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### Limiting Extraterritoriality Beyond Securities Laws

By Alan Brudner, Stephen Trigg, and Mor Wetzler — October 27, 2011

In *Morrison v. National Australia Bank, Ltd.*, 561 U.S. \_\_\_, 130 S. Ct. 2869 (June 24, 2010) the U.S. Supreme Court affirmed the dismissal of a securities class action in which a foreign issuer was sued by foreign plaintiffs who bought their securities on a foreign exchange. *Morrison*'s effect on securities actions has been immediate and significant—the case has etched the term “F-Cubed” into the practitioner’s lexicon. However, *Morrison* also has had a significant impact on the extraterritorial application of non-securities statutes.

#### ***Morrison* and the Presumption Against Extraterritorial Application**

In *Morrison*, foreign investors purchased shares of a foreign company on a foreign exchange. They later brought a securities fraud claim in a U.S. court under section 10(b) of the Securities Exchange Act of 1934 and rule 10b-5 thereunder. The district court dismissed the claims as lacking subject-matter jurisdiction, and the Second Circuit affirmed on appeal. Applying its test for determining when the Exchange Act should apply to transnational securities fraud, the Second Circuit examined whether sufficient wrongful conduct had occurred in the United States to trigger section 10(b). The Second Circuit affirmed the dismissal, concluding that the conduct central to the alleged fraud had occurred entirely overseas and that any U.S. connection was too attenuated from the plaintiffs’ alleged injury.

On appeal, the U.S. Supreme Court affirmed. The Supreme Court first determined that the extraterritorial application of section 10(b) is not a question of subject matter jurisdiction: “to ask what conduct § 10(b) reaches is to ask what conduct § 10(b) prohibits, which is a merits question.” Next, the Court addressed two tests generally employed by lower courts to determine the extraterritorial application of section 10(b) and rejected both. These tests were the “conduct” test (whether the wrongful conduct occurred in the United States) and the “effects” test (whether the wrongful conduct had a substantial effect in the United States or on U.S. citizens). The Court explained that these two tests are textually unsupported and that they ignore the “longstanding principle of American law that legislation of Congress, unless a contrary intent appears, is meant to apply only within the territorial jurisdiction of the United States.” The Court clarified that this presumption against extraterritorial application should apply “in all cases, preserving a stable background against which Congress can legislate with predictable effects.” The Court then applied the presumption and found no “affirmative indication” in the statute that Congress intended Section 10(b) to apply extraterritorially.

#### ***Morrison* Beyond the Securities Laws**

*Morrison*'s presumption has been applied, with varying results, to limit the extraterritorial



application of other U.S. laws, including the Racketeer Influenced and Corrupt Organizations Act (RICO).

A RICO claim (*see* 18 USC §§ 1961–68) requires proof of four elements: there must be an enterprise affecting interstate commerce; the defendants must have been employed by or associated with the enterprise; the defendants must have participated, directly or indirectly, in the conduct or affairs of the enterprise; and the defendants must have participated through a pattern of racketeering activity that must include at least two predicate acts of racketeering. Examples of predicate acts include state felonies such as murder, kidnapping, or extortion, or federal crimes such as mail fraud or wire fraud. The Supreme Court has interpreted the “pattern” requirement to include requirements of “relatedness” (same or similar purposes, results, participants, victims, or methods) and “continuity” (the series extends over time; at least two acts must be within 10 years of one another). *See, generally, H.J. Inc. v. Northwestern Bell Tel. Co.*, 492 U.S. 229 (1989). In many cases, the racketeering enterprise crosses international borders. Specific predicate acts potentially occur in the United States while the effects of those acts are felt only abroad. Following *Morrison*, courts have struggled with the extraterritorial application of RICO.

### **Pre-Morrison**

The extraterritorial application of RICO pre-*Morrison* largely mirrored the securities case law. The Second Circuit decision in *Alfadda v. Fenn*, 935 F.2d 475 (2d Cir. 1991) is illustrative of this. Investors in the defendant, Saudi European Investment Corporation N.V. (SEIC), alleged they were defrauded when their stake in SEIC was diluted by sales in breach of an offering prospectus and that the defendants diverted the proceeds from the sales for their own benefit. The plaintiffs brought claims for violations of RICO, the Securities Exchange Act, rule 10b-5, and various state-law claims. The district court held that it lacked jurisdiction after finding that the alleged fraud was perpetrated outside the United States. The Second Circuit reversed this decision and remanded for further proceedings based on the plaintiffs’ allegations that fraudulent conduct occurred in the United States. Various meetings and sales that allegedly diluted the plaintiffs’ holdings occurred within the United States, even though the allegedly fraudulent prospectuses were delivered to them outside the country’s borders.

The Second Circuit explained that, “[l]ike the Securities Exchange Act, the RICO statute is silent as to its extraterritorial application. Thus, we must ascertain whether Congress would have intended that federal courts should be concerned with specific international controversies.” *Alfadda*, 935 F.2d at 479. The court recognized the lack of Second Circuit precedent regarding the extraterritorial application of RICO but rejected the arguments circumscribing RICO’s extraterritorial application to foreign enterprises. The court then applied the “conduct” test for determining the application of securities fraud laws to determine whether RICO applied to the facts before it. The court concluded that the sales that diluted the plaintiffs’ holdings were predicate acts that occurred primarily in the United States; hence, they were a sufficient basis of jurisdiction for the RICO claims.

In *North-South Finance Corp. v. Al-Turki*, 100 F.3d 1046 (2d Cir. 1996), the court discussed the application of the “effects” test—used in the securities and antitrust contexts—to determine the extraterritorial application of RICO. The case concerned a dispute among groups of foreign companies and foreign nationals, arising out of the sale and reorganization of a French bank. The all-foreign plaintiffs alleged under RICO that two French investment-banking groups who acquired the bank artificially depressed the sale price of the bank by corrupting its general manager and manipulated post-sale transactions so that contingent payments of the purchase price would be fraudulently reduced or eliminated. Connections to the United States included a New York office of the bank and post-sale transactions that occurred in the United States.

The district court ruled that the extraterritorial reach of RICO in a given case was determined by whether the “conduct” of the defendants in the United States “was material to the completion of a racketeering act.” The Second Circuit did not decide whether the test that had been applied by the district court was the only available test but affirmed the dismissal of the RICO claims because the defendants’ alleged conduct in the United States was insufficient to support subject-matter jurisdiction under RICO.

The court reiterated that the RICO statute is silent as to extraterritorial application and that a corporate defendant that is a foreign entity is not, for that reason alone, shielded from the reach of RICO. Less clear was what character and amount of activity in the United States would justify RICO jurisdiction over a foreign entity. The court reviewed the application of securities and antitrust laws outside the United States and noted that the tests for asserting jurisdiction extraterritorially varied depending on the substantive law to be applied abroad. The court stated, “It may be that the effects-oriented approach borrowed from antitrust cases is an equally or even more appropriate test [than the conduct test], especially since the ‘the civil action provision of RICO was patterned after the Clayton Act’” and RICO provides for treble damages, which heightens concerns regarding international comity and foreign enforcement.

### **Post-Morrison**

Because *Morrison* rejected the “conducts” and “effects” tests, it is not surprising that post-*Morrison* cases considering RICO’s extraterritorial application reflect a drastically different type of analysis. In the first case to apply *Morrison* to RICO, the plaintiffs sought “‘damages arising out of a wide-ranging money laundering scheme that utilized New York-based U.S. banks to hold, move and conceal the fruits of fraud, extortion, and private abuse of public authority’ by Venezuelan government officials and their confederates.” *Cedeno v. Intech Group, Co.*, 733 F. Supp. 2d 471 (S.D.N.Y. 2010). The alleged scheme’s contacts with the United States were limited to the movement of funds through U.S. banks. Some of the defendants moved to dismiss on the grounds that the complaint exceeded the territorial limits of RICO’s reach.

Initially, the court noted *Morrison*’s repudiation of the prior “effects” and “conduct” tests employed to determine the extraterritoriality of statutes that were silent on the issue, noting the need to examine congressional intent in enacting the statute. Citing *North South Finance Corporation* for the proposition that RICO is silent as to any extraterritorial application, the court

determined that, under *Morrison*, the RICO statute is presumed not to apply to claims that are essentially extraterritorial.

