UNIVERSITY OF MIAMI BUSINESS LAW REVIEW

## TABLE OF CONTENTS

### ARTICLES

# UNIVERSITY OF MIAMI BUSINESS LAW REVIEW

The UNIVERSITY OF MIAMI BUSINESS LAW REVIEW, (the "Review") publishes submitted articles and student notes and comments on legal issues arising in any field related to business. These areas include, but are not limited to, corporation, tax, antitrust, banking, securities regulation, bankruptcy, environmental, sports, insurance, and labor law. Authors seeking publication can submit their articles electronically in Microsoft Word format to the following email address: umblr@students.law.miami.edu or through the ExpressO Submission Service. Alternatively, authors may submit printed manuscripts to the address listed herein. Footnotes should conform to the 19th edition of *The Bluebook: A Uniform System to Citation*, published by the Harvard Law Review Association.

THE REVIEW, formerly the Business Law Journal, (ISSN 1047-2819) is published two times annually by the students of the University of Miami School of Law. Available on LEXIS-NEXIS and WESTLAW databases.

Subscription Price is $40 per annum. Subscriptions are automatically renewed in the Fall, unless prior notice of cancellation is received.

THE REVIEW selects members on the basis of academic performance and a student writing competition. THE REVIEW does not discriminate on the basis of age, color, handicap, national origin, race, religion, sex, or sexual orientation.

UNIVERSITY OF MIAMI
SCHOOL OF LAW
1311 MILLER DR.
ROOM D334
CORAL GABLES, FLA. 33124-8087

(305) 284-6885

Publication Agreement
No. 40641054

Cite as: U. MIAMI BUS. L. REV.

UNIVERSITY OF MIAMI BUSINESS LAW REVIEW

VOLUME XXI | SPRING 2013 | NUMBER 1

# POLITICS AND LEGAL REGULATION IN THE INTERNATIONAL BUSINESS ENVIRONMENT: AN FDI CASE STUDY OF ALSTOM, S.A., IN ISRAEL

JEFFREY A. VAN DETTA[1]



[1] Professor of Law & Associate Dean for Scholarship, Atlanta's John Marshall Law School (AJMLS), Atlanta, Georgia. Professor Van Detta teaches courses in both International Business Transactions and International Civil Litigation. He dedicates this article to the memory of James F. Van Detta, Jr. (1922-2012)—the author's father and his greatest teacher.

In Memoriam
JAMES F. VAN DETTA, JR.

April 10, 1922 — February 21, 2012

*Business Teacher 1948-1987*

"'. . . annuus exactis completur mensibus orbis,
ex quo reliquias divinique ossa parentis
condidimus terra maestasque sacravimus aras.
Iamque dies, nisi fallor, adest, quem semper acerbum,
semper honoratum . . . habebo.'" (*Aeneid*, Bk. V, ll. 46-50)

## I. INTRODUCTION

With the economic instability roiling through the European Union (EU),[2] companies located in the Euro Zone will be challenged truly to "think outside of the box" in structuring international growth from a now suddenly unstable home base.[3] There is evidence that looking for investment opportunities outside the Euro Zone will continue to be a very propitious source of attractive economic returns.[4] In turn, we who teach courses in International Business Transactions (IBT) will be challenged to help our students learn to lead, rather than follow, their future clients to do so as well.[5]

Globalization's realities and permanency became established in the American consciousness during the 1990s and the first decade of the 21st

---

[2] Patrick R. Hugg, *Redefining the European Union's Position in the Emerging Multipolar World: Strong Global Leadership Potential, Restrained by Asymmetry of Power and Dissonant Voices*, 20 TUL. J. INT'L & COMP. L. 145 (2011); Inese Vaidere, *The Impact of Regional and Cohesion Policy on the Economic Development of the EU*, EUROPEAN INTEGRATION STUDIES (Lith.), no. 5, 2011, available at http://www.eis.ktu.lt/index.php/EIS/article/view/1092/1168 ("As the global financial and economic crisis hit the European Union, no country was left unharmed. To this day, the Member States share the burden of excessive foreign debt, inflation, budget deficit, high unemployment levels, shaken stability of the currency, and many more."); Daniel Daianu, *Euro Zone Crisis and EU Governance: Tackling a Flawed Design and Inadequate Policy Arrangements* (Jan. 1, 2012). CASE Network Studies and Analyses No. 433, *available at* http://ssrn.com/abstract=1991162; Stefano Micossi, *Misguided Policies Risk Breaking Up the Eurozone and the EU*, (Ctr. for Eur. Pol. Stud. (Belg.) Working Paper No. 260, 2011), *available at* http://ssrn.com/abstract=1996457.

[3] *See, e.g.*, Alfredo Jimenez & Juan Bautista Delgado-Garcia, *Proactive Management of Political Risk and Corporate Performance: The Case of Spanish Multinational Enterprises*, 21 INT'L BUS. REV. (Spain), (forthcoming Dec. 2012) (manuscript at 2) *available at* http://dx.doi.org/10.1016/j.ibusrev.2011.11.008 (noting that Spanish MNEs have displayed "a proactive use of political risk in the internationalization strategy . . . by taking advantage of their political capabilities in certain areas").

[4] For examples of how the EU has benefitted from foreign trade even in the face of the Euro Zone crisis, see Rajnish Tiwari, *Bilateral Business Defies Financial Crisis and Economic Slowdown*, INDO-GERMAN ECON., May 2012, at 19-21, *available at* http://ssrn.com/abstract=2083082. As scholar Julien Chaisse reports:

> [T]he EU is the world's largest exporter of international investments, and the world's leading recipient of foreign direct investment (FDI). By 2010, the EU's outward FDI totaled US$ 3.88 trillion, down from US$ 9.15 trillion, while its inward FDI amounted to US$ 3.6 trillion, down from US$ 5.36 trillion. Over the last three years, the EU accounted for approximately 30% of global FDI flows.

Julien Chaisse, *Promises and Pitfalls of the European Union Policy on Foreign Investment—How Will the New EU Competence on FDI Affect the Emerging Global Regime?*, 15 J. INT'L ECON. L. 51, 52 (internal citation omitted), *available at* http://jiel.oxfordjournals.org/content/15/1/51.

[5] As we do so, we must be mindful not only of skills and doctrine, but also of ethics and professionalism issues that are peculiar to a law practice that includes IBT. *See* William F. Fox, *Professional Responsibility and International Business Transactions: Five Tough Questions*, SN056 ALI-ABA 515 (2008); Elizabeth Spahn, *International Bribery: The Moral Imperialism Critiques*, 18 MINN. J. INT'L L. 155 *passim* (2009).

century.[6] Concomitantly, American law students have been enrolling in IBT courses in increasing numbers.[7] Since the nascent stirrings of an IBT specialization in the legal academy during the 1960s to 1980s,[8] the challenges that face students and teachers of IBT have grown as the complexity of globalization has unfolded.[9] As Professor Dunning reminded us in his groundbreaking paper, written while a member of the law faculty at the University of Reading, the study of IBT requires an interdisciplinary approach.[10] Political and legal considerations are among the disciplines for which IBT requires us to account.[11] Thus, law students who wish to provide advice to future clients on IBT matters should take course work not only in IBT, but also in International Civil Litigation.[12]

---

6 *See* Hazel L. Johnson, *Resource Guide for International Business Transactions* LEXMUNDI, *available at* www.lexmundi.com/images/lexmundi/PDF/ResourceGuide2004.pdf; *see generally* THOMAS L. FRIEDMAN, IWORLD IS FLAT: A BRIEF HISTORY OF THE TWENTY-FIRST CENTURY (2005).

7 *See, e.g.*, Samuel Robert Mandelbaum, *The Legacy of W. Gary Vause to International Legal Education and Practice in Florida*, 33 STETSON L. REV. 43, 47-48 (2003) ("Courses in international business transactions are drawing unprecedented numbers of students in colleges and universities, and providing continuing education for established business and professional persons who wish to expand their involvement in the global marketplace.") (quoting GARY VAUSE, INTRODUCTION TO INTERNATIONAL BUSINESS TRANSACTIONS 1 (1997)).

8 The earliest mention in published American legal scholarship is by Professor Donald T. Wilson at the 1985 American Society of International Law annual meetings. *See* Judith R. Hall, *A Common Core for Courses in International Economic Law?*, 79 AM. SOC'Y INT'L L. PROC. 336, 336-37 (1985) (quoting "Remarks by the Chairman, Donald T. Wilson," which include the following: "[O]ne may generalize to the point of saying that international trade involves the movement of goods, money, people, services, and information across national borders. The study of the prescriptive rules bearing on those movements is the stuff of the law of international business transactions."); Richard B. Bilder & Valerie Epps, *Teaching International Law in the 1990s. By John King Gamble.*, 87 AM. J. INT'L L. 686, 688 (1993) (book review) ("In about fifteen law schools, more than two-thirds of the students are currently enrolled in the basic introductory course, the international business transactions course, or both.").

9 *See, e.g.*, Brian D. Farrow, *A Lawyer's Guide to International Business Transactions. By Walter S. Surrey & Crawford Shaw*, 79 HARV. L. REV. 448, 448-49 (1965) (book review); Leo H. Phillips, *International Business Transactions in a Nutshell. By Donald T. Wilson*, 76 AM. J. INT'L L. 920 (1982) (book review); William R. Slomanson, *International Business Transactions in a Nutshell (2d Ed.). By Donald T. Wilson*, 80 AM. J. INT'L L. 273, 274 (1986) (book review).

10 John H. Dunning, *The Study of International Business: A Plea for a More Interdisciplinary Approach*, 20 J. INT'L BUS. STUD. 411 (1989).

11 Jean J. Boddewyn & Thomas L. Brewer, *International-Business Political Behavior: New Theoretical Directions*, 19 ACAD. MGMT. REV. 119, 119 (1994) ("Research in international business (IB) is much more infused with a consideration of political factors than its domestic counterpart. Authors of IB studies have constantly mentioned and even emphasized government as a variable, rather than a constant or given, because international firms (exporters, importers, licensors, foreign direct investors, etc.) operate under a great variety of evolving political regimes that have an impact on these firms' entry, operation, and exit."); Nathan M. Jensen, *Firm-Level Responses to Politics: Political Institutions and the Operations of U.S. Multinationals* (paper presented at the Conf. on the Pol. Econ. of Int'l Fin., Feb. 9, 2007), *available at* halleinstitute.emory.edu/pdfs/PIEF_Jensen.pdf.

12 I introduced both of those courses to my law school's curriculum in 2007 and 2008, respectively, and

Accordingly, the time is ripe for those teaching IBT coursework to re-consider how EU-based multi-nationals might modify their decision-making templates for identifying and undertaking opportunities for foreign direct investment (FDI), tempering that perspective with an analysis of the potential for litigation over certain kinds of FDI. Well before the recent economic crisis in Europe came to a head, IBT scholarship recognized the challenges presented even in an ideal world by the web of overlapping regulatory regimes of national, EU, bilateral, and multilateral rules on foreign direct investment.[13] In addition, commentators have worked to identify various factors from the multinational-investor perspective, and the potential host-country prospective, both of which are relevant to FDI proposals and projects.[14]

My goal, therefore, has been to start American law students on the path that prepares them to assist Multinational Enterprises (MNEs) in the FDI decision-making process; and it is in pursuit of that goal that I came to write the present article. The article grew out of my research and reflection in preparing a case-study problem for both my IBT and International Civil Litigation (ICL) courses, which I designed to be complimentary and supportive of the full development of future IBT practitioners. For purposes of this article, I have taken the case study beyond limitations that might be imposed by the confines of an academic course. In so doing, I explore one of the most promising, yet often politically risky, FDIs—creating the infrastructure for renewable energy systems.[15] The importance of such investments cannot be overstated, both to MNEs, and to the host states in which MNEs contribute to energy infrastructure development. Given a century of experience with the attendant practical travails and political pitfalls of traditional energy

---

I continue to teach them annually. *See* http://www.johnmarshall.edu/courses/international-business-transactions-2/ (last visitied Nov. 16, 2012); http://www.johnmarshall.edu/courses/international-civil-litigation/ (last visited Nov. 16, 2012). In each course, I employ two of the leading casebooks on those subjects. *See* DANIEL C.K. CHOW & THOMAS J. SCHOENBAUM, INTERNATIONAL BUSINESS TRANSACTIONS: PROBLEMS, CASES & MATERIALS (2d ed. 2010); GARY B. BORN & PETER B. RUTLEDGE, INTERNATIONAL CIVIL LITIGATION IN UNITED STATES COURTS (5th ed. 2011).

[13] *See* Ramon Torrent, *The Contradictory Overlapping of National, EU, Bilateral, and Multilateral Rules on Foreign Direct Investment: Who is Guilty of Such a Mess?,* 34 FORDHAM INT'L L.J. 1377, 1378, 1398-99 (2011).

[14] Mustafa Fuat Vardar, *Factors of Investment Decision for Multinational Corporations: The Case of Turkey*, J. TURKISH WKLY., http://www.turkishweekly.net/article/343/factors-of-investment-decision-for-multinational-corporations-the-case-of-turkey.html.

[15] Daniel R. Sieck, Note, *Confronting the Obsolescing Bargain: Transacting Around Political Risk in Developing and Transitioning Economies Through Renewable Energy Foreign Direct Investment*, 33 SUFFOLK TRANSNAT'L L. REV. 319, 319-21 (2010).

sources, MNEs have started to shift more attention to renewable energy sources as FDIs:

> Access to a reliable source of energy is indispensable to the stability of all nations. Beyond the requirements of domestic demand, energy access is a component of any national security program and can be a primary source of wealth in producing countries. Energy producers' ability to shut off world supply gives them a powerful bargaining position politically and economically. Recent expropriations of foreign energy investments in fossil fuel producing countries demonstrate the vulnerability of international energy investments to government intervention. As an alternative, some investors avoid the fossil fuel market altogether and instead choose renewable energy.[16]

This is an especially timely topic, particularly given the risks created for fossil-fuel economies by the instability introduced during the Arab Spring.[17] Many MNEs will undoubtedly seek, assess, and ultimately decide whether to pursue new FDI opportunities in the rapidly changing landscape of the Middle East,[18] as they have in India.[19] Legal counsel whose practice is, or aspires to be, focused on international business transactions will need a good understanding of a coherent approach to advising clients on both the business and legal aspects of FDIs. Counsel will be required to appreciate the additional considerations that go into a true FDI decision, as compared to the joint-venture decision to "'team up' contractually with an entity . . . in another country where [that]

---

16 *Id.* at 320 (footnotes omitted).

17 Paul Antony Barbour, Persephone Economou, Nathan M. Jensen & Daniel Villar, *The Arab Spring: How Soon Will Foreign Investors Return?*, 67 COLUMBIA FDI PERSPECTIVES, May 7, 2012, *available at* http://www.vcc.columbia.edu/content/arab-spring-how-soon-will-foreign-investors-return ("The events of the Arab Spring have dramatically increased the risk perceptions of foreign investors. In directly affected countries, these events led to disruptions in economic activity including plummeting tourism and foreign direct investment (FDI) flows, all of which negatively impacted economic growth."); *World Economic Slowdown May Hit Kingdom's Exports*, ARAB NEWS, (May 21, 2012), http://www.arabnews.com/world-economic-slowdown-may-hit-kingdom%E2%80%99s-exports (noting that "[t]he regional instability generated by the Arab Spring will increase the risk aversion of foreign investors and the risk premium on finance in the [Saudi] Kingdom").

18 The subject has drawn scholarly attention in European universities. *See, e.g.*, Seyedfarhad Mirghiasimoradi, *Competitive Project Businesses in the Middle East: Opportunities and Obstacles?*, 81-82 (Apr. 2012) (master's thesis, Tempere University of Technology (Fin.)), *available at* http://URN.fi/URN:NBN:fi:tty-201205221145 (summarizing the strengths and challenges for FDI in the Middle East).

19 *See* Premila Nazareth Satyanand, *Foreign Direct Investment in India's Power Sector*, J. INFRASTRUCTURE DEV., June 2011, at 65-89.

entity will produce and sell goods or provide services using the licensed trademarks, patent, knowhow, or other intellectual property rights owned by the MNE"[20] By contrast, as Professor John Head at the University of Kansas School of Law observes, in FDI—

> [W]e see a different constellation of potential risks and returns facing a client. With FDI, a company no longer has an arms-length association with the production and marketing of goods in another country; instead, the company enters that other country itself, exposing itself directly to the other country's legal and regulatory system. Doing so creates serious risks. However, doing so also creates exciting opportunities for rewarding business activities.[21]

As part of my International Business Transactions Course, I lay out for the students a multi-stage paradigm for identifying the key factors relevant to an FDI decision. The paradigm presupposes groundwork to identify, at least conceptually, the parameters of a specific FDI proposal for specific participants in a specific host nation. Starting from that presupposition, the paradigm consists of two main stages.

In Stage One, we analyze the general business and regulatory environment for a proposed FDI. That includes a close, fact-intensively detailed examination of the host state, the MNE, and the proposed FDI project. That examination is followed by an articulation, and critical evaluation of, the three most significant arguments in favor of the MNE undertaking the proposed FDI project. In Stage One, students learn to do the research needed to create an accurate factual foundation; and from that foundation, students practice organizing facts according to their relevance to that FDI proposal. A key element of Stage One is the critical assessment of the sources employed; and after establishing the bona fides of the sources, the key skills developed are in logical reasoning from the facts in support of business arguments, and the clear and concise articulation of those arguments.

Stage Two undertakes a critical evaluation of legal issues raised not only under the regulatory environment of the host state, but also under the legal system of the FDI investor's home state and third-states to which the FDI investor has substantial connections. This inquiry is both

---

[20] John W. Head, Global Business Law: The Business And Practice of International Commerce And Investment 384 (2d ed. 2007)

[21] *Id.*

inductive and deductive;[22] students will apply their increasing body of general knowledge concerning crucial aspects of International Business Transactions with their knowledge of international civil litigation, particularly as it takes place in the courts of the United States. The legal considerations examined serve both to transition IBT students to the study of International Civil Litigation and to allow students who have previously studied ICL to apply that learning in the specific business context of an IBT course.[23]

In this article, I demonstrate how this multi-stage paradigm might be applied to identify potential FDIs worth further investigation and more detailed development. Specifically, I show how the multi-stage paradigm might work in a hypothetical FDI, using as an example one of the world's largest MNEs, France's Alstom, S.A., and a possible investment in Israel regarding one of Alstom's leading businesses, the manufacture, installation, and operation of equipment and installations for using the wind to generate electrical power. Those are the subjects of Section II, infra, an application of Stage One. Then, in Section III, I undertake the Stage Two analysis to demonstrate how issues that are recognized in an IBT course can be further developed through analytic paradigms studied in International Civil Litigation, including the nature and risks to MNEs of litigation filed against them over FDI-related issues. Suits under municipal human-rights related laws of various jurisdictions are a major source of ICL, and thus, in the Alstom-Israel FDI proposal, I examine examples from the laws of France, Quebec Province in Canada, and the United States. Special and extended attention is focused on 28 U.S.C. § 1350, colloquially known as the Alien Tort Statute (ATS) in the United States, given the extensive attention it has received in recent years, as well as the extensive expressions of angst that the corporate business community has expressed concerning human-rights litigation against MNEs over FDIs.[24]

---

[22] There are, of course, even more detailed ways to express this paradigm. *See, e.g.*, "Conceptual Outline And Checklist of Foreign Direct Investment Issues," in CHOW & SCHOENBAUM, *supra* note 12, at 446-48.

[23] The importance of examining FDI within a broader legal environment is well-described in Kenneth C. Randall & John E. Norris, *A New Paradigm for International Business Transactions*, 71 WASH. U. L.Q. 599 (1993).

[24] One of the most notable expressions of business community angst, GARY CLYDE HUFBAUER & NICHOLAS K. MITROKOSTAS, AWAKENING MONSTER: THE ALIEN TORT STATUTE OF 1789 (2003), proclaims the following in Chapter 1, entitled "Nightmare Scenario":

> This one sentence law—the Alien Tort Statute (ATS) of 1789—could plausibly culminate in a nightmare, more than 200 years after it was enacted. Within the next decade, for example, 100,000 class action Chines plaintiffs, organized by New York trial lawyers, could sue General Motors, Toyota, Volkswagen, General Electric, Mitsubishi, Siemens, Motorola, NTT,

The example operates on a general level of conceptual business and legal viability, which would naturally precede a second-stage, more focused review of taxation implications for the investing MNE,[25] project financing issues,[26] business strategies revealed by an in-depth application of strategic operations management,[27] a detailed assessment of the overall structure and specific provisions needed for a suitable joint-venture agreement,[28] and the most recent thinking among strategic management scholars on traditional and newer variables considered by MNEs when making FDI decisions and their models providing a structure for applying those variables.[29] While that which is undertaken here is preliminary and at varying levels of both generality and specificity, it nonetheless provides the essential point of entry for American law students and lawyers examining the intersection of law and business arising from FDI in the 21st century.

---

> Nokia, and 20 other blue-chip corporations in a federal court for abetting China's denial of political rights, for observing China's restrictions on trade unions, and for impairing the Chinese environment. These plaintiffs might claim actual damages of $6 billion and punitive damages of $20 billion. To minimize their exposure to punitive damages, the corporations could settle for an intermediate amount, such as $ 10 billion.
>
> . . . .
>
> To be sure, no *decided* ATS case can be cited to confirm that the nightmare scenario we have just sketched will come to pass. . . . [S]everal blockbuster cases are working their way through federal and state court systems. If plaintiff[s'] lawyers prevail, today's imagined nightmare will become tomorrow's reality.

*Id.* at 1-2 (emphasis in original) (footnotes omitted). In the period after Hufbauer and Mitrokostas' book appeared, the claims in several ATS cases against MNEs survived dispositive motions; one awaits further trial court proceedings; and the others were settled for substantial sums.

[25] *See* D. Kevin Dolan, *Special Issues in Structuring International Joint Ventures – Part One*, 22 TAX MGMT. INT'L J. 51 (1993).

[26] *See* HEAD, *supra* note 20, at 425-47; *see, e.g.*, William M. Stelwagon, *Financing Private Energy Projects in the Third World*, 37 CATH. LAW. 45, 45-48 (1996).

[27] *See, e.g.*, Laura Diaconu *Business Strategies of the Multinational Corporations,* 4 CES WORKING PAPERS 141, 141-42 (2012) (Ctr. for Eur. Stud. at Alexandru Ioan Cuza University of Iasi (Rom.)), *available at* http://www.cse.uaic.ro/WorkingPapers/articles/CESWP2012_IV2_DIA.pdf (detailing how "the international business offers the possibility of exploiting three sources of the competitive advantage, unavailable for the national companies: global efficiencies, the multinational flexibility and worldwide learning process").

[28] *See, e.g.*, Michael E. Hooton, *Structuring and Negotiating International Joint Ventures*, 27 CREIGHTON L. REV. 1013, 1013-14 (1994).

[29] *See, e.g.*, Wesam M. Sedik, *The Impact of Country Risk and New Institutional Economics on Foreign Direct Investment: A Panel Data Analysis for Middle East and North Africa Region (1999-2010)* (presented at the 16th Meeting of the International Society for New Institutional Economics, University of Southern California, June, 2012), *available at* http://extranet.isnie.org/uploads/isnie2012/sedik_seoudy.pdf.

## II. Stage One: The Legal and Business Environment

In the first stage, we analyze the general business and regulatory environment for a proposed FDI. Stage One consists of a flexible inquiry, built out from a solid structure of relevant information-gathering, to which logical analysis is applied:

First, we start with a clear articulation of the FDI proposal itself. That articulation presupposes that one of the following preliminary scenarios has transpired:

1. A specific MNE client has tasked its management or in-house law department to examine opportunities for new FDI in [a] a particular line of its business in [b] a specific geo-political region, market, or nation; or
2. A specific MNE client has tasked its management or in-house law department to examine a specific FDI proposal, having already identified [a] the particular line of its business and [b] specific geo-political region, market, or nation.

In developing this as an IBT learning event, a course facilitator may take a number of approaches. The facilitator may assign a specific, existing FDI proposal involving a particular MNE or group of MNEs. Typically, this choice works best when there have been *preliminary* reports of the FDI project in the news media or through a company's press releases—i.e., before the FDI project becomes so well delineated that students are tempted to spend more time describing actual plans than on employing imaginative research and reasoning to flesh out various directions a preliminarily described project may take. To encourage less of the former and more of the latter, the facilitator may instead assign a particular MNE without a specific FDI-project in the works. That will allow the facilitator to assign the more open-ended task of identifying and evaluating any feasible FDI project for the MNE. The emphasis in that approach will be more on brainstorming about possible projects within the reasonable scope of the MNE's business, and developing processes and paradigms for narrowing a wide range of possibilities—starting with the fundamental task of identifying a geo-political region, market, or nation as the potential host for the project.

A *via media* between extremes is what I have aimed for in this article: designating a specific MNE and a specific host nation, as well as a sector of the MNE's business—wind-powered electrical generation in Alstom's case—within which to develop the specific FDI proposal for analysis.

Developing the specific FDI proposal requires preliminary research into both the current businesses of the MNE (along with lines of business it either is considering, or should consider given particular synergies that might be realized from it), along with a suitable project for the specific host nation. Identification of a specific company within the host nation to act as business partner in the FDI can facilitate identification of the project itself. Normally, the way in which the MNE's business will be organized within the host state must be considered, after identifying the specific forms of business entity available under the legal tradition and legal system of the host nation.[30] However, for purposes of this article, the more popular joint-venture arrangement is the standing assumption.[31]

With these parameters established, one of the most useful pairings I have found of MNE and host state is Alstom, a corporation organized under the laws of France as a Société Anonyme (S.A.),[32] with the State of Israel as the host nation. Although one of the world's largest MNEs, Alstom will be new to many law students studying in the United States, particularly those who are encountering International Business Transactions for the first time. Selecting a distinctly non-U.S. MNE like

---

[30] There is no redundancy in examining not only a country's laws, but also the legal tradition from which its laws emanate. *See, e.g.*, AMANDA PERRY, LEGAL SYSTEMS AS A DETERMINANT OF FDI: LESSONS FROM SRI LANKA 14-16 (2001). Keen awareness of the characteristics of the major legal traditions is important for both MNE and counsel to keep in mind. Such awareness reduces the risks of easy glosses or approximate translations of business forms—using terminology such as "corporation" or "partnership" loosely, and with the common-law tradition's viewpoints—which can have unexpected, unanticipated, and unwelcome results. *See, e.g.*, Puerto Rico v. Russell & Co., 288 U.S. 376 (1933) (involving American partners who organized a business venture under Puerto Rico's laws—which are part of the Spanish Civil Law heritage—who found that the rough translation of partnership into a Civil Law *sociedad en comandita* had, in fact, given their venture a corporation-like juridical personality that took on the citizenship of its situs); Baja Devs. LLC v. Loreto Partners, CV-09-756-PHX-LOA, 2010 WL 1758242 (D. Ariz. Apr. 30, 2010) *report and recommendation adopted sub nom*. Baja Developments LLC v. TSD Loreto Partners, CV09-0756-PHX-LOA, 2010 WL 2232196 (D. Ariz. June 3, 2010); *see also*, Keith S. Rosenn, *Overview of Brazilian Business Forms*, in CHOW & SCHOENBAUM, *supra* note 12, at 539-45.

[31] Sam Foster Halabi, *Efficient Contracting Between Foreign Investors and Host States: Evidence from Stabilization Clauses*, 31 NW. J. INT'L L. & BUS. 261, 276 (2011) (Among the joint venture's advantages as an FDI vehicle, "[i]nvestors may also reduce political risk by engaging in joint ventures," thus "simultaneously limit[ing] an investor's exposure and increas[ing] the number of parties that might eventually pressure a government that passes an unfavorable law or regulation.").

[32] Another important aspect of IBT study generally and FDI study in particular is close attention to the forms of business organizations as they exist both in other municipal law systems as well as in other legal traditions. The Société Anonyme, or S.A., is a popular and familiar business organization form within the Civil Law traditions of both France and Spain. *See* Naomi R. Lamoreaux & Jean-Laurent Rosenthal, *Legal Regime and Business's Organizational Choice: A Comparison of France and the United States During the Mid-Nineteenth Century* 8 (Nat'l Bureau of Econ. Research, Working Paper No. 10288, 2004), available at http://www.nber.org/papers/w10288; *see also* Rosenn, *supra* note 30, at 541-43.

Alstom fosters several lessons. First, there are many MNEs of enormous economic influence and power that thrive in other business cultures, even if not familiar to the American consciousness. Second, not all opportunities in international business transactions come from U.S.-based MNEs seeking FDI. Third, the foreign MNE may well be situated to take advantage of expansion into the United States as a step in FDI projects to which an American presence may prove helpful.

Similarly, Israel is an ideal subject for students to evaluate as a host nation. Information about Israel is plentiful, and there are many original sources in English. Israel also stands distinct from many of its neighbors in the Middle East in that it has a legal, political and business culture that, while distinct, shares more in common with the American legal, political, and business culture than the American culture shares with Shari'a law states, for example.[33] In addition, Israel, unlike most of its neighbors in

---

33 *See, e.g.*, JOHN H. BARTON, JAMES LOWELL GIBBS, JR., VICTOR HAO LI, AND JOHN HENRY MERRYMAN, LAW IN RADICALLY DIFFERENT CULTURES 16-21 (1983) (explaining the history and law of Islam as a comparison to American culture). As Professor Barton and his co-authors observed:

> The traditional sources of the law were the *Quaran* itself, together with the *sunna* or the custom of the early Islamic community by which the reliability of individual hadith (sayings of the Prophet) were judged, the *ijma* or the consensus of Islamic community, and *qiyas* and *yihad* or, respectively, analogies and personal reason from the first three sources. The intellectual guardianship and authoritative statement of the law were the responsibility of the juristic schools, not of the state or the *qadi*. Thus, not only was there no legislation: neither was there a doctrine of stare decisis or common-law type of law[-]making. Interpretation and statement of principles were the tasks of the *ulema*, or upright scholars, of the society, and of the mufti, or legal advisors to the *quadi*. The doctors of Al Azhar still issue *fatwas* or opinions on controversial points of law. There were four major juristic schools . . . that evolved during the first centuries of Islam. By about the third century of the Islamic era, the door of *ijihad* (personal reasoning) was closed, permitting no further change in the law. The only flexibility left then was to reject the law or to pick and choose among the doctrines of existing schools.
>
> Since the law was God's law and could not be changed and since moral and legal principles were so intertwined, the role of the state was very different from that in the contemporary West. The state had in effect no significant legislative authority. To the contrary, its responsibility, as suggested by the task of the first Caliphs, was to uphold and help enforce and spread the *sharia*. It was through this responsibility that the state gained its legitimacy. (Some of the more religious rules of the *sharia* were enforceable only in conscience rather than through the community, however.)
>
> The inflexibility of such a law was sensed early on and led, even in traditional Islamic law, to escape devices. From a theoretical viewpoint, the most important of these was the doctrine of *siyasa*—a doctrine that the government in fact seeks the public interest (for the ruler has some knowledge of God's purpose for the society), and this pursuit of the public interest may necessitate deviation from the *sharia*, and that obedience is due the rule even if he deviates. It also permitted some division between the civil authority and the Caliphate. At the procedural level, the corresponding discretion and flexibility were reflected in the creation of *mazalim* or political ruler's courts that could avoid the limitations of the *sharia* courts and often became, in direct contradiction to the *sharia*, a means of appeal form the *qadi*'s decision. There was thus a tension between the political

the Middle East, has a Bilateral Investment Treaty (BIT) with the U.S., which allows exploration of the possible roles such treaties play in an MNE's FDI decisionmaking.

My example provides another useful synergy between MNE and host-state experience that Alstom has in doing business in the Middle East, and the projects—including transportation and conventional power-generation—which it has undertaken in Israel over the past decade. These include a 20-year operation and maintenance contract, worth around €330 million, with Dalia Power Energies Ltd for the 835 MW gas-fired Tzafit power plant in Israel,[34] a contract with Dalia Power Energies to construct two 417 MW gas-fired combined cycle units on an engineering, procurement and construction (EPC) basis;[35] a 50% stake in a joint venture, Horizon, based in Dimona in southern Israel, in collaboration with Israeli high-tech firms Rotem Industries, Ltd., and Gefen Biomed Investments, to finance and support the growth of innovative start-ups in the field of renewable and alternative energy and energy-saving technologies;[36] and another joint venture, this one with Israel's BrightSource Energy, to build solar thermal power plants throughout the Mediterranean and in Africa.[37]

---

> reality and the *sharia* ideal of government. For the philosophical reasons specified above and perhaps also because the society lacked a sense of progress, this tension was not thought to be troublesome. This fact is itself an important aspect of Islamic law.

