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# THE EVOLUTION OF INVESTOR-STATE DISPUTE SETTLEMENTS IN A GLOBAL ECONOMY

*Michael Hastings Wendt\**

## INTRODUCTION

Investor-State Dispute Settlements (ISDS) is a mechanism in investment and trade agreements that allows foreign companies to settle disputes with the hosting country through arbitration.<sup>1</sup> This is intended to protect foreign companies against expropriation or discrimination on the basis of nationality.<sup>2</sup> More than 2,700 bilateral or multilateral investment treaties include the ISDS mechanism.<sup>3</sup> From 1987 through the present, investors have initiated approximately 1,000 ISDS cases against 117 countries.<sup>4</sup> Investors have litigated the vast majority of these cases within the past fifteen years.<sup>5</sup> More than 600 cases were resolved either on the merits or jurisdictional grounds.<sup>6</sup> A statistical breakdown shows that ISDS arbitration tribunals decided 36% of cases in favor of the state and 29% in favor of the investor, the parties settled 23% of cases, the investor discontinued 10% of cases, and arbitration tribunals found in 2% of cases a treaty breach with liability for the state but no damages attributable to the investor.<sup>7</sup>

Common allegations in ISDS cases involve seizures or nationalization of investments; termination or nonrenewal of contracts, licenses, and permits; state harassment through improper criminal prosecution or wrongful detention; and legislative reforms that adversely impact investments.<sup>8</sup> Investors claim damages ranging from several million to tens of billion dollars.<sup>9</sup> More than 500 individuals have served as arbitrators in ISDS cases.<sup>10</sup> The United States is the most frequent home state of investors litigating ISDS cases, which have brought 174 cases against other states to date.<sup>11</sup>

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\* MACL, Univ. of Mich. L. Sch. (2019); J.D., Liberty Univ. Sch. of L. (2014).

<sup>1</sup> *ISDS: Important Questions and Answers*, OFF. OF THE U.S. TRADE REPRESENTATIVE (March 2015), <https://ustr.gov/about-us/policy-offices/press-office/blog/2015/march/isds-important-questions-and-answers-0>.

<sup>2</sup> *Id.* There are two types of expropriation: direct and indirect. “Direct expropriation means a mandatory legal transfer of the title to the property or its outright physical seizure” while “[i]ndirect expropriation involves total or near-total deprivation of an investment but without a formal transfer of title or outright seizure.” *Expropriation: UNCTAD Series on Issues in Int’l Inv. Agreements II*, UNITED NATIONS CONF. ON TRADE AND DEV. 6, 7 (2012), [https://unctad.org/en/Docs/unctadddiaeia2011d7\\_en.pdf](https://unctad.org/en/Docs/unctadddiaeia2011d7_en.pdf).

<sup>3</sup> *Background Info. on the Int’l Centre for Settlement of Inv. Disps. (ICSID)*, INT’L CENTRE FOR SETTLEMENT OF INV. DISP. 1, <http://icsidfiles.worldbank.org/icsid/icsidblobs/CaseLoadStatistics/ICSIDOverview-English.pdf>.

<sup>4</sup> *Fact Sheet on Investor-State Disp. Settlement Cases in 2018*, UNITED NATIONS CONF. ON TRADE AND DEV. [UNCTAD], 1, (2019), [https://unctad.org/en/PublicationsLibrary/diaepcbinf2019d4\\_en.pdf](https://unctad.org/en/PublicationsLibrary/diaepcbinf2019d4_en.pdf). For a list of all past and current ISDS cases, including pending status or final disposition, see UNITED NATIONS CONF. ON TRADE AND DEV. [UNCTAD], *Inv. Disp. Settlement Navigator*, <https://investmentpolicy.unctad.org/investment-dispute-settlement> (last visited May 20, 2020).

<sup>5</sup> See UNCTAD Report *supra* note 4, at 1.

<sup>6</sup> *Id.* at 4.

<sup>7</sup> *Id.* at 5.

<sup>8</sup> *Id.* at 4.

<sup>9</sup> *Id.*

<sup>10</sup> *Id.* at 5.

<sup>11</sup> See UNCTAD Report *supra* note 4, at 3.

ISDS is designed to spur investor trust and confidence, especially in countries where the domestic legal system is underdeveloped.<sup>12</sup> However, in recent years many politicians, lawyers, and academics have criticized ISDS as a one-way street that favors foreign corporations.<sup>13</sup> While companies can use the ISDS system to invoke arbitration against the hosting state, the converse is not so.<sup>14</sup> The critics allege that foreign corporations may use the ISDS system to undermine environmental, health, and labor laws.<sup>15</sup> While some countries publish the proceedings of ISDS cases for the public, many countries opt for secretive settlements, which have led to demands for more transparency in the ISDS process.<sup>16</sup>

This article will briefly explore how the ISDS system works and the problems associated with ISDS, but it will then detail and evaluate a number of enacted and proposed changes. Some examples include the reformation of the North American Free Trade Agreement (NAFTA) into the United States-Mexico-Canada Agreement (USMCA) and the European Union's commitment to establish a regional investor court system. ISDS is an area that is ripe for change and practitioners should be kept informed of potential shifts. While there is no "one-size-fits-all solution" to the criticisms leveled at ISDS, certain structural and procedural reforms to ISDS are designed to ease the skeptic's suspicion of potential abuses in the status quo. Each country and region of countries should meticulously consider its own unique circumstances and trade interests prior to adopting any type of sweeping reform. Part II of this paper will provide a brief history on international arbitration, including the emergence of the ISDS mechanism. Part III will discuss the

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<sup>12</sup> See OFF. OF THE U.S. TRADE REPRESENTATIVE, *supra* note 1. For a perspective that questions whether ISDS is effective in promoting foreign investment, see Lise Johnson, Brooke Skartvedt Güven, & Jesse Coleman, *Investor-State Dispute Settlement: What Are We Trying to Achieve? Does ISDS Get us There*, COLUMBIA CENTER ON SUSTAINABLE INV. (Dec. 11, 2017), <http://ccsi.columbia.edu/2017/12/11/investor-state-dispute-settlement-what-are-we-trying-to-achieve-does-ids-get-us-there/>.

<sup>13</sup> Senator Elizabeth Warren, a former U.S. presidential candidate, proclaimed that "ISDS provides a huge handout to global corporations while undermining American sovereignty." Press Release from the Office of Senator Elizabeth Warren, Warren Urges U.S. Trade Rep to Remove ISDS Provisions During Next Round of NAFTA Negotiations (Sept. 19, 2017), <https://www.warren.senate.gov/newsroom/press-releases/warren-urges-us-trade-rep-to-remove-ids-provisions-during-next-round-of-nafta-negotiations>; see letter signed by more than 300 state legislators to the Hon. Robert Lighthizer, U.S. Trade Representative (Sept. 12, 2018) <https://www.citizen.org/wp-content/uploads/migration/state-legislator-letter-ids-nafta-sept-2018.pdf> (urging the end of ISDS provisions in NAFTA); see also a letter from 230 law and economics professors to President Donald J. Trump (Oct. 25, 2017) [https://www.citizen.org/wp-content/uploads/migration/case\\_documents/ids-law-economics-professors-letter-oct-2017\\_2.pdf](https://www.citizen.org/wp-content/uploads/migration/case_documents/ids-law-economics-professors-letter-oct-2017_2.pdf) (urging the removal of ISDS provisions from NAFTA and future trade agreements); Paul Aims, *ISDS: The most toxic acronym in Europe*, POLITICO (Sept. 17, 2015) <https://www.politico.eu/article/ids-the-most-toxic-acronym-in-europe/> (explaining that the controversy over ISDS is also prevalent in European politics); Simon Lester & Ben Beachy, *Special Courts for Foreign Investors*, CATO INSTITUTE (April 15, 2015), <https://www.cato.org/publications/commentary/special-courts-foreign-investors> (opining that ISDS only benefits foreign firms and their lawyers).

<sup>14</sup> Nevertheless, states may respond with counterclaims when an investor initiates an ISDS action. Lorenzo Cotula, Brooke Guven, Lise Johnson, & Thierry Berger, *Investor-State Arb.: An Opportunity for Real Reform?*, COLUMBIA CTR. ON SUSTAINABLE INV. (Dec. 7, 2018), <http://ccsi.columbia.edu/2018/12/07/investor-state-arbitration-an-opportunity-for-real-reform/>.

<sup>15</sup> See James McBride and Andrew Chatzky, *How Are Trade Disps. Resolved?*, COUNCIL ON FOREIGN RELS. (Jan. 6, 2020, 7:00 AM), <https://www.cfr.org/backgrounder/how-are-trade-disputes-resolved>.

<sup>16</sup> *Id.*; Lise Johnson and Brooke Skartvedt Guven, *The Settlement of Inv. Disps: A Discussion of Democratic Accountability and the Pub. Int.*, INT'L INST. FOR SUSTAINABLE DEV. (Mar. 13, 2017), <https://www.iisd.org/itn/2017/03/13/the-settlement-of-investment-disputes-a-discussion-of-democratic-accountability-and-the-public-interest-lise-johnson-and-brooke-skartvedt-guven/>.

criticisms leveled at ISDS and examine several case studies where ISDS was problematic. Part IV will discuss several proposed and enacted reforms for ISDS.

## II. A BRIEF HISTORY OF INTERNATIONAL ARBITRATION

### A. Early Concepts of Arbitration

The concept of using arbitration to resolve international disputes has long been a part of history. The Greek city states and early Roman Republic occasionally used arbitration as a mechanism of resolving cross-border disputes.<sup>17</sup> In Greek antiquity, Athens and Sparta drafted an arbitration clause, which essentially stated that both sides should maintain the peace and would submit themselves to an arbitration body to resolve conflicts.<sup>18</sup> Nevertheless when both sides attempted to invoke arbitration to avoid conflict, diplomatic relations broke down and Athens and Sparta blamed each other for refusing to submit to arbitration.<sup>19</sup> The result was the Peloponnesian War, which ended in a colossal defeat for Athens, including the destruction of their navy.<sup>20</sup> Much later, the Romans acted as mediators and arbitrators between the Greek city states.<sup>21</sup> However, the Romans considered themselves dominant in the arena of international affairs, and they were highly reluctant to apply the principles of arbitration to their own cross-border disputes.<sup>22</sup>

In the early fourteenth century, the Normans proposed establishing an arbitration panel to resolve disputes and maintain the peace between European kingdoms and feudal lands.<sup>23</sup> The proposal posited that the panels should consist of nine members: three ecclesiastical members and three from each of the parties. An appeal could be made to the Pope if the parties disagreed with the panel's decision.<sup>24</sup> Although this proposal never came to fruition, it demonstrates that the notion of cross-border arbitration predated the twentieth century. The Enlightenment era philosophers, including Jean-Jacques Rousseau and Jeremy Bentham, favored constructing a mechanism to resolve disputes between European states.<sup>25</sup> The Treaty of Guadalupe Hidalgo in 1848, which settled the Mexican-American War, contained an arbitration clause allowing for the appointment of arbitrators on an ad hoc basis to settle future conflicts between the two countries.<sup>26</sup> The first Hague Conference of 1899 created the Permanent Court of Arbitration as a means for resolving state-to-state disputes.<sup>27</sup>

In the aftermath of the Second World War, with the establishment of the United Nations and decolonization of the old European empires, countries recognized the necessity of entering

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<sup>17</sup> Henry S. Fraser, *Sketch of the History of International Arbitration*, 11 CORNELL L. REV. 179, 185 (1926).

<sup>18</sup> W. L. Westermann, *Interstate Arbitration in Antiquity*, 2 THE CLASSICAL J. 197, 200 (1907).

<sup>19</sup> *Id.*

<sup>20</sup> *Id.*; see *Historical Context for History of the Peloponnesian War by Thucydides*, COLUMBIA COLL. (last visited May 20, 2020), <https://www.college.columbia.edu/core/node/1750>.

<sup>21</sup> Westermann, *supra* note 18, at 206.

<sup>22</sup> *Id.* at 206.

<sup>23</sup> Fraser, *supra* note 17, at 179.

<sup>24</sup> *Id.*

<sup>25</sup> *Id.* at 183.

<sup>26</sup> *Id.* at 200; Treaty of Guadalupe Hidalgo art. XXI, Mex.-U.S., Feb. 2, 1848.

<sup>27</sup> *Hist.*, PERMANENT COURT OF ARB. (last visited July 31, 2019), <https://pca-cpa.org/en/about/introduction/history/>.

into trade agreements and having a procedural mechanism for resolving trade disputes.<sup>28</sup> Bilateral and multilateral trade agreements began to emerge.<sup>29</sup> Deals between private parties spurred increased cross-border business transactions.<sup>30</sup> Nevertheless, issues arose regarding the procedures for resolving disputes, including the proper forum and enforcement measures.<sup>31</sup> Slowly, trade agreements and private contracts between international parties permitted the use of arbitration.<sup>32</sup> The advantage of arbitration is that the parties to an international agreement or private contract could perform an arm's length negotiation of how to resolve disputes.<sup>33</sup>

## B. The New York Convention

The members of the United Nations began to realize that arbitration would be undermined without a compliance mechanism.<sup>34</sup> In 1958, the United Nations published the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards 1958 (New York Convention).<sup>35</sup> The signatories to the New York Convention, designated as the contracting states, must recognize and enforce arbitration awards made outside of their respective jurisdictions.<sup>36</sup> Essentially, the purpose of the New York Convention is to enforce arbitration awards made pursuant to cross-border commercial contracts.<sup>37</sup> A contracting state may, on the basis of reciprocity, declare that it will only recognize and enforce arbitration awards made in other contracting states.<sup>38</sup> Furthermore, a contracting state may declare that it will apply the New York Convention only to legal differences that it considers to be commercial under its national laws.<sup>39</sup> The contracting state may refuse to recognize and enforce an arbitration award if the commercial contract was invalid under the parties' choice of law, if there was a procedural violation under the arbitration rules that the parties consented to, or if it would be contrary to the public policy of the contracting state.<sup>40</sup> Currently, there are 163 contracting states to the New York Convention.<sup>41</sup>

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<sup>28</sup> See Kenneth J. Vandeveld, *A Brief History of International Agreements*, 12 U.C. DAVIS J. INT'L L. & POL'Y 157, 161 (2005).

<sup>29</sup> *Id.* at 168.

<sup>30</sup> *Id.* at 171.

<sup>31</sup> *Id.* at 174.

<sup>32</sup> *Id.*

<sup>33</sup> *Id.*

<sup>34</sup> See Gary B. Born, *The New York Convention: A Self-Executing Treaty*, 40 MICH. J. INT'L L. 115, 117 (2018).

<sup>35</sup> Conv. on the Recognition and Enf't of Foreign Arbitral Awards (N.Y. Conv.), June 10, 1958, 21 U.S.T. 2517, 330 U.N.T.S. 3, <http://www.newyorkconvention.org/11165/web/files/original/1/5/15432.pdf>.

<sup>36</sup> *Id.* at art. I.

<sup>37</sup> *Scherk v. Alberto-Culver Co.*, 417 U.S. 506, 520 n.15 (1974).

<sup>38</sup> N.Y. Conv., *supra* note 35, at art. I.

<sup>39</sup> *Id.*

<sup>40</sup> *Id.* at art. V.

<sup>41</sup> *Chapter XXII: Com. Arb. and Mediation*, Conv. on the Recognition and Enf't of Foreign Arbitral Awards, UNITED NATIONS TREATY COLLECTION, <https://treaties.un.org/doc/Publication/MTDSG/Volume%20II/Chapter%20XXII/XXII-1.en.pdf> (last visited June 10, 2020). The contracting states include the United States, United Kingdom, Sweden, Ukraine, Russia, China, Brazil, Canada, Mexico, Poland, Germany, France, Egypt, South Africa, Singapore, Nigeria, India, Japan, and many others. *Contracting States*, N.Y. ARB. CONV., <http://www.newyorkconvention.org/countries> (last visited May 20, 2020). The New York Convention is enforced in the United States under the Federal Arbitration Act as codified in 9 U.S.C. §§ 201-08. "The court shall confirm the award unless it finds one of the grounds for refusal or deferral of recognition or enforcement of the award specified in the said Convention." *Id.*, § 207. This section essentially allows for limited judicial review.

### C. Emergence of Investor-State Dispute Settlements: The ICSID Convention

With the advent of decolonization, developed countries were concerned that assets of their citizens could be expropriated by their former colonies.<sup>42</sup> Recognizing the need of protecting their overseas assets, developed countries began to include arbitration in bilateral investment treaties with developing countries as a means for resolving disputes between foreign investors and the “hosting state.”<sup>43</sup> In September 1966, twenty states ratified the Convention on the Settlement of Investment Disputes between States and Nationals of Other States (ICSID Convention).<sup>44</sup> It is a multilateral treaty formed under the World Bank.<sup>45</sup> The purpose of the ICSID Convention was to encourage private investments in developing countries and to enumerate procedures on how to resolve disputes between investors and states.<sup>46</sup> Currently, there are 154 countries that are signatories to the ICSID Convention.<sup>47</sup>

ICSID Convention promulgates procedural protections for investors. Any monetary awards made through arbitration under the ICSID Convention are final and binding.<sup>48</sup> Even if a contracting state disagrees with the arbitration result, it may not disregard the judgment.<sup>49</sup> In fact, all contracting states agree to enforce the arbitration decision as if it were a final court judgement in their home jurisdictions.<sup>50</sup> However, written consent between the contracting state and a foreign national of another member state is needed for the ICSID Convention to have jurisdiction over the dispute.<sup>51</sup> The dispute must also arise out of an investment by the foreign national into the contracting state.<sup>52</sup>

The member states may, at their discretion, opt out of the ICSID Convention’s jurisdiction over certain classes of disputes.<sup>53</sup> If the parties consent to the jurisdiction of the ICSID Convention, its rules provide the exclusive remedy over the dispute.<sup>54</sup> However, a contracting state may accept

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<sup>42</sup> See Vandeveld, *supra* note 28, at 166; see also 1 *History of the ICISD Conv.*, INT’L CTR. FOR SETTLEMENT OF INV. DISPS. 2 (1970), <https://icsid.worldbank.org/en/Documents/resources/History%20of%20ICSID%20Convention%20-%20VOLUME%20I.pdf>.

<sup>43</sup> See Vandeveld, *supra* note 28, at 168.

<sup>44</sup> *History of the ICSID Conv.*, *supra* note 42, at 10.

<sup>45</sup> *About ICSID*, INT’L CTR. FOR SETTLEMENT OF INV. DISPS. (last visited July 31, 2019), <https://icsid.worldbank.org/en/Pages/about/default.aspx>.

<sup>46</sup> *Id.*

<sup>47</sup> *ICSID Conv.*, INT’L CTR. FOR SETTLEMENT OF INV. DISPS., <https://icsid.worldbank.org/en/Pages/icsiddocs/ICSID-Convention.aspx> (last visited July 31, 2019). The ICSID member states include the United States, Canada, Mexico, United Kingdom, France, Germany, Switzerland, Spain, Italy, Turkey, United Arab Emirates, Saudi Arabia, Jordan, Israel, Egypt, Kenya, China, Japan, South Korea, Malaysia, Singapore, Australia, Columbia, Peru, Argentina, and many others. See *Database of ICSID Member States*, INTERNATIONAL CENTRE FOR SETTLEMENT OF INVESTMENT DISPUTES, <https://icsid.worldbank.org/en/Pages/about/Database-of-Member-States.aspx> (last visited May 20, 2020). Although Russia is a signatory, it has not ratified the ICSID Convention. *Id.*

<sup>48</sup> Conv. on the Settlement of Inv. Disps. Between States and Nat’ls of Other States (ICSID Convention) art. 53, *opened for signature* Mar. 18, 1965, 17 U.S.T. 1270, 575 U.N.T.S. 159 (entered into force Oct. 14, 1966), <https://icsid.worldbank.org/sites/default/files/ICSID%20Convention%20English.pdf>.

<sup>49</sup> *Id.*

<sup>50</sup> *Id.* at art. 54.

<sup>51</sup> *Id.* at art. 25.

<sup>52</sup> *Id.*

<sup>53</sup> *Id.*

<sup>54</sup> ICSID Convention at art 26.

jurisdiction on the condition that the aggrieved party first attempts to exhaust the local remedies within the member state.<sup>55</sup> There is no provision for specific performance, so an investor can only request damages.<sup>56</sup> The only remedy for a losing party is to either request revision of the award due to a clerical error or ambiguous provision or request annulment for a due process violation, such as the failure to follow the arbitration rules or corruption of a member of the arbitration panel.<sup>57</sup> A new panel is convened to consider the annulment request.<sup>58</sup> Any resulting award from arbitration may be enforced through the ICSID Convention.<sup>59</sup>

#### D. The Panama Convention

In January 1975, the member-states of the Organization of American States<sup>60</sup> adopted the Inter-American Convention on International Commercial Arbitration (Panama Convention).<sup>61</sup> The Panama Convention is modeled after the New York Convention but with several key differences.<sup>62</sup> Enforcement through the Panama Convention is generally limited to awards made through international arbitration involving parties from different states. Conversely, the New York Convention allows a party to initiate an enforcement action in a foreign state for awards that arise from either domestic or international arbitration—the parties do not need to be from different states.<sup>63</sup> Furthermore, the Panama Convention only recognizes the procedural rules specified by the Inter-American Commercial Arbitration Commission unless the parties agree to opt out of those rules.<sup>64</sup> In the United States, if a conflict arises between enforcement through the Panama Convention as opposed to the New York Convention, the Panama Convention is enforced if the

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<sup>55</sup> *Id.*

<sup>56</sup> *Id.* at art. 48.

<sup>57</sup> *Id.* at art. 50, 51, & 52.

<sup>58</sup> *Id.* at art. 52.

<sup>59</sup> See 22 U.S.C. § 1650a(a). The ICSID Convention is enforced in the United States under 22 U.S.C. § 1650a. However, the Federal Arbitration Act does not apply to the ICSID Convention because courts must give full faith and credit to the arbitration award and cannot engage in judicial review. See also Theodore R. Posner, *An App. Mechanism for Inv.-State Disp. Settlement: A Persp. Based on the WTO Body Experience*, CROWELL & MORING LLP 13-14 (undated), <https://www.crowell.com/documents/An-Appellate-Mechanism-for-Investor-State-Dispute-Settlement.pdf> (last visited May 20, 2020).

<sup>60</sup> *Who We Are*, ORG. OF AMERICAN STATES, [http://www.oas.org/en/about/who\\_we\\_are.asp](http://www.oas.org/en/about/who_we_are.asp) (last visited May 20, 2020). Founded in 1948, the Organization of American States (OAS) includes all thirty-five independent states of the western hemisphere. The OAS model is analogous to the United Nations because it has its own general assembly, permanent council, and general secretariat. See *Organizational List*, ORG. OF AMERICAN STATES, [http://www.oas.org/en/about/organizational\\_list.asp](http://www.oas.org/en/about/organizational_list.asp) (last visited May 20, 2020).

<sup>61</sup> Inter-Am Convention Int'l Com. Arbitration (Panama Convention), Jan. 30, 1975, O.A.S.T.S. No. 42, 1438 U.N.T.S. 245 (Jun. 16, 1976), <https://treaties.un.org/doc/Publication/UNTS/Volume%201438/volume-1438-I-24384-English.pdf>. (The Panama Convention is enforced in the United States under 9 U.S.C. §§ 301-07).

<sup>62</sup> Albert Jan van den Berg, *The New York Convention 1958 and Panama Convention 1975: Redundancy or Compatibility?*, 5 ARBITRATION INT'L 214, 218 (1989).

<sup>63</sup> *Energy Transp., Ltd. v. Sebastian*, 348 F. Supp. 2d 186, 198 (S.D.N.Y. 2004) (citing John P. Bowman, *The Panama Convention and Its Implementation under the Federal Arbitration Act*, 11 AM. REV. INT'L. ARB. 1, 36 (2000)); Albert Jan van den Berg, *supra* note 62, at 219 (However, United States law will not apply the New York Convention if the parties to the arbitration are only citizens of the United States, “unless that relationship involves property located abroad, envisages performance or enforcement abroad, or has some other reasonable relation with one or more foreign states.” 9 U.S.C. § 202).

<sup>64</sup> Panama Convention, *supra* note 61, at art. III.

majority of the parties to the arbitration are from states that ratified or acceded to the Panama Convention.<sup>65</sup>

### E. The World Trade Organization

Investor-state arbitration under the ICSID Convention is handled differently than state-to-state disputes under the World Trade Organization (WTO). Founded in 1995, the WTO adjudicates disputes between its 164 member states over generally agreed trade policies, such as lowering tariffs and market barriers.<sup>66</sup> The WTO adjudicates disputes through three-member panels and has a permanent seven-member appellate body.<sup>67</sup> In contrast, investor-state arbitration arises on an ad hoc basis, as provided for in bilateral or multilateral investment treaties, with neither a permanent tribunal nor an appellate body.<sup>68</sup> Through the WTO, an aggrieved state can use a favorable ruling as a justification to impose retaliatory sanctions or tariffs against the offending state.<sup>69</sup> Nevertheless, a state may unilaterally impose sanctions regardless of the WTO ruling and treaty provisions.<sup>70</sup> Furthermore, certain states can stall the appointment of judges on WTO tribunals, which can grind the adjudicatory process to a halt.<sup>71</sup>

The emergence of the ISDS mechanism is a powerful tool for investors to protect their assets. In return, states benefit from foreign investment and development. Nevertheless, there are concerns over potential abuses of the ISDS arbitration process that are worth exploring.

### III. PROBLEMS ASSOCIATED WITH ISDS AND INDIVIDUAL CASE STUDIES

There have been many criticisms leveled at the ISDS system over the last several decades. Politicians, academics, and journalists contend that the ISDS mechanism is a handout to foreign corporations looking to exploit legitimate investment treaties.<sup>72</sup> Many view ISDS as a get-out-of-jail-free card for corporations that do not wish to comply with legitimate environmental, health, and labor laws.<sup>73</sup> A corollary issue is that ISDS allows arbitration tribunals, which are not directly accountable to the hosting state, to undermine the hosting state's sovereignty.<sup>74</sup> The state citizenry tend to trust their own domestic courts over ad hoc arbitration tribunals composed of foreign

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<sup>65</sup> 9 U.S.C. § 305.

<sup>66</sup> *Who We Are*, WORLD TRADE ORGANIZATION (last visited July 31, 2019), [https://www.wto.org/english/thewto\\_e/whatis\\_e/who\\_we\\_are\\_e.htm](https://www.wto.org/english/thewto_e/whatis_e/who_we_are_e.htm).

<sup>67</sup> *Understanding the WTO: Settling Disputes, The Panel Process*, WORLD TRADE ORGANIZATION, [https://www.wto.org/english/thewto\\_e/whatis\\_e/tif\\_e/disp2\\_e.htm](https://www.wto.org/english/thewto_e/whatis_e/tif_e/disp2_e.htm) (last visited July 31, 2019); Ian F. Fergusson, *Dispute Settlement in the WTO and U.S. Trade Agreements*, CONG. RSCH. SERV. (Dec. 6, 2019), <https://crsreports.congress.gov/product/pdf/IF/IF10645>.

<sup>68</sup> McBride and Chatzky, *supra* note 15.

<sup>69</sup> *Understanding the WTO: Settling Disputes: A Unique Contribution*, WORLD TRADE ORGANIZATION (last visited July 31, 2019), [https://www.wto.org/english/thewto\\_e/whatis\\_e/tif\\_e/disp1\\_e.htm](https://www.wto.org/english/thewto_e/whatis_e/tif_e/disp1_e.htm).

<sup>70</sup> Jeffrey Frieden and Joel Trachtman, *U.S. Trade Policy: Going it Alone or Abiding by the World Trade Organization*, ECONOFACT (June 15, 2018), <https://econofact.org/u-s-trade-policy-going-it-alone-vs-abiding-by-the-world-trade-organization>.

<sup>71</sup> McBride and Chatzky, *supra* note 15.

<sup>72</sup> See Senator Elizabeth Warren's press release, *supra* note 13; see also letters from state legislators and law and economics professors to President Donald J. Trump and Hon. Robert Lighthizer, *supra* note 13.

<sup>73</sup> *Id.*

<sup>74</sup> *Id.*

lawyers.<sup>75</sup> The cost to a country's taxpayers to defend against an ISDS claim can be just as large, if not larger, than the cost of defending it in a domestic court.<sup>76</sup> In fact, it is estimated that the average amount awarded to investors winning ISDS actions in 2016 was \$545 million plus interest.<sup>77</sup>

However, without an ISDS mechanism, foreign investors may be wary of entering the market of the hosting state. Foreign investment is crucial to developing countries that are looking to improve their economies and lift their citizens out of poverty. If oil company X sets up drilling operations in country Y, but country Y nationalizes the oil industry and seizes X's assets, it will scare away potential investors. Furthermore, X would have difficulty in seeking a remedy for Y's expropriation in Y's domestic court system. In effect, without an ISDS mechanism, there is no remedy. With an ISDS mechanism, the best option is a favorable decision through an arbitration tribunal and subsequent enforcement of a damages award through either the ICSID Convention, the New York Convention, the or Panama Convention, if applicable, unless the investment treaty specifies another method of enforcement.<sup>78</sup>

The history of arbitration demonstrates the advantages of creating a process to resolve cross-border disputes. While the ISDS system has been quite successful in spurring investor trust, it has not alleviated the public's concerns in the hosting states. Public skepticism has encouraged governments to move away from the ISDS mechanism and seek out alternatives. There are several prominent cases that demonstrate why the public views ISDS with suspicion.

### A. Ethyl Corporation v. Government of Canada

Investors have used ISDS provisions in investment treaties to target laws that protect the environment. Ethyl was a chemical company that was incorporated and headquartered in Richmond, Virginia.<sup>79</sup> It manufactured and sold Methylcyclopentadienyl Manganese Tricarbonyl (MMT), which is a fuel additive that increases the octane level of unleaded gasoline.<sup>80</sup> Ethyl created a wholly-owned subsidiary in Mississauga, Ontario, through which it imported MMT into Canada.<sup>81</sup>

In April 1997, the Canadian parliament passed a law banning the importation and interprovincial sale of MMT.<sup>82</sup> The legislature was concerned that MMT increased the toxicity of

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<sup>75</sup> *Id.*

<sup>76</sup> Lise Johnson, Lisa Sachs, Brooke Skartvedt Güven, and Jesse Coleman, *Costs and Benefits of Investment Treaties: Practical Considerations for States*, COLUMBIA CENTER ON SUSTAINABLE INVESTMENT 11 (Mar. 2018), <http://ccsi.columbia.edu/files/2018/04/Cost-and-Benefits-of-Investment-Treaties-Practical-Considerations-for-States-ENG-mr.pdf>.

<sup>77</sup> *Id.*

<sup>78</sup> See Vincent O. Nmehielle, *Enforcing Arbitration Awards Under the International Convention for the Settlement of Investment Disputes (ICSID Convention)*, 7 ANN. SURV. INT'L & COMP. L. 21, 29 (2001) (discussing methods of enforcement).

<sup>79</sup> Ethyl Corp. v. Gov't of Can., NAFTA/UNCITRAL Case, Award on Jurisdiction, ¶ 1 (June 24, 1998), <https://www.italaw.com/sites/default/files/case-documents/ita03000.pdf>.

<sup>80</sup> *Id.*

<sup>81</sup> *Id.*

<sup>82</sup> *Id.* ¶ 5.

fuel exhaust and that it ran afoul of Canada's goal to reduce automobile emissions.<sup>83</sup> Ethyl invoked arbitration through Chapter 11 of NAFTA,<sup>84</sup> alleging that the restrictions on MMT constituted unlawful expropriation and violated the national treatment performance requirements of NAFTA.<sup>85</sup> While technically the law did not ban the sale and production of MMT in Canada, the import and interprovincial sale restrictions meant that Ethyl could only continue to market MMT by opening new manufacturing plants in each Canadian province.<sup>86</sup> Ethyl claimed \$201 million in damages.<sup>87</sup> The Canadian government requested the arbitration tribunal to dismiss the claims based on lack of jurisdiction and that the claims were outside the scope of NAFTA.<sup>88</sup> However, the tribunal allowed the claims to proceed on the merits.<sup>89</sup> Subsequently, Canada settled with Ethyl for \$13 million.<sup>90</sup>

## B. Philip Morris Asia Limited v. The Commonwealth of Australia

Investors can attempt to use the ISDS mechanism to neutralize public health and safety laws, such as those designed to combat the health risks of smoking. Philip Morris International owned subsidiaries in Asia and Australia.<sup>91</sup> In July 2010, Australia proposed a timeline for passing and enacting a "plain packaging" legislation, which would ban the use trademarks, symbols, and images on tobacco packaging.<sup>92</sup> Tobacco companies would be only allowed to print their name on the packaging, which was problematic because it could cause brand confusion among customers.<sup>93</sup> The Australian government's goal was to pass and implement the law by July 2012.<sup>94</sup>

In September 2010, Phillip Morris began a restructuring process where its Hong Kong subsidiary, Phillip Morris Asia Limited, purchased all of the shares in the Australian subsidiary.<sup>95</sup> Phillip Morris invoked arbitration under the Australia-Hong Kong Bilateral Investment Treaty on the basis that the plain packaging law constituted expropriation and resulted in an unspecified amount of damages that would exceed a billion Australian dollars.<sup>96</sup> The Australian government argued in part that jurisdiction was not proper because Phillip Morris used their restructuring process as a pretext for bringing an arbitration claim.<sup>97</sup>

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<sup>83</sup> *Cases filed against the Government of Canada*, Ethyl Corporation v. Government of Canada, GLOBAL AFFAIRS CANADA, <https://www.international.gc.ca/trade-agreements-accords-commerciaux/topics-domaines/diff-ethyl.aspx?lang=eng> (last updated Dec. 21, 2017).

<sup>84</sup> Ethyl Corp., *supra* note 79, ¶ 4.

<sup>85</sup> *Id.* ¶ 7.

<sup>86</sup> *Id.* ¶ 6.

<sup>87</sup> *Cases filed against the Government of Canada*, *supra* note 83.

<sup>88</sup> Ethyl Corp., *supra* note 79, ¶¶ 43-45.

<sup>89</sup> *Id.* ¶ 85.

<sup>90</sup> 1 SEAN D. MURPHY, UNITED STATES PRACTICE IN INTERNATIONAL LAW 234 (1999-2001).

<sup>91</sup> Philip Morris Asia Ltd. v. Austl., PCA Case No. 2012-12, Award on Jurisdiction and Admissibility, ¶¶ 95-97 (Dec. 17, 2015), <https://pcacases.com/web/sendAttach/1711>.

<sup>92</sup> *Id.* ¶ 130.

<sup>93</sup> *Id.* ¶ 7.

<sup>94</sup> *Id.* ¶ 130.

<sup>95</sup> *Id.* ¶ 143.

<sup>96</sup> *Id.* ¶¶ 8, 183.

<sup>97</sup> *Philip Morris Asia Ltd.*, PCA Case No. 2012-12 at ¶ 184.

The arbitration tribunal agreed and noted that Phillip Morris was aware of the plain packaging legislation when it had ordered its Hong Kong subsidiary to purchase shares in its Australian subsidiary.<sup>98</sup> This constituted an abuse of the purpose of the protections within the treaty and the tribunal dismissed the claim.<sup>99</sup> Despite the favorable result for the Australian government, it had spent nearly \$39 million over a six-year period to defend against Phillip Morris's claim.<sup>100</sup> Ultimately, Phillip Morris had to reimburse Australia for its legal expenses; however, the Australian taxpayer had to make payments in the intervening years during the pendency of the arbitration action.<sup>101</sup>

### C. Phillip Morris Brands Sàrl v. Oriental Republic of Uruguay

Australia was not the only country where Phillip Morris attempted to use the ISDS mechanism to undermine public health laws. Three Phillip Morris subsidiaries, operating from Switzerland and Uruguay, brought a similar action against the Uruguayan government under the Switzerland-Uruguay Bilateral Investment Treaty.<sup>102</sup> Uruguay promulgated new regulations in 2008 and 2009 regarding cigarette brands.<sup>103</sup> Particularly, the regulations required cigarette brands to have a "single presentation," with no variation in marketing for each brand.<sup>104</sup> This barred Phillip Morris from marketing different varieties within a brand such as "Marlboro Red," "Marlboro Gold," "Marlboro Blue," and "Marlboro Green (Fresh Mint)."<sup>105</sup> As a result, Phillip Morris had to cease selling all but one of its variants for each brand on the market.<sup>106</sup> Uruguay also imposed an "80/80 regulation" which required 80% of each cigarette package to have warning labels on the dangers of smoking.<sup>107</sup> This left only 20% of the cigarette package for trademarks.<sup>108</sup>

Phillip Morris alleged that these regulations constituted inequitable treatment, impairment of use and enjoyment of investments, and expropriation under the bilateral investment treaty.<sup>109</sup> Uruguay responded that these regulations were "the legitimate exercise of State sovereign police power to protect public health."<sup>110</sup> The arbitration tribunal agreed with Uruguay, declaring that a state's good faith exercise of police power for the purpose of promoting the general welfare, including health and safety, does not constitute expropriation, on condition that it is enacted in a

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<sup>98</sup> *Id.* ¶¶ 584-88.