The plaintiffs argued that their claims survived *Morrison* because they alleged predicate acts of money laundering involving transfers to and from the Southern District by U.S. banks. In response, the court quoted language from *Morrison* that the presumption against extraterritoriality would be a craven watchdog if it retreated to its kennel whenever some domestic activity was involved in the case. The court reasoned that RICO is not so concerned with the predicate acts but is focused instead on the enterprise and how it is affected by the pattern of racketeering—and nowhere does the statute evidence any concern with foreign enterprises, let alone a concern sufficient to overcome the presumption against extraterritoriality. According to the court, where the alleged enterprise and the impact of the predicate activity on it are entirely foreign, RICO does not apply.

The next case to address RICO and extraterritoriality was *Norex Petroleum, Ltd. v. Access Industries, Inc.*, 631 F.3d 29 (2d Cir. 2010). The plaintiff, Norex, alleged that the defendants conspired to take control of a Russian oil company and reduce Norex from the controlling majority shareholder to a minority one. This was allegedly done through a widespread racketeering and money-laundering scheme with the goal of seizing control of most of the Russian oil industry. The plaintiff alleged that numerous acts committed within the United States in furtherance of the scheme constituted racketeering within the meaning of RICO. These acts allegedly included mail and wire fraud, money laundering, Hobbs Act violations, Travel Act violations, and bribery.

The court noted that *Morrison* rejected the “conduct” and “effects” tests and wholeheartedly embraced the presumption against extraterritoriality. The court next considered Second Circuit precedent, namely the *Al-Turki* case discussed above, finding that RICO is silent as to any extraterritorial application. The court then turned to Norex’s arguments for applying RICO extraterritorially. First, Norex argued that RICO’s definition of interstate commerce includes foreign commerce. The court explained that *Morrison* foreclosed this argument by noting that even statutes containing broad language in their definitions of commerce do not apply abroad. Next, Norex argued that because some of RICO’s predicate acts possess an extraterritorial reach, RICO itself possesses an extraterritorial reach. *Morrison* rejected the same argument regarding section 30(b) of the Exchange Act by noting that the presumption against extraterritoriality operates to limit that provision to its terms. Finally, Norex argued that its allegations regarding domestic conduct were sufficient to support the domestic application of RICO. Finding these slim contacts insufficient, the court rejected this. In response to concerns regarding the government’s application of RICO, the court amended the decision to add a statement that the court did not express any opinion on the extraterritorial application of RICO when enforced by the government.

The next case to address the extraterritorial application of RICO was *European Cmty. v. RJR Nabisco, Inc.*, 2011 U.S. Dist. Lexis 23538 (E.D.N.Y. Mar. 8, 2011). The European Community

and 26 European countries brought a RICO action against various American cigarette manufacturers in relation to their cigarette sales practices. Specifically, the plaintiffs alleged that the defendants participated in a global money-laundering scheme involving Colombian and Russian criminal organizations and the exchange of illicit drugs, Euros, and cigarettes.

Citing *Norex*, the court noted that RICO's silence as to any extraterritorial application prohibited extraterritorial application. The court next considered whether the claims at issue warranted extraterritorial application of RICO. The court reviewed the focus of the statute, the activities it seeks to regulate, and the parties to those activities whom the statute seeks to protect. After analyzing the statute, the court determined that the focus of the statute was on enterprises; it seeks to regulate enterprises by protecting them from being victimized by or conducted through racketeering activity. Because RICO applies only to domestic enterprises, the court examined enterprise location for RICO purposes. The court compared the analysis to determining the geographic location of a corporation and adopted the nerve center test for determining principal place of business. To determine an enterprise's location, the court focused on the decisions effectuating the relationships and common interest of its members, as well as how those decisions were made.

Applying the nerve center test to the complaint, the court noted that none of the allegations even remotely suggested that the cigarette companies had any hand in the planning, decisions, or overall corporate policy of many of the steps involved in the scheme. Instead, the cigarette companies were mere sellers of fungible goods. Moreover, the alleged overall corporate policy of the enterprise issued from various criminal organizations located outside the United States. On this basis, the court dismissed the RICO claims against the cigarette companies.

More recently, the U.S. District Court for the District of Columbia considered *Morrison's* effect on RICO in *United States v. Phillip Morris USA, Inc.*, 2011 U.S. Dist. Lexis 32053 (D.D.C. Mar. 28, 2011). The case involved an alleged scheme to defraud smokers and potential smokers for purposes of financial gain by making false and fraudulent statements, representations, and promises in violation of RICO sections 1962(c) and (d). One of the defendants was the British American Tobacco (Investments), Ltd. (BATCo). On August 17, 2006, the court issued an opinion ruling that all the defendants, including BATCo, were liable. On May 22, 2009, the D.C. Court of Appeals affirmed the judgment of liability and other provisions in a remedial order. On December 28, 2010, the United States moved to compel BATCo's compliance with the 2006 order, which BATCo opposed based on the intervening *Morrison* decision.

BATCo is organized under the laws of England and Wales, and its principal place of business is in England. Its officials and scientists attended some meetings with other defendants in the United States. BATCo had been found liable because its activities and statements furthered the enterprise's overall scheme, which had a large impact on the United States. BATCo argued that because *Morrison* changed the law concerning the use of the "effects" test to determine extraterritoriality, the legal basis for the finding of liability against it was invalid. The government argued that the *Morrison* decision did not turn principally on the presumption

against extraterritoriality and that the case was meant to apply only to Section 10(b) of the Securities Exchange Act. Moreover, the government argued that some of the predicate acts giving rise to RICO liability are extraterritorial in nature, so Congress must have meant for RICO to have extraterritorial scope.

The court analyzed *Morrison* and determined that its holding—that, when a statute does not have a clear indication of extraterritorial reach, it does not have any—applies to all statutes. The court also found there was no evidence that Congress intended to criminalize foreign racketeering activities under RICO. Finally, BATCo’s limited domestic conduct was not enough to apply RICO to essentially foreign activity, and BATCo’s domestic conduct had not been the basis for its RICO liability. Thus, the court found that *Morrison* invalidated the basis for liability against BATCo and refused to compel BATCo to comply with the 2006 order.

### **Lanham Act**

In at least some situations, *Morrison* has been held not to affect the analysis regarding extraterritoriality. In *Love v. Associated Newspapers*, 611 F.3d 601 (9th Cir. 2010), for example, the Ninth Circuit addressed the effect of *Morrison* on its Lanham Act jurisprudence. The case involved the Beach Boys and the distribution of CDs in Britain. The court employed a three-part test borrowed from the antitrust context to analyze the Lanham Act’s coverage of foreign activities. In a footnote, the court addressed *Morrison*.

The court differentiated the Lanham Act from the securities laws based on statutory language. The court said that according to Ninth Circuit precedent, “commerce” for Lanham Act purposes is sweepingly defined as all commerce that may lawfully be regulated by Congress. According to the court, the breadth of this language contrasted readily with the language of the securities laws at issue in *Morrison*. The Lanham Act language did not refer merely to foreign commerce but expressly covered all commerce Congress could regulate. This language represented a clear indication that the statute applied extraterritorially. Therefore, the court saw no reason to revisit its case law regarding the extraterritorial application of the Lanham Act.

### **State Blue-Sky Laws and Dormant Commerce Clause Analysis**

*Morrison*’s transactional test has also been adopted by at least one court in determining the permissible reach of state blue-sky laws. For example, the court in *In re National Century Financial Enterprises, Inc.*, addressed whether Credit Suisse Securities, LLC, was liable under Ohio’s blue-sky laws for its role in the sale of asset-backed securities issued by National Century Financial Enterprises, Inc. 2010 U.S. Dist. Lexis 131724 (S.D. Oh. Dec. 13, 2010). Credit Suisse argued that the transactions at issue occurred wholly outside of Ohio and that to apply the Ohio statute to it would violate the dormant commerce clause.

