.[176]

Due to the murky Code language, the executory contract provision creates significant transaction costs in the U.S. A statutory definition would at least reduce the litigation costs that arise when parties puzzle over the meaning of executory. At this point, 80% of an effective executory provision would be just showing up in the Code.

The Puerto Rico Act codifies the functional test. § 326 of the P.R. Recovery Act provides that "a petitioner may reject any contract if the rejection is in the petitioner's best interests." The statutory test, then, mimics the business judgment test that the 11th Circuit and some other U.S. courts implement. The functional test does not only show up, but also goes an extra step towards effectiveness by placing economic efficiency at the center of the inquiry.

8. Collective Bargaining Agreements

Public employee contracts are another area where the P.R. Recovery Act provides a better solution that the U.S. federal approach simply by addressing the issue statutorily. Collective bargaining agreements are one of the largest outstanding questions in governmental bankruptcy, both monetarily and constitutionally. The Puerto Rico Act explicitly addresses collective bargaining agreements. As such, the Commonwealth's law promotes efficiency by anticipating and preventing ambiguity in federal law that elevates transaction costs. § 326(d) of the Act provide additional special protections for the opposite party to a contract in a collective bargaining agreement, retirement or post-employment benefit plan, mandating that:

> The Court shall not approve the rejection of a collective bargaining agreement or retirement or post-employment benefit plan unless the petitioner has demonstrated that:
>
> > (a) the equities balance in favor of the rejection of such agreement or plan . . .
> >
> > (b) absent rejection, the petitioner will likely be unable to perform public functions; and

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[175] NAT'L BANKR. REV. COMM'N, BANKRUPTCY: THE NEXT TWENTY YEARS (1997), http://govinfo.library.unt.edu/nbrc/report/01title.html.
[176] 3-365 COLLIER ON BANKRUPTCY P 365-02.

> (c) the petitioner shared with the representatives for employees and retirees, as applicable, the data underlying its request to reject the agreement or plan and conferred, at reasonable times, in good faith with the representative(s) to reach voluntary modifications to such agreements or plans, and such efforts did not succeed.

The U.S. Code, on the other hand, is unclear throughout, and especially in Chapter 9, on the treatment of collective bargaining and pension agreements. Federal law, generally, varies jurisdictionally as to the level of constitutional and contractual protection applicable to collective bargaining and pension agreements. In Chapter 11, it is more difficult for a debtor to reject a collective bargaining agreement than to reject other types of agreement. In the 1984 case Bildisco, the Supreme Court held that unexpired collective bargaining agreements are executory contracts under § 365, but rejection demands a higher level of inquiry by the court than the typical business judgment standard. Instead, the debtor must show that "(1) the collective bargaining agreement burdens the estate, (2) after careful scrutiny, the equities balance in favor of contract rejection and (3) reasonable efforts to negotiate a voluntary modification have been made, and are not likely to produce a prompt and satisfactory solution."[177]

Congress overturned Bildisco by enacting § 1113. However, § 1113 does not apply in Chapter 9 cases, introducing an additional level of uncertainty into labor contract decisions in the Chapter 9 context. For example, the standard for rejecting collective bargaining agreements in Chapter 9 cases was the subject of extensive litigation in In re Orange County.[178] The court there held that Bildisco rather than § 1113 applied, but that the debtor also needed to meet additional state law standards. More recently, the Vallejo court agreed with Orange County that Bildisco rather than the more stringent § 1113 standard applied in Chapter 9 cases, but disagreed that the debtor must also meet state law requirements.[179] Pension agreements bring up an additional set of issues, as courts disagree as to whether pensions are contracts at all, let alone executory versus non-executory, and then, what the appropriate standards for rejection are. The uncertainty under U.S. law, as well as public policy issues involved, makes the issue ripe for Congress to weigh in about whether collective bargaining agreements should be treated differently from ordinary contracts under bankruptcy law, as Puerto Rico's legislature wisely did. In the meantime, litigation costs will amass.

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[177] *See* COLLIER ON DEBT ADJUSTMENT FOR MUNICIPALITIES § 7 (discussing NLRB v. Bildisco & Bildisco, 465 U.S. 513, 526 (1986)).
[178] *In re* County of Orange, 179 B.R. 177 (Bankr. C.D. Cal. 1995).
[179] *In re* City of Vallejo, 403 B.R. 72 (Bankr. E.D. Cal. 2009).