<sup>99</sup> *Id.*

<sup>100</sup> Gareth Hutchins and Christopher Knaus, *Revealed: \$39m cost of defending Australia's tobacco plain packaging laws*, THE GUARDIAN (July 1, 2018), <https://www.theguardian.com/business/2018/jul/02/revealed-39m-cost-of-defending-australias-tobacco-plain-packaging-laws>.

<sup>101</sup> Phillip Morris Asia Ltd. v. Austl., PCA Case No. 2012-12, Final Award Regarding Costs, ¶ 108 (Mar. 8, 2017), <https://pcacases.com/web/sendAttach/2190>.

<sup>102</sup> Phillip Morris Brands Sàrl v. Oriental Republic of Uru., ICSID Case No. ARB/10/7, Award, ¶¶ 1-5 (July 8, 2016), <https://www.italaw.com/sites/default/files/case-documents/italaw7417.pdf>.

<sup>103</sup> *Id.* ¶¶ 9-11.

<sup>104</sup> *Id.* ¶ 10.

<sup>105</sup> *Id.*

<sup>106</sup> *Id.* ¶¶ 10, 111.

<sup>107</sup> *Id.* ¶ 11.

<sup>108</sup> *Phillip Morris Brands Sàrl*, ICSID Case No. ARB/10/7 at ¶ 11.

<sup>109</sup> *Id.* ¶ 12.

<sup>110</sup> *Id.* ¶¶ 13, 181.

nondiscriminatory and proportionate manner.<sup>111</sup> Economic loss alone is not expropriation.<sup>112</sup> The tribunal ordered Phillip Morris to reimburse Uruguay \$17 million in costs for defending the case.<sup>113</sup>

#### **D. Vattenfall AB v. The Federal Republic of Germany**

The Vattenfall case is another illustration of litigants using the ISDS mechanism to challenge environmental reforms. Vattenfall is a Swedish energy firm that planned to construct a coal-fired power plant on bank of the Elbe River near Hamburg, Germany.<sup>114</sup> Although Vattenfall originally planned to construct a single-block plant at the estimated cost of 700 million euros, in 2004, the city of Hamburg requested a dual-block plant which increased the estimated cost to more than 1.8 billion euros.<sup>115</sup> In 2006, Vattenfall agreed and proceeded to file for the requisite permits.<sup>116</sup> Nevertheless at the behest of a German Senator, the city delayed issuing the permits due to concerns with how the power plant may impact climate change.<sup>117</sup> In particular, the city was concerned that the power plant's design system called for the use of cooling water from the river and the power plant would discharge the water back into the river.<sup>118</sup> As a result, the power plant's operation would increase the temperature of the river and jeopardize the ecosystem.<sup>119</sup>

While Vattenfall and Hamburg were negotiating over the permits, in 2008 the Green Party won the local city elections.<sup>120</sup> Under new leadership, Hamburg agreed to issue the permits with severe restrictions.<sup>121</sup> In effect, these restrictions rationed the amount of cooling water that the power plant can use, which meant that the power plant could not run at full capacity.<sup>122</sup> Vattenfall alleged that the power plant would need to shut down for days or even weeks during the summer to accommodate the rationing.<sup>123</sup>

In March 2009, Vattenfall filed for arbitration under the ISDS provision of the Energy Charter Treaty, of which Sweden and Germany are signatories.<sup>124</sup> Vattenfall alleged that Hamburg's permit restrictions impaired the value of their investment in the power plant and constituted expropriation.<sup>125</sup> Furthermore, Vattenfall demanded 1.4 billion euros in damages.<sup>126</sup>

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<sup>111</sup> *Id.* ¶¶ 295-301, 305.

<sup>112</sup> *Id.*

<sup>113</sup> *Id.* ¶ 590.

<sup>114</sup> Vattenfall AB v. Fed. Republic of Ger., ICISD Case No. ARB/09/6, Request for Arbitration to the Convention on the Settlement of Investment Disputes, ¶¶ 8, 11 (Mar. 30, 2009), <https://www.italaw.com/sites/default/files/case-documents/ita0889.pdf>.

<sup>115</sup> *Id.* ¶ 12.

<sup>116</sup> *Id.* ¶¶ 12, 14.

<sup>117</sup> *Id.* ¶ 16.

<sup>118</sup> *Id.* ¶¶ 13, 17.

<sup>119</sup> *Id.*

<sup>120</sup> Vattenfall AB, ICISD Case No. ARB/09/6 at ¶ 29.

<sup>121</sup> *Id.* ¶ 36.

<sup>122</sup> *Id.* ¶¶ 37-38.

<sup>123</sup> *Id.*

<sup>124</sup> *Id.* ¶¶ 56, 58.

<sup>125</sup> *Id.* ¶ 69.

<sup>126</sup> *Id.* ¶ 79.

After two years of expensive proceedings, in March 2011, Germany settled with Vattenfall for an undisclosed amount.<sup>127</sup> The power plant began operating in 2014.<sup>128</sup>

Yet this debacle was not the end of the feud between Vattenfall and Germany. In the aftermath of the nuclear meltdown at the Japan's Fukushima plant in 2011, Germany decided to phase out nuclear power plants by 2022.<sup>129</sup> Again, Vattenfall invoked arbitration under the ISDS provision of the Energy Charter Treaty.<sup>130</sup> Germany's phaseout of nuclear power plants is estimated to cost Vattenfall 1.18 billion euros in damages.<sup>131</sup> The case is still pending.<sup>132</sup>

### E. Apotex Inc. v. United States

A litigant can attempt to use the ISDS mechanism to undermine the legitimacy of domestic courts. The Apotex case involved a series of back-to-back claims combined into an ISDS arbitration proceeding.<sup>133</sup> Apotex is a Canadian company that manufactures generic drugs.<sup>134</sup> United States law dictates that a generic pharmaceutical manufacturer does not need to wait for a patent on an equivalent non-generic drug to expire prior to obtaining preliminary approval from the Food and Drug Administration to prepare the generic version for the commercial market.<sup>135</sup> This is a pragmatic measure designed to expedite the bureaucratic red tape, which allows generic drugs to enter the market immediately after the patent of an equivalent non-generic drug has expired.<sup>136</sup>

United States law grants a generic pharmaceutical manufacturer 180 days of market exclusivity during which the Food and Drug Administration will not approve other applications from competitors for the generic version of the drug.<sup>137</sup> However, this 180-day market exclusivity rule is triggered by the earlier of either of the following: (1) the first-filer's commercial marketing of the generic drug, or (2) a court decision holding that the non-generic patent is either invalid or not infringed.<sup>138</sup>

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<sup>127</sup> Vattenfall AB v. Fed. Republic of Ger., ICISD Case No. ARB/09/6, Certified Award, p. 5-6 (Mar. 11, 2011), <https://www.italaw.com/sites/default/files/case-documents/ita0890.pdf>.

<sup>128</sup> *Moorburg Coal-fired Power Plant, Hamburg*, POWER TECHNOLOGY, <https://www.power-technology.com/projects/moorburg-coal-fired-power-plant-hamburg/> (last visited July 31, 2019).

<sup>129</sup> Nathalie Bernasconi-Osterwalder and Rhea Tamara Hoffmann, *The German Nuclear Phase-Out Put to the Test in International Investment Arbitration? Background to the new dispute Vattenfall v. Germany (II)*, THE INTERNATIONAL INSTITUTE FOR SUSTAINABLE DEVELOPMENT 2 (June 2012), [https://www.iisd.org/system/files/publications/german\\_nuclear\\_phase\\_out.pdf](https://www.iisd.org/system/files/publications/german_nuclear_phase_out.pdf).

<sup>130</sup> *Id.* at 3.

<sup>131</sup> *Id.*

<sup>132</sup> Vattenfall AB and others v. Fed. Republic of Ger., ICSID Case No. ARB/12/12, INT'L CTR. FOR SETTLEMENT OF INV. DISP. (describing case status), <https://icsid.worldbank.org/en/Pages/cases/casedetail.aspx?CaseNo=ARB/12/12> (last visited May 20, 2020).

<sup>133</sup> Apotex Inc. v. United States, Award on Jurisdiction and Admissibility, ¶¶ 14-17 & 22-23 (June 14, 2013), <https://www.italaw.com/sites/default/files/case-documents/italaw1550.pdf>.

<sup>134</sup> *Id.* ¶¶ 5, 12.

<sup>135</sup> *Id.* ¶¶ 56-57, 65.

<sup>136</sup> *Id.*

<sup>137</sup> *Id.* ¶ 66.

<sup>138</sup> *Id.* (citing 21 U.S.C. § 355(j)(5)(B)(iv) (2002)).

Apotex sought approval from the Food and Drug Administration of the generic equivalent to an antidepressant, patented by Pfizer.<sup>139</sup> However, another competitor, Ivax Corporation, had already preserved market exclusivity through a settlement in a separate litigation with Pfizer.<sup>140</sup> Thus, to gain preferred access to the market, Apotex would need to prompt Pfizer to sue it over patent infringement.<sup>141</sup> To that end, Apotex certified to the Food and Drug Administration that its generic version of the antidepressant did not infringe on Pfizer's nonexpired patent.<sup>142</sup> Nevertheless, Pfizer decided to refrain from suing Apotex because Pfizer wanted to bottleneck the market.<sup>143</sup> When Apotex realized that its strategy failed, it filed suit in federal district court seeking a declaratory judgement against Pfizer with the goal of triggering market exclusivity through a court decision.<sup>144</sup> The district court dismissed the case due to lack of subject matter jurisdiction, which was affirmed on appeal.<sup>145</sup> The United States Supreme Court denied Apotex's certiorari petition.<sup>146</sup> As a result, Ivax launched its generic drug with market exclusivity.<sup>147</sup>

Apotex attempted a similar strategy for the generic version of heart medication tablets, patented by Bristol Myers Squibb ("BMS").<sup>148</sup> However, two other competitors were ahead in the queue for market exclusivity for their generic brands when the patent was to expire.<sup>149</sup> When Apotex filed for approval from the Food and Drug Administration, BMS adopted a strategy similar to Pfizer and refused to sue Apotex for patent infringement.<sup>150</sup> Although Apotex obtained oral assurances from BMS that it would not sue Apotex if it marketed the generic drug prior to the patent expiration, BMS refused to sign any written agreement.<sup>151</sup> Therefore, Apotex sued BMS in federal district court seeking a declaratory judgement that BMS's oral assurances prevent it from suing Apotex if it were to commercially launch its product prior to patent expiration.<sup>152</sup> The court dismissed the case.<sup>153</sup>

The Food and Drug Administration initially agreed with Apotex that the dismissal triggered the court-decision prong of the market exclusivity rule.<sup>154</sup> However, Teva, a competitor of Apotex, challenged this conclusion in federal court.<sup>155</sup> After a lengthy litigative process, which involved the Food and Drug Administration reversing its earlier opinion, the court agreed that the dismissal

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<sup>139</sup> *Id.* ¶ 84.

<sup>140</sup> *Id.* ¶¶ 86, 89.

<sup>141</sup> *Id.* ¶¶ 90-91.

<sup>142</sup> *Id.*

<sup>143</sup> *Id.*

<sup>144</sup> *Id.* ¶ 92.

<sup>145</sup> *Id.* ¶¶ 94, 97. Specifically, the U.S. district court found that "Apotex has not shown that Pfizer created a reasonable apprehension of patent litigation, and thus no actual controversy exists." *Apotex Inc. v. Pfizer Inc.*, 385 F. Supp. 2d 187, 193 (S.D.N.Y. 2005).

<sup>146</sup> *Apotex Inc.*, *supra* note 133, ¶ 98.

<sup>147</sup> *Id.* ¶ 102.

<sup>148</sup> *Id.* ¶¶ 105-07.

<sup>149</sup> *Id.* ¶ 108.

<sup>150</sup> *Id.* ¶¶ 112-13.

<sup>151</sup> *Id.* ¶ 114.

<sup>152</sup> *Id.*

<sup>153</sup> *Id.* ¶ 116.

<sup>154</sup> *Id.* ¶¶ 117-18.

<sup>155</sup> *Id.* ¶ 120.

did not trigger the market exclusivity rule, which was affirmed on appeal.<sup>156</sup> Apotex declined to file a certiorari petition to the United States Supreme Court.<sup>157</sup>

Apotex initiated an ISDS arbitration proceeding against the United States government through NAFTA, and alleged that their losses, before the federal judiciary, constituted a breach of fair and equitable treatment regarding Apotex's investments and interfered with and "expropriated Apotex's property rights."<sup>158</sup> In its arbitration pleadings, Apotex asserted the federal courts, including the United States Supreme Court, engaged in conduct that was "unlawful," "wrongful," "improper," "arbitrary," "capricious," and "unjust."<sup>159</sup> Apotex claimed damages in the amount of \$8 million for the antidepressant drug and also \$8 million for the heart medication drug.<sup>160</sup> Apotex asserted that the federal courts committed an error of law in deciding these cases and that the market exclusivity rule should have been triggered in Apotex's favor.<sup>161</sup> In effect, Apotex was attempting to relitigate cases decided by federal courts and wanted the arbitration tribunal to act as an extraterritorial super court of appeals.

The United States primarily argued that the tribunal lacked jurisdiction over the case because Apotex was not an "investor" with a qualifying "investment" under NAFTA.<sup>162</sup> Apotex has no presence inside the United States because it manufactures pharmaceuticals and then exports them into the United States.<sup>163</sup> Apotex argued that its preparation for filings with the Food and Drug Administration at the cost millions of dollars, the expenditure on litigation, the purchase of raw ingredients from the United States, and its preparation to formulate and manufacture goods all constitute an investment.<sup>164</sup> The tribunal found in favor of the United States on the basis that exports prepared outside of the United States, the costs associated with obtaining regulatory approval, and the purchase of raw ingredients do not qualify as investments.<sup>165</sup> Even if these activities did qualify as an investment, Apotex did not exhaust all of its local remedies as required by NAFTA.<sup>166</sup> The tribunal ordered Apotex to reimburse the United States in the amount of \$525,814 in legal representation fees and also 50% for the costs of arbitration.<sup>167</sup>

The foregoing cases illustrate why the public views the ISDS mechanism with skepticism. However, these cases ultimately resulted in a victory to states over investors. In *Ethyl*, the investor claimed \$201 million in damages but settled with Canada for a meager \$13 million.<sup>168</sup> Phillip Morris lost its claims against Australia's and Uruguay's public health laws, and the arbitration tribunals ordered Phillip Morris to reimburse those governments for the costs in defending the

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<sup>156</sup> *Id.* ¶¶ 120-28.

<sup>157</sup> *Id.* ¶ 219.

<sup>158</sup> *Id.* ¶¶ 100, 132.

<sup>159</sup> *Id.* ¶ 103, 130.

<sup>160</sup> *Id.* ¶¶ 104, 133.

<sup>161</sup> *Id.* ¶¶ 99, 102, 134.

<sup>162</sup> *Id.* ¶¶ 135, 146.

<sup>163</sup> *Id.* ¶ 146.

<sup>164</sup> *Id.* ¶¶ 147-48.

<sup>165</sup> *Id.* ¶¶ 243-46, 358.

<sup>166</sup> *Id.* ¶¶ 298, 358.

<sup>167</sup> *Id.* ¶ 358.

<sup>168</sup> *Cases filed against the Government of Canada*, *supra* note 83; Sean D. Murphy, *supra* note 90, at 234.

claims.<sup>169</sup> In *Apotex*, the arbitration tribunal refused to overrule United States federal courts, but it instead ordered Apotex to reimburse the United States government's legal costs.<sup>170</sup> *Vattenfall* was the most successful because Germany agreed to allow the power plant to operate; however, the settlement amount is not public.<sup>171</sup>

These cases indicate that the ISDS process does not favor investors, or alleged investors, that bring arguably abusive actions. In contrast, the public outrage over ISDS focuses primarily on the potential that a foreign investor may undermine a state's sovereignty to enforce legitimate laws, and the costs for taxpayers to defend cases, rather than the actual results of the ISDS process.<sup>172</sup> Although ISDS arbitration tribunals do not have the authority to strike down laws, they have the potential to render laws ineffective through large damage awards.<sup>173</sup> It is for these reasons that countries are seeking reforms to the ISDS mechanism.

#### IV. PROPOSED AND ENACTED REFORMS

In the wake of these controversial cases and others, many countries now question the propriety of the ISDS mechanism. There are several proposed reforms regarding the ISDS mechanism. These include redrafting bilateral and multilateral trade agreements to limit the scope of ISDS over certain environmental, health, and labor laws, establishing international or regional investor courts, creating an appellate arbitration panel, creating procedural reforms to ISDS to give the arbitration panels more guidance on adjudicating cases, or entirely eliminating ISDS and returning to adjudication through domestic courts.<sup>174</sup> This part will explain the proposed reforms in the European Union and North America and evaluate their differences and merits. It will also evaluate the proposition floated by commentators that ISDS is generally better with ad hoc appellate panels because they would establish an additional check and balance in ISDS decisions.

##### A. The European Union Plans to Reorganize ISDS into a Regional Investor Court System

ISDS has been a common mechanism for resolving intra-state disputes between European corporations and the member states of the European Union.<sup>175</sup> However, the European Union is

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<sup>169</sup>Philip Morris Asia Ltd. v. Austl., PCA Case No. 2012-12, Final Award Regarding Costs, ¶ 108 (Mar. 8, 2017); Phillip Morris Brands Sàrl v. Oriental Republic of Uru., ICSID Case No. ARB/10/7, Award, ¶ 590 (July 8, 2016).

<sup>170</sup> Apotex Inc. v. United States, Award on Jurisdiction and Admissibility, ¶ 358 (June 14, 2013). Apotex Inc., *supra* note 133, ¶ 358.

<sup>171</sup> Vattenfall AB v. Fed. Republic of Ger., ICISD Case No. ARB/09/6, Award (Mar. 11, 2011); *Moorburg Coal-fired Power Plant, Hamburg*, *supra* note 128.

<sup>172</sup> See Senator Elizabeth Warren's press release, *supra* note 13; see also letters from state legislators and law and economics professors to President Donald J. Trump and Hon. Robert Lighthizer, *supra* note 13.

<sup>173</sup> See Martin A. Weiss, Shayerah Ilias Akhtar, Brandon J. Murrill, and Daniel T. Shedd, *International Investment Agreements (IIAs): Frequently Asked Questions*, CONGRESSIONAL RESEARCH SERVICE 18 (May 15, 2015) (explaining that ISDS cannot alter law or regulation), <https://fas.org/sgp/crs/misc/R44015.pdf>; see also Convention On The Settlement Of Investment Disputes Between States And Nationals Of Other States, *supra* note 47, art. 48 (allowing damages as the only remedy).

<sup>174</sup> See *infra* notes 201-04, 240, 242-43, 249-50, 255.

<sup>175</sup> See Christopher A. Casey, *The End of Intra-EU Investor-State Dispute Settlement (ISDS): Implications for the United States*, CRS INSIGHT (Feb. 13, 2019), <https://fas.org/sgp/crs/row/IN11041.pdf>.

planning to move away from ISDS and establish a regional investor court system.<sup>176</sup> This current proposition by the European Union makes sense because the European Union already has a general court system; however, the establishment of a separate investor court system as a replacement for ISDS will allow for greater specialization of the judiciary.<sup>177</sup>

The writing on the wall for ISDS manifested itself in *Slovak Republic v. Achmea BV* where the European Court of Justice ruled that the Treaty on the Functioning of the European Union foreclosed the use of ISDS in bilateral investment treaties between two member states.<sup>178</sup> The case originated from a dispute between Achmea, a Netherlands company, and Slovakia regarding the sale of private medical insurance services.<sup>179</sup> In 2004, Slovakia reformed its health care system to allow for these services.<sup>180</sup> Afterwards, Achmea entered the market to offer private medical insurance.<sup>181</sup> Nevertheless, in 2006, Slovakia's legislature passed a law that banned companies from garnering profits from these sales.<sup>182</sup> In 2008, Achmea invoked arbitration under a bilateral investment treaty.<sup>183</sup> Slovakia argued that Achmea lacked jurisdiction on the basis that the ISDS provision in the bilateral investment treaty conflicted with the law of the European Union.<sup>184</sup> In 2010, the arbitration tribunal rejected this argument.<sup>185</sup>

In 2011, Slovakia reversed course and decided to permit companies to gain profits on their sales of private medical insurance.<sup>186</sup> However, in 2012, the case proceeded on the merits and the arbitration tribunal ruled that Slovakia must pay Achmea 22.1 million Euros in damages.<sup>187</sup> At first, Slovakia appealed the decision through the German Court system because Germany had been the location of arbitration; however, the Federal Court of Justice in Germany referred the case to the Court of Justice of European Union (CJEU).<sup>188</sup>

CJEU emphasized that the law of the European Union reigned supreme over the laws of the individual member states, including any bilateral investment treaties enacted prior to those

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<sup>176</sup> *Id.*; *A Multilateral Investment Court: State of the Union 2017*, COM (2017), [http://trade.ec.europa.eu/doclib/docs/2017/september/tradoc\\_156042.pdf](http://trade.ec.europa.eu/doclib/docs/2017/september/tradoc_156042.pdf).

<sup>177</sup> See *The Multilateral Investment Court project*, EUROPEAN COMMISSION (Dec. 21, 2016), [https://policy.trade.ec.europa.eu/enforcement-and-protection/multilateral-investment-court-project\\_en](https://policy.trade.ec.europa.eu/enforcement-and-protection/multilateral-investment-court-project_en) (last updated February 14, 2022); see also Céline Lévesque, *The European Commission Proposal for an Investment Court System: Out With The Old, In With The New?*, Investor-State Arbitration Series, Paper No. 10, CENTRE FOR INTERNATIONAL GOVERNANCE INNOVATION 8 (Sept. 2016), available at <https://www.cigionline.org/publications/european-commission-proposal-investment-court-system-out-old-new>.

<sup>178</sup> Case C-284/16, *Slovak Republic v. Achmea BV*, ECLI:EU:C:2018:158, ¶¶ 58-60 (Mar. 6, 2018) (Judgement of the Court), <http://curia.europa.eu/juris/document/document.jsf?text=&docid=199968&pageIndex=0&doclang=EN&mode=req&dir=&occ=first&part=1&cid=432158>.

<sup>179</sup> *Id.* ¶¶ 2, 7.

<sup>180</sup> *Id.* ¶ 7.

<sup>181</sup> *Id.*

<sup>182</sup> *Id.* ¶ 8.

<sup>183</sup> *Id.* ¶ 9.

<sup>184</sup> *Id.* ¶ 11.

<sup>185</sup> *Id.*

<sup>186</sup> *Id.* ¶ 8.

<sup>187</sup> *Id.* ¶ 12.

<sup>188</sup> *Id.* ¶¶ 10, 12.

states joining the European Union.<sup>189</sup> Slovakia had joined the European Union in 2004; however, it had entered into a bilateral investment treaty with the Netherlands in 1993.<sup>190</sup> The Treaty on the Functioning of the European Union, stated that “[m]ember States undertake not to submit a dispute concerning the interpretation or application of the Treaties to any method of settlement other than those provided for therein.”<sup>191</sup> Although the Treaties of the European Union encompass the courts of the individual member states, they do not refer to the ISDS mechanism in bilateral investment treaties between the member states.<sup>192</sup> Given that the European Union treaties did not cover the ISDS arbitration tribunal at issue, the German courts could not refer any questions of law to CJEU.<sup>193</sup>

The CJEU did not end its analysis there, but examined whether the individual courts of the member states can review the decisions of an ISDS arbitration tribunal without running afoul of the European Union treaties.<sup>194</sup> Although it noted that German law permitted German courts to review ISDS arbitration decisions, German law imposes tight restrictions on review.<sup>195</sup> Limited review “could prevent disputes from being resolved in a manner that ensures full effectiveness of EU law.”<sup>196</sup>

The Treaty on the Functioning of the European Union forbids the members states from engaging in actions that could result in the breakdown of mutual trust between neighboring member states.<sup>197</sup> Additionally, the principle of sincere cooperation requires the member states to apply their domestic laws in a manner that respects European Union law.<sup>198</sup> German courts adjudicating a dispute between the Netherlands and Slovakia could wear on the cohesiveness of the European Union.<sup>199</sup> Therefore, the bilateral investment treaty was incompatible with the purpose and structure of the European Union.<sup>200</sup>

The CJEU decision in *Slovak Republic v. Achmea BV* generated uncertainty within European circles regarding the future of the ISDS mechanism in bilateral investment treaties between member states.<sup>201</sup> In response to the CJEU’s decision, the European Union member states decided to eliminate the ISDS mechanism in all bilateral investment agreements between the members states, which is essentially a death knell to ISDS.<sup>202</sup> Although there is no immediate replacement for ISDS, since 2015 the European Commission has been calling for an “investor court system” to supplant ISDS.<sup>203</sup> At first, this proposal was slow to gain support because there

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<sup>189</sup> *Id.* ¶¶ 33-34, 56

<sup>190</sup> *Id.* ¶ 6.

<sup>191</sup> *Id.* ¶ 37.

<sup>192</sup> *Id.* ¶ 17.

<sup>193</sup> *Id.*

<sup>194</sup> *Id.* ¶¶ 52-53.

<sup>195</sup> *Id.*

<sup>196</sup> *Id.* ¶ 56.

<sup>197</sup> *Id.* ¶¶ 34, 58.

<sup>198</sup> *Id.*

<sup>199</sup> *Id.* ¶¶ 38-60.

<sup>200</sup> *Id.*

<sup>201</sup> Casey, *supra* note 175 ¶ 6.

<sup>202</sup> *Id.* .

<sup>203</sup> *Id.*

was uncertainty regarding its compatibility with the European Union treaties.<sup>204</sup> Despite this reservation, in March 2018 the European Union formally adopted directives to begin negotiations with its members to replace ISDS with an investor court system for intrastate disputes.<sup>205</sup> In April 2019, the CJEU issued an opinion that the proposed investor court system in Comprehensive Economic Trade Agreement was compatible with the structure of the European Union.<sup>206</sup>

The idea of an investor court system was the subject of a separate trade agreement between the European Union and Canada; it was designated as the Comprehensive Economic and Trade Agreement (CETA). At its core, CETA's purpose is to reduce trade barriers between the European Union and Canada by removing almost all customs duties and encouraging investors to invest capital in each respective region.<sup>207</sup> More importantly, it establishes a robust investor court system.<sup>208</sup> The new system will promote transparency as all court decisions will be public information.<sup>209</sup> This is unlike some ISDS decisions, which are not publicly available. All tribunal judges will preside full time over the proceedings, which allow them to gain specialized experience adjudicating cases.<sup>210</sup> This is a stark contrast to ISDS arbitration tribunals, which are convened on an ad hoc basis and arbitrators may not have as much extensive experience.<sup>211</sup> Unlike ISDS, there is a defined appellate process.<sup>212</sup> However, the investor court system only provisionally applies until the European Parliament gives final approval.<sup>213</sup>

The European Union is charging forward to an investor court system as a replacement for the ISDS mechanism in bilateral investment treaties. This makes sense given the purpose and structure of the European Union. Its purpose is to break down trade barriers between the member states.<sup>214</sup> To facilitate this purpose, the European Union has constructed an overarching, governing authority and court system.<sup>215</sup> The next step is to create a more specialized court system to replace ISDS. For those states that existed outside of the European Union, bilateral investment treaties were logical, arm's length agreements because there was no regional authority to govern trade disputes. States had to negotiate trade agreements one-on-one and provide a mechanism for resolving disputes. Nevertheless, the induction of a state into the European Union, in effect, transformed these agreements into arcane relics of the past.

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<sup>204</sup> *Id.*

<sup>205</sup> *Commission welcomes adoption of negotiating directives for a multilateral investment court*, News Archive, EUR. COMM'N. (Mar. 20, 2018), [https://policy.trade.ec.europa.eu/news/commission-welcomes-adoption-negotiating-directives-multilateral-investment-court-2018-03-20\\_en](https://policy.trade.ec.europa.eu/news/commission-welcomes-adoption-negotiating-directives-multilateral-investment-court-2018-03-20_en).

<sup>206</sup> *Trade: European Court of Justice confirms compatibility of Investment Court System with EU Treaties*, Press Release, EUR. COMM'N. (April 30, 2019), [http://europa.eu/rapid/press-release\\_IP-19-2334\\_en.htm](http://europa.eu/rapid/press-release_IP-19-2334_en.htm).

<sup>207</sup> *One year on EU-Canada trade agreement delivers positive results*, News Archive, EUR. COMM'N (Sept. 20, 2018), [https://ec.europa.eu/commission/presscorner/detail/en/IP\\_18\\_5828](https://ec.europa.eu/commission/presscorner/detail/en/IP_18_5828).

<sup>208</sup> *The EU-Canada agreement explained*, EUR. COMM'N (Last updated September 21, 2017), [https://policy.trade.ec.europa.eu/eu-trade-relationships-country-and-region/countries-and-regions/canada/eu-canada-agreement/agreement-explained\\_en](https://policy.trade.ec.europa.eu/eu-trade-relationships-country-and-region/countries-and-regions/canada/eu-canada-agreement/agreement-explained_en).

<sup>209</sup> *Id.*

<sup>210</sup> *Id.*

<sup>211</sup> *Id.*

<sup>212</sup> *Id.*

<sup>213</sup> *Id.*

<sup>214</sup> See James McBride, *How Does the European Union Work?*, COUNCIL ON FOREIGN RELATIONS (April 17, 2020), <https://www.cfr.org/backgrounder/how-does-european-union-work>.

<sup>215</sup> *Id.*

While an investor court system may work for the European Union, the rest of the world is much more complex. It is unlikely that a regional or international court system geared toward resolving investor disputes could function outside of the European Union. A condition precedent for such a specialized system would be a strong governing international or regional body. The only one that currently exists is the European Union, but even its future longevity is questionable due to the current political climate.<sup>216</sup>

## **B. North American Free Trade Agreement vs. United States-Mexico-Canada Agreement**

The United States-Mexico-Canada Agreement's (USMCA) reform of the ISDS mechanism from the North American Free Trade Agreement (NAFTA) is quite peculiar. It eliminates ISDS between the United States and Canada after a three-year phaseout period for existing legacy claims from NAFTA, but it provides procedural reforms to limit the scope of ISDS between the United States and Mexico.<sup>217</sup> Understanding these changes requires an understanding of the structure and controversy regarding NAFTA.

NAFTA went into effect in January 1994.<sup>218</sup> Its purpose was to phaseout a variety of tariffs over a five to fifteen year period.<sup>219</sup> It also required its signatories to refrain from discrimination against foreign investors among NAFTA parties.<sup>220</sup> But there were exceptions to this nondiscrimination rule, including allowing Mexico to ban foreign investment in their energy industry.<sup>221</sup> Furthermore, NAFTA strengthened the intellectual property protective measures between the three countries.<sup>222</sup> If a dispute arose through NAFTA, the parties at issue can resolve it through the NAFTA Trade Commission or through arbitration tribunals.<sup>223</sup>

NAFTA's Chapter 11 enumerates the protections for investors from the signatory parties and establishes the ISDS provisions, which allow investors to bind the hosting government through arbitration.<sup>224</sup> Chapter 11 requires the signatory governments to grant foreign investors "most-favored nation status," which means that they must treat foreign investors no less favorably than

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<sup>216</sup> For a skeptical view of the European Union Investor Court System, see Hon. Charles N. Brower & Jawad Ahmad, *From the Two-headed Nightingale to the Fifteen-headed Hydra: The Many Follies of the Proposed International Investment Court*, 41 *Fordham Int'l L.J.* 791 (2018). These authors argue that the proposed Investor Court System for the European Union will not solve the problems created by ISDS. Instead, it will further politicize the appointment of adjudicators as the member states will quarrel over who is selected for the court.

<sup>217</sup> M. ANGELES VILLARREAL & IAN F. FERGUSSON, CONG. RSRCH. SERV., R44981, *NAFTA AND THE UNITED STATES-MEXICO-CANADA AGREEMENT (USMCA)* 23 (March 2, 2020), <https://crsreports.congress.gov/product/pdf/R/R44981>.

<sup>218</sup> *Id.* at 2.

<sup>219</sup> M. ANGELES VILLARREAL & IAN F. FERGUSSON, CONG. RSRCH. SERV., R42965, *THE NORTH AMERICAN FREE TRADE AGREEMENT (NAFTA)* 5 (May 24, 2017), <https://fas.org/sgp/crs/row/R42965.pdf>.

<sup>220</sup> *Id.* at 8.

<sup>221</sup> *Id.*

<sup>222</sup> *Id.*

<sup>223</sup> *Id.*

<sup>224</sup> CHRISTOPHER A. CASEY & M. ANGELES VILLARREAL, CONG. RSRCH. SERV., IF11167, *USMCA: INVESTMENT PROVISIONS* (April 3, 2019), <https://fas.org/sgp/crs/row/IF11167.pdf>.

they treat their own domestic investors.<sup>225</sup> Moreover, the hosting government must treat the foreign investor in accordance with international law, including “fair and equitable treatment and full protection and security.”<sup>226</sup>

More specifically, it bars the hosting government from discriminating against foreign investors; this includes provisions against restricting the nationalities of the employees, imposing certain quotas on imports and exports, inhibiting transfers of investments, and expropriation without just compensation.<sup>227</sup> For example, if a foreign investor from a signatory party establishes a petroleum company, the hosting government cannot seize and nationalize the petroleum company without compensating the investor. In this case, the aggrieved investor may claim that the hosting government has engaged in expropriation of the investor’s assets and seek damages equivalent to the fair market value of its assets.<sup>228</sup> Chapter 11 also specifies the procedures for pursuing an ISDS claim, including how to file a claim, the composition of arbitration tribunals, and which rules govern arbitration procedures.<sup>229</sup> NAFTA’s trade and ISDS provisions are very similar to provisions found in many bilateral or multilateral trade agreements.<sup>230</sup>

In the United States, NAFTA became highly controversial. Its advocates argued that NAFTA’s reduction of tariffs and other market barriers generated an economic renaissance.<sup>231</sup> Its opponents proclaimed that NAFTA encouraged the manufacturing industry to relocate blue collar jobs to Mexico, where the costs of production are cheaper.<sup>232</sup> The criticism of NAFTA reached a high point when the United States compelled Canada and Mexico to renegotiate NAFTA, presumably on terms more favorable to the United States.<sup>233</sup> On November 30, 2018, the parties completed the renegotiation of NAFTA into the USMCA.<sup>234</sup> It took effect on the United States, Mexico, and Canada on July 1, 2020.<sup>235</sup>

The USMCA makes a series of changes regarding the ISDS mechanism. Critics of NAFTA’s ISDS mechanism in both the United States and Canada alleged that it gives special procedural protections to foreign investors that are not available for domestic investors, and foreign investors can exploit the ISDS mechanism to undermine benign environmental and health regulations.<sup>236</sup> The greatest number of ISDS disputes under NAFTA were between the United

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<sup>225</sup> North American Free Trade Agreement, ch. 11, art. 1103, Dec. 17, 1992, <https://can-mex-usa-sec.org/secretariat/agreement-accord-acuerdo/nafta-alena-tlcan/index.aspx?lang=eng>.

<sup>226</sup> *Id.* at ch. 11, art. 1105.

<sup>227</sup> *Id.* ch. 11, art. 1101-1102, 1106, 1107, 1109, & 1110.

<sup>228</sup> *Id.* ch. 11, art. 1110.

<sup>229</sup> *Id.* ch. 11, Section B - Settlement of Disputes between a Party and an Investor of Another Party.

<sup>230</sup> VILLARREAL & FERGUSON, *supra* note 216, at 22.

<sup>231</sup> VILLARREAL & FERGUSON, *supra* note 218, at 10.

<sup>232</sup> *Id.* at 11.

<sup>233</sup> *Id.* at 24.

<sup>234</sup> *United States-Mexico-Canada Agreement*, OFFICE OF THE UNITED STATES TRADE REPRESENTATIVE, <https://ustr.gov/trade-agreements/free-trade-agreements/united-states-mexico-canada-agreement> (last visited May 20, 2020).