The Ohio Securities Act said little about its territorial reach. Prior precedent held that the Ohio statute could be applied to securities transactions between a non-Ohio seller and a non-Ohio buyer, so long as the issuer was from Ohio and the seller had significant contacts with the issuer. The court determined that the Ohio statute applied to the situation before it but then addressed

whether that ran afoul of the Dormant Commerce Clause prohibiting states from passing legislation that discriminates against interstate commerce. The court discussed multiple tests that had been used to determine whether a statute was being applied extraterritorially.

The court concluded that the Ohio Securities Act focused on the securities transactions, not on the fraud perpetrated upon the buyers. The plaintiffs' attempt to impose liability on Credit Suisse merely for participating or aiding in making the sale, not for committing the fraud, would impose a burden on interstate commerce by rescinding sales of securities that take place entirely in other states under whose laws the transactions would not be rescinded without a further element of intent or knowledge. The fact that a particular transaction may affect or impact a state does not license that state to regulate commerce occurring outside of its jurisdiction. Accordingly, the court adopted the *Morrison* transactional test and held that the Ohio Securities Act did not apply extraterritorially.

### Conclusion

*Morrison* has had an immediate and significant impact on areas of law outside of the securities context, particularly in RICO cases. *Morrison* has also superseded the tests used to determine extraterritorial applicability in other areas, such as the Lanham Act, and in reviewing the permissible reach of state laws under Dormant Commerce Clause analysis. The reasoning and language of *Morrison* thus puts new moves on the litigation chessboard when a case or controversy has international components, particularly with respect to international parties whose links to the United States are attenuated.

**Keywords:** litigation, international litigation, Securities Exchange Act, Racketeer Influenced and Corrupt Organizations Act, *Morrison v. National Australia Bank, Ltd.*

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## Fixing the Way Multi-Arbitrator Tribunals Are Formed

By Herman Manuel Duarte — October 27, 2011

One of the pressing issues in international arbitration is the practice of unilaterally appointing arbitrators and its effect on the decision-making process. The term “unilateral appointment” refers to a party’s decision to appoint its own arbitrator at will, without an agreement by the counterparty or the arbitral institution. This does not mean that the arbitrator appointment violates the rules of the arbitral institution; rather, the decision rests with the appointing party alone. The common practice in multi-arbitrator tribunals is that two out of the three arbitrators are unilaterally appointed by the parties, one each. The third arbitrator is selected by the arbitrators appointed by the parties. This can create all types of situations, from collaborative

arbitrators who fulfill their functions with due diligence to rebellious arbitrators who refuse to participate in proceedings or who issue ugly dissents.

As an example of the latter, there are reports made by experienced practitioners showing that an elevated number of dissents are produced by the arbitrator who was unilaterally appointed by the losing party. At least two independent studies have shown a strong correlation between dissents and the unilateral appointee of the losing party. The problem becomes even more significant when the dissents are used as the basis for a challenge or to raise objections to the enforcement of the award.

### **Problematic Situations in Multi-Arbitrator Tribunals**

One advantage of arbitration over litigation is the possibility of selecting the panel of persons who will hear and decide a dispute in contrast to the preexisting list of judges who handle cases in a given court system. The common arbitration scenario is to have a tripartite panel, where each side of the dispute has selected one arbitrator, and the two party-appointed arbitrators agree on the name of the chairperson. The parties are jointly responsible for the costs of all three arbitrators, subject to any ultimate allocation of costs. Further, all three arbitrators are expected to be neutral, independent, and impartial.

Often, the selection of an arbitrator will consume a considerable amount of time for the party making the appointment. This can include research about a potential arbitrator's capacity to understand the factual issues presented and potential sympathies to the appointing party's views, in addition to the typical analysis of the arbitrator's prospective compliance with the duties of diligence, impartiality, and neutrality. Unfortunately, this exhaustive process can sometimes result in a litany of problems.

The problems include a number of issues that are innocent and less than drastic, albeit still irritating, that can arise. For example, it is common that the hearing, or scheduling conference, has to be postponed on repeated occasions due to the busy agendas international arbitrators usually have. And, although some of these problems can be innocent or harmless, there have been reports of annulment of awards due to excessive delays.

In other cases, constant communication between an arbitrator and one of the parties can provide a different kind of challenge. Not all private communications between arbitrators and one of the parties is forbidden, but arbitrators need to be reluctant to engage in private meetings with one party because this could lead to the creation of an appearance of bias and eventually open a window to a possible challenge of the arbitrator or the award.

Commentators have also noted that some arbitrators make themselves unavailable just before the start of a hearing, apparently with the sole aim of delaying the hearing. The excuses presented are innumerable, from feigned illness to personal appointments. In the same context, there have been incidents where arbitrators resign at the last minute, which obviously complicates the

management of the dispute. In addition, there have been many reports of arbitrators behaving in a biased manner during the hearing itself.

Controversies can also arise during the period of the tribunal's deliberations. Some arbitrators will hold out the possibility of a dissenting opinion to extract concessions from the chairman, who often writes the award. And when no consensus can be reached, dissenting opinions by the arbitrator appointed by the losing party are increasingly common.

Dissenting opinions, just like people, come in different sizes and shapes. A prominent commentator in the field classifies dissents as good, when those dissents are short and polite but allow the arbitrator to express disagreement with the majority's decision. A dissent is bad when the arbitrator displays his or her temper in expressing disagreement with the majority's reasoning. And, according to the commentator, dissents are ugly when the arbitrator, apart from disagreeing with the rationale used by the majority, takes the opportunity to attack the manner in which the proceedings were conducted, alleging serious procedural violations and leaving the award vulnerable to a challenge.

These ugly dissents may raise a number of different topics, such as pointing out that parties were not given equal opportunities to present the case; excluding the arbitrator from the deliberations; or even accusing the rest of the tribunal of not being impartial.

There are also situations where arbitrators promise to issue a dissent by a certain date for the purpose of delaying the delivery of the award to the parties. In the end, this helps the party who appointed the arbitrator gain time for a possible settlement. In this context, there have been cases where the arbitrator sends a copy of the draft award to one of the parties, giving it vital information for negotiating with its counterparty. On some occasions, arbitrators have admitted to having acted in a non-neutral way so as to favor their appointing party. Finally, there have been outrageous cases where arbitrators crossed over the boundaries of civilized behavior and threatened other arbitrators with physical harm.

Unfortunately, many of these challenging situations result from the behavior of a party-appointed arbitrator who favors the party who made the appointment. And the sheer number of episodes of unseemly behavior should at least raise the question of potential problems in the constitution of arbitral tribunals.

### **Is It Time to Change the Way Tribunals are Constituted?**

Before addressing the issue of changing the appointment mechanism that is common to many arbitral institutions, it is important to consider the psychology of the unilateral appointment process. Behind every unilateral appointment, there is a party intent on winning the case. Different factors reflect that intention, and sometimes it gives confidence to the appointing counsel that there will be at least one member of the tribunal who will be receptive to his or her ideas. Occasionally, the appointed arbitrator serves as a translator. In this sense, the arbitrator communicates on behalf of a party because the cultural differences among the participants are of



such magnitude that, to completely understand one party's actions, someone who shares a legal and cultural background with them is needed. This can increase a party's comfort with the arbitration process, even if there is no hint of partiality.

It is also a common practice that the co-arbitrator consults with his or her appointing party to make the selection of the presiding arbitrator. This situation gives the parties a sense of proximity to and control of the process. And, of course, on some occasions, the appointing party believes that, based upon his or her mere selection of an arbitrator to hear the dispute, the party's nominee will actively help to win the case.

As a result, it is clear that unilateral appointment gives confidence to the parties and reflects one of the greatest advantages arbitration has over litigation—the selection of the persons in charge of deciding the dispute.

Considered in this light, the controversy makes more sense. If the commercial relations between two or more companies have gone to the extreme of initiating arbitral proceedings, how can either of the parties have confidence that the arbitrator selected by its ex-business partner will undertake his or her duties in an impartial and neutral manner?