*Id.* at 19-21.

[34] *A Service Contract Worth Around _330 Million for Tzafit Gas-Fired Plant in Israel,* ALSTOM (July 27, 2011), http://www.alstom.com/press-centre/2011/7/service-contract-330-million-euros-Tzafit-gas-fired-plant-Israel/.

[35] Alstom *Wins Contract Worth Approximately _500 Million to Construct Israel's Biggest Private Power Station*, ALSTOM (June 6, 2011), http://www.alstom.com/press-centre/2011/6/alstom-wins-contract-to-construct-Israel-biggest-private-power-station/.

[36] *Teaming Up With Rotem and Gefen in Israel to Promote Innovative Start-Ups in Renewable Energy and Energy Efficiency*, ALSTOM (July 3, 2011), http://www.alstom.com/press-centre/2011/3/Alstom-teams-up-with-Rotem-and-Gefen-in-Israel-to-promote-innovative-start-ups-in-renewable-energy-and-energy-efficiency/; *see also* Amiram Barkat, *Dalia Teams With Alstom for Israel's Largest Private Power Station—The Tzafit Station West of Beit Shemesh Will Have a Total Capacity of 835 Megawatts,* GLOBES: ISRAEL'S BUS. ARENA (July 31, 2011), http://www.globes.co.il/serveen/globes/docview.asp?did=1000668977&fid=1725; Ira Moskowitz, *France's Alstom Enters Joint Venture to Invest in Israeli Cleantech Technology—Alstom, Which is Providing the Trams for the Jerusalem Light Rail Project, Will Invest in Israeli Cleantech*, GREENPROPHET (Nov. 9, 2010), http://www.greenprophet.com/2010/11/frances-alstom-enters-joint-venture-to-invest-in-israeli-cleantech-technology/.

[37] Lisa Damast, *BrightSource, Alstom Partner on Solar Thermal*, GREENPROPHET (Oct. 9, 2010), http://www.greenprophet.com/2010/10/brightsource-alstom-solar-partnership/. The plants will use a proprietary technology developed by BrightSource, which went public in 2011, that "relies on thousands of mirrors all focused on a central tower with a water boiler atop of it to heat the water and turn it to steam which then turns a conventional turbine that generates electricity." *Id.*

To avoid re-ploughing existing furrows, we look at Alstom's past FDI record in Israel. Taking into account projects such as the Horizon joint venture to help Israel develop renewable and alternative energy sources, Alstom's Wind Turbine unit becomes the perfect focus for exploring a new FDI project. This requires visualizing a new context and new issues for Alstom in a country that is familiar to Alstom in other contexts. The FDI proposal that we will evaluate for purposes of this article, therefore, is that the France-based international energy conglomerate, Alstom Group, will joint venture with Israel-based Energix-Renewable Energies, Ltd., to expand wind power output from the Golan Heights wind farm.[38]

Having clearly articulated a specific FDI proposal, we will then be ready to move to the next phase of our Part One analysis. Using authoritative resources,[39] we undertake the information-gathering process. This is not merely an exercise in fact collection. Rather, I emphasize that the facts chosen, and the way in which those facts are presented, must be filtered through, and guided by, their relevance to the specific FDI proposal under consideration.[40]

---

[38] Originally, Alstom's joint venture partner in a Golan Heights wind farm project would have been Multimatrix, an Israel-based firm which had acquired an interest in land on the Golan Heights. In July 2011, Multimatrix sold its stake in an Israeli wind-energy venture to Energix-Renewable Energies, Ltd. (ENRG:IT) for 45 million shekels. *See* Sharon Wrobel, *Israel Stocks: Delek Fuel, Delek Real Estate, Gilat, Multimatrix*, BLOOMBERG (July 13, 2011), http://www.bloomberg.com/news/2011-07-13/israeli-stocks-delek-fuel-delek-real-estate-and-multimatrix.html. Energix is traded on the Tel Aviv Stock Exchange. *See* http://www.bloomberg.com/quote/ENRG:IT. Thus, Alstom's joint venture partner will now be Energix, rather than Multimatrix. As of this writing, Energix's website is under construction. *See* http://www.energix-group.com/ (last visited Nov. 17, 2012). For further discussion on the current state of wind energy in Israel, see, e.g., Daniel Farb, *Israel Should Catch the Wind*, GLOBES (July 31, 2011), http://www.globes.co.il/serveen/globes/docview.asp?did=1000669294&fid=1724; Ehud Zion Waldoks, *Draft Tender Published for Negev Wind Farms—At Present, There is Only One Facility Operating in Israel - Mei Golan Wind Energy on the Golan Height's Mount Bnei Rasan - Producing a Paltry Six MW*, JERUSALEM POST (Aug. 30, 2009), http://www.jpost.com/HealthAndSci-Tech/ScienceAndEnvironment/Article.aspx?id=153340.

[39] For regularly updated and detailed online resources of nations, see the Fact Sheets of the U.S. State Department, U.S. DEP'T OF STATE, COUNTRIES & REGIONS, http://www.state.gov/misc/list/index.htm. Similarly useful—and sometimes more detailed—are the listings from the Central Intelligence Agency's Factbook, www.cia.gov/cia/publications/factbook. In addition, the Library of Congress's Federal Research Division detailed Country Studies—a wealth of well-researched, well-documented, and well-presented information that is invaluable when conducting a proper FDI analysis. *See Country Studies*, LIBR. OF CONG. (Sept. 20, 2012), http://lcweb2.loc.gov/frd/cs/. Exploration of the host nation's media's reporting on its own political and business affairs can be launched from http://www.kidon.com/media-link/index.shtml.

[40] Such as identification of neighboring countries: territorial size of the host country: population; political system; current office holders in the country's executive branch (e.g., Prime Minister and/or President); identity and history of the political party currently in power, and of its allied and rival political parties; description of its current legal system, including the legal tradition (e.g., Civil Law, Common Law, Shari'a) to which its legal system belongs; description and classification of its economic system (e.g., developed or developing world;

In the next phase of Stage One, we discuss and critically evaluate the evidence gathered regarding factors relevant to the specific FDI decision. Emphasis is placed on establishing a number of separate, independent grounds for recommending the FDI project. In examining each ground for the recommendation, we pay particular attention to evidence from the host country's media sources about topics relevant to the FDI project, the MNE, and changes and challenges within the host nation itself. Such sources are subjected to evaluation for, among other things, fairness and balance of coverage and any potential biases.

In the final phase of Stage One, a conclusion and recommendation are stated, and the bases for them are summarized. Assuming that the merits of the FDI have been proven sufficiently in this preliminary, conceptual evaluation to warrant further investigation followed by serious consideration by the MNE's board, the recommendation will be to move forward.

### *A. The State of Israel and its Environs*

Situated between its small southern coastline on the Red Sea and its expansive western coastline on the Mediterranean Sea, the State of Israel is a parliamentary democracy,[41] whose 7,850 square-mile territory covers an area roughly the size of New Jersey.[42] Israel's 7.59 million people (composed of Jews 76.2%; Arabs 19.5%; other 4.3%) make it the 97th most populated country in the world[43] and the seventh most populated

---

industrial or agricultural; capitalist, communist, socialist, or 'state capitalism'); indicators for that country, and trends in those indicators, such as GNI and the GNI per capita PPP; identification of major natural resources and discussion of any leverage, or vulnerabilities, that it creates for the host nation, along with any political issues arising from or competing sovereign claims for those resources; identification of the major products and services exported, and discussion of the markets and countries to which they are exported; identification of the major products and services that are imported, and discussion of the markets and countries from which they are imported; identification of any economic integration organizations to which the host state belongs or to which it seeks admission; and facts about the host nation's official currency, including exchange policies and any limits on expatriation of cash earned in the FDI.

[41] CIA, Israel: *Government*, in THE WORLD FACTBOOK (2012), https://www.cia.gov/library/publications/the-world-factbook/geos/is.html.

[42] CIA, Israel: *Geography*, in THE WORLD FACTBOOK (2012), https://www.cia.gov/library/publications/the-world-factbook/geos/is.html (describing Israel as "slightly larger than New Jersey").

[43] CIA, Israel: *People and Society*, in THE WORLD FACTBOOK (2012), https://www.cia.gov/library/publications/the-world-factbook/geos/is.html.

(and the fourth most densely populated)[44] country in the Middle East.[45] The populace espouses religions including Judaism, Islam, Christianity, and Druze.[46] Hebrew (official), Arabic (official), English, and Russian are the commonly-spoken languages.[47] Egypt and Jordan abut Israel to the south and southwest, respectively;[48] Syria borders to the northeast; and Lebanon shares Israel's northern border.[49] Israel's Syrian border includes a tract of disputed territory known as the Golan Heights (population 38,000, composed of 18,200 Arabs and about 20,000 Israeli settlers).[50] Ninety-two per cent of Israel's population is urban, distributed primarily among Tel Aviv-Yafo (3.2 million); the major port city, Haifa (1 million); and the capital Jerusalem (768,000).[51]

Since it was created in 1948, Israel has boisterous politics,[52] with 13 different political parties represented in their unicameral legislature, the Knesset, which elects a Prime Minister (currently Binyamin Netanyahu, Likud ("Consolidation" party[53])[54] and a President (currently Shimon Perez), a largely ceremonial post.[55] Social scientists have described the current (18th) Knesset as "the most representative of Israel's diversified society since the establishment of the State in 1948."[56] It in fact is a

---

44 Mideast Web, Middle East Population At A Glance—Geography and Population (May 2006), http://www.mideastweb.org/geogpop.htm.

45 For more information about Israel, see *Background Notes: Israel—Profile*, U.S. STATE DEP'T, UNDER SECRETARY FOR PUB. DIPLOMACY & PUB. AFFAIRS—BUREAU OF PUB. AFFAIRS (Near East), http://www.state.gov/r/pa/ei/bgn/3581.htm.

46 *Id.*

47 *Id.*

48 Israel's Jordanian border includes the West Bank, a large area west of the River Jordan, which has been the subject of two treaties (1964 & 1994) and continuing disputation; Israel's Egyptian border includes disputed territory known as the Gaza Strip. *Id.*; *see also Travel Warning: Israel, the West Bank and Gaza*, U.S. STATE DEP'T, BUREAU OF CONSULAR AFFAIRS (June 22, 2011), http://travel.state.gov/travel/cis_pa_tw/tw/tw_5511.html (showing that continuing instability and volatility make these areas unattractive for FDI).

49 *Id.* (map of Israel and the vicinity).

50 *Id.*; *see also* Overseas Security Advisory Council (OSAC), *Israel 2009 Crime & Safety Report*, https://www.osac.gov/Pages/ContentReportDetails.aspx?cid=8044.

51 CIA, Israel: *People and Society*, in THE WORLD FACTBOOK (2012), https://www.cia.gov/library/publications/the-world-factbook/geos/is.html.

52 *See The World in Figures: Israel*, ECONOMIST (Nov. 22, 2010), at http://www.economist.com/node/17510423.

53 LIKUD, http://www.likud.org.il/ (last visited Nov. 15, 2012).

54 *See Currently Functioning Parliamentary Groups*, 18TH KNESSET, http://www.knesset.gov.il/faction/eng/FactionCurrent_eng.asp (under "Factions" tab) (last visited Nov. 15, 2012).

55 The Basic Law—President of the State, Official Knesset Website, http://www.knesset.gov.il/laws/special/eng/basic12_eng.htm

56 *Israel's 18th Knesset: Too Many Voices. . . Too Little Connection With the People of Israel*, AMERICA'S

fragmented coalition among Prime Minister Netanyahu's Likud and five other political parties across a conservative spectrum, in which Likud controls only 27 of 66 seats in the coalition.[57] The Prime Minister appoints, subject to Knesset approval,[58] an array of ministers to lead the many departments (currently 22)[59] of Israel's government.[60]

Israel has a "mixed legal system of English common law, British Mandate regulations, and Jewish, Christian, and Muslim religious laws,"[61] clearly reflective of the area's complex history. Equally reflective of Israel's history is the nation's modern currency; the new Israeli Shekel (ILS) harkens back to the days of King David, and its exchange rate with the U.S. dollar recently has ranged from a high of 4.4565 (2006) to a low of 3.588 (2008).[62] The Shekel is freely convertible,[63] and is one of only 17 currencies that are freely convertible in currency exchange markets.[64]

The U.S. State Department describes Israel's economic system as "a diversified, technologically advanced economy with substantial but decreasing government ownership and a strong high-tech sector."[65] Among its economic vitals are GDP growth: 3.4%; GDP: $227bn (PPP: $229bn); Inflation: 2.4%; GDP per head and $29,410 (PPP: $29,690).[66]

---

FRIENDS OF THE CECI BLOG (Apr. 26, 2010), http://cecisrael.wordpress.com/2010/04/26/israels-18th-knesset-too-many-voices-too-little-connection-with-the-people-of-israel/ (describing research conducted by Tel Aviv University Ph.D. Candidate Asaf Becker for "The CECI Forum for Government Stability").

57 *Israeli Politics: Can the Doves Take Off Again? A Split in Israel's Labour Party may give the Peace-Minded Left a New Lease of Life*, ECONOMIST (Jan. 20, 2011), *available at* http://www.economist.com/node/17963325.

58 *See Prime Minister's Office*, ISRAEL GOV. PORTAL, http://www.pmo.gov.il/PMOEng/Government/Panel/ (last visited Nov. 15, 2012).

59 *See Prime Minister's Office*, ISRAEL GOV. PORTAL, http://www.pmo.gov.il/PMOEng/Government/Offices/ (last visited Nov. 15, 2012).

60 *See* Yehudah Lev Kay, *Largest Cabinet Ever Missing Health Minister—With 30 ministers and 5 deputy ministers, the new cabinet is the largest ever, but not one wanted to serve as Health Minister*, ARTUZ SHEVA (Apr. 1, 2009), http://www.israelnationalnews.com/News/News.aspx/130713#.Tq1wRHFGwf.

61 CIA, Israel: *Government*, in THE WORLD FACTBOOK (2012), https://www.cia.gov/library/publications/the-world-factbook/geos/is.html.

62 CIA, Israel: *Economy-Exchange Rate*, in THE WORLD FACTBOOK (2012), https://www.cia.gov/library/publications/the-world-factbook/geos/is.html.

63 Sharon Wrobel, *Shekel Begins Trading On Global Market*, JERUSALEM POST (May 26, 2008*),available at* http://www.jpost.com/Business/BusinessNews/Article.aspx?id=102359.

64 Moti Bassok, *Israelis Can Soon Travel the World with Shekels in Their Pockets*, HAARETZ (Feb. 14, 2008), http://www.haaretz.com/news/israelis-can-soon-travel-the-world-with-shekels-in-their-pockets-1.239265.

65 *Background Notes: Israel*, *supra* note 45.

66 *The World in Figures*, *supra* note 52 (This contrasts with its neighbor, Egypt, whose vitals are GDP growth: 5.5%; GDP: $253bn (PPP: $534bn); Inflation: 10%; and GDP per capita: $2,940 (PPP: $6,190); and the United States, whose vitals are GDP growth: 1.5%; GDP: $14,996bn (PPP: $14,996bn); Inflation: 1.0%; and GDP per capita: $48,010 (PPP: $48,010)).

According to the World Bank, Israel's GNI is $210,352,507,970 and its GNI per capita PPP is $27,630.[67] Israel boasts low start-up costs for business: the World Bank reports start-up costs of businesses in Israel, as a percentage of gross national income (GNI) per capita, is 4%, similar to the U.S.'s 1%. By comparison in the region, Egypt is 10%; Jordan is 14%; Syria is 17%; and Lebanon is 67%.[68]

Israel is also economically integrated with the major inter-governmental organizations including memberships in the World Trade Organization,[69] the World Intellectual Property Organization,[70] the International Monetary Fund, the World Bank Group, the Organization for Economic Cooperation and Development, the European Bank for Reconstruction and Development, and the Inter-American Investment Corporation.[71] Israel also has Bilateral Investment Treaties with 37 nations and is negotiating them with several more.[72] Israel has Free Trade Area agreements with Canada, European Free Trade Association (EFTA), European Union (EU), Mercosur (Southern Common Market), Mexico, Turkey, and the United States, and is negotiations with India.[73] With Jordan and Egypt, Israel has Qualified Industrial Zones (QIZ) agreements.[74]

Israel's natural resources include timber, potash, copper ore, phosphate rock, magnesium bromide, clays, sand, and—as revealed by major finds during exploration in 1999 and 2010—natural gas in territorial waters off Israel's Mediterranean coast.[75]

---

67 This compares to Egypt's $214,529,580,920 GNI and $6,030 GNI per capita PPP, and the United States' $14,365,600,000,000 GNI and $47,310 GNI per capita PPP. *GNI Per Capita, PPP (Current International $)—2010*, WORLD BANK, http://data.worldbank.org/indicator/NY.GNP.PCAP.PP.CD (last updated 2012); *GNI (Current US$)—2010*, WORLD BANK, http://data.worldbank.org/indicator/NY.GNP.MKTP.CD (last updated 2012).

68 *Cost of Business Start-Up Procedures (% of GNI per Capita)—2011*, WORLD BANK, http://data.worldbank.org/indicator/IC.REG.COST.PC.ZS (last updated 2012).

69 *Israel and the WTO*, WORLD TRADE ORG., http://www.wto.org/english/thewto_e/countries_e/israel_e.htm (last visited Nov. 15, 2012).

70 *Information By Country: Israel,* WORLD INTELL. PROP. ORG., http://www.wipo.int/members/en/details.jsp?country_id=79&country_code=IL (last visited Nov. 15, 2012).

71 *International Organizations*, MINISTRY OF FIN., http://eng.mni.gov.il/FinanceIsrael/Pages/en/EconomicData/InternationalOrganizations.aspx (last visited Nov. 15, 2012).

72 *International Agreements*, MINISTRY OF FIN., http://eng.mni.gov.il/FinanceIsrael/Pages/en/EconomicData/InternationalAgreements.aspx (last visited Nov. 15, 2012).

73 *Id.*

74 *Id.*

75 *Israel and its Natural Resources: What A Gas! Israel's New Gas Finds May Affect Its Strategic Friendships, Too,* ECONOMIST (Nov. 11, 2010), *available at* http://www.economist.com/node/17468208.

Israel's main exports include "cut diamonds, high-technology equipment, and agricultural products" (especially fruits and vegetables).[76] The United States (32.1%), Hong Kong (6.3%), India (5.1%), and Belgium (5.1%) were Israel's leading export markets in 2010.[77] Israel imports raw materials, military equipment, investment goods, rough diamonds, grain, and consumer goods—and especially fossil fuel (including oil imports of 282,200 bbl/day measured against daily consumption of 238,000 bbl/day, and electrical consumption of 47 billion kWh (48th in the world) as compared to production of only 53 billion kWh (45th in the world)).[78] Notably, the Israeli Ministry of Energy and Water Resources forecasts increased demand for electrical power in Israel and a doubling of electrical consumption in Israel by 2020.[79] Energy resources are closely tied to the region's politics, and energy dependence or independence, and energy import or export, significantly contribute to defining the relative power and vulnerabilities of Israel and its neighbors.[80]

### *B. The Business Proposal: Alstom's Joint Venture with Energix to Expand the Golan Heights Wind Farm*

The FDI proposal that we will evaluate for presentation is that the France-based international energy conglomerate, Alstom Group, will joint venture with Israel-based Energix, Ltd., to expand wind power output from the Golan Heights wind farm.[81]

Alstom Group is a world leader in transport infrastructure, power generation and transmission; has business presence in 100 countries and realized _20.9 billion in sales during 2010-2011; and employs over 93,000 people. Alstom has 30 years' experience designing, siting, and operating wind-powered turbines, and operates wind farms in Spain, UK, France, Italy, Portugal, Morocco, Brazil, Turkey, Japan and India. Alstom's 2,100 turbines currently installed or under construction can generate more than

---

[76] CIA, Israel: *Economy*, in THE WORLD FACTBOOK (2012), https://www.cia.gov/library/publications/the-world-factbook/geos/is.html.

[77] *Id.*

[78] *Id.*

[79] *The National Energy Sector in Israel—Factors Contributing to the Increase in the Demand for Electricity*, MINISTRY OF ENERGY & WATER RES., http://energy.gov.il/English/Subjects/Electricity/Pages/GxmsMniElectricitySector.aspx (last visited Dec. 31, 2012).

[80] *See What Role Have Natural Resources Played in the Politics And Economy of the Middle East?*, PBS—GLOBAL CONNECTIONS, http://www.pbs.org/wgbh/globalconnections/mideast/questions/resource/index.html (last visited Nov. 16, 2012)

[81] *See, e.g.*, *Israel Should Catch the Wind*, *supra* note 38; *Draft Tender*, *supra* note 38.

2,700 MW. It has expertise in on-shore, as well as off-shore, electric wind turbines, and in matching equipment needs to suit the geography of the wind farm (e.g., mountainous, desert, arctic or other geographically difficult regions/climates, as well as in more space-constrained populated areas). Alstom uses proprietary technology to produce climate kits and a unique and proven rotor support concept that protects the drive train to ensure reliability under the most challenging and adverse conditions. Alstom has yet to establish a wind turbine presence in the Middle East, yet has invested in other projects in Israel, even in disputed territories and in the face of criticism at home and abroad (such as the Jerusalem Light-Rail Project).[82]

Energix purchased its stake in the Golan Heights wind project from Multimatrix, Ltd., in June 2011,[83] and has most recently invested in a pair of wind-energy projects in Poland.[84] Energix describes itself as "an

---

82 The source for information on Alstom's business is Alstom's own website. *See, e.g.,* http://www.alstom.com/about-us/ (last visited December 21, 2012) ; http://www.alstom.com/power/renewables/wind/turbines/ (last visited December 21, 2012). The information on Alstom's involvement in the Jerusalem Light-Rail Project comes from a variety of sources. *See Jerusalem Light Rail Project*, RAILWAY-TECHNOLOGY, http://www.railway-technology.com/projects/jerusalem/ (2011) (last visited Nov. 16, 2012); Daniel Machover & Adri Nieuwhof, *Opinion/Editorial: French Court Decision On Jerusalem Light Rail Must Be Challenged*, ELECTRONIC INTIFADA (June 27, 2011), http://electronicintifada.net/content/french-court-decision-jerusalem-light-rail-must-be-challenged/10115#.TryGBnFGwfo (noting Alstom's defense of its work in disputed Jerusalem territory and its victory in a French court); Abe Selig, *Palestinians Irate Over New Jerusalem Light Rail*, JERUSALEM POST (Feb. 3, 2010), http://www.jpost.com/Israel/Article.aspx?id=167717 ("Jerusalem's light rail starts test runs this spring, with its sleek silver cars gliding across the city and promising to relieve the perpetual congestion. But Palestinians see no reason to celebrate. They hope to derail the $1 billion tram because they fear it will further entrench Israeli control over east Jerusalem. They've asked a French court to force two French multinationals, Veolia and *Alstom*, out of the project and are urging Arab countries to cancel contracts with the two companies.") (emphasis added); Abe Selig, *Palestinian Boycott Calls Won't Hinder Jerusalem Light Rail Construction*, JERUSALEM POST (Nov. 23, 2009), http://www.jpost.com/Israel/Article.aspx?id=161130 ("Despite recent calls by Palestinian Authority officials to boycott two French companies working on Jerusalem's much-anticipated light rail system, the local spokesman for one of those companies - Alstom - told The Jerusalem Post on Sunday that the light rail work was moving ahead as scheduled, and that political considerations would not interfere with the firm's completion of the project. 'Alstom is not a political company, said the company's Israel spokesman, Nissim Zvili, a former MK and Labor Party secretary-general who served as ambassador to France from 2002 to 2005."); *see also 'French Firm Drops J'lem Project Due To Political Pressure'—Dan Bus Lines Says Veolia Leaving Light Rail Project Because of Anti-Israel Boycotts; French Transportation Company Denies Allegations*, JERUSALEM POST (Nov. 28, 2010), http://www.jpost.com/NationalNews/Article.aspx?id=197093.

83 *Energix Invests NIS 45m in Golan Wind Energy Projects—The Company has Replaced Multimatrix as Mei Golan Wind Energy Development's Partner*, AHK (July 14, 2011), http://israel.ahk.de/en/news/news-single/artikel/energix-invests-nis-45m-in-golan-wind-energy-projects/?cHash=972a80277ac4e0278030c273e067687a.

84 Aviv Levi, *Energix To Invest In Wind Energy In Poland—The Company Will Invest Up To _25 Million In Two Wind Energy Projects*, GLOBES (February 12, 2012), http://www.globes.co.il/serveen/globes/docview.asp?did=1000726284&fid=1725

alternative energy company that invests in wind energy projects,"[85] is listed on the Tel Aviv Stock Exchange (TASE),[86] and made its IPO on TASE in May 2011.[87] It is an appointed market-maker for its securities.[88] Its predecessor-in-interest, Multimatrix, is a small Israel-based investments company that has also been listed on the Tel-Aviv Stock Exchange.[89] Unlike Energix, Multimatrix is not primarily an energy company; indeed, Multimatrix has been notable to date only for the acquisition of two principal assets:[90] a resort complex on the Canary Islands, and an interest in property on the wind-swept Golan Heights in Israeli territory annexed from (but still claimed by) Syria after the 1967 "Six-Days' War," upon which it proposed to site numerous, modern electricity-generating wind turbines.[91] Multimatrix sought to re-develop wind energy on the Golan Heights by buying a half share of Mei Golan, a company that operates a

---

85 *Overview*, REUTERS (2012), http://www.reuters.com/finance/stocks/overview?symbol=ENRG.TA.

86 For Energix's TASE listing, see http://www.tase.co.il/TASEEng/General/Company/companyMainData.htm?companyID=001581&shareID=011233.63&subDataType=3. As another stock exchange explains, "market makers are important players in the marketplace, as they support the liquidity of securities by providing continuous bid and ask quotations. Holders of securities that have appointed market makers can be confident that they can sell their holdings at any time. Through enhancing the liquidity of securities, market makers contribute to the maintenance of an efficient and orderly market." *Market Makers*, NASDAQ OMX ARMENIA, http://www.nasdaqomx.am/en/market_makers.htm. *See also* Robert B. Thompson, *Market Makers and Vampire Squid: Regulating Securities Markets after the Financial Meltdown*, 89 WASH. U. L. REV. 329 (2011); Rafi Eldor, Shmuel Hauser , Batia Pilo, & Itzik Shurki, *The Contribution of Marketmakers to Liquidity and Efficiency of Options Trading in Electronic Markets,* 30 J. BANKING & FIN. 2025, 2025-40 (2006); Kumar Venkataramana & Andrew C. Waisburda, *The Value of the Designated Market-Maker*, 42 J. FIN. & QUANT. ANAL. 735 (2007); John F. Gould & Allan W. Kleidon, *Market Maker Activity on Nasdaq: Implications for Trading Volume*, 1 STAN. J.L. BUS. & FIN. 11 (1994).

87 Aviv Levy, *Energix Renewable Energy Raises NIS 146m In IPO—Energix Builds and Operates Small Photovoltaic Facilities*, GLOBES (May 2, 2011), http://www.globes.co.il/serveen/globes/docview.asp?did=1000642262&fid=1725.

88 *See Energix-Renewables Energies Ltd*, TEL AVIV STOCK EXCHANGE, http://www.tase.co.il/TASEEng/General/Company/companyMainData.htm?companyID=001581&subDataType=0&shareID=01123355 (market maker status denoted by "MM" next to stock symbol; hold cursor over notation to see status").

89 *Markets—Multimatrix Ltd (MLTX.TA),* REUTERS, http://www.reuters.com/finance/stocks/companyProfile?rpc=66&symbol=MLTX.TA (last visited Nov. 15, 2012).

In September 2012, after it had sold its interest in the Golan Heights wind farm project to Energix, Multimatrix suspended trading in its shares on the TASE. *See Multimatrix Ltd*, TEL AVIV STOCK EXCHANGE, http://www.tase.co.il/TASEEng/General/Company/companyMainData.htm?companyID=000052& (last visited Nov. 15, 2012)

90 *Company Profile—Multimatrix Ltd (MLTX.TA)*, REUTERS, http://www.reuters.com/finance/stocks/companyProfile?rpc=66&symbol=MLTX.TA (last visited Nov. 16, 2012).

91 Maurice Picow, *Multimatrix Invests Millions In Israel's Small Wind Market*, GLOBAL PROPHET (May 8, 2010), http://www.greenprophet.com/2010/05/wind-energy-golan-heights/. Please recall that in June 2011, Multimatrix sold its interest in the Golan Heights wind farm to another Israeli company, Energix. *See supra* text accompanying note 38.

nearly 20-year-old, now outdated wind farm on the Golan Heights,[92] and it is that half share that Energix purchased in 2011.[93] Energix's predecessor, Multimatrix, aspired to build 160 wind turbines on the 18-acre area, and generate 450 MW of power. In purchasing Multimatrix's interest in the project for 45 million shekels,[94] Energix presumably shares the view that Multimatrix had of the political situation involving Syria's claim to the Golan Heights as not presenting much of a disincentive to developing the wind turbine farm: "'If the land is returned to Syria in a peace deal, we will be compensated,'" Multimatrix's former Chairman, Uri Omid,[95] once commented: "'Regardless, this project can work for us or work for them. Someone will always need the electricity.'"[96]

A decision as complex as Alstom would be making in deciding to joint venture with an Israeli company to develop Golan Heights wind power involves numerous factors, a great deal of information gathering, a substantial amount of sophisticated analysis, and informed intuition on the part of seasoned managers and executives. Such complexity can be overwhelming to students in an IBT course and could prevent the learning objectives from being accomplished.[97] For purposes of our

---

92 Ari Rabinovitch, *Israel Uses Golan To Build Wind Energy Industry,* REUTERS (Apr. 29, 2010), http://uk.reuters.com/article/2010/04/29/us-israel-energy-wind-idUKTRE63S37320100429.

93 Sharon Wrobel, *Israel Stocks: Delek Fuel, Delek Real Estate, Gilat, Multimatrix*, BLOOMBERG (July 13, 2011), http://www.bloomberg.com/news/2011-07-13/israeli-stocks-delek-fuel-delek-real-estate-and-multimatrix.html. In addition, Energix presumably also purchased Multimatrix's "35% of a wind farm in Tel Assaya, Israel, [that] produces six megawatt of electricity and is about to be upgraded to 14 megawatts" which Multimatrix had purchased along with "50% of another wind farm under development in the Golan heights, with expected capacity of 400 megawatts, for the sum of NIS 38 million." *Multimatrix Ltd. Acquires Holdings in Two Wind Farms in Israel,* REUTERS (Nov. 30, 2011), http://www.reuters.com/finance/stocks/MLTX.TA/key-developments/article/2035673

94 *Id.*

95 Mr. Omid resigned effective March 5, 2012. *Multimatrix Ltd Announces Resignation of Chief Executive Officer, Mr. Uri Omid*, REUTERS (March 4, 2012), http://www.reuters.com/finance/stocks/MLTX.TA/key-developments/article/2495110.

96 *Multimatrix Ltd. Acquires Holdings in Two Wind Farms in Israel,* REUTERS (Nov. 30, 2011), http://www.reuters.com/finance/stocks/MLTX.TA/key-developments/article/2035673.

97 An excellent roundup of various, primarily academic, templates and paradigms for evaluating FDI decisions is Sethi, Guisinger, Phelan & Berg, *Trends in Foreign Direct Investment Flows: A Theoretical and Empirical Analysis*, 34 J. INT'L BUS. STUD. 315 (2006). Sethi et al. provide a bedazzling list of such templates and paradigms: industrial organization tradition; product life-cycle concept; exploitation of ownership advantages approach; risk diversification model; organizational assets and knowledge-transfer approach; internalization-of-transactions perspective, bandwagon-effect, eclectic paradigm (an ownership, location, and internalization advantages-based framework to analyze why, and when, MNEs would invest abroad); the Upsaala model of incremental FDI; the resource-based approach; the evolutionary perspective; the organizational-management approach; the ownership advantages theory (encompassing technology intensity, capital intensity, and product differentiation), and the

discussion, therefore, I telescope the complexity into three, macro-view propositions for further research and development.[98] These three reasons are the strongest militating in favor of the FDI, and they become the foundation of a strategic business plan. In assessing the FDI under consideration, students should see that the three strongest reasons why Alstom should embrace this joint venture opportunity with Energix are:

---

more recent "regional-variations" approach. *Id.* at 316-17. The authors' regional-variations approach examines the effect of the following factors not merely on FDI within in a particular country, but FDI within a particular region, including market lucrativeness, market size, market growth, economically "liberal" host state policies (particularly concerning currency expatriation, expropriation, tax concessions, and private ownership), technological infrastructure, availability of skilled labor, absence of trade barriers, overhead costs (production, transportation, and wage costs), political stability, and "psychic" distance of host state and the related notion of "cultural proximity." *Id.* at 316-18. In their model, Sethi et al. analyze from the perspective of six propositions:

> *Proposition 1.* Notwithstanding each MNE's unique FDI location decision, collectively such flows target economically and culturally integrated regions rather than specific countries.
>
> . . . .
>
> *Proposition 2.* MNE investments initially flow to the region that provides the best mix of the traditional FDI determinants.
>
> . . . .
>
> Proposition 3. Build-up of intense competitive pressures in the original host region would cause MNEs to make efficiency-seeking investments into low-wage countries to reduce costs.
>
> . . . .
>
> *Proposition 4.* MNEs' efficiency and market-seeking investments into a region will be contingent upon the countries in that region adopting investor-friendly liberalization policies.
>
> . . . .
>
> *Proposition 5.* The optimal mix of FDI determinants for low-wage countries would be different from the mix for the developed countries – the original FDI destinations.
>
> . . . .
>
> *Proposition 6.* The factor of psychic distance will assume less importance in MNEs' FDI decisions, all other factors being equal.