<sup>235</sup> *USMCA To Enter Into Force July 1 After United States Takes Final Procedural Steps For Implementation*, Press Releases, OFFICE OF THE UNITED STATES TRADE REPRESENTATIVE (April 24, 2020), <https://ustr.gov/about-us/policy-offices/press-office/press-releases/2020/april/usmca-enter-force-july-1-after-united-states-takes-final-procedural-steps-implementation>.

<sup>236</sup> CASEY & VILLARREAL, *supra* note 224.

States and Canada.<sup>237</sup> There have been approximately fifty-nine ISDS cases between the three countries, including sixteen against the United States, twenty-five against Canada, and eighteen against Mexico.<sup>238</sup> Canada had initiated fifteen of the sixteen ISDS cases against the United States.<sup>239</sup> Although the United States has won every ISDS case, the arbitration tribunals have ruled against Mexico and Canada in several cases and required them to payout more than \$100 million in compensation to foreign investors.<sup>240</sup>

Under the USMCA, the ISDS mechanism will be phased out over a three-year period for existing NAFTA legacy claims between the United States and Canada.<sup>241</sup> Investors bringing nonlegacy claims from either country must exhaust the remedies offered by the hosting government.<sup>242</sup> For example, a Canadian company disputing an environmental regulation must exhaust its remedies through the Environmental Protection Agency's administrative review process, and if still dissatisfied, seek judicial review through the United States judiciary.

The ISDS mechanism will continue to exist between the United States and Mexico.<sup>243</sup> However, a foreign investor must first seek to exhaust its local remedies over a thirty-month period prior to filing for ISDS arbitration.<sup>244</sup> Nevertheless, there are some exceptions between the United States and Mexico that allow an acceleration of an ISDS claim, including government issued contracts for specific industries such as oil and natural gas, infrastructure, telecommunications, and transportation.<sup>245</sup>

The revised USMCA provisions also give a much broader definition of what constitutes an investment.<sup>246</sup> Here, "investment" means "every asset that an investor owns or controls, directly or indirectly, that has the characteristics of an investment including such characteristics as the commitment of capital or other resources, the expectation of gain or profit, or the assumption of risk."<sup>247</sup> The USMCA then proceeds to list some examples of investments, such as stocks, bonds, intellectual property rights, and enterprises.<sup>248</sup> This is dissimilar to NAFTA's provisions, which only enumerate a list of what constitutes an investment.<sup>249</sup> Interestingly, the USMCA's definition of investment may allow for more legal causes of action compared to NAFTA, but it limits the means by which claimants may pursue them, such as drastically reducing the scope of the ISDS mechanism or, in the case of the United States and Canada, eliminating the ISDS mechanism.

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<sup>237</sup> *Id.*

<sup>238</sup> Geoffrey Gertz, *Renegotiating NAFTA: Options for Investor Protection*, Issue No. 7 BROOKINGS INSTITUTION 1 (Mar. 2017), <https://www.brookings.edu/wp-content/uploads/2017/03/global-20170315-nafta.pdf>.

<sup>239</sup> CASEY & VILLARREAL, *supra* note 224.

<sup>240</sup> Geoffrey Gertz, *supra* note 237, at 1.

<sup>241</sup> CASEY & VILLARREAL, *supra* note 224.

<sup>242</sup> *Id.*

<sup>243</sup> *Id.*

<sup>244</sup> *Id.*

<sup>245</sup> *Id.*

<sup>246</sup> *Id.*

<sup>247</sup> United States-Mexico-Canada Agreement, art. 14.1 (text as of Dec. 13, 2019), *available at* <https://ustr.gov/trade-agreements/free-trade-agreements/united-states-mexico-canada-agreement/agreement-between>.

<sup>248</sup> *Id.*

<sup>249</sup> North American Free Trade Agreement, *supra* note 224, ch. 11, art. 1139.

The USMCA attempts to provide some clarification regarding the “most-favored nation status,” the minimum standard of treatment expected under customary international law, and the enforcement of benign environmental, health, and safety regulations. In the prior NAFTA regime, several ISDS arbitration tribunals decided that the passage of a new regulation, such as one designed to protect the environment, constituted a breach of the provision requiring “fair and equitable treatment” because it was inconsistent with the investor’s prior expectations and, as a consequence, diminished the value of the investment.<sup>250</sup> However, the USMCA clarifies the signatories may pass environmental, health, and safety regulations and that their enforcement, in itself, does not constitute a breach of the investor protections.<sup>251</sup>

Moreover, hosting governments do not necessarily need to give foreign investors special treatment over domestic investors. “The concepts of ‘fair and equitable treatment’ and ‘full protection and security’ do not require treatment in addition to or beyond that which is required by that standard, and do not create additional substantive rights.”<sup>252</sup> Instead, the “treatment [must be] no less favorable than the most favorable treatment accorded, *in like circumstances*, by that government to investors in its territory, and to investments of those investors.”<sup>253</sup> Here, “like circumstances” is evaluated under a totality of the circumstances standard, which may include “whether the relevant treatment distinguishes between investors or investments on the basis of legitimate public welfare objectives.”<sup>254</sup>

The USMCA’s reforms are peculiar but likely warranted. The sheer volume of ISDS cases between the United States and Canada has led to mistrust of the ISDS mechanism. The hosting governments have a duty to promulgate and enforce laws designed to safeguard the environment and public health. Given this mistrust, their choice to abandon ISDS is not irrational. It can be just as expensive for hosting governments to defend against ISDS cases as court litigation.<sup>255</sup> Furthermore, both countries have highly developed and sophisticated court systems. In contrast, the United States and Mexico believe that the ISDS mechanism is salvageable. They struck a reasonable compromise that expands the definition of investor but limit how that investor can challenge benign laws in the hosting government. The USMCA demonstrates that either the elimination of ISDS or reformation to limit its scope are feasible alternatives depending on the circumstances.

### C. Restructuring ISDS to include an Appellate Panel

Some commentators have speculated that the ISDS mechanism could be improved if it included an appellate component, which would review decisions and provide more consistency, predictability, and accountability.<sup>256</sup> Countries could rewrite bilateral and multilateral investment

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<sup>250</sup> CASEY & VILLARREAL, *supra* note 224.

<sup>251</sup> United States-Mexico-Canada Agreement, *supra* note 247, art. 14.16.

<sup>252</sup> *Id.* art. 14.6.

<sup>253</sup> *Id.* art. 14.5 (emphasis added).

<sup>254</sup> *Id.*

<sup>255</sup> *Fact Sheet on Investor-State Dispute Settlements in 2018*, *supra* note 4, at 4.

<sup>256</sup> Theodore R. Posner, *supra* note 59, at 13-14; J. C. Thomas QC, *An appellate mechanism for investment treaty disputes?*, NATIONAL UNIVERSITY OF SINGAPORE CENTRE FOR INTERNATIONAL LAW (undated), [http://legal.un.org/avl/pdf/ls/Thomas\\_presentation.pdf](http://legal.un.org/avl/pdf/ls/Thomas_presentation.pdf) (Last visited May 20, 2020); Leon Trakman, *Enhancing Panels in Investor-State Arbitration: The Way Forward?*, 48 GEO. J. INT’L L. 1145, 1186 (2017).

treaties to add another level to the arbitration process. Nevertheless, it is important to flesh out the procedures involved in an ISDS appellate panel, such as the standard of review.

If appellate panels are to be incorporated into the ISDS mechanism, then the corresponding investment treaties will need to enumerate the standards of review for the appellate panel. Administrative agencies in the United States have their own levels of adjudication and enumerate several review standards for their appeals panels.<sup>257</sup> Arbitration panels could adopt similar standards, such as a *de novo* review for error of law,<sup>258</sup> whether the decision is supported by substantial evidence regarding the factual findings<sup>259</sup> or if initial panel abused its discretion.<sup>260</sup> Appellate panels should have the authority to remand the case back to the initial panel for unresolved issues regarding facts or for abuse of discretion. An appellate panel can act as an additional check and balance against the initial arbitration tribunal.

Some commentators have examined whether an ISDS appellate panel should be a permanent adjudicatory body, like the World Trade Organization (WTO).<sup>261</sup> This arguably opens the door for decisions that have precedential value.<sup>262</sup> It also facilitates a permanent staff to gain expertise on complex issues arising from disputes in investment treaties.<sup>263</sup> The problem with this idea is that the WTO, in its current condition, is broken. The United States has neutralized the WTO's appellate body by blocking the appointment of judges.<sup>264</sup> As a result, the WTO does not have enough judges to hold a quorum to hear cases.<sup>265</sup>

It would be more efficient to form appellate panels on an *ad hoc* basis, just like the initial arbitration panels. Each party will select their own arbitrators and mutually agree on a third

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<sup>257</sup> See 5 U.S.C. § 706 (1966); see also 20 C.F.R. § 404.900 (2017), specifying a four-tiered administrative review process for Social Security cases, including an Appeals Council. If the claimant is dissatisfied after appealing the case to the final level of administrative review, then the claimant may seek judicial review in federal district court. See 20 C.F.R. § 404.970 (2020), specifying the standards of review for the agency's appellate level.

<sup>258</sup> *De novo* review, BLACK'S LAW DICTIONARY, (pocket 3d ed. 2006) (meaning "nondeferential of an administrative decision, usually through review of the administrative record, plus additional evidence that the parties present.").

<sup>259</sup> 20 C.F.R. § 404.901 (2009). "Substantial evidence means such relevant evidence as a reasonable mind might accept as adequate to support a conclusion." This is less than a preponderance of the evidence, but more than a mere scintilla. See also SSA Hearings, Appeals, and Litigation Law Manual (HALLEX) § I-3-3-4 (2017), [https://www.ssa.gov/OP\\_Home/hallex/I-03/I-3-3-4.html](https://www.ssa.gov/OP_Home/hallex/I-03/I-3-3-4.html).

<sup>260</sup> "The standard of review applicable to the evidentiary rulings of the district court is abuse of discretion." *Old Chief v. United States*, 519 U.S. 172, 174, n.1 (1997) (citing *United States v. Abel*, 469 U.S. 45, 54-55 (1984)). See also "[A]n abuse of discretion is a plain error, discretion exercised to an end not justified by the evidence, a judgment that is clearly against the logic and effect of the facts as are found." *Int'l Jensen, Inc. v. Metrosound U.S.A. Inc.*, 4 F.3d 819, 822 (9th Cir. 1993).

<sup>261</sup> Posner, *supra* note 59, at 1-2; Emily Palombo, Comment, Evaluating a Permanent Court Solution For International Investment Disputes 53 U. RICH. L. REV. 799, 825 (2019); see U.N Comm'n on Int'l Trade Law, *Possible reform of investor-State dispute settlement (ISDS) appellate and multilateral court mechanisms*, UNITED NATIONS GENERAL ASSEMBLY 9-10 (Nov. 29, 2019), [https://uncitral.un.org/sites/uncitral.un.org/files/wp\\_185e\\_appeal\\_court\\_for\\_submissionreduced\\_for\\_website.pdf](https://uncitral.un.org/sites/uncitral.un.org/files/wp_185e_appeal_court_for_submissionreduced_for_website.pdf).

<sup>262</sup> Posner, *supra* note 59, at 8-9.

<sup>263</sup> See U.N. Conference on Trade and Development, *Reform of Investor-State Dispute Settlement: In Search of a Roadmap*, IIA Issues Note 2, (June 26, 2013), [https://unctad.org/en/PublicationsLibrary/webdiaepcb2013d4\\_en.pdf](https://unctad.org/en/PublicationsLibrary/webdiaepcb2013d4_en.pdf).

<sup>264</sup> McBride & Chatzky, *supra* note 15.

<sup>265</sup> *Id* (explaining that as of December 2019, the WTO appellate body only has one appellate adjudicator).

arbitrator.<sup>266</sup> This selection process is common in arbitration provisions for tribunals in investment treaties.<sup>267</sup> Additionally, it is not necessary to have a permanent staff because those who are chosen to be arbitrators on current ISDS panels are already experts in corporate and investment law.<sup>268</sup> Finally, ISDS panels are not designed to create precedential value.<sup>269</sup> They only bind the parties to the current case or controversy.<sup>270</sup> Nevertheless, allowing extraterritorial appellate panels to create binding precedent may increase the public's mistrust of the ISDS mechanism and encourage more demands for its abolition.

Even if an appellate panel is formed on an ad hoc basis, it may create more problems than it solves. First, it prolongs the arbitration process and increases its associated expenses. Second, it does not necessarily resolve the issue of inconsistency between arbitration decisions. An appellate panel may rule in favor of one party between Country A and Corporation B, but a different appellate panel may reach the opposite result in a similar situation between country A and Corporation C. As eluded to earlier, ISDS cases do not create legal precedent, so there is no common law to bind appellate panels.<sup>271</sup> Instead, they are left to their own discretionary devices. Ultimately, it may be preferable to revise investment treaties to allow a dissatisfied party to seek judicial review of an initial arbitration decision in an actual court, rather than convene an appellate panel.

## V. CONCLUSION

The purpose of the ISDS mechanism is to establish trust between foreign investors and the hosting government. This trust encourages foreign companies to invest capital in other countries, which benefits their economic development. Foreign investment should be encouraged, especially if it lifts the population of developing countries out of poverty. While the purpose and benefits of ISDS are laudable, companies have occasionally abused and exploited ISDS for financial gain. These are notable in the cases presented in this article where companies attempted to evade compliance with environmental, health, safety, and labor laws.

To mitigate the problems generated by the ISDS mechanism, countries and regions have prescribed several reforms. The European Union is moving to an investor court system, which will allow greater transparency, consistency in decision-making, and specialization of adjudicators. This is a natural move given the structure of the European Union, which is designed to break down trade barriers between the member states. With the proposed USMCA in North America, the United States and Canada will eliminate the ISDS mechanism, but the United States and Mexico will limit the scope of the ISDS mechanism. Other commentators have floated the idea of an appellate panel. These proposals and reforms illustrate that there is no one-size-fits-all approach to ISDS. The key to the success or failure of these proposals and reforms will revolve around whether they restore trust between the foreign investor, the hosting government, and the public.

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<sup>266</sup> See David Gaukrodger & Kathryn Gordon, *Investor-State Dispute Settlement: A Scoping Paper for the Investment Policy Community*, OECD 7, 42 (March 2012).

<sup>267</sup> *Id.*

<sup>268</sup> *Id.* at 43.

<sup>269</sup> Weiss et al., *supra* note 173, at 22.

<sup>270</sup> *See id.*

<sup>271</sup> *Id.*

# THE INSIDER TRADING PROHIBITION THEORIES IN THE LITERATURE – A CRITIQUE

*Mangesh Patwardhan\**

## ABSTRACT

The regulation of insider trading is a comparatively recent phenomenon in most of the jurisdictions around the world. The United States was the first legal jurisdiction to prohibit insider trading. Insider trading is defined nowhere in the United States federal law. The prohibition has been read into the general anti-fraud provisions of the federal securities law. Several commentators have been critical of the evolution of the U.S. prohibition entirely through judicial pronouncements. This state of affairs is at least partly attributable to the fact that there is a fundamental disagreement over the necessity of insider trading prohibition. Arguments have been advanced in support of legalizing insider trading. On the other side, a number of arguments in favor of prohibiting insider trading have been advanced as well. In view of this, it is important to clarify the policy and theoretical basis of the prohibition. Unless a well thought out theoretical foundation for the prohibition is in place, the enactment of a statutory framework may amount to little more than a hasty, knee-jerk legislative solution. As a first step, it is imperative to attempt a nuanced analysis of the current insider trading theories, as enunciated by the U.S. Courts as well as those proposed by legal scholars. This article is a sequel to my earlier article wherein I offered a critique of the judge-made insider trading prohibition theories in the United States. As promised there, I come back here to offer a critique of the major strands of the insider trading prohibition theories proposed by legal scholars. In the final article in this three-part series, I plan to propose a new theory of insider trading prohibition that I argue aligns better with the mandate of securities law and also avoids certain problems associated with the other theories.

## INTRODUCTION

The regulation of insider trading is a comparatively recent phenomenon in most jurisdictions around the world. Before the 1980s, most countries left insider trading virtually unregulated. Today, the vast majority of countries have insider trading laws on the books.<sup>1</sup> The United States was the first jurisdiction to enact insider trading regulation.<sup>2</sup> The term insider trading is not defined anywhere in the United States law. The prohibition on insider trading has been read into the general anti-fraud provisions of the securities law — Section 10(b) of the Securities Exchange Act of 1934<sup>3</sup> (Exchange Act) and Rule 10b-5<sup>4</sup> thereunder. This has been done through a series of judicial pronouncements.

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<sup>1</sup> JOHN P. ANDERSON, *INSIDER TRADING: LAW, ETHICS, AND REFORM* 5 (Cambridge, 1st ed. 2018).

<sup>2</sup> Han Shen, *A Comparative Study of Insider Trading Regulation Enforcement in the U.S. and China*, 9 J. BUS. & SEC. L. 41, 43 (2009).

<sup>3</sup> 15 U.S.C. § 78j(b). Section 10(b) makes it unlawful for any person, directly or indirectly, "to use or employ, in connection with the purchase or sale of any security ..., any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

<sup>4</sup> 17 C.F.R. § 240.10b-5. Rule 10b-5 provides that: it shall be unlawful for any person, directly or indirectly, to employ any device, scheme, or artifice to defraud ... or ... to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person in connection with the purchase or sale of any security.

Bainbridge argues that the Exchange Act and its legislative history suggest that the statute was not intended to prohibit the use of inside information, but only the use of manipulative devices such as market pools.<sup>5</sup> Rather, it is the later courts that have interpreted Section 10(b) — a general anti-fraud provision—so as to include a prohibition on insider trading. As he points out, Section 10(b) received minimal attention during the hearings on the Exchange Act and was apparently seen simply as a grant of authority to the SEC to prohibit manipulative devices not covered by Section 9 of the Exchange Act.<sup>6</sup> Interestingly, even the U.S. Congress contended that the elimination of insider trading abuses was one of the goals of the Exchange Act.<sup>7</sup>

Several commentators have been critical of the evolution of the U.S. prohibition entirely through judicial pronouncements. Prakash terms the United States insider trading regime dysfunctional.<sup>8</sup> Nagy argues that a hodgepodge of theories, rules, and decisions form the basis of today's insider trading law in the United States.<sup>9</sup> According to Preet Bharara — former U.S. Attorney for the Southern District of New York — insider trading laws have for too long lacked clarity, generated confusion, and failed to keep up with the times. This lack of clarity and certainty, in this important area of law and our securities markets, has benefited no one.<sup>10</sup>

This state of affairs is at least partly attributable to the fact that there is a fundamental disagreement over the very necessity of insider trading prohibition. Arguments have been advanced in support of legalizing insider trading. It has been argued that insider trading acts as an effective compensation scheme for a company's executives.<sup>11</sup> The other argument advanced in favor of legalization is that the effect of insider trading will always be to move a share's price towards the level correctly reflecting all the real facts about the company.<sup>12</sup>

On the other side, arguments in favor of prohibiting insider trading have been advanced. These include the adverse impact of insider trading on market liquidity, the increase in the cost of capital for companies, and possibly the extinction of public stock markets<sup>13</sup>. Another family of arguments focuses on the harm caused to the company itself.<sup>14</sup>

In view of this, it is important to clarify the policy and theoretical basis of the prohibition. Unless a well thought out theoretical foundation for the prohibition is in place, the enactment of a statutory framework may amount to little more than a hasty, knee-jerk legislative solution. As a

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<sup>5</sup> Stephen Bainbridge, *A Critique of the Insider Trading Sanctions Act of 1984*, 71 VA. L. REV. 455, 459 (1985).

<sup>6</sup> *Id.* at 460.

<sup>7</sup> *See id.* at 459.

<sup>8</sup> Saikrishna Prakash, *Our Dysfunctional Insider Trading Regime*, 99 COLUM. L. REV. 1491, 1493 (1999).

<sup>9</sup> Donna M. Nagy, *Insider Trading and the Gradual Demise of Fiduciary Principles*, 94 IOWA L. REV. 1315, 1365 (2009).

<sup>10</sup> *Bharara Task Force on Insider Trading Publishes Report: Recommending Reforms to Insider Trading Law*, BUSINESSWIRE (Jan. 27, 2020), <https://www.businesswire.com/news/home/20200127005079/en/Bharara-Task-Force-Insider-Trading-Publishes-Report>.

<sup>11</sup> *See* Henry G. Manne, *Insider Trading and Property Rights in New Information*, 4 CATO J. 933, 936 (1985).

<sup>12</sup> *Id.* at 935.

<sup>13</sup> *See generally* George W. Dent, Jr., *Why Legalized Insider Trading Would Be a Disaster*, 38 DEL. J. CORP. L. 247 (2013).

<sup>14</sup> *See, e.g.*, Robert J. Haft, *The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation*, 80 MICH. L. REV. 1051, 1055 (1982).

first step, it is imperative to attempt a nuanced analysis of the current insider trading theories as enunciated by U.S. Courts, as well as those proposed by legal scholars.

This article is a sequel to my earlier article wherein I offered a critique of the judge-made insider trading prohibition theories in the United States.<sup>15</sup> As promised there, I come back here to offer a critique of the major strands of the insider trading prohibition theories proposed by legal scholars.

The plan of the article is as follows. In the following Section, I offer a critique of the Property Rights Theory which has been fairly influential in recent years. In Section III, I take up the discussion of the Deception-Based Theory that conceptualizes wrongful insider trading in terms of deceptive acquisition of information. In Section IV, I discuss the fraud on the market theory in the context of its proposed application to insider trading. Section V focuses on another variant of the fraud-based approach to insider trading—the Contractual Fraud Theory. In Section VI, I analyse the Corruption Theory, which treats insider trading as a form of private corruption. In Sections VII and VIII, I consider two recent novel approaches—prohibition predicated on the duty to hold lost or stolen information in confidence and insider trading as an agency law issue.<sup>16</sup> The final Section summarizes the discussion and concludes.

The analysis focuses on assessing the internal coherence and the alignment of these theories with the mandate of securities law—to protect the interests of investors in securities and to promote the development and regulation of the securities market.<sup>17</sup> Dooley also suggests that the rationale (or demand, as he terms it) for insider trading prohibition determines the legitimacy of the substantive prohibition. Thus, either the investors or the securities market, if not both, must be the primary beneficiaries of insider trading regulation to justify the existence of the regulation.<sup>18</sup>

## I. THE PROPERTY RIGHTS THEORY

In *United States v. O'Hagan*, the U.S. Supreme Court recognized that a company's confidential information qualifies as property to which the company has a right of exclusive use.<sup>19</sup> This formulation might suggest a property rights-based theory for the insider trading prohibition.

However, the *O'Hagan* Court finally settled on the non-disclosure of the intent to trade as the determinative factor in establishing deception and, therefore, the insider trading prohibition. In

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<sup>15</sup> Mangesh Patwardhan, *To Legislate or Not to Legislate: Judging the Judge-Made Insider Trading Prohibition Theories in the United States*, 45 DEL. J. CORP. L. 323 (2021). In the interest of brevity, I cite this source rather liberally in the current article, so that I do not have to repeat the arguments made there.

<sup>16</sup> Another approach discussed in the literature is the Unjust Enrichment Theory. I do not discuss it here. The unjust argument approach is implicit in the version of the misappropriation theory enunciated by the Chief Justice's dissent in *Chiarella v. United States*. I discussed his theory in my earlier article. Patwardhan, *supra* note 15, at 401-09.

<sup>17</sup> The Securities and Exchange Board of India Act, 1992 (SEBI Act) explicitly states that the object of the Act is to provide for the establishment of SEBI to carry out these two functions. The US Supreme Court articulated "insuring honest securities markets and thereby promoting investor confidence" as the "animating purpose" behind the Exchange Act. *United States v. O'Hagan*, 521 U.S. 642, 658 (1997).

<sup>18</sup> Michael P. Dooley, *Enforcement of Insider Trading Restrictions*, 66 VA. L. REV. 1, 3 (1980).

<sup>19</sup> *O'Hagan*, 521 U.S. at 654.

fact, during oral arguments, the Government accepted that so long as the trader tells the source her intent to trade on the basis of material non-public information (MNPI), there is no deception and therefore no prohibition on trading on such information.<sup>20</sup> This is the reason why this version of the misappropriation theory cannot be reconciled with the property rights theory.

The other version, the Chief Justice's dissent in *Chiarella v. United States* implicitly treats unauthorized trading as the source of the prohibition.<sup>21</sup> This surely seems to align more closely with the property rights theory. However, even here, though non-authorization by the source of the information is relied on to establish deception, this theory does not cast such source as the victim of such trading. Rather, the Chief Justice's focus is to ensure that dealing in securities is fair and without undue preferences or advantages among investors.<sup>22</sup> Further, he holds that trading on such unauthorized information amounts to the trader enriching herself at the expense of others,<sup>23</sup> and here he surely does not mean that such trading is at the expense of the source, but rather the counterparty. Thus, after a detour through deception on the source, he ultimately treats the counterparty as the harmed party.

Thus, any attempt to interpret either version of the misappropriation theory in property rights terms leads to unsatisfactory results. A full-fledged property rights theory would recognize the source of the information as the party holding rights over the information and harmed as a result of a person trading on such information. Indeed, such a position has been advocated.

#### A. Insider Trading and Property Rights in Corporate Information

Several legal scholars have attempted to support an insider trading prohibition regime based on the property rights argument.<sup>24</sup> However, in recent times, the strongest proponent of this line of thinking is Bainbridge.<sup>25</sup> He states that reviving the old equal access standard makes no policy sense.<sup>26</sup> If one steps back and evaluates insider trading from first principles, what immediately jumps out is that we are really dealing with property rights in information.<sup>27</sup>

He further explains that there are two ways of creating such rights. One, the law may allow the owner to enter into transactions without disclosing the information. Two, the law may prohibit others from using the information.<sup>28</sup> The federal insider trading prohibition operates as the latter version of property rights.<sup>29</sup> He comments that property rights in intangibles such as patents,

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<sup>20</sup> See Adam C. Pritchard, *United States v. O'Hagan: Agency Law and Justice Powell's Legacy for the Law of Insider Trading*, 78 B. U. L. REV. 13, 38 (1998).

<sup>21</sup> Patwardhan, *supra* note 15, at 404.

<sup>22</sup> *Chiarella v. United States*, 445 U.S. 222, 241 (1980) (Burger, C.J., dissenting) (citations and internal quotation marks omitted).

<sup>23</sup> *Id.*

<sup>24</sup> See, e.g., Edmund W. Kitch, *The Law and Economics of Rights in Valuable Information*, 9 J. LEGAL STUD. 683, 719 (1980); Richard J. Morgan, *Insider Trading and the Infringement of Property Rights*, 48 OHIO ST. L. J. 79 (1987).

<sup>25</sup> See, e.g., Stephen M. Bainbridge, *Regulating Insider Trading in the Post-fiduciary Duty Era: Equal Access or Property Rights?*, in RESEARCH HANDBOOK ON INSIDER TRADING 80 (Stephen M. Bainbridge ed., 2013).

<sup>26</sup> *Id.* at 91.

<sup>27</sup> *Id.*

<sup>28</sup> *Id.*

<sup>29</sup> See *id.*

copyrights, and trademarks are a well-established phenomenon—rights in information are just another such instance. There are doctrinal parallels between these as well. Under U.S. law, using another’s trade secret is actionable only if it involved a breach of fiduciary duty, misrepresentation, or theft.<sup>30</sup>

That raises the obvious question of whether public enforcement should have any role in protecting such a private property right. Bainbridge’s response is that even though the right is private in character, the cost of enforcing this right is excessive. Therefore, it makes sense for the state to use its regulatory power to enforce it.<sup>31</sup>

#### B. Incentivizing the Creation of Corporate Information—Assessing the Policy Rationale

Bainbridge argues that insider trading may harm the employer in some circumstances. It could injure the firm if it creates incentives for managers to delay the transmission of information to superiors.<sup>32</sup> It might adversely interfere with corporate plans (e.g. when managers of a potential acquirer start buying up shares of the target, making the acquisition more expensive).<sup>33</sup> Managers may elect to follow policies that increase the fluctuations in the price of the firm’s stock.<sup>34</sup>

These concerns may well be justified. However, these arguments do not support an absolute prohibition on insider trading with its civil and criminal penalties. Private enforcement by the corporation itself appears to be a more appropriate option in this case.

Bainbridge candidly admits that whether insider trading harms the company is not dispositive.<sup>35</sup> There is no avoiding the necessity of assigning property rights in information, either to the corporation or the insider. A rule allowing insider trading assigns a property interest to the insider, while a rule prohibiting insider trading assigns it to the corporation.<sup>36</sup> As with other property rights, the law should simply assume (even though the assumption will sometimes be wrong) that assigning the property right to agent-produced information to the firm maximizes the social incentives for the production of valuable new information.<sup>37</sup>

However, contrary to his claim, this argument is not akin to the one in the context of other intellectual property rights such as patents. Even in the absence of an insider trading prohibition, companies would still produce much of the information either because it is in their interests (e.g. new product development) or because it is mandated by law (preparing and disseminating financial information). Thus, the assignment of property rights in such information to the company is not a necessary condition for creating this information in the first place.

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<sup>30</sup> *See id.*

<sup>31</sup> *See Id.*

<sup>32</sup> *Id.* at 92.

<sup>33</sup> *See id.*

<sup>34</sup> *Id.* at 93.

<sup>35</sup> *Id.* at 94.

<sup>36</sup> *Id.*

<sup>37</sup> *Id.* at 95.

Private enforcement of the insider trading laws are rare and usually parasitic on public enforcement proceedings.<sup>38</sup> This fact itself may indicate that insider trading is usually not a concern to companies and is not perceived to be against their interests, at least in a large number of cases.

*SEC v. Obus*<sup>39</sup> is squarely on the point. “There, an analyst for GE Capital, Strickland, was helping to develop the financing of a possible acquisition of a company called SunSource. Strickland called a friend who worked at a hedge fund that held a large equity stake in SunSource. Among other things, the conversation included the fact that the client [GE Capital] was planning the acquisition. The hedge fund later acquired more SunSource stock.”<sup>40</sup> Now, according to the property rights theory, the relevant information regarding the impending acquisition should be assigned to GE Capital. Any other person would be barred from using this information for securities trading or tipping others. This is based on the consideration that the use of such information harms the company.

An Indian case, *Rakesh Agarwal v. SEBI*<sup>41</sup> is another relevant example. In that case, Rakesh Agarwal, who was the Managing Director of ABS Ltd. ,a takeover target company, traded in the shares of his company based on this non-public information. However, it was nobody’s contention that such trading harmed the company. Mr. Agarwal was under a contractual obligation on his part to enable the acquirer to acquire 20% shares in the open offer. The response to the public offer was lukewarm. There was a distinct possibility that the acquirer might not be able to acquire 20%, causing the whole transaction to fall through. There was a general agreement that ABS stood to benefit significantly by the proposed takeover, a contention not disputed by the Securities and Exchange Board of India (SEBI), either. Thus, Mr. Agarwal’s purchases of his company’s shares smoothed the acquisition process. Therefore, the assumption that “trading by the insiders based on non-public information always harms the company” seems to be too simplistic.

Indeed, the “defendants [in *Obus*] argued that the phone call was meant to serve the client’s interest, which would preclude a finding of misappropriation.”<sup>42</sup> As Langevoort notes, this could be true from a number of different perspectives—“Strickland might have been trying to get helpful information about SunSource from the hedge fund manager, and/or trying to use his connection to curry favour with a large shareholder that could be used to smooth along the acquisition.”<sup>43</sup> In fact, “GE Capital did investigate and chose not to sanction Strickland, suggesting that it did not feel particularly deceived by his behaviour.”<sup>44</sup>

Therefore, while Strickland did *use* the information regarding the acquisition, it may have been in the interests of GE Capital. That still leaves the question as to whether the hedge fund could be said to have injured GE Capital by infringing its property rights by trading on this

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<sup>38</sup> *Id.* at 91.

<sup>39</sup> Securities and Exchange Commission v. Obus, 693 F.3d 276 (2nd Cir. 2012).

<sup>40</sup> Donald C. Langevoort, “*Fine Distinctions*” in *the Contemporary Law of Insider Trading*, 2013 COLUM. BUS. L. REV. 429, 449 (2013). This case was brought under the misappropriation theory, but the analysis here would carry over, with even greater force, to the discussion under the property rights theory.

<sup>41</sup> 2004 49 SCL 351 SAT (India).

<sup>42</sup> Langevoort, *supra* note 40, at 449.

<sup>43</sup> *Id.* at 449.

<sup>44</sup> *Id.* at 455.

information. Here, the answer turns on the specific factual matrix of the case. If the hedge fund's acquisition of further stock increased the cost of acquisition, it surely would injure GE Capital. On the other hand, by taking the hedge fund (which already was a big investor in SunSource) into confidence regarding the acquisition deal, it could have become easier for GE Capital to carry out the acquisition. In this case, the hedge fund buying more stock arguably benefitted GE Capital even further since the hedge fund would offer a larger block of stock when GE Capital commenced the tender offer. This is precisely what happens in the context of warehousing. "Warehousing refers to the practice whereby a person or company (or a group of persons and/or companies) accumulates, without public disclosure, a substantial block of shares in a company with a view either to making a takeover bid or to selling the block to someone else who then makes a bid."<sup>45</sup>

Therefore, neither Strickland's tipping (if one may call it that) nor the hedge fund's buying shares based on this information have hurt or benefitted GE Capital. Thus, even in the seemingly simple case where a third party trades in the shares of a potential target based on information received from the acquirer, it does not necessarily harm the acquirer (as one would normally assume since it is supposed to increase the cost of acquisition).

Under the property rights theory with its mandatory prohibition rule as advocated by Bainbridge and other scholars, such trading would be prohibited. It seems perverse to prohibit the use of a resource even when such use benefits its owner and does not harm anybody else.<sup>46</sup>

### C. Property Rights Theory and Path Dependence

In an earlier article, Bainbridge argues the same position, but through the lens of the historical evolution of the U.S. insider trading prohibition. He frames the issue in terms of the concept of path dependence.<sup>47</sup> Path dependence claims that inefficient local equilibria can persist over time. Initial conditions, which may be determined by chance or other non-economic forces (such as political interests), direct the system down a particular path. Subsequent deviations from that path may be precluded as too costly, even if there are more desirable or efficient alternatives available.<sup>48</sup>

At the outset, Bainbridge is careful to point out that he uses the concept of "path dependence [as] a pedagogically useful metaphor."<sup>49</sup> According to him, "the insider trading prohibition ought to be viewed as a means of protecting property rights in information, rather than as a means of preventing securities fraud."<sup>50</sup> He argues that there was nothing inevitable about

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<sup>45</sup> Razeen Sappideen, *Takeover Bids and Target Shareholder Protection: The Regulatory Framework in the United Kingdom, United States and Australia*, 8 J. COMP. BUS. CAP. MKT. L. 281, 307 n. 53 (1986).

<sup>46</sup> This "no harm" argument flows from the fact that the property rights theory, unlike both versions of the misappropriation theory, conceptualizes the issue exclusively in terms of the harm to the source of information. In fact, Bainbridge criticizes the equal access theory as one that makes no policy sense. See Bainbridge, *supra* note 25, at 91.

<sup>47</sup> See Stephen M. Bainbridge, *Insider Trading Regulation: the Path Dependent Choice Between Property Rights and Securities Fraud*, 52 SMU L. REV. 1589 (1999).

<sup>48</sup> *Id.*

<sup>49</sup> *Id.* at 1590.

<sup>50</sup> *Id.* at 1591.

insider trading being treated as a species of securities fraud.<sup>51</sup> He states that “insider trading ought to be regarded as a property rights problem rather than as a securities fraud issue, but that the prohibition’s path dependent evolution suggests the need for doctrinal compromise in order to resolve the resulting tensions. Unfortunately, the *O’Hagan* majority muffed the opportunity to craft just such a compromise.”<sup>52</sup>

Of course, this fact of path dependence by itself should not be determinative in deciding the future course of the insider trading prohibition in other jurisdictions. For instance, unlike in the U.S., there is an explicit prohibition in India against insider trading written into the SEBI Act and the Regulations made thereunder. Therefore, Bainbridge may well be correct that insider trading has nothing much to do with the interest of the investors or the securities market but is all about property rights in information. In that case, a better option would be for the Indian legislature to omit the insider trading prohibition provisions from SEBI Act and leave it to the sources of such information to pursue a private remedy for the infringement of their property rights and subject to any proof of any injury arising out of such infringement. Thus, the insider trading prohibition would simply cease to be a securities law issue and SEBI would have no jurisdiction over monitoring and enforcing the prohibition.