Some scholars and practitioners argue that the institution of the party-appointed arbitrator corrupts the entire process. For example, prominent arbitration scholar Hans Smit, in his article "The Pernicious Institution of the Party Appointed Arbitrator," has explained that "the presence of a partisan arbitrator on a panel will normally reduce, if not eliminate, the free exchange of ideas among the members of the panel. The chair will be less receptive to arguments that appear to be moved by partisan considerations or may join one of the arbitrators."

This concern with the consequences of unilateral appointments strikes directly at the heart of arbitration as a viable method for resolving disputes. Specifically, the opponents of such appointments suggest that the practice is jeopardizing the institution of arbitration as a whole because it presents the image of a dispute-resolution system that is denatured and debased by the lack of impartiality of the decision makers.

### **Analysis of the Pros and Cons: Is Change Even Possible?**

One of the most recurring illustrations of the lack of impartiality of an arbitrator is said to be reflected in the high percentage of dissenting opinions in favor of the appointing party. However, the issuance of a dissenting opinion is the exception to the general rule of unanimous awards, as can be confirmed by existing statistical reports. Furthermore, the numbers show that the relative percentage of arbitral dissents is declining over time.

Nonetheless, the absence of a dissenting opinion does not guarantee that the arbitrators have acted in an impartial manner. To reach a unanimous award, it is quite common for the arbitrators to make compromises resulting in undeserved benefits to the recalcitrant arbitrator's appointing

party. In the same context, other forms of biased behavior during the proceedings can similarly go undetected but nevertheless have important effects.

Despite the high costs of the unilateral appointment system for the integrity of the arbitral process, changing that system would also involve very high costs. As an initial consideration, the unilateral appointment system is a practice that is engrained in the culture of arbitration. Businesspeople, who are the users of arbitration, and their legal counsel, who are frequently the source of the recommendation to resort to arbitration, feel comfortable with this institution of arbitrator appointment because there is an opportunity to select the judges for the dispute, and this translates into greater confidence in the process and its outcome.

The dispute-resolution marketplace itself reflects the value of this appointment system: The majority of institutional rules and national arbitration laws have unilateral appointments as a predetermined method of composing multi-arbitrator tribunals. Free market principles and competition suggest that as long as it is possible to enforce awards produced by tribunals formed by party-appointed arbitrators, parties' agreements will keep supporting the appointment system. In addition, because of the wide range of legal norms and arbitral rules that support the existing appointment system, systematic reform would be costly and would need to be revised. Even if unilateral appointment could be eradicated as an appointment system, the benefits of doing so might well be minimized if dissatisfied users abandoned arbitration in favor of a different dispute-resolution approach.

### **Alternatives to Unilateral Appointments**

Although it is unlikely that the arbitral institutions will eliminate unilateral appointment as a default means of arbitrator selection, the parties to an arbitration agreement are always free to agree on a different method of selection. As a result, the possibility of excluding unilateral appointments on a case-by-case basis is always an option. Parties who agree to do so have several available options.

### **Sole Arbitrators**

A recommendation for a sole arbitrator can be made, either by stipulating that the appointment must be made by consensus of the parties, or by agreeing upon the name of another person or institution who will be responsible to make the appointment. The logic behind resorting to a sole arbitrator is simple: Because each side normally has the right to appoint one arbitrator with the expectation that its nominee will be successful in persuading the third arbitrator, then the votes and persuasive influence of the two party-appointed co-arbitrators should in effect offset one another. Therefore, by eliminating the two party-appointed arbitrators and keeping the sole non-party-appointed arbitrator, the end result should be no different (except for the costs of getting there).

Some of the obvious problems with this approach are the possibility that the parties will not be able to agree on the name of the arbitrator and that they will not be entirely satisfied by the appointment made by the arbitral institution. In addition, there can be cases of such complexity

that having more than one arbitrator would contribute to a deeper and broader understanding of the matter.

### **Appointment Made by a Third Party**

A second alternative is for the parties to maintain a multi-arbitrator tribunal but agree that all of the arbitrator appointments, or at least the appointments that would normally be made by the parties, are to be decided by a neutral third party. This option can be available either in institutional or ad hoc proceedings.

The greatest advantage of this solution is the likelihood that the quality of the proceedings and the award will increase as a consequence of having a higher level of collegiality. Moreover, if all of the arbitrators are being selected by a neutral third party, the appointing institution could include as tribunal members those individuals with special knowledge in particular subject areas, which could result in the tribunal having a greater overall level of relevancy expertise.

However, this approach is also not immune from criticism. The parties might well be dissatisfied with the particular selections made by the appointing institution. Moreover, the relatively small pool of available professionals could result in the repeated appointments of arbitrators, contributing to an increase of challenges of arbitrators due to perceived conflicts, and thereby making procedures less expeditious. Other problems could be the high entry costs to new arbitrators wishing to join the pool of arbitrators who receive institutional appointments, and the resulting distortions to the system.

### **Blind Appointments**

Another option available is to keep confidential from the arbitrators the identity of the specific parties that appointed them, to promote the free exchange of ideas between arbitrators during the period of the proceedings, especially during the deliberations. This method guarantees (at least in theory) that none of the arbitrators will feel any particular pressure to favor one side or the other.

The main problem with this solution is that it is not particularly reliable in practice, where it is extremely easy to find out (or presume) which party has appointed whom. Moreover, blind appointments can also be difficult to apply in ad hoc arbitrations where the parties lack an institutional framework and must themselves structure the proceedings by agreement.

### **Non-Neutral Arbitrators**

A final and alternative proposal has been put forth by Hans Smit: Party-appointed arbitrators should be banned unless their role as advocates for the party that appointed them is fully disclosed and accepted. In other words, Professor Smit advocates the acceptance of non-neutral arbitrators as has been typical in domestic arbitrations in the United States.

The most interesting aspect of this proposal is that, even though it embraces the other extreme of the party-appointment dilemma, it provides a clear solution to the problem of hypocrisy that results when “neutral” arbitrators know they owe their appointments to a specific party to the

dispute. Although this approach does not eliminate all problems that can be caused by unilateral appointments, it does more clearly and realistically acknowledge the likely role of the party-appointed arbitrator, and it allows the parties the benefits of retaining some control over the formation of the arbitral tribunal.

## Conclusion

Although there are obvious problems with unilateral appointments, banning them entirely seems out of the question. Instead, parties should consider whether to employ alternative approaches when drafting their arbitration agreements, as indicated in the possible solutions above. Not only do these alternative solutions protect the party autonomy that is central to the arbitration process; they also serve to eliminate some of the pitfalls inherent in unilateral appointments.

**Keywords:** litigation, international litigation, multi-arbitrator tribunals, unilateral appointments

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This article is intended for young lawyers.

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## U.K. Bribery Act: Assessing Risk, Implementing Procedures

By Michelle Duncan and Sara A. Murphy — October 27, 2011

The U.K. Bribery Act 2010 came into effect on July 1, 2011. The much-heralded legislation replaces the United Kingdom's existing anti-bribery laws with the two general offenses of offering or accepting a bribe, a new offense of bribing a foreign public official, and a controversial, strict-liability corporate offense of failing to prevent bribery. Public reaction to the Bribery Act was so strong that the U.K. Ministry of Justice (MOJ) delayed implementation of the act to hold a period of public consultation that culminated in March 2011 with the publication of guidance from the U.K. Ministry of Justice and the Joint Prosecution Guidance of the Director of the Serious Fraud Office (SFO) and the Director of Public Prosecutions.

Many companies are still seeking answers to threshold questions about the applicability of the Bribery Act to their subsidiaries, officers, directors, and employees. Many of these questions will only be answered through judicial application of the Bribery Act. The only prosecution pending under the new law is not against a company or individual who offered a bribe but rather against a court clerk who allegedly requested and received a £500 bribe to improperly influence a pending criminal case for a motoring offense. In the absence of case law interpreting the jurisdiction of the Bribery Act, a host of companies with limited connections to the United Kingdom is left to decide whether they are subject to the act, and if so, how to adopt an effective compliance program or modify an existing compliance program to comply with the act.

While some questions remain unanswered, the statutory language of the Bribery Act, the MOJ guidance, and the Joint Prosecution Guidance provide a framework for assessing whether an

organization, its subsidiaries, officers, directors, and employees fall within the jurisdiction of the Bribery Act, and, if so, how to adopt adequate procedures to protect the organization from liability under the Bribery Act.