*Id.* at 317-19. The authors posit that MNEs make FDI decisions in cycles, because FDI activity eventually becomes saturated in particular reasons, and thus, "[t]o remain competitive, MNEs are compelled to seek new FDI destinations that offer wage and factor cost reductions and also open up new markets," and while "[s]uch countries/regions are also evaluated on the same traditional FDI determinants, . . . firms might now accept a different mix compared to that for the original destinations." *Id.* at 318-19. Somewhat lost in Sethi et al.'s survey of factors is political risk as a potentially *positive* factor. *See, e.g.*, Alfredo Jiménez, *Political Risk as a Determinant of Southern European FDI in Neighboring Developing Countries*, 47 EMERGING MKTS. FIN. & TRADE 59 (July-August 2011) ("Despite the fact that one might expect global flows to fall as a consequence of political risk, those from the countries in the sample increase, because they come from firms that are searching for a market niche where they can take advantage of their political capabilities"); Jiménez & Delgado-García, *supra* note 3. More generally, I discuss political risks of Alstom's hypothesized Golan Heights investment in Section III.C.2, *infra*.

[98] This is consistent with the analytic framework developed and espoused by a former McKinsey & Company consultant, who has become a leading authority on techniques for expressing the business-decisionmaking process. *See generally* BARBARA MINTO, MINTO PYRAMID PRINCIPLE: LOGIC IN WRITING, THINKING, AND PROBLEM-SOLVING 121-67, 170-76 (1991).

*1. Israel's need for electrical power currently exceeds supplies and will continue to grow.*

*2. Electricity generated by wind turbines is a sustainable energy source that has great room for growth in Israel and increases Israel's energy independence.*

*3. Israeli government support for wind-generated electrical generation is growing, and Israel's FTA Agreement with the U.S. will permit Energix to import Alstom's American-made wind turbines duty-free.*

In Section II.C, we expand upon and evaluate each of these three reasons, seriatim, in a proposed strategic plan.

### *C. A Proposed Strategic Plan: Why Expanding the Golan Wind Farm in Joint Venture with Energix Optimizes Alstom's Strategic Advantages in Opening a New Market for its Products and Services in the Middle East*

#### *1. Israel's Need for Electrical Power Currently Exceeds Supplies and Will Continue to Grow*

Israel has a dynamic economy that continues to grow: GDP has increased at a rate of 4 to 5 percent annually since 2005,[99] and is heavily weighted to manufacturing and service industries that consume substantial amounts of electrical power.[100] In fact, Israeli electricity consumption has grown by about 4 percent a year since the early 1990s.[101]

This growth creates practical challenges for Israel.[102] Certainly, Israel cannot afford to have the kind of massive electrical power outage that confronted India in July 2012, in which nearly 700 million people—one-tenth of the world's population—were plunged into darkness in an

---

[99] *Israel Heading Towards Ending Fossil Fuel Dependence*, IPLANET ENERGY INDUSTRY NEWS (Jan. 9, 2011), http://iplanetenergynews.com/index.php/2011/01/09/israel-heading-towards-ending-fossil-fuel-dependence [hereinafter " IPLANET"]; Uriel Heilman, *Is An Israeli Energy Revolution in the Offing?,* B'NAI B'RITH MAGAZINE, Spring 2010, *available at* http://www.urielheilman.com/0401-israel-alternative-energy.html.

[100] U.S. STATE DEP'T, Under Secretary for Public Diplomacy and Public Affairs— Bureau of Public Affairs (Near East), Background Notes: Israel—Economy, http://www.state.gov/r/pa/ei/bgn/3581.htm#econ (Dec. 10, 2010).

[101] IPLANET, *supra* note 99; Heilman, *supra* note 99.

[102] *See, e.g.*, Gregg Tepper & Stuart Winer, *Electricity Grid Stretched to Brink as Sweltering Israelis Turn to Air Conditioners for Relief—Power Outages May Occur in Coming Days if Electricity Use Exceeds Supply; Public Asked to Reduce Consumption in Late Afternoon*, TIMES OF ISRAEL (July 17, 2012), *available at* http://www.timesofisrael.com/israel-sets-2012-electricity-consumption-record/

unexpected power grid failure.[103] While Israel's infrastructure is more stable than India's, Israel is facing its own energy issues because of politics and geography.[104] For example, McKinsey & Company found that Israeli greenhouse gas emissions are expected to double by 2030 as a result of increased energy consumption.[105] Israel's electricity grid is not connected to any of its neighbors' grids. Israel imports 85 percent of its energy, mostly in the form of coal, but also in natural gas. In 2009, the country

---

[103] *See, e.g.*, Santanu Choudhury, Romit Guha & Saurabh Chaturvedi, *After Blackout, India Seeks to Restore Faith—Electricity is Back But Confidence Will Take Longer; Economic Prospects, Investor Patience Dwindle*, WALL ST. J. (Aug. 1, 2012), *available at* http://online.wsj.com/article/SB10000872396390443687504577563001658535464.html; Sruthi Gottipat, *India Endures World's Largest Blackout,* N.Y. TIMES (July 31, 2012), *available at* http://india.blogs.nytimes.com/2012/07/31/india-hosts-worlds-largest-blackout/. Reporter Gottipat put the event in perspective:

> The colossal power failure that swept through half of India early Tuesday afternoon, causing disruptions in the lives of hundreds of millions of people, has earned India a new and dubious distinction: Host of the World's Largest Blackout.
>
> Some 600 million people were estimated to be affected after power was halted in 11 states in northern and eastern India and in the country's capital of 16 million people. Imagine most of Europe without power, or more people powerless than the populations of the United States, Mexico and Central America combined.

*Id.* As two other reporters observed:

> It had all the makings of a disaster movie: More than half a billion people without power. Trains motionless on the tracks. Miners trapped underground. Subway lines paralyzed. Traffic snarled in much of the national capital.
>
> On Tuesday, India suffered the largest electrical blackout in history, affecting an area encompassing about 670 million people, or roughly 10 percent of the world's population. Three of the country's interconnected northern power grids collapsed for several hours, as blackouts extended almost 2,000 miles, from India's eastern border with Myanmar to its western border with Pakistan.
>
> For a country considered a rising economic power, Blackout Tuesday—which came only a day after another major power failure—was an embarrassing reminder of the intractable problems still plaguing India: inadequate infrastructure, a crippling power shortage and, many critics say, a yawning absence of governmental action and leadership.

Jim Yardley & Gardiner Harris, *India Staggered by Power Blackout; 670 Million People in Grip*, N.Y. TIMES (Aug. 1, 2012), *available at* http://www.nytimes.com/2012/08/01/world/asia/power-outages-hit-600-million-in-india.html); *see also* Gardiner Harris & Vikas Bajaj, *As Power is Restored in India, the 'Blame Game' Over Blackouts Heats Up*, N.Y. TIMES (Aug. 1, 2012), *available at* http://www.nytimes.com/2012/08/02/world/asia/power-restored-after-india-blackout.html.

[104] *Cf.* Editorial, *When Half of India Loses Electricity, Time for Lessons on Going Local India's Electricity Grid Went Out for 600 Million People Tuesday. The Historic Blackout Shows How Nations Must Reconsider Big, Complex Infrastructure Like Centralized Electric Utilities*, CHRISTIAN SCIENCE MONITOR (July 31, 2012), *available at* http://www.csmonitor.com/Commentary/the-monitors-view/2012/0731/When-half-of-India-loses-electricity-time-for-lessons-on-going-local; Jeff Myhre, *Indian Blackout Lesson: Invest in Infrastructure*, FOREIGN POL'Y ASS'N NETWORK (August 3, 2012), *available at* http://foreignpolicyblogs.com/2012/08/03/indian-blackout-lesson-invest-in-infrastructure/.

[105] iPLANET, *supra* note 99; Heilman, *supra* note 99.

spent $5 billion on energy imports.[106] In addition, politics makes Israel an "energy island." Thus, while recent natural gas finds in the Mediterranean will benefit some energy-consuming sectors, these finds will not be used to generate additional electrical power, and the finds themselves are also embroiled in political controversy over sea boundaries with neighboring Lebanon and and face possible Hezbollah rocket attacks on gas refines launched from Lebanon.[107] Israel has no backup to meet consumption, and current energy sources have been destabilized by major acts of sabotage following the instability created by the fall of the Mubarak government in Egypt.[108] Israeli officials warn that as a result, the country soon could encounter rolling blackouts, much as California experienced intermittently throughout the last decade. Israel already is experiencing brownouts. Heavy reliance on foreign supplies makes Israel highly subject to global price fluctuations—not to mention potential boycotts by hostile energy-exporting states.[109] Thus, Israel faces both a steady and growing demand for electrical energy while at the same time having limited access to the traditional means of generating electrical power and facing environmental limitations on generating electricity by burning fossil fuels.

It is important for both law students and lawyers in this "information age" of the 21st century to think critically about the sources, particularly non-legal sources, upon which they rely in gaining familiarity with their clients' businesses and the context for their FDI deliberations. Indeed, the internet age has—seemingly like a *jinni* from the *1001 Nights*[110]—allowed unprecedented access to virtually unlimited amounts of data from myriad sources with breathless alacrity. At the same time, however, never has so much misinformation been spread so widely so quickly.[111] Thus, in learning IBT, just as in learning other disciplines that require the location,

---

[106] iPLANET, *supra* note 99; Heilman, *supra* note 99.

[107] Ethan Bronner, *Natural Gas Deposits Improve Israel's Energy Outlook*, N.Y. TIMES (Aug. 20, 2010), *available at* http://www.nytimes.com/2010/08/21/world/middleeast/21israel.html.

[108] *Blasts Hit Egypt's Gas Pipeline to Israel, Jordan—Saboteurs Blew up a Sinai Pipeline on Thursday, Halting Gas Supplies from Egypt to Israel and Jordan in the Sixth Such Attack Since the Overthrow of President Hosni Mubarak*, REUTERS (Nov. 10, 2011), *available at* http://www.reuters.com/article/2011/11/10/us-egypt-gas-explosion-idUSTRE7A92RD20111110 [hereinafter, *Saboteurs*].

[109] iPLANET, *supra* note 99; Heilman, *supra* note 99.

[110] 1 ARABIAN NIGHTS: TALES OF 1001 NIGHTS, at 5-7, 965 (Penguin Classics 2008) (Malcom C. & Ursula Lyons, trans.). Of course, in its most baleful incarnations, the internet may be more properly comparable to an *ifrit*—an "evil" *jinni*. *See id.* at 10-25, 965. Unlike the *ifrit*, however, the internet cannot be beguiled into returning to its bottle. *Id.* at 24-25.

[111] *See, e.g.*, JAMIE BARTLETT & CARL MILLER, TRUTH, LIES, AND THE INTERNET: A REPORT INTO YOUNG PEOPLE'S DIGITAL FLUENCY (2011), *available at* http://www.demos.co.uk/publications/truth-lies-and-the-internet.

collection, and assessment of online data, it is important to join the "major campaign to place digital fluency at the heart of learning,"; and at the heart of digital fluency is "having the skills and knowledge to evaluate and assess" the provenance and content of the information found and the perspective and critical discernment to recognize proper modes and strategies for information searches.[112] In the preliminary research into FDI options, we can begin to emphasize these skills by requiring our students to provide critical, objective assessments of the quality, potential bias, and reliability of sources on which they rely.[113]

For example, the sources cited in this subsection to support the information and observations provided are, in addition to the internationally reputable and Pulitzer-Prize winning *New York Times*, at least prima facie reliable and verifiable. Thus, although the United States is a staunch ally of Israel, the State Department's information is gathered for governmental decision-making purposes by a third-party to Israel, and therefore is not likely subject to significant distortion or bias since it is not used primarily to shape U.S. public opinion. The *iPlanet* source may be

---

112 *Id.* at 7.

113 *See, e.g.*, M. Neil Browne, et al., *The Importance of Critical Thinking for Student Use of the Internet*, 34 College Student J. No. 3 (Sept. 2000), *available at* http://www.freepatentsonline.com/article/College-Student-Journal/66760560.html. As M. Neil Browne, Distinguishing Teaching Professor of Economics at Bowling Green State University in Ohio, observed over a decade ago—before the problem reached the proportions it has now attained:

> Students may develop a "misunderstanding of research itself" by using the Internet as a research tool, . . . , due partly to the decontextualized nature of information found electronically. Historical research, for example, involves recognition and appreciation of context; the handwriting, typeface, layout and paper qualities of a document are valuable clues to a document's meaning. . . . Such contextual clues are unavailable to students who find a document on-line as opposed to in the library archives. In using the Internet to find the majority of research on a topic, students do not learn the importance of information's context, leading to a very narrow understanding of what careful research requires of the researcher.
>
> The increasing reliance of students on Internet research has also been accompanied by a decline in the quality of the their work, according to some educators. They maintain that students are piecing Internet-based information together as if it were from one point of view and entirely factual, although information provided by the Web is decontextualized and sometimes unreliable.
>
> . . . .
>
> Without carefully considering the source from which an argument has arisen and the reasoning behind the argument's conclusion, students are doing little to develop their minds. If the goal of our educational system is indeed to "expand students' intellectual capacities", . . . then we should expect students to evaluate any arguments they encounter. Sites on the Internet have varying purposes, perspectives, and credibility in the same way that non-electronic sources do. Any individual who wishes to conduct research via the Internet must consider these qualities.

*Id.* at 3 (citations omitted).

subject to more bias, because it is the product of an Israeli trade and lobbying group[114] that advocates "green" and alternative energy sources;[115] however, the subject matter involves relatively straightforward reporting of facts that can be verified by reference to other, independent international sources (such as those of the State Department, the WTO, and the World Bank), eliminating the skewing effect seen in reporting that involves advocacy of an industry's self-interested position. B'Nai B'rith, which published Heilman's article, is a well-known Jewish fraternal organization zealously promoting Israel and its interests,[116] and thus needs to be used cautiously; however, Mr. Heilman is a reporter recognized for his objectivity and accuracy in reporting,[117] and is a watchdog for accuracy in reporting by others.[118]

### 2. *Electricity Generated by Wind Turbines is a Sustainable Energy Source That has Great Room for Growth in Israel and Increases Israel's Energy Independence*

Israel's energy needs are defined by its natural resource limitations, and the current Prime Minister, Benyamin Netanyahu, has led a government focused on expanding the country's energy base and promoting new

---

114 iPlanet discloses the following about itself:

> Founded in 2007, the Israel Energy and Security Consortium (iConsortium) is made up of Israeli companies and organizations that have united to provide comprehensive professional greenbuilding energy savings and production retrofits, and security construction services, which integrate high-caliber greenbuilding, cleantech, and security technologies. iConsortium members are successful companies and organizations, the majority of which operate in both Israeli and overseas markets. It represents the multi-sector convergence of for-profit, not-for profit and academia towards a common goal, by incorporating leading businesses, an award-winning environmental NPO and a business ethics expert in its core group of founding members.

*About iPlanet Energy News*, IPLANET, http://iplanetenergynews.com/index.php/about-2/ (last visited Nov. 15, 2012).

115 ICONSORTIUM, http://i-consortium.com/ ("iConsortium, member-companies offer the gamut of renewable energy, energy savings and green building technologies, products and services.") (last visited Nov. 15, 2012).

116 Alfred M. Lilienthal, *The Changing Role of B'nai B'rith's Anti-Defamation League*, WASH. REP. ON MID. E. AFFAIRS (June 1993), http://www.wrmea.com/backissues/0693/9306018.htm.

117 *See* Minnesota Public Radio, *Conflict Coverage And Journalistic Objectivity*, Aug. 15, 2006, http://minnesota.publicradio.org/display/web/2006/08/15/midmorning1/ ; *see, e.g.*, Honest Reporting in Canada, http://www.honestreporting.ca/hrc-in-news.aspx; *Award-Winning Stories by Uriel Heilman*, URIELHEILMAN.COM, http://www.urielheilman.com/award.html (last visited Nov. 16, 2012).

118 *See, e.g.*, Uriel Heilman, *Playing Fast and Loose with the Facts at NGO Monitor*, JEWISH TELEGRAPHIC AGENCY (June 17, 2009), http://blogs.jta.org/telegraph/article/2009/06/17/1005957/playing-fast-and-loose-with-the-facts-at-ngo-monitor.

sources of energy.[119] Utilities throughout the world have turned to wind-power to expand electricity-generating capacity.[120] "With the advancement of technology and the dropping of production prices wind has become a serious and important component of utility generation."[121] Wind power has become a desirable and affordable means of generating electricity, and one of the fast-growing means that utilities world-wide are implementing.[122] As the Global Wind Energy Council (GWEC) has observed, "there is huge and growing global demand for emissions-free wind power, which can be installed quickly, virtually everywhere in the world" and "[w]ind energy is the only power generation technology that can deliver the necessary cuts in CO2 in the critical period up to 2020, when greenhouse cases must peak and begin to decline to avoid dangerous climate change."[123] Among alternative energy sources, wind-generated electricity has particular attraction for Israel; significant regions of the country are sufficiently windy on a continuous basis to sustain commercial electrical production.[124] At present, Israel has only one wind turbine farm, located in the Golan Heights.[125]

In addition to the reputable *New York Times* and *Jerusalem Post*, the sources for this section include information from two wind-industry groups, the American Wind Energy Association (AWEA) and the GWEC, both of which are, naturally, biased somewhat in favor of promoting wind-energy and wind-energy producers and manufacturers. Gotland University's Report on wind-energy viability in Israel should be

---

119 *See* Andrew Revkin, *What If: On Uprisings, Oil Kingdoms and the Energy Gap*, N.Y. TIMES (Feb. 3, 2011), *available at* http://dotearth.blogs.nytimes.com/2011/02/03/what-if-on-uprisings-oil-kingdoms-and-the-energy-gap.

120 *See, e.g.*, Mathew L. Wald, *Taming Untruly Wind Power*, N.Y. TIMES (Nov. 4, 2011), *available at* http://www.nytimes.com/2011/11/05/business/energy-environment/as-wind-energy-use-grows-utilities-seek-to-stabilize-power-grid.html [hereinafter Wald, *Taming*]; Mathew L. Wald, *Is Wind Worth it?,* N.Y. TIMES (Oct. 19, 2011), *available at* http://green.blogs.nytimes.com/2011/10/19/is-wind-worth-it/ [hereinafter Wald, *Worth it?*].

121 *Utilities and Wind Power*, American Wind Energy Association, http://www.awea.org/learnabout/utility/index.cfm.

122 *Wind Powering America*, U.S. DEP'T ENERGY, http://www.windpoweringamerica.gov/pdfs/2011_annual_wind_market_report.pdf.

123 *Wind is a Global Energy Source*, GWEC, http://www.gogreen.ae/greenstory_view.php?storyid=1281.

124 YOUSRE ODEH, WIND POWER POTENTIAL IN PALESTINE/ISRAEL, AN INVESTIGATION STUDY FOR THE POTENTIAL OF WIND POWER IN PALESTINE/ISRAEL, WITH EMPHASIS ON THE POLITICAL OBSTACLES 18, (Gotland University, Swed.) (June 6, 2011), *available at* http://www.hgo.se/wpmaster/2615-hgo/version/default/part/AttachmentData/data/Wind_Power_Potential_in_Palestine%20%282%29.pdf (discussing findings relevant to Golan Heights region).

125 Sharon Udasin, *Experts: Israel Stagnant on wind, renewable energy*, JERUSALEM POST (June 17, 2012), http://www.jpost.com/Sci-Tech/Article.aspx?id=274200.

more balanced and objective, though it must be noted that the University has a Wind Energy Department and offers a M.S. degree in Wind Energy Project Management, and thus is likely to be influenced by a bias in favor of wind-energy manufacturers, operators, and promoters, who are likely employers and sponsors of students and graduates in the program.[126]

*3. Israeli Government Support for Wind-Generated Electrical Generation is Growing, and Israel's FTA Agreement with the U.S. Will Permit Energix to Import Alstom's American-Made Wind Turbines Duty-Free*

The Israeli government strongly supports the development of wind-generated electricity in Israel.[127] As the *Jerusalem Post* reports, "Prime Minister Binyamin Netanyahu has declared the" further development of the Golan Heights wind farm a "national project," and "as fears continue to loom over energy shortages," the expansion of wind-generated electricity on the Golan Heights is "widely supported by government officials who see a growing need for alternative energy sources in Israel."[128] Indeed, Israel's cabinet has approved an allocation of 800 megawatts of energy production from wind farms as part of Prime Minister's 10-Year Energy Plan for Israel, which seeks by 2020 to generate from renewable energy sources 10% of the country's electricity.[129] "Between now and 2014, the government is looking for 460MW from large-scale solar installations, 110MW from rooftop solar, 800MW from wind power and about 210MW from biogas and waste-to-energy."[130] The Israeli government's ambitious program is also creating an opportunity to enter a secondary market in wind power—individual office and apartment buildings. Manufacturing, importing, and selling

---

126 *See, e.g.*, *Master Program in Wind Power Project Management*, GOTLAND U. http://www.hgo.se/utbud/hgo/en/TAMWM (last visited Nov. 16, 2012).

127 Ira Moskowitz, *Wind energy in Israel: Wind Farm on Golan Heights a National Project*, REVE (Sept. 25, 2010), http://www.evwind.es/noticias.php?id_not=7515; Sharon Udasin, *Local firm to construct more Golan Heights wind turbines*, JERUSALEM POST (AUG. 24, 2011), http://www.jpost.com/Sci-Tech/Article.aspx?id=235179; Oliver Wagg, *Israel Government Approves 2.8GW 2020 Renewables Goal—Israel's Cabinet has Given the Go-Ahead to a Plan to Generate 10% of the Country's Electricity from Renewables by 2020*, RECHARGE: THE GLOBAL SOURCE FOR RENEWABLE ENERGY NEWS (July 18, 2011), http://www.rechargenews.com/business_area/politics/article267837.ece.

128 Kalindi O'Brien, *Golan Heights Wind Farm Production to Begin Soon*, JERUSALEM POST (Sept. 27, 2010), http://www.jpost.com/HealthAndSci-Tech/ScienceAndEnvironment/Article.aspx?id=189440.

129 Gil Ronen, *Cabinet Approves Electricity Production from Renewable Sources*, ARUTZ SHEVA (July 17, 2011), http://www.israelnationalnews.com/News/News.aspx/145798#.UKu5YYdT-ZY."

130 Wagg, *supra* note 127.

smaller wind turbines for installation on roofs has already started in Tel Aviv, and Israel's public utility authority has adopted a rule allowing individuals to generate their own wind-made electricity and to sell their excess back to the electric power grid.[131] Alstom is well-positioned to manufacture and import into Israel both the larger wind-turbines needed for the Golan Heights project, as well as a separate line of smaller, commercial and residential building units.

In 2010, Alstom announced the opening of a new wind-turbine assembly manufacturing plant sited in Amarillo, Texas,[132] which is the latest component of its North American Wind Operations Division headquartered in Richmond, Virginia.[133] Ground was broken on the facility[134]; certification of its production processes are underway[135]; and the U.S. Energy Department has already awarded Alstom a $4.1 million "to research and develop advanced control systems and integrated sensors that increase energy production and lower the capital cost[s]" of electricity-generating wind turbines.[136] The American presence is especially timely, because it will allow Alstom to take advantage of the Free Trade Area agreement between the United States and Israel,[137] the first FTA into which the U.S. entered 25 years ago.[138] Under Annex I of the FTA, products "of the United States" are imported duty-free into

---

131 Zafrir Rinat, *On the Roof, Wind Turbines to Bring Power*, HAARETZ (May 15, 2008), http://www.haaretz.com/print-edition/features/on-the-roof-wind-turbines-to-bring-power-1.245923; Jonathan Shapira, *Israel Sets Feed-In Tariff for Wind Power*, CLEANTECH INVESTING IN ISRAEL (Feb. 22, 2009), http://cleantech-israel.blogspot.com/2009/02/israel-sets-feed-in-tariff-for-wind.html.

132 *See Alstom Outlines Plans for North American Wind Turbine Assembly Facility*, PRNEWSWIRE (May 25, 2010), http://multivu.prnewswire.com/mnr/alstom/43916/.

133 *U.S. Locations*, ALSTOM, http://www.alstom.com/us/locations/ (Turbine engineering, manufacturing and service center; power automation & controls, excitation systems, monitoring and diagnostics).

134 *Alstom Breaks Ground With Wind Turbine Nacelle Assembly Facility in Amarillo, Texas*, PRNEWSWIRE (May 27, 2010), http://www.prnewswire.com/news-releases/alstom-breaks-ground-with-wind-turbine-nacelle-assembly-facility-in-amarillo-texas-95024609.html.

135 *Alstom Wind Turbine Starts N. American Certification Testing*, TEXAS TECH NEWS (Feb. 2, 2011), http://today.ttu.edu/2011/02/alstom-wind-turbine-starts-n-american-certification-testing/; Kevin Welch, *Alstom Energy Begins Work On First Wind Turbine Nacelles*, AMARILLO GLOBE-NEWS (May 30, 2012), http://amarillo.com/news/local-news/2012-05-31/alstom-energy-begins-work-first-wind-turbine-nacelles ("Set-up of Alstom's LEED silver-certified Amarillo wind turbine nacelle assembly is complete, and [it has] hired 25 people to begin an initial production run of 3-megawatt nacelles to validate its processes.").

136 *DOE Awards $4.1m Research Grant to Alstom*, ENERGY BUS. REV. (Sept. 19, 2011), http://wind.energy-business-review.com/news/doe-awards-41m-research-grant-to-alstom-190911.

137 *International Agreements*, MINISTRY OF FIN., http://eng.mni.gov.il/FinanceIsrael/Pages/en/EconomicData/InternationalAgreements.aspx (last visited Nov. 15, 2012).

138 *Israel Free Trade Agreement*, OFFICE OF THE U.S. TRADE REPRESENTATIVE, http://www.ustr.gov/trade-agreements/free-trade-agreements/israel-fta (last visited Nov. 15, 2012).

Israel.[139] To be considered a "product of the United States," an item must qualify as "wholly the growth, product, or manufacture of the United States of America or is a new or different article of commerce that has been grown, produced, or manufactured in the United States of America," and "the sum of (a) the cost or value of the materials produced in the United States of America plus (b) the direct cost of processing operations performed in the United States of America is not less than 35 percent of the appraised value of the article at the time it is entered into Israel."[140] Although Alstom currently manufactures a portion of the wind turbine components outside of the U.S., there are indications it plans nacelle manufacture in the Texas facility as well as wind turbine assembly;[141] and the assembled wind turbines will qualify for tariff-free treatment because at the Texas facility they will be "substantially transformed into a new article having a new name, character, or use."[142] In addition, "To benefit from the provisions of the U.S.-Israel FTA, qualifying goods exported to Israel must be accompanied by a special 'US Certificate of Origin for Exporting to Israel.'"[143] Should there be any disputes with customs officials in Israel over the status or documentation of imported wind-turbines, the FTA provides a dispute resolution process facilitated by the Joint Committee.[144] Alstom can also be assured of protection of its intellectual property by Article 14 of the Treaty; Article 14 provides "national and most favored nation treatment with respect to obtaining, maintaining and enforcing" legal protections on American and Israeli companies' intellectual and industrial property of all kinds.[145]

France, unlike the U.S., does not have an FTA with Israel. While Israel enjoys trade concessions granted through the application of the EU-Israel Association Agreement to its territory, the territorial requirement does not include the Arab territories occupied by Israel, such as the Golan

---

139 *Israel Free Trade Agreement*, Arts. 2(2), 2(3), Annexes II, III, TRADE COMPLIANCE CENTER, http://tcc.export.gov/Trade_Agreements/All_Trade_Agreements/exp_005439.asp (last visited Nov. 15, 2012).

140 *Id.* at Annex III; *see U.S.-Israel Free Trade Agreement*, EXPORT.GOV, http://export.gov/FTA/israel/eg_main_017711.asp (last visited Nov. 15, 2012).

141 Walt Nett, *Tech Wind Researchers Partnering In Offshore-Turbine Study*, LUBBOCK AVALANCHE-JOURNAL, (Sept. 20, 2011), http://lubbockonline.com/business/2011-09-20/tech-wind-researchers-partnering-offshore-turbine-study#.

142 *Export-Import Assistance, U.S.-Based Companies Exporting To Israel*, AMERICA-ISRAEL CHAMBER OF COMMERCE/CHICAGO, http://www.americaisrael.org/scripts/exp_Index.asp (last visited Nov. 15, 2012).

143 *U.S.-Israel Free Trade Agreement, Documenting Origin, Obtaining the U.S.-Israel FTA Certificate of Origin,* EXPORT.GOV, http://http://export.gov/fta/israel/eg_main_017713.asp.

144 *Israel Free Trade Agreement*, Arts. 17, 19, TRADE COMPLIANCE CENTER, http://tcc.export.gov/Trade_Agreements/All_Trade_Agreements/exp_005439.asp (last visited Nov. 15, 2012).

145 *Id.* at Art. 14.

Heights.[146] Thus, Alstom's operations in France would appear not to benefit directly from the Association Agreement's amelioration of tariffs.[147] However, Alstom's FDI in Israel would not involve imports from Occupied Territories in the EU, but rather, exports from the EU into Occupied Territories. It is not clear whether Israel would impose tariffs on items Alstom might import into Israel bound for the Golan heights in retorsion[148] for the EU's stance that goods imported from the Occupied Territories into the EU do not get the benefit of tariff amelioration. Yet, even with that qualification, it bears noting that the Association Agreement is under fire from within and without the EU, and there is ongoing condemnation within the EU of Israeli resistance to certain EU policy imperatives for the occupied territories.[149]

Besides the government sources on treaties and energy policy, which are evidently reliable reports of legal documents and pronouncements, the sources used in this section come from a variety of industry- and company-specific sources that are not entirely objective, and often choose to put actions, trends, and challenges into the light most favorable to them. As such, those sources—and the print and online media reportage

---

[146] *See, e.g.*, Andrew Rettman, *EU Court Strikes Blow Against Israeli Settlers*, EU OBSERVER (Feb. 25, 2010), *available at* http://euobserver.com/foreign/29558. The report notes a decision by the European Court of Justice in a case concerning whether syrup for soft drinks imported into the E.U. by Brita from an Occupied Territories producer, Soda-Club, was entitled to the tariff preferences for "products of Israel" recognized in the EU-Israel Association Agreement. *Id.* The report quotes the critical holding of the European Court of Justice that Soda-Club should have obtained papers from the Palestinian Authority instead if it wanted any customs breaks. *Id.* ("Products obtained in locations which have been placed under Israeli administration since 1967 do not qualify for the preferential treatment provided for under that [EU-Israel] agreement. . . ."). Whether this ruling has persuaded Israeli's custom authorities to withdraw tariff amelioration for certain E.U. imports as a retorsionary measure, or whether such a measure has even been suggested or considered in Israel, remains indeterminate in the author's research to date.

[147] *Id.*; *see, e.g.*, Victor Kattan, *A Message for the EU: Withdrawing Preferential Trade with Israel is an Appropriate Response to Israel's Violation of International Human Rights Law*, BADIL (Summer 2005), *available at* http://www.badil.org/ariiculo-74-/item/917-a-message-for-the-eu-withdrawing-preferential-trade-with-israel-is-an-appropriate-response-to-israel%E2%80%99s-violation-of-international-human-rights-law#3.