In Bainbridge’s analysis, however, this is not the end of the matter. He argues that “the Securities and Exchange Commission (SEC) has a demonstrable comparative advantage in detecting and prosecuting insider trading.”<sup>53</sup> “Insider trading is an activity that is hard to detect and difficult to prosecute” successfully.<sup>54</sup> “It is difficult to tell whether insider trading is taking place”—and if so, who is doing it—if many people have access to MNPI.<sup>55</sup> Thus, even if a company wanted to protect its property rights in information, it would have neither the wherewithal nor the resources for enforcing such protection.

Today, the regulators around the world carry out computer based surveillance of the securities markets and use sophisticated algorithms to flag any suspicious activity, including insider trading.<sup>56</sup> Company insiders and other persons buying or selling shares above a prescribed threshold are required to report their trading activity to the stock exchanges.<sup>57</sup> The regulators can compel discovery to aid their investigation.<sup>58</sup> Informants, computer monitoring of stock transactions, and reporting of unusual activity by either self-regulatory organizations or market professionals, or both, are the usual ways in which insider trading cases come to light. As a

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<sup>51</sup> *Id.* at 1590.

<sup>52</sup> *Id.* at 1592.

<sup>53</sup> *Id.* at 1591.

<sup>54</sup> *Id.* at 1623.

<sup>55</sup> *Id.*

<sup>56</sup> *See, e.g.*, Securities and Exchange Board of India, Annual Report 2013-14, 177 (2014) for a discussion of the initiatives taken by SEBI in this regard.

<sup>57</sup> In India, provisions regarding this are contained in Regulation 9(1) and 9(2) r/w Schedule B (Minimum Standards for Code of Conduct to Regulate, Monitor and Report Trading by Insiders) of SEBI (Prohibition of Insider Trading) Regulations, 2015.

<sup>58</sup> Securities and Exchange Board of India Act, 1992, § 11, 8-9 (codified as amended by Securities Laws (Amendment) Act, 2014)) explaining that in India, Clauses (i), (ia), and (ib) of Section 11(2) of SEBI Act confer power on SEBI to call for information and records from various parties (including other authorities within or outside India) in the course of any investigation or enquiry.

practical matter, these techniques are available only to public law enforcement agencies. In particular, they are most readily available to the SEC.<sup>59</sup>

Allocating prosecutorial responsibility to the SEC may also be justified on institutional expertise grounds. The Commission's enforcement staff will handle many more insider trading cases than will counsel representing private corporations. As such, they will develop greater expertise in handling such prosecutions, which further enhances the Commission's competitive advantage in dealing with insider trading.<sup>60</sup>

However, even if the securities regulator has a comparative advantage and is so uniquely placed to enforce the prohibition, its enforcement actions ultimately benefit the private entities in protecting their enforcement rights. Thus, while the regulator may help the companies detect insider trading based on their proprietary information, the regulator ought to recover the cost of such enforcement from the companies as they are the beneficiaries of this (under the property rights theory). Since it may not be possible to determine the exact benefit derived by a particular company due to prevention of such trading in the first place, such recovery could be by way of a fee, say imposed on all listed companies in proportion to their market capitalization.<sup>61</sup> Further, a company should be free to opt out of this regime (and avoid paying the fees) if, in its view, it is not harmed by insider trading in its securities.

This is important because developing sophisticated algorithms and implementing those for constant monitoring requires considerable resources in terms of money as well as expertise. There is also an opportunity cost involved. Resources spent on the enforcement of the insider trading prohibition reduce what is available for enforcement of other “core” securities law issues such as prevention of market manipulation. In the context of the increasing complexity of the securities markets and the consequent higher vulnerability to securities fraud, it is even questionable whether the securities regulators should devote any resources for the enforcement of the insider trading prohibition, which the property rights theory treats as not related to any of the core concerns related to the securities market. This point would remain valid notwithstanding any comparative advantage that the regulator may have.

This point is even more significant when the information does not belong to the company but to a third party totally unconnected to the securities market, as in *Carpenter v. United States*. There, the information pertained to the contents of the daily column published in the *Wall Street Journal* titled “Heard on the Street” that contained recommendations regarding stock market trading.<sup>62</sup> It is not clear why the securities regulator should spend resources in monitoring any

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<sup>59</sup> Bainbridge, *supra* note 47, at 1624.

<sup>60</sup> *Id.*

<sup>61</sup> As the Indian Supreme Court held in *Municipal Corporation of Baroda v. Babubhai*, AIR 1989 SC 2091 (1989), in regard to fees there is, and must always be, a correlation between the fee collected and the service intended to be rendered. However, the element of *quid pro quo* in the strict sense is not always a *sine qua non* for a fee. The imposition of a fee as suggested above fits the description. Thus, it would qualify as a fee and not as a tax. Thus, it would not attract Article 265 of the Constitution of India, which provides that no tax shall be levied or collected except by authority of law. In particular, SEBI may impose such a fee in exercise of its function under Section 11(2)(k) of SEBI Act.

<sup>62</sup> *Carpenter v. United States*, 484 U.S. 19 (1987).

violation of a *newspaper's property rights in its unpublished material*, even though the material may be connected to the securities market.

#### D. The Harm Fiction

There have been other related criticisms of the property rights theory as well. Fisch also contends that this theory simply does not justify government intervention. If inside information is corporate property, the company should be free to allocate it, by contract, just as it can do so in case of other forms of property. In particular, the company should be able to authorize its directors or officers to trade on the basis of inside information.<sup>63</sup> According to Fisch, this means that the government must defer to the company's decision to contractually allocate that property.<sup>64</sup>

Dooley recognizes that the law generally has permitted one who has developed valuable information to benefit by withholding it when contracting with others.<sup>65</sup> A fiduciary is forbidden to benefit personally from developing valuable information, not because it would be unfair in an abstract sense but because the agency costs of such behavior exceed any realizable social benefits derived from increased incentives to develop the information.<sup>66</sup> The parties themselves could avoid this problem by drafting elaborate agreements that require information sharing and then engage in extensive monitoring and bonding activities. The resulting transaction costs, however, will likely prove excessive.<sup>67</sup> Efficiency can be enhanced at less cost by a legal rule that vests the property right to valuable information in the firm.<sup>68</sup>

The firm will be harmed if the discoverer either organizes a rival business to exploit the information or remains in the firm but attempts to drive out his partners. Although the first strategy can be pursued in any size organization, the second is feasible only in a firm with relatively few members or shareholders.<sup>69</sup>

Because insiders in publicly held corporations cannot exclude all outsiders from sharing in the benefits of new information, their purchase of additional shares does not conflict with the overall interests of the corporation or its outside shareholders.<sup>70</sup> Therefore, the efficiency considerations that are relevant in the context of mandatory disclosure in case of agencies, partnerships, or closely held companies simply do not apply in the case of publicly held companies. Under common law, no fiduciary standards were imposed on directors and officers while trading on an impersonal exchange.<sup>71</sup>

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<sup>63</sup> Jill Fisch, *Start Making Sense: An Analysis and Proposal for Insider Trading Regulation*, 26 GA. L. REV. 179, 225 (1991) (footnote omitted).

<sup>64</sup> *Id.* at 225.

<sup>65</sup> Dooley, *supra* note 18, at 63.

<sup>66</sup> *Id.* at 64.

<sup>67</sup> *Id.* at 65.

<sup>68</sup> *Id.*

<sup>69</sup> *Id.* at 66.

<sup>70</sup> *Id.*

<sup>71</sup> Dooley, *supra* note 18, at 66.

This is exactly the problem that was noted in my analysis elsewhere of the classical theory. The *Chiarella* Court simply invented a “disclose-or-abstain” duty in the context of market-based transactions—a fiduciary fiction.<sup>72</sup>

Dooley’s analysis gives a new angle to the issue in the context of the property rights theory—what may be termed as “harm fiction.” It is true that unauthorized use of information can, in certain other settings (such as agency or partnership), be harmful to a party who produces that information, and therefore the law prohibits such use. This principle is then sought to be generalized even to impersonal, market-based transactions, even when no such harm is implicated. This is exactly parallel to the case where one starts from the fact that fiduciary relationships exist in certain personal, face-to-face situations and then simply extrapolates these to market-based transactions in order to justify the classical theory.<sup>73</sup>

#### E. Insider Trading as Private Corruption and Property Rights Theory<sup>74</sup>

Kim conceptualizes insider trading as private corruption—the use of an entrusted position for self-regarding gain.<sup>75</sup> She notes certain problems with the property rights argument.

One of the core features of property is that the owner enjoys a right to exclusive possession generally as against the world.<sup>76</sup> The existence of any fiduciary or similar duty of trust or confidence is irrelevant. However, this fact is crucial in establishing liability under the current U.S. insider trading law.<sup>77</sup>

This criticism seems to be off the mark. This anomaly only says that the current U.S. law is not actually based on the property rights theory, notwithstanding the *O’Hagan* Court’s (rather fleeting) reference to property rights. It says nothing about the desirability of adopting the property rights theory.

However, there is another point that can be made in this respect. Taking the right to exclude seriously undermines the entire mandatory disclosure regime in the U.S. and several other jurisdictions. The legal framework in these jurisdictions requires that listed companies disclose financial and other information about their operations to the market.<sup>78</sup> But by treating corporate information as property, companies should be free to decide whether and to what extent they would disclose such information. This is clearly against the spirit of the current disclosure-based regime that makes such disclosures mandatory as a mechanism to ensure market efficiency and to detect and prevent fraud. In this context, Justice Brandeis’s famous remark that publicity is justly

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<sup>72</sup> See Patwardhan, *supra* note 15, at 361-63.

<sup>73</sup> See *id.* at 363.

<sup>74</sup> See *infra* Section V for a detailed discussion of the corruption theory.

<sup>75</sup> Sung Hui Kim, *Insider Trading as Private Corruption*, 61 UCLA L. REV. 928 (2014).

<sup>76</sup> *Id.* at 977.

<sup>77</sup> See *id.* at 978 (discussing the hypothetical example of the ninja trader).

<sup>78</sup> SEBI Regulations (Listing Obligations and Disclosure Requirements), 2015 (dealing with market disclosures by an entity which has listed, on a recognised stock exchange, certain designated securities issued by it or issued under schemes managed by it).

commended as a remedy for social and industrial diseases is often quoted. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman.<sup>79</sup>

The second point that Kim makes is concerning the general alienability of property. Here, Kim accepts that not all property rights are fully alienable; examples include contested commodities (such as organs and babies), negative externalities (such as pollution or overharvesting), and fundamental rights. Additionally, Kim remarks that the right to use inside information about the firm in securities transactions does not fall in any of those domains.<sup>80</sup>

At this point, it may be argued that Kim is merely begging the question (since it needs to be argued why it does not obviously fall in the same category). However, the point here is that alienability is a general feature of property rights, and a departure from this can be made only if a compelling policy interest justifies otherwise. No such compelling argument has been given (except the purported corporate harm which cannot be accepted as a universally true proposition), and thus any insider trading prohibition regime based on property rights must permit alienability.

Kim gives the example wherein the Chief Executive Officer (CEO) of a company may negotiate the right to use inside information for trading, instead of another perquisite such as a company-provided car. Both involve a private exchange of property for services.<sup>81</sup> So long as the shareholders are satisfied that such exchanges are not abusive, they should be free to permit either. However, the property rights theory of the insider trading prohibition would forbid the former while permitting the later. Thus, it does not take corporate property rights in information seriously.

#### F. Informational-Egalitarianism v. Informational-Propertarianism

Krawiec argues that it is the “nature of information itself” that creates the policy and doctrinal puzzles of the insider trading prohibition.<sup>82</sup> Krawiec frames the distinction between the equal access theory and the property rights theory as the tension between two approaches—“informational-egalitarian” and “informational-propertarianism.”<sup>83</sup>

Krawiec argues against the standard property rights theory and offers another proposal on the issue, which is a variant of the standard property rights theory. There are three strands of this argument. First, it displays a certain scepticism toward intellectual property as a means to optimal information production and dissemination. Then, it considers challenges to the argument that use and production are necessarily maximized in a system of private property rights, particularly in the context of information.<sup>84</sup> The arguments here delve deep into economic theory and go far beyond the specific issue of insider trading and cover other intellectual property rights as well.

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<sup>79</sup> Louis D. Brandeis, *Chapter V: What Publicity Can Do, in OTHER PEOPLE’S MONEY, AND HOW THE BANKERS USE IT* (1914), <https://louisville.edu/law/library/special-collections/the-louis-d.-brandeis-collection/other-peoples-money-chapter-v>.

<sup>80</sup> Kim, *supra* note 75, at 979 (footnotes omitted).

<sup>81</sup> See *id.* at 980.

<sup>82</sup> Kimberly D. Krawiec, *Fairness, Efficiency, and Insider Trading: Deconstructing the Coin of the Realm in the Information Age*, 95 NW. U. L. REV. 443, 445 (2001).

<sup>83</sup> *Id.* at 447.

<sup>84</sup> *Id.* at 481.

Second (the third point in order of analysis), Krawiec argues that traditionally, the American legal system has been reluctant in recognizing property rights in information. This should, at the very least, cause a more careful consideration of the assertion that issuers are deserving of an exclusive property right in information about themselves.<sup>85</sup>

Finally, Krawiec points to the crucial fact about information—that it has multiple uses. Therefore, it is not at all obvious that companies need any extra incentive to produce information about themselves. The possibility of multiple profitable uses for the same information may provide sufficient incentives for information production, obviating the need for an endowment of property rights in information creators.<sup>86</sup>

Companies always develop new products or technologies and build efficient business structures, say through mergers and acquisitions, so they can operate a successful enterprise.<sup>87</sup> They would not stop engaging in these activities, thereby producing new information, just because people privy to this undisclosed information may also use it for securities trading. This undercuts the policy argument offered in favour of the property rights theory—that it provides an economic incentive to produce socially valuable information.

Krawiec then offers a “middle ground” to avoid the problems of both “informational-egalitarian” and “informational-propertarianism.”<sup>88</sup>

Krawiec also identifies the need to encourage the dissemination of valuable inside information to the marketplace as the key issue. While an “always disclose” rule would achieve this, it is impracticable.<sup>89</sup> On the other side, permitting insider trading would create “perverse incentives” for the insiders, thus the Bainbridge “corporate harm” arguments are repeated.<sup>90</sup>

Krawiec advocates the privatization of the “outsider” insider trading regime. This regime would permit trading on non-public information by corporate outsiders, defined as those persons who are neither employees nor constructive insiders of the issuer and who did not receive their information in a tip from the issuer's employees or constructive insiders.<sup>91</sup> Prohibiting (actual or constructive) insiders from trading on inside information is aimed at avoiding the perverse incentives problem.

Corporate insiders and constructive insiders are those who have assumed a fiduciary duty to the corporation and its shareholders and who often control the corporation's information flow to the outside world.<sup>92</sup>

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<sup>85</sup>*Id.* at 490.

<sup>86</sup>*Id.* at 488 (footnote omitted).

<sup>87</sup>*Id.* at 489.

<sup>88</sup> *Id.* at 493.

<sup>89</sup>*Id.* at 495.

<sup>90</sup>*Id.* at 496.

<sup>91</sup>*Id.* at 498.

<sup>92</sup>*Id.*

The other “true” outsiders would be free to trade on any inside information that they may get access to, subject to any confidentiality agreements they may have signed with the company. However, the burden of enforcing such agreements would be shifted from the SEC to the private parties and state courts. The SEC’s monitoring expertise could also be employed to assist companies with enforcing private contracts regarding the use of valuable corporate information.<sup>93</sup>

He concludes that a nonexclusive property right in corporate outsiders who possess inside information may strike the most appropriate balance between incentives and access—a difficult balancing act, but one that is performed with some measure of success in connection with other types of intellectual property.<sup>94</sup>

However, as Krawiec himself admits, insiders will attempt to evade the federal limitations on insider trading by trading through or tipping friends and family members and then arguing that these illegal trades and tips are actually misappropriations, which are governed by state contract law.<sup>95</sup> Some of the more egregious instances could be prevented by allowing the Commission to bring enforcement actions when it believes that an insider has attempted to disguise her trades in this manner, but the burden of proof would be on the government to show that what appears to be outsider trading is, in fact, disguised insider trading.<sup>96</sup>

In practice, it could be challenging for the Regulator to discharge this burden, since it is the friends and family members of the insider who would be involved in the tipping and trading scheme.

On the other hand, instances of “true” outsiders getting access to inside information would, by definition, be rather rare. Thus, it is not at all clear whether such a regime would advance Krawiec’s avowed policy goal of the dissemination of valuable inside information to the marketplace. On the contrary, it may leave a loophole for the insiders to trade on non-public information through their friends and family members in the guise of legal “outsider” insider trading.

#### G. Property And... Other Valid Principles

Douglas accepts that his analysis does not support the claim that the U.S. insider trading doctrine is a property doctrine or that a property rationale is sufficient for explaining past cases or deciding future cases. However, the analysis does support the conclusion that it would be a mistake to treat certain non-property doctrines as completely unrelated to property doctrine.<sup>97</sup> He terms this “Property And... Other Valid Principles.”<sup>98</sup>

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<sup>93</sup>See *id.* at 498.

<sup>94</sup>*Id.* at 502.

<sup>95</sup>*Id.* at 499.

<sup>96</sup>*Id.*

<sup>97</sup>Kevin R. Douglas, *Missing the Role of Property in the Regulation of Insider Trading*, 69 CATH. U. L. REV. 209, 233 (2020).

<sup>98</sup>*Id.* at 239.

He notes that insider trading law departs from the standard property rights doctrine.<sup>99</sup> The insider trading doctrine is more analogous to an inalienability rule or a vice law than a property rule.<sup>100</sup> It prohibits certain information owners from using their information for securities trading and bars these owners from licensing third parties to do the same. These restrictions contradict the common and long-standing expectation that property owners have a right to partially alienate their property for consideration.<sup>101</sup> According to him, apart from property rights, valid competing principles are also motivating the doctrine. Most legal regimes contain general rules and exceptions to those rules.<sup>102</sup>

Some exceptions are authorized by an overarching policy objective that also justifies the general rule. Other exceptions to general rules are authorized by a competing government interest that is given explicit priority in a specific context.<sup>103</sup> According to Douglas, fairness and investor confidence are two obvious candidates for the additional principles in insider trading law that compete with property doctrine.<sup>104</sup>

The first principle is about an equal-information conception of fairness.<sup>105</sup> In that context, he mentions the two-pronged test explaining liability for insider trading found in *Cady, Roberts*, and *Chiarella*, “(i) the existence of a relationship affording access to inside information intended to be available only for a corporate purpose, and (ii) *the unfairness of allowing a corporate insider to take advantage of that information by trading without disclosure.*”<sup>106</sup>

However, I have argued elsewhere that this two-pronged test actually makes the underlying theory ambiguous and dichotomous. Further, the impersonal nature of today’s securities markets fundamentally alters the victim analysis. In the context of impersonal markets, the counterparties are not harmed by insider trading and may actually benefit. This is so regardless of whether such counterparties are time traders or price traders.<sup>107</sup>

The second candidate for an additional principle animating this area of law is the investor confidence or market integrity rationale offered by the Court in *O’Hagan*.<sup>108</sup> In *O’Hagan*, the Court states that imposing liability under the misappropriation theory is in line with the “animating purpose of the Exchange Act: to ensure honest securities markets and thereby promoting investor confidence.”<sup>109</sup>

*O’Hagan* acknowledges that some information asymmetries are inevitable in securities markets.<sup>110</sup> It is unclear how the average investor would determine which kind of information

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<sup>99</sup> *Id.* at 211.

<sup>100</sup> *Id.* at 237.

<sup>101</sup> *Id.*

<sup>102</sup> *Id.* at 239.

<sup>103</sup> Douglas, at 239 (footnote omitted).

<sup>104</sup> *Id.* at 240.

<sup>105</sup> *Id.*

<sup>106</sup> *Id.* (quoting *Chiarella*, 445 U.S. at 227).

<sup>107</sup> See Patwardhan, *supra* note 15, at 346-47 for an elaboration of this point.

<sup>108</sup> Douglas, *supra* note 97, at 241 (quoting *O’Hagan*, 521 U.S. at 658).

<sup>109</sup> *Id.* (quoting *O’Hagan*, 521 U.S. at 658).

<sup>110</sup> *Id.*

advantages (if any) are being used by his counterparties in the marketplace. This epistemic challenge may explain how the pursuit of some version of investor confidence through the prohibition of some information asymmetries might cause departures from long-standing property principles. If investors would find it difficult to differentiate between counterparties with acceptable and unacceptable information advantages, then it may be equally difficult for courts and enforcement officials to do so. Therefore, to the extent that insider trading doctrine departs from the common elements of a property regime, the difficulty of precisely differentiating between acceptable and unacceptable information advantages may have caused the development of conflicts in the doctrine.<sup>111</sup>

*O'Hagan* held that since deception consists of undisclosed use of information by the trader, the fraud is consummated when, without disclosure to his principal, he uses the information to purchase or sell securities.<sup>112</sup> Further, *O'Hagan* states that the harm results because the counterparty is at an informational disadvantage vis-a-vis a one who misappropriates material non-public information, and, further, such disadvantage stems from contrivance, not luck. It is a disadvantage that cannot be overcome with research or skill.<sup>113</sup>

However, if the insider trading prohibition is aiming at preventing trading based on informational disadvantage that cannot be overcome with research or skill, the misappropriation theory is clearly underinclusive. This is because the counterparty (or the entire marketplace) would suffer the same disadvantage if the trader traded on MNPI after disclosing to the source its intent to trade, or even with its blessings. Further, the counterparty cannot overcome such disadvantage with research or skill. Thus, while the deception is that of the source of information, the harm results to the counterparty. The paradox here is that disclosure *to the source* of an intent to trade supposedly eliminates any harm *to the counterparty or the marketplace*. This makes the theory incoherent, to say the least.<sup>114</sup>

Therefore, if it is the difficulty of precisely differentiating between acceptable and unacceptable information advantages that may cause the development of conflicts in the doctrine, the property and other valid doctrines approach does not seem to be of any help in clarifying the law in light of a competing government interest. As *O'Hagan* demonstrates, this approach can actually misalign the prohibition regime with the underlying policy rationale and obscure the core focus of insider trading law.

Douglas also argues that we do not have to choose only one of the property doctrines and fairness.<sup>115</sup> If common law nondisclosure and trade secret doctrines can contain property principles and fairness principles, it may be possible for the insider trading doctrine to contain equal-information principles and investor confidence principles while simultaneously being motivated by property principles.<sup>116</sup>

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<sup>111</sup> *Id.* (footnote omitted).

<sup>112</sup> *O'Hagan*, 521 U.S. at 655.

<sup>113</sup> *Id.* at 658.

<sup>114</sup> Patwardhan, *supra* note 15, at 381.

<sup>115</sup> Douglas, *supra* note 97, at 242.

<sup>116</sup> *Id.*

Under common law, nondisclosure is viewed as analogous to an affirmative misrepresentation only in exceptional cases, including when the non-disclosing party has information that “the other is entitled to know because of a fiduciary or other similar relation of trust and confidence between them.”<sup>117</sup> This is the language that the *Chiarella* Court seized upon to impose liability under the classical theory.<sup>118</sup> However, in the context of impersonal markets, the concept of counterparty is meaningless—not just as a matter of legal form, but even as a matter of substance. Therefore, it is a stretch to extend the common law nondisclosure duty to the securities transactions executed on impersonal markets.<sup>119</sup>

Douglas notes that defining fairness as the protection of some party’s property rights is a common aspect of American law, especially in the area of trade secrets.<sup>120</sup> In applying Texas’s trade secret law, the Fifth Circuit Court of Appeals described the principle in the following manner:

That the cost of devising the secret and the value the secret provides are criteria in the legal formulation of a trade secret shows the equitable underpinnings of this area of the law. It seems only fair that one should be able to keep and enjoy the fruits of his labour. If a businessman has worked hard, has used his imagination, and has taken bold steps to gain an advantage over his competitors, he should be able to profit from his efforts. Because a commercial advantage can vanish once the competition learns of it, the law should protect the businessman’s efforts to keep his achievements secret. As is discussed below, this is an area of law in which simple fairness still plays a large role.<sup>121</sup>

This analogy is again clearly inapplicable in the context of insider trading. In trade secrets law, the fairness principle is invoked to justify assigning property rights to the person who developed the particular property. This is held to be a fair outcome for such holder of property rights. The objective here is to incentivize the production of such intellectual property. As already discussed, this rationale is inapplicable in the context of insider trading, as the corporates will produce valuable business information for enhancing corporate value anyway, regardless of whether someone else may also use it for trading in the securities of the corporation.<sup>122</sup> Further, according to the proposal under discussion, it is not fairness to the holder of property rights in the information (the corporate) that animates the fairness principle. Rather, the insider trading prohibition is justified on the ground that it is fair *to third parties*, i.e. the traders in the securities markets or the investors in general.

Of course, Douglas does not offer his theory as a normative proposal. His theory is aiming at the explanation of the developing positive law. He notes the need for legal reform. The call for legal reform might be satisfied by bringing the doctrine into greater harmony with the expected features of a property regime. Alternatively, reformers can *clearly* authorize a departure from the expectations of a property regime.<sup>123</sup>

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<sup>117</sup> *Id.* at 224 (quoting RESTATEMENT (SECOND) OF TORTS § 551 (AM. L. INST. 1977)).

<sup>118</sup> See *Chiarella*, 445 U.S. at 228.

<sup>119</sup> See Patwardhan, *supra* note 15, at 364 for an elaboration of this point.

<sup>120</sup> Douglas, *supra* note 97, at 232.

<sup>121</sup> *Metallurgical Indus. Inc. v. Fourtek, Inc.*, 790 F.2d 1195, 1201 (5th Cir. 1986).

<sup>122</sup> See *supra* text accompanying Section I.B.

<sup>123</sup> Douglas, *supra* note 97, at 242 (footnote omitted).

As the discussion in this subsection shows, the rationale for bringing in other principles such as common law nondisclosure and fairness are inapposite in the context of insider trading law. Furthermore, by comingling other legal principles with property rights, courts seem to reach bizarre results that are out of tune with their proffered justification for prohibiting insider trading.

#### H. The Takeaway

To conclude the assessment of the property rights theory, it must be said that this is not two-faced, unlike the special relationship and misappropriation theories.<sup>124</sup> It is based on the notion that information is basically property, and property rights in corporate information must be assigned to the company itself as a mandatory rule. Further, this right is inalienable. Any trading based on such corporate information then amounts to a violation of this inalienable property right and is prohibited. Some proponents of this theory openly admit that the origin of the prohibition in securities law was a historical accident, and the underlying rationale for the prohibition has nothing much to do with the core concerns of securities law.

However, the policy arguments offered in support of this theory are weak. It can be argued that in a large number of cases, trading on corporate information does not harm the company or may even benefit it. Thus, companies should be free to alienate this right by permitting others to trade on such corporate information if it is in the company's interests. Also, companies would anyway produce valuable information for furthering their business interests, independent of any assignment to them of property rights in corporate information.

Further, the argument for extending this principle, even in a case of third parties who are unconnected to the securities markets (such as newspapers), is even weaker. Finally, there seems to be no reason why the SEC (or other securities regulators) should spend considerable resources on monitoring the insider trading prohibition, especially if it is not connected to the core mandate of securities law and does not implicate the interest of investors or the development of the securities markets. This is true regardless of any comparative advantage that the securities regulators may have in this regard.

## II. DECEPTION-BASED THEORY

In an earlier article, I discussed Saikrishna Prakash's critique of the misappropriation theory discussed by the *O'Hagan* Court.<sup>125</sup> Prakash argues that the *O'Hagan* Court unwittingly adopts a Deceptive Trading Theory.<sup>126</sup> Misappropriation is not necessary because *any* deception triggered by a securities transaction is enough.<sup>127</sup> Haire also predicted the ultimate evisceration of the duty model itself.<sup>128</sup>

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<sup>124</sup> See Patwardhan, *supra* note 15, at 336-38 & 380-81.

<sup>125</sup> See *id.* (citation omitted).

<sup>126</sup> Prakash, *supra* note 8, at 1533.

<sup>127</sup> *Id.* at 1539.

<sup>128</sup> M. Breen Haire, *The Uneasy Doctrinal Compromise of the Misappropriation Theory of Insider Trading Liability*, 73 N.Y.U. L. REV. 1251, 1288 (1998).

This prediction turned out to be accurate. The lower courts, while paying lip service to the binding holding in *O'Hagan*, began predicating insider trading liability on mere wrongful acquisition of information, even in the absence of any fiduciary-like duty.<sup>129</sup> The SEC promulgated Rule 10b5-2 to effectively expand the scope of the prohibition even where no fiduciary or similar duty was at issue.<sup>130</sup>

Nagy also notes this trend—what she calls the gradual demise of fiduciary principles.<sup>131</sup> The *O'Hagan* Court remarked that because Section 10(b) is only a partial antidote to the problems it was designed to alleviate, it does not call into question its prohibition of conduct that falls within its textual proscription.<sup>132</sup>

However, in the backdrop of the Court's (unwitting) adoption of a Deceptive Trading Theory, the Court's pessimism may have been unwarranted. One way to add a modicum of clarity and consistency to the law of insider trading would be for courts to embrace a new theory premised on the deceptive acquisition of confidential information. This new theory of insider trading liability under Rule 10b-5 could function as a third alternative to the classical and misappropriation approaches.<sup>133</sup> This approach would expand liability even where there is no pre-existing duty between the trader and her source, but the acquisition of information involves deception.

Nagy discusses a few such examples. These involve a person hacking into a computer to obtain information for securities trading, a friend who "dupes" another into revealing MNPI that she then uses in a securities transaction,<sup>134</sup> and a person who tricks another into leaving a business meeting in order to access confidential file folders left on the table.<sup>135</sup> In such cases, there would be no liability under *O'Hagan*, but such acts are deceptive and therefore trading on the basis of such information would be prohibited under the theory currently being discussed.

Coffee offers a similar proposal. In fact, he goes further and proposes that the SEC frame a rule (what he terms Rule 10b5-4) to define such non-duty based deception.<sup>136</sup>

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<sup>129</sup> See Patwardhan, *supra* note 15, at 389-91 for a brief discussion of these cases.

<sup>130</sup> *Id.* (discussing Rule 10b5-2).

<sup>131</sup> See Nagy, *supra* note 9, at 1321.

<sup>132</sup> *O'Hagan*, 521 U.S. at 659 n.9.

<sup>133</sup> Nagy, *supra* note 9, at 1369.

<sup>134</sup> *Id.* at 1371.

<sup>135</sup> *Id.* at 1372.

<sup>136</sup> John C. Coffee, Jr., *Mapping the Future of Insider Trading Law: Of Boundaries, Gaps, and Strategies*, 2013 COLUM. BUS. L. REV. 281, 306 (2013). The proposed Rule reads: For the purposes of Section 10(b) of the Securities Exchange Act of 1934, Section 17(a) of the Securities Act of 1933, and the antifraud rules thereunder, the terms "deceptive," "deceit," and "artifice to defraud" shall be deemed, without limitation, to include the following conduct when done in connection with the purchase or sale of a security or a security-based swap agreement: (1) misrepresenting one's identity or purpose in obtaining or attempting to obtain access to information that the actor is aware is likely to be material and non-public; (2) taking, emailing, reproducing, photocopying, or otherwise misappropriating business records or other confidential information, or disseminating such records or information to persons not authorized to receive such information, through either an affirmative misrepresentation or by means of a covert act or subterfuge, when one knows, or is recklessly indifferent to the prospect, that such records or information are likely to contain material non-public information that the lawful owner of the information has not authorized for contemporaneous public release; (3) failing to disclose one's identity, employment, status, conflict of interest, or other

One advantage that this theory offers is, as remarked earlier, it expands the reach of the insider trading prohibition, as compared to the *O'Hagan* misappropriation theory, which Nagy's examples bear out.

However, it still does not cover all cases where the information may have been acquired without any deception. An example is where a trader obtains confidential information through outright theft, but the theft is accomplished without any act of deception.<sup>137</sup>

How does this theory compare with the Chief Justice's preferred theory in his dissent in *Chiarella*? "Deceptive acquisition of information" is a narrower term than "misappropriation" in the Chief Justice's dissent.<sup>138</sup> For example, trading on information acquired through theft would be prohibited under the latter but not the former. Thus, this theory seems to be in between *O'Hagan* "misappropriation" and the "misappropriation" per the Chief Justice's dissent. If prohibiting trading on wrongfully obtained information is the policy goal, the Chief Justice's dissent in *Chiarella* offers a more expansive framework.

This theory inherits the same dichotomy inherent in the two misappropriation versions—maybe because it sits between them! As Nagy candidly admits, the sources of the information—and not securities investors—are deceived by the defendant's conduct. Yet, it is insider trading's impact on the securities market and the confidence of investors that provides the rationale for the prohibition.<sup>139</sup>

This fact makes the theory incoherent. In this regard, Prakash's criticism of *O'Hagan* misappropriation is relevant here as well. It reaches deceptions of parties wholly outside of and unconnected to the securities markets.<sup>140</sup>

This dichotomy leads to bizarre results. As Coffee notes, his formulation requires the disclosure of one's identity or conflict when one is hearing an extended conversation (regarding MNPI), but it would not cover overhearing the ten-second remark in an elevator.<sup>141</sup>

Similarly, if a trader "tricks" another person into letting her use the computer of such person and makes a trade through such computer, such trading is prohibited. In other words, deception need not be in the context of material non-public information but can be in the context of any resource.<sup>142</sup> This resource, agnostic nature of the theory implies that calling it an insider trading prohibition theory may be a misnomer! Further, if she outright steals the computer—in full view of its owner—and uses it for placing a trade, such trading is not prohibited, since the computer was not acquired through deception!

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relevant information when one knows that such disclosure would likely cause another person not to reveal, or to cease to reveal, information that is material and non-public.

<sup>137</sup> Nagy, *supra* note 9, at 1372.

<sup>138</sup> The version of the misappropriation theory offered by the Chief Justice prohibits trading on MNPI without authorization from the source. See Patwardhan, *supra* note 15, at 401-04.

<sup>139</sup> *Id.*

<sup>140</sup> Prakash, *supra* note 8, at 1496.

<sup>141</sup> Coffee, *supra* note 136, at 307.

<sup>142</sup> See Prakash, *supra* note 8, at 1496 for a discussion of the same issue in the context of the misappropriation theory.

In both cases, the respective distinction is totally irrelevant from the investors' point of view. Still, the issue of legality or otherwise of securities trading in each context is crucially dependent on just such distinctions. Again, the total disconnect of this theory with the core mandate of securities law (and even with the underlying policy objective that is sought to be achieved) can be clearly seen.

Therefore, this theory suffers from the same incoherence and policy flaws as both versions of "misappropriation." In addition, it is narrower than the Chief Justice's version of "misappropriation" in *Chiarella* that makes it an even less desirable candidate as a foundation for the insider trading prohibition.

In all fairness, it must be said that scholarly support for this theory may be motivated by the fact that, at least as of now, the insider trading prohibition regime in the U.S. must necessarily be based on some concept of "deception." This is because of the textual requirement of Section 10(b) of the SEA, into which the prohibition has been read. Thus, predicating an insider trading prohibition on deception—defined in the widest possible manner—may be the best option that does not warrant recourse to any legislative initiative by the U.S. Congress.

In that sense, both the Chief Justice's version of misappropriation as well as the structural disparity theories<sup>143</sup> go "outside the line" of Section 10b-5, unless of course one can point to another set of persons who are deceived. However, as discussed earlier, the argument that the counterparty or even the entire market is deceived by the insider trader is not sustainable in the context of an impersonal, exchange-based transaction.

Thus, based on the above discussion, it can be concluded that the deception-based theory to the insider trading prohibition is incoherent and a poor fit, even to its own purported policy justification.

### III. FRAUD ON THE MARKET

Coffee offers yet another proposal to provide a foundation for the insider trading prohibition. The theory that he offers here is known as fraud on the market (FOTM). According to him, one of the curious features of existing insider trading law is that it has largely ignored FOTM doctrine and the significance of market efficiency. He attributes it to path dependency.<sup>144</sup>

In particular, the economic foundation of FOTM is the efficient market hypothesis (EMH). EMH says that in an efficient market the price of a security reflects certain available information.<sup>145</sup> The upshot is that a particular investor may not have access to all such information or may not

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<sup>143</sup> See Patwardhan, *supra* note 15, at 401-09 & 410-18.

<sup>144</sup> Coffee, *supra* note 136, at 297. Nagy advocates what she terms "fraud on investors" theory. See Nagy, *supra* note 9, at 1373. Despite the similarity in the nomenclature, Nagy takes the Chief Justice Burger's dissent in *Chiarella* as the starting point. In a latter article, Nagy terms it "fraud on contemporaneous traders." See Donna M. Nagy, *Salman v. United States: Insider Trading's Tipping Point?*, 69 STAN. L. REV. ONLINE 28, 35 (2016).