## Understanding Jurisdiction

Understanding the jurisdictional reach of the Bribery Act is the first step for companies and individuals seeking to understand whether they are at risk of being prosecuted for potential violations of the Bribery Act. The broad language of the Bribery Act gives a potentially wide jurisdictional scope and affords significant discretion to prosecutors seeking to enforce the statute. The MOJ guidance and Joint Prosecution Guidance provide a framework for exercising that discretion that emphasizes applying a common-sense approach. Public statements by the SFO indicate that the Bribery Act will be used to prosecute foreign entities that undercut U.K. organizations in other countries through improper practices. Additional factors, such as cooperation with foreign governments, may also help determine which cases ultimately receive the attention and resources of U.K. prosecutors. However, uncertainty remains as questions of jurisdiction will ultimately be decided by the courts.

## General Offenses

The act creates, among other offenses, two general offenses of offering a bribe and accepting a bribe as well as the offense of bribing a foreign public official. These offenses have a similar territorial scope. Jurisdiction is conferred when the relevant act or omission takes place in the United Kingdom or anywhere in the world when committed by a person closely connected with the United Kingdom. The two general offenses include acts where all parties are private citizens.

As a result, courts will have jurisdiction over any offenses under Section 1 (bribing another person), Section 2(4) (receiving a bribe as a reward for improperly performing a relevant function or activity), or Section 6 (bribery of foreign public officials) that are committed in the United Kingdom. Courts will also have jurisdiction for offenses committed outside the United Kingdom where the person committing them has a close connection to the United Kingdom, such as being a British national or ordinarily resident in the United Kingdom, a body incorporated in the United Kingdom, or a Scottish partnership.

## Corporate Offense

The act also creates a strict liability corporate offense with wide extraterritorial reach. The jurisdiction of this offense extends to all U.K. partnerships, limited partnerships, and incorporated companies wherever they do business regardless of where the offense is committed; all commercial organizations that “carry on business or part of a business” in the United Kingdom regardless of their jurisdiction of incorporation; and the furtherance of offenses that occurs in the United Kingdom regardless of the jurisdiction of incorporation.

Further, commercial organizations may be liable for the actions of any person “associated” with it. Such an associated person is not required to have close connection to the United Kingdom. Under Section 7, a relevant commercial organization is guilty of an offense if an associated

person bribes another person intending to obtain or retain business for the organization or to obtain or retain an advantage in the conduct of business for the organization. It is not necessary for the associated person to be prosecuted for bribery in order for the organization to face liability. However, as stated in the MOJ guidance, to trigger Section 7, the prosecution must prove beyond a reasonable doubt that an offense under Sections 1 or 6 has been committed. An organization can be found liable for a Section 7 offense in addition to being liable on the same facts for a Section 1 or 6 violation. The organization has an absolute defense to the Section 7 offense if it can prove that it had in place “adequate procedures” designed to prevent associated persons from undertaking the bribe.

### **Ambiguity of Jurisdiction of the Corporate Offense**

The guidance sets out the limits of a corporation’s liabilities in relation to suppliers and third parties as “associated” persons.

The MOJ guidance recognized that where a supply chain involves several entities or a project is to be performed by a prime contractor with a series of subcontractors, the organization is only likely to exercise control over its relationship with its contractual counterparty. This addresses concerns previously raised regarding the potentially wide liability for actions by persons “associated” with a commercial organization over which a corporate may have little or no control.

It is expected that commercial organizations will approach bribery risks that arise as a result of a supply chain by employing the types of measures referred to in the guidelines on “adequate procedures.” This includes risk-based due diligence and the use of anti-bribery terms and conditions as well as requesting that the contractual counterparty adopt a similar approach with the next party in the chain.

It is unclear whether a fine imposed for acts that occurred by a non-U.K. affiliate of a non-U.K. registered or based company will affect only the portion of U.K. business by the indicted company or whether it would have a broader reach to the non-U.K. generated revenue.

### **Carrying on Business**

The provision of the Bribery Act that has garnered the most attention from critics is the strict-liability corporate offense under which a “relevant commercial organisation” that “carries on a business in the UK” can be held liable for failing to prevent bribery under Section 7 of the Bribery Act.

The MOJ guidance stated that “the Government anticipates that applying a common sense approach would mean that organizations that do not have a demonstrable business presence in the UK” would not be subject to Section 7. Ultimately, the courts will make the decision on a case-by-case basis according to the facts of each case, but based on the MOJ guidance and common-law interpretations of “carrying on business” one can anticipate that, in general, the following principles are likely to be applied.



As noted in the MOJ guidance, the Ministry of Justice does not anticipate that a company will be considered to “carry on business” in the United Kingdom solely based on the fact that a company’s securities have been admitted to the United Kingdom. Listing Authority’s Official list and are therefore admitted to trading on the London Stock Exchange. This is on the basis that such a company has no other business presence in the United Kingdom other than to raise capital.

The MOJ guidance also indicates that a parent company does not “carry on business” in the United Kingdom merely by virtue of having a U.K. subsidiary, as that subsidiary may act independently from the parent or group of companies. This is consistent with English case law holding that the fact that a subsidiary was set up to reduce the potential tortious liability of the parent constituted a legitimate use of the corporate form and did not constitute a ground for piercing the corporate veil of the subsidiary so as to treat its activities as being those of the parent.

However, a subsidiary that does not act independently from the parent could be considered the parent company’s place of business in the United Kingdom and would likely make the parent liable for a Section 7 offense. Generally, if a foreign company maintains a place of business or an office in the United Kingdom in its own name rather than through a subsidiary, the foreign company will be deemed to carry on business in the United Kingdom.

Under common law, “carrying on” implies a repetition or series of acts, so a single transaction in the United Kingdom or an isolated visit by an employee is unlikely to make a foreign company subject to liability under Section 7.

Additionally, under common law, having an agency is not necessarily carrying on business by the principal. However, if the agent makes a contract for the foreign corporation, the foreign corporation is deemed to be carrying on business.

### **Determining Jurisdiction**

All acts committed in the United Kingdom are subject to the Bribery Act, and U.K. citizens and residents face Bribery Act liability for their actions all over the world. Companies doing business in the United Kingdom should be slow to disregard the risk that their activities could be found to constitute “carrying on business” in the United Kingdom and thus bring the company within the definition of “relevant commercial organisation.” It is relatively certain that courts will have jurisdiction to enforce the Bribery Act against companies formed under the laws of the United Kingdom and those with subsidiaries in the United Kingdom that are not independent. Similarly, companies with offices or major operations in the United Kingdom or third party agents with the ability to commit the company to contracts in the United Kingdom should anticipate that the courts will be able to exercise jurisdiction over them under the Bribery Act.

The full reach of the Bribery Act will become clear as U.K. authorities begin enforcing the statute and case law develops. In the meantime, the potential for unlimited fines and criminal

penalties, including imprisonment for individuals, makes underestimating the jurisdictional scope of the Bribery Act a potentially costly mistake. The best protection for commercial organizations subject to the Bribery Act is to develop adequate procedures that will prevent bribery. Such procedures will provide a defense to Section 7 liability and will help deter violations of Sections 1, 2, and 6 and put an organization in a better position to negotiate with authorities should allegations of bribery lead to government action.

## **Adequate Procedures**

The MOJ guidance, released on March 30, 2011, provided instruction on how to develop adequate procedures, which are a defense for a commercial organization facing charges of failing to prevent bribery by associated persons under Section 7. The MOJ guidance explained that bribery prevention procedures should be proportionate to risk. Risk will vary based on the degree to which companies operate outside the United Kingdom and interact with foreign government officials, as well as the way in which companies obtain and retain business. The MOJ highlighted that companies of different sizes face different types of risks and that a one-size-fits-all approach would not work for designing robust and effective compliance programs. Instead, the MOJ guidance outlined six principles that should inform a company in preparing and implementing adequate procedures. While these principles are not prescriptive, they are useful in evaluating an existing anticorruption compliance program and preparing an enhanced program.