[148] *Rétorsion,* as it was originally formulated in French diplo-speak, describes "a legal, but deliberately unfriendly act," taken by one nation in retaliation for a similar, equally unfriendly, lawful act of another nation, in hopes of "compel[ling] the offending state to change its unfriendly conduct." Christopher C. Joyner, *Coercion*, in MAX PLANCK ENCYCLOPEDIA OF PUBLIC INTERNATIONAL LAW (R Wolfrum ed., 2008).

[149] DELEGATION OF THE EUROPEAN UNION TO ISRAEL, STATEMENT BY HIGH REPRESENTATIVE CATHERINE ASHTON ON THE ISRAELI DECISION TO EXPEDITE SETTLEMENT ACTIVITY (Apr. 2, 2011), http://eeas.europa.eu/delegations/israel/press_corner/all_news/news/2011/20111102_01_en.htm (expressing EU's "dee[p] concer[n]" due to "the latest Israeli decisions to expedite settlement activities in response to Palestinian accession to UNESCO," declaring that "Israeli settlement activity is illegal under international law," and "call[ing] on Israel to reverse this decision").

based on those sources—must be viewed cautiously and tested repeatedly as additional information comes to light, particularly if the new information is inconsistent rather than corroborating.

*4. The Recommendation from the Business Environment Perspective*

Alstom's opportunity to enter into the Middle Eastern market through Energix's investment in the Golan Heights wind farm is timely both in terms of Israel's energy needs and Alstom's expansion of its world-wide wind-energy presence. Wind energy has become a real player in electrical generation throughout the world, and Israel's close trade relationship with the United States, where Alstom has established a strong presence, makes the Golan Heights project an ideal showcase market for Alstom in the region, where Israel's neighbors are also looking to wind-generation to ease electricity supply shortages. The venture is not without risk: most wind-suitable areas in Israel, offshore as well as onshore, are part of disputed territories,[150] vulnerable to terrorism,[151] and subject to the political volatility that has characterized the region since 1948; moreover, some energy experts have called for a turn to nuclear rather than hydro-or-wind generation;[152] exploitation of recently discovered offshore natural gas fields[153] may increase the supply of other, extant energy sources that might be redirected to electricity production;[154] and Israel's political tensions with most of its neighbors may cloud the impact that a showcase project should have.[155] However, Alstom has shown itself capable of rising above the static and making even the most controversial projects, like Jerusalem's light rail, work.[156] This proposed venture is far less risky; involves territory where the dispute (with Syria) has been for some time a "cold" rather than a "hot" dispute; is founded on information that is overall reliable; and involves a country with fewer energy options than most (and whose sudden natural-gas richness also comes with potentially serious political complications and vulnerabilities to sabotage and terrorism), making its commitment to wind-energy more credible and sustainable. The balance for a French multi-national like Alstom, which

---

150 ODEH, *supra* note 124, at 3-4.

151 *See, e.g.*, *Saboteurs*, *supra* note 108.

152 *See, e.g.*, Wald, *Taming*, *supra* note 120; Wald, *Worth it?*, *supra* note 120.

153 *Israel and its Natural Resources*, *supra* note 75.

154 Bronner, *supra* note 107.

155 *See* ODEH, *supra* note 124, at 32-37.

156 *See supra* authorities cited in note 82.

seeks a truly global presence, tips decisively in favor of approving a proposed joint venture with Energix.

## III. Stage Two—Critical Evaluation of Legal Issues: Not Only Those Under the Host State's Regulatory Environment, but Also Those Under the FDI Investor's Home State's Laws and the Laws of Third-States to Which the FDI Investor Has Substantial Connections

### *A. The Role of Treaties in the IBT Decision*

Webs of treaties used to be the stuff of diplomatic intrigue[157] and disastrous, trip-wire networks of alliances that led to conflagrations such as World War I.[158] Since the Bretton Woods agreement in 1946,[159] however, bilateral treaties concerning trade, along with multilateral conventions, have become the superstructure on which a complex, globalized trade system has been erected.

One of the most important developments in IBT has been its most recent phase. Since the 1960s, a "centralized global atmosphere" emerged, and concomitantly, "legal institutions are creating a true body of substantive international law to regulate many transnational business deals."[160] The United States' first bilateral trade agreement was concluded with Israel in 1985.[161] Since then, the United States has negotiated and ratified for FTAs with 16 more countries, and has negotiated and ratified BITs with over four nations.[162] Some have criticized the use of such treaties as inimical to, or at least a deterioration of, the World Trade

---

[157] *See, e.g.*, Sir Arthur Conan Doyle, *The Naval Treaty* (1889), in II The Annotated Sherlock Holmes: The Four Novels and Fifth-Six Short Stories Complete, at 167-92 (William S. Baring-Gould ed. 1967)

[158] Winston S. Churchill, 1 The World in Crisis: 1911-1918, 1-13 (1938).

[159] *See, e.g.*, Gerald M. Meier, *The Bretton Woods Agreement: Twenty-Five Years After*, 23 Stan. L. Rev. 235, 236 (1971) (noting that the entities created by the Bretton Woods Agreement—"[t]he International Monetary Fund (IMF), the International Bank for Reconstruction and Development (World Bank), and the General Agreement on Tariffs and Trade (GATT)—have been the dominant international economic organizations since World War II.").

[160] Kenneth C. Randall & John E. Norris, *supra* note 23, at 160.

[161] Overview of the Israel Free Trade Agreement, U.S. Trade Representative, http://www.ustr.gov/trade-agreements/free-trade-agreements/israel-fta

[162] Summary of U.S. Free Trade Agreements, U.S. Dep't of State, http://www.state.gov/e/eeb/tpp/bta/fta/c26474.htm; United States Bilateral Investment Treaties, U.S. Dep't of State, http://www.state.gov/e/eb/ifd/bit/117402.htm.

Organization regime. In a recent discussion of FTAs, Professor Paul Gathii observed that—

> [t]he continued breakdown of WTO negotiations—indicated by the collapse of ministerial meetings in Seattle in 1999 and in Cancún, Mexico in 2003—has led developed nations to a shift towards regional and bilateral agreements to further goals that have been delayed or frustrated at the WTO. Negotiations stalled when the ministerial conference in 1999 was cancelled due to a lack of agreement among the countries and large protest activities outside the conference building In Cancún, the negotiations collapsed again. This time, developing countries were unwilling to negotiate the "Singapore issues." The "Singapore issues" refers to four things—competition policy, trade facilitation, investment liberalization, and government procurement—which developed countries have sought to negotiate with a view to arriving at new agreements covering these four areas since 1996. In August 2004, three of the issues—investment, competition, and government procurement—were, by agreement, dropped from the Doha agenda. Negotiations for trade facilitation, however, would continue. As one commentator noted, this "ended, for the time being, the developed countries' attempt to greatly expand the WTO by introducing three new major areas of liberalization."[163]

---

[163] James Thuo Gathii, *The Neoliberal Turn in Regional Trade Agreements*, 86 WASH. L. REV. 421, 441-42 (2011) (footnotes omitted). Professor Gathii also takes note of a less sanguine subtext of the regionalization trend:

> [T]he United States and EU have found that it is much easier to negotiate with countries individually or in small groups than at the WTO. This strategy serves the interests of developed nations because they can use their market power to leverage negotiations to their advantage over much weaker economies. Bilateralism favors those with more resources since it limits the ability of weaker states to form cross-issue alliances which could increase their ability to negotiate with richer States. Similarly, WTO adjudication in the Dispute Settlement Body increases the likelihood that developing countries will gain better outcomes than in bilateral negotiations. By contrast, FTAs give powerful governments the opportunity to consolidate their vision of market governance through debt conditions, enforceable trade commitments and tied aid. An example is the Aid for Trade program, a $41.7 billion program that conditions aid to developing countries on subscription to the package of reforms imposed by big donors and lenders, including international financial institutions. Aid for Trade may further indebt developing economies and undermine rather than contribute to poverty eradication. FTAs therefore give powerful governments an opportunity to "more directly and less publicly [pressure] weaker governments to make extensive commitments."

*Id.* at 445-46 (footnotes omitted). *See also* Professor Gathii's article in which he reviews the arguments "over whether regional trade agreements are building or stumbling blocks" to developing nations, *African Regional Trade Agreements as Flexible Legal Regimes,* 35 N.C. J. INT'L L. & COM. REG. 571 (2010).

Other observers, however, see the FTAs as emblematic of "the pluralistic reality of U.S. trade policy making," which encourages other nations to "learn how to penetrate the U.S. decision-making process and to persuade enough of the machinery to advance their interests, including when those interests have been to negotiate a bilateral or free trade accord."[164] The FTA and BIT agreements, therefore, assume an outsized importance when a MNE of the dimension, diversity, and divisions boasted by an Alstom surveys its opportunities for leveraging various aspects of its operations. The presence—or absence—of meaningful FTA or BIT treaties vis-à-vis the location of relevant divisions, operations, and assets can become, as in the Alstom-Energix hypothetical FDI presented here, an important factor. Indeed, the U.S.-Israel FTA has had a significant, positive impact for MNEs that seek to do business between the two countries. As the U.S. State Department notes of that FTA, one of its effects is that "[i]n 2011, the United States was Israel's largest trading partner" exchanging "almost $37 billion in total merchandise trade."[165] While several previously signed FTAs are still pending for various reasons, the Senate ratified a major FTA with South Korea in 2011, which went into force in 2012.[166]

Yet, FTAs and BITs can also become a point of leverage by stronger economic nations over less-dominant nations. By entering into an FTA, a nation such as Israel can create increasingly optimized conditions for FDI by businesses affiliated with its trading-partner nations; but at the same time, it can unwittingly create a tool for future economic leverage by those nations in pursuit of political agendas.[167] This is especially true as the sensitivity towards the linkages between economics and human rights continue to be the subject of increasing international debate among advocacy organizations, governments, and scholars. For Israel, this has had particular significance in the political hand that the nations of the European Union have sought to play with respect to disputes over occupied territories and ethnically distinct groups within those territories. We see this manifested particularly in the context of the EU-Israel Trade Association Agreement, as well as in public communications between the

---

164 Richard E. Feinberg, *The Political Economy of United States' Free Trade Agreements*, 26 THE WORLD ECONOMY 1037-38 (2003) *available at* available at http://irps.ucsd.edu/assets/004/5362.pdf.

165 *See Benefits of Free Trade Agreements—Israel*, U.S. DEP'T OF STATE, http://www.state.gov/e/eb/tpp/bta/fta/c26474.htm (last visited Nov. 15, 2012).

166 *See id.*

167 *See* Jane Kelsey, *Confronting Trade-Related Human Rights in a GATS-Compatible World*, L. SOC. JUST. & GLOBAL DEV. 1, 3 *available at* http://www.go.warwick.ac.uk/elj/lgd/2007_1/kelsey.

EU's representative in Israel and the Government of Israel.[168]

In 2010, the European Court of Justice (ECJ) rendered a judgment in *Brita GmbH v. Hauptzollamt Hamburg-Hafen*, which put squarely in issue the status under the Trade Association Agreement of products originating in the Occupied Territories.[169] By way of background, as a recent commentator observed:

> A core principle in trade relations that generates disagreements between parties to BITs is that of "rules of origin." Determining the country of origin of a product is a critical factor in determining whether customs benefits will apply to the product. The "rules of origin" issue is one of the main features of the 1995 European Community-Israel Association Agreement (AA). In 1997, the question raised in various EU Member States was whether Israeli settlements in the Occupied Territories, namely the West Bank, Gaza Strip, East Jerusalem, and the Golan Heights, constituted part of the territory of the State of Israel—did products produced in these Israeli settlements violate the rules of origin pursuant to the AA?
>
> Several European customs authorities began to challenge Israel by demanding that it verify the origins of goods coming from the Israeli settlements. This dispute developed into a major source of friction between Israel and Europe.[170]

---

168 *See generally* Sharon Prado & Lior Zemer, *Bilateralism and the Politics of European Judicial Desire*, 17 COLUM. J. EUR. L. 263 (2011).

169 Case C-386/08, Firma Brita GmbH v. Hauptzollamt Hamburg-Hafen, 2010 ECJ EUR-Lex LEXIS 63 (Feb. 25, 2010) *available at* http://curia.europa.eu/juris/liste.jsf?language=EN&jur=C,T,F&num=386/08&td=ALL [hereinafter *Brita Case*]. For a spirited, and divided, scholarly commentary upon the case, see the various postings as Julian Ku*, ECJ Rules that West Bank Goods are NOT "Made in Israel,"* OPINIO JURIS (Feb. 27, 2010), http://opiniojuris.org/2010/02/27/ecj-rules-that-west-bank-goods-are-not-made-in-israel/. Some commentators contended that "while it is true that now the products made in the West Bank are not going to fall within the scope of the EC-Israel Agreement, they are no[t] going to be subject to import duties," because "[t]he EC-PLO Agreement will apply to these goods instead," while other commentators insist that" the EU/PLO agreement is only applicable if the PLO administration is the exporting state and issues proof of origin." *Id.*

170 Prado & Zehmer, *supra* note 168, at 266. The European Commission had repeatedly taken the position that "according to UN General Assembly and Security Council resolutions, no Israeli settlement in the West Bank, Gaza Strip, East Jerusalem, or the Golan Heights could be considered part of the territory of the State of Israel." *Id.* at 277. In response, "the Israeli interpretation of its recognized area was very different from the European position," and "[d]uring closed Israeli-EU meetings and in inter-ministerial correspondences, Israel argued that, under domestic law, East Jerusalem and the Golan Heights formed part of the territory of the country." *Id.* at 278.

In *Brita*, German drink-filter and drink-dispenser company Brita GmbH "contested the customs duties imposed on it by the German authorities for importing drink-makers for sparkling water manufactured in the West Bank for which the Israeli customs authorities issued a movement certificate attesting to the Israeli origin of those products."[171] Brita sought to import these goods from Israeli producer Soda-Club, made at the Mishor Adumin industrial park located east of Jerusalem in the West Bank territory,[172] and sought to overturn the German court decision denying the goods preferential duties treatment on the grounds, *inter alia,* that products were made in the Israeli-occupied territories.[173] In presenting the case to the Court, Advocate General Yves Bot[174] urged the ECJ to rule that "goods certified by the Israeli customs authorities as being of Israeli origin but which prove to originate in the occupied territories, more specifically the West Bank, are not entitled either to the preferential treatment under the EC-Israel Agreement or to that under the EC-PLO Agreement."[175] The ECJ's lengthy and technocratic-sounding ruling went against Brita's position (and that of Israeli customs authorities), but in a more nuanced way:

> [T]he Court (Fourth Chamber) hereby rules:
>
> 1. The customs authorities of the importing Member State may refuse to grant the preferential treatment provided for under the

---

171 "Opinion of Advocate General Bot," *Brita Case*, *supra* note 169, at ¶ 2.

172 As Prado and Zehmer explain the lay of the land:

> The manufacturing facility of Soda-Club is located in the Adumim Industrial Park in Maale Adumim, the largest Israeli settlement in the occupied Palestinian West Bank between Jerusalem and Jericho. Even though Soda-Club's systems and accessories are produced in the Palestinian Occupied Territories, Brita marked all of these products "Made in Israel" and applied for an exemption from customs duties under the AA. To that end, Brita filed customs declarations stating that the State of Israel was the country of origin of these systems and accessories. Soda-Club presented invoices declaring that the goods were all produced in Israel.

Prado & Zehmer, *supra* note 168, at 282.

173 *EU Court Keeps West Bank Out of EU-Israel Trade Deal*, EU Business (Feb. 25, 2010), *available at* http://www.eubusiness.com/news-eu/mideast-unrest.2vf .

174 As Professor Engle explains:

> The Advocate General is a post which has no real parallel in U.S. law. The Advocate General writes advisory opinions which can be analogized to an "amicus curiae" brief. The ECJ may or may not take the Advocate General's opinion into account and may or may not use in reaching its final verdict. The Advocate General's opinion has no binding authority.

Eric Allen Engle, *EU-Israel Free Trade & the Occupied Territories*, Harv. Int'l L.J. (Nov. 2009), available at http://www.harvardilj.org/2009/11/eu-israel-free-trade-the-occupied-territories/ (quoting note 2).

175 "Opinion of Advocate Genera Bot," *Brita Case*, *supra* note 169, at ¶ 8.

> Euro-Mediterranean Agreement establishing an association between the European Communities and their Member States . . . and the State of Israel . . . signed in Brussels on 20 November 1995, where the goods concerned originate in the West Bank. Furthermore, the customs authorities of the importing Member State may not make an elective determination, leaving open the questions of which of the agreements to be taken into account – namely, the Euro-Mediterranean Agreement establishing an association between the European Communities and their Member States . . . and the State of Israel [;] and the Euro-Mediterranean Interim Association Agreement on trade and cooperation between the European Community . . . and the Palestine Liberation Organisation (PLO) for the benefit of the Palestinian Authority of the West Bank and the Gaza Strip, . . . signed in Brussels on 24 February 1997 – applies in the circumstances of the case and of whether proof of origin falls to be issued by the Israeli authorities or by the Palestinian authorities.
>
> 2. [T]he customs authorities of the importing State are not bound by the proof of origin submitted or by the reply given by the customs authorities of the exporting State where that reply does not contain sufficient information . . . to enable the real origin of the products to be determined. Furthermore, the customs authorities of the importing State are not obliged to refer to the Customs Cooperation Committee . . . a dispute concerning the territorial scope of that agreement.[176]

Of course, for Alstom's situation in a Golan Heights FDI, Alstom would be exporting its equipment and services to the Golan Heights, rather than importing anything into the EU from the Golan Heights. Although the normal sovereign response to a ruling like *Brita* might be to engage in retorsion by subjecting EU imports to heightened tariffs at the border of the Golan Heights (or at another border of Israel, such as the port at Haifa), there is no indication Israel has taken that path. Nor would it make much sense for Israel to do so. No Israeli-based company is competing with Alstom, and Israel needs Alstom's technology and expertise. Moreover, tariffing the Alstom imports would serve only to drive up the cost of the wind power, and diminish the viability of a major wind farm that will serve Israeli's grid.

---

176 "Judgment of the Court," *Brita Case*, *supra* note 169, at ¶ 74.

While all of this does not directly impact the particular FDI deal under consideration in this article, it does suggest an environment of partisanship within the EU, and a strong contingent of EU nations and officials ready to use economic and diplomatic pressure to incentivize Israel to slow—indeed, cease—activities in the Occupied Territories that expand its claims to sovereignty. By increasing the pressure brought on by the *Brita* decision, the EU's High Representative for Foreign Affairs became the medium for the EU to rebuke Israel's renewed pace in settling occupied territories.[177] Alstom would not wish to become caught up in this dispute in ways that have more than public relations impact, particularly after the controversy—and litigation—attendant to its work on another Occupied Territories project, the Jerusalem Light Railway.

A final set of observations should be devoted to Israel's own efforts to weave its commerce into the tapestry of international trade. Israel has worked to create a web of BITs, although it has marched to the beat of its own drummer in doing so:

> Between 1976 and 2004, Israel signed 34 agreements, four of which have not been ratified as of yet. Most of these agreements were signed with developing countries and emerging economies, where Israel had strong, rising investment interests. The few agreements that were signed with countries in which Israel had no significant investment interest, the agreements served either specific strategic or diplomatic goals, or were part of a broader framework of international economic agreements (trade, double-taxation, etc). The vast majority of these agreements do not reflect reciprocal investment relations and they strengthen Israel's status as a state in transition from a developing to a developed economy.[178]

Noteworthy, too, is the fact that Israel "traditionally tends to avoid

---

[177] *See, e.g.*, Raffaella A. Del Sarto, *Israel, the EU and the Union for the Mediterranean*, 16 MEDITERRANEAN POL. 117 (2011); *see also Statement By EU High Representative Catherine Ashton On Settlement Expansion*, UNITED NATIONS INFORMATION SYSTEM ON THE QUESTION OF PALESTINE (UNISPAL), (June 8, 2012), *available at* http://unispal.un.org/UNISPAL.NSF/0/B018709AAC07D1D785257A1A00469086. The E.U. has now expanded its criticism of Israeli's definition of its borders to areas within the boundaries established before the 1967 and 1973 wars. *See* Ora Coren, *European Union: Parts of Modi'in do not Belong to Israel—List Released by EU says Modi'in-Maccabim-Re'ut Municipality, Situated Halfway Between Jerusalem and Tel Aviv is Part of a 1948 No-Man's Land Between Israel, West Bank*. HAARETZ, Aug. 14, 2012, http://www.haaretz.com/news/diplomacy-defense/european-union-parts-of-modi-in-do-not-belong-to-israel.premium-1.458222.

[178] Efraim Chalamish, *An Oasis in the Desert: The Emergence of Israeli Investment Treaties in the Global Economy*, 32 LOY. INT'L & COMP. L. REV. 123 (2010).

negotiating BITs with other developed countries, as part of the view that developed countries should not sign BITs among themselves," and "[s]ince Israel views itself as a developed country with a stable economy, it has made it a general rule not to sign or negotiate BITs with other developed countries, with the exceptions of France and Germany."[179] Israel's BITs with both nations, however, have been superseded by the European Union,[180] and, as discussed above, the EU Israel Trade Association Agreement, with its strictures about the Occupied Territories, has replaced it.[181]

### B. *The Role in FDI Decisions of Litigation Risk in Municipal Courts—With a Particular Emphasis on Corporate Social Responsibility*

Notions of corporate social responsibility have assumed greater roles in MNE activities, reflecting "increasing ethical demands made not of states, but of firms, which are now perceived as more capable to address a large range of complaints."[182] This is particularly true of French MNEs, such as Alstom, which came relatively late to the appreciation of *public*, as distinguished from *internal corporate*, accountability for corporate social

---

[179] *Id.* at 132 (citing Entre le Gouvernement de la Republique Française et le Gouvernment de l'Etat d'Israel sur l'encouragement et la protection reciproques des investissements [Treaty between the Government of the Republic of France and the Government of the State of Israel Concerning the Encouragement and Reciprocal Protection of Investments, *available at* http://www.unctad.org/sections/dite/iia/docs/bits/france_israel_fr.pdf).

[180] *Id.* at 152 n.120 (observing that "the European Union and Israel are currently negotiating the future status of BITs that were signed between Israel and countries that joined the EU since the ratification of that particular BIT" because "the EU has a separate trade and investment policy, bilateral investment treaties of member states with third parties can be either unnecessary or inconsistent"). The Israeli Finance Ministry lists no BIT with France, although it does continue to list a BIT with Germany. *See Ministry of Finance—International Agreements—Bilateral Investment Treaties (BIT)*, http://www.financeisrael.mof.gov.il/FinanceIsrael/Pages/En/EconomicData/InternationalAgreements.aspx; *accord* Government of Israel—Economic Mission, http://www.israeleconomicmission.com/index.php?option=com_content&task=view&id=76&Itemid=52. The International Centre for the Settlement of Investment Disputes (ICSID) database of BITs, however, continues to list the French-Israeli BITs as one of 103 BIT treaty entries for France, and one of 36 BIT treaty entries for Israel. *See ICSID Database of Bilateral Investment Treaties*, https://icsid.worldbank.org/ICSID/FrontServlet.

[181] *See supra* notes 168-170.

[182] Ariel Colonomos & Javier Santiso, *Vive La France! French Multinationals And Human Rights*, 27 HUM. RTS. Q. 1307, 1308, 1328 (2005) (noting evolution of corporate social responsibility perspectives from narrow focus on "staff-industrial relations within French corporations" to "environmental issues," relationships "between businesses and their external parties, cities, the social fabric surrounding them, and their fellow citizens" and "[f]inally, and as the last stage in this expansion . . . a number of French firms are now asked to account for their activities abroad from a human rights perspective.").

responsibility.[183] As a result, French MNEs are "the leaders in a great many African and Middle Eastern countries, some of which have very poor human rights records."[184] Thus, French MNEs, such as Alstom, "are confronted with a double threat": they are "increasingly exposed to NGO criticism" for their activities (including those through subsidiaries) in developing countries, and at the same time, "elements of US society—the courts or the media—will react negatively on the basis of those reports."[185]

Litigation is a tool of strategic business management, and it can also be employed as a tool by which private parties or organizations use the municipal courts of various countries to control the activities of MNEs, including to hobble—or even stop—particular FDI projects. This has certainly proven to be the case with FDIs in the Occupied Territories of Israel.[186] Such litigation has often been viewed as a peculiarly American phenomenon; but other nations and their court systems are now among the fora hosting such disputes.

In the following subsections, litigation in municipal courts of France; Quebec Province, Canada; and the United States, arising from MNE activity, including FDIs, in other nations, is examined, and the impact of such lawsuits on Alstom's hypothesized FDI in the Golan Heights is assessed.

### 1. *Alstom's Vulnerability to Suits at Home Over its FDI in Israel: Not an American in Paris, but a Nanterrean in Nanterre*

A relevant, yet less obvious, set of risks attendant to FDIs arise from lawsuits brought in the *home* state(s) of an MNE. For an MNE that has the global span of an Alstom, this translates into legal entanglements in countries other than the host state. These entanglements portend both

---

[183] *Id.* at 1311, 1322 (noting that "with Anglo-American funds ever more present in their capital structure, French firms became singularly receptive over the course of the 1990s to developments in North America, adopting and adapting to the emerging normative standards").

[184] *Id.* at 1332. The authors observe that French attitudes holding that "human rights should not be taken into account in the framing of foreign policy" and FDIs because that "would create an obstacle to the decision making process." *Id.* at 1343-44.

[185] *Id.* at 1338-40.

[186] *See, e.g.*, Yishai Blank, *Legalizing the Barrier: The Legality and Materiality of the Israel/Palestine Separation Barrier*, 46 TEX. INT'L L.J. 309, 311 (2011) (analyzing the "legal campaign against" the wall erected in the Occupied Territories, including "(1) the legal norms in which the litigators and the courts operated; (2) the theoretical approaches—often of extra-legal disciplines—regarding the harm that the barrier caused (or might cause); and (3) the strategic and tactical choices taken by the various NGOs which spearheaded the campaign, often a result of compromises among disagreeing parties").

protractedness and costliness. The costs include not only the potential litigation, but also the difficulties that such lawsuits create for the MNE with investors and the public at-large, not to mention politicians in the home states who may seek to use the stage created by litigation against the MNE to pursue legislative or regulatory investigations.

Alstom's exposure to such suits is very much worth considering, particularly in light of a case brought in France against Alstom concerning the Jerusalem Light Rail Project.[187] Two NGOs, the Association France Palestine Solidarité (AFPS) and the Palestinian Liberation Organization (PLO), sued Alstom and Veolia Transport, another contractor working on the Jerusalem Light Rail Project, in the French Courts, contending that these MNEs were collaborating in the violation of international law through their work on building a tramway through the occupied territories in Israel.[188] The papers initiating the legal action in the French Court of Grand Instance at Nanterre sought a court order "to cancel the Israeli contract given to Alstom, which will provide the train carriages, and to Veolia Transport, the public transport operator."[189] Significantly, the complaint survived the usual procedural defenses. The French appeals court affirmed an interlocutory decision of the Nanterre court that the courts of France had subject matter jurisdiction over the claims asserting violation of international law, as well as over the claims asserted under

---

[187] *See* Harriet Sherwood, *Jerusalem's Long-Awaited Light Railway Splits Opinion*, GUARDIAN, August 17, 2011, http://www.guardian.co.uk/world/2011/aug/17/jerusalem-light-railway-opinion?INTCMP=SRCH (noting that the railway opened in 2011).

[188] Wolfgang Kaleck, *From Pinochet to Rumsfeld: Universal Jurisdiction in Europe 1998-2008*, 30 MICH. J. INT'L L. 927, 971-72 (2009); *see also* Aurine Crémieu, Rubrique, *"En Mouvement" Israel et Territoires Occupes*, CHRONIQUE, (Mar. 1, 2006), *available at* http://www.amnesty.fr/index.php/amnesty/s_informer/la_chronique/mars_2006_sommaire/israel_et_territoires_occup. Kaleck refers to the suit in France against Alstom in the following context that will be useful to framing our discussion of Alstom's vulnerability to suit in both France and the U.S. on any project – light rail or wind turbine farms – that it undertakes in the Occupied Territories. Kaleck refers to the suit in France against Alstom in the following context that will be useful to framing our discussion of Alstom's vulnerability to suit in both France and the U.S. on any project – light rail or wind turbine farms – that it undertakes in the Occupied Territories:

> As stated earlier, the U.S. ATCA is a unique phenomenon. No European jurisdiction offers a civil remedy that is specifically designed to compensate victims of human rights violations committed abroad. Universal jurisdiction has not been codified in European civil law—that is, outside of the criminal context—and it can be said that European civil legislation is not yet designed to handle cases of transnational human rights crimes.
>
> Nevertheless, some countries have successfully provided other civil remedies for human rights violations, including the United Kingdom, the Netherlands, France, and Germany.

*Id.* at 971-72 & n.307 (internal citations omitted).

[189] Rory McCarthy & Angelique Chrisafis *PLO Disputes Jerusalem Rail Plan*, GUARDIAN, Oct. 23, 2007, http://www.guardian.co.uk/world/2007/oct/26/france.israel?INTCMP=SRCH.

France's Civil Code.[190] That in and of itself is quite an important ruing, for it opens the French courts to future cases filed against Alstom and other MNEs alleging violations (or complicity in violating) international legal norms.

The litigation before the Nanterre court consumed four years, according to the Paris-based law firm, August & Debouzy Avocats, before it was resolved in the MNEs' favor:[191]

> [T]he Nanterre Civil Court (Tribunal de Grande Instance) has just ruled that the French companies Veolia Transport, Alstom and Alstom Transport's membership of an Israeli consortium in charge of building and operating the Jerusalem light rail system did not constitute a violation of public international law.
>
> In February 2007, the French association France Palestine Solidarité (AFPS), joined several weeks later by the Palestine Liberation Organisation (PLO), sued the French companies before the Nanterre Civil Court requesting that they be prohibited from participating in the consortium and arguing that the light rail project violated various rules of public international law regarding, inter alia, the status of the areas beyond the East Jerusalem "Green Line" as "occupied territories."
>
> The discussions pertained to the application of the rules of public international law as well as to the route of the light rail system, the conditions of its construction along pre-existing roadways and how it was perceived by local populations. In its judgment, the Nanterre Civil Court first excluded the application of the rules of public international law invoked by the PLO and AFPS to private companies. However, the Civil Court also confirmed that neither the signature of the concession agreement by these companies and their subsidiaries, nor the route and operating conditions of the light rail system, constituted a fault under Article 1382 of the French Civil Code, as claimed by AFPS and PLO. Finally, the Court dismissed the voluntary joinder of the PLO in this case.

---

190 *August & Debouzy Advise Veolia Transport on the Lawsuit Between Veolia, Alstom and the Palestine Liberation Organisation*, AUGUST & DEBOUZY AVOCATS, http://www.august-debouzy.com/en/495/august-debouzy-advise-veolia-transport-lawsuit-between-veolia-alstom-and-palestine-liberation-or (last visited Nov. 15, 2012).

191 *Overview*, AUGUST & DEBOUZY AVOCATS, http://www.august-debouzy.com/en/about-us.html (last visited Nov. 15, 2012).

> AFPS and the PLO have lodged an appeal against this judgment.[192]

Another activist organization calls Alstom's FDI in Jerusalem "[b]uilding the infrastructure of the occupation," and contends that Alstom "is actively supporting Israel's colonial ambitions in Jerusalem," is complicit in "violations of international law and alleged war crimes," is "profiting directly from Israel's occupation," and is "help[ing] to cement Israel's hold on occupied East Jerusalem and tie the surrounding settlements even more firmly into the State of Israel."[193] Activists against Alstom also recently claimed that the publicity and debate generated by their opposition were the cause of a failed Alstom bid "to build the build a high-speed railway on the Muslim pilgrim[age] route between Mecca and Medina in Saudi Arabia," a project claimed to be worth $10 billion.[194]

### 2. *Alstom's Vulnerability in Francophone Courts over FDI in Israel*

France has not been the only nation to see litigation under its municipal laws over an FDI in Israel. The Courts of Québec Province in Canada, for example, have been the forum for at least one lawsuit filed over an FDI in Israel, *Bil'In (Village Council) & Yassin v. Green Park International Inc.*[195] In *Bil'In*, the municipal authority over the Palestinian village of Bil'in, and a group of residents, sued two Québec corporations for their involvement in building housing for Israelis in the West Bank.[196] The plaintiffs' filings in the suit included what the Québec Superior Court described as the essence of their legally complex and contentious case:

---

192 *August & Debouzy*, *supra* note 190.