<sup>145</sup> EMH actually posits different degrees of efficiency. This distinction will be discussed shortly.

bother to read or understand it. However, when she decides to buy or sell a security at the price set by the market, it is as if she has done it on the basis of this information.

#### A. FOTM in Securities Class Action Suits

FOTM was first advocated in the context of granting a class certification in case of class action suits pertaining to securities fraud. The U.S. Supreme Court first endorsed it in *Basic Inc. v. Levinson*.<sup>146</sup> In a later case, the Court declined to overrule *Basic*.<sup>147</sup>

The problem that FOTM sought to address was that of proving reliance in case of a securities fraud class action, where the securities trading happens in an impersonal market. This is because “in face-to-face transactions, the inquiry into an investor's reliance upon information is into the subjective pricing of that information by that investor.”<sup>148</sup> Thus, it can be inquired whether there was any material misrepresentation—or nondisclosure in the face of a duty to speak by one party—and whether the counterparty relied on the same.

In case of an impersonal market, the counterparties do not know each other and there is no element of reliance. Further, the price is not mutually negotiated but the trade happens at the price set by the market. Thus, the typical case of a face-to-face transaction wherein a person, based on the representations made to her, forms a judgement as to the value of the security is simply inapplicable here.

For a private right of action to succeed, the plaintiffs need to prove reliance, transaction causation, and loss causation.<sup>149</sup> Proving reliance in such cases could be difficult as the plaintiffs will have to prove that they were aware of such misrepresentations and actually relied on these. As *Basic* put it, “reliance provides the requisite causal connection between a defendant's misrepresentation and a plaintiff's injury.”<sup>150</sup> However, in an impersonal market, there are no direct representations either from one party to the trade or the issuer of the securities to the counterparty. The information is disclosed to the market as a whole. The counterparty buys shares based on the price set by the market.

FOTM provides a way out. As the *Basic* Court put it:

[In case of a market-based transaction], the market is interposed between seller and buyer and, ideally, transmits information to the investor in the processed form of a market price. Thus the market is performing a substantial part of the valuation process performed by the investor in a face-to-face transaction. The market is acting as the unpaid agent of the investor, informing him that given all the information available to it, the value of the stock is worth the market price.<sup>151</sup>

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<sup>146</sup> *Basic Inc. v. Levinson*, 485 U.S. 224 (1988).

<sup>147</sup> *Halliburton Co. v. Erica P. John Fund, Inc.*, 573 U.S. 258 (2014).

<sup>148</sup> *Basic*, 485 U.S. at 244.

<sup>149</sup> *Amgen v. Connecticut Retirement Plans and Trust Funds*, 568 U.S. 455, 460 (2013) (quoting *Matrixx Initiatives, Inc. v. Siracusano*, 563 U.S. 27, 37 (2011)).

<sup>150</sup> *Basic*, 485 U.S. at 243.

<sup>151</sup> *Id.* at 244 (quoting *In re LTV Securities Litigation*, 88 F.R.D. 134, 143 (N.D. Tex. 1980)).

The Court further added that, “[a]n investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price.”<sup>152</sup>

The Court further wrote:

The fraud on the market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business.... Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements.... The causal connection between the defendants' fraud and the plaintiffs' purchase of stock in such a case is no less significant than in a case of direct reliance on misrepresentations.<sup>153</sup>

Thus, FOTM creates a rebuttable presumption of reliance.<sup>154</sup> Thus, in case of corporate misstatements, all those who purchased the company's shares between the time the misstatement was made and it came to light are presumed to have relied on the same. This is presumed to have happened through their reliance on the integrity of the market price, which was actually distorted due to the misrepresentations.

Coffee argues that if FOTM works for other securities fraud action, it should work for insider trading as well. *Basic* provides a plausible basis for viewing the trading counterparty as a victim of insider trading. In both contexts, the investor who buys an overvalued stock is relying on the accuracy of the market price. The defendant in both cases knows the stock is mispriced.<sup>155</sup>

## B. Difficulties with FOTM

However, it can be argued that FOTM cannot serve as a sound foundation for the insider trading prohibition. First, FOTM in itself is a contested theory. Justice White was clearly apprehensive about “embrac[ing] novel constructions of a statute based on contemporary microeconomic theory” with “no staff economists, no experts schooled in the [EMH],” and “no ability to test the validity of empirical market studies.”<sup>156</sup> Recent empirical research has cast doubts on the validity of the EMH.<sup>157</sup> Doubts regarding the EMH spill over to FOTM and further extend to its application to insider trading.

Second, there is no unanimity in academic literature whether the application of FOTM as a general proposition is valid. In developed markets, which are apparently efficient, reliance should be presumed from the materiality of the deception. But because it is at best uncertain whether undeveloped markets are efficient, FOTM theory should not be applied to them in any form.<sup>158</sup> If this is correct, in an FOTM-based insider trading prohibition framework, insider trading would be

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<sup>152</sup> *Id.* at 247.

<sup>153</sup> *Id.* at 241 (quoting *Peil v. Speiser*, 806 F.2d 1154, 1160 (1986)).

<sup>154</sup> *See id.* at 245.

<sup>155</sup> Coffee, *supra* note 136, at 298.

<sup>156</sup> *Basic*, 485 U.S. at 253 (White, J., concurring in the judgment in part and dissenting in part).

<sup>157</sup> *See, e.g.*, Donald C. Langevoort, *Basic at Twenty: Rethinking Fraud on the Market*, 2009 WIS. L. REV. 151, 175 (2009) (stating that doubts about the strength and pervasiveness of market efficiency are much greater today than they were in the mid-1980s).

<sup>158</sup> Note, *The-Fraud-on-the-Market Theory*, 95 HARV. L. REV. 1143, 1161 (1982).

prohibited or otherwise, depending on the degree of development and consequently the efficiency of the market.

Macey questions whether we can conclude that FOTM theory is socially desirable merely because it is *coherent*. He discusses a hypothetical example to argue that imposing liability for a certain sort of incomplete disclosure, particularly in the absence of a showing of reliance on any actual misstatements by the defendant, provides a strong disincentive to disclose at all. Thus, the fraud on the market theory, by penalizing those firms that choose to disclose corporate news, ultimately may make the markets less efficient.<sup>159</sup>

This example, of course, does not directly carry over to insider trading. However, the underlying lesson of this example is that in certain cases, the issue of full disclosure needs to be balanced against legitimate corporate interests.

### C. FOTM and Insider Trading

More importantly, even if it is assumed that the application of EMH and FOTM in other areas of securities law is universally valid, its application to insider trading raises other specific issues. To see this, it is necessary to look at the structure of the EMH in greater detail.

EMH does not look at efficiency in all or nothing terms. It identifies three forms of market efficiency. The weak form of the EMH says that market prices impound all historical price data; therefore, no investor can earn an above-market return by trading on such information.<sup>160</sup>

The “semi-strong” version posits the same, but with respect to all publicly available information,<sup>161</sup> of which historical price data is a proper subset. Finally, the strong form posits it with respect to *all* information, whether publicly available or not.<sup>162</sup>

In *Basic*, the Court specifically seems to have adopted FOTM based on the semi-strong version of the EMH. This is clear from its remarks regarding “the market performing the valuation process and informing the investor that *given all the information available to it*, the value of the stock is worth the market price.”<sup>163</sup> In other words, the market vouches for the integrity of the price *only with reference to publicly available information*.

This fact implies that FOTM in this form is inapplicable to insider trading. By definition, insider trading implies that a person trades, based on nonpublic information that is available to them, but not to the market. Thus, even if the said information is not reflected in the market price, it says nothing about the integrity of the market price in the semi-strong sense. So, long as the

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<sup>159</sup> Jonathan R. Macey, *The Fraud on the Market Theory: Some Preliminary Issues*, 74 CORNELL L. REV. 923, 924 (1988-1989).

<sup>160</sup> See Frederick C. Dunbar & Dana Heller, *Fraud on the Market Meets Behavioral Finance*, 31 DEL. J. CORP. L. 455, 463 (2006).

<sup>161</sup> See, e.g., Lynn A. Stout, *The Mechanisms of Market Inefficiency: An Introduction to the New Finance*, 28 J. CORP. L. 635, 640 n. 24 (2003) (citing Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FINANCE 383, 388 (1970)).

<sup>162</sup> Dunbar & Heller, *supra* note 160, at 463-64.

<sup>163</sup> See *supra* note 151 (emphasis added).

market price reflects all publicly available information, the market is efficient in the semi-strong sense. There has been no distortion of the market process.

This point will be clearer if the example above is contrasted with another situation. Assume a company makes financial misstatements by way of reporting inflated revenue and profits. Such misstatements “pollute” the mix of information that is publicly available. If the company had stated its accurate revenue and profit figures, the market would have placed a lower price on company securities (as the semi-strong version implies). Thus, these financial misstatements have distorted the valuation process in a clear sense.

On the other hand, whether the insider traded on such information or abstained from trading, there is no change in the information mix that is publicly available. Thus, the market price would be the same in either case. Thus, the insider’s trading on such information in no way affects the integrity of the price as set by the market in the semi-strong sense. Thus, the very basis of FOTM as fleshed out in *Basic* is inapposite in this case. An investor who traded in that security would have paid or received the same price in either case.

One may argue here that the insider’s non-disclosure deprives the market of this information, and therefore the mix of publicly available information is reduced. However, this seems to be circular logic. The insider’s duty to disclose is predicated on the assumption that applying FOTM in the insider trading context is valid. On the other hand, the application of FOTM to insider trading seems to be predicated on the assumption that the insider has a duty to disclose.

Another potential counterpoint to this analysis could be to argue that *Basic* set too low a threshold by focusing on semi-strong efficiency. One could instead advocate FOTM based on strong form efficiency. Thus, whether the market sets the price in an integrity preserving way would be a function of not just the information that is publicly available, but all information that is material from the viewpoint of assessing the security’s value.

The obvious problem with this proposal is that the market, by definition, cannot impound information that is not available to it. The only way to ensure strong form efficiency is to require the companies to disclose information to the market on a daily, or even hourly, basis. If this is done, the semi-strong version effectively is collapsed into the strong version, as there is no material information that is not publicly available. There are genuine business considerations why all information cannot be instantly disclosed to the market.<sup>164</sup> Therefore, the focus of *Basic* on semi-strong efficiency is well justified.

In fact, it can be argued that permitting insider trading is possibly the only way to go beyond semi-strong efficiency. If the insiders trade in large quantities, or if their trades trigger derivative trading by the outsiders who infer the existence of material, nonpublic information, such trading would result in the market indirectly incorporating such information in the market, without actual

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<sup>164</sup> Other “external” information such as an impending change in government policy, or a Court judgment that will be soon delivered also impact the price of a security. By definition, such information may stay nonpublic for an extended period of time. This is another reason why there will be an irreconcilable gap between all material information and what is publicly available, at a given point of time. If such a gap did not exist, there would be no opportunity for insider trading, and no point in writing this article!

disclosure of that information. Thus, the market could actually go in the direction of strong efficiency, at least to some extent. In the process, the integrity of the valuation process would improve. Investors who trade at such price cannot be said to have been harmed in any way. Thus, FOTM actually seems to justify legalizing insider trading.

Korsmo challenges the received wisdom on the link between market efficiency and FOTM. According to him, “it is possible to accept market efficiency and reject the FOTM theory, or to reject market efficiency and accept the FOTM theory.”<sup>165</sup> He argues that, “the logic of the FOTM rests not on market efficiency, but on the structure of impersonal securities markets.”<sup>166</sup> Apart from the fact that prices in such markets are set by impersonal market mechanisms, the other important feature is that securities are typically not being purchased for any form of personal consumption, instead of or in addition to for investment and resale.<sup>167</sup>

How are these facts relevant to FOTM? Korsmo provides an example to elucidate the point:

Assume a buyer is willing to buy a used car that is being offered for \$10,000. The seller falsely represents that the car's tires are brand new, when they are actually old and in need of replacing, which will cost \$500. The buyer would be willing to pay up to \$11,000 for the car if it had new tires, but would value it at \$10,500 if she knew the truth about the tires. The buyer pays \$10,000 for the car. The buyer cannot be said to have been harmed by the misrepresentation, because the buyer is in the same position he would have been in had he known the truth, or had the misrepresentation never been made. Either way, the buyer would have paid \$10,000 for a car with old tires.<sup>168</sup>

Thus, the buyer did not rely on the misstatement, as he would have bought the car at \$10,000 anyway, even in the absence of such misrepresentation. In other words, she would pay the same price, with or without misrepresentation.

Next, Korsmo discusses an analogous example:

The issuer of a security that is trading at \$9,500 makes a misrepresentation that causes the market price to rise to \$10,000. The buyer believes the security is mispriced, and is really worth \$11,000. Even if the buyer knew the truth, she would be willing to pay up to \$10,500 for it. She therefore buys the security for \$10,000. Just like in the previous example, the buyer would have still been willing to pay \$10,000 even if she had known the truth.<sup>169</sup>

Korsmo's insight here is that:

The buyer is *not* in the same position she would have been in absent the misrepresentation. If the misrepresentation had not been made, she may still have been *willing* to pay \$10,000,

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<sup>165</sup> Charles R. Korsmo, *Market Efficiency and Fraud on the Market: The Danger of Halliburton*, 18 LEWIS & CLARK L. REV. 827 (2014).

<sup>166</sup> *Id.* at 868.

<sup>167</sup> *Id.* at 868.

<sup>168</sup> *Id.* at 868-69.

<sup>169</sup> *Id.* at 869.

but she would not, in fact, have paid \$10,000—she would have paid \$9,500. Thus, even if she knew the truth, and even if she did not rely on the market price as reflecting the “true value” of the security, the buyer has still been harmed by the misrepresentation.<sup>170</sup>

Now we can add a twist to the tale. Suppose, as in the example above, the security initially trades at \$9,500 and the price rises to \$10,000 after the issuer’s misrepresentation. Certain insiders, aware of the misrepresentation, start selling company shares. As a result of their trading (and maybe triggered trading), the price declines to \$9,950. While the investor suffered harm as a result of corporate misstatements, insider trading in company shares actually reduced her loss (as she could buy at \$9,950 instead of \$10,000). Thus, insider trading, if at all has any price effect, it moves the price in the “right” direction.

Therefore, whether we analyze FOTM from the viewpoint of reliance or pure market structure, its application to insider trading is unjustified. In fact, FOTM seems to provide an argument in support of the legalization of insider trading.

#### D. Corporate Misstatements v. Trader Misrepresentations

There is one important difference between the typical corporate misstatement examples discussed and insider trading. Market misstatements originate from the issuer who is not a party to the securities trade in the secondary market. In the context of FOTM, insider trading is implicitly treated as a misrepresentation to the effect that the insider is not aware of any material, nonpublic information. Here, the purported misrepresentation originates from a party to the trade. Does this difference possibly account for the conclusion that the application of FOTM in the corporate misstatement context does not carry over to insider trading?

This question must be answered in the negative. To see this, it is necessary to consider a misrepresentation that originates from a trader. Circular trading refers to the practice wherein a group of traders sell securities to each other in a circular fashion. This is usually done through synchronized trading. The traders with prior understanding enter orders in such a way that their orders will definitely, or in all likelihood, match with each other.<sup>171</sup>

In India, synchronization *per se* is not illegal. However, if done to artificially raise or depress the price of a security, it distorts price integrity and becomes a manipulative and deceptive device, prohibited under Section 12A of SEBI Act.<sup>172</sup> In effect, such trading amounts to a misrepresentation that such trades are genuine trades, based on the trader’s assessment of the price, and therefore the market price that is set as a result of such trades is integrity preserving. However, the mix of publicly available information here is clearly “polluted” as the market knows about the higher price (and possibly higher volume), without knowing that these have been achieved by creating a false market, rather than through a genuine interplay of market demand and supply forces.

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<sup>170</sup> *Id.*

<sup>171</sup> SUMIT AGARWAL & ROBIN J. BABY, A LEGAL COMMENTARY ON SEBI ACT, 1992 285 (2011).

<sup>172</sup> *Id.* at 286.

In Korsmo's example, instead of corporate misstatements, if circular trades are distorted in order to raise the price to \$10,000, the net effect for the investor is the same. She ends up paying \$500 more than the price the market would have set in the absence of the distortion (due to misstatements or circular trades). This is because in either case, the market price moves away from what it would be if accurate information was known to the market. On the other hand, insider trading results in at least a partial incorporation of non-public information in the price.

#### E. Davis on the Fraud on the Market Theory

Davis argues in support of adopting FOTM theory in insider trading law.<sup>173</sup> He argues that, "the injuries the law should seek to prevent are the deception on the counterparty and the inevitable loss in investor confidence."<sup>174</sup> He notes that the question of "whether the counterparty actually suffers any injury at all, however, has been a controversial question."<sup>175</sup> After considering arguments on both sides, he states that "the sounder conclusion is that the counterparty is injured and that such injury requires a robust insider trading law."<sup>176</sup>

According to him:

The question remains how to redirect the focus of insider trading law away from a breach of fiduciary duty to the source and toward a breach of duty to the counterparty. One obstacle to this refocusing is the lack of a direct interaction between parties trading in impersonal, computerized markets.<sup>177</sup>

In essence, his argument hinges on combining the disclose-or-abstain duty with FOTM. *In re Cady, Roberts & Co.* the SEC first enunciated the disclose-or-abstain duty. The SEC stated:

We and the courts have consistently held that insiders must disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment. Failure to make disclosure in these circumstances constitutes a violation of the anti-fraud provisions. If, on the other hand, disclosure prior to effecting a purchase or sale would be improper or unrealistic under the circumstances, we believe the alternative is to forego the transaction.<sup>178</sup>

I have argued elsewhere that the SEC's articulation of the insider trading prohibition is ambiguous and dichotomous, making the theory two-faced.<sup>179</sup> The SEC enunciated two factors inherent in the theory. The fact that the insider had a relationship with the company that gave her access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a

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<sup>173</sup> Kenneth R. Davis, *Insider Trading Flaw: Toward a Fraud-on-the-Market Theory and Beyond*, 66 AM. U. L. REV. 51 (2017).

<sup>174</sup> *Id.* at 70.

<sup>175</sup> *Id.*

<sup>176</sup> *Id.* at 73.

<sup>177</sup> *Id.* at 77.

<sup>178</sup> *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 911 (1961) (footnote omitted).

<sup>179</sup> See Patwardhan, *supra* note 15, at 336-38.

party takes advantage of such information knowing it is unavailable to those with whom he is dealing.<sup>180</sup>

This two-faced nature of the theory is the source of the dichotomy. The first factor seems to indicate that the concerned information is essentially treated as a corporate resource. This resource has been entrusted to the insider in order to discharge her corporate duties and it should not be used for the personal benefit of anyone.<sup>181</sup> Thus, this factor implies that insider trading is basically wrongful conversion of a corporate resource (in this case information) for obtaining a personal gain. Thus, the company itself is the victim of such trading.<sup>182</sup>

The SEC seems to have implicitly accepted this when it held that the counterparties do not have any private right of action against the inside traders due to the lack of privity between them. At the same time, it held that this fact does not absolve an insider from responsibility for fraudulent conduct.<sup>183</sup> However, the second factor seems to pull the theory in the opposite direction. The reference to the “inherent unfairness” raises the question “unfair to whom”? Since the supposed unfairness arises because one party has information that the other party does not have access to, the conclusion here is that it is unfair to the counterparty.<sup>184</sup>

Therefore, if an insider trades on MNPI after disclosing the same to the counterparty, the unfairness is arguably eliminated, as the counterparty now has access to this information. Of course, the source may have other legal remedies available to it for wrongful conversion of this information. On the other hand, such trading may well be beneficial to the source of information<sup>185</sup> and so the source may authorize the insider to trade on such information. Such trading, without the disclosure of the information to the counterparty, is not an improper conversion of a corporate resource, but nonetheless is clearly unfair to the counterparty. While the duty not to trade on MNPI runs to the source, such trading is held to be unfair to the counterparty. The interests of these two parties are often not coextensive. Therefore, adopting the SEC disclose-or-abstain theory is problematic.

Further, the lack of a direct interaction between parties trading in impersonal, computerized markets is not just an obstacle to be overcome. The impersonal nature of today’s securities markets fundamentally alters the victim analysis. I demonstrate elsewhere that in the context of impersonal markets, the counterparties are not harmed by insider trading and in fact may actually benefit. This is the case, regardless of whether such counterparties are time traders or price traders.<sup>186</sup>

In the context of insider trading, ordinary investors believe that corporate insiders have an advantage that renders trading securities a game of Russian roulette. When investor distrust of the

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<sup>180</sup> *In re Cady, Roberts*, at 912 (footnote omitted).

<sup>181</sup> Patwardhan, *supra* note 15, at 336.

<sup>182</sup> *Id.* at 336-37.

<sup>183</sup> *In re Cady, Roberts*, at 915.

<sup>184</sup> Patwardhan, *supra* note 15, at 337 (footnote omitted).

<sup>185</sup> See *supra* Section I.B for a discussion of relevant caselaw.

<sup>186</sup> See Patwardhan, *supra* note 15, at 346-47.

securities markets swells, their willingness to invest falters, trading volume sinks, stock prices fall, and fewer new issues come to market.<sup>187</sup> This policy basis speaks more to the market-wide harms of insider trading,<sup>188</sup> rather than any fraud on the counterparty or other traders in the market. FOTM seems to be beside the point here. FOTM basically serves to dispense with the need to prove actual reliance by the counterparty on any material misstatements (or material nondisclosure) by the trader in an impersonal market, in order to establish deception. If the objective behind prohibiting insider trading is to prevent the market harms of insider trading, it is unrelated to the issues whether certain traders, such as employees of a corporation, have a fiduciary duty to the counterparty and whether FOTM allows us to invoke this duty and establish deception even in the context of impersonal markets. Thus, prohibiting insider trading to prevent any adverse impact on market liquidity, access to capital, and the cost of capital may well be justified independent of the validity of FOTM.

Finally, Davis concedes that his theory reaches only those cases where the trade occurred in a market efficient at disseminating material information.<sup>189</sup> Thus, trading on MNPI is not prohibited in markets that are not efficient, at least under FOTM theory. However, Langevoort argues that because market efficiency is not a binary, yes-or-no question, one cannot sensibly argue in every case that material information affects market prices.<sup>190</sup> Therefore, whether insider trading liability attaches in a particular case would turn on the difficult question as to whether the particular trade was executed on an efficient market. It is unclear if the judiciary is equipped to take this call.

#### F. The Takeaway

To conclude, basing the insider trading prohibition on FOTM seems to be unsatisfactory. Even in other areas of securities law, the wisdom of endorsing FOTM by judicial fiat has been questioned, in the absence of any economic expertise on the part of the judges. Recent research has cast doubts on the validity of FOTM. Further, its endorsement as a matter of universal application may not be socially or economically desirable.

The application of FOTM to insider trading raises its own specific concerns. The semi-strong version of FOTM, relied on in *Basic*, is inapplicable to insider trading, as the latter implicates information that is not publicly available. More important, corporate misstatements or circular trading “pollute” the mix of publicly available information and consequently the integrity of the market price. If at all, insider trading results in at least a partial incorporation of nonpublic information and thus helps the market to go in the direction of strong efficiency, albeit in a small way. Thus, FOTM seems to justify legalization of insider trading.

This conclusion is not at all surprising. If the investors do rely on the presence of insider trading, they do it by reading the signals correctly. For example, if a company is a potential takeover target, and persons privy to this information start buying company shares, the price would

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<sup>187</sup> Davis, *supra* note 173, at 73.

<sup>188</sup> For example, Dent argues that the prevalence of insider trading implies that persons other than the insiders would always have an informational disadvantage and thus would be reluctant to trade, reducing liquidity and increasing the cost of capital for companies. Ultimately, this would lead to the extinction of public stock markets. Dent, *supra* note 13, at 263-64.

<sup>189</sup> Davis, *supra* note 173, at 55.

<sup>190</sup> Donald C. Langevoort, *Basic at Twenty: Rethinking Fraud on the Market*, 2009 WIS. L. REV. 151, 167-68 (2009).

go up. Those who detect this sudden price rise are likely to read it as indicating the presence of some nonpublic positive information and so they too would be on the buy side. Mere interjection of FOTM and the consequent indirect reliance does not change the fact that if the investors do place any reliance on the insiders' trades, it is in the "right" manner and therefore cannot be said to have been harmed.

#### IV. CONTRACTUAL FRAUD THEORY

Zachary Gubler has developed another fraud-based theory of the insider trading prohibition.<sup>191</sup> He notes the problems with explaining the prohibition under traditional views of fraud. Perhaps for this reason, many commentators view insider trading law's roots in fraud as hardly more than a quirk of history.<sup>192</sup> He offers an alternative account – what he terms the contractual fraud theory.

##### A. The Theory Explained

Under this theory:

Insider trading liability arises whenever the trading breaches a duty to report — either explicit or implied by a court — a violation of an underlying covenant — whether contractual or fiduciary-based — that prohibits insider trading in the first place. This failure to report constitutes fraud pursuant to Rule 10b-5 and should therefore give rise to the fraud-like, extra compensatory damages provided for by the rule.<sup>193</sup>

The rationale that he offers is that insider trading is extremely costly to detect for parties wishing to protect their information from any impermissible use – the “costly detection problem.”<sup>194</sup> A firm that hires a consultant to provide strategic advice regarding a potential merger may want to protect its merger-related information against impermissible uses by the consultant, including insider trading. It may do so relying on either fiduciary duty law or contract law.<sup>195</sup>

This is an archetypal case of the costly detection problem as detecting a breach of duty by the consultant, in the context of insider trading, is very costly. To overcome this problem, the firm may contractually require the consultant to report a breach of the underlying duty – by way of inserting a “Reporting Covenant.”<sup>196</sup>

The consultant will have an incentive to report the violation only if the breach of the Reporting Covenant is subject to extra-compensatory damages.<sup>197</sup> However, at common law, courts are extremely reluctant to allow contracting parties to “contract for fraud liability”; that is

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<sup>191</sup> Zachary J. Gubler, *Insider Trading as Fraud*, 98 N.C.L. REV. 533 (2020).

<sup>192</sup> *Id.* at 536.

<sup>193</sup> *Id.* at 565.

<sup>194</sup> *Id.*

<sup>195</sup> *Id.* at 538 (footnotes omitted).

<sup>196</sup> *Id.* at 539 (footnotes omitted).

<sup>197</sup> *Id.*

to say to enforce the breach of a contractual disclosure obligation through extra-compensatory (in other words fraud) damages.<sup>198</sup>

Under the contractual fraud theory, “parties can *explicitly* contract for fraud liability for insider trading through the use of a Reporting Covenant.”<sup>199</sup> Further, “courts can—in certain circumstances—find that parties have contracted for fraud liability *implicitly* under Rule 10b-5.”<sup>200</sup> The court should ask “whether the parties themselves would have opted into the Rule 10b-5 regime if they had explicitly addressed this issue.”<sup>201</sup>

Gubler argues that his theory offers several advantages. First, it is “more respectful of the fraud-based nature of Rule 10b-5’s text than alternative theories of insider trading.”<sup>202</sup> Further, “it actually explains the law as it has been received.”<sup>203</sup> In particular, the contractual fraud theory helps untangle that “riddle, wrapped in a mystery”.<sup>204</sup> In other words, the contractual fraud theory seems to do a good job of explaining the law “as it is”—at least in the context of the insider trading prohibition regime in the United States. Going beyond the explanatory power of this theory, Gubler argues that his theory responds to potentially significant welfare implications of insider trading—public as well as private welfare.<sup>205</sup>

#### B. Public-Welfare Maximizing View

Gubler argues that courts or the SEC ought to take a public-welfare maximizing view in determining whether a contract contains an implicit provision for fraud liability.<sup>206</sup> They could decide whether to find an implied Reporting Covenant in these contracts, and therefore effectively decide whether Rule 10b-5 applies, based on considerations about the *public* costs and benefits of insider trading.<sup>207</sup>

He provides a quick summary of the social costs and benefits of insider trading, as discussed in the literature. Insider trading may “create the perception, if not the reality, that the market is ‘rigged’ and only serves to benefit the well-placed and the well-heeled of corporate America.”<sup>208</sup> “A decrease in market integrity is feared to lead to a decrease in market participation, which would result in lower liquidity.”<sup>209</sup>

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<sup>198</sup> *Id.* at 539-40.

<sup>199</sup> *Id.* at 540.

<sup>200</sup> *Id.*

<sup>201</sup> *Id.*

<sup>202</sup> *Id.*

<sup>203</sup> *Id.*

<sup>204</sup> *Id.* at 540-41 (footnotes omitted).

<sup>205</sup> *Id.* at 568.

<sup>206</sup> *Id.* at 569.

<sup>207</sup> *Id.* at 578.

<sup>208</sup> *Id.* at 578-79 (footnote omitted).

<sup>209</sup> *Id.* at 578-79 (footnote omitted).

“Balanced against this cost, there is the possibility that insider trading might result in markets that are more informationally and allocatively efficient.”<sup>210</sup> Market efficiency is important since it is correlated with greater gross domestic product and societal wealth more generally.<sup>211</sup>

Gubler considers the possible objection to the argument “that judicial or regulatory decisionmakers might interpret contracts in light of public, not private, considerations.”<sup>212</sup> “This suggestion might seem eccentric, but it is not unprecedented.”<sup>213</sup> “After all, it is well established in contract law that courts can refuse to enforce contracts for public policy reasons.”<sup>214</sup>

There are two points that can be argued against this. It is one thing for courts to refuse to put their stamp of approval on contracts that are against public policy. Courts reading an implicit Reporting Covenant into a private contract to further the public policy objectives of prohibiting insider trading seems to go much further.

In the context of considering a private-welfare maximizing view, discussed in the following subsection, Gubler suggests that whether the contract should be interpreted as containing an implicit provision triggering Rule 10b-5 liability for insider trading would turn on a hypothetical bargaining analysis.<sup>215</sup> This is a standard way of deciding contract interpretation questions. The hypothetical bargain analysis asks what the parties themselves were likely to have decided had they considered this issue at the time of contracting.<sup>216</sup> This, in turn, depends on two factors: the difficulty of detecting the underlying breach and the availability of alternative means for enforcing compliance.<sup>217</sup>

This seems to create a puzzle for the contractual fraud theory. Assume that in a particular context of potential insider trading, the contracting parties themselves do not see any private-welfare maximizing benefit in incorporating the Reporting Covenant. Thus, the bargaining analysis would not permit courts or the SEC read such an implicit covenant. They may still determine that there is a public-welfare maximization angle involved here and read such a Covenant into the contract anyway. This clearly goes beyond, and actually contradicts, the intentions of the contracting parties. If the SEC makes a determination that public welfare is indeed implicated in a particular case and reads the Reporting Covenant in the contract, the defaulting party would be liable to pay the other party extra-compensatory damages for the breach of the Reporting Covenant. Since the contracting parties themselves do not see any private-welfare maximizing benefit in incorporating such a Covenant (as the hypothetical bargaining analysis shows), it results in unjust enrichment of the collecting party.

Gubler also states that given the nature of the public-welfare maximizing determination, it does not seem like an inquiry that is naturally suited for the judiciary. It seems more appropriately

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<sup>210</sup> *Id.* at 579.

<sup>211</sup> *Id.*

<sup>212</sup> *Id.* at 579.

<sup>213</sup> *Id.*

<sup>214</sup> *Id.* at 579-80.

<sup>215</sup> *Id.* at 569.

<sup>216</sup> *Id.* at 569-70 (footnote omitted).

<sup>217</sup> *See Id.* at 570.

allocated to the province of expert regulators, such as the SEC.<sup>218</sup> Gubler suggests that insider trading liability is not private-welfare maximizing for arm's-length contracts.<sup>219</sup> The SEC could take a public-welfare maximizing approach to the problem, in which case it would focus on the public costs and benefits posed by insider trading.<sup>220</sup> The SEC has brought Rule 10b5-2. It does not draw any distinction between different types of contractual relationships, let alone whether they are arm's length or otherwise. Rather, it simply provides that a confidentiality agreement (whether express or implied) is sufficient for liability.<sup>221</sup>

This does not mean that there are no constraints on what the SEC can do here. At a minimum, parties must have entered into a contractual relationship subject to a confidentiality agreement, which is what Rule 10b5-2 requires. Thus, while the rule is valid, it is bordering the limit of the SEC's authority under the contractual fraud theory.<sup>222</sup>

The question that one may ask at this point is why the SEC's determination of the public costs of insider trading should be circumscribed by the contractual fraud theory. The SEC, as an expert regulator, may well determine that insider trading has social costs that outweigh any social benefits, even beyond what the contractual fraud theory can accept. In particular, the SEC may well determine that any trading on unequal access to information is socially undesirable. The perception of unfairness will persist so long as such trading happens. The fiduciary or contractual relationship between the contracting parties is simply irrelevant.

In fact, the SEC seems to be sympathetic to such equal access argument. I have argued elsewhere that the SEC Rule 14e-3<sup>223</sup> was aimed at proscribing the practice of warehousing. The Rule was a prophylactic measure to ensure that the market for corporate control functions in a smooth and transparent manner. On this reading, the reach of the Rule is limited to only those cases where trading on nonpublic information regarding impending tender offers happens with the collusion of the offering person.<sup>224</sup>

In later cases, the SEC seems to have applied this Rule effectively as an equal access theory in the tender offer context. The Rule was invoked in contexts other than warehousing and where the offering persons were not aware of trading on nonpublic information regarding their intended tender offer; additionally, the trader's intention was not to buy a substantial block of shares with a

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<sup>218</sup> *Id.* at 580.

<sup>219</sup> *See infra* Section IV.C.

<sup>220</sup> Gubler, *supra* note 191, at 590.

<sup>221</sup> *Id.*.

<sup>222</sup> *Id.*

<sup>223</sup> 17 C.F.R. § 240.14e-3 (2019). The rule reads, in part: It shall constitute a fraudulent, deceptive or manipulative act or practice within the meaning of section 14(e) of the Act for any other person who is in possession of material information relating to (a) tender offer which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from (1) The offering person, (2) The issuer of the securities sought or to be sought by such tender offer, or (3) Any officer, director, partner or employee or any other person acting on behalf of the offering person or such issuer, to purchase or sell or cause to be purchased or sold any of such securities or any securities convertible into or exchangeable for any such securities or any option or right to obtain or to dispose of any of the foregoing securities, unless within a reasonable time prior to any purchase or sale such information and its source are publicly disclosed by press release or otherwise.

<sup>224</sup> *See* Patwardhan, *supra* note 15, at 392-93.

view either to making a takeover bid or to selling the block to someone else who then makes a bid.<sup>225</sup>

The SEC adopted Regulation Fair Disclosure (Regulation FD) in 2000. It requires issuers to publicly disclose any MNPI conveyed to market professionals and other specified people. This regulation requires that public disclosure must be simultaneous for intentional disclosures and prompt for unintentional disclosures.<sup>226</sup> Now the regulation specifically provides that any failure to make a public disclosure shall not be deemed to be a violation of Rule 10b-5 (and therefore of the insider trading prohibition).<sup>227</sup> This seems to be designed to ensure that there is no head-on conflict with the Supreme Court's rejection of the prohibition based on equal access consideration.<sup>228</sup>

At the same time, Regulation FD clearly undercuts the holding in *Chiarella* and *Dirks*. The Rule focuses on corporate issuers and corporate officials as the source of such asymmetries. If selective disclosures by corporate insiders could be prevented at the source, regulators would have less need to address trading by the recipients of that information. In effect, this seems to be an indirect (or alternate) approach to addressing information asymmetry.<sup>229</sup>

The SEC has also contested the "personal benefit" test evolved by the Supreme Court in the context of tipping cases. In *Dirks*, the Court held that the insider is guilty of violating the prohibition only if she discloses MNPI in breach of her duty. In turn, this depends on whether the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings.<sup>230</sup> Absent personal gain and breach by the insider, there has been no breach of duty to stockholders nor a derivative breach.<sup>231</sup>

The SEC advocated a more expansive test. According to it, "(w)here 'tippees'—regardless of their motivation or occupation—come into possession of material 'corporate information that they know is confidential and know or should know came from a corporate insider[sic]' they must either publicly disclose that information or refrain from trading."<sup>232</sup>

The upshot here is that if an expert regulator such as the SEC is better equipped to assess whether prohibiting insider trading in a particular context is desirable from a public-welfare perspective. It should be permissible for it to take a call on this, directly based on considerations related to public costs and benefits of such trading. There is no reason why the choice must be

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<sup>225</sup> *Id.* at 393-94.