### **Principle 1: Proportionate Procedures**

The first principle recognizes that a commercial organization's procedures should be proportionate to the bribery risk it faces and to the nature, scale, and complexity of its activities. Developing proportionate procedures requires an assessment of the bribery risk facing the organization. Adequate procedures should include not only policies articulating the organization's position on bribery but also procedures for implementing the policies. The size of the organization may influence the form and scale of the procedures, but the primary inquiry is the bribery risk associated with an entity due to the nature of its work. The policies and procedures should address high-risk relationships with employees and third parties that would be considered "associated" persons as well as high-risk activities, including those identified through the risk assessment process.

### **Principle 2: Top-Level Commitment**

The second principle addresses the role of top-level managers in creating a culture of compliance and fostering an atmosphere in which bribery is unacceptable. Often called "tone from the top," the second principle seeks to establish a clear message from the Board of Directors, senior executives, and managers that the company is committed to operating with integrity and to involving the organization's leadership in approving, designing, and implementing the organization's anticorruption compliance program.

### **Principle 3: Risk Assessment**

An initial risk assessment is required in order to design proportionate procedures. The obligation to assess risk does not stop after the first assessment is completed. Instead, risk assessments

should be periodic to address the evolution of the business itself. Ongoing, well-documented risk assessments allow an organization to understand its changing bribery risks and to better mitigate those risks. For some organizations, it may be advisable to adopt policies and procedures for assessing risk on individual projects or prioritizing risks to be mitigated through changes in policies and procedures. Even where this is not necessary, periodic risk assessments will be necessary to evaluate and address external risks arising from the countries in which the organization operates, the sector in which it does business, and individuals' transactions, business opportunities, and partnerships.

#### **Principle 4: Due Diligence**

The fourth principle acknowledges the need to conduct risk-based due diligence on persons associated with an organization who may give rise to liability for failing to prevent bribery. Due diligence is particularly important where local law dictates the use of a local agent or partner and when an organization is seeking to acquire another entity. Due diligence may be advisable for both third parties and employees. The scope of due diligence and the materials required to complete it will vary based on the risk posed by the proposed relationship and may require independent verification.

#### **Principle 5: Communication (Including Training)**

Commercial organizations applying the fifth principle will ensure that their anticorruption policies and procedures are communicated both throughout the organization and externally. Training of employees and, in some instances, associated persons should be continuous and regularly monitored and evaluated. The content of the training should be proportionate to the risk it seeks to address and may be tailored to specific risks arising from an individual's job function or location.

#### **Principle 6: Monitoring and Review**

The final principle seeks to address the need to assess the effectiveness of a compliance program and to make improvements as required. Internal financial control mechanisms and feedback from employees and third parties on trainings can provide insight on whether the compliance program is meeting its stated goals. Organizations should also consider periodic reviews and reports to top-level management and may wish to seek external verification of the effectiveness of anticorruption policies and procedures, such as an audit or review by outside counsel.

#### **Conclusion**

As enforcement of the U.K. Bribery Act has begun, it is imperative that companies and individuals determine whether its jurisdictional reach extends to them. Where it is unclear whether jurisdiction will apply, a conservative approach is recommended in light of the Bribery Act's steep penalties and unlimited fines. A company seeking to comply with the Bribery Act should review its existing compliance programs in light of the six principles articulated by the MOJ and ensure that it can demonstrate and document an effective compliance program tailored to the bribery risks posed by its business.



**Keywords:** litigation, international litigation, United Kingdom, U.K. Bribery Act, Ministry of Justice

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## Comparing Commercial and Investment Arbitration

By Diego Brian Gosis — October 27, 2011

In reviewing the current wealth of arbitration symposia, conferences, and events being organized by the most respectable institutions and academic organizations, one wonders whether the proposed topics of the organizers' programs are being covered from the perspective of commercial arbitration or investment arbitration or irrespective of the differences between those two dispute resolution practices.

Although at first sight there are many such areas in which the issues can be tackled from either angle without any distinction, when dealing with investment arbitration, as opposed to its commercial counterpart, certain practical and theoretical considerations justify varying approaches. This is particularly important because a growing number of arbitrators are serving in both the commercial and investment arbitration arenas.

### Production of Evidence

It is a commonly shared view that arbitrators should be allowed to draw reasonably negative inferences when a given party fails to provide "internal" documents or information requested by the opposing party or the tribunal itself that could have relevant effects in the fact-finding stages of the proceedings. This is in fact the stance taken by section 9.5 of the IBA Rules on Taking of Evidence in International Arbitration, which have seen a change in denomination in their latest revision in 2010 (with the removal of the word "commercial") to accommodate the fact that they can and will be applied in both investment and commercial arbitration contexts.

Of course, time is usually a scarce resource in large, complex proceedings, and the timeframe within which a party is supposed to have those documents or information made available, or else be considered to be hiding it from public light is, more often than not, rather tight.

This applies to commercial and investment arbitration proceedings alike, but, in the specific case of investment arbitration, it is very rarely the case that the information or documents requested of a state party to the proceedings, however "internal" (issued or registered by or in an instrumentality or agency of the party state), is not publicly available to anyone interested enough to spend the requisite time, travel the requisite distance, and wipe the requisite dust from what tends to be an old file that is physically located in largely unvisited public offices in little towns of distant provinces, sometimes several hundred miles away from the state's capital city

(the usual place of business of both counsel for the state party and some counsel for the investor party).

In these cases, even where counsel for the investor is, if not better, just as equally suited to go hunting for that old missing piece of paper of alleged great relevance, a commercial-minded arbitrator would be prone to place the burden upon counsel for the state to embark on this sometimes perilous (and certainly time-consuming) task, lest the tribunal should consider any delay as a showing of reluctance in producing this evidence.

On the other hand, a good investment arbitrator would first ask the investor party to show that the evidence requested is actually beyond the reach of a private, proactive, search(ing) party. Only then would it ask the state to release it from any confidentiality or otherwise protective shelter impeding it from reaching the eyes of the tribunal, and make the evidence available.

Ultimately, the issue revolves around the construction to be given to standards such as those contained in section 3.3(c) of the IBA Rules, which allow for a Request for Production to be submitted where the documents requested “are not in the possession, custody or control of the requesting Party.” In other words, should a tribunal interpret that, where a certain document is in the public domain, it is in the “possession” of an investor party intending to rely on it? Or should it consider that, if it is registered before a state agency, the fact that it is in the host state party’s “custody” should prevail over its accessibility by the public? It seems there is no single answer to this conundrum.

It could be argued that these considerations should apply to any state party to arbitration proceedings, irrespective of whether commercial or investment arbitration rules or institutions have come into play. However, as a matter of scope, commercial arbitrations against states are—with some noteworthy exceptions, such as the ICC cases of *BRIDAS v. Government of Turkmenistan*—related to private-law transactions with a public agency, which can more easily lead to the need for documents beyond public reach. In contrast, investment arbitration deals, as the *Vivendi I Ad Hoc* Committee put it, with “treaty causes of action,” as opposed to “contractual causes of action” (Decision on Annulment, at paragraph 113). These in turn rely rather heavily on governmental acts of the host state, which are, in all likelihood, publicly available in most currently fashionable state forms.

### **Institution-Related Conflicts of Interest**

In the context of international arbitration, it is often agreed that arbitrators appointed by an arbitral institution owe a duty of allegiance to the institution that appointed them. This was, by way of example, one of the premises for a fruitful debate on ethics in international arbitration hosted in Vienna some time ago by a panel moderated by Pierre Karrer and comprised of many renowned arbitrators from several continents. Among other subjects, the panelists discussed whether it was permissible for arbitrators to propose to the parties that the proceedings be transformed into ad hoc arbitration after the panel had been constituted under the rules of a given institution.

This proposition, however neutral in appearance, turns out upon closer examination not to be as applicable to investment arbitration as it seems to be to commercial arbitration.