9. Creditor Protection in Plan Confirmation

A major difference between Chapter 9 and Chapter 11 is § 1129(a)(7), which requires that the plan pay each creditor a value at least equaling the value he or she would have received in a Chapter 7 liquidation. This standard does not readily transfer to Chapter 9 because the municipality cannot be liquidated and so is not incorporated into municipal bankruptcy law.[180] Instead, Chapter 9 requires the plan to be "in the best interest of creditors," a vague standard that opens the door to litigation, reduces predictability, and, in its vagueness, does not necessarily offer creditors meaningful protection, as the level of protection depends on the individual judge's interpretation of "in the best interest of creditors."

The Puerto Rico Act solves this dilemma clearly and elegantly. § 315(d) of the Act mandates that "the plan provides for every affected creditor in each class of affected debt to receive payments and/or property having a present value of at least the amount the affected debt in the class would have received if all creditors holding claims against the petitioner had been allowed to enforce them on the date the petition was filed," and § 315(k) mandates that "each class of affected debt that will not be satisfied in full under the plan absent the additional consideration provided in this subsection shall be entitled to receive annually in arrears its pro rata share of 50% of the petitioner's positive free cash flow, if any, at the end of any fiscal year," after deducting for necessary payments, up to the amount necessary to pay the claim in full. These requirements apply to secured and unsecured creditors alike.[181] The P.R. Recovery Act thus offers more meaningful protection to creditors than Chapter 9 does, as well as more predictability *ex ante*, thereby reducing transaction costs.

At least in theory, the P.R. Recovery Act ambitiously strengthens both the debtor's and creditors' financial positions, granting each creditor not only "at

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[180] *See* Monographl COLLIER ON DEBT ADJUSTMENT FOR MUNICIPALITIES § 8.

[181] In addition to the §§ 315(d) and (k) creditor protections, which do not distinguish between secured and unsecured creditors, §§ 315(m) and (n) provide additional plan requirements that distinguish between secured and unsecured creditors. § 315(m) lifts § 1129(b)(2)'s protection for secured creditors. The P.R. Recovery Act plan must provide that secured creditors both retain their liens and receive cash payments totaling at least the value of the collateral, as determined "by the Court based on the plan's proposed disposition or use of the property." § 315(n) requires that payments to unsecured creditors be "in the best interest of creditors and shall maximize the amounts distributable to such creditors to the extent practicable." Additionally, the Puerto Rico Act imposes an absolute priority rule in a separate requirement: § 315(p) requires that "except to the extent agreed to by an affected creditor, the plan does not provide for a materially different and adverse treatment for such claim as compared to the treatment of claims in different classes under the plan having the same priority unless the petitioner demonstrates a rational basis to permit such disparate treatment." Presumably, §§ 315(m), (n) and (p) are additional requirements—albeit vague ones in the case of (n) and (p)—on top of § 315(d) and (k). Ideally, the Puerto Rican legislature would add language clarifying the relationship between these provisions.

least the amount . . . [they] would have received" if their claims were enforced on the date of filing, but also "50% of the petitioner's positive free cash flow." Thus, the P.R. Recovery Act would improve some creditors' positions.

Granted, the P.R. Recovery Act omits some creditor protections present in the Code. The P.R. Recovery Act does not specifically provide a safe harbor for derivative contracts or protect special revenue bondholders.[182] These are the type of amendments the legislature could easily add. In the meantime, the law is broad enough such that courts could read such protections into the law, given the general purpose of protecting creditors and incorporation of Chapter 9 and Chapter 11 case law as precedent.

C. Additional Proposed Chapter 9 Amendments

1. Involuntary Filings

As in Chapter 9, but in contrast with Chapter 7 and 11, under the P.R. Recovery Act, only the debtor may initiate filing. In federal bankruptcy language, a debtor-initiated proceeding is called "voluntary," and a creditor-initiated proceeding is "involuntary."[183] The P.R. Recovery Act does not explain in its text why it prohibits involuntary filings. But it is easy to see why empowering creditors to force the government into bankruptcy would strike terror into the hearts of legislators, who might imagine an endless onslaught of one involuntary petition after another, forever tying up the government's time and money in court.

However, allowing involuntary bankruptcy in the governmental debtor context would serve economic efficiency, preserving both dollars and debtor credibility in the specific instance and legitimizing government bankruptcy in the long run. First of all, involuntary bankruptcy would not significantly increase frivolous litigation. Creditors are already free to sue the government whenever they would like; permitting involuntary filings would make doing so more difficult, if anything, by introducing screenings such as the threshold number of creditors and dollar value of claims.