<sup>226</sup> 17 C.F.R. § 243.100(a).

<sup>227</sup> 17 C.F.R. § 243.102.

<sup>228</sup> See *Chiarella v. United States*, 445 U.S. 222 (1980); *Dirks v. SEC*, 463 U.S. 646 (1983).

<sup>229</sup> Jill Fisch, *Regulation FD: An Alternative Approach to Addressing Information Asymmetry*, in RESEARCH HANDBOOK ON INSIDER TRADING 112 (Stephen M. Bainbridge ed., 2013) (quoting Proposed Rule: Selective Disclosure and Insider Trading, SEC Release Nos. 33-7787, 34-42259, IC-24209 (Dec. 20, 1999), 64 Fed. Reg. 72574 (Dec. 28, 1999) ("We propose to use our authority to require full and fair disclosure from issuers . . . We believe this approach would further the full and fair public disclosure of material information, and thereby promote fair dealing in the securities of covered issuers.")).

<sup>230</sup> 463 U.S. 646, 663 (1983).

<sup>231</sup> *Id.* at 662.

<sup>232</sup> *Id.* at 651 (quoting 21 S. E. C. Docket 1401, 1407 (1981)).

constrained by any outer limits set by the contractual fraud theory. If this is correct, the contractual fraud theory seems to become superfluous in the context of public-welfare considerations.

### C. Private-Welfare Maximizing View and the Proposed Default Rule

In the context of private-welfare maximization analysis, the question is under what circumstances should courts (or the SEC) infer an implicit Reporting Covenant in a relationship, whether contractual or fiduciary.

From a private-welfare maximizing view, there are two relevant factors: the difficulty of detecting the underlying breach and the availability of alternative means for enforcing compliance. The more costly it is to detect the underlying breach, while the alternative means cost less, the more likely contracting parties will choose to enforce prohibitions via Rule 10b-5.<sup>233</sup> Here, courts should employ a hypothetical bargaining analysis.<sup>234</sup>

Gubler compares the case of the Chief Marketing Officer (CMO) of the firm with that of its supplier. He argues that if a firm has sensitive information that does not need to be used for insider trading, it is easier to refuse to share or delay information with the supplier.<sup>235</sup> In contrast, the firm is hiring the CMO's knowledge and expertise for a variety of unspecified, and multifaceted problems that will persist over an undetermined period of time. In that context, it will be difficult to control the flow of information to the CMO.<sup>236</sup> Therefore, he advocates that courts should adopt default rules reflecting this result—that is to say, a default Reporting Covenant in intrafirm relationships, but not in arm's-length ones. In fact, this is what the Supreme Court essentially did in *O'Hagan*.<sup>237</sup>

He argues that although private parties could contract around the rule the Court announced in *O'Hagan*, they rarely do. This is evidence that this is in fact the private-welfare maximizing result.<sup>238</sup>

There may be a simpler explanation. Parties – O'Hagan and his law firm – may not have this possibility on their mind that O'Hagan may trade based on nonpublic information that is obtained from the law firm. The firm may be injured by such trading, and yet the firm may have difficulty discovering his trade when they entered into the contract. Consequently, the issue of whether O'Hagan should be permitted to trade on this information and the disclosure of such trading may not have been addressed in the contract.

Going beyond this hypothetical musing, one may offer more concrete evidence. If the employee trades on nonpublic information and the firm is injured as a result of such trading, the firm would be in a position to recover by compensatory remedies. However, it may be costly for the employer to detect such breach. The point of the Reporting Covenant is to make non-disclose

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<sup>233</sup> Gubler, *supra* note 191, at 570.

<sup>234</sup> See *supra* note 217 and accompanying text.

<sup>235</sup> Gubler, *supra* note 191, at 571.

<sup>236</sup> *Id.*

<sup>237</sup> *Id.* at 575.

<sup>238</sup> *Id.*

itself actionable by permitting the employer to seek extra-compensatory damages, in addition to the compensation for the loss suffered. This incentivizes the employee to actually report the underlying breach.<sup>239</sup>

This implies that once the government (or the SEC) initiates an action against an employee inside trader--can be read into the contract as a default rule--becomes aware of the underlying breach and also that of the Reporting Covenant. Since courts have not yet accepted the contractual fraud theory, the employer would not be able to claim extra-compensatory damages for the latter breach. However, it would certainly be entitled to recover compensatory damages, in case it suffers a loss as a result of such trading. Because this rarely happens, firms do not think they are harmed by their employees' insider trading. In this situation, there is no question of their intention to incorporate the Reporting Covenant.<sup>240</sup>

Also-- notwithstanding the scholarly disagreement over the costs and benefits of insider trading-- the practice has definitely earned a bad name in public perception. It has been suggested that our society's contempt for all forms of insider trading can be traced (at least in part) to moralism rather than morality. For example, one plausible explanation for our society's general contempt for insider trading is that it often reflects the vice of greed in such traders.<sup>241</sup> In this context, no firm would risk a severe loss to its reputation by incorporating a clause to permit the employees to contract around *O'Hagan* and by implication condoning the vice of greed.

#### D. Contractual Fraud Theory and Fiduciary Relationships

Gubler notes certain federalism concerns. If Rule 10b-5 is really about property, (fiduciary duty law or unjust enrichment), there is a concern about what effect incorporating these common law categories into federal law might have on the common law itself.<sup>242</sup> Liability under *O'Hagan* would attach not only to traditional fiduciary relationships but also to other fiduciary-like relationships as well. Moreover, the court would have to determine which obligations apply to such fiduciary-like relationships. Thus, the federalization of fiduciary duty law would likely affect not only the domain but also the content of fiduciary duty law. As a consequence, federal securities law would drive these determinations.<sup>243</sup>

These concerns seem to be equally at play where the contractual fraud theory is predicated on a fiduciary duty. Federal courts would need to make the determination as to the existence and the contours of such a duty in the context of insider trading. Thus, federalization of fiduciary duty law again looms large. As an alternative, federal courts could look at the relevant state law, in order to determine the content of fiduciary duty law that should apply in a particular case. This would lead to insider trading law being even more incoherent and unpredictable than what it already is.

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<sup>239</sup> *See Id.* at 567.

<sup>240</sup> *See supra* Section I.B for a discussion of cases where trading or tipping was probably in the interest of the issuer.

<sup>241</sup> John P. Anderson, *Greed, Envy, and the Criminalization of Insider Trading*, 2014 UTAH L. REV. 1, 48 (2014).

<sup>242</sup> Gubler, *supra* note 191, at 562.

<sup>243</sup> *Id.* at 562 (footnotes omitted).

Molk flags the issue of non-corporate insider trading. He notes that in the United States, for insider trading liability to attach, fiduciary duties are required between either insiders and their trading partners or between insiders and their provider of information.<sup>244</sup> In the last few years, new types of entities such as limited liability companies (LLCs) and limited partnerships (LPs) have emerged as the entities of choice.<sup>245</sup> “These alternative entities now dwarf the rate of new corporate formations.”<sup>246</sup>

Many states grant these entities “the power for complete elimination of core insiders’ state law fiduciary duties.”<sup>247</sup> “Publicly traded LLCs span a variety of industries.”<sup>248</sup> A few such prominent LLCs are TravelCenters, MGM Growth Properties, and Enterprise Product Partners.<sup>249</sup> The last-mentioned LLC has a market capitalization of \$63 billion.<sup>250</sup> Almost half—49%—publicly traded Delaware LLCs and LPs waived all three fiduciary duties of loyalty, care, and good faith.<sup>251</sup>

The contractual fraud theory predicated on fiduciary duty law is clearly inapplicable here. It may be possible to retrofit an implied contractual duty with its Reporting Covenant in the specific context of insider trading. However, this seems to run counter to the very rationale behind permitting such entities. One of the major reasons why these non-corporate entities have grown in popularity is the governance flexibility that they provide.<sup>252</sup> The law often grants these alternative entities “wide latitude to such entities in their contractual ability to modify or eliminate entirely the mandatory fiduciary duties traditionally owed by company insiders.”<sup>253</sup> Thus, it is a policy determination that such flexibility needs to be given to these entities. Bargaining analysis here would suggest that the contracting parties would have decided against incorporating any Reporting Covenant, making the contractual fraud theory inapplicable as a matter of contractual relationships as well. The alternative—simply postulating such a default rule by fiat—gain runs afoul of federalism concerns.

#### A. Fit With the Existing Law

Gubler claims that his theory does a better job in explaining the current state of the law.<sup>254</sup> He takes certain classes of persons who trade on non-public information and shows that the

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<sup>244</sup> Peter Molk, *Uncorporate Insider Trading*, 104 MINN. L. REV. 1693 (2020).

<sup>245</sup> *Id.* at 1694 (quoting Rodney D. Chrisman, *LLCs Are the New King of the Hill: An Empirical Study of the Number of New LLCs, Corporations, and LPs Formed in the United States Between 2004–2007 and How LLCs Were Taxed for Tax Years 2002–2006*, 15 FORDHAM J. CORP. & FIN. L. 459, 460 (2010)).

<sup>246</sup> *Id.*

<sup>247</sup> *Id.* at 1709.

<sup>248</sup> *Id.* at 1710-11.

<sup>249</sup> *Id.* at 1711.

<sup>250</sup> *Id.*

<sup>251</sup> *Id.* at 1713 (quoting Mohsen Manesh, *Contractual Freedom Under Delaware Alternative Entity Law: Evidence from Publicly Traded LPs and LLCs*, 37 J. CORP. L. 555, 575 (2012)).

<sup>252</sup> *See id.* at 1711-12.

<sup>253</sup> *Id.* at 1695.

<sup>254</sup> Gubler, *supra* note 191, at 542.

contractual fraud theory agrees with Supreme Court jurisprudence in terms of whether such persons are covered under the U.S. federal insider trading prohibition.<sup>255</sup>

Beyond this, it is important to see whether the theory squares up with the other aspects of U.S. insider trading law. The theory views the breach of the Reporting Covenant in *fraud-like* terms that gives rise to non-compensatory damages.<sup>256</sup> “After all, the failure to disclose information while under an obligation to do so sounds a lot like classic fraudulent concealment, which, as a species of fraud, triggers non-compensatory damages.”<sup>257</sup> In effect, the theory permits courts to give effect to an explicit Reporting Covenant or infer one implicitly based on bargaining analysis to enable a contracting party to seek extra-compensatory damages.

Under the contractual fraud theory, Rule 10b-5 allows parties to contract for extra-compensatory damages for a particular instance of the costly detection problem: insider trading.<sup>258</sup> In addition to the criminal penalties for insider trading, the civil penalties include treble damages.<sup>259</sup> In effect, Gubler treats the civil penalties as extra-compensatory damages. “Rule 10b-5 allows the contracting parties to have such contract provisions enforced by public enforcement authorities, another feature that helps address the costly detection problem by making it more likely that such breaches will be detected.”<sup>260</sup>

At this point, it is worthwhile to repeat the objections raised against public enforcement of the insider trading prohibitions in the context of the property rights theory.<sup>261</sup> Even if the securities regulator has a comparative advantage and so uniquely placed to enforce the prohibition (due to the costly detection problem), its enforcement actions ultimately benefit the private entities in protecting their enforcement rights. Thus, while the regulator may help the companies detect insider trading based on their proprietary information, the regulator ought to recover the cost of such enforcement from the companies as they are the beneficiaries of this. Since it may not be possible to determine the exact benefit derived by a particular company due to prevention of such trading in the first place, such recovery could be by way of a fee imposed on all listed companies in proportion to their market capitalization. Further, a company should be free to opt out of this regime—and avoid paying the fees—if, in its view, it is not harmed by insider trading in its securities.

Moreover, under the contractual fraud theory it would be more logical for the regulator to pass on the information regarding any insider trading to the source of the information and leave it to such source to seek compensatory and extra-compensatory damages for the underlying breach and the breach of the Reporting Covenant respectively. Once the regulatory oversight brings to light the underlying breach, the costly detection problem has been overcome. It should then be left to the contracting parties themselves to recover damages for the underlying breach as well as that

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<sup>255</sup> See *id.* at 591-93 (discussing different scenarios).

<sup>256</sup> See *id.* at 565.

<sup>257</sup> *Id.* at 567 (quoting RESTATEMENT (SECOND) OF TORTS § 551(1)–(2)(a) (AM. LAW INST. 1977)).

<sup>258</sup> See *id.* at 568.

<sup>259</sup> *Id.* at 568 n. 228 (quoting Donald C. Langevoort, *The Insider Trading Sanctions Act of 1984 and Its Effect on Existing Law*, 37 VAND. L. REV. 1273, 1278 (1984)).

<sup>260</sup> *Id.* at 568.

<sup>261</sup> See *supra* Section I.C.

of the Reporting Covenant. This is true in a pure private-welfare maximization context as it is a party to the contract that is harmed by the breach.

One may support public enforcement of insider trading law all the way down when a public-welfare maximization concern is at play; however, this position can be supported independent of the plausibility of the contractual fraud theory. In fact, as discussed above, the contractual fraud theory arguably becomes superfluous in this context.<sup>262</sup>

Finally, Section 20A of the Securities Exchange Act (SEA) grants a private right of action to the contemporaneous traders against the inside trader. Thus, such traders may sue the insider trader for damages.<sup>263</sup> Under the contractual fraud theory, in the context of private-welfare argument, it should logically be the source of information who should have a right of recovery (and also the right to seek extra-compensatory damages for the breach of the Reporting Covenant). In the context of the public-welfare argument, since it focuses on the market harms of insider trading, it would be logical to grant the right of recovery to the regulator on behalf of the securities market and credit any recovery to a common fund.<sup>264</sup>

Finally, it is difficult to square the criminal penalties provided under insider trading law with the contractual fraud theory. This theory essentially departs from common law by permitting the parties to contract for fraud liability in the context of insider trading and allows the defrauded party to seek extra-compensatory damages for the breach of the Reporting Covenant. Criminal penalties are at odds with the scheme of this theory.

#### E. The Takeaway

To sum up, the contracting fraud theory plausibly explains certain specific aspects of current U.S. law. However, it seems that the theory becomes rather superfluous in the context of its public-welfare maximization rationale. In the context of private-welfare argument, it is not tenable to support the argument that the judiciary may read a default Reporting Covenant in intrafirm relationships as a general rule. The theory also raises federalization concerns in the context of the exact scope of fiduciary relationships and the newly emerged non-corporate entities. Finally, the framework of civil and criminal penalties under the current law in the United States is at odds with the underlying logic of the contractual fraud theory.

### V. CORRUPTION THEORY

Kim offers a new theory of insider trading law—that insider trading should be viewed as a form of private corruption.<sup>265</sup> She begins with the definition of public corruption in the political

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<sup>262</sup> See *supra* Section IV.B.

<sup>263</sup> Stuart J. Kaswell, *An Insider's View of the Insider Trading and Securities Fraud Enforcement Act of 1988*, 45 BUS. LAW. 145, 166 (1989).

<sup>264</sup> See Securities and Exchange Board of India Act, 1992, §11(5). The SEBI Act provides that any recovery made on account of disgorgement shall be credited to the Investor Protection and Education Fund established by SEBI and such amount shall be utilized by SEBI in accordance with the regulations made under SEBI Act.

<sup>265</sup> Kim, *supra* note 75, at 951.

science and political economy literatures as the “use of public office for private gain.”<sup>266</sup> She further defines private gain as “personal gain that is supererogatory—neither part of the explicit compensation allocated to the public official nor *culturally* viewed as an acceptable or unavoidable perquisite of the role.”<sup>267</sup>

Building on this, she defines private corruption as the use of one’s entrusted position for self-regarding gain.<sup>268</sup> In analogy with private gain, the term self-regarding gain refers to gain that is supererogatory—neither part of the explicit compensation allocated to the individual, nor culturally viewed as an acceptable or unavoidable perquisite of the role.<sup>269</sup>

Kim identifies three costs of private corruption and applies those to insider trading. First, there is the temptation cost.<sup>270</sup> Insider trading may distort managerial incentives and thereby misallocate corporate financial resources. Managers may be tempted not to enhance corporate value, but to reap self-regarding gains generated by inside trades.<sup>271</sup>

Second, there are distraction costs. Insider trading opportunities will consume at least some of the manager’s time that would otherwise be devoted to promoting the corporate interest. In order to take advantage of these opportunities, the corporate insider trader will have to research, plan, and execute his insider trading strategies.<sup>272</sup>

Finally, there are legitimacy costs.<sup>273</sup> If investors come to see the securities markets as a rigged game—one that seems by design to systematically disadvantage ordinary investors—they could respond by discounting the amount that they are willing to pay for all securities, thereby raising the cost of capital. But without knowing the volume and frequency of insider trading, setting the proper discount would be nearly impossible. The perception of rampant insider trading might also discourage investors from trading as much or as often, or may even catalyze exit en masse. Either response would weaken the depth and liquidity of securities markets, which would decrease market efficiency.<sup>274</sup>

It should be noted that Kim accepts the role that culture plays in the notion of corruption. According to her, it is true that relying on cultural views is precarious because they are shifting, vague, contradictory, and hard to measure. Given such difficulties, it is tempting to define “private gain” more narrowly, for example, as gain that breaches some formal rule or law. But this alternative definition would buy clarity at the cost of accuracy because corruption undeniably incorporates a cultural dimension.<sup>275</sup>

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<sup>266</sup> *Id.* at 952.

<sup>267</sup> *Id.* at 953 (footnote omitted).

<sup>268</sup> *Id.* at 957 (footnote omitted).

<sup>269</sup> *Id.* at 956.

<sup>270</sup> *Id.* at 961.

<sup>271</sup> *Id.* at 962.

<sup>272</sup> *Id.* at 964 (footnote omitted).

<sup>273</sup> *Id.*

<sup>274</sup> *Id.* at 967 (footnotes omitted).

<sup>275</sup> *Id.* at 953 (footnotes omitted).

This implies that the issues of whether, and which forms of, insider trading must be prohibited vary from culture to culture. In fact, she cites empirical evidence in behavioural finance that connects corruption more generally to insider trading.<sup>276</sup> In a survey, subjects were asked to read and evaluate various vignettes describing activity ranging from clearly illegal under federal insider trading law to clearly innocent. Strong correlations were found between the high levels of perceived public sector corruption in the country and the tendency to view insider trading as acceptable. The more corrupt that citizens judged their country, the less objectionable were the inside trades and vice versa.<sup>277</sup>

Going by Kim's definition of private corruption, the logical implication is that in those jurisdictions where insider trading is deemed to be acceptable, it does not amount to private corruption. Therefore, the private corruption theory does not support an insider trading prohibition in such jurisdictions.

If this is correct, the recent global trend towards the adoption of insider trading laws may be explained by regulatory ritualism.<sup>278</sup> Anderson discusses how ritualism may have played out in the arena of insider trading as well as human rights law.<sup>279</sup>

I have argued elsewhere that the Indian prohibition regime is beset with serious doctrinal discontinuity and incoherence.<sup>280</sup> Huang argues that for the Chinese insider trading prohibition to be effective, it is necessary to clarify and streamline its theoretical basis.<sup>281</sup> This may be because of the fact that countries such as India and China have imported the concept of the insider trading prohibition from the United States without paying close attention to the desirability of such a prohibition and the contours of the prohibition regime as suited to their specific situation.

Guttentag discusses the recent Chris Collins story. He attempts to make sense of Collins' seemingly inexplicable behavior by turning to the work of criminologists to identify distinctive features of the crime of insider trading.<sup>282</sup> Even the desire to pursue one's own self-interest is a product of cultural factors rather than simply an innate feature of human nature.<sup>283</sup> Recognizing the socially constructed nature of motivation raises the possibility that someone engaging in insider trading, perhaps in providing a tip, might be motivated more by a desire to enhance their reputation and social standing than the hope of receiving a pecuniary gain from the tip.<sup>284</sup>

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<sup>276</sup> *Id.* at 960 (footnote omitted).

<sup>277</sup> *Id.* at 960 (footnote omitted).

<sup>278</sup> ANDERSON, *supra* note 1, at 137.

<sup>279</sup> *See generally Id.* at 133-37.

<sup>280</sup> Mangesh Patwardhan, *The Insider Trading Prohibition in India— In Search of a Doctrine*, 14(2) INT'L & COMP. CORP. L.J. 38 (2020).

<sup>281</sup> Hui Huang, *The Regulation of Insider Trading in China: Law and Enforcement*, in RESEARCH HANDBOOK ON INSIDER TRADING 303, 316 (Stephen M. Bainbridge ed., 2013).

<sup>282</sup> Michael D. Guttentag, "Huh?" *Insider Trading: The Chris Collins Story*, 15 TENN. J.L. & POL'Y 95, 95-96 (2020).

<sup>283</sup> *Id.* at 107 (quoting James William Coleman, *Motivation and Opportunity: Understanding the Causes of White-Collar Crime*, in WHITECOLLAR CRIME: CLASSIC AND CONTEMPORARY VIEWS 360, 363 (Gilbert Geis et al. eds., 3d ed. 1995) [hereinafter, Coleman, *Motivation and Opportunity*]).

<sup>284</sup> *Id.* at 107-8.

Further, the necessity of neutralizing ethical constraints is an element of motivation for committing a white-collar crime. Neutralization of ethical concerns is important because white-collar criminals are likely to accept many aspects of the existing social order as valid. One of the common neutralization techniques is believing that ill-gotten gains are actually earned or deserved.<sup>285</sup>

In terms of motivation, there are several rationalizations that can be surmised from the record that Collins may have relied on to neutralize ethical concerns.<sup>286</sup> Collins viewed himself as something of a savior of Innate. At one point he stated that “[w]ithout me, [Innate] would have gone down.”<sup>287</sup> Collins might have believed that because of his central role in ensuring Innate could run a clinical trial on a potential treatment for SPMS that he was entitled to a privileged position when the time came for sharing losses resulting from the failed clinical trial.<sup>288</sup> While Collins may have relied on this as a rationalization technique, it may well be seen as an acceptable behaviour in another culture.

The upshot here is that each jurisdiction ought to begin from first principles and determine whether insider trading should be prohibited in the first place, and if so, what should be the scope and contours of its prohibition regime in the backdrop of its own specific cultural milieu. In that case, it is not possible to offer a general, universal argument in support of enacting the prohibition and its scope.

There also seems to be some tension between the cultural dimension present in the corruption theory and the analysis of the economic costs of insider trading—viewed as a form of private corruption—at least in the case of temptation costs and distraction costs. In the case of legitimacy costs, whether the perception of rampant insider trading actually discourages investors from trading as much or as often—with the consequent adverse impact on liquidity and the cost of capital—may be at least partially determined by whether insider trading is perceived to be culturally acceptable.

However, the other two costs seem to be culturally agnostic. The distortion of managerial incentives and the diversion of managerial time, in the context of insider trading opportunities, would happen regardless of whether insider trading is deemed to be acceptable in that particular culture.

As for temptation costs, Kim argues that managers can accelerate receipt of revenue, change depreciation strategy, or alter dividend payments in an attempt to affect share prices and insider returns. Alternatively, they may direct the company to pursue projects that are easier to conceal from public scrutiny or structure transactions in such a manner as to exploit informational advantages in trading stock. They may push the firm into riskier projects or manipulate the timing and content of information release in a manner that will generate more price volatility than

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<sup>285</sup> *Id.* at 108 (quoting Coleman, *Motivation and Opportunity*, *supra* note 283, at 368).

<sup>286</sup> *Id.* at 113

<sup>287</sup> *Id.* (quoting Transcript of Interview of Representative Collins, Review No. 17-3509\_Exhibits-Final Redacted\_Part 1, at 16 (2017)).

<sup>288</sup> *Id.*

otherwise.<sup>289</sup> Insider trading opportunities also have distraction costs as these will consume at least some of the manager's time that would otherwise be devoted to promoting the corporate interest.<sup>290</sup> These concerns, if valid, would be clearly relevant regardless of the cultural attitude to insider trading.

Kim cites international evidence for temptation and distraction costs. One such study found that more stringent insider trading laws and enforcement were positively associated with higher corporate values for the sample firms. This finding is consistent with the hypothesis that stricter insider trading regimes help reduce the controlling shareholder's incentive to divert corporate value through insider trading.<sup>291</sup> The implication here is that a prohibition on insider trading, predicated on these two costs, can in fact be supported independent of whether insider trading is seen as a self-regarding gain in a particular culture and therefore independent of the corruption theory itself.

Kim considers some hard cases and analyses those through the lens of the corruption theory. One such case is *SEC v. Dorozhko*.<sup>292</sup> Here, the question presented was whether a hacker's infiltration of a company's server and his subsequent trading on the extracted financial information violated federal insider trading law.<sup>293</sup> Kim suggests that under the corruption theory, Dorozhko would not be liable for insider trading.<sup>294</sup> She notes that it might be helpful to go beyond the primary question of asking whether the act fits the formal analytic definition of corruption to a secondary exploration of whether the act generates those costs tightly associated with corruption: temptation, distraction, and legitimacy costs.<sup>295</sup>

Under the primary definitional analysis, hacking and trading does not fit the definition of corruption. A secondary analysis employing corruption's signature costs does not give a strong reason to revise this initial judgment. Accordingly, under the corruption theory, the Second Circuit's opinion in *Dorozhko* goes too far in classifying hacking and trading as a violation of federal insider trading laws.<sup>296</sup>

Another case is *SEC v. Cuban*.<sup>297</sup> According to SEC allegations, in 2004 the CEO of Mamma.com contacted Mark Cuban, who held 6.3 percent of Mamma.com's outstanding shares, to invite him to participate in a forthcoming PIPE financing.<sup>298</sup> After first obtaining Cuban's promise to keep such information confidential, the CEO disclosed the details of the proposed

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<sup>289</sup> Kim, *supra* note 75, at 962 (footnotes omitted).

<sup>290</sup> *Id.* at 964.

<sup>291</sup> *Id.* at 968 (footnote omitted).

<sup>292</sup> *SEC v. Dorozhko*, 606 F. Supp. 2d 321 (S.D.N.Y. 2008) (*Dorozhko I*), *vacated*, *SEC v. Dorozhko*, 574 F.3d 42 (2d Cir. 2009) (*Dorozhko II*).

<sup>293</sup> *Dorozhko II*, 574 F.3d at 42.

<sup>294</sup> Kim, *supra* note 75, at 998.

<sup>295</sup> *Id.* at 998-99.

<sup>296</sup> *Id.* at 1000.

<sup>297</sup> *SEC v. Cuban (Cuban I)*, 634 F. Supp. 2d 713 (N.D. Tex. 2009), *vacated*, *SEC v. Cuban (Cuban II)*, 620 F.3d 551 (5th Cir. 2010).

<sup>298</sup> Kim, *supra* note 75, at 1000-01 (footnote omitted). A PIPE (private investment in public equity) transaction is a private placement followed shortly by a registered offering that enables PIPE investors to resell their shares to the public.

transaction. Cuban immediately protested on the ground that the financing would dilute the value of his existing shares. He added: “Well, now I’m screwed. I can’t sell.” But he dumped all of his shares before the PIPE deal was publicly announced and avoided a loss of more than \$750,000.<sup>299</sup> Again, based on the secondary analysis, Kim concludes that it is neither to identify any temptation or distraction costs nor any overwhelming concerns regarding legitimacy costs.<sup>300</sup>

The implication here is that for deciding a case based on the corruption theory, it is imperative for the judiciary to go beyond the mere formal definition of corruption and engage in a secondary analysis regarding any concerns present in that particular case with reference to temptation, distraction, and legitimacy costs and attach liability only if these are overwhelmingly present.

As Kim mentions, we have relied on the judiciary to adapt the law forward with each case through acts of interpretation, extension, and innovation. But without an adequate theory of what is wrong with insider trading, that common-law-like development has reached a crisis with circuits on the cusp of explicit disagreement and some courts initiating a soft rebellion against what appeared to be doctrinal orthodoxy.<sup>301</sup> It is unclear whether the judiciary is well-equipped to engage in the kind of secondary analysis that is required by the corruption theory of the three costs of insider trading on a case-to-case basis. As a result, we may see even more disagreement among different courts and greater uncertainty surrounding insider trading law.

To sum up, under the corruption theory the question of whether insider trading must be prohibited and, if so, what should be the contours of the prohibition becomes a culture-specific issue. It is not possible to offer a universal argument in support of enacting the prohibition and its precise scope. This lends support to the view that the enactment of insider trading prohibition in several jurisdictions may be nothing more than an exercise in regulatory ritualism. Further, there seems to be some tension between the cultural dimension present in the corruption theory and the analysis of the economic costs of insider trading, viewed as a form of private corruption, at least in the case of temptation and distraction costs. The adverse impact of these two, the distortion of managerial incentives and the diversion of managerial time, is arguably culturally agnostic. The implication is that a prohibition on insider trading, predicated on these two costs, can in fact be supported without an appeal to the corruption theory, making the theory superfluous. Finally, courts would need to go beyond the formal definition of corruption and engage in a secondary analysis on a case-by-case basis to determine if significant concerns regarding one or more of the three costs of corruption are implicated. This would arguably engender even more disagreement among different courts and greater uncertainty surrounding insider trading law.

## VI. DUTY TO HOLD LOST OR STOLEN INFORMATION IN CONFIDENCE

Coffee explores yet another proposal. He considers the question as to what is the duty that the tippee might breach when the tippee is not a fiduciary (or the tippee of a fiduciary) but has

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<sup>299</sup> *Id.* at 1001 (footnote omitted).

<sup>300</sup> *See generally id.* at 1002.

<sup>301</sup> *Id.* at 1008.

come into possession of material non-public information. Coffee's proposal here seeks to cover two specific cases.<sup>302</sup>

First, when the information is stolen, but taken without deception, the law could be viewed as imposing a constructive trust on such stolen property that holds the thief accountable for his ill-gotten profits.<sup>303</sup> For instance, if a thief who steals a briefcase with documents that contain material, non-public information were to sell this briefcase and its contents, the common law would likely subject his ill-gotten gains to a constructive or implied trust.<sup>304</sup>

When the information has been obtained deliberately by someone who is "stalking" the source of the information, equitable considerations dictate that the law should impose a constructive trust on the stolen property to prevent these more predatory actors from realizing an ill-gotten gain.<sup>305</sup> One such example is a cab driver who waits outside the offices of a well-known Manhattan law firm late at night, hoping to pick up mergers and acquisitions lawyers who then discuss pending transactions on their cell phones on the drive home. Further, the cab driver has done this repeatedly and profited handsomely.<sup>306</sup>

Additionally, even when the information is leaked inadvertently, as in the overheard conversation in the elevator, the law could treat the recipient of the information as a "finder" who has come into possession of lost property and therefore has an obligation to act as a bailee to protect this property by not tipping or trading on it.<sup>307</sup> Similarly, the cab driver may simply happen to drive a mergers and acquisitions lawyer who discusses a pending transaction on her cell phone. In either case, the information has clearly not been stolen.

Coffee acknowledges that few courts could be willing to go so far on their own. But they might be induced to accept and enforce SEC rules articulating such a duty.<sup>308</sup> He terms his proposed rule "Rule 10b5-3."<sup>309</sup>

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<sup>302</sup> Coffee, *supra* note 136, at 300.

<sup>303</sup> *Id.* Coffee notes in the footnote that as a technical matter, the appropriate remedy may be an equitable accounting, rather than a constructive trust. *Id.* at 300 n. 46.

<sup>304</sup> *Id.* at 302-3.

<sup>305</sup> *See id.* at 302.

<sup>306</sup> *Id.* at 293.

<sup>307</sup> *Id.* at 300-01.

<sup>308</sup> *Id.* at 303.

<sup>309</sup> *Id.* at 304. It is captioned "Duty Not to Trade on Inadvertent or Unauthorized Releases of Material Information." It reads: (a) Whenever a person receives or obtains material nonpublic information from a source that owns or has the right to control the release of such information and such recipient either (i) knows that the release of such information has not been lawfully authorized by the party entitled to possession or control over such information, or (ii) is aware of a reasonable possibility that such release was not lawfully authorized, such person may not (1) purchase or sell any security, or any security-based swap agreement, whose value is likely to be affected by such information, or (2) communicate such information to other persons under circumstances which make it reasonably foreseeable that they will trade on such information, until in each case such information has been publicly released. (b) As used in this rule, the phrase "lawfully authorized," when used with respect to the release of information, shall not include, without limitation, information that is released (i) inadvertently or by mistake; (ii) as the result of a trick, subterfuge, false representation, or other misappropriation; (iii) as a gift, favor or other benefit, either from or to the information recipient; or (iv) for a specific, limited purpose to a customer, supplier, lender, business associate, or agent of any thereof, but was not intended to be generally released.

This is surely a novel approach, as it covers cases where the recipient of the information has no pre-existing duty of trust and confidence to the source of the information, nor does she employ any deception in gaining access to such information.

However, if the fact that such information was stolen or found is to be taken as the basis for an insider trading prohibition, objections can be raised against the proposal. First, as Coffee himself states, at common law and by statute in many jurisdictions, one who finds lost property (like a diamond ring left by mistake in a washroom) is typically under a duty to restore it to the true owner.<sup>310</sup> Even a good faith purchaser of the stolen property would often have to restore it to the true owner.<sup>311</sup> In case of non-public information, it is not even clear what restoring such property to the true owner means.

In the alternative, the remedy of equitable accounting may be invoked.<sup>312</sup> In that case, the thief or the finder would have an obligation to account for any profits made by trading on such information to the principal.

Coffee points out that in *Carpenter v. United States*, the US Supreme Court held that confidential information acquired or compiled by a corporation in the course and conduct of its business is a species of property to which the corporation has the exclusive right and benefit and which a court of equity will protect through the injunctive process or other appropriate remedy.<sup>313</sup>

Therefore, the corporation should be fully entitled to benefit from any material, non-public information in its possession. This consideration also shows that any framework based on stolen or found information cannot lead to an insider trading prohibition. The owner of the information would be fully entitled to use it for securities trading and keep any profits she makes.

Coffee further states that his proposed Rule would bar the finder of such information from either trading or tipping others, but only until the information was publicly released.<sup>314</sup>

This argument raises another issue. The issue here is whether mere authorized release of the information may be equated with the authorization to trade on it. If I display my gold chain openly at Marine Drive in Mumbai or Times Square in New York it can hardly be inferred that I have now permitted others to take it and walk away.<sup>315</sup> Release of information is just that, others are now aware of it in the same way they would be aware of my gold chain. The owner of the

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<sup>310</sup> *Id.* at 301.

<sup>311</sup> *Id.* at 303.

<sup>312</sup> *See supra* note 303.

<sup>313</sup> *Carpenter v. United States*, 484 U.S. 19, 26 (1987) (quoting 3 William Meade Fletcher et al., *Fletcher Cyclopaedia of the Law of Private Corporations* § 857.10 (rev. ed. 1986)).

<sup>314</sup> Coffee, *supra* note 136, at 305. Even though he does not mention “thief,” the same rule would be applicable, since his proposed Rule and its prohibition on trading only turns on whether the release of information is “lawfully authorized.” Thus, once the information is lawfully released, the person who earlier “stole” it would be entitled to trade on it as well, as the information gets “unstolen.”

<sup>315</sup> Presumably, mere display would not be tantamount to “abandoning” it, as under Coffee’s formulation here, such abandonment of information would amount to authorizing others to trade on it. *See infra* note 317 and accompanying text. For example, I could openly announce that this display is meant to flaunt my possession and I intend to keep my ownership of the chain intact!

information should similarly be able to release the information without intending to authorize anyone to trade on it.

Thus, the fundamental flaw of this theory seems to be that it just cannot be connected to the real issue of insider trading, which is prohibiting trading on material non-public information. In the case of information not lawfully authorized to be released, any person who steals or finds it is not prohibited from trading on it. She must restore it or account for the profits made out of such trading to the true owner. Further, the owner of the information would be fully entitled to derive a benefit by trading on that. Even after the information is lawfully released, the release itself cannot be held to constitute an authorization for others to trade on it unless it is argued that such release itself constitutes the owner abandoning her exclusive right over such information, which usually is not the case.

This fundamental flaw derives from the fact this theory has a basic disconnect with the core mandate of securities law which focuses on the development of the securities market and prevention of harm to the investors or the marketplace. This proposal is essentially a variation on the property rights theory discussed above.<sup>316</sup> It focuses on the manner in which a person acquired information from the source of such information. As is to be expected, there is no reason why focusing on this inquiry should have any connection with the totally distinct issue of the impact of the acquirer trading on such information in the marketplace. This is because the source of the information, the investors in general, and the counterparty in particular are often distinct and unconnected entities.