It is unlikely that a party involved in a commercial arbitration will have a conflict of interest with the institution administering it or the rules under which the proceedings are taking place. One could think of a controversy between the publishing arm of a commercial arbitration center and a publishing scholar who is, at the same time, counsel for such party in proceedings administered by such center, but it must be noted that it took the author a considerable effort to come up with such an example and the potentialities for conflict are so low that they would only marginally affect the apparent consensus upon the validity of the assertion at the beginning of this section.

In any event, in spite of this considerable effort, the author could not come up with a situation where the conflict of interest would be based on the controversy that is the subject matter of the arbitration proceedings themselves. On the other hand, let's take a look at the International Centre for Settlement of Investment Disputes (ICSID), its structure and its work.

The ICSID was established by the Convention on the Settlement of Investment Disputes between States and Nationals of Other States, which entered into force in 1966. As described by ICSID in the Introduction to the ICSID Regulations and Rules, "The Convention was formulated by the Executive Directors of [the World Bank]. On March 18, 1965, the Executive Directors submitted the Convention, with an accompanying Report, to member governments of the World Bank for their consideration of the Convention with a view to its signature and ratification."

The ICSID is a member of the World Bank Group, as is the International Finance Corporation (IFC) and other agencies. As stated in article V of the ICSID Convention, the president of the World Bank is ex officio the chairman of the administrative council of ICSID and, in spite of not having a vote in this administrative council, it nominates the secretary general and deputy secretary general of ICSID, according to article X. Similarly, under rule 4 of the ICSID arbitration rules, if the tribunal is not constituted within the prescribed time periods, the president of the World Bank could well end up appointing the arbitrator or arbitrators not yet appointed and designating an arbitrator to be the president of the tribunal.

As the foremost part of its mandate, the IFC fosters sustainable economic growth in developing countries by financing private sector investment. As a consequence, there are instances where the IFC is granted, through collateralization or otherwise, an ownership stake in a financed company. In other instances, where the financed company is unable to satisfy the aggregate amounts received under IFC financing as originally planned, the IFC has been known to accept some degree of amendment to the terms and conditions of its credit to make a certain portion of the credit rights contingent upon a given "liquidity event" for the debtor company or its shareholders. It is here, alas, that the source for a potential conflict of interest lies.

The author knows of at least two separate instances of IFC being either a shareholder in a company that appeared as claimant in an ICSID proceeding or the holder of a credit against a

financed company that was contingent upon such company (or its shareholders) being awarded damages under an ICSID proceeding against the state where the company had its seat. Arguably, this might create an appearance of bias on any action related to these proceedings devised to be taken by ICSID itself, and, more specifically, by the President of the World Bank or ICSID personnel directly nominated by the latter. This appearance of bias could arise in deciding upon the registration of a claim against a host state, upon the manifold decisions adopted by ICSID's Secretariat before, during, and after the workings of the arbitration tribunal, and even, when aimed at multiple arbitrators in a single tribunal or in single-arbitrator proceedings, any decision on disqualifications of arbitrators. The potential for bias in so many common scenarios is indeed troubling.

So far, the situation seems to have been overlooked by most rules and guidelines dealing with conflicts of interest. As an example, the commendable IBA Guidelines on Conflicts of Interest in International Arbitration, which recognize in their Introduction that they might apply in the context of investment arbitration, refer exclusively to conflicts of interest faced by the arbitrators (*see* their General Principle 1) and not by the arbitration centers under which rules they act. Of course, this doesn't mean that conflicts of interest in arbitrators and in arbitration centers are of equal relevance or recurrence, the former being of far clearer legal and statistical importance than the latter. Rather, the issue, marginal in any context other than that of ICSID arbitration, has not yet secured the attention of scholarly and regulating bodies.

Certainly, as awareness and concern over matters of arbitration ethics grow, the shaded area of institution-related conflicts of interest must still become the subject of illumination, review, and regulation. However, the fact remains that, for all those who tripped over the mat at the ICC headquarters on a rainy day and for all countries facing BIT claims by multilaterally financed investors, a certain degree of leveling of the arbitration ground is still necessary.

## Conclusion

The foregoing arguments should be read as being in support of, and not in opposition to, arbitration as a practice. The author is a strong advocate of international arbitration. It is, to say the least, very difficult for him to conceive a better alternative for dispute resolution in international controversies than commercial or investment arbitration.

But we should focus on—and force tribunals, clients, and institutions to focus on—conducting an investment arbitration that requires, even when arguing before or against colleagues already faced in commercial arbitration, a separate set of precautions, considerations, and protocols specific to that context. Otherwise, we will be playing American football on a rugby court. Close, but not quite.

**Keywords:** litigation, international litigation, commercial arbitration, investment arbitration, arbitration

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## Possible Setback for CMS Spread Ladder Swaps in Germany

By Jan Kraayvanger and Armineh Gharibian — October 27, 2011

Are financial institutions required to disclose their profit margins when they sell their own financial products to their customers? As a general rule, pursuant to long-established precedent, this is not the case in Germany. (BGH, judgment of 15 April 2010, ref. no. III ZR 196/09, BGHZ 185, 185). However, with regard to a form of structured derivative known as constant maturity swap (CMS) spread ladder swaps, it has long been a matter of dispute whether or not financial institutions are obliged to disclose the so-called initial negative market value when they enter into a swap transaction with a customer.

The swap has an initial negative market value if the bank has structured the transaction in a way that *ab initio* the chances of the bank to gain profit are slightly higher than the risk to suffer losses. The bank, therefore, can (synthetically) sell its rights and obligations under the swap agreement to a third party and thereby make a profit. Thus, in economic terms, the initial negative market value is nothing but the profit margin of the bank and, therefore, many lower courts have held in the past that a bank is not obliged to disclose the initial negative market value. (See, e.g., Higher Regional Court of Bamberg, judgment of 11 May 2009, ref. no. 4 U 92/08, ZIP 2009, 1209; Higher Regional Court of Frankfurt, judgment of 29 July 2009, ref. no. 23 U 76/08, WM 2009, 1563; *but see* Regional Court of Stuttgart, judgment of 26 February 2010, ref. no. 9 U 164/08, ZIP 2010, 716.)

However, in its landmark decision dated March 22, 2011, the German Federal Supreme Court rendered a judgment against Deutsche Bank, finding that financial institutions must disclose the negative market value to their customers to advise them properly on the risks of the transaction. BGH, judgment of 22 March 2011, ref. No. XI ZR 33/10, ZIP 2011, 756. This judgment has received a lot of attention because the Supreme Court has once again imposed a high standard of advisory duties on financial institutions vis-à-vis their customers, even if the latter are experienced investors.

In the disputed case, the claimant was a midsized company that brought a claim against Deutsche Bank for losses incurred in connection with a CMS spread ladder swap transaction. Prior to concluding the transaction, the claimant had entered into two interest rate swap agreements with another bank, each with a term of 10 years. To reduce the interest charges under these agreements, Deutsche Bank recommended to the claimant a CMS spread ladder swap. The bank's recommendation, which was based on its own prognosis, stated that the spread between the two-year interest rate and the 10-year interest rate would increase. Under the swap transaction, the bank was obliged to make biannual payments to the claimant based on the

reference amount of €2 million at a fixed interest rate of 3 percent p.a. In return, the claimant had to pay to the bank interest in the amount of 1.5 percent p.a. in the first year, and thereafter a variable interest rate, which was at least 0.0 percent and was calculated on the basis of movements in the spread between the ten-year and the two-year swap median on EURIBOR-basis (CMS10–CMS2).

In regards to the risks of the transaction, the bank informed the claimant that if the interest difference declined substantially, the interest payments owed by the claimant would exceed the payments due by the bank. The claimant's risk to incur losses was referred to by the bank as "theoretically unlimited," based on the claimant's potential obligation to pay interest in an unlimited amount. The bank had structured the transaction in a way that at the time the transaction was executed, the CMS spread ladder swap had a negative market value in the amount of approximately 4 percent of the reference sum (about €80,000). The bank did not disclose this fact to the claimant.

### **Breach of Duty to Advise Properly on Risks**

The Federal Supreme Court decided that the bank had to pay damages to the claimant because it had breached its duty to advise the claimant appropriately.