Secondly, involuntary filing would reduce the inefficient stigma costs that currently plague municipal bankruptcy law.

Expanding Chapter 9 would reduce inefficiencies that currently arise from the law's stigma effects. When Orange County filed for bankruptcy in 1994, the municipal bond market crashed under the weight of investors' fears. But Orange County's economy recovered rapidly, and today remains a standout in the region, with high job growth that currently drives the housing market recovery in

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[182] McGowen, *supra* note 20.

[183] Chapter 7 and Chapter 11 allow involuntary filings, so long as there are at least three creditors filing with a minimum dollar value of claims. 11 U.S.C. § 303 (2010).

the area.[184] Like Orange County in 1994, after Puerto Rico enacted the P.R. Recovery Act, the three major credit ratings agencies downgraded the island's debt, citing the availability of municipality as their reason for doing so. However, as Orange County illustrated, investors' perception that bankruptcy reduces value may not be true. Credit restriction in Orange County's case had more to do with stigma than with real financial costs of bankruptcy.

An involuntary filing would signal that the creditors believed bankruptcy would serve their interests better than the alternatives and would thus counteract the stigma effects of bankruptcy. Stigma costs arise when creditors worry that debtors are filing opportunistically, to avoid their debt obligations because they do not want to pay, rather than because they are unable to pay. Involuntary filings would give creditors an effective tool to enforce their debt contracts in a coordinated, predictable way, and would thereby save costs for the municipality and creditors alike. Due to sovereign immunity, it is difficult and unpredictable for creditors to enforce obligations.

Empirical data also shows that, due to their concerns about stigma, debtors delay filing beyond the optimal time. Operating in a state of insolvency harms the debtor's economy and citizens, and further decreases creditors' chance of payment in the end. Prolonging the inevitable helps no one. Involuntary filings would counteract the debtor's tendency to drag its feet.[185]

2. Reduce Exclusivity Periods

Both Chapter 9 and the Puerto Rico Act impose indefinite exclusivity periods, which means that only the debtor and not creditors may propose reorganization plans. From an efficiency perspective, exclusivity is a toss-up. On the one hand, exclusivity reduces transaction costs. Only the debtor must incur the direct legal costs of forming and filing a plan, as well as the opportunity costs of diverting its attention towards plan formation and thus away from other activities. And the judge only needs to review a single plan. However, creditors still must approve the plan. The less involved creditors are in plan formation the less likely they will be to approve the plan, which will send the debtor back to the drawing board and cancel out any cost savings.

From a fairness perspective, exclusivity is a loser. Creditors will be more likely to find plan formation fair when their voices are part of the process. Though the P.R. Recovery Act imposes plan formation exclusivity, which, on

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[184] *See* James Flanigan, *In The Year Since Bankruptcy, Orange County's Economy Has Become Vibrant Again, Helping To Lead The Region On The Road To Recovery*, L.A. TIMES: BUS. (Nov. 29, 1995), http://articles.latimes.com/1995-11-29/business/fi-8294_1_orange-county (describing Orange County's recovery). *See also* Ricardo Lopez, *Orange County Economy Expected To Accelerate Through 2015*, L.A. TIMES: BUS. (Apr. 2, 2013), http://articles.latimes.com/ 2013/apr/02/business/la-fi-oc-forecast-20130402 (describing Orange County's continued economic success).

[185] For a similar argument regarding desirable provisions for an international sovereign bankruptcy regime, see Bolton & Skeel, *supra* note 30, at 786.

balance, does not necessarily improve efficiency and certainly does not improve the law's reputation in the eyes of creditors, the Puerto Rico Act mitigates these costs by including creditors in other ways. The Chapter Two procedure foresees negotiations between creditors and the debtor, ensuring creditor input into plan formation at the early, pre-confirmation stages of the process.

Chapter 9 theoretically requires early creditor input, as well. Under § 109(c)(5), the debtor must either present the creditors with a plan for debt adjustment and obtain the agreement of each impaired class, attempt in good faith but fail to present creditors with a plan and obtain agreement from the majority of each impaired class, or show that negotiating with creditors would be impracticable.

However, the requirement of § 109(c)(5)(C) removes the teeth of the other three eligibility requirements. Any municipality can show that negotiating would be impracticable, especially those with multiple creditors and complex capital structures—in other words, those likely to desire debt adjustment in the first place. Puerto Rico would have no problem demonstrating that negotiating with its diverse bondholders and public employees would be time consuming, expensive, and distracting for its politicians.