Two examples may help elucidate this point further. First, Coffee states that a “line would necessarily need to be drawn in such a rule between information that was truly ‘lost’ and information that was ‘abandoned’ through reckless mishandling.”<sup>317</sup> Such distinctions would be totally irrelevant to the counterparty, to the trade, or the investors in general. It makes no difference to them whether the material non-public information was stolen or found by the trader or abandoned by the owner. But the scope and the coverage of the rule crucially depends on such distinction.

Second, in *O’Hagan*, Justice Thomas noted that the SEC’s “construction of the relevant language in § 10(b), and the incoherence of that construction, becomes evident as the majority attempts to describe why the fraudulent theft of information falls under the Commission’s misappropriation theory, but the fraudulent theft of money does not.”<sup>318</sup> The logic of that argument carries over here as well with even greater force. If a person steals or finds money and then uses it for securities trading, she is accountable to the owner of that money for any profits made. As we have seen, exactly the same is true if the person steals or finds material non-public information and uses it for trading.

Therefore, in this case, it can be seen even more clearly that this theory is agnostic in terms of the precise nature of the resource that is involved. In fact, it can be stated as a general principle

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<sup>316</sup> See *supra* Section I.

<sup>317</sup> Coffee, *supra* note 136, at 303.

<sup>318</sup> *United States v. O’Hagan*, 521 U.S. 642, 681 (Thomas, J., concurring in the judgment in part and dissenting in part).

that a thief or finder of any resource is liable to the owner of the resource to account for any profits or gains the thief or finder makes from using the resource for securities trading.

Thus, any insider trading prohibition based on this theory is two-faced and ambiguous. It purportedly addresses an issue, trading on material non-public information, perceived to be harmful to the investors, the securities markets, or both. At the same time, it seeks to address it by focusing on an entirely different inquiry – the purported rights of the owner of such information and the remedies available to such owner in the event of a violation of her rights.

Finally, this theory also undercuts the rationale for the public enforcement of the insider trading prohibition. This objection is the same as raised in the context of the property rights theory. At the very least, the securities regulator should recover the cost of such enforcement from its beneficiaries. Even better, the securities regulator should completely stay out of the enforcement of an insider trading prohibition (if it is to be based on this theory) and leave the issue of protecting against the misuse of stolen or found information to owners of such information. The resources this frees can be productively employed to address other issues related to the core concerns of securities regulation.<sup>319</sup>

To sum up, the attempt to predicate the insider trading prohibition on the fact that trading took place on stolen or lost information leads to incoherent results. Further, such a prohibition does not square with the core mandate of securities law. There is no reason why such a prohibition should be located in securities law, nor does it offer any rationale for its public enforcement by the securities regulator.

## VII. INSIDER TRADING AS AN AGENCY LAW ISSUE

Coffee offers one final proposal as a basis for the insider trading prohibition. This is the law of agency. For this, he relies on the Restatement (Second) of the law of Agency.

Comment C to Section 388 of the Restatement (Second) of the law of Agency reads:

Use of confidential information. An agent who acquires confidential information in the course of his employment or in violation of his duties has a duty . . . to account for any profits made by the use of such information, although this does not harm the principal.<sup>320</sup>

Further, the commentary to this section specifically applies this rule to the context of insider trading.<sup>321</sup> Under Section 388, no fiduciary breach or act of deception is necessary. It is sufficient that the agent acquires the "confidential information in the course of his . . . duties." Thus, "if a cab driver is considered an agent to his passenger, then . . . he may not profit, as agent, from confidential information received from the passenger, as principal."<sup>322</sup> This is regardless of

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<sup>319</sup> See *supra* Section I.C.

<sup>320</sup> See RESTATEMENT (SECOND) OF AGENCY § 388 cmt. c (1958) (citation omitted). Section 395 then forbids the agent to tip others. See *id.* § 395; see also RESTATEMENT (THIRD) OF AGENCY § 8.05 cmt. c (2006) (using same language).

<sup>321</sup> Coffee, *supra* note 136, at 309.

<sup>322</sup> *Id.* at 310 (footnote omitted).

whether the driver had any fiduciary duty towards the passengers or whether the passengers were harmed by her trading.

However, as Coffee himself mentions, “issues could arise both as to whether the cab driver was an agent (as opposed to an independent contractor) or whether he knew the information was confidential.”<sup>323</sup> However, he says that, at least in the case of the stalker driver, the prosecutors have another theory, based on agency law, at their disposal.<sup>324</sup>

This seems to be problematic. Whether the driver happened to get mergers and acquisitions lawyers as his passengers or he stalked them by purposely waiting outside their office cannot have any bearing on whether the lawyer is their agent or not. In either case, the service he is required to perform and the consideration for it are the same. His stalking only shows that he had an ulterior motive which is more about his intentions rather than the nature of the relationship itself.

Again, notwithstanding the application of this Section to insider trading, the pertinent issue is whether an insider trading prohibition can actually be read into that. Again, this Section only provides for the agent accounting for any profits made out of the use of such information. Therefore, the principal would be entitled to the profits made by such agent. In fact, Coffee approvingly quotes the New York Court of Appeals opinion in *Diamond v. Oreamuno*.<sup>325</sup> However, the court there also noted that profits made by the agent in stock transactions based on such inside information “are held in constructive trust for the principal.”<sup>326</sup>

Therefore, in the cab driver example the driver would be required to account for the profits made to the mergers and acquisitions lawyers, who are his principals. The lawyers themselves would probably be treated as agents of their employer, who in turn would be the agent of the acquiring, or target, company that hired it.

Similarly, Section 215 of the Indian Contract Act, 1872, also provides that when an agent deals on his own account in the business of agency without the principal's consent, the principal may repudiate the transaction. Trading in securities may or may not be the business for which the agency relationship has been entered into all cases. Section 216 authorizes the principal to claim from the agent any benefit which may have resulted to him from such transaction.<sup>327</sup>

Thus, in both jurisdictions, it is the prevention of harm to the principal or equitable considerations (such as depriving the agent of any gains that he may make by use of such confidential information and handing these over to the principal) that underlie this legal position. The provisions are focused on maintaining the integrity of the agency relationship and nothing much to do with the concerns related to the securities market.

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<sup>323</sup> *Id.* (footnote omitted).

<sup>324</sup> *Id.* (footnote omitted).

<sup>325</sup> *Diamond v. Oreamuno*, 248 N.E.2d 910 (N.Y. 1969).

<sup>326</sup> *Id.* at 914.

<sup>327</sup> Since Comment c to Section 388 of the Restatement (Second) of the law of Agency in the US specifically speaks to the use of confidential information, unlike in the case of *O'Hagan* misappropriation or the proposal based on the duty to hold lost or stolen information in confidence, it does not carry over to the use of other resources such as money or computer. However, the Indian version of the prohibition based on the law of agency would so carry over, in which case the same objection voiced by Justice Thomas in *O'Hagan* would apply.

As such, this theory has a basic disconnect with securities law. If the driver trades on such information and accounts for the profits made to her immediate principal or the ultimate principal in the chain, it makes no difference to the counterparty, to the trade, or the investors in the market. This is yet another instance where the law aimed at protecting the interests of one entity, the principal in an agency relationship, is sought to be retrofitted to securities law whose basic mandate is to facilitate the development of securities markets and protect the interests of the investors. Again, the principal and the investors are two distinct parties, wholly unconnected to each other. This again results in a poor doctrinal fit.

Finally, this raises the issue whether the principal can authorize her agent to trade on such information and allow her to keep the profits. To take one example, if the takeover target is the ultimate principal and it is interested in fending off the offer from the acquiring company, it may even be benefitted if persons privy to the takeover attempt trade the company's shares and drive up the price. In that case, it may actually contract with its agents to so trade and permit them to keep the profits. The profits that the agents keep are simply the consideration they receive for performing the service.

The same is true with warehousing, where the acquiring company as the principal may tip off a few persons to buy the shares of the target company. Such persons may make a profit when they ultimately tender their shares to the acquirer. The acquirer may allow them to retain the profit as consideration for the services rendered by them.<sup>328</sup>

Thus, the accounting of profits argument does not imply a prohibition on trading based on confidential information acquired from the principal. If such trading benefits the principal in any way, profits made on such trading can in fact be used as a compensation to the agent for the services provided.

In this view, Manne's argument that managerial insider trading can act as an effective compensation scheme also comes into play. Manne argued in favour of this as a tool to encourage managerial innovation that would ultimately create value for the shareholders.<sup>329</sup>

Viewing insider trading as an agency law issue adds another gloss to this argument. Jensen and Meckling, in their seminal paper, gave an economic analysis of the agency relationship. They observed that the agent will not always act in the best interests of the principal. The principal can limit divergences from her interest by establishing appropriate incentives for the agent and by incurring monitoring costs designed to limit the aberrant activities of the agent. In addition, the owner has an incentive to minimize managerial costs so as to maximize her own wealth.<sup>330</sup>

Applied in the context of a company, this implies that the company as the principal would seek to establish a mechanism so as to make sure that the managers act in the best interests of the company. This could be done by seeking to align the managers' interests with those of the

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<sup>328</sup> See *supra* note 45 and accompanying text.

<sup>329</sup> See Manne, *supra* note 11, at 936.

<sup>330</sup> See generally Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

shareholders. Permitting the managers to trade on confidential information that creates value for the company could be one such incentive. This would also be efficient in terms of minimizing managerial cost, as the managers' reward from insider trading comes from the market and not from the company.

Of course, a number of objections can be raised against holding that insider trading is an effective managerial compensation scheme. Kripke notes the "attribution problem" in this context. It is not easy to allocate corporate success between different causes, such as pure luck and genuine entrepreneurial initiative by an executive or a group of executives. Even if that could somehow be done, determining the amount of optimal reward would still be challenging.<sup>331</sup>

Even leaving aside the problem mentioned above, it would be difficult to ensure that only those executives who are innovators would be able to reap the benefits by way of insider trading in proportion to their contribution to the enhanced value. Typically, in a modern organization, information flows through multiple levels and many more employees unrelated to the innovation often come into possession of such information. Therefore, this problem is real.

Finally, if insider trading occurs in the context of a new product being developed or the company winning a major lawsuit, the enhancement in the corporate value may at least plausibly be attributed to the product development team or the legal team respectively. Quite often, insider trading occurs in the context of inside information which is not generated as a result of any innovation by the information generator. To take one example, the chief financial officer (CFO) of a company would know that the quarterly profits of the company are far above the market estimates. There is no plausible reason to attribute the same to the CFO. In that context, it is hard to see why the CFO should be entitled to use this information to her advantage by engaging in insider trading activity.

Those objections are fairly robust and persuasive. Thus, the focus of this analysis is not to support Manne's argument. However, if insider trading is seen as an agency issue, it could lend some respectability to the argument that companies should be free to opt out of the insider trading prohibition regime.

For example, a company may argue that it can put in place a monitoring mechanism so as to avoid the problems associated with permitting the managers to trade on confidential information, while keeping the upside-alignment of their interests with those of their principal-shareholders. This could be a powerful argument since it purportedly shows that such insider trading actually benefits the shareholders of the company.

To sum up, framing insider trading as an agency law issue does not imply a prohibition on insider trading, only the requirement that the agent must account for any profits made to the principal. Since the duty to account for profits is based on preventing harm to the principal, or on equitable considerations, the principal should be free to authorize such trading if it does not harm or benefit her. In particular, the profits made by the agent on such trading can be used as a

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<sup>331</sup> See Homer Kripke, *Manne's Insider Trading Thesis and Other Failures of Conservative Economics*, 4 CATO J. 945, 946 (1985).

compensation to the agent for the services rendered. It also seems to lend respectability to Manne's argument for treating insider trading as an effective managerial compensation scheme.

Again, a major problem with this proposal is its basic disconnect with the securities market. The focus of the rule, to maintain the integrity of the agency relationship, and the concerns of securities law, development of the market and protection of the investors' interest, are totally distinct. Further, the two constituencies are wholly unconnected to each other and do not necessarily have co-extensive interests.

#### VIII. SUMMARY AND CONCLUSION

The unsettled state of insider trading law is partly attributable to the fact that there is a fundamental disagreement over the necessity of and the appropriate rationale behind the insider trading prohibition. In view of this, it is important to offer a sound theoretical foundation for the prohibition. As the first step, it is imperative to attempt a nuanced analysis of the insider trading theories as enunciated by the US Courts and legal scholars. In an earlier article, I offered a critique of the judge-made insider trading prohibition theories in the United States. Here, I offer a critique of the major strands of the insider trading prohibition theories proposed by legal scholars.

There is an influential school of thought that treats insider trading as essentially a property rights issue. The basic policy justification for casting the issue in this way is that giving the companies property rights in their proprietary information would encourage them to produce socially valuable information. However, this argument is rather weak as the companies anyway produce such information to further their business interests. The fact that someone else may also use it for insider trading is not a real deterrent factor. This theory also implies that the companies should be able to trade based on the information that they own, or authorize others to trade on it if it is in their interest. The adoption of this theory would also undercut the current disclosure-based regime in securities law, as presumably the companies should be able to decide whether and to what extent they wish to disclose information to the market. This theory also implies that the insider trading prohibition is basically a matter of private enforcement by the companies whose property rights have been infringed.

Another approach is to base the prohibition on the deceptive acquisition of information. The problem here is that the issue whether the trader traded on non-public information that was acquired from the source through deception or elsewhere is totally distinct and often irrelevant from the investors' point of view. This implies that this approach has a basic disconnect with the core concern of securities law.

FOTM seemingly resolves the "lack of reliance" challenge in the context of impersonal markets. However, it also fails for the same reason as the equal access theory—the absence of any demonstrable harm to the counterparties or even a demonstrable gain. In fact, insider trading arguably helps the market go beyond semi-strong efficiency. Thus, FOTM seems to actually support legalization of insider trading.

A variant of the fraud-based approach—the contracting fraud theory—plausibly explains certain specific aspects of current U.S. law. However, it seems that the theory becomes rather

superfluous in the context of its public-welfare maximization rationale. In the context of the private-welfare argument, it is not plausible to support the argument that the courts may read a default Reporting Covenant in intrafirm relationships as a general rule. The theory also raises federalization concerns in the context of the exact scope of fiduciary relationships and the newly emerged noncorporate entities. Finally, the framework of civil and criminal penalties under the current law in the United States is at odds with the underlying logic of the contractual fraud theory.

The corruption theory treats insider trading as a form of corruption. Under this, the question whether insider trading must be prohibited and, if so, what should be the contours of the prohibition becomes a culture-specific issue. It is not possible to offer a general, universal argument in support of enacting the prohibition and its precise scope. This lends support to the view that the enactment of insider trading prohibition in several jurisdictions may be nothing more than an exercise in regulatory ritualism. Further, there seems to be some tension between the cultural dimension present in the corruption theory and the analysis of the economic costs of insider trading—viewed as a form of private corruption—at least in the case of temptation and distraction costs. The adverse impact of these two—the distortion of managerial incentives and the diversion of managerial time—is arguably culturally agnostic. The implication is that a prohibition on insider trading, predicated on these two costs, can in fact be supported without an appeal to the corruption theory, making the theory superfluous. Finally, proposals based on the duty to hold stolen or lost information and agency law do not imply any prohibition on trading based on material, non-public information. They merely imply that the trader becomes accountable to the owner/principal for the profits made on such trading. Further, this again casts the issue as one for private enforcement.

At this stage, there are two options available. One can accept that, contrary to the current dominant view, there is really nothing wrongful about insider trading. Therefore, the proponents of legalization of insider trading are right.

The other option is to explore whether it is possible to articulate a policy rationale for prohibiting insider trading that avoids the problems with the existing theories and the policy rationales that underlie these theories. If so, the next task would be to craft a theory that seeks to effectuate the offered rationale. I intend to take this up in the final article in this three-part series.

# ADVANCING THE RULE OF LAW: IMPROVING PRETRIAL DIVERSION IN MODERN FOREIGN CORRUPT PRACTICES ACT ENFORCEMENT ACTIONS

*Maxwell N. Patel\**

## INTRODUCTION

In the United States, the Foreign Corrupt Practices Act of 1977, as amended 15 U.S.C. §§ 78dd-1, *et seq.* (FCPA), is the principal statute used by United States enforcement agencies to criminalize certain types of payments made by business entities, or their agents, to foreign government officials for assistance in obtaining or retaining business on favorable terms.<sup>1</sup> Despite the widely understood importance of reducing corruption, the FCPA remains one of the most controversial and hotly debated international regulatory statutes. Scholars and politicians have weighed in with all manner of opinions regarding its effectiveness, its fairness, its extraterritoriality, and its impact on American companies seeking to do business abroad.<sup>2</sup> Although the FCPA was designed to improve the international marketplace by criminalizing bribery, the predominant method enforcement agencies use to resolve violations of the FCPA seemingly conflicts with the broader spirit of the statute in strengthening the rule of law. Enforcement agencies may settle violations of the FCPA without the accused party ever admitting guilt or going to trial through pretrial diversion processes.

While there may be economic efficiencies to utilizing pretrial diversion, this note takes the position that current pretrial diversion practices in FCPA enforcement actions do not provide enough procedural protections or transparency. By increasing the role of the judiciary in the pretrial diversion, potential risk of abuse through process or lack of information can be mitigated. Additionally, this note suggests that funds collected from resolving FCPA enforcement actions should be used to facilitate anti-corruption programing abroad as a means of providing relief for victims and strengthening the international rule of law.

Part II situates this note by providing background information on the topic of international rule of law and serves as a primer on the origins and development of the FCPA. Part III introduces pretrial diversion techniques that are used to resolve FCPA enforcement actions and identifies problems related to accountability and transparency associated with current methods of pretrial

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<sup>1</sup> Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, 91 Stat. 1494, *amended by* Omnibus Trade and Competitiveness Act of 1988, Pub. L. No. 100-418, tit. V, §§ 5001-03, 102 Stat. 1415, *also amended by* International Anti Bribery and Fair Competition Act of 1998, Pub. L. No. 105-366 (codified as amended at 15 U.S.C. §§ 78m, 78dd-1, 78dd-2, 78dd-3, 78ff (2018)) [hereinafter The FCPA], <https://www.justice.gov/sites/default/files/criminal-fraud/legacy/2012/11/14/fcpa-english.pdf>.

<sup>2</sup> *See, e.g.*, Sean J. Griffith & Thomas H. Lee, *Toward an Interest Group Theory of Foreign Anti-Corruption Laws*, 2019 ILL. L. REV. 1227, 1266 (2019); *See, e.g.*, Rebecca L. Perlman & Alan O. Sykes, *The Political Economy of the Foreign Corrupt Practices Act: An Exploratory Analysis*, 9 J. LEGAL ANALYSIS 153, 182 (2018); *See also, e.g.*, Renae Merle, *Trump called global anti-bribery law 'horrible.' His administration is pursuing fewer new investigations.*, WASH. POST (Jan. 31, 2020, 2:27 PM), <https://www.washingtonpost.com/business/2020/01/31/trump-fcpa/>.

diversion. Part IV proposes recommendations to resolve some of the issues associated with current pretrial diversion practices in FCPA enforcement actions. Part V concludes with final takeaways.

## **I. UNDERSTANDING INTERNATIONAL RULE OF LAW AND THE MODERN FOREIGN CORRUPT PRACTICES ACT**

To understand the issues with the modern enforcement of the Foreign Corrupt Practices Act and the position of this note, it is imperative to establish a relevant background in the topic of international rule of law as well as the relevant history and development of the FCPA.

### A. *International Rule of Law and Scope of International Bribery*

Rule of law is an incredibly complex term of art because there is no settled academic definition for the phrase. Traditionally, rule of law definitions have been characterized on a spectrum from “thin” to “thick.”<sup>3</sup> A thin definition of rule of law usually focuses on the procedures used to formulate and apply rules and contains little mention of limits to the State and its institutions regarding accountability or human rights protections.<sup>4</sup> This thin rule of law definition is sometimes referred to as “rule by law.” At the other end of the spectrum is a thick or comprehensive rule of law definition, where states, leaders, and institutions are held accountable for their decisions.<sup>5</sup> It is important to also note that rule of law and human rights have an interdependent relationship; human rights protections cannot be assured without a robust rule of law and rule of law cannot be assured without actions to protect human rights. One frequently cited thick definition of the international rule of law comes from former United Nations Secretary-General Kofi Annan:

[A] principle of governance in which all persons, institutions and entities, public and private, including the State itself, are accountable to laws that are publicly promulgated, equally enforced and independently adjudicated, and which are consistent with international human rights norms and standards. It requires, as well, measures to ensure adherence to the principles of supremacy of law, equality before the law, accountability to the law, fairness in the application of the law, separation of powers, participation in decision-making, legal certainty, avoidance of arbitrariness and procedural and legal transparency.<sup>6</sup>

International anti-bribery statutes, including the Foreign Corrupt Practices Act, are essential to strengthening the international rule of law, government transparency, and fostering global economic development. In 2018, the World Economic Forum reported that bribes and other corrupt practices steal at least five percent of the world’s gross domestic product (GDP) from the global economy each year.<sup>7</sup> That figure was estimated to be over U.S. \$2.6 trillion in 2018 and may be over U.S. \$4.7 trillion as of 2021.<sup>8</sup> Furthermore, the World Bank estimates that businesses and individuals pay more than U.S. \$1 trillion dollars in bribes to public officials every year.<sup>9</sup> The effects of corruption are far-reaching; corruption weakens the public trust in institutions and fair enforcement of laws.<sup>10</sup> Governments and officials who partake in corrupt practices create systems

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<sup>3</sup> Massimo Tommasoli, *Rule of Law and Democracy: Addressing the Gap Between Policies and Practices*, UN CHRON., Dec. 31 2012, <https://www.un.org/en/chronicle/article/rule-law-and-democracy-addressing-gap-between-policies-and-practices>.

<sup>4</sup> *Id.*

<sup>5</sup> *Id.*

<sup>6</sup> U.N. Secretary-General, *The Rule of Law and Transitional Justice in Conflict and Post-Conflict Societies* (Aug. 23, 2004), [https://www.un.org/en/ga/search/view\\_doc.asp?symbol=S/2004/616](https://www.un.org/en/ga/search/view_doc.asp?symbol=S/2004/616).

<sup>7</sup> Press Release, Security Council, *Global Cost of Corruption at Least 5 Per Cent of World Gross Domestic Product, Secretary-General Tells Security Council, Citing World Economic Forum Data*, U.N. Press Release SC/13493 (Sept. 10, 2018), <https://www.un.org/press/en/2018/sc13493.doc.htm>.

<sup>8</sup> *Id.*; See also IMF, *World Economic and Financial Surveys: World Economic Outlook Database* (Oct. 2021), <https://www.imf.org/en/Publications/WEO/weo-database/2021/October>.

<sup>9</sup> *Id.*

<sup>10</sup> *Id.*

that negatively impact citizens.<sup>11</sup> Corruption diverts public funds from state budgets, which limits the ability for the state to provide public goods like access to education, law enforcement, infrastructure, and healthcare. The diversion of public funds leads to further corrosion of institutions that affects billions of people worldwide. To put this figure into perspective, in 2017, Transparency International reported that nearly one in four people worldwide paid a bribe to access public services during the twelve months before being surveyed.<sup>12</sup> Because of international anti-bribery statutes like the FCPA, many companies conducting business abroad have developed robust compliance programs to assure they are not at odds with government enforcement agencies or international development goals.<sup>13</sup>

### B. *A Brief History of the Foreign Corrupt Practices Act*

The Foreign Corrupt Practices Act was enacted during the late-1970s anti-corruption era in response to a Securities and Exchange Commission (SEC) report that found that hundreds of U.S. companies had paid bribes to engage in business abroad on favorable terms.<sup>14</sup> These instances of foreign bribery were largely adverse to numerous U.S. foreign policy objectives, especially goals related to strengthening the rule of law, international security, and government transparency abroad.<sup>15</sup> One of the most influential scandals in shaping the FCPA was that the Lockheed Corporation, the prominent U.S. aerospace and defense contractor, had spent millions of dollars bribing numerous foreign politicians and members of government, including officials in Italy and Japan, to win procurement contracts.<sup>16</sup> The Lockheed scandal was significant enough to bring down the government of Prime Minister Tanaka in Japan, yet there was no legal course of action to penalize Lockheed, prompting Congress to act.<sup>17</sup>

Since its passage, significant pushback remained from groups arguing that the FCPA disadvantaged U.S. businesses seeking to conduct business abroad.<sup>18</sup> Over time, these criticisms led to subsequent amendments revising the FCPA to narrow its scope to instances in which the business entity must have acted “willfully,” which has generally been construed by courts to mean an act committed voluntarily, purposefully, and with a bad purpose.<sup>19</sup>

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<sup>11</sup> *Id.*

<sup>12</sup> Transparency Int’l, *People and Corruption: Citizens’ Voices from Around the World*, at 7 (Nov. 2017), [https://images.transparencycdn.org/images/GCB\\_Citizens\\_voices\\_FINAL.pdf](https://images.transparencycdn.org/images/GCB_Citizens_voices_FINAL.pdf).

<sup>13</sup> See, e.g., *Impact of Foreign Corrupt Practices Act on U.S. Business*, U.S. GOV’T ACCOUNTABILITY OFF., AFMD-81-34, (1981), <https://www.gao.gov/assets/afmd-81-34.pdf>.

<sup>14</sup> U.S. SEC. EXCH. COMM’N, 94TH CONG., REPORT OF THE SECURITIES AND EXCHANGE COMMISSION ON QUESTIONABLE AND ILLEGAL CORPORATE PAYMENTS AND PRACTICES 3 (Comm. Print 1976), <https://www.sec.gov/spotlight/fcpa/sec-report-questionable-illegal-corporate-payments-practices-1976.pdf>.

<sup>15</sup> See generally *Multinational Corporations and United States Foreign Policy: Hearings Before the Subcomm. on Multinational Corps. Of the S. Comm. On Foreign Relations Part 12*, 94th Cong. 1 (1975).

<sup>16</sup> See Sean J. Griffith and Thomas H. Lee, *Toward an Interest Group Theory of Foreign Anti-Corruption Laws*, 2019 ILL. L. REV. 1227, 1237, <https://fcpa.stanford.edu/academic-articles/20190820-toward-an-interest-group-theory-of-foreign-anti-corruption-laws.pdf> (discussing the origins of the FCPA).

<sup>17</sup> *Id.*

<sup>18</sup> See e.g. John L. Graham, *The Foreign Corrupt Practices Act: A New Perspective*, 15 J. OF INT’L BUSINESS STUDIES 107 (1984); See also Brad Graham & Caleb Stroup, *Does anti-Bribery Enforcement Deter Foreign Investment?*, 23 APPLIED ECON. LETTERS, 63, 67 (2015).

<sup>19</sup> U.S. DEP’T OF JUSTICE & U.S. SEC. & EXCH. COMM’N, A RESOURCE GUIDE TO THE U.S. FOREIGN CORRUPT PRACTICES ACT, at 13 (July 2020), <https://www.justice.gov/criminal-fraud/file/1292051/download>, [Hereinafter FCPA Resource Guide].

In recent years, the Department of Justice (DOJ) and the Securities and Exchange Commission (SEC) have brought enforcement actions under the FCPA with increasing frequency.<sup>20</sup> Between its adoption in 1977 and 1996, forty enforcement actions were brought under the FCPA.<sup>21</sup> Yet, in the period from 1997 through 2020, enforcement agencies brought 626 actions under the FCPA.<sup>22</sup> This dramatic increase in enforcement frequency has been attributed to a wide range of factors.

Perhaps the most notable of these factors has been a shift towards greater focus on rule of law and more significant international consensus that corruption continues to be a barrier to global economic development. Greater international U.S. advocacy initially prompted a few other states to adopt similar international anti-bribery statutes.<sup>23</sup> However, the 1997 Organization for Economic Co-operation and Development Convention on Combating Bribery of Foreign Public Officials (OECD Anti-Bribery Convention) reflected a growing international consensus as member states agreed to establish and enforce criminal penalties for offering, promising, or giving any undue payment to a foreign official for the purpose of gaining favorable business treatment.<sup>24</sup> With the passage of the OECD Anti-Bribery Convention, the FCPA was amended under the International Anti-Bribery and Fair Competition Act of 1998.<sup>25</sup> These amendments to the FCPA made the act truly universal by expanding its application to all U.S. nationals, as well as foreign nationals and entities (including subsidiaries of U.S. businesses), regardless of the instrumentality being used in furtherance of a prohibited payment.<sup>26</sup>

Many recent FCPA enforcement actions have been brought against entities and activities that would, in many other contexts, be considered “foreign” and not subject to U.S. law.<sup>27</sup> Often, the FCPA has had jurisdiction over entities solely because of operations and contacts within the United States.<sup>28</sup> The extraterritorial application of the FCPA has drawn immense criticism from numerous scholars and foreign business leaders because of optics suggesting that the United States imposes FCPA enforcement actions against other states to gain a relative competitive advantage and penalize foreign enterprises. Despite these notable criticisms, the FCPA is consistent with the international norms implied by the 1997 OECD Anti-Bribery Convention. Although there is no mention of extraterritoriality in the convention, Article 4 of the OECD Anti-Bribery Convention implies the potential for jurisdictional overlap when two or more countries’ anti-bribery laws assert

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<sup>20</sup> See *DOJ and SEC Enforcement Actions per Year*, STANFORD L. SCH.: FOREIGN CORRUPT PRACTICES ACT CLEARINGHOUSE, <http://fcpa.stanford.edu/statistics-analytics.html> (last visited Sep. 10, 2020).

<sup>21</sup> *Id.*

<sup>22</sup> *Id.*

<sup>23</sup> *Id.*

<sup>24</sup> OECD, *Convention on Combating Bribery of Foreign Public Officials in International Business Transactions*, CONVENTION ON COMBATING BRIBERY OF FOREIGN PUBLIC OFFICIALS IN INTERNATIONAL BUSINESS TRANSACTIONS (Nov. 21, 1997), [https://www.oecd.org/daf/anti-bribery/ConvCombatBribery\\_ENG.pdf](https://www.oecd.org/daf/anti-bribery/ConvCombatBribery_ENG.pdf).

<sup>25</sup> International Anti-Bribery and Fair Competition Act of 1998, Pub. L. No. 105–366, 112 Stat. 3302, <https://www.congress.gov/105/plaws/publ366/PLAW-105publ366.pdf>.

<sup>26</sup> *Id.*

<sup>27</sup> See, e.g., DOJ, *Siemens AG and Three Subsidiaries Plead Guilty to Foreign Corrupt Practices Act Violations and Agree to Pay \$450 Million in Combined Criminal Fines*, (Dec. 15, 2008), <https://www.justice.gov/archive/opa/pr/2008/December/08-crm-1105.html>.

<sup>28</sup> See Sean J. Griffith & Thomas H. Lee, *Toward an Interest Group Theory of Foreign Anti-Corruption Laws*, 2019 ILL. L. REV. 1221, 1247 (2019), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3451446&download=yes](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3451446&download=yes).

jurisdiction over the same individual or entity.<sup>29</sup> In such instances, the convention recommends that those countries consult with each other to determine the proper jurisdiction.<sup>30</sup> Thus, rather than suggesting that extraterritoriality should be limited in enforcing anti-bribery laws, the OECD Anti-Bribery Convention provides space for international cooperation between states where there are jurisdictional overlaps.

### C. *The Foreign Corrupt Practices Act Today*

The Foreign Corrupt Practices Act's statutory scheme may be broken down into two distinct categories of application, the anti-bribery provisions and the accounting provisions.<sup>31</sup> While both the DOJ and SEC have the authority to bring enforcement actions under the FCPA, the DOJ has primary responsibility for enforcing the anti-bribery provisions of the act.<sup>32</sup> The SEC tends to focus on enforcing the accounting provisions.<sup>33</sup> The anti-bribery provisions prohibit corrupt payments to a foreign official to obtain or retain business and are structured as three parallel provisions within Title 15 that describe the categories of persons and entities to which the FCPA applies.<sup>34</sup> Section 78dd-1 provides that the FCPA applies to all issuers, both foreign and domestic, that have registered securities or are required to file with the SEC. Section 78dd-2 applies to domestic concerns including U.S. citizens, nationals, residents, and business entities formed under U.S. law or have their principal place of business in the United States.<sup>35</sup> Section 78dd-3 reaches other persons or entities who act in furtherance of corrupt payments while within the United States.<sup>36</sup> Each part of the FCPA applies beyond the entities mentioned above, allowing enforcement against officers, directors, employees, and agents acting on behalf of the entity.<sup>37</sup>

Interestingly, the anti-bribery provisions of the FCPA stop short of prohibiting all payments to foreign officials in business dealings. Each of the three anti-bribery provisions contains an "exception for routine governmental action."<sup>38</sup> These exceptions provide that the anti-bribery provisions do not apply for any facilitating or expediting payment to a foreign official to expedite or secure the performance of routine governmental action by that foreign official.<sup>39</sup> For example, a payment made by a business entity to a customs officer at an international port to expedite, but not influence the outcome of, the processing of papers for a larger import of goods would likely fall under the exception for routine governmental action, provided that the officer is in a role that regularly processed the type of papers described. Although these types of payments exist on the edge of what may rise to the level of an FCPA violation, it is important to note that the exception is consistent with Article 1 of the OECD Anti-bribery Convention, which provides that "small

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<sup>29</sup> OECD, *supra* note 24, at 5.

<sup>30</sup> *Id.*

<sup>31</sup> The FCPA, *supra* note 1.

<sup>32</sup> *Id.*

<sup>33</sup> *Id.*

<sup>34</sup> *Id.*

<sup>35</sup> *Id.*

<sup>36</sup> *Id.*

<sup>37</sup> The FCPA, *supra* note 1.

<sup>38</sup> *Id.*

<sup>39</sup> *Id.*

‘facilitation’ payments do not constitute payments made ‘to obtain or retain business or other improper advantage.’”<sup>40</sup>

The accounting provisions of the FCPA work alongside the anti-bribery provisions to “strengthen the accuracy of the corporate books and records and the reliability of the audit process which constitute the foundations of our system of corporate disclosure.”<sup>41</sup> These accounting provisions apply to publicly traded companies and ensure transparency by requiring that they “make and keep books and records that accurately and fairly reflect the transactions of the corporation.”<sup>42</sup> Furthermore, the companies are required to develop and maintain internal accounting controls.<sup>43</sup> While the accounting provisions are a crucial part of the FCPA and its goals, they are applicable beyond instances of bribery and are frequently the basis for many accounting fraud and issuer disclosure cases.<sup>44</sup>

While the Act is criticized for being a vague prohibition on certain types of payments to foreign officials, there is increasing clarity from enforcement agencies regarding what kind of acts would violate the FCPA. For many years, it was somewhat unclear exactly what level of conduct would rise to the level of a violation. This is especially noteworthy because in many international business operations, it is not uncommon for certain legally permissible facilitation payments to low-level foreign officials to occur in order to expedite certain routine governmental actions.<sup>45</sup> To assist businesses with navigating the FCPA, the DOJ and SEC published “A Resource Guide to the US Foreign Corrupt Practices Act in 2012.”<sup>46</sup> The Resource Guide provides a significant amount of information about the FCPA and examples of the types of exchanges with foreign officials that would or would not be considered violations.<sup>47</sup> For example, the guide includes hypothetical scenarios regarding gifts, travel, and entertainment provided to public officials and then explains why the conduct violates the FCPA.<sup>48</sup> While not every type of conduct is discussed within the Resource Guide, its release represents a significant step toward the equitable application of the FCPA. This is because businesses are put on notice and may have greater awareness to take actions to avoid behavior that could result in a violation.

## II. PROBLEMATIC BARGAINS: PRETRIAL DIVERSION

Most FCPA enforcement actions are resolved through pretrial diversion, namely through deferred prosecution agreements (DPAs), non-prosecution agreements (NPAs), and declinations under the DOJ FCPA Pilot Program. These agreements exist somewhere between choosing not to prosecute and seeking to obtain a conviction.<sup>49</sup> Unlike a plea bargain, these agreements do not require that the accused entity admit guilt or even begin litigation proceedings.<sup>50</sup> Resolutions under

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<sup>40</sup> OECD, *supra* note 24, at 12.

<sup>41</sup> S. Rep. No. 95-114, at 7.

<sup>42</sup> 15 U.S.C. § 78m(b)(2)(A).

<sup>43</sup> 15 U.S.C. § 78m(b)(2)(B) (2015).

<sup>44</sup> FCPA Resource Guide, *supra* note 19, at 9.

<sup>45</sup> *See id.* at 40.

<sup>46</sup> *Id.* at 9.

<sup>47</sup> *Id.*

<sup>48</sup> *Id.* at 17.

<sup>49</sup> *See* FCPA Resource Guide, *supra* note 19, at 75-76.