193 *Briefing: Veolia: Building the Infrastructure of the Occupation*, PALESTINIAN GRASSROOTS ANTI-APARTHEID WALL CAMPAIGN, http://www.stopthewall.org/downloads/pdf/Veolia_briefing_final.pdf; *Briefing: Alstom: Building the Infrastructure of the Occupation*, PALESTINIAN GRASSROOTS ANTI-APARTHEID WALL CAMPAIGN, http://stopthewall.org/alstom-building-infrastructure-occupation

194 *BDS Claims Victory After Alstom Project Derails*, MA'AN NEWS AGENCY, Oct. 27, 2011, http://www.maannews.net/eng/viewdetails.aspx?id=433036. The activists also claim that "Alstom suffered blows when a Swedish pension fund excluded it from its investment portfolio, as did the Dutch ASN Bank, due to involvement in Israel's occupation of Palestinian land." *Id.*

195 Bil'In Village Council v. Green Park Int'l, 2009 CanLII 4151 (Can. Q. S.C.) *available at* http://www.canlii.org/en/qc/qccs/doc/2009/2009qccs4151/2009qccs4151.html#_ftn59 [hereinafter *Bil'In*]

196 Stephen Pitel, *Quebec Court Stays Palestinian Claim Against West Bank Builders*, CONFLICTOFLAWS.NET, (Sept. 27, 2009), http://conflictoflaws.net/2009/quebec-court-stays-palestinian-claim-against-west-bank-builders/.

[5] The Plaintiffs' civil action is largely summarized in the following paragraph of the motion introducing their action:

> 24. The Village pleads that the corporate Defendants, on their own behalf and as agents of the State of Israel, are constructing residential and other buildings and are creating a new dense settlement neighbourhood on the lands of the Village and are marketing and selling therein condominium units and other built up areas to the civilian population of the occupying power, the State of Israel, for the purpose of transferring the civilian population of Israel to the village's land and removing the population of the Village from their land. In so doing, the corporate Defendants are aiding, abetting, assisting and conspiring with the State of Israel in carrying out an illegal purpose. The Defendant, LaRoche, is deemed legally to be liable for the conduct of the corporate Defendants in her capacity as their sole registered director and officer. The Defendants, and each of them, are therefore in violation of the aforesaid Article 49(6) of the Fourth Geneva Convention dated August 12, 1949, Section 3(1), Schedule V Protocol 1, Part 1, Article 1 (1) and Schedule V Protocol 1, Part V, Section 11, Article 85 (4)(a) of the Geneva Conventions Act, R.S. 1985, c. G-3 , Articles 8(2)(b(viii) and 25 (c) of the Rome Statute of the International Criminal Court dated July 17, 1998, Section 6(1)(c), 6(3) and 6 (4) of the Canadian Crimes against Humanity and War Crimes Act S.C. 2000, c. 24, Sections 6 and 8 of the Charter of Human Rights and Freedoms, R.S.Q., c. C-12 and Article 1457 of the Civil Code of Québec.

[6] More succinctly, the Plaintiffs allege that by transferring part of its civilian population to territory it occupies in the West Bank, Israel is violating international law as well as Canadian and Québec laws and that by constructing and selling condominiums exclusively to Israeli civilians, the Defendants are assisting Israel in the perpetration of war crimes.

[7] On those bases, the Plaintiffs seek declarations that the Defendants are in violation of the legal provisions mentioned above. They also seek punitive damages, the immediate cessation of the Defendants' activities, the demolition of the buildings in dispute and a complete accounting.

> [8] The Plaintiffs ask that their action be decided according to Canadian and Québec laws, rather than the laws where the injurious acts and injuries allegedly occurred, arguing that the courts of Israel will refuse to find that Israel is in violation of the international instruments on which they rely.[197]

The suit raised a plethora of issues, including the recognition of a foreign judgment (in litigation that had transpired among the parties in Israel); whether such a foreign judgment would be afforded res judicata effect: and if so, the extent to which the Canadian court would accord claim preclusive effect to the foreign judgment.[198] Ultimately, the court gave limited res judicata effect to the prior Israeli judgments; but the crux of the court's opinion was to find that the case belonged, in the court's view, in Israel, and thus the court effected a forum non conveniens dismissal.[199]

While these Québec corporations managed to avoid even more protracted litigation in Canada, there are elements of the *Bil'In* opinion that could be cause for concern to an MNE like Alstom, i.e., an MNE with significant investments in Israel. The Québec court—like the courts in France—was willing to give more than short shrift to the notion that Israel's obligations under customary international law and international conventions might well be enforceable against a corporation found to be "assisting" Israel in alleged international law violations. The court speculated about this potential in discussing the effect of the broad concept of a "delict"—literally, a "fault", or what common-law lawyers commonly a call "tort"— under the Québec Civil Code, after concluding that although Israeli law normally would apply under the lexi loci delicti choice of law principle, the content of Israeli's law had not been pleaded or proven, and therefore the court was free to apply the Québec Civl

---

197 *Bil'In*, *supra* note 195, ¶¶ 5-8.

198 *Id.* at ¶¶ 18-19.

199 *Id.* at ¶¶ 207-335. In the United States, there has been considerable debate over whether forum non conveniens provides a proper procedural disposition of similar cases brought under the Alien Tort Statute. *See* Section III.C.3, *infra*. *Compare* Aric K. Short, *Is the Alien Tort Statute Sacrosanct—Retaining Forum Non Conveniens in Human Rights Litigation*, 33 N. Y. U. J. INT'L L. & POL. 1001 (2001) (pro-forum non conveniens) *with* Erin Foley Smith, *Right to Remedies and the Inconvenience of* Forum Non Conveniens: *Opening U.S. Courts to Victims of Corporate Human Rights Abuses*, 44 COLUM. J.L. & SOC. PROBS. 145 (2010); Kathy Lee Boyd, *Inconvenience of Victims: Abolishing Forum Non Conveniens in U.S. Human Rights Litigation* , 39 VA. J. INT'L L. 41 (1998); *and* P.J. Kee, Comment, *Expanding the Duties of the Vigilant Doorkeeper: ATS Litigation and the Inapplicability of the Act of State Doctrine and Forum Non Conveniens*, 83 TUL. L. REV. 495 (2008) (against application forum non conveniens).

Code. The Civil Code provision at issue imposes a very broad, and (from an MNE's perspective) ill-defined, duty on all persons:

> ***1457.*** Every person has a duty to abide by the rules of conduct which lie upon him, according to the circumstances, usage or law, so as not to cause injury to another.
>
> Where he is endowed with reason and fails in this duty, he is responsible for any injury he causes to another person by such fault and is liable to reparation for the injury, whether it be bodily, moral or material in nature.
>
> He is also liable, in certain cases, to reparation for injury caused to another by the act or fault of another person or by the act of things in his custody.[200]

---

[200] Civil Code of Québec, L.R.Q. 2012 c. C-1991, § 1457. § 1457 is part of the civil-law code style of statute, relatively unfamiliar to most American lawyers outside of Louisiana or Puerto Rico; it is contained, like a nesting doll, within Civil Code "CHAPTER III—CIVIL LIABILITY, SECTION I—CONDITIONS OF LIABILITY, § 1.— General provisions." *Id.* The usages that have grown up around that statute in civil-law Québec are different than the understanding might be in a common-law province:

> [33] As we noted above, the general rules of civil liability set out in art. 1457 C.C.Q. are based on fault. [translation] "This is a universal concept, since it applies every time a victim alleges that a person who caused injury is liable under the general rules" of art. 1457 C.C.Q. "To answer this question, the standards provided for in statutes and regulations, often called 'legislative' standards", [sic] must be analysed [sic] in light of the basic concept of civil fault.
>
> [34] In Québec civil law, the violation of a legislative standard does not in itself constitute civil fault. For that, an offence provided for in legislation must also constitute a violation of the standard of conduct of a reasonable person under the general rules of civil liability set out in art. 1457 C.C.Q. The standard of civil fault corresponds to an obligation of means. Consequently, what must be determined is whether there was negligence or carelessness having regard to the specific circumstances of each disputed act or each instance of disputed conduct. This rule applies to the assessment of the nature and consequences of a violation of a legislative standard.
>
> [35] The French position is different. In French law, the violation of a legislative standard in itself constitutes civil fault. This means that it is not necessary [translation] "to find negligence, imprudence, carelessness or something deficient in the conduct of the person who caused the injury." Thus, where a legislative standard is violated, the general rules of civil liability transform the standard into an obligation of result, since the victim can [translation] "establish fault by proving a simple material fact without having to show that the conduct of the person who caused the injury was also morally or socially blameworthy."
>
> [36] In Québec, art. 1457 C.C.Q. imposes a general duty to abide by the rules of conduct that lie upon a person having regard to the law, usage or circumstances. As a result, the content of a legislative standard may influence the assessment of the duty of prudence and diligence that applies in a given context. In a civil liability action, it will be up to the judge to determine the applicable standard of conduct—the content of which may be reflected in the relevant legislative standards—having regard to the law, usage and circumstances.

From that starting point, future litigants challenging an FDI in Israel might seek to link together the following portions of the Québec court's opinion, starting with its views on at least one of the international treaty obligations allegedly violated with the Québec corporations' help:

> (i) Fourth Geneva Convention
>
> [148] ***
>
> In 1949, four new Geneva Conventions were adopted [Reference omitted.] . . . Convention IV is new, since it is the first one dealing exclusively with the protection of civilians in times of war. Indeed, until 1949, IHL [International Humanitarian Law] was mainly concerned with the protection of combatants. However, the Convention supplements some Hague Regulations on land warfare relating to civilians. The Convention focuses on the treatment of civilians who are under the jurisdiction of the enemy, either in its territory or in occupied territory. To a lesser extent, it also seeks to protect civilians from attacks and other effects of war.
>
> [149] In Article 1, the High Contracting parties undertake to respect and ensure respect for the Convention "in all circumstances."
>
> [150] Article 49(6) provides that "The Occupying Power shall not ( . . . ) transfer parts of its own civilian population into the territory it occupies."
>
> [151] The Plaintiffs allege that Israel has ratified the Fourth Geneva Convention.
>
> [152] They further allege, and this is of vital importance, that the Fourth Geneva Convention is considered "customary international law binding all countries"] If so, the Fourth Geneva Convention is part of the domestic (or "municipal") law of Israel.[201]

The litigants could next turn to the Québec court's ruminations

---

*Bil'In*, *supra* note 195 at ¶ 172 (quoting St. Lawrence Cement Inc. v. Barrette, 2008 SCC 64) (internal citations omitted).

[201] *Bil'In*, *supra* note 195, at ¶¶ 148-52.

about whether allegations of corporate assistance to Israel could be an actionable "delict" or "fault" against the corporations themselves:

> [188] . . . Defendants would be under the general obligation not to prejudice the Plaintiffs by favouring even indirectly a breach by Israel of its undertakings as a High Contracting Party pursuant to the Fourth Geneva Convention. Knowingly participating in such breach would constitute a civil fault, as would an intentional participation to a war crime.
>
> [189] Allegations of this nature are made against the Corporations and Defendant Laroche.
>
> [190] *The Defendants' contention that the rights created by the Fourth Geneva Convention inure to the exclusive benefit of signatory states and that only states and their agents are subject to its obligations are therefore not decisive:* ***if the Plaintiffs' allegations are true, a trial judge could find that the Corporations are at fault for knowingly participating in Israel's alleged illegal Policy***.[202]

To complete the argument, the litigants would then likely cite the Québec court's conclusions from the premises set forth above:

> **(c) Conclusions whether the Action is unfounded in law even if the facts alleged are true**
>
> [204] To summarize, the Superior Court has jurisdiction over defendants domiciled in Québec regarding a civil action based on extracontractual liability for an injury caused and suffered in a foreign country. The law that normally applies in such case is the law of the country where the injurious act occurred, i.e. where the injury was caused. That law must be proven. In the absence of proof, by default, the Superior Court will apply the substantive law of Québec.
>
> [205] Under Québec law, a defendant will incur civil liability if he causes damages to another by his fault. Knowingly favouring a breach of a High Contracting Party's undertakings pursuant to an international instrument or knowingly assisting a state in the perpetration of a war crime are both civil faults. Assuming for

---

[202] *Id.* at ¶¶ 188-90 (emphasis supplied).

> purposes of discussion that the Defendants knowingly assisted Israel for the purpose of committing a war crime as alleged, the Defendants committed a civil fault and are liable to appropriate civil remedies. This is consistent with a restrictive interpretation of state immunity that limits its benefit to sovereign entities and their agents.
>
> [206] Given the grave consequences of dismissing an action without a hearing on the merits, as a rule, an action ought not be dismissed summarily on a motion based on art. 165(4) C.C.P. unless such action is obviously not founded.[76] In the case at bar, a generous reading of the Action, considered as a whole, does not lead to the inescapable conclusion that it is unfounded in law even if the facts alleged are true.[203]

The Québec court left the plaintiffs to seek their judicial remedy in the courts of Israel, rather than in the courts of Québec: "this is one of those exceptional situations where the Superior Court is compelled to decline jurisdiction on the basis of *forum non conveniens*, as the Plaintiffs have selected a forum having little connection with the Action in order to inappropriately gain a juridical advantage over the Defendants and where the relevant connecting factors, considered as a whole, clearly point to the [Israeli High Court of Justice] as the logical forum and the authority in a better position to decide."[204] Yet, the Québec court also wrote quite a bit

---

203 *Id.* at ¶¶ 204-06.

204 *Id.* at ¶ 335. Of course, as Professor Reichman, of the Haifa University Law Faculty, has observed of the pressures that such matters bring on courts in Israel:

> [T]he Israeli example suggests that two factors may be worth considering in assessing the [Israeli Supreme] Court's response to pressure generated by an emergency situation. The first is the duration of the conflict and its acuteness. The second is the structure of the communication between the municipal court and the international and transnational legal community.
>
> Regarding the first factor, to the extent that the Court is faced with a prolonged armed conflict that entails control over civilian population lacking recourse to meaningful alternative judicial venues, the Court faces not only pressure to accommodate the military, but also a countervailing pressure to provide the civilian population under occupation access to legal process. Under such circumstances it has become increasingly difficult for the Court to maintain threshold barriers (such as justiciablity or a deferential attitude towards the discretion of the security establishment), when such doctrinal hurdles were already relaxed in other areas of the law applicable in Israel. The longer the armed conflict lasts, the more routine it becomes and the more difficult it is for the Court to treat it with a set of legal tools designed to distance the Court from contentious cases. As the discussion in this Article reveals, the Israeli Court has, slowly but surely, established itself over the occupied territories as a court with powers and doctrines similar to those it holds with respect to Israel's sovereign territory, and thus was able to accord some protection to the rights of the Palestinians living under a regime of belligerent

that might become a roadmap for future litigation over challenges to FDI in Israel. While tucked away in this trial court opinion, and influenced in part by some of the idiosyncrasies of the parties' pleadings, arguments, and litigation choices, the logic laid down by the Quebec court in this dictum could have sweeping consequences should a plaintiff or group of plaintiffs with standing seek to sue an MNE, such as Alstom, in the courts of Canada, alleging that the MNE violated international law through its contractual activities with the Government of Israel.[205]

---

> occupation. This dynamic, in turn, carried with it an institutional price the Court had to pay. In Israel, the institutional capital of the Court, measured by its diffuse public confidence, has suffered in part because of the heightened friction with the security establishment.
>
> It is because of this tension between two opposing views regarding the concept of judicial independence that the Israeli example is interesting. When the issue is the application of international norms amidst an armed conflict, there is no easy solution to this tension. The Court has realized—at least since the 1990s—that the transnational community is a necessary check on its discretion when adjudicating cases pertaining to the military commander's use of his occupying power under international law. By providing reasons addressed at the international community of jurists, the Court can be seen as seeking to alleviate some of the concerns that might otherwise be associated with its judgments (e.g. judgments reflecting the perspective of only one side of the conflict). Courts fully removed from the case may notice whether the decision of the Israeli Court is overly tilted to the Israeli side, and thus serve as a useful audience.
>
> At the same time, the Court harnessed the presence of the international audience in order to address its domestic audience. It has insisted that in a globalized world, ignoring the international community may lead to greater interventions and loss of independence. In so doing, the dependence of the Court on the presence of the international community—but not on its actual intervention—serves as a buffer between the Court and the pressure generated by the security establishment. But, dependence on the international community does not sacrifice the position of the Court as an independent municipal court worthy of the confidence of the citizens of the forum state. Perhaps, following the debate regarding international tribunals, this position can be termed as "bounded nondependence" or "restricted independence." Time will tell to what extent the Israeli Supreme Court will be able to continue walking on this tightrope and whether the emergence of hierarchical international courts, such as the ICJ, will disrupt this balance.

Amnon Reichman, *Judicial Independence in Times of War: Prolonged Armed Conflict and Judicial Review of Military Actions in Israel*, 2011 UTAH L. REV. 63, 94-95. *See also Bil'In*, *supra* note 195, at ¶¶ 251-65 (discussing viability of the plaintiffs' claims in the Israeli HCJ).

205 While to some observers it may seem like Quixotic tilting at windmills, there is a very serious and coordinated effort afoot in international human rights advocacy circles to use the courts of any Western country as venues for putting on trial—even only if for the publicity it generates—MNEs who are alleged to aid and abet governments in violating, or themselves with government support are alleged to violate directly, a wide range of rights characterized under the human-rights rubric. *See generally* François Larocque, *Recent Developments in Transnational Human Rights Litigation: A Postscript to Torture as Tort*, 46 OSGOODE HALL L.J. 605, 654 (2008) ("The developments in transnational human rights litigation since 2001 are wide-ranging and far-reaching."); François Larocque & Mark C. Power, TORTURE AS TORT: COMPARATIVE PERSPECTIVES ON THE DEVELOPMENT OF TRANSNATIONAL HUMAN RIGHTS LITIGATION ( CRAIG SCOTT, ED.) 41 Osgoode Hall L.J. 147 (2003) (book review); Craig Forcese, *ATCA's Achilles Heel: Corporate Complicity, International Law and the Alien Tort Claims Act*,

### 3. A Frenchman in New York, not an American in Paris: Alstom's Vulnerability to International Civil Litigation in American Courts

#### a. International Litigation in U.S. Courts

Alstom is also vulnerable to international civil litigation in U.S. courts, which have been the forum for a number of suits arising out of Arab-Israeli conflict.[206] There's nothing like getting sued in an American court. Most often, such suits end up in the U.S. federal courts, either because the cause of action arises under federal law, or because the cause of action falls within the alienage jurisdiction that Article III of the U.S. Constitution empowers the federal courts to exercise and which Congress actuated in 28 U.S.C. § 1332(d); and a MNE with non-U.S. citizenship may use the Removal Statute to displace such cases filed against them even when they have been filed originally in courts of a state, commonwealth,

---

26 YALE J. INT'L L. 487, 515 (2001) (speaking of the search for "a means for plaintiffs to seek compensation from companies practicing an unabashed form of militarized commerce in joint ventures with human rights abusing regimes"). It is worth noting that the Canadian Parliament recently enacted a law (appellated the "Justice for Victims of Terrorism Act") that purports to give Canadian courts an enhanced subject matter jurisdiction that "brings Canada into the very small group of states in which it is possible to use domestic courts to seek redress for violations of international law"—but "the Act is limited to responsibility for acts of terrorism, and does not cover other violations of international law such as torture and war crimes, despite some earlier calls for a wider ambit." René Provost, *Canada's Alien Tort Statute*, EILJ: TALK! (March 29, 2012), http://www.ejiltalk.org/canadas-alien-tort-statute/. While it is obvious that this kind of law would not reach cases pleaded under the facts of *Bil'In* or, as discussed in Section III.B.3.c, *infra, Corrie v. Caterpillar*, it is not clear whether this law may be a first step in a widening assertion of subject matter jurisdiction by the Canadian Parliament, or even the Canadian federal courts, over alleged violations of a wider range of human rights under the protection of international law. See *id.*, wherein Professor Provost writes that "[i]t is noteworthy that the Act is limited to responsibility for acts of terrorism, and does not cover other violations of international law such as torture and war crimes, despite some earlier calls for a wider ambit." For a dual English-French official text of the Act, see Parliament of Canada, Bill C-110, 60-61 ELIZABETH II http://parl.gc.ca/HousePublications/Publication.aspx?Language=E&Mode=1&DocId=5465759&File=29#1. The Preamble states:

> And whereas Parliament considers that it is in the public interest to enable plaintiffs to bring lawsuits against terrorists and their supporters, which will have the effect of impairing the functioning of terrorist groups in order to deter and prevent acts of terrorism against Canada and Canadians . . . Now, therefore, Her Majesty, by and with the advice and consent of the Senate and House of Commons of Canada, enacts as follows —

*See also* Joanna Harrington, *If Not Torture, Then How About Terrorism – Canada Amends Its State Immunity Act*, EILJ: TALK! (March 28, 2012), at http://www.ejiltalk.org/if-not-torture-then-how-about-terrorism-canada-amends-its-state-immunity-act/

[206] *See generally* Adam N. Schupack, *The Arab-Israeli Conflict and Civil Litigation Against Terrorism*, 60 DUKE L.J. 247 (2010).

or territory of the United States.[207]

### b. *A Slice of Alstom's Prior Experience in U.S. Courts:* In re *Alstom Securities Litigation*

Nearly a decade ago, Alstom got a strong lesson of what "Litigation-American Style" can be like in a class-action securities fraud case filed against Alstom in the U.S. federal courts. The mere "whiff of grapeshot" in America's courts—the filing of the action—sent shudders through Alstom, which was financially quite a bit more vulnerable a decade ago than today. As *The Guardian* reported the litigation effect:

> Debt-stricken French engineering group Alstom received a sharp reminder yesterday that its fight for survival is just beginning when it emerged that the manufacturer of London Underground trains is facing a class action lawsuit in the United States.
>
> The news - which came one day after a controversial €3.2bn (£2.2bn) rescue plan for Alstom was agreed - appeared to unsettle investors, who began to fret about the company's long term viability, sending its shares plunging 14% on the Paris stock exchange at one stage.[208]

Alstom battled this case in the U.S. federal courts for seven years; and but for the grace of an intervening U.S. Supreme Court decision in *Morrison* narrowing the extraterritorial reach of the federal securities laws,[209] Alstom would still be embroiled in a very large litigation,[210] which the District Judge whittled down after refusing to certify a class of "trans-national" plaintiffs in 2008,[211] and in dismissing claims based on

---

[207] *See generally* BORN & RUTLEDGE, *supra* note 13. This is the text that the author uses to teach International Civil Litigation, the companion to the author's IBT course.

[208] Andrew Osborne, *Alstom Investors Flee on News of U.S. Lawsuit*, GUARDIAN. Sept. 23, 2003, http://www.guardian.co.uk/business/2003/sep/24/france.internationalnews

[209] Morrison v. Nat'l Austl. Bank, 130 S. Ct. 2869, 2873 (2010).

[210] Kelly Morris White, Note, *Is Extraterritorial Jurisdiction Still Alive? Determining the Scope of U.S. Extraterritorial Jurisdiction in Securities Cases in the Aftermath of* Morrison v. National Australia Bank, 37 N.C. J. INT'L L. & COM. REG. 1187, 1232-33 (2012); *see also* Merritt B. Fox, *Securities Class Actions Against Foreign Issuers*, 64 STAN. L. REV. 1173, 1220 & n.125 (2012).

[211] *See* Gary W. Johnson, Note, *Rule 23 and the Exclusion of Foreign Citizens as Class Members in U.S. Class Actions*, 52 VA. J. INT'L L. 963 (2012). As the Note's author aptly describes this waystation in Alstom's sojourn through the U.S. federal courts:

> In *In re Alstom S.A. Securities Litigation*, the plaintiffs sought to certify a class of U.S., Canadian,

foreign-exchange sales of Alstom shares in 2010 on the authority of *Morrison*.[212] That serendipitious and signal corporate victory does not

---

> French, English, and Dutch citizens, entities who purchased stock in Alstom, a French multinational conglomerate, and certain subsidiaries, including a U.S. subsidiary. The Alstom court noted, "Courts may properly consider res judicata concerns when evaluating the Superiority Requirement with respect to a proposed class that includes foreign class members." The defendants argued that "a United States class action is not a superior method for adjudicating Plaintiffs' claims because a resulting judgment would not be given preclusive effect by courts in France, England, the Netherlands, and Canada." The court held that the plaintiffs failed to prove that "French courts would more likely than not recognize and give preclusive effect to any judgment rendered" and refused to certify a class consisting of French citizens. This conclusion was only after the Alstom court extensively considered French law.

*Id.* at 972-73 (footnotes omitted) (citing *In re* Alstom S.A. Securities Litigation, 253 F.R.D. 266, 281-82 (S.D.N.Y. 2008)). Although the court did "find that plaintiffs sufficiently demonstrated that English, Dutch, and Canadian courts 'would more likely than not recognize and give preclusive effect to any judgment rendered' by it with respect to some of the defendants named in the class action," *id.* at 973 n.56, Alstom nonetheless persuaded the District Judge "to modif[y]" the proposed class "to delete the inclusion of French persons or entities as to all Defendants, English persons or entities as to Alstom, and Dutch persons or entities as to Alstom." *In re* Alstom S.A. Securities Litigation, 253 F.R.D. at 272.

[212] *In re* Alstom, S.A. Securities Litigation, 741 F. Supp. 2d 469 (S.D.N.Y. 2010). As Judge Victor Marrero stated in his eloquent introduction to the opinion:

> On what can literally be called the eve of summary judgment, the parties present to the Court two issues more commonly addressed much earlier in litigation on a Fed.R.Civ.P. 12(b)(6) ("Rule 12(b)(6)") motion to dismiss. The first issue, raised by defendants, is whether the securities fraud claims of the putative class in this case, including purchasers of securities on a French stock exchange, remain viable after the United States Supreme Court's decision in Morrison
>
> . . . .
>
> The first complaint was filed in this case more than seven years ago on August 29, 2003 . . . . The next round of dispositive motions in this case, following the completion of several years of discovery, principally in France, are currently scheduled to be submitted in two months [i.e., November 2010].

*Id.* at 470-71. The listing of counsel is prodigious, and the bills likely mirror that, *see id.*; and the litany of previous decisions in the case gives some clue as to its inconvenience and cost:

> Plaintiffs' allegations are detailed more fully in the Court's prior opinions in this action, *In re* Alstom SA Sec. Litig., 406 F. Supp. 2d 346 (S.D.N.Y. 2005) ("Alstom I"), *In re* Alstom SA Sec. Litig., 406 F. Supp. 2d 433 (S.D.N.Y. 2005) ("Alstom II"), *In re* Alstom SA Sec. Litig., 406 F. Supp. 2d 402 (S.D.N.Y. 2005) ("Alstom III"), *In re* Alstom SA Sec. Litig., 454 F. Supp. 2d 187 (S.D.N.Y. 2006) ("Alstom IV"), and *In re* Alstom Sec. Litig., 253 F.R.D. 266 (S.D.N.Y. 2008).

*Id.* at 471. After seven years of transcontinental litigation, Judge Marerro emphatically rejected the plaintiffs' arguments that the United States had legislative jurisdiction over the conduct that plaintiffs had urged were regulated by U.S. federal securities laws:

> Plaintiffs argue that purchases of Alstom securities recorded on Euronext are domestic transactions under Morrison because such purchases were initiated in the United States. Plaintiffs' submission to the Court, though less than a model of clarity, also suggests that because these common shares were registered and listed on the NYSE, though not actually purchased there, these Euronext transactions fulfill the letter of Morrison' s rule that the federal securities fraud laws apply to transactions in securities "listed on a domestic exchange." *Morrison*, 130 S. Ct. at 2886.

prevent executive-level management, however, from being sued, being served, being deposed, and having to expend considerable emotional and professional time defending against international civil litigation in U.S. courts[213]—all of which comes at a considerable transaction cost to the MNE.[214]

### *c. Relic—or Modern Human-Rights Litigation Sword? The Curious Career of the Alien Tort Statute as a Significant Source of U.S. Litigation Risk to MNEs*

> *The district courts shall have original jurisdiction of any civil action by an alien for a tort only, committed in violation of the law of nations or a treaty of the United States.*[215]

---

The Court is not persuaded by either argument.

*Id.* at 471-72. However, there are plaintiffs left in the case, which continues pending on summary judgment motions, for the District Court's ruling merely applied only to "claims of Plaintiffs who purchased securities on foreign exchanges," where were the only group of plaintiffs "dismissed from this action." *Id.* at 473.

[213] *See, e.g.*, Hannah L. Buxbaum, *Personal Jurisdiction Over Foreign Directors In Cross-Border Securities Litigation*, 35 J. CORP. L. 71 (2009); *In re* Alstom S.A. Sec. Litig., 406 F. Supp. 2d 346, 401 (S.D.N.Y. 2005) (observing that "it would have been foreseeable to those creating and disseminating the [registration statements] that the documents would have an effect in the United States," in the course of considering personal jurisdiction over inside French directors).

[214] Also noteworthy are the anti-bribery laws under which Alstom management has been investigated. *See, e.g.*, Frank C. Razzano & Travis P. Nelson, *The Expanding Criminalization of Transnational Bribery: Global Prosecution Necessitates Global Compliance*, 42 INT'L LAW. 1259, 1281 (2008) (in addition to a prosecution in Italy, "nineteen investigations are under way in France concerning payments of hundreds of millions of dollars in bribes to secure contracts in Asia and Latin America between 1998 and 2003 by Alstom in connection with projects in those regions"); Richard Grime & Ann Savage, *FCPA Jurisdiction over Foreign Entities & Individuals: The Trend of Increasingly Aggressive Enforcement*, *in* PRACTISING LAW INST., CORPORATE LAW AND PRACTICE COURSE HANDBOOK SERIES—WHITE COLLAR CRIME 2008: PROSECUTORS AND REGULATORS SPEAK 163, 189 (2008) (noting that the class of major MNEs "subject to prosecution and investigation in more than one country include[s] Alstom (Switzerland, France, Brazil, and Mexico)").

[215] 28 U.S.C. § 1350, captioned "Alien's Action for Tort." Some sources refer to this statute as "The Alien Torts Claims Act" or "ACTA." That practice is incorrect for at least three reasons. First, it misleading suggests that the statute is the product of a focused, separate piece of legislation devoted to tort claims by aliens. *See* Curtis A. Bradley, *The Alien Tort Statute and Article III*, 42 VA. J. INT'L L. 587, 592-97 (2002) (explaining that "Alien Tort Statute" is more accurate than the "Alien Tort Claims Act" since § 1350 is a subject-matter jurisdiction statute that in and of itself creates no cause of action). It is evident from its undistinguished and virtually uncommented upon inclusion in an omnibus court establishment bill that such an impression is utterly false. Second, it makes it sound as if the law were conceptually and temporally related to a modern statute, the Federal Torts Claims Act, or FTCA, but the two could not be more different. *See* 28 U.S.C. §§ 1346(b), 2671-2680 (2006); *see, e.g.*, Feres v. United States, 340 U.S. 135 (1950); Dalehite v. United States, 346 U.S. 15, 26-30 (1953). Finally, the U.S. Supreme Court has consistently appellated the statute "the Alien Tort Statute,"

These 33 words, couched as a jurisdictional statute enacted within the Judiciary Act of 1789, would hardly seem the source of a major threat to Alstom, a French MNE, as it undertakes FDI in Israel. Indeed, prior to 1980, the Alien Tort Statute would have been irrelevant to this—and similar—FDIs by MNEs anywhere.

However, as explained in this subsection, the ATS has become a major source of risk, expense, and transactional costs for all MNEs over which the U.S. federal courts have personal jurisdiction;[216] and while the risk to MNEs, such as Alstom, whose projects are sited in political tinderboxes such as Jerusalem and the Golan Heights, is considerable—and needs to be understood by both IBT counsel and the MNE—the Supreme Court may be on the verge of bringing the curious career of the ATS as a regulator of FDI to an abrupt (but well-deserved) close, as discussed in the concluding paragraphs of this subsection.[217]

The ATS was originally the 9th section of the Judiciary Act of 1789, collected with along with all the other jurisdictional provisions appearing in that Act, by which Congress fulfilled Article III's directive that "[t]he judicial power of the United States, shall be vested in one Supreme Court, and in such inferior courts as the Congress may from time to time ordain and establish."[218] Nor was the ATS the marquee attraction of 9th section of the 1789 Judiciary Act; it was simply enumerated among the many bases for subject matter in Section 9's lengthy laundry list:

> SEC. 9. And be it further enacted, That the district courts shall

---

beginning with Argentine Republic v. Amerada Hess Shipping Corp., 488 U.S. 428, 436 (1989), and continuing with Sosa v. Alarez-Machain, 542 U.S. 692 *passim* (2004). As Judge Kim McLane Wardlaw has observed:

> Panels of our Court have referred to this statute by no fewer than three different names. *See, e.g.*, Alperin v. Vatican Bank, 410 F.3d 532, 541 (9th Cir. 2005) ("Alien Tort Statute"); Deutsch v. Turner Corp., 317 F.3d 1005, 1017 (9th Cir. 2003) ("Alien Tort Claims Act"); Martinez v. City of Los Angeles, 141 F.3d 1373, 1377 (9th Cir. 1998) ( "Alien Tort Act"). Because the Supreme Court most recently used the appellation "Alien Tort Statute," Sosa v. Alvarez-Machain, 542 U.S. at 697, we do so too.