As a starting point, the Federal Supreme Court held that the parties had implicitly entered into an advisory agreement, which obliged the bank to advise appropriately with respect to the investor's risk profile and the specific risks of the CMS spread ladder swap. According to the court, as regards the risk profile of the customer, the bank had to explore which risks the customer was prepared to take, how knowledgeable the customer was, and what the goals and purposes of his investment were. Only after the bank had explored these circumstances, could it recommend a specific product to the customer that fit into the customer's risk profile.

In a second step, the bank had to advise on the specific risks of the financial product recommended by drawing a full and complete picture of the risks involved. (For the contents and scope of the bank's advisory duties, *see* BGH, judgment of 6 July 1993, ref. no. XI ZR 12/93, BGHZ 123, 126; judgment of 7 October 2008, ref. no. XI ZR 89/97, BGHZ 178, 149; judgment of 9 May 2000, ref. no. XI ZR 159/99, WM 2000, 1441; judgment of 14 July 2009, ref. no. XI ZR 152/08, WM 2009, 1647.)

The Federal Supreme Court found that the bank had not carried out its duty to advise the claimant appropriately regarding the risks of the CMS spread ladder swap. According to the Federal Supreme Court, the bank's advisory duties were particularly high because the CMS spread ladder swap was a highly complex and risky product. Therefore, the court found that it was not sufficient to disclose the calculation method of the variable interest rates and to provide calculation examples in different scenarios. Rather, the advising bank had to explain in a comprehensive and nontrivializing manner that the risk to the customer was not only a theoretical risk but, depending on the development of the spread, could be real and ruinous. Moreover, the Federal Supreme Court held that "the information provided must also in respect of

such a complex product provide for the customer to have basically the same level of knowledge and expertise as the bank with regard to the risks of the transaction”; the qualification of the customer alone was not sufficient to allow the bank to assume knowledge or experience of the customer with financial futures. In particular, the Court rejected the bank’s position that the claimant had had sufficient knowledge because the Prokurist (the holder of a special statutory authority) of the claimant, a qualified economist, had been present when the transaction was presented to the claimant.

The Court further emphasized that in implicitly concluding the advisory agreement, the bank assumed the responsibility to issue a recommendation that was exclusively geared to the interests of the customer. As a consequence, the bank was obliged to disclose any conflict of interest that could endanger the customer’s interests. With regard to the CMS spread ladder swap agreement, the Court identified a massive conflict of interest because, in transactions of this nature, the profit of one party corresponds to the other party’s loss. In other words, the swap transaction was only profitable for the bank if its prognosis as to the increase in the interest difference turned out to be wrong and the customer incurred losses. Moreover, the bank had structured the CMS spread ladder swap transaction in a way that *ab initio* the chances of the bank to realize a profit were slightly higher than the risk of suffering losses. Conversely, it was more likely for the customer to suffer a loss than to make a profit. This imbalance was reflected in the initial negative market value of the product. The Court ruled that, given that the bank had not disclosed the negative market value, it had concealed its conflict of interest and violated its advisory duties.

With this decision, the Federal Supreme Court confirmed its longstanding view that financial institutions offering financial products to their customers implicitly enter into an advisory agreement, according to which they owe a duty to advise their customers comprehensively and correctly. (*See e.g.*, BGH, judgment of 6 July 1993, ref. no. XI ZR 12/93, BGHZ 123, 126.)

First, the bank is obliged to offer only such financial products that fit the specific needs of the customer. To fulfill this obligation, the bank must explore the risk profile of the customer (the risks the customer is prepared to assume). It is also important to consider the customer’s level of knowledge, his or her experience, and the goal and purpose of his or her investment. As the case at hand demonstrates, these advisory duties are in no way limited only to consumers; they also apply in the commercial field vis-à-vis companies that are commercially active, regularly invest in (other) financial products, and can rely on employees educated and skilled in business administration.

Second, the financial institution has to advise on the risks of the product by drawing a full picture of the product and its specifications, rather than trivializing the risks or overstating the advantages of the product. In particular, the financial institution has to ensure that the customer obtains “the same level of knowledge and expertise as the bank with regard to the risks of the transaction.” In very complex transactions, this might turn out to be impossible. Here the question arises: In the future, to what extent will banks be able to sell complex financial products



to customers outside of the financial industry, if at all? The more complex a financial product is, the more difficult it will be for the banks to prove that they advised their customers so they could fully understand all aspects of the product and, therefore, obtain the same level of knowledge as the bank.

The judgment does not suggest that, in the future, financial institutions are under a general duty to disclose their profit margins when they market their own investment products. The Federal Supreme Court expressly denied such an obligation because it was obvious to every customer that financial institutions aim to make a profit when they offer and sell their financial products. On the other hand, one could ask whether the conflict of interest, which the Federal Supreme Court identified in its judgment, was not also obvious—at least to an economically skilled Prokurist.

There is also doubt whether the negative market value was really of such significant importance that the customer would not have entered into the swap transaction had the customer known about the negative market value. After all, an initial negative market value of 4 percent does not appear to be unusual and, therefore, could be anticipated by the customer, particularly as the claimant had entered into other swap transactions with negative market values before.

While consumers certainly require the highest level of protection vis-à-vis financial institutions, it is questionable whether the same strict advisory duties should be applicable in the commercial field. One could expect that a mid-sized company is able to understand the high risks connected to the financial transaction, particularly if there is no underlying transaction that the swap transaction is meant to secure or optimize. The very strict approach of the Federal Supreme Court appears to be overly protective. One can expect a skilled businessperson and investor to be able to independently decide whether he or she has sufficiently understood the product or requires more information—or whether the product is too complex for the investor. Moreover, it is the investor's decision whether to take a risk that has probably not been fully understood or to refrain from concluding the transaction. In any event, one would expect that a skilled investor understands that the parties to swap transactions have inherently conflicting interests and that a bank will only market such products as are profitable for the bank.

Several companies and municipalities have brought lawsuits against financial institutions due to losses incurred in connection with swap transactions. How this strict approach of the Federal Supreme Court will be applied by the lower courts, and with what consequences, remains to be seen.

**Keywords:** litigation, international litigation, constant maturity swaps, swap transactions, initial negative market value

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## NEWS & DEVELOPMENTS

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### Ninth Circuit Expands Jurisdiction over Foreign Companies

On May 18, 2011, the Ninth Circuit issued its decision in *Bauman et al. v. DaimlerChrysler Corp. et al.*, \_\_\_ F.3d \_\_\_, 2011 WL 1879210, a potentially transformative case that expands the use of “agency theory” to impose general jurisdiction over foreign corporations that do business in the United States solely through their U.S. subsidiaries. The Ninth Circuit held that personal jurisdiction existed over DaimlerChrysler Aktiengesellschaft (DCAG), a German company, because DCAG maintained the right to control its wholly owned U.S. subsidiary, Mercedes-Benz USA, LLC (MBUSA), such that DCAG could be haled into court in California due to MBUSA’s contacts with that state. Notably, the *Bauman* decision subjected DCAG to California’s jurisdiction despite the fact that the events giving rise to the lawsuit did not take place in the United States or involve the contacts relied on by the court in exercising general jurisdiction over DCAG in the first place.

*Bauman* is significant and merits attention because it increases the likelihood that foreign corporations will be sued in American courts based on the activities of their U.S. subsidiaries. Use of the “agency test” to establish general jurisdiction over foreign companies with U.S. subsidiaries makes every foreign corporation potentially vulnerable to lawsuits in America, even on issues having nothing to do with the actions or activities of the U.S. subsidiary.

*Bauman*’s reach, however, may be curtailed depending on how courts apply the U.S. Supreme Court’s recent decision in *Goodyear Dunlop Tires S.A. v. Brown*, 564 U.S. \_\_\_ (June 27, 2011). Whether *Goodyear* will be used as a scalpel or a sledgehammer with respect to *Bauman* remains to be seen, as DaimlerChrysler filed a petition for a rehearing *en banc* before the Ninth Circuit in early July. Given the uncertainty of whether the *Goodyear* decision undermines *Bauman*, foreign companies should still tread carefully if they, or their subsidiaries, act within the United States.

**Keywords:** litigation, international litigation, agency theory, subsidiaries, jurisdiction

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