<sup>50</sup> *Id.*

these pretrial diversion agreements often require the implementation of significant reform efforts to resolve the issues created by the payments. They often include substantial monetary fines, but often offer more lenient terms than a conviction.<sup>51</sup> Pretrial diversion is advantageous to the government because it significantly helps to lower costs and increases the efficiency of both enforcement agencies and the courts. In many contexts, pretrial diversion seemingly balances justice and pragmatism; however, current application in FCPA enforcement presents the potential for problematic outcomes.

Given that the FCPA was enacted and revised to help facilitate international anti-corruption efforts and bolster the rule of law, pretrial diversion seems to go against the spirit of the statute's origins. First, the use of pretrial diversion agreements avoids actual criminal convictions.<sup>52</sup> Therefore, these agreements may allow for a company undertaking severely non-compliant activities to resolve its issues without achieving proper deterrence. Additionally, pretrial diversion is administered with essentially no oversight from the judiciary, leaving open the possibility for procedural due process issues. Finally, the fines and disgorgement paid to the U.S. government serve only as a deterrent and are merely allocated to the General Fund of the U.S. Treasury, which has little direct impact on strengthening the rule of law abroad.

#### A. *The Original Shift Toward Pretrial Diversion: DPA and NPA.*

The original purpose of pretrial diversion was far removed from the context of the Foreign Corrupt Practices Act and corporate criminal enforcement in general. Initially, pretrial diversion agreements were used in cases involving juvenile offenders as a way of helping to resolve criminal violations while avoiding the developmental problems and societal stigma created by labeling juveniles as criminals.<sup>53</sup> The use of pretrial diversion at the federal level expanded significantly during the 1960s to curtail the significant caseload of federal prosecutions related to drug use.<sup>54</sup>

Before the 2000s, the use of pretrial diversion for matters related to commercial entities was incredibly rare. One of the first notable instances of a government enforcement agency offering something that resembled a pretrial diversion in the corporate context occurred in 1992 during a government treasury securities fraud investigation of Salomon Brothers, a major multinational investment bank.<sup>55</sup> Because Salomon Brothers fully cooperated with the government, paid substantial fines, and undertook significant reforms to ensure that future violations would not occur, the DOJ choose to forgo indictment.<sup>56</sup> This occurrence was highly unusual for the time. It was not until 1994 that the DOJ formally agreed to an official pretrial diversion where the government offered a DPA to Prudential Securities in return for substantial internal compliance program reforms and full cooperation.<sup>57</sup> The Prudential Securities agreement

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<sup>51</sup> *Id.*

<sup>52</sup> *Id.*

<sup>53</sup> Benjamin M. Greenblum, Note, *What Happens to a Prosecution Deferred? Judicial Oversight of Corporate Deferred Prosecution Agreements*, 105 COLUM. L. REV. 1863, 1866 (2005).

<sup>54</sup> *Id.*

<sup>55</sup> Peter Spivack & Sujit Raman, *Regulating the 'New Regulators': Current Trends in Deferred Prosecution Agreements*, 45 AM. CRIM. L. REV. 159, 163 (2008).

<sup>56</sup> *Id.*

<sup>57</sup> Leonard Orlando, *The Transformation of Corporate Criminal Law*, 1 BROOK. J. CORP. FIN. & COM. L. 45, 60 (2006).

helped shape the conditions for future deferred prosecution agreements; however, as few as eight more pretrial diversions were used to resolve corporate criminal enforcement actions during the 1990s.<sup>58</sup> Two probable reasons for the low initial number of pretrial diversions is because the office of the U.S. Attorney General had not issued formal guidelines on the use of pretrial diversions in the corporate context as well as the fact that traditionally prosecutorial discretion was perceived as a binary choice, to either prosecute or choose not to prosecute.<sup>59</sup>

Several memoranda and events that occurred at the turn of the century and in the early 2000s dramatically upended the traditional prosecution of business entities. First, in 1999 Deputy Attorney General Eric Holder circulated a memorandum titled *Federal Prosecution of Corporations*, which laid out factors that prosecutors should weigh when considering bringing charges against corporate entities.<sup>60</sup> These factors include: (1) the nature and severity of the offense, (2) the pervasiveness of the wrongdoing, (3) the entity's history of similar conduct, (4) any voluntary disclosure of wrongdoing and ensuing cooperation, (5) the existence of a compliance program, (6) efforts at remediation, (7) potential for collateral consequences that could harm third parties, and (8) the availability of civil or regulatory remedy.<sup>61</sup> While the memorandum did not specifically mention pretrial diversions, the guidelines reflected a similar rationale to situations where pretrial diversion had been utilized and set the stage for future modification.<sup>62</sup>

In the early 2000s, a series of high-profile corporate accounting scandals—publicly traded Enron Corporation, Tyco International, Global Crossing, ImClone, Adelphia, and MCI-WorldCom—led to the passage of the Sarbanes-Oxley Act of 2002, which created more stringent rules and penalties surrounding accounting, public disclosures, and recordkeeping.<sup>63</sup>

Subsequently, the government took intense action against Arthur Andersen, one of the largest accounting firms in the world at the time, and the firm primarily responsible for the accounting fraud that led to the Enron disaster.<sup>64</sup> Arthur Andersen refused to adopt the remedial measures in an attempt to shirk the accusations, and discussions over a deferred prosecution collapsed.<sup>65</sup> As a result, the company was indicted and faced immense scrutiny during the subsequent litigation.<sup>66</sup> The litigation and substantial penalties issued at trial ultimately forced Arthur Andersen out of business, leading to the loss of tens of thousands of jobs despite the fact that only a small number of employees were responsible for the Enron accounting fraud.<sup>67</sup>

The significant losses that resulted from the Arthur Andersen litigation led both corporations and the DOJ to reconsider the costs of failing to comply with government

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<sup>58</sup> *Id.* at 57.

<sup>59</sup> Spivack & Raman, *supra* note 55, at 164.

<sup>60</sup> Memorandum from Eric H. Holder, Jr., Deputy Att'y Gen., Federal Prosecution of Corporations, to All Component Heads and U.S. Att'ys (June 16, 1999), <https://www.justice.gov/sites/default/files/criminal-fraud/legacy/2010/04/11/charging-corps.PDF>.

<sup>61</sup> *Id.*

<sup>62</sup> *Id.*

<sup>63</sup> Orland, *supra* note 57, at 50-51; *See also* Spivack & Raman, *supra* note 55, at 164-65; *See also* Orlando, *supra* note 57, at 50-51.

<sup>64</sup> Spivack & Raman, *supra* note 51, at 164-65.

<sup>65</sup> *Id.*

<sup>66</sup> *Id.*

<sup>67</sup> *Id.*

enforcement actions. Corporations saw the Arthur Andersen litigation and passage of the Sarbanes-Oxley Act as a warning and began to take more substantial steps to ensure that they complied with federal regulations. The government also saw the fallout as highly problematic because the litigation effectively caused the collapse of a major corporate entity and the loss of many American jobs. In order to avoid some of the negative outcomes associated with corporate criminal prosecutions, Deputy Attorney General Larry D. Thompson issued a memorandum in 2003 that revised the guidance of the earlier Holder memorandum by placing “increased emphasis on and scrutiny of the authenticity of a corporation’s cooperation.”<sup>68</sup> Perhaps more importantly, Thompson’s new directive strongly suggested federal prosecutors consider using pretrial diversion agreements to address corporate misconduct.<sup>69</sup>

While there have been several more recent memoranda revising guidance of corporate prosecutions, since Thompson’s memorandum was released, there has been a significant shift toward the use of DPA and NPA in criminal corporate enforcement actions. Currently, these pretrial diversion tactics are the primary method of resolving corporate criminal violations.<sup>70</sup> The majority of recent FCPA violations are similarly resolved through a DPA, an NPA, or a plea agreement. The remaining minority of FCPA enforcement actions have been resolved through declinations under the FCPA Pilot Program, which is discussed further in section III.B.<sup>71</sup>

### 1. Non-Prosecution Agreements (NPAs)

Under an NPA, the enforcement agency maintains the right to file charges against the entity but refrains from doing so to allow the company to demonstrate “good conduct” during the term of the NPA.<sup>72</sup> Rather than being filed with the court like a DPA, NPAs are maintained by the parties.<sup>73</sup> Despite not being officially filed with courts, NPAs are made available to the public on enforcement agency webpages.<sup>74</sup> The requirements of an NPA often stipulate payment of a monetary penalty, waiver of the statute of limitations, cooperation with the enforcement agency, and the enactment of compliance and remediation commitments. The primary reason that a company might be offered an NPA rather than a DPA is in the case where a company voluntarily self-discloses possible violations to the government. If the entity complies with the agreement throughout its term, the DOJ does not file criminal charges.<sup>75</sup>

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<sup>68</sup> Memorandum from Larry Thompson, Deputy Att’y Gen.’s Office, Principles of Fed. Prosecution of Bus. Org. (Jan. 20, 2003), [https://assets.hcca-info.org/Portals/0/PDFs/Resources/Conference\\_Handouts/Clinical\\_Practice\\_Compliance\\_Conference/2006/Tues/501-%20Handout%201.pdf](https://assets.hcca-info.org/Portals/0/PDFs/Resources/Conference_Handouts/Clinical_Practice_Compliance_Conference/2006/Tues/501-%20Handout%201.pdf).

<sup>69</sup> *Id.*

<sup>70</sup> See Mike Koehler, *DOJ Prosecution of Individuals - Are Other Factors at Play?*, FCPA PROFESSOR (Sept. 22, 2011), <http://www.fcpaprofessor.com/doj-prosecution-of-individuals-are-other-factors-at-play>.

<sup>71</sup> FCPA RESOURCE GUIDE, *supra* note 19, at 75-8.

<sup>72</sup> *Id.* at 75.

<sup>73</sup> *Id.*

<sup>74</sup> *Id.*

<sup>75</sup> *Id.*

## 2. Deferred Prosecution Agreements (DPAs)

Under a DPA, the enforcing agency files a charging document with the court and simultaneously requests that the prosecution be postponed to allow the company to demonstrate “good conduct.”<sup>76</sup> This demonstration typically involves paying a monetary penalty, waiving the statute of limitations, cooperating with the enforcement agency, and entering into compliance and remediation commitments.<sup>77</sup> These agreements describe the entity’s conduct, level of cooperation, necessary remediation, and provide a calculation of the penalty. If the company successfully adheres to the DPA for the duration specified in the agreement, the enforcement agency will then move to dismiss the filed charges.<sup>78</sup> Because a DPA is actually filed with a court, the agreement could theoretically be subjected to judicial scrutiny; however, a 2009 Government Accountability Office (GAO) assessment of the role that the courts play in the DPA process concluded that meaningful judicial scrutiny was essentially nonexistent.<sup>79</sup>

### *B. The DOJ Foreign Corrupt Practices Act Pilot Program*

#### 1. The Pilot Program Generally

In 2016, the DOJ Criminal Division added another pretrial diversion option to Foreign Corrupt Practices Act enforcement actions under the FCPA Pilot Program.<sup>80</sup> The stated goal of the FCPA Pilot Program is to “promote greater accountability for individuals and companies that engage in corporate crime by motivating companies to voluntarily self-disclose FCPA-related misconduct, fully cooperate with the Fraud Section, and, where appropriate, remediate flaws in their controls and compliance programs.”<sup>81</sup> Furthermore, the FCPA Pilot Program is designed to “further deter individuals and companies from engaging in FCPA violations in the first place, encourage companies to implement strong anti-corruption compliance programs to prevent and detect FCPA violations,” as well as “increase the [DOJ] Fraud Section’s ability to prosecute individual wrongdoers whose conduct might otherwise have gone undiscovered.”<sup>82</sup>

Under the FCPA Pilot Program, companies would be provided certain “declination” or mitigation credits, which could take the form of a different type of disposition, a reduction in fine, or no requirement of a monitor, in exchange for timely voluntary self-disclosure, full cooperation all FCPA-related matters, and adoption of appropriate remediation measures.<sup>83</sup> Rather than balancing various factors for eligibility, like in the case of a DPA or an NPA negotiation, full cooperation and voluntary disclosure are required to be considered for the program.<sup>84</sup> Since the

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<sup>76</sup> *Id.* at 74

<sup>77</sup> *Id.*

<sup>78</sup> *Id.*

<sup>79</sup> U.S. GOV’T ACCOUNTABILITY OFF., GAO-10-110, CORPORATE CRIME: DOJ HAS TAKEN STEPS TO BETTER TRACK ITS USE OF DEFERRED AND NON-PROSECUTION AGREEMENTS, BUT SHOULD EVALUATE EFFECTIVENESS 25 (2009), <https://www.gao.gov/products/gao-10-110>.

<sup>80</sup> U.S. DEPT. OF JUST., CRIM. DIV., Andrew Weissmann, DOJ, CRIMINAL DIV., THE FRAUD SECTION’S FOREIGN CORRUPT PRACTICES ACT ENFORCEMENT PLAN AND GUIDANCE 2 (2016), <https://www.justice.gov/archives/opa/blog-entry/file/838386/download>.

<sup>81</sup> *Id.*

<sup>82</sup> *Id.*

<sup>83</sup> *Id.* at 3-9.

<sup>84</sup> See *id.*

creation of the FCPA Pilot Program, the DOJ has used declinations to resolve fifteen of FCPA enforcement actions.<sup>85</sup>

## 2. Declinations with Disgorgement

Within the fifteen declinations that have been used to resolve Foreign Corrupt Practices Act enforcement actions, half have required “disgorgement” as a requirement for declination.<sup>86</sup> While most of the declinations under the FCPA Pilot Program have ultimately needed disgorgement, there is a distinction between instances where DOJ declination was contingent upon disgorgement and instances where disgorgement to the SEC occurs under a separate agreement.<sup>87</sup>

The first instance where a declination was seemingly contingent on disgorgement within the same agreement occurred in September 2016, when the DOJ granted “declinations with disgorgement” to two separate and unrelated entities under the FCPA Pilot Program.<sup>88</sup> Because the two businesses were privately held and not issuers they were not subject to the SEC’s FCPA jurisdiction.<sup>89</sup> Rather than drafting the agreement such that the disgorgement would occur as a result of the company’s actions, the disgorgement was provided as a condition of the declination.<sup>90</sup> The letters sent to counsel of the two companies that were subjected to the first “declinations with disgorgement,” specified that the DOJ investigations found that the companies had paid bribes to foreign government officials.<sup>91</sup> Despite these findings, the DOJ provided the companies with declinations because both of the companies’ voluntary self-disclosure, full cooperation, comprehensive internal investigation, significant remedial measures, and agreement to disgorge all profits it made from the illegal conduct to the DOJ.<sup>92</sup>

### C. Differing Methods, but Common Problems

There are numerous reasons why pretrial diversions are a practical tool for federal enforcement agencies. As a matter of efficiency, it is far less costly to resolve enforcement actions through pretrial diversion than to engage in formal prosecutions.<sup>93</sup> Given the consequences of the Arthur Andersen trial that resulted in the loss of thousands of jobs as well as significant expense

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<sup>85</sup> See *Foreign Corrupt Practices Act, Pilot Program, Declinations*, DEPT. OF JUST., <https://www.justice.gov/criminal-fraud/pilot-program/declinations> (last updated March 24, 2022).

<sup>86</sup> *Id.*

<sup>87</sup> *Id.*

<sup>88</sup> Letter from Lorinda Laryea, Trial Att’y, Criminal Div., DOJ, to Steven A. Tyrell, Weil, Gotshal & Manges LLP, Counsel for HMT, LLC (Sept. 29, 2016), <https://www.justice.gov/criminal-fraud/file/899116/download>; Letter from Lauren N. Perkins, Assistant Chief, Criminal Div., DOJ, to Paul E. Coggins & Kiprian Mendrygal, Locke Lord LLP, Counsel for NCH, Corp. (Sept. 29, 2016), <https://www.justice.gov/criminal-fraud/file/899121/download>.

<sup>89</sup> *Id.*

<sup>90</sup> Karen Woody, “*Declinations with Disgorgement*” in *FCPA Enforcement*, 51 U. MICH. J. L. REFORM 269, 286 (2018).

<sup>91</sup> Letter from Lorinda Laryea, Trial Att’y, Criminal Div., DOJ, to Steven A. Tyrell, Weil, Gotshal & Manges LLP, Counsel for HMT, LLC (Sept. 29, 2016), <https://www.justice.gov/criminal-fraud/file/899116/download>; Letter from Lauren N. Perkins, Assistant Chief, Criminal Div., DOJ, to Paul E. Coggins & Kiprian Mendrygal, Locke Lord LLP, Counsel for NCH, Corp. (Sept. 29, 2016), <https://www.justice.gov/criminal-fraud/file/899121/download>.

<sup>92</sup> *Id.*

<sup>93</sup> See Spivack & Raman, *supra* note 51, at 164-65.

for the government enforcement agencies, it is of minimal surprise that there would be a shift toward attempting to resolve or rehabilitate companies through alternative means.<sup>94</sup> Pretrial diversions under DPAs, NPAs, and the DOJ FCPA Pilot Program all promote alternative and efficient means to resolve FCPA violations; however, each of these processes as they are currently structured raises significant concerns about the extent to which rule of law is benefited and limits the potential of the FCPA.

While the original intent of the FCPA was to limit business activities averse to the U.S. foreign policy goals, especially those related to strengthening the international rule of law and countering bribery, the processes used in pretrial diversion seemingly present ironic outcomes. By paying fines or a disgorgement and adopting certain practices to help avoid future violations, businesses are essentially able to pay off the US government for their misconduct. While the substantial fines are typical penalties an entity business that violates federal regulations, the resolution process seemingly misses the mark of providing an equitable result. The far-reaching effects of corrupt payments are not addressed by the resolutions, and businesses entities may escape criminal liability for egregious violations with ease through pretrial diversion, limiting both the strength of the statute as a tool for fighting corruption and its deterrent effect.

To exemplify the issues with the application of pretrial diversion in FCPA enforcement, consider the results from a recent enforcement action against WPP plc. In September 2021, WPP plc, the world's largest advertising group, agreed to pay the SEC and DOJ more than US\$19 million to settle allegations that it had violated the FCPA, of which US\$8 million was imposed as a penalty by the SEC.<sup>95</sup> This violation of the FCPA's anti-bribery, books and records, and internal accounting controls arose out of an aggressive growth strategy that involved the consolidation of numerous advertising agencies in emerging markets.<sup>96</sup> The company failed respond to repeated warning signs of corruption and control failures at certain subsidiaries.<sup>97</sup> In addition, the company's subsidiaries in China, Brazil, and Peru were also engaged in other schemes and internal accounting control deficiencies.<sup>98</sup> Despite these fairly significant breaches of the FCPA, the company did not have to admit guilt and still generated a U.S. \$1.29 billion pre-tax profit margin.<sup>99</sup> While the company did adopt additional compliance programs in order to help prevent future violations, the fines paid to the SEC as a penalty seemingly fail to address the larger issues of corruption in the foreign states where the violations took place. Instead, WPP essentially paid the enforcement agency and continued business as usual.

The lack of accountability for government enforcement agencies in making determinations in FCPA enforcement is also counter to the goals of enhancing the rule of law. Having measures in place to ensure that proper justification in legal decisions and process is axiomatic to the rule of law. Pretrial diversion occurs between the government enforcement agencies and the accused entities with minimal oversight. Furthermore, violations of DPAs and NPAs are solely determined

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<sup>94</sup> *See Id.*

<sup>95</sup> *SEC Charges World's Largest Advertising Group with FCPA Violations*, SEC (Sept. 24, 2021), <https://www.sec.gov/news/press-release/2021-191>.

<sup>96</sup> *Id.*

<sup>97</sup> *Id.*

<sup>98</sup> *Id.*

<sup>99</sup> Ian Walker, *WPP 2021 Like-for-Like Net Sales Rose 12.1%*, MARKETWATCH (Feb. 24, 2022, 2:20 AM), <https://www.marketwatch.com/story/wpp-2021-like-for-like-net-sales-rose-12-1-271645687207>.

by the enforcement agency. The DOJ FCPA Pilot Program is perhaps even more restrictive than DPAs and NPAs, as the requirements to gain a declination are fixed and non-negotiable.

Because of the lack of judicial oversight, there are significant questions of ensuring procedural due process in FCPA enforcement. To draw a distinction, plea bargains at the minimum require that a judge confirm a factual basis for the plea, the knowing voluntariness of the defendant's plea, and may retain discretion in dictating the sentence. Although in most U.S. jurisdictions the judiciary plays a passive role in the plea-bargaining process, there is still a requisite level of oversight that facilitates procedural due process. With pretrial diversion, the entire process is removed from the judicial system and the enforcing agencies (which are executive departments) control both the discretion to bring an enforcement as well as the ability to dictate the remedial measures entirely. Thus, under the current processes, pretrial diversion practices fail to minimize the risks that outcomes are coerced, uninformed, or inconsistent with the facts of the case, even with highly sophisticated entities. These risks are even more problematic when considering that the spirit of the FCPA was designed to strengthen the international rule of law.

### III. STRENGTHENING THE INTERNATIONAL RULE OF LAW IN FOREIGN CORRUPT PRACTICES ACT ENFORCEMENT

Although there are numerous measures that could be taken to address various shortcomings in the enforcement of the Foreign Corrupt Practices Act, the recommendations provided in this note are grounded in the goal of achieving greater accountability and combating ironic outcomes that stem from lack of oversight. By working to enhance transparency in pretrial diversion during FCPA enforcement actions, the overall effectiveness of the statute as a framework for strengthening international rule of law may be enhanced.

#### A. *Allocating a Portion of Fines and Disgorgements Collected in FCPA Enforcement Actions to Anti-corruption Initiatives*

In the context of cooperate prosecutions and enforcement actions, the funds that are paid to the federal government as fines or disgorgement are generally either allocated to a victims relief fund for the particular incident or to the General Fund of the U.S. Treasury.<sup>100</sup> However, when enforcers utilize pretrial diversion, these payments are always allocated to the General Fund.<sup>101</sup> While the fines and disgorgements may serve as a meaningful deterrent for FCPA violations, the funds collected from FCPA enforcement actions could do more to help strengthen and repair the rule of law and damage to the public trust once a violation has occurred. Rather than submitting the funds to the General Fund, as is typical in a corporate enforcement action, funds collected from FCPA enforcement actions ought to be earmarked toward programming for fighting corruption and working to restore the losses of public goods that results from corruption.

In cases where pretrial diversion is utilized and victims are clearly identifiable or recorded, such as in the 2016 Wells Fargo scandal where the bank profited from opening unauthorized accounts and selling unnecessary financial products to unknowing customers, a sizable portion of

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<sup>100</sup> [31 U.S.C. § 3302.](#)

<sup>101</sup> *Id.*

the fines collected are siloed for victim relief.<sup>102</sup> Elsewhere, there are examples of pretrial diversion being utilized, but the harm is more general to the public. Like in the case of a violation of an environmental regulation, fines are used both as a deterrent, but also often include an agreement to cover the costs of repairing the damage created by the violation.<sup>103</sup> With FCPA enforcement, no such parallel of accountability for the harm created to the rule of law abroad exists. Prominent FCPA enforcements have required fines and disgorgement exceeding U.S. \$1 Billion,<sup>104</sup> but, unlike other types of corporate enforcement actions, it does not appear that any portion of these funds are directly allocated to helping restore the damage to rule of law in areas where companies have actively facilitated corruption.

The U.S. government regularly engages in funding programs that fight against corruption and strengthen the rule of law abroad.<sup>105</sup> Fines collected in FCPA enforcement could still be added to the General Fund and allocated to projects through standard federal budgeting practices, but within a silo that denotes that the funds shall be used to anti-corruption programming abroad. These funds could be allocated more specifically to address issues of corruption in the country where the FCPA violation giving rise to those funds occurred as a means of helping to restore the public goods that have been harmed through a violation of the FCPA. The creation of such a fund silo would be analogous to a victims' relief fund in the case of a corporate fraud or a mandatory clean-up in the case of environmental harm in that it would help to ensure that stakeholders benefit from the FCPA enforcement action.

Although this note strongly advocates for using funds collected in FCPA enforcement actions to help fight corruption, it is important to address the fact that these efforts can take a variety of forms beyond traditional targeted interventions and instead address root causes of corruption by working with civil society actors, nongovernmental organizations, and government agencies. Targeted anti-corruption efforts have been shown to dramatically reduce corruption where programming has been implemented; however, corruption is highly difficult to overcome

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<sup>102</sup> See, e.g., *Wells Fargo to Pay \$500 Million for Misleading Invest. About the Success of Its Largest Bus. Unit*, SE (Feb. 21, 2020), <https://www.sec.gov/news/press-release/2020-38>.

<sup>103</sup> See, e.g., *Exide Tech. Admits Role In Major Hazardous Waste Case And Agrees To Permanently Close Battery Recycling Facility In Vernon*, DOJ (Mar. 12, 2015), <https://www.justice.gov/usao-cdca/pr/exide-technologies-admits-role-major-hazardous-waste-case-and-agrees-permanently-close>.; See also *FirstEnergy Nuclear Operating Co. to Pay \$28 Million Relating to Operation of Davis-Besse Nuclear Power Station*, DOJ (Jan. 20, 2006), [https://www.justice.gov/archive/opa/pr/2006/January/06\\_enrd\\_029.html](https://www.justice.gov/archive/opa/pr/2006/January/06_enrd_029.html).

<sup>104</sup> See e.g., *Goldman Sachs Resolves Foreign Bribery Case And Agrees To Pay Over \$2.9 Billion*, DOJ (Oct. 22, 2020), <https://www.justice.gov/usao-edny/pr/goldman-sachs-resolves-foreign-bribery-case-and-agrees-pay-over-29-billion>.; See also *Airbus Agrees to Pay over \$3.9 Billion in Global Penalties to Resolve Foreign Bribery and ITAR Case*, DOJ (Jan. 31, 2020), <https://www.justice.gov/opa/pr/airbus-agrees-pay-over-39-billion-global-penalties-resolve-foreign-bribery-and-itar-case> (note that only roughly US \$500 million was paid to the United States for the FCPA, the rest of the amount would be paid to other countries enforcing parallel antibribery statutes).

<sup>105</sup> See, e.g., *Justice Department Anticorruption Task Force Launches New Measures to Combat Corruption in Central America*, DOJ (Oct. 15, 2021), <https://www.justice.gov/opa/pr/justice-department-anticorruption-task-force-launches-new-measures-combat-corruption-central>; See also *Combating Corruption and Promoting Good Governance*, Department of State Bureau of International Narcotics and Law Enforcement Affairs, <https://www.state.gov/combating-corruption-and-promoting-good-governance/>.

through targeted intervention once it takes hold.<sup>106</sup> A study of World Bank-funded development aid tenders over twelve years in over 100 developing countries found that corruption decreased in the targeted areas, but that corrupt actors took evasive actions that largely cancelled out the overall efforts of the intervention.<sup>107</sup> Officials receiving corrupt payments often attempt to find new avenues of receiving payments or move into different areas with weaker controls.<sup>108</sup> Therefore, utilizing funds to implement broader reforms and strengthen the rule of law more broadly while building integrity can have greater effect than targeted programming. By utilizing the funds collected from FCPA violations to aid in fighting against the broader issues that lead to corruption more directly, FCPA enforcement actions would further reduce corruption issues internationally.

### B. *Increasing Judicial Involvement in Pretrial Diversion*

Increasing judicial involvement in FCPA enforcement at different stages could help alleviate many of the issues and potentially ironic outcomes associated with using pretrial diversion. In the case of DPA and NPA negotiations Peter Reilly, a professor at Texas A&M University School of Law who has written extensively on the FCPA, has argued that judicial oversight could significantly improve equity in FCPA enforcement.<sup>109</sup> Reilly's reasoning is logical because, unlike representatives from the DOJ or SEC, the judiciary's role is in part to ensure that all parties correctly follow procedures in a neutral manner. The benefits of utilizing the judiciary to ensure proper process and prevent abuses under the more recently developed DOJ FCPA Pilot Program are perhaps even greater because complete cooperation with enforcement agencies is required.

There are numerous ways that the judiciary could reasonably play a greater supervisory role throughout the pretrial diversion process. First, during preliminary negotiations between the entity and the enforcement agencies the judiciary could play a type of supervisory role. As a matter of pragmatism, a member of the judiciary could be available on an as-needed basis for any disputes where concerns over process arise. It would be highly inefficient to suggest an alternative that would require that a member of the judiciary to be present at each negotiation between the enforcement agency and the accused party. However, ensuring that the accused entity can call in an official to ensure that procedural rights are maintained would help improve the inherent power imbalance between the government enforcement agency and entity during negotiations.

Similar benefits have been observed where an active judiciary is involved in plea bargain negotiations. Although Rule 11 of the Federal Rules of Criminal Procedure bars judges from participation in plea negotiations or making comments that might influence the negotiations, there are jurisdictions within the United States where judges play an active role plea bargaining and similar negotiations.<sup>110</sup> In Connecticut, the judiciary is highly involved in plea negotiations and

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<sup>106</sup> Elizabeth Dávid-Barrett and Mihály Fazekas, *Anti-corruption in aid-funded procurement: Is corruption reduced or merely displaced?*, 132 *World Development* (2020), <https://doi.org/10.1016/j.worlddev.2020.105000>.

<sup>107</sup> *Id.*

<sup>108</sup> *Id.*

<sup>109</sup> See Peter Reilly, *Negotiating Bribery: Toward Increased Transparency, Consistency, and Fairness in Pretrial Bargaining under the Foreign Corrupt Practices Act*, 10 *HASTINGS BUS. L.J.* 347, 402-05 (2014).; See Karen Woody, *supra* note 89, at 310.

<sup>110</sup> Jenia Iontcheva Turner, *Judicial Participation in Plea Negotiations: A Comparative View*, 54:1 *AMER. J. COMP. L.* (2006), 199-267, at 202, <https://www.jstor.org/stable/20454489?seq=3>; See also Fed. R. Crim. P. 11(c).

judges serve as moderator that comments on both the sentence as well as the merits of the case.<sup>111</sup> Parties may negotiate without the presence of a judge; however, the parties often elect to hold negotiations that are judicially moderated.<sup>112</sup> To protect against the potential for judicial coercion, a judge that serves during the plea negotiation process is prohibited from presiding over the trial of the same defendant if the defendant ultimately chooses not to accept the plea agreement.<sup>113</sup> One of the primary advantages to this system is it provides greater certainty and allows the parties to come to a more reasoned decision than would be provided under the federal system; however, there are some concerns that judges in this system have been shown to value efficiency over fairness in moderating negotiations.<sup>114</sup> Although the process would need to be adjusted to fit the context of an FCPA enforcement action and it is unlikely that the federal bench could reasonably be as involved as the Connecticut judiciary. However, this example provides a reasonable framework for fostering greater judicial involvement.

Second, the judiciary should be required to review pretrial diversion agreements. There are numerous analogous circumstances where judicial approval of the settlement is required. Peter Reilly has noted examples of where judicial approval of a negotiated settlement is required including: “(1) bankruptcy claims; (2) class action and shareholder derivative suit settlements; (3) environmental clean-up consent decrees under the Comprehensive Environmental Response, Compensation, and Liability Act (“CERCLA”); (4) settlements of actions in which receivers are appointed; (5) consent decrees in civil antitrust suits brought by the United States; (6) settlements of employment claims under the Fair Labor Standards Act (“FLSA”); and (7) settlements in cases involving incompetent persons or minors.”<sup>115</sup> Many of these situations reflect the government exerting its regulatory authority similarly to an FCPA enforcement action. Such review could be used to ensure that procedural rights are upheld and provide instances where an entity that has engaged in particularly egregious actions does not get off too lightly. It would not impose a significant burden on the judiciary to offer a review at this stage as FCPA enforcements are relatively rare and would draw greater parallel between the role of the judiciary in reviewing plea agreements in most U.S. jurisdictions.

Third, providing judicial oversight in pretrial diversion could help to provide guidance and information that would help to reduce the power discrepancy created by the limited amount of case law generated under recent FCPA enforcement actions. The release of the FCPA Resource Guide by the DOJ and SEC in 2012 (and updates in 2020) has provided businesses an effective tool that helps serve the purpose of demystifying whether certain types of payments rise to the level of a violation.<sup>116</sup> To continue to shift toward increased transparency in FCPA enforcement actions, enforcement agencies should provide more public information about the procedures used in deciding the terms of a DPA or NPA in lieu of case law. The judiciary could help to fill these gaps between publicly available documents and case law, helping to provide equitable remedies to enforcement actions. In this regard a member of the judiciary would serve in an informational

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<sup>111</sup> *Id.*, at 247.

<sup>112</sup> *Id.*, at 248-49.

<sup>113</sup> *Id.*

<sup>114</sup> *Id.*, at 252-54.

<sup>115</sup> Peter Reilly, *supra* note 109, at 405.

<sup>116</sup> *See generally* FCPA RESOURCE GUIDE, *supra* note 19.

capacity that would aid in increasing transparency throughout the process of pretrial diversion negotiations.

In Florida, judges deviate slightly from Rule 11 of the Federal Rules of Criminal Procedure by often serving in an informational capacity to parties in plea negotiations to ensure that parties enter into satisfactory arrangements. Rule 3.171(d) of the Florida Rules of Criminal Procedure “allows judges to advise the parties, prior to the acceptance of a plea, whether factors unknown to the parties at the time may make the judge's concurrence to the plea impossible,” meaning that judges can be more greatly involved in informing plea negotiations.<sup>117</sup> In order to mitigate the probability that judicial involvement in plea negotiations would prejudice the outcome of a case, the Supreme Court of Florida held in *State v. Warner* that a judge’s preliminary evaluation in plea negotiations is not binding when new material facts emerge before a sentencing hearing.<sup>118</sup> It is worth noting that, unlike the Connecticut judiciary, Floridian judges are not precluded from presiding over a trial that the judge assisted with in the negotiation phase if the plea is withdrawn.<sup>119</sup> This non-prohibition on hearing trials when the judge aided in plea negotiations seems reasonable given their more limited role of providing information to the parties. Additionally, the court has developed special procedures to mitigate coercion by weighing additional factors on a motion to disqualify a judge where the judge has engaged in the plea negotiation process.<sup>120</sup> These additional factors include whether the judge adhered to procedural regulations: (1) prohibiting judges from initiating plea negotiations, (2) requiring all plea related communications between the parties and judge be entered into record, (3) prohibiting a judges from stating or implying that future sentencing choices hinge on the defendant’s procedural choices, and (4) allowing the defendant to challenge a potentially coercive judicial remark that has been entered into the record.<sup>121</sup> While the resolution process differs slightly in the case of a pretrial diversion, a similar role for judges could be envisioned for the pretrial diversion process where judges could review the negotiations and drafts of agreements to assure that the parties are fully informed of their legal standing before they formally enter into an agreement.

Finally, in a situation where an entity appears to have violated the terms of a pretrial diversion agreement, allowing for judicial involvement in reviewing the conduct observed before the company can be found in violation would ensure that the entity is given proper process as well as strengthen institutional accountability in government enforcement actions. Under the current system, the enforcement agency has the absolute authority to determine whether an entity or individual violated the terms of a pretrial diversion agreement. When an entity has been found to have broken its NPA or DPA agreement, it triggers the potential for great financial and reputational consequences for the business entity. Because of the magnitude of potential harm, providing judicial scrutiny would limit the possibility of improper outcomes.

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<sup>117</sup> Turner, *supra* note 110, at 238

<sup>118</sup> *State v. Warner*, 762 So. 2d 507, 507 (Fla. 2000).

<sup>119</sup> *Id.*

<sup>120</sup> *Id.*, at 240.

<sup>121</sup> *Id.*

#### IV. CONCLUSION

Although there are significant issues with the manner that Foreign Corrupt Practices Act enforcement actions are resolved, the FCPA itself provides an essential framework for business accountability on the international stage. By improving transparency and accountability in pretrial diversion, the FCPA could be enforced in a method more consistent with its original goals in strengthening the international rule of law. Departing from the traditional process of merely allocating funds acquired in FCPA enforcement actions through fines and disgorgement to the General Fund and shifting toward a system that silos these funds for the purpose of international development and fighting corruption would do more to help offset the negative effects caused by violations. Additionally, providing greater judicial oversight throughout pretrial diversion would benefit the rule of law by ensuring procedural due process and well-reasoned outcomes in achieving resolutions to FCPA enforcement actions. Throughout the negotiation process, providing access to a member of the judiciary could offer substantial procedural protections and provide review negotiation agreements, creating meaningful oversight and additional accountability for government enforcement agencies. Working to improve the pretrial diversion process in FCPA enforcement actions would facilitate a more transparent and equitable international marketplace while facilitating global development.