Corrie v. Caterpillar, Inc, 503 F.3d 974, 979 n.5 (9th Cir. 2007).

216 *See, e.g.*, Travis Robert-Ritter, *Achilles' Heel: How the ATS and NAFTA Have Combined to Create Substantial Tort Liability for US Corporations Operating in Mexico*, 42 U. MIAMI INTER-AM. L. REV. 443 (2011).

217 For an international perspective on the extraterritoriality aspect of the Supreme Court's deliberations in *Kiobel v. Royal Dutch Petroleum Co.*, 621 F.3d 111 (2d Cir. 2010), *reh'g denied*, 642 F.3d 268 (2d Cir. 2011), *reh'g en banc denied*, 642 F.3d 379 (2d Cir. 2011), *cert. granted*, 132 S. Ct. 472 (2011), see Barrie Sander, Kiobel*: The US steals the Headlines in First Round of Supplemental Briefs on Universal Civil Jurisdiction under the Alien Tort Statute*, EILJ: TALK! (June 26, 2012), http://www.ejiltalk.org/kiobel-the-us-steals-the-headlines-in-first-round-of-supplemental-briefs-on-universal-civil-jurisdiction-under-the-alien-tort-statute/.

218 U.S. CONST. ART. III, § 1.

> have, exclusively of the courts of the several States, cognizance of all crimes and offences that shall be cognizable under the authority of the United States, committed within their respective districts, or upon the high seas; where no other punishment than whipping, not exceeding thirty stripes, a fine not exceeding one hundred dollars, or a term of imprisonment not exceeding six months, is to be inflicted; and shall also have exclusive original cognizance of all civil causes of admiralty and maritime jurisdiction, including all seizures under laws of impost, navigation or trade of the United States, where the seizures are made, on waters which are navigable from the sea by vessels of ten or more tons burthen, within their respective districts as well as upon the high seas; saving to suitors, in all cases, the right of a common law remedy, where the common law is competent to give it; and shall also have exclusive original cognizance of all seizures on land, or other waters than as aforesaid, made, and of all suits for penalties and forfeitures incurred, under the laws of the United States. **And shall also have cognizance, concurrent with the courts of the several States, or the circuit courts, as the case may be, of all causes where an alien sues for a tort only in violation of the law of nations or a treaty of the United States.** And shall also have cognizance, concurrent as last mentioned, of all suits at common law where the United States sue, and the matter in dispute amounts, exclusive of costs, to the sum or value of one hundred dollars. And shall also have jurisdiction exclusively of the courts of the several States, of all suits against consuls or vice-consuls, except for offences above the description aforesaid. And the trial of issues in fact, in the district courts, in all causes except civil causes of admiralty and maritime jurisdiction, shall be by jury.[219]

It was against this background that U.S. Circuit Court of Appeals Judge Henry J. Friendly—recently the subject of a thorough intellectual biography that called him "greatest judge of his era"—confronted one of only four recorded, up to that time, post-enactment attempts by litigants

---

[219] Judiciary Act of 1789, ch. 20, 1 Stat. 73, *available at* http://www.ourdocuments.gov/doc.php?flash=true&doc=12&page=transcript (emphasis added). *See generally* Wythe Holt, *"To Establish Justice": Politics, the Judiciary Act of 1789, and the Invention of the Federal Courts*, 1989 DUKE L.J. 1421 (1989).

in 190 years to invoke the ATS.[220] In *ITT v. Vencap, Ltd.*,[221] a Luxemburg-based investment trust chose the U.S. federal courts in which to sue a Bahamian corporation and several individual defendants over a foreign investment in which the trust made allegations of fraud, conversion and corporate waste.[222] Subject matter jurisdiction was one of the principal issues, and, in particular, whether the federal securities laws provided subject matter jurisdiction of an action seeking damages or rescission by defrauded foreign individuals where United States was used as basis for manufacturing fraudulent security devices for export.[223] In the course of evaluating these questions, the district court had considered, in addition to the securities laws, that the Alien Tort Statute might plausibly provide subject matter jurisdiction for the litigation. Judge Friendly, however, was not impressed; and in his discussion on that contention, he pithily and penetratingly summed up the very problematic nature of the ATS:

> This leaves 28 U.S.C. § 1350 which confers jurisdiction over "any civil action by an alien for a tort only, committed in violation of the law of nations or a treaty of the United States". This old but little used section is a kind of legal Lohengrin; although it has been with us since the first Judiciary Act, § 9, 1 Stat. 73, 77 (1789), no one seems to know whence it came. We dealt with it some years ago in *Khedivial Line, S. A. E. v. Seafarers' Union*, 278 F.2d 49, 52 (2d Cir. 1960) (per curiam). At that time we could find only one case where jurisdiction under it had been sustained, in that instance violation of a treaty, *Bolchos v. Darrell*, 3 Fed.Cas.

---

220 DAVID M. DORSEN, HENRY FRIENDLY: GREATEST JUDGE OF HIS ERA 1-3, 346-59 (2012). Judge Richard Posner has written of Friendly that:

> [O]ne might suppose that he was a formalist judge par excellence, deploying text and precedent to produce decisions that satisfied the legal profession's longing for formal correctness and objective validity. But that was not the kind of judge he was. He tempered academic brilliance with massive commence sense. He was less mercurial, more matter-of-fact, than any of the other great judges. . . . He saw cases not as intellectual puzzles to be solved but as practical disputes to be resolved sensibly and humanely. He bent his powerful legal intelligence to the service of shaping legal doctrine to the enablement of sensible results in individual cases. The aim was to improve the law—American law is in constant need of improvement, in fact is a mess to a degree that only insiders can appreciate—without unduly perturbing the doctrinal and institutional framework that provides necessary stability and continuity.

Richard A. Posner, *Foreword* to DORSEN, *supra*, at xiii.

221 519 F.2d 1001 (2d Cir. 1975).

222 *Id.* at 1004.

223 *Id.* at 1015.

> 810, No.1, 607 (D.S.C. 1795); there is now one more. *See Abdul-Rahman Omar Adra v. Clift*, 195 F. Supp. 857, 863-65 (D.Md. 1961). Here there is no allegation of anyone's violating a treaty. The reference to the law of nations must be narrowly read if the section is to be kept within the confines of Article III. We cannot subscribe to plaintiffs' view that the Eighth Commandment "Thou shalt not steal" is part of the law of nations. While every civilized nation doubtless has this as a part of its legal system, a violation of the law of nations arises only when there has been "a violation by one or more individuals of those standards, rules or customs (a) affecting the relationship between states or between an individual and a foreign state, and (b) used by those states for their common good and/or in dealings inter se." *Lopes v. Reederei Richard Schroder*, 225 F.Supp. 292, 297 (E.D.Pa. 1963). *See also Damaskinos v. Societa Navigacion Interamericana, S. A., Pan.*, 255 F.Supp. 919, 923 (S.D.N.Y. 1966); *Valanga v. Metropolitan Life Insurance Co.*, 259 F.Supp. 324, 328 (E.D.Pa. 1966). We therefore turn to the two sections of the securities laws.[224]

An MNE might well think that Judge Friendly's lucid and persuasively logical reasoning would have conclusively settled the matter—far from it. As an MNE with far-flung FDIs, a European company such as Alstom might well see subsequent court decisions, leading in 1997 to the assumption of extraterritorial, foreign corporate liability under the ATS, in the following terms: Just as a provenance devoid of detail *allows* characters in Wagner's 1843 opera *Lohengrin* to speculate recklessly about the identity and purpose of the knight whose name is not spoken,[225] and *encourages* directors of that opera to project their own idiosyncrasies into its realization,[226] the blank slate of the ATS

---

[224] *Id.* (internal citations have been updated to reflect proper requirements).

[225] *See, e.g.*, ERNEST NEWMAN, "*Lohengrin*," in THE WAGNER OPERAS, 105-68 (1991).

[226] Critic Fiona Maddocks observed of Hans Neuenfels's controversial new production of *Lohengrin* in Bayreuth:

> Lab rats, a dead horse and bridesmaids with long, pert rodent tails and hybrid dahlias on their heads hardly feature in the original of Wagner's *Lohengrin*. Nor does a fat, cloned baby which crawls out of its placenta and severs its own umbilical cord, tossing it to the people of Brabant like a string of raw Bavarian sausages: a doubtful new era begins.

Fiona Maddocks, *Bayreuth Festival 2010*, GUARDIAN U.K.: OBSERVER July 31, 2010, http://www.guardian.co.uk/music/2010/aug/01/lohengrin-bayreuth-maddocks-review (noting that Hans Neuenfel's controversial new production of *Lohengrin* in Bayreuth contained elements that "hardly feature in the original of Wagner's [production]").

http://www.guardian.co.uk/music/2010/aug/01/lohengrin-bayreuth-maddocks-review has *allowed*—*even encouraged*—litigants and more than a few courts to paint canvasses of the most fantastic imagination with the 33 words of that Act, starting with Judge Friendly's head-line seeking colleague (and successor as Chief Judge[227]) Judge Irving Kaufman[228] in *Filartiga v.*

---

[227] Arnold H. Lubasch, *Kaufman Due to Succeed Friendly on U.S. Bench; Takes Over May 28 as Chief Appeals Judge in 2d Circuit*, N.Y. TIMES, Apr. 6, 1973, http://select.nytimes.com/gst/abstract.html?res=F40C14FE395C1A7A93C4A9178FD85F478785F9

[228] *See, e.g.*, Marilyn Berger, *Judge Irving Kaufman, of Rosenberg Spy Trial and Free-Press Rulings, Dies at 81*, N.Y. TIMES, Feb. 3, 1992, http://www.nytimes.com/1992/02/03/nyregion/judge-irving-kaufman-of-rosenberg-spy-trial-and-free-press-rulings-dies-at-81.html. The obituary included a number of insightful observations by those familiar with Judge Kaufman's work:

> It was Judge Kaufman's hope that he would be remembered for his role not in the Rosenberg case, the espionage trial of the century, but as the judge whose order was the first to desegregate a public school in the North; who was instrumental in streamlining court procedures, who rendered innovative decisions in antitrust law and, most of all, whose rulings expanded the freedom of the press.
>
> "I'm sure the decision plagued him to his last days," Prof. Yale Kamisar of the University of Michigan Law School said of the Rosenberg case, adding that Judge Kaufman was "someone whose desire for recognition was not easily fulfilled."
>
> "He continued to write on public issues for a very long time and he certainly worked hard on developing an image of a thoughtful, liberal, sensitive, concerned person on public issues," Professor Kamisar said.
>
> . . . .
>
> In 1975, Judge Kaufman was forced to cancel a speech at a graduation ceremony at Pomona College in California because of disturbances at a rally over reopening the trial. He wrote in an article in The New York Times Magazine that the potential threat from the appearance did not arise from the nature of his planned remarks, "but rather from a continuing pattern of harassment because of a trial I presided over more than 20 years ago, prior even to the birth of the vast majority of present university students."
>
> "I felt it unfortunate," he wrote, "if not unfair, that these old issues should affect an invitation to speak today, for in the intervening years I had written decisions in a wide range of cases."
>
> And he was known to carry clippings endorsing his conduct of the trial in his breast pocket, to quote from at dinner parties.
>
> . . . .
>
> A law professor at Yale University, Geoffrey Hazard, said: "I think he was an extraordinarily able and energetic person. It is also true that he felt a strong inclination to be in the public eye. I think his inclination in that regard diminished the professional appreciation of his judicial abilities."

*Id.* In his analytic and intellectual biography of Judge Friendly, David M. Dorsen recounts how then-District Judge Kaufman lobbied hard for appointment to the Circuit, and when Friendly had received endorsements from Justice Frankfurter, Judge Learned Hand, and the American Bar Association (which rated Friendly "exceptionally well qualified"), Kaufman tried to, in effect, negotiate Friendly out of the picture by "suggest[ing] the following compromise: Kaufman would get the next slot, and in turn he would support Friendly for Hincks's spot." DORSEN, *supra* note 220, at 75. (Judge Carroll Hincks had been appointed the Circuit Judge from Connecticut by President Eisenhower in 1953, and he took senior status in 1959. *See Biographical Directory of Federal Judges—Hincks, Carroll Clark*, FED. JUD. CTR., http://www.fjc.gov/servlet/nGetInfo?jid=1052&cid=999&ctype=na&instate=na.) Friendly's response was, in essence, that Kaufman was insulting his intelligence with "the ruse, since

*Pena-Irala*.[229]

While the cause of ending extra-judicial torture and bringing torturers to account for their wrongs is a powerful one, it would not be unreasonable for the counsel to an MNE to conclude that surely *Filartiga* was wrongly decided as a matter of statute reading.[230] Indeed, supporters in Congress of more aggressive human rights laws recognized just how problematic *Filartiga* was, for they took the extraordinary step of amending the ATS in 1992, after proper deliberation and legislative process, to codify *Filartiga* in a supplemental statute (as a Note to § 1350) called the Torture Victims Protection Act (TVPA).

---

Hinck's successor obviously would be from Connecticut," not Judge Friendly's home state, New York. DORSEN, *supra* note 220, at 75 & n.27.

229 630 F.2d 876 (2d Cir. 1980). True to a pattern that emerged over the years, Judge Kaufman's opinion was headline news in the New York Times: Marcia Chambers, *Court Says Alien Can Sue For Torture in Paraguay; Lower Court Ruling Overturned Decision Is Unanimous*, N.Y. TIMES, July 1, 1980, http://select.nytimes.com/gst/abstract.html?res=FA0714FE385C11728DDDA80894DF405B8084F1D3. The drama was palpable:

> Relying on an obscure statute enacted by the Congress in 1789, the three-judge panel held that the plaintiffs, Joel Filartiga, and his daughter Dolly, were entitled to sue, Americo Pena-Irala, the police official, for the torture-murder four years ago of Joelita, Dr. Filartiga's 17-year-old son. Mr. Pena is now in Paraguay.
>
> . . . .
>
> The ruling by the United States Court of Appeals for the Second Circuit establishes for the first time that federal courts have the power and jurisdiction to try purported acts of torture and award civil damages if a violation of the law of nations has been proved. The opinion leaves open to further litigation the date on which the statute of limitations begins to run. *Id.* Of course, the opinion left far more open than the limitations issue; it left open a veritable Pandora's box of questions that have proven to be legislative in nature and a poor fit for common-law style judicial decisionmaking. *See, e.g.*, Tel-Oren v. Libyan Arab Republic, 726 F.2d 774 (D.C. Cir. 1984) (four-paragraph per curiam opinion followed by 52-pages of separate concurring opinions by then-Circuit Judges Edwards, Robb, and Bork); Sosa v. Alvarez-Machain, 542 U.S. 692 (2004); Kiobel v. Royal Dutch Petroleum, 621 F.3d 111 (2d Cir. 2010), *reh'g denied* (with concurring opinion filed by Chief Judge Jacobs), 642 F.3d 468 (2d Cir. 2011), *reh'g en banc denied* (with concurring opinion filed by Chief Judge Jacobs and dissenting opinions by Judges Lynch and Katzmann), 642 F.3d 379 (2d Cir. 2011), *cert denied*, 132 S. Ct. 248 (Sept. 3, 2011), *then cert. granted*, 132 S. Ct. 472 (Oct. 17, 2011), argued Feb. 27, 2012 and set for reargument and supplemental briefing during October Term 2012, see Order List for 565 U.S., Case 10-1491, issued March 5, 2012, available from link at http://www.scotusblog.com/case-files/cases/kiobel-v-royal-dutch-petroleum-et-al/; *see also* Kiobel v. Royal Dutch Petroleum, OYEZ PROJECT (Oct. 2012), http://www.oyez.org/cases/2010-2019/2011/2011_10_1491 (reargument and supplemental briefing to address whether and when the Alien Tort Statute allows courts to recognize a cause of action for violations of the law of nations occurring within the territory of a sovereign other than the United States); Sarei v. Rio Tinto, PLC, 671 F.3d 736 (9th Cir. 2011) (en banc), *petition for cert. filed*, 80 USLW 3335 (Nov 23, 2011) (NO. 11-649).

230 *See Sarei*, 671 F.3d at 806-08 (Kleinfeld, J., dissenting); *Tel-Oren*, 726 F.2d at 799 (Bork, J., concurring in the result).

A foreign observer, such as an MNE's general counsel, of American legal developments might be understandably puzzled by the order in which the legislative process proceeded, and skeptical of the whole affair—*i.e.*,that Judge Kaufman had, in effect, written the statute that Congress had not enacted in 1789; and that Congress in 1992 enacted, in effect, the statute that Judge Kaufman had written in the guise of a judicial opinion. If that view sounds a bit cynical, the cynicism by an MNE's general counsel would be understandable; it is one largely shared by their governments.[231] From where MNEs and foreign sovereigns stand, the

---

[231] *See, e.g.*, Brief of the Governments of the Kingdom of the Netherlands and the United Kingdom of Great Britain and Northern Ireland as Amici Curiae in Support of Neither Party, Kiobel v. Royal Dutch Petroleum Co., No. 10-1491, (U.S. June 13, 2012), 2012 WL 2312825. The positions articulated in this brief are worth examining in some detail; the consistent remonstration of European and other sovereigns against the expansiveness of the ATS is reflective of the concerns of MNEs domiciled within their territories, such as Alstom, and deserves more attention by scholars, courts, and Congress:

> The Governments of the Kingdom of the Netherlands and the United Kingdom of Great Britain and Northern Ireland ("U.K.") (collectively "the Governments") are committed to the rule of law, including the promotion of, and protection against violations of, human rights. It has been the longstanding view of the Governments that a State must protect the human rights of those within its jurisdiction, and must provide appropriate remedies for violations of those rights.
>
> The Governments firmly believe that corporations should not be able to act with impunity vis-à-vis human rights issues, and that they should respect human rights. Accordingly, the Governments have recognized that the operations of corporations can have both beneficial and detrimental impacts on the enjoyment of human rights by those affected by their operations and are engaged in multilateral dialogue to determine how best to address this at the international level
>
> Nevertheless, just as international law imposes human rights obligations on States, it imposes restraints on the assertion of jurisdiction by one State over civil actions between persons that primarily concern another State. Jurisdictional restraints are a fundamental underpinning of the international legal order and are essential to maintaining international peace and comity. The Governments are, therefore, opposed to broad assertions of extraterritorial jurisdiction over alien persons arising out of foreign disputes with little, or no, connection to the United States ("U.S."). Such assertions of jurisdiction are contrary to international law and create a substantial risk of jurisdictional and diplomatic conflict. They may also prevent another State with a greater nexus to such cases from effectively resolving a dispute.
>
> As such, the Governments have maintained their concern with the extraterritorial application of U.S. law over a long period of time. They have expressed their concern in numerous amicus briefs submitted to this Court, including a brief by the Governments at an earlier stage of these proceedings . . . .
>
> The Governments remain deeply concerned about the failure by some U.S. courts to take account of the jurisdictional constraints under international law when construing the ATS, which in turn has led those courts to entertain suits by foreign plaintiffs against foreign defendants for conduct that took place entirely in the territory of a foreign sovereign. In this regard, for example, the U.K., Germany, Switzerland and South Africa sent diplomatic notes to the U.S. reasserting their opposition to a broad assertion of extraterritorial jurisdiction in an ATS case based on South Africa's Apartheid history.
>
> This brief is intended to set out the views of two nations that historically have been concerned with

Second Circuit created a new statute out of whole cloth, opening the door to make the U.S. federal courts a forum for allowing private parties to attempt to turn legislative and executive matters of great complexity and serious foreign policy implications into federal lawsuits. In so doing, the path to serious and direct confrontations between the federal courts and the political branches of government was set before MNEs that make FDIs in politically volatile areas of the world. In his limited concurrence in the U.S. Supreme Court's only ruling on the ATS, *Sosa v. Alvarez-Machain*, Justice Scalia clearly articulated the kinds of legal difficulties that MNEs have faced when trying to assess the broader legal environment of their FDIs beyond the municipal law of their host states:

> The Second Circuit, which started the Judiciary down the path the Court today tries to hedge in, is a good indicator of where that path leads us: directly into confrontation with the political branches.
>
> ***
>
> We Americans have a method for making the laws that are over us. We elect representatives to two Houses of Congress, each of which must enact the new law and present it for the approval of a President, whom we also elect. For over two decades now, unelected federal judges have been usurping this lawmaking power by converting what they regards as norms of international law into American law.
>
> ***
>
> American law—the law made by the people's democratically elected representatives—does not recognize a category of activity that is so universally disapproved by other nations that it is automatically unlawful here, and automatically gives rise to a private action for money damages in federal court.[232]

Presciently, Judge Robert Bork warned in his 1986 concurring opinion in *Tel-Oren v. Libyan Arab Republic*[233]that *Filartiga* was fundamentally flawed:

---

> the extraterritorial exercise of jurisdiction by the U.S. courts because of its inconsistency with international law. It echoes the views expressed by other governments in ATS, antitrust and securities cases before this Court - including the Governments of Australia, Belgium, Canada, France, Germany, and Japan.

*Id.* at *1-4 (footnotes omitted).

[232] 542 U.S. at 748, 750-51 (2004) (Scalia, J., concurring in part & concurring in the judgment).

[233] 726 F.2d at 799 (Bork, J., concurring in the result).

> The question in this case is whether appellants have a cause of action in courts of the United States for injuries they suffered in Israel. Judge Edwards contends, and the Second Circuit in *Filartiga* assumed, that Congress' grant of jurisdiction also created a cause of action. That seems to me fundamentally wrong and certain to produce pernicious results. For reasons I will develop, it is essential that there be an explicit grant of a cause of action before a private plaintiff be allowed to enforce principles of international law in a federal tribunal. It will be seen below, however, that no body of law expressly grants appellants a cause of action; the relevant inquiry, therefore, is whether a cause of action is to be inferred. That inquiry is guided by general principles that apply whenever a court of the United States is asked to act in a field in which its judgment would necessarily affect the foreign policy interests of the nation.[234]

Even lawyers of a non-originalist judicial philosophy would have to concede that the only reasonable explanation for the 1789 Congress to have included the ATS clause in the 1789 Judiciary Act was out of fear of retribution from other nations, not in order to pass judgment on them.[235] The ATS was a response to incidents involving a tort committed against

---

234 *Id.* at 801.

235 *See* Michele Landis Dauber, *The War Of 1812, September 11th, And The Politics Of Compensation*, 53 DePaul L. Rev. 289, 289 (2003) ("'The sufferers too well remember, the toilsome days and sleepless nights of December, 1813 and January, 1814; and while they remember the want of governmental protection, the smoking ruins, the devastation and the sufferings, they will burn with indignation, not to be quenched, until that government, (who denied them protection, in the hour of danger, and who now actually turns a deaf ear to their petitions,) shall amply remunerate their losses, by a prompt and honorable liquidation of their claims.'") (quoting Smith Salisbury, *Niagara Frontier Claims,* Buff. Gazette, Jan. 28, 1817, at 3); Curtis A. Bradley, *Attorney General Bradford's Opinion and the Alien Tort Statute*, 106 Am. J. Int'l L. 1, 18, 19 (2012) ("Under the customary international law of the late 1700s, when the ATS was enacted, the United States would have had a duty to ensure that certain torts in violation of international law, especially those committedby its citizens, were punished and redressed"; thus, Congress enacted the ATS to "vindicate U.S. responsibilities under international law . . . rather to sit in judgment on the actions of foreign governments and their corporations."); *see also Tel-Oren*, 726 F.2d at 827 (Robb, J., concurring in the judgment). In *Tel-Oren*, Judge Robb reminds us of the dangers of anachronistic thinking when we overlay old statutory language with modern-day aspirations:

> We ought not to parlay a two hundred years-old statute into an entree into so sensitive an area of foreign policy. We have no reliable evidence whatsoever as to what purpose [§ 1350] was intended to serve. We ought not to cobble together for it a modern mission on the vague idea that international law develops over the years. Law may evolve, but statutes ought not to mutate. To allow § 1350 the opportunity to support future actions of the sort both countenanced in *Filartiga* and put forward here is to judicially will that statute a new life. Every consideration that informs the sound application of the political question doctrine militates against this result. My colleagues concede that

an ambassador and concern for enforcing safe-conducts when America was young, vulnerable to at least three European nations (England, France, and Spain) with large foot-holds in North America, and ill-prepared for military action against those powers, as amply demonstrated 25 years later in the War of 1812.[236] To assume that *Filartiga*'s reading of the ATS—and the even broader readings of the ATS that were bootstrapped in *Filartiga*'s wake—had anything to do with either the intention of or words used by the 1789 Congress would strike counsel to MNEs across the globe as delusional.[237] From the pragmatist point-of-view with which the business

---

> the origins and purposes of this statute are obscure, but it is certainly obvious that it was never intended by its drafters to reach this kind of case.

*Id.* (citations omitted). *See also Lawsuits and Foreign Policy*, WASH. POST, Aug. 12, 2000, at A20 ("proceed[ing] under an ill-conceived but now well-accepted reading of a 1789 law that . . . is a modern graft on a largely moribund statute" is "troubling" because, inter alia, "international human rights law did not exist in the 18th century.")

[236] Ali Shafi v. Palestinian Auth., 642 F.3d 1088, 1099 (D.C. Cir. 2011) (Williams, J., concurring) ("The concern was that U.S. citizens might engage in incidents that could embroil the young nation in war and jeopardize its status or welfare in the Westphalian system."). While the author does not entirely agree with some of his interpretation of the historical record or the inferences he draws therefrom, Professor Lee's 2006 article on the ATS at least refocuses the discussion of the ATS to a rational, rather than upon a fanciful or an anachronistic, context. *See* Thomas H. Lee, *The Safe-Conduct Theory of the Alien Tort Statute*, 106 COLUM. L. REV. 830, 896-907 (2006). One of Professor Lee's most worthy points is that "suit in domestic court for tort remedies by an alien against the one who injured his person or property was mainly a political expedient premised on the host sovereign's hope that if the alien received a speedy and fair remedy, the other sovereign might not be informed of, or act upon, the safe-conduct breach, diminishing the risk that the offended sovereign would exercise its lawful right to make war." *Id.* at 881.

[237] In *Tel-Oren*, Judge Robb more politely, yet just as pointedly, observed that in cases of the tortured versus the torturer, or the victims versus the terrorist, "[w]e are here confronted with the easiest case and thus the most difficult to resist," which he described as "a similar magnet" to that which "drew the Second Circuit into its unfortunate position in *Filartiga*":

> I do not doubt for a moment the good intentions behind Judge Kauffman's opinion in *Filartiga*. But the case appears to me to be fundamentally at odds with the reality of the international structure and with the role of United States courts within that structure. The refusal to separate rhetoric from reality is most obvious in the passage which states that "for the purposes of civil liability, the torturer has become-like the pirate and slave trader before him- *hostis humani generis*, an enemy of all mankind." This conclusion ignores the crucial distinction that the pirate and slave trader were men without nations, while the torturer (and terrorist) are frequently pawns, and well controlled ones, in international politics. When Judge Kauffman concluded that "[o]ur holding today, giving effect to a jurisdictional provision enacted by our First Congress, is a small but important step in the fulfillment of the ageless dream to free all people from brutal violence," *id.*, he failed to consider the possibility that ad hoc intervention by courts into international affairs may very well rebound to the decisive disadvantage of the nation. A plaintiff's individual victory, if it entails embarrassing disclosures of this country's approach to the control of the terrorist phenomenon, may in fact be the collective's defeat. The political question doctrine is designed to prevent just this sort of judicial gambling, however apparently noble it may appear at first reading.

community approaches problems, the clearest thinking on this point came from Judge Bork in *Tel-Oren:*

> I have discovered no direct evidence of what Congress had in mind when enacting the provision. The debates over the Judiciary Act in the House—the Senate debates were not recorded—nowhere mention the provision, not even, so far as we are aware, indirectly.
>
> Historical research has not as yet disclosed what section 1350 was intended to accomplish. Th[at] fact poses a special problem for courts. A statute whose original meaning is hidden from us and yet which, if its words are read incautiously with modern assumptions in mind, is capable of plunging our nation into foreign conflicts, ought to be approached by the judiciary with great circumspection. It will not do simply to assert that the statutory phrase, the "law of nations," whatever it may have meant in 1789, must be read today as incorporating all the modern rules of international law and giving aliens private causes of action for violations of those rules. It will not do because the result is contrary not only to what we know of the framers' general purposes in this area but contrary as well to the appropriate, indeed the constitutional, role of courts with respect to foreign affairs.
>
> What little relevant historical background is now available to us indicates that those who drafted the Constitution and the Judiciary Act of 1789 wanted to open federal courts to aliens for the purpose of avoiding, not provoking, conflicts with other nations. A broad reading of section 1350 runs directly contrary to that desire. It is also relevant to a construction of this provision that until quite recently nobody understood it to empower courts to entertain cases like this one or like *Filartiga*.[238]

---

726 F.2d at 826-27 (Robb, J., concurring in the result) (internal citation omitted).

[238] 726 F.2d at 812-13 (footnotes omitted). As Judge Bork continued:

> Though it is not necessary to the decision of this case, it may be well to suggest what section 1350 may have been enacted to accomplish, if only to meet the charge that my interpretation is not plausible because it would drain the statute of meaning. The phrase "law of nations" has meant various things over time. It is important to remember that in 1789 there was no concept of international human rights; neither was there, under the traditional version of customary international law, any recognition of a right of private parties to recover . . . . ***Clearly, cases like this***

Yet, it did not take long for the federal courts to assume that MNEs could be sued in the U.S. federal courts on ATS claims involving injuries sustained by individuals and groups entirely outside of U.S. sovereign territory.[239] Those courts did so without thinking through the separation-

---

> ***and Filartiga were beyond the framers' contemplation.*** That problem is not avoided by observing that the law of nations evolves. It is one thing for a case like *The Paquete Habana* to find that a rule has evolved so that the United States may not seize coastal fishing boats of a nation with which we are at war. It is another thing entirely, a difference in degree so enormous as to be a difference in kind, to find that a rule has evolved against torture by government so that our courts must sit in judgment of the conduct of foreign officials in their own countries with respect to their own citizens. The latter assertion raises prospects of judicial interference with foreign affairs that the former does not. ***A different question might be presented if section 1350 had been adopted by a modern Congress that made clear its desire that federal courts police the behavior of foreign individuals and governments. But section 1350 does not embody a legislative judgment that is either current or clear and the statute must be read with that in mind.***

*Id.* at 813 (citations omitted) (emphases added). One does not have to share Judge Bork's social philosophies or political conservatism (*see, e.g.*, SLOUCHING TOWARDS GOMORRAH: MODERN LIBERALISM AND AMERICAN DECLINE (1996)) to see that no theory of rational statutory interpretation supports the federal courts' reanimation of the ATS from 1980 onwards. *See, e.g.*, ANTONIN SCALIA & BRYAN A. GARNER, READING LAW: THE INTERPRETATION OF LEGAL TEXTS 268-72 (explaining the "Extraterritoriality Canon" of statutory interpretation , and quoting Justice Robert H. Jackson's admonition that "if any construction otherwise be possible, an Act will not be construed as applying to foreigners in respect to acts done by them outside the dominions of the sovereign power enacting.'") (quoting Lauritzen v. Larsen, 345 U.S. 571, 578 (1953)). Or, as it was reportedly put by a very pragmatic jurist and a committed internationalist, Chief Judge Charles Evans Hughes, "[i]t is well to be liberal, but not messy." *See generally* FRED W. FRIENDLY, MINNESOTA RAG: THE DRAMATIC STORY OF THE LANDMARK SUPREME COURT CASE THAT GAVE NEW MEANING TO FREEDOM OF THE PRESS 105 (1981) (discussing the judicial philosophy of Chief Justice Hughes).

[239] These include: Doe v. Unocal, 248 F.3d 915 (9th Cir. 2001), involving allegations of human rights violations against indigenous people in Burma during the construction of a pipeline, which was settled, *see* "Doe v. Unocal," EARTH RIGHTS INT'L, http://www.earthrights.org/legal/doe-v-unocal; and Wiwa v. Royal Dutch Shell, 226 F.3d 88, (2d Cir. 2000), involving allegations of complicity in human rights violation against a Nigerian poet and activist who was executed by the Nigerian government; the case settled on the eve of trial for $15.5 million, *see* "Wiwi v. Royal Dutch Shell," EARTH RIGHTS INT'L, http://www.earthrights.org/legal/wiwa-v-royal-dutchshell. A less sanguine view of these developments was offered by Second Circuit Judge José A. Cabranes, who has explained that the ATS is:

> [A] jurisdictional provision unlike any other in American law and of a kind apparently unknown to any other legal system in the world. Passed by the first Congress in 1789, the ATS lay largely dormant for over 170 years. . . . Then, in 1980, the statute was given new life, when our Court first recognized in Filartiga v. Pena-Irala that the ATS provides jurisdiction over (1) tort actions, (2) brought by aliens (only), (3) for violations of the law of nations (also called "customary international law" including, as a general matter, war crimes and crimes against humanity-crimes in which the perpetrator can be called "hostis humani generis, an enemy of all mankind." Since that time, the ATS has given rise to an abundance of litigation in U.S. district courts. For the first fifteen years after Filartiga-that is, from 1980 to the mid-1990s-aliens brought ATS suits in our courts only against notorious foreign individuals; the first ATS case alleging, in effect, that a corporation (or "juridical" person) was an "enemy of all mankind" apparently was brought as recently as 1997.

of-powers implications, let alone the ahistoricity, of this expansion.[240]

---

Kiobel v. Royal Dutch Petroleum, 621 F.3d 111, 116 & n.5 (2d Cir. 2010) (noting that "[t]he first ATS case brought against a corporate defendant appears to have been Doe v. Unocal Corp., 963 F. Supp. 880 (C.D.Cal.1997), *aff'd in part and rev'd in part*, 395 F.3d 932 (9th Cir. 2002)") (footnote omitted). On October 17, 2011, the U.S. Supreme Court granted petitions for writs of certiorari to review Kiobel v. Royal Dutch Shell (2d Cir. 2010) and Mohamad v. Rajoub (D.C. Cir. 2011). *See* Trey Childress, *United States Supreme Court to Again Consider the Alien Tort Statute*, CONFLICTOFLAWS.NET (Oct. 17, 2011), http://conflictoflaws.net/2011/united-states-supreme-court-to-again-consider-the-alien-tort-statute/. The Court proceeded to decide the *Mohamad* case, *sub nom.* Mohamad v. Palestinian Authority, 132 S. Ct. 1702 (Apr. 18, 2012), holding that the term "individual" within the TVPA did not include a corporation as a juridical entity, though the term would, of course, include specific individuals through whom a corporation operates. Writing for a unanimous Court, Justice Sotomayor put the TVPA in a perspective that emerges from a confluence of its text, as well as materials comprising its legislative history:

> Petitioners' final argument is that the Act would be rendered toothless by a construction of "individual" that limits liability to natural persons. They contend that precluding organizational liability may foreclose effective remedies for victims and their relatives for any number of reasons. Victims may be unable to identify the men and women who subjected them to torture, all the while knowing the organization for whom they work. Personal jurisdiction may be more easily established over corporate than human beings. And natural persons may be more likely than organizations to be judgment proof. Indeed, we are told that only two TVPA plaintiffs have been able to recover successfully against a natural person—one only after the defendant won the state lottery. *See* Jean v. Dorelien, 431 F.3d 776, 778 (11th Cir. 2005).
>
> We acknowledge petitioners' concerns about the limitations on recovery. But they are ones that Congress imposed and that we must respect. "[N]o legislation pursues its purposes at all costs," Rodriguez v. United States, 480 U.S. 522, 525–526, . . . (1987) (per curiam), and petitioners' purposive argument simply cannot overcome the force of the plain text. We add only that Congress appeared well aware of the limited nature of the cause of action it established in the Act. See, e.g., 138 Cong. Rec. 4177 (1992) (remarks of Sen. Simpson) (noting that "as a practical matter, this legislation will result in a very small number of cases"); 137 Cong. Rec. 2671 (1991) (remarks of Sen. Specter) ("Let me emphasize that the bill is a limited measure. It is estimated that only a few of these lawsuits will ever be brought").

132 S. Ct. at 1710. In a discussion that, although treating an interpretative issue of a different nature than the one in Kiobel, may be prescient of the ultimate rationale the Court reaches on restricting extraterritorial application of the ATS, Justice Sotomayor concluded "[t]he text of the TVPA convinces us that Congress did not extend liability to organizations, sovereign or not. There are no doubt valid arguments for such an extension. But Congress has seen fit to proceed in more modest steps in the Act, and it is not the province of this Branch to do otherwise." *Id.* at 1710-11. For a discussion of the *Mohamad* case and its impact on international human rights litigation in the U.S. courts, see Alberto Bernabe, *Supreme Court decides* Mohamad v. Rajoub*: no cause of action against corporations under Torture Victim Protection Act*, TORTS BLOG (Apr. 23, 2012), http://bernabetorts.blogspot.com/2012/04/supreme-court-decides-mohamad-v-rajoub.html, which includes many links to a wide spectrum of legal and popular media discussion of the ruling, such as Adam Liptak, *Justices Limit Suits Under Law on Torture*, N.Y. TIMES, Apr. 18, 2012, at A20.

[240] *See, e.g.*, John O. McGinnis, *Foreign to Our Constitution*, 100 NW. U. L. REV. 303, 307 n.22 (2006) ("[D]efenders of the use of contemporary international law want to use evolving standards of an international law that has grown in scope to become a kind of local municipal law and changed in nature from natural to positive law. In this respect, modern international law does not resemble the law of nations known to the Framers.").

Nor did they consider the business ramifications of permitting such litigation. As one human-rights advocacy group, the "Center for Justice and Accountability" (CJA), boasts on its website:

> Beginning in the mid-1990s, a new class of ATS suits emerged that aimed to hold multinational corporations accountable for complicity in human rights abuses. Although backlash from certain sectors of the business community unleashed heated criticism of this use of the ATS, attempts to repeal or attenuate the statute have failed.[241]

Even scholars neutral, or favorably disposed, toward such a use of the ATS are compelled to admit that "[a]s a practical matter, plaintiffs choose to sue under the ATS to forum shop their way into a U.S. court in hopes of finding a more favorable forum in which to litigate their case."[242] A leading scholar of MNE trends in FDI has summarized so well the corporate view of the ATS, that it provides the basic starting point for our discussion of a new—and potentially potent—kind of political risk to enterprises such as Alstom's East Jerusalem Light-Rail Project, as well as our hypothetical Golan Heights Wind Farm project:

> Multinationals also encountered a new form of political risk – legal action in developed countries, notably the United States, for alleged human rights abuses in developing countries. Although there remained no international law regarding the human rights obligations of multinationals, companies found themselves increasingly vulnerable to litigation under the obscure Alien Tort Claims Act (ATCA) of 1789. This 33-word act of the newly-established United States specified that "The district courts shall have original jurisdiction of any civil action by an alien for a tort (civil wrong) only, committed in violation of the law of nations or a treaty of the United States." The Act lay dormant for almost two hundred years, until in 1979 it was used against a Paraguayan police inspector living in the United States, who was accused of torturing and killing the son of a Paraguayan dissident in Paraguay. The victim's relatives won a $10 million judgment, which was

---

241 *The ATS in the Modern Era—Corporate Accountability for Aiding and Abetting*, CTR. JUST. & ACCOUNTABILITY, http://www.cja.org/article.php?id=435 (last visited Nov. 15, 2012).

242 Donald Earl Childress, III, *The Alien Tort Statute, Federalism, and the Next Wave of Transnational Litigation*, 100 GEO. L.J. 709, 723 (2012).

never paid.[243]

Professor Jones observed that for FDI purposes, MNEs have to be aware that "for multinationals, the most significant feature of [ATS] was that, in addition [to] individuals, companies could be sued in US courts for internationally recognized human rights violations anywhere in the world."[244] This represents an especially troublesome wrinkle for MNEs, because "[a]lthough it proved difficult to win [ATS] cases, the legal costs and bad publicity generated by the cases became a major issue for companies," particularly for MNEs such as Alstom: "Given the political and security circumstances in many developing countries, especially in Africa, [ATS] obliged multinationals to give increased attention to human rights and environmental strategies, and to resolve complex issues related to different legal and ethical standards between some developed and some developing countries."[245] As of this writing, Mercedes-Benz is going to school on this lesson in *Bauman v. DaimlerChrysler Aktiengesellschaft*,[246] an ATS case involving claims by "twenty-two Argentinian residents . . . against DaimlerChrysler Aktiengesellschaft (DCAG) alleging that one of DCAG's subsidiaries, Mercedes-Benz Argentina (MBA) collaborated with state security forces to kidnap, detain, torture, and kill the plaintiffs and/or their relatives during Argentina's 'Dirty War,'" a conflict that "began in 1976 when the military overthrew the government of President Isabel Peron and set up a military dictatorship."[247]

Nor would it be unprecedented for litigants to use the ATS as a vehicle for challenging an MNEs participation in an Israel-based FDI. In fact, it has already occurred. Another major corporate project partner of Israel's, Caterpillar, was sued in the U.S. under the ATS for allegedly aiding and abetting alleged human-rights violations in the Occupied

---

243 Geoffrey Jones, *Multinational Strategies and Developing Countries in Historical Perspective* 34-35 (Harvard Business School Entrepreneurial Management Working Paper No. 10-076, 2010) *available at* www.hbs.edu/research/pdf/10-076.pdf (working draft of paper initially presented at the International Business History Conference, Hitotsubashi University, Tokyo January 8-10, 2010).

244 *Id.*

245 *Id.* at 36.

246 644 F.3d 909 (9th Cir. 2011) (resolving in favor of plaintiffs solely the issue whether long-arm jurisdiction in California existed over the German parent corporation through its separately incorporated American subsidiary under the sovereignty and convenience branches of *International Shoe v. Washington*, 326 U.S. 310 (1945), and its progeny such as *World-Wide Volkswagen Corp. v. Woodson*, 444 U.S. 286 (1980)).

247 *Id.* at 911-12 & n.3, *reh'g en banc denied by a divided court*, 676 F.3d 774 (9th Cir. 2011) (O'Scannlain, J., joined by Tallman, Bybee, Callahan, Bea, M. Smith, Ikuta, and N.R. Smith, J.J., dissenting from denial of rehearing en banc), *petition for cert. filed*, 80 USLW 3461 (Feb 06, 2012) (NO. 11-965).

Territories by bulldozer sales to Israel when the bulldozers were used in constructing and expanding settlements in the Occupied Territories.

In *Corrie v. Caterpillar, Inc.*,[248] Judge Kim McLane Wardlaw succinctly set out the theory behind the ATS claim in the case:

> Plaintiffs Cynthia and Craig Corrie, Mahmoud Al Sho'bi, Fathiya Muhammad Sulayman Fayed, Fayez Ali Mohammed Abu Hussein, Majeda Radwan Abu Hussein, and Eida Ibrahim Suleiman Khalafallah filed this action after their family members were killed or injured when the Israeli Defense Forces ("IDF") demolished homes in the Palestinian Territories using bulldozers manufactured by Caterpillar, Inc., a United States corporation. The IDF ordered the bulldozers directly from Caterpillar, but the United States government paid for them.
>
> ★★★
>
> Following the Six Day War in 1967, Israel occupied and took control of the West Bank and Gaza Strip. Caterpillar is the world's leading manufacturer of heavy construction and mining equipment. Among its customers is the IDF, which since 1967 has utilized Caterpillar bulldozers to demolish homes in the Palestinian Territories. According to plaintiffs' complaint, Caterpillar sold the bulldozers to the IDF despite its actual and constructive notice that the IDF would use them to further its home destruction policy in the Palestinian Territories; a policy plaintiffs contend violates international law. Seventeen members of plaintiffs' families-sixteen Palestinians and one American-were killed or injured in the course of the demolitions.[249]

While the complaint against Caterpillar was dismissed by the District Court and by the Ninth Circuit, those courts *did not find* that [1] corporations *were not* appropriate ATS defendants; [2] the FDI of Caterpillar in Israel, given the *Filartiga* and progeny re-write of the statute, *was outside of* the ATS; or [3] the ATS *is inapplicable* to extraterritorial conduct. Instead, those courts dismissed that particular complaint solely because the U.S.-government actually paid for Caterpillar's sale of equipment to Israel, which put the political question doctrine squarely into play:

---

[248] 503 F.3d 974 (9th Cir. 2007), *aff'g* 403 F. Supp. 2d 1019 (W.D. Wash. 2005).

[249] 503 F.3d at 977.

> The decisive factor here is that Caterpillar's sales to Israel were paid for by the United States. Though mindful that we must analyze each of the plaintiffs' "individual claims," . . ., each claim unavoidably rests on the singular premise that Caterpillar should not have sold its bulldozers to the IDF. Yet these sales were financed by the executive branch pursuant to a congressionally enacted program calling for executive discretion as to what lies in the foreign policy and national security interests of the United States. See 22 U.S.C. § 2751 (stating that the purpose of the Arms Export Control Act, which authorizes the FMF program, is to support "effective and mutually beneficial defense relationships in order to maintain and foster the environment of international peace and security essential to social, economic, and political progress").
>
> Allowing this action to proceed would necessarily require the judicial branch of our government to question the political branches' decision to grant extensive military aid to Israel. It is difficult to see how we could impose liability on Caterpillar without at least implicitly deciding the propriety of the United States' decision to pay for the bulldozers which allegedly killed the plaintiffs' family members.
>
> ★★★
>
> We cannot intrude into our government's decision to grant military assistance to Israel, even indirectly by deciding this challenge to a defense contractor's sales. Plaintiffs' claims can succeed only if a court ultimately decides that Caterpillar should not have sold its bulldozers to the IDF. Because that foreign policy decision is committed under the Constitution to the legislative and executive branches, we hold that plaintiffs' claims are nonjusticiable. . . .[250]

Thus, the failure of the particular ATS claim in *Corrie* can provide no succor to MNEs in Alstom's position.[251] A case filed against Alstom over a

---

[250] 503 F.3d at 982 (citations & footnotes omitted).

[251] Indeed, Ms. Corrie's parents sued the state of Israel in the courts of that country. Rory McCarthy, *Rachel Corrie's Family Bring Civil Suit Over Human Shield's Death In Gaza—Parents Want Case To Highlight Events That Led To American Activist's Death Under Israeli Army Bulldozer*, GUARDIAN, Feb. 23, 2010, http://www.guardian.co.uk/world/2010/feb/23/corrie-death-law-case. It appears that the suit did not encompass Caterpillar; but it conceivably might well have. The suit went to trial in March 2012 before Haifa District Court Judge Oded Gershon. Joanna Paraszczuk, *Court To Decide Rachel Corrie Case In August*, JERUSALEM POST, May 7, 2012, http://www.jpost.com/NationalNews/Article.aspx?id=268949; Erin Cunninham, *Seven Years After Rachel*

Golan Heights wind-project might well get more traction under the ATS, and subject Alstom to the considerable transactional costs attendant to American-style discovery and civil practice, the generation of negative public opinion and negative opinion among investors and analysts, and the costs of settlement[252]—which corporate ATS defendants have incurred in more than a few cases—just to bring the legal proceedings to a definitive

---

*Corrie Death, Her Parents Sue Israel—Seven Years After US Activist Rachel Corrie was Hit and Killed by a Bulldozer Driven by an Israel Soldier, her Parents are Suing the Israeli Military for Culpability in the Incident*, CHRISTIAN SCIENCE MONITOR, March 17, 2010, http://www.csmonitor.com/World/Middle-East/2010/0317/Seven-years-after-Rachel-Corrie-death-her-parents-sue-Israel. In August 2012, after a lengthy trial of the Corrie family's' claims, the court in Haifa returned a defense verdict, finding no intentionally tortious or negligent act or omission on the part of Israel's government or military, and finding contributory negligence by Ms. Corrie. Harriet Sherwood, *Rachel Corrie's Death was an Accident, Israeli Judge Rules—Judge Finds no Fault in Military Investigation that Cleared Defence Force of Responsibility for Protester Being Killed by Bulldozer*, GUARDIAN, Aug. 28, 2012, http://www.guardian.co.uk/world/2012/aug/28/rachel-corrie-verdict-accident-judge; Yonah Jeremy Bob, *Haifa Court Rules Against Rachel Corrie Family—Judge Invokes "Combatant Activities" Exception, says US Activist who was Killed by IDF Bulldozer Could Have Avoided Danger*, JERUSALEM POST, Aug. 28, 2012, http://www.jpost.com/NationalNews/Article.aspx?id=282862. For an extensive summary of Judge Gershon's opinion, see Ben Lynfield, *Israeli Court Dismisses Corrie Family's Lawsuit, Ending Effort To Put Army On Trial*, CHRISTIAN SCIENCE MONITOR, Aug. 28, 2012, http://www.csmonitor.com/World/Middle-East/2012/0828/Israeli-court-dismisses-Corrie-family-s-lawsuit-ending-effort-to-put-army-on-trial-video. The proceedings were extensive, expensive, and generated a great deal of public attention — something that most MNEs would want to avoid. *See* Jodi Rudoren & Danielle Ziri, *Court Rules Israel Is Not at Fault in Death of American Activist*, N.Y. TIMES, Aug. 28, 2012, http://www.nytimes.com/2012/08/29/world/middleeast/court-rules-israel-wasnt-at-fault-in-rachel-corries-death.html.

[252] This has been very pointedly expressed by the Second Circuit's Chief Judge, Dennis Jacobs, who expressed concern that such a use of ATS litigation permits—

> invasive discovery that ensues [which] could coerce settlements that have no relation to the prospect of success on the ultimate merits. American discovery in such cases uncovers corporate strategy and planning, diverts resources and executive time, provokes bad public relations or boycotts, threatens exposure of dubious trade practices, and risks trade secrets. I cannot think that other nations rely with confidence on the tender mercies of American courts and the American tort bar. These coercive pressures, combined with pressure to remove contingent reserves from the corporate balance sheet, can easily coerce the payment of tens of millions of dollars in settlement, even where a plaintiff's likelihood of success on the merits is zero. Courts should take care that they do not become instruments of abuse and extortion.

Kiobel v. Royal Dutch Petroleum Co., 642 F.3d 268, 271 (2d Cir. 2011) (Jacobs, C.J., concurring in denial of rehearing), *cert. denied*, 132 S. Ct. 248 (Sept. 3, 2011), *cert. granted*, 132 S. Ct. 472 (Oct. 17, 2011), argued Feb. 27, 2012 and set for reargument and supplemental briefing during October Term 2012, see Order List for 565 U.S., Case 10-1491, issued March 5, 2012, available from link at http://www.scotusblog.com/case-files/cases/kiobel-v-royal-dutch-petroleum-et-al/; *accord*, Kiobel v. Royal Dutch Petroleum, 621 F.3d at 116 (Cabranes, J.) ("Such civil lawsuits, alleging heinous crimes condemned by customary international law, often involve a variety of issues unique to ATS litigation, not least the fact that the events took place abroad and in troubled or chaotic circumstances. The resulting complexity and uncertainty-combined with the fact that juries hearing ATS claims are capable of awarding multibillion-dollar verdicts-has led many defendants to settle ATS claims prior to trial.").

close.[253] Indeed, the objective, it seems, of more than a few ATS suits filed against MNEs is to reset the context and terms of activism in opposition to the FDIs of those MNEs.[254] The effect of the ATS-litigation risk on MNEs—whether U.S.-based[255] or foreign-based—is more than *de*

---

[253] As Professor Childress has noted recently, there have been ATS cases against corporations that have been tried to plaintiff's verdicts. *See* Childress, *supra* note 243, at 713 n.25. The decisions to which he cites are: Chowdhury v. Worldtel Bangladesh Holding, Ltd., 588 F. Supp. 2d 375 (E.D.N.Y. 2008), *appeal filed*, No. 09-4483-cv (2d Cir.) (awarding a $1.5 million ATS judgment against corporate defendant); Licea v. Curacao Drydock Co., 584 F. Supp. 2d 1355, 1366 (S.D. Fla. 2008) ($80 million ATS judgment against corporate defendant). Professor Childress also notes that "there have been two trials in which defendants have prevailed. *See* Bowoto v. Chevron Corp., 621 F.3d 1116 (9th Cir. 2010); Romero v. Drummond Co., 552 F.3d 1303 (11th Cir. 2008)."

[254] Professor Childress has articulated the apparent strategy in such cases:

> In light of the dim chances for success in ATS cases based on the small number of plaintiff judgments to date, it is arguable that modern uses of the ATS against corporations have not been driven solely by forum shopping and choice of law, but rather by the signaling value that is offered when bringing suit against a corporation for alleged violations of international law. By alleging that a corporation is violating international law, plaintiffs subject corporations to brand damage while gaining significant publicity in hopes of both encouraging policy change and a monetary settlement. The use of the ATS converts a claim sounding in tort against a corporation into a claim sounding as a violation of international law. This has the potential to create public-relations problems for corporations, and thus force a settlement, because no corporation wishes to be known as a human-rights abuser or violator of international law. Put another way, it seems that the real value of an ATS case is that it transforms a tort case into a human-rights case. The public-relations fallout from being labeled a human-rights abuser is perhaps much greater than the fallout from committing a tortious act. As a litigation tactic, it is not totally clear that this has worked, although there is some evidence that nonlegal ends have been reached on account of bringing suit under the ATS. While some settlements have been reached, most corporations have marched forward to defend ATS cases and have achieved favorable results.

Childress, *supra* note 242, at 725-26 (footnotes omitted); *see also* Pan American World Airways, Inc. v. Aetna Cas. & Sur. Co., 368 F. Supp. 1098, 1101 (S.D.N.Y. 1973) (in airline's suit against insurer to cover loss of aircraft that terrorists hijacked and destroyed, long-time federal judge Frankel observed that "[w]e have been led by the nature of the insurance questions to touch in the trial upon large topics of history, politics, and human sorrow in the Middle East" and that "all involved have been made aware that people called as witnesses, as well as others allied in political interest with them, have seen fit to hope or believe that their causes might be advanced or obstructed by an American court's reasons for saying one group of insurers rather than another must pay for the destroyed airplane"). For a recent example of an ATS complaint, replete with narratives and photographs in its body, that seems designed primarily as a press release, consider the lawsuit filed by Professor Anthony D'Amato, acting as lead counsel, on behalf of Hungarian victims of the Holocaust against Hungary's national railway. *See* Abelesz v. Magyar Nemzeti Bank, 2012 WL 3590804 (7th Cir. Aug. 22, 2012); Abelesz v. OPT Bank, 2012 WL 3590802 (7th Cir. Aug. 22, 2012); Abelesz v. Erste Group Bank, A.G., 2012 WL 3590815 (7th Cir. Aug. 22, 2012); Julian Ku, *D'Amato Sues Hungarian Railways for Holocaust-Era Complicity*, OPINIO JURIS (Feb. 17, 2010, 3:24 PM), http://opiniojuris.org/2010/02/17/damato-sues-hungarian-railways-for-holocaust-era-complicity/ (links to complaint).

[255] Jack L. Goldsmith & Alan O. Sykes, Commentary, *Lex Loci Delictus and Global Economic Welfare*: Spinozzi v. ITT Sheraton Corp., 120 HARV. L. REV. 1137, 1137 (2007); *see also* Spinozzi v. ITT Sheraton Corp., 174 F.3d 842, 845 (7th Cir. 1999) (Posner, J.) (noting that the place of a foreign tort, not a U.S.

*minimis*; it creates considerable problems for the United States, as well as for the MNEs, as Chief Judge Dennis Jacobs of the U.S. Second Circuit Court of Appeals explained in a recent, high-profile ATS case:

> All the cases of the class affected by this [ATS] case involve transnational corporations, many of them foreign. Such foreign companies are creatures of other states. They are subject to corporate governance and government regulation at home. They are often engines of their national economies, sustaining employees, pensioners and creditors—and paying taxes. I cannot think that there is some consensus among nations that American courts and lawyers have the power to bring to court transnational corporations of other countries, to inquire into their operations in third countries, to regulate them—and to beggar them by rendering their assets into compensatory damages, punitive damages, and (American) legal fees. Such proceedings have the natural tendency to provoke international rivalry, divisive interests, competition, and grievance—the very opposite of the universal consensus that sustains customary international law. . . . Is it plausible that customary international law supports proceedings that would harm other civilized nations and be opposed by them—or be tantamount to "judicial imperialism?"[256]

Thus, the *Corrie* case does not by any means preclude viable ATS lawsuits against other corporations, such as Alstom, which are working on projects sited in the Occupied Territories.

From the viewpoint of an MNE such as Alstom, whose core businesses are often FDIs, the *Sarei v. Rio Tinto, PLC* litigation is perhaps the epitome of how costly, divisive, and dangerous ATS litigation can be to MNEs. No less than eight published federal court opinions has it

---

courtroom, "is the place that has the greatest interest in striking a reasonable balance among safety, cost, and other factors pertinent to the design and administration of a system of tort law. Most people affected whether as victims or as injurers by accidents and other injury-causing events are residents of the jurisdiction in which the event takes place. So if law can be assumed to be generally responsive to the values and preferences of the people who live in the community that formulated the law, the law of the place of the accident can be expected to reflect the values and preferences of the people most likely to be involved in accidents—can be expected, in other words, to be responsive and responsible law, law that internalizes the costs and benefits of the people affected by it.").

[256] Kiobel v. Royal Dutch Petroleum Co., 642 F.3d 268, 270 (2d Cir. 2011) (Jacobs, C.J., concurring in denial of rehearing), *cert. denied*, 132 S. Ct. 248 (Sept. 3, 2011), *cert. granted*, 132 S. Ct. 472 (Oct. 17, 2011), argued Feb. 27, 2012 and set for reargument and supplemental briefing during October Term 2012, 132 S. Ct. 1738 (March 5, 2012); *see also* Order List for 565 U.S., Case 10-1491, issued March 5, 2012, (available from link at http://www.scotusblog.com/case-files/cases/kiobel-v-royal-dutch-petroleum-et-al/).

spawned.[257] Six of these published opinions are by the Ninth Circuit—including two separate rehearings en banc. Two opinions are from the U.S. District Court in Los Angeles. The crown jewel of these labyrinthine proceedings, however, is the latest opinion, issued in October 2011. In what might be mistaken for a dramatization of the Tower of Babel story, the Ninth Circuit's opinion is prodigiously long, prodigiously confusing, and prodigiously unhelpful to a rational planning process by MNEs, like Alstom, that as part of making an FDI decision might want to make a realistic risk assessment of ATS litigation in an American forum.[258]

One might be justified in asking—given 170 pages of slip opinion containing hundreds of citations to case law from around the world and non-legal sources as well—"wither the 33-words with which Congress expressed the ATS in the 1789 Judiciary Act?"[259] They are *nowhere* to be

---

[257] Sarei v. Rio Tinto PLC., 221 F. Supp. 2d 1116 (C.D. Cal. 2002), *aff'd in part*, *vacated in part*, *rev'd in part*, 456 F.3d 1069, (9th Cir. 2006), *withdrawn and superseded on reh'g in part by* 487 F.3d 1193, (9th Cir. 2007), *reh'g en banc granted by* 499 F.3d 923 (9th Cir. 2007), *rev'd by*, 550 F.3d 822 (9th Cir. 2008), *on remand*, 650 F. Supp. 2d 1004 (C.D. Cal. 2009), *aff'd*, 671 F.3d 736, (9th Cir. 2011) (en banc), *petition for cert. filed*, 80 USLW 3335 (Nov 23, 2011); *see also* Sarei v. Rio Tinto, PLC, 625 F.3d 561 (9th Cir. 2010).

[258] Indeed, a critical pressure point is whether the MNE can prevail at the (relatively) early stage of the Fed. R. Civ. P. 12(b)(6) motion to dismiss, which may be brought on the many grounds debated in the eight *Sarei* opinions, or under the reinvigorated pleading standards that the Supreme Court left to the federal district and appeals courts through *Bell Atlantic v. Twombly*, 550 U.S. 554 (2007) and *Ashcroft v. Iqbal*, 556 U.S. 662 (2009). *See* Jordan D. Shepherd, *When* Sosa *Meets* Iqbal: *Plausibility Pleading In Human Rights Litigation*, 95 MINN. L. REV. 2318 (2011); *see also Kiobel*, 621 F.3d at 155 (Leval, J., concurring only in the judgment) (after extensively, and bitterly, responding to the 2-judge majority's opinion on corporate liability under the ATS, concluding that the suit must be dismissed "because the pertinent allegations of the Complaint fall short of mandatory standards established by decisions of this court and the Supreme Court," which "establish a requirement that, for a complaint to properly allege a defendant's complicity in human rights abuses perpetrated by officials of a foreign government, it must plead specific facts supporting a reasonable inference that the defendant acted with a purpose of bringing about the abuses").

[259] As a legal commentator observed at the time the October 2011 en banc opinions in *Sarei* were issued:

> An Alien Tort Statute case arising out of the operations of the Rio Tinto mining group on the island of Bougainville, Papua New Guinea and the resulting uprising against Rio Tinto that led to military intervention and numerous deaths.
>
> These things transpired in the 1980s. The docket number of this appeal begins with "02-". This is not the second time this case has been before the Ninth Circuit. This is the second time it's been before an en banc Ninth Circuit court.
>
> It's important. It's long-running. And it's hopelessly fractured. You can barely tell the result even with a scorecard.
>
> . . . .
>
> The whole shebang is 170 single-spaced pages. Of dense, dense prose. One of the dissents alone — Judge Kleinfeld's — has 136 footnotes of its own.

Shaun Martin, *Sarei v. Rio Tinto PLC,* CALIFORNIA APPELLATE REPORT—THOUGHTS ON RECENT NINTH CIRCUIT AND CALIFORNIA APPELLATE CASES FROM PROFESSOR SHAUN MARTIN AT THE UNIVERSITY OF SAN found in most of the *Sarei* opinion. Yet, an MNE such as Alstom might well share Judge Kleinfled's astonishment at the result of the *Sarei* en banc decision, which prompted him to observe that "[o]ur decision makes the Ninth Circuit the best place in the world to bring class actions against deep-pocket private defendants to recover compensatory and punitive damages and attorneys' fees for the evils so prevalent all over the world," a consequence which Judge Carlos Bea characterized as tantamount to a "claim of supervisory authority over the entire planet [that] is unwise as well as legally incorrect."[260]

Judge Kleinfeld's *cri de couer* has apparently found resonance with the Supreme Court, and the Court may be on the verge of bringing the curious career of the ATS as a regulator of FDI to end.[261] After had been granted certiorari in *Kiobel v. Royal Dutch Petroleum* to consider whether an ATS claim lay against a corporation[262]—a point on which, as just about

---

DIEGO SCHOOL OF LAW, Oct. 25, 2011, http://calapp.blogspot.com/2011/10/sarei-v-rio-tinto-9th-cir-oct-25-2011.html.

[260] 671 F.3d at 814 (Bea, J., dissenting).

[261] Some student commentators have predicted otherwise, contending that the "the context in which the First Congress enacted the Alien Tort Statute provides enough evidence to overcome the presumption against extraterritorial application." Michelle K. Fiechter, *Extraterritorial Application of the Alien Tort Statute: The Effect of* Morrison v. National Australia Bank, Ltd. *on Future Litigation*, 97 IOWA L. REV. 959 (2012). Other student commentators have—as so many federal courts have until the Supreme Court apparently appears set to call them on—assumed extraterritorial applicability, and thereby missed what is shaping up to be the decisive issue in the case. *See, e.g.*, Tyler G. Banks, Note, *Corporate Liability Under the Alien Tort Statute: The Second Circuit's Misstep Around General Principles of Law in* Kiobel V. Royal Dutch Petroleum Co., 26 EMORY INT'L L. REV. 227 (2012).

[262] The principle "argument that has been raised for corporate liability is that current American law, as well as the law in many other countries, recognizes the personhood of corporations." Maria Florencia Librizzi, *The Alien Tort Statute and Corporate Liability: Looking Ahead to the Supreme Court Decision in* Kiobel, N.Y.U. J. INT'L L. & POL. Feb. 12, 2012, http://nyujilp.org/the-alien-tort-statute-and-corporate-liability-looking-ahead-to-the-supreme-court-decision-in-kiobel/#refX. Because "corporations have many of the same rights and obligations that a natural person has," it would seem "plausible, therefore, that corporations should be amenable to suit under the ATS":

> This conclusion is consistent with Citizens United v. Federal Election Commission, in which the Supreme Court decided that the "government may not, under the First Amendment suppress political speech on the basis of the speaker's corporate identity. By analogy, it is reasonable to conclude that corporations should be held liable when aiding and abetting torts. In this context, a ruling diminishing corporate responsibility for human rights violations would be in tension with the recent ruling protecting corporate rights in the framework of personhood.

*Id.* at 32-34 (footnotes omitted); *see also* Matthew E. Danforth, Note, *Corporate Civil Liability Under the Alien Tort Statute: Exploring Its Possibility and Jurisdictional Limitations,* 44 CORNELL INT'L L.J. 659, 661 (2011). Some international rights advocates have pointed out, however, some very significant unintended consequences that will flow from a recognition of corporations as juridical persons in international law. *See, e.g.*, Jose E. Alvarez, *Are Corporations "Subjects" of International Law?,* 9 SANTA CLARA J. INT'L L. 1 (2011).

every other aspect of the ATS, the circuits differ[263]—the first oral argument of *Kiobel* demonstrated that at least some members of the Supreme Court had become concerned with the very notion that the ATS has been regularly asserted in cases far beyond Congress's legislative jurisdiction. For example, Justice Kennedy at the first oral argument in *Kiobel* very quickly interjected a concern that "no other nation in the world permits its courts to exercise universal civil jurisdiction over alleged extraterritorial human rights abuses to which the nation has no connection."[264] Justice Alito commented: "I think the question is whether there's any other country in the world where these plaintiffs could have brought these claims against the respondents."[265] Chief Justice John Roberts added that "[i]f there is no other country where this suit could have been brought, regardless of what American domestic law provides, isn't it a legitimate concern that allowing the suit itself contravenes international law?"[266] Shortly after these exchanges in the first oral argument, the Court ordered supplemental briefing, followed by a new oral argument on October 1, 2012, in which the Court's desire to limit the ATS's extraterritorial reach was palpable.[267]

The purpose of this aspect of an FDI analysis is not to defend corporate misconduct. Complicity of MNEs in the murder, torture, enslavement, wrongful detention, and other criminal abuses of human being beings—e.g., "ethnic cleansing, genocide, torture" and other

---

263 The only Circuit to squarely hold that corporations are not juridical persons within the ambit of § 1350 is the Second. *See* Kiobel v. Royal Dutch Petroleum, 621 F.3d 111, 118–20 (2d Cir. 2010). The remaining Circuits which have addressed the issue, whether as a holding or in dicta, have held that corporations, like private individuals, are proper defendants under § 1350. *See* Flomo v. Firestone Natural Rubber Co., 643 F.3d 1013, 1017–21 (7th Cir. 2011); Doe VIII v. Exxon Mobil Corp., 654 F.3d 11, 39–57 (D.C. Cir. 2011); Sarei v. Rio Tinto, 550 F.3d 822, 831 (9th Cir. 2008); Romero v. Drummond Co., 552 F.3d 1303, 1315 (11th Cir. 2008). Notably, the Court has ruled that the TVPA's specific reference to "individual" in defining its scope—a term conspicuously absent in the 200-years older § 1350—does not include "corporations." Mohamad v. Palestinian Auth., 132 S. Ct. 1702 (2012).

264 Lyle Denniston, *Argument Recap: Downhill, from the Start*, SCOTUSblog (Feb. 28, 2012, 3:05 PM), http://www.scotusblog.com/2012/02/argument-recap-downhill-from-the-start/. Links to audio and text transcripts of the oral argument are available on http://www.scotusblog.com/case-files/cases/kiobel-v-royal-dutch-petroleum-et-al/. However, within a month after this oral argument, a Dutch court appears to have done just what Justice Kennedy had observed was unprecedented. *See infra* note 281.

265 Denniston, *supra* note 264.

266 *Id*.

267 An audio and text archive of both the first and second oral arguments are available on the webpage devoted to the *Kiobel* case by IIT Chicago-Kent College of Law's Oyez Project. See http://www.oyez.org/cases/2010-2019/2011/2011_10_1491

human rights violations—are serious, and intolerable.[268] Corporate social responsibility is a modern, and overdue, movement[269] that gives MNEs the opportunities, as well as the incentives, to self-police and to participate in the formulation of a legal regime that effectively regulates MNE conduct[270]— and to the extent MNEs fail to do so, gives home- and host-state governments the standards by which to legislate compliance.[271]

---

[268] Goldsmith & Sykes, *supra* note 255, at 1146; *see also* Ronen Shamir, *Between Self-Regulation and the Alien Tort Claims Act: On the Contested Concept of Corporate Social Responsibility*, 38 L. & SOC'Y REV. 635 (2004) (arguing that from the "perspective of a C[orporate] S[ocial] R[esponsibility] field that exists above and beyond any concrete judicial outcome, the career of the [Alien Tort Statute] cases, by forcing the issue of corporations and human rights into the open, already shapes corporate behavior because it forces corporations to reflect upon, if not to institutionalize, human rights-related issues") .

[269] *See, e.g.*, Donald J. Kochan, *Legal Mechanization of Corporate Social Responsibility Through Alien Tort Statute Litigation: A Response to Professor Branson with Some Supplemental Thoughts*, 9 SANTA CLARA J. INT'L L. 251, 254 (2011) ("The corporate social responsibility discussion raises three principal issues about how a moral corporation lives its life: how a corporation chooses its self-interest versus the interests of others, when and how it should help others if control decisions may harm the shareholder owners, and how far the corporation must affirmatively go to help right the perceived wrongs in the world in which it operates.") (footnotes omitted).

[270] *See, e.g.*, Norbert Horn, *International Rules for Multinational Enterprises: The ICC, OECD, and ILO Initiatives*, 30 AM. U. L. REV. 923 (1981); A. A. Fatouros, *On the Implementation of International Codes of Conduct: An Analysis of Future Experience*, 30 AM. U. L. REV. 941 (1981); Richard D. Kauzlarich, *Review of the 1976 OECD Declaration on International Investment and Multinational Enterprises*, 30 AM. U. L. REV. 1009 (1981); *but see* Timothy W. Stanley, *International Codes of Conduct for MNC's: A Skeptical View of the Process*, 30 AM. U. L. REV. 976 (1981).

[271] A leading model is the Guidelines for MNEs that the Organization for Economic Cooperation and Development issued originally in 1976. *See* Daniel Plaine, *OECD Guidelines for Multinational Enterprises*, 11 INT'L L. 339, 339-41 (1977); Jernej Letnar Cernic, *Corporate Responsibility for Human Rights: A Critical Analysis of the OECD Guidelines for Multinational Enterprises*, 3 HANSE L. REV. 71 (2008). The OECD Guidelines are not mere window-dressing. As Professor Cernic observes, the OECD Guidelines are—

> the only corporate responsibility instrument formally adopted by state governments. The OECD Guidelines are recommendations addressed to enterprises operating in OECD countries. However, corporations are encouraged to extend good practices throughout the universe. The Guidelines form part of a broader and balanced instrument of rights and obligations – the OECD Declaration on International Investment and Multinational Enterprises. In this regard, the OECD Member States are obliged to establish National Contact Points (NCP) which has the primary responsibility to ensure the follow-up of the Guidelines at the national level.

*Id.* at 77; *see also* Ashley L. Santner, *A Soft Law Mechanism For Corporate Responsibility: How the Updated Oecd Guidelines for Multinational Enterprises Promote Business for the Future,* 43 GEO. WASH. INT'L L. REV. 375, 376-77 & n.5 (2008). The Guidelines have been updated five times since they were first adopted in 1976. *See* "OECD Guidelines for International Enterprises," OECD, http://www.oecd.org/daf/internationalinvestment/guidelines formultinationalenterprises/oecdguidelinesformultinationalenterprises.htm (last visited Nov. 15, 2012). The institution of NCPs was designed to provide a specific accountability element to OECD concept of MNE regulation, which involves voluntary compliance, home-state government pressure, and corporate peer pressure as well as institutional investor pressure. *See* Santner, *supra* at 376 n.4. For a detailed discussion of how NCPs are organized and operate within the 42 nations that have them, including the United States and France, see Leyla Davarnejad*, In the Shadow of Soft Law: The Handling of Corporate Social Responsibility Disputes Under the Oecd*

But such regulation should be more predictable and clearly stated than the common-law-style case adjudication that courts have attempted under the ATS, particularly where that adjudication is done by courts in nations other than where the MNE's conduct, or the effects of the MNE's

---

*Guidelines for Multinational Enterprises*, 2011 J. DISP. RESOL. 351 (2011). Speaking of the Corporate Social Responsibility (CSR) initiatives that are part of the OECD movement, Ms. Davarnejad writes:

> Not only are the dimensions and subject matter of CSR manifold, there is also debate about whether CSR standards have or ought to have a hard law nature CSRs can be legally binding or voluntary, depending on whether MNEs are bound by domestic law or whether they respond to societal expectations. The normative quality and significance of internationally agreed CSR standards are often unclear, however.
>
> It is important to note that when discussing CSRs' international initiatives and their legal quality, a distinction should be made between governmental, nongovernmental/private, and multi-stakeholder acts. The Guidelines represent a governmental initiative because only the adhering countries can determine how to change and implement the Guidelines. In addition, representatives on the part of civil society—in particular business, trade unions, and NGOs—are consulted concerning all aspects of the Guidelines, including their implementation. However, the Guidelines have to be distinguished from multi-stakeholder initiatives, which are very common in the context of CSR. In terms of these initiatives various private actors cooperate and determine their form and content, sometimes with and sometimes without the contribution of governments.

*Id.* at 354-55 (footnotes omitted). The progress made in the United States in OECD implementation, including NCPs, is compared to that of France and the Netherlands. *See* Christopher N. Francoise, *A Critical Assessment of the United States' Implementation of the OECD Guidelines for Multinational Enterprises*, 30 B.C. INT'L & COMP. L. REV. 223, 228 n.41 (2007) ("[T]he U.S. NCP is the Office of Investment Affairs, a part of the Bureau of Economic and Business Affairs located in the Department of State. In contrast to the U.S. institutional arrangement, other adhering nations such as the Netherlands and France use interdepartmental offices, which assign different government ministries various bureaucratic roles."); Bureau of Economic and Business Affairs, U.S. DEP'T OF STATE, OECD: U.S. National Contact Point, http://www.state.gov/e/eb/oecd/usncp/us/index.htm. The Bureau describes the NCP's "main functions" as to: (1) promote awareness of the Guidelines to business, civil society, and the general public; and (2) work with business, civil society and the public on all matters relating to the Guidelines, including in circumstances when a party raises concerns ("specific instance") regarding an MNE's observance of the Guidelines," and adds that "[i]n some cases, NCPs may facilitate a voluntary mediation or conciliation process among the interested parties." http://www.state.gov/e/eb/oecd/usncp/index.htm. The details of the "specific instance" process—which the Bureau describes as providing "a forum to assist MNE's and interested parties (such as employee organizations or NGOs), in resolving questions regarding the consistency of an MNE's activities with the Guidelines"—are summarized at http://www.state.gov/e/eb/oecd/usncp/specificinstance/index.htm, and beginning in 2011, the Bureau has released reports on "specific instances" which it has mediated.

http://www.state.gov/e/eb/oecd/usncp/specificinstance/assessments/index.htm. All NCPs provide to the OECD Secretariat an annual summary of past and current specific instance submissions, and the Bureau has provided a table summarizing specific instances addressed by the U.S. NCP as of June 2011 at http://www.state.gov/e/eb/oecd/usncp/links/rls/183060.htm, as well as detailed summaries of two specific instances that it released in February 2012, *The Lead Group and Innospec*, http://www.state.gov/e/eb/oecd/usncp/links/rls/183059.htm, and in March 2012, *UNITE HERE and LSG Sky Chefs*, http://www.state.gov/e/eb/oecd/usncp/links/rls/185107.htm, and conduct, transpired.[272] A legislative process, like the one that led to Congress's enactment of the TVPA, allows for a considerably more nuanced and holistic assessment of the wide range of relevant economic and foreign relations factors implicated in such law-making than courts can even approach in case-by-case adjudication.[273] Judge Bork's observation in *Tel-Oren* is quite apropos here: that the subjects to which courts have been asked since *Filartiga* to extend the ATS are far better committed to "a modern Congress that ma[kes] clear its desire that the federal courts police the behavior of foreign individuals and governments" in a statute that "embod[ies] a legislative judgment that is" both "current" and "clear."[274] Judge Robb, who also wrote a separate

---

[272] Goldsmith & Sykes, *supra* note 255, at 1147 (nothing importance of goal to "eliminate[e] . . . distorting economic effect by ensuring that all firms are subject to the same standard of liability for torts committed in a particular place"); *see also* Jack L. Goldsmith, Note, *Interest Analysis Applied to Corporations: The Unprincipled Use of a Choice of Law Method*, 98 YALE L.J. 597 (1989).

[273] For example, in addition to the question of whether, and if so, to what extent, an ATS-successor statute applies extraterritorially, there are questions such as whether aliens suing under the ATS should have to exhaust local remedies before being allowed to bring an ATS-like suit in the U.S. federal courts. *Compare, e.g.*, Ron A. Ghatan, *The Alien Tort Statute and Prudential Exhaustion*, 96 CORNELL L. REV. 1273, 1274-75, 1292-93, 1297, 1298-1300 (2011) (recommending the that the reach of the ATS be limited by requiring *prudential* exhaustion of local remedies "in which there is a weak nexus to the United States "and alleged violation of norms that are not Peremptory," which "could greatly reduce the number of claims available to plaintiffs under the ATS") *with* Sarei v. Rio Tinto, PLC, 487 F.3d 1193, 1225–26, 1235–36 (9th Cir. 2007) (Bybee, J., dissenting) (arguing that "international law *requires exhaustion* of local remedies as a condition to bringing an international cause of action in a foreign tribunal," such as an ATS suit in a U.S. federal court, and that "[e]ven if international law did not so require exhaustion, I would, as an exercise in discretion, require it as a matter of our domestic law")., vacated en banc, 550 F.3d 822 (9th Cir. 2008); *see also* IAN BROWNLIE, PRINCIPLES OF PUBLIC INTERNATIONAL LAW 472-73 (6th ed. 2003) (explaining the general rule of *mandatory* exhaustion: "A claim will not be admissible on the international plane unless the individual alien or corporation concerned has exhausted the legal remedies available to him in the state which is alleged to be the author of the injury.This is a rule which is justified by practical and political considerations. . . .").

[274] 726 F.2d at 813 (Bork, J., concurring). For example, former State Department Legal Advisor John Bellinger identified several recurring areas under § 1350 to which call out for legislation to bring both currency and clarity:

> [C]ontinued litigation under the ATS reflects fundamental problems with how lower courts have approached these suits. These problems center on five key issues: First, whether the ATS applies extraterritorially—that is, whether a U.S. court can properly apply U.S. federal common law under the ATS to conduct that occurred entirely in the territory of a foreign State. Second, even if such a cause of action could properly be recognized, whether exhaustion of adequate and available local remedies in that foreign country should be a prerequisite to bringing an ATS suit. Third, whether corporations or other private entities may be held liable under the ATS for aiding and abetting human rights abuses perpetrated by foreign governments. A fourth issue is how to apply [the Supreme Court's] requirement that an international law norm be sufficiently accepted and specific. And fifth, in what circumstances should courts dismiss suits based on what Sosa referred to as "case-specific deference to the political branches"?

concurrence in *Tel-Oren*, echoed Judge Bork's observation: given the "broad and novel questions" raised in § 1350 cases, "courts ought not to appeal for guidance to the Supreme Court, but should instead look to Congress and the President. Should these branches of the Government decide that questions of this sort are proper subjects for judicial inquiry, they can then provide the courts with the guidelines by which such inquiries should proceed."[275] While recent attempts at such legislation have gone nowhere,[276] the impending Supreme Court decision in *Kiobel* should rekindle an effort for which scholars called for a generation ago,[277]

---

John B. Bellinger, III, *Enforcing Human Rights In U.S. Courts And Abroad: The Alien Tort Statute and Other Approaches*, 42 VAND. J. TRANSNAT'L L. 1, 5-6 (2009). We must remark here that in the interim while this article was being readied for press, Judge Bork passed away at age 85. *See* Paul J. Larkin, Jr., *On the Death of Judge Robert Bork,* THE FOUNDRY, Dec.19, 2012, http://blog.heritage.org/2012/12/19/on-the-death-of-judge-robert-bork/.

275 726 F.2d at 827 (Robb, .J., concurring).

276 *See* 109 CONG. REC. S11433-S11436 (daily ed. Oct. 17, 2005); *see also* Philip Mariani, Comment, *Assessing the Proper Relationship Between the Alien Tort Statute and the Torture Victim Protection Act*, 156 U. PA. L. REV. 1363, 1384 & n.1 (2008) (noting that "[o]n October 17, 2005, a bill entitled the Alien Tort Statute Reform Act was introduced in the Senate, proposing to amend 28 U.S.C. § 1350 in order to, among other things, 'clarify jurisdiction of Federal Courts over a tort action brought by an alien,'" but that [o]nce introduced, this bill was referred to the Committee on the Judiciary; at the time of this writing, no further action has been taken on the bill") (citing S. 1874, 109th Cong. (2005).); Keith A. Petty, *Who Watches the Watchmen: Vigilant Doorkeeping, the Alien Tort Statute, and Possible Reform*, 31 LOY. INT'L & COMP. L. REV. 183, 185, 217-19 (2009) (proposal for amending § 1350 by, inter alia, "mirror[ing] the CIL violations specified in the Third Restatement of Foreign Relations Law," "adding a simple provision to the statute allowing for case by case deference to the executive when cognizable foreign policy interests are at stake"); Lucien J. Dhooge, *A Modest Proposal to Amend the Alien Tort Statute to Provide Guidance to Transnational Corporations,*13 U.C. DAVIS J. INT'L L. & POL'Y 119 (2007); *see also* Roger Alford, *What is Feinstein Thinking in Amending the ATS?*, OPINIO JURIS, (Oct. 22, 2005), http://lawofnations.blogspot.com/2005/10/what-is-feinstein-thinking-in-amending.html (describing the details of Senator Feinstein's proposed amendment and her rationales for the proposal); Roger Alford, *Senate Considers Removing International Law from the Alien Tort Statute*, OPINIO JURIS (Oct. 19, 2005), http://lawofnations.blogspot.com/2005/10/senate-considers-removing.html (observing that "Sen. Feinstein is proposing that Congress "de-internationalize" the Alien Tort Statute" by replacing the current judicial practice of "looking to foreign courts or international tribunals (or to international law professor articles)" and instead creating a full statutory scheme so that the courts "considering a claim under the ATS would look to the text of the statute and the legislative history") (also providing the text of the proposed bill); Roger Alford, *Feinstein Withdraws ATS Amendment*, OPINIO JURIS (Oct. 26, 2005), http://lawofnations.blogspot.com/2005/10/feinstein-withdraws-ats-amendment.html, (describing Senator Feinstein's "terse letter to Senator Specter states that while the legislation was designed to address concerns about the clarity of the existing statute in light of *Sosa* 'I believe that the legislation in its present form calls for refinement in light of concerns raised by human rights advocates, and thus a hearing or other action by the Committee on this bill would be premature.'").

277 Kenneth C. Randall, *Further Inquiries into the Alien Tort Statute and a Recommendation*, 18 N.Y.U. J. INT'l L. & POL. 473, 539 (1986). In a nutshell, Dean Randall proposed a more comprehensive, detailed, and substantive (rather than purely jurisdictional) ATS, in order to "specifically address the judiciary's express[ed] difficulties with the statute" and to" clarify the statute's language and jurisdictional requirements; direct courts to

and continue to call for today.[278] Thus, MNEs, such as Alstom, should embrace the opportunity to contribute meaningfully to this debate,[279] for a domestication of the ATS in *Kiobel* will not pretermit the need to address the kinds of claims found in ATS cases.[280] Any evaluation of risk

---

sustain jurisdiction where specific international law violations are at issue; and provide guidance to the courts on the applicability of certain judicial abstention doctrines." *Id.* at 512. Dean Randall provided the text of his proposed §§ 1350(a), (b), & (c), along with detailed commentary about his rationales and sources for his proposed statute. *See id.* at 511-32. In addition to defining eight specific categories of international law violations encompassed within his revision, Dean Randall would explicitly create a conduit between the Executive Branch and the federal courts via his § 1350(c): "Where a district court has jurisdiction under subsection (a), the action may not be dismissed, in whole or in part, based on either the act-of-state or political question doctrines, unless the executive branch of the government determines that, based on the foreign policy interests of the United States, the application of those doctrines is required in a specific case and a suggestion to that effect is filed with the court. *Id.* at 528-532. *See also* Roger Alford, *The Feinstein Amendment and Presidential Waivers*, OPINIO JURIS (Oct. 25, 2005), http://lawofnations.blogspot.com/2005/10/feinstein-amendment-and-presidential_25.html (describing the Executive "veto" provision of Senator Feinstein's proposed, then withdrawn, Alien Tort Statute dismissals on forum non conveniens or sovereign immunity grounds (per the Foreign Sovereign Immunities Act, 28 U.S.C. § 1601)); Kenneth C. Randall, *Federal Jurisdiction Over International Law Claims: Inquiries into the Alien Tort Statute*, 18 N.Y.U. J. INT'L L. & POL. 1 (1985). It is interesting to note that Dean Randall did not appear to think that extraterritorial application of the ATS was a major issue; in fact, he assumed that the ATS applies extraterritorially. Randall, *supra* at 513-14 ("contexts other than those involving the Alien Tort Statute, judicial jurisdiction over extraterritorial acts has been increasingly upheld"). However, in the 26 years since the publication of Dean Randall's article, the Supreme Court has taken a different approach, demanding more evidence—especially statutory text—that overcomes the general presumption against extraterritorial application of Congressional legislation. *See, e.g.*, Morrison v. National Australia Bank, Ltd., 130 S. Ct. 2869 (2010) (unanimous 8-0 opinion written by Justice Scalia); SCALIA & GARNER, *supra* note 238, at 268-72; Genevieve Beyea, Morrison v. National Australia Bank *and the Future of Extraterritorial Application of the U.S. Securities Laws*, 72 OHIO ST. L.J. 549 (2012); Rachel Doyle, *The Presumption Against Extraterritoriality:* Pakootas v. Teck Cominco Metals Ltd. *and Transboundary Environmental Harm after* Morrison v. National Australia Bank Ltd. (May 30, 2012), *available at* http://ssrn.com/abstract=2070852; *see also* R. Davis Mello, *Life After* Morrison: *Extraterritoriality and Rico*, 44 VAND. J. TRANSNAT'L L. 1385, 1414 (2011) (advocating a third approach that RICO "should have domestic application when a plaintiff alleges the commission of enough predicate acts in the United States withinthe statutory time period to establish a "pattern of racketeering activity," regardless of the situs of the enterprise or the commission of additional predicate acts in a foreign jurisdiction. This approach represents the best way to reconcile prior RICO jurisprudence with the Court's renewed emphasis on the presumption against extraterritorial application of U.S. laws in Morrison.").

[278] Banks, *supra* note 261, at 279; Michael Garvey, Comment, *Corporate Aiding and Abetting Liability Under the Alien Tort Statute: A Legislative Prerogative*, 29 B.C. THIRD WORLD L.J. 381 (2009).

[279] *See, e.g.*, Lauren A. Dellinger, *Corporate Social Responsibility: A Multifaceted Tool to Avoid Alien Tort Claims Act Litigation While Simultaneously Building a Better Business Reputation*, 40 CAL. W. INT'l L.J. 55 (2009)

[280] Banks, *supra* note 261, at 279. Mr. Banks observes:

> [O]ne more solution to this problem lurks in ATS litigation and is actually hinted at by the majority in *Kiobel*. The majority wrote, in conclusion, "[N]othing in this opinion limits or forecloses corporate liability other than the ATS—including the domestic statutes of other States—and nothing in this opinion limits or forecloses Congress from amending the ATS to bring corporate defendants within our jurisdiction." From this, it is clear that a congressional mandate could bring corporations

posed by Alstom's FDIs in Israel, whether the Jerusalem Light Rail Project in the West Bank Occupied Territories or a hypothesized wind-energy project in the disputed Golan Heights, should include a discussion of the larger question whether Alstom will seek to influence the policy and laws of its host nations,[281] as well as its home state, through participation in political and legislative processes, as well as amicus participation in litigation over the scope of laws that may impact Alstom's present and future business strategies.[282]

---

> back within the scope of the ATS. This is not as unlikely a scenario as it may seem. Congress has previously codified at least one violation of international norms beyond the three recognized paradigms, which served as the basis of the Sosa decision—the Torture Victim Protection. Yet, it is also clear that pro-corporate interest lobbying efforts would not sit quietly while Congress attempted to provide a means of possible worldwide corporate liability in U.S. courts.

*Id.* at 279 (footnotes omitted). The point is well-taken, even if the article may betray youthful exuberance in its failure to consider the countervailing costs of such lawsuits, or the realpolitik extent of their effect on U.S. foreign relations in a rapidly-changing global socio-economic and political landscape. Indeed, a court in the Netherlands recently exercised what amounts to universal jurisdiction of the kind sought by ATS plaintiffs. *See Dutch Courts Compensate Palestinian for Libya Jail—A Dutch Court has Awarded 1m Euros ($1.3m; £838,000) in Compensation to a Palestinian Doctor who was Imprisoned in Libya for Eight Years for Allegedly Infecting Children with HIV/Aids*, BBC NEWS, March 28, 2012, http://www.bbc.co.uk/news/world-middle-east-17537597

[281] Recently, a Japanese foundation representing whaling interests attempted to use § 1350 to turn the tables on activists who oppose whaling, by suing a "Washington-based conservation organization, which engaged in frequent confrontations with whalers in the Southern Ocean, . . . alleging a violation of their right to free navigation at sea and piracy" and "moved for a preliminary injunction requiring organization's ships and boats to stay at least 800 meters from their vessels, and prohibiting attacks on the whaling crew members or its ships." Institute of Cetacean Research v. Sea Shepherd Conservation Soc'y, 2012 WL 958545 (W.D. Wash. March 19, 2012). However, another MNE recently enjoyed success in a similar injunction suit, invoking federal maritime subject matter jurisdiction under 28 U.S.C. § 1333 against planned activism by Greenpeace directed at artic oil exploration. Shell Offshore Inc. v. Greenpeace, Inc., 2012 WL 1067968 (D. Alaska Mar. 28, 2012). Such offensive use of the U.S. federal courts by MNEs is an innovative avenue, complementary to legislative lobbying, to protecting investments, both domestic and foreign, from private activism as well as from judicial disruption. Of course, the observation is one relevant to general strategy; Alstom would not likely be able to employ similar litigation tactics to dissuade activism against its FDI sites in Israel. However, such litigation might be useful were there to be activism directed against its North American subsidiaries, including the nacelle production facility it opened in Texas.

[282] For example, BP America, Caterpillar, Conoco Phillips, General Electric, Honeywell, and International Business Machines have stepped forward in an effort to influence the Supreme Court's rulings on extraterritoriality, as well as corporate amenability, in *Kiobel*, through an Amicus Brief prepared by lead counsel including former Solicitor General Paul Clements, now in private practice:

> Amici are corporations that have extensive operations around the world BP America, Inc. (on behalf of the global group of BP companies), Caterpillar, Inc., ConocoPhillips Company, General Electric Company, Honeywell International, Inc., and International Business Machines Corporation are industry leaders in various business sectors, including energy, construction, transportation, health care, and information technology.
>
> Amici strongly condemn human rights violations, and each company abides by its detailed corporate

### C. Legal Aspects of the Political Risk Inherent in Alstom's Choice of a Golan Heights FDI

#### 1. Syria's Claims to the Golan Heights

While trade treaties may create legal strategic advantage and municipal law may create legal risk, the politics of the Golan Heights as host to the Alstom-Energix FDI has discernible legal implications that Alstom cannot ignore. Israel wrested the Golan Heights territory from Syria in the course of 1967's Six-Day War.[283] After the subsequent, and brief, 1973 conflict between Syria and Israel and a 1974 "disengagement agreement," or cease-fire, the Golan Heights (except 100 square kilometers ceded back in 1974) remained in a legal limbo but a practical stasis.[284] The Golan Heights Law, enacted by Israel's Parliament in 1981, changed that status by applying Israeli law, jurisdiction and administration to the Golan Heights, which Syria complained to the United Nations Security Council constituted annexation in violation of international law, and which the U.N. Security Council and General Assembly rebuked.[285] However, the actions and reactions at that point were more symbolic than substantive, and a new stasis emerged.[286]

---

> social responsibility policy. Yet many amici have been and may continue to be defendants in suits predicated on various expansive theories of liability under the Alien Tort Statute ("ATS"), 28 U.S.C. § 1350, based on their operations - or those of their subsidiaries - in developing countries. Those suits impose severe litigation and reputational costs on corporations that operate in developing countries and chill further investment. Amici have a strong interest in ensuring that the ATS is applied in an appropriately circumscribed manner, consistent with its text and original purposes. And because plaintiffs may seek to bring ATS suits against corporate officers and directors even if the Court affirms the decision below on the issue of corporate liability, amici have a strong interest in ensuring that the Court resolve the pendent issues of extraterritorial application and aiding and abetting liability that constitute the root causes of ongoing diplomatic tension.

Brief of Amici Curiae BP America, Caterpillar, Conoco Phillips, General Electric, Honeywell, and International Business Machines in Support of Respondents, 2012 WL 392536, at *1-2 (February 3, 2012) (footnote omitted).

283 Preface, *On the Legal Status of the Golan Heights: Application of Israeli Law or Annexation?,* 20 BROOK. J. INT'L L. 331 (1994).

284 *See* Muhammad Muslih, *The Golan: Israel, Syria, and Strategic Calculations*, 47 MIDDLE E. J. 611, 621, 625-27 (1993).

285 *Id.* at 624; Asher Maoz, *The Application of Israeli Law to the Golan Heights is Annexation*, 20 BROOK. J. INT'L L. 355, 386-88 (1994); Leon Sheleff, *The Application of Israeli Law to the Golan Heights is not Annexation*, 20 BROOK. J. INT'L L. 333 (1994).

286 According to Professor Sheleff, the 1981 Golan Heights Law:

> [I]s quite simply an affirmation the existing situation in the Heights where Israeli law fills a void caused by an absence of regular Syrian institutions, such as a judiciary. This vacuum formed because the majority of the population fled the Heights during the Six Day War, [FN16] when the territory

For some years after the row of the early 1980s, the dispute over Israel's development of the Golan Heights has not been as "hot" as the disputes over the development of Jerusalem and the West Bank. Syria did not concede its claims, and remained concerned about the commanding vista the Heights have over Damascus; Israel did not budge on its insistence that the return of any portion of the Golan Heights must be met by Syrian recognition of Israel and accession to Israeli security demands.[287] There were stirrings of a possible land-for-peace-and-recognition deal in the early 1990s, and during the first term of President Bill Clinton, the United States attempted to facilitate dialogue between Hafez al-Assad, Syria's President (1971-2000), and Yitzhak Rabin, Israel's Prime Minister (1992-1995).[288] However, now the "Arab Spring," in its sweep from Libya to Egypt, has at last reached Syria.[289] The stasis that has remained in effect since 1973 is in jeopardy as the sovereign players enter into uncharted territory. Yet, despite the uncertainty that lies ahead, there seems to be one certainty—that the post-Assad Syria that emerges from the current civil war will not likely be a significant military (as opposed to terroristic) threat to Israel or its occupation of the Golan Heights anytime soon. As one anti-Assad activist was quoted by journalists recently to have observed:

> Like other critics, Mr. Amasha said that Mr. Assad had made no genuine effort to liberate the Golan Heights and had opposed Israel only "on television." He said he believed that only a strong democratic Syria could liberate the territory, whether through

---

> was occupied by the Israeli Defense Force (I.D.F.). Thus, for a substantial period of time prior to the passing of the Golan Heights Law, Syrian law had ceased to be an effective legal instrument in the Golan Heights, and legal problems were solved either by I.D.F. institutions, or, and perhaps principally, by the autonomous activities of the Druze community which comprised most of the Syrian population remaining in the Heights after the termination of the war. The customs of the community and the influence of its leaders are the central factors in resolving day-to-day disputes and legal questions facing the local population.

Leon Sheleff, *supra* note 285, at 337-38 (footnotes omitted).

[287] *See, e.g.*, *id.* at 340-41.

[288] *See* Clyde Haberman, *Rabin Hints Peace Could Cost Golan*, N.Y. TIMES, Apr. 22, 1994, http://www.nytimes.com/1994/04/22/world/rabin-hints-peace-could-cost-golan.html. That dialogue was cut short by Mr. Rabin's death at the hands of a domestic assassin in November 1995. David Grossman