VI. CONCLUSION

Puerto Rico's exclusion from the Code is costing its citizens, who live in a state of financial distress, investors, whose traditionally safe municipal bond holdings have transformed quickly into risky investments, and the federal government, which continues to bail the island out through tax credits. Additionally, the credit market is deprived of the chance to develop a predictable body of Chapter 9 law, which can only happen through quantity and quality of Chapter 9 filings.

On February 11, 2015, Pedro Pierluisi, the Commonwealth's nonvoting Congressional delegate, introduced the "Puerto Rico Chapter 9 Uniformity Act of 2015" in the House of Representatives. The bill suggests that Congress amend Chapter 9 of the Bankruptcy Code to include Puerto Rico.[186] The National Bankruptcy Conference, an influential group of experts, endorsed the bill.[187] Fitch Ratings Agency agreed and issued a press release entitled, "Chapter 9 Extension Would Be a Positive for Puerto Rico."[188] As of the time of this writing in March 2015, Congress is conducting hearings on the proposal.[189]

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[186] *Pierluisi Introduces Bill to Include Puerto Rico in Chapter 9 of the U.S. Bankruptcy Code*, U.S. CONGRESSMAN PEDRO PIERLUISI: PRESS RELEASES (July 31, 2014), http://pierluisi.house.gov/media-center/press-releases/pierluisi-introduces-bill-to-include-puerto-rico-in-chapter-9-of-the-us.

[187] Kyle Glazier, *Pierluisi Offers Bill to Include Puerto Rico Under Muni Bankruptcy Law*, THE BOND BUYER (July 31, 2014), http://www.bondbuyer.com/news/washington-budget-finance/pierluisi-offers-bill-to-include-puerto-rico-under-muni-bankruptcy-law-1064876-1.html.

[188] *Chapter 9 Extension Would Be a Positive for Puerto Rico*, FITCH RATINGS (Aug. 6, 2014), https://www.fitchratings.com/site/pressrelease?id=845614&cm_sp=homepage--Featured_Content

A general policy by both Congress as well as judges to interpret Chapter 9 inclusively would serve efficiency goals. Approving Pierluisi's proposal would be a step in the direction towards a broader Chapter 9.

Cities and states play two roles. In one role, they are public goods that provide fundamental services to citizens. In the other, they are businesses that issue debt on the market, hire employees, and manage other people's resources as efficiently as possible.

In this way, they resemble banks. Banks also have a quasi-private, quasi-public function. They are private businesses that generate profits for shareholders, but they also play a crucial role in the money supply, and their failures create major negative externalities. For these reasons, the federal government both supports them through federal deposit insurance and also monitors their activity through regulatory regimes that have become even stronger over the past five years.

Cities and states also receive significant aid from the federal government, both in terms of direct dollars as well as federal income tax exclusion of municipal bonds. Like banks, they create public value when they prosper and effect the public negatively when they fail.[190] And yet, the federal government does not restrict their ability to lend. Municipal bankruptcy law presents an opportunity for federal monitoring of state lending in cases where the states are clearly mismanaging their resources. U.S. governmental agencies lend at subsidized rates, so the marketplace does not discipline them through increased interest rates.

Tenth Amendment principles are already undermined by the interconnectedness of state and federal governments when the federal government lends and subsidizes state budgets. It is inconsistent to interpret the Tenth Amendment strictly in the case of default, which is an inevitable corollary of lending, but permits lending on the front end. In the long run, this inconsistency will restrict governmental access to the capital markets, which will undermine their ability to invest in projects and provide public services.

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[189] *See* Aaron Kuriloff, *House Panel to Hear Proposal for Puerto Rico Bankruptcy Protections*, WALL ST. J. (Feb. 13, 2015, 5:30 PM), http://www.wsj.com/articles/house-panel-to-hear-proposal-for-puerto-rico-bankruptcy-protections-1423866611. *See also* Robert Slavin, *Three Puerto Rico House Members Call For Debt Restructuring*, THE BOND BUYER (Mar. 16, 2015, 12:41 PM), http://www.bondbuyer.com/news/regionalnews/three-puerto-rico-house-members-call-for-debt-restructuring-1071387-1.html.

[190] For a discussion of the unique characteristics of banks that make special regulation appropriate, see Schaake v. Dolley, 118 P. 80 (Kan. 1911). *See also* RICHARD SCOTT CARNELL, JONATHAN R. MACEY, & GEOFFREY P. MILLER, THE LAW OF BANKING AND FINANCIAL INSTITUTIONS 59–60 (5th ed. 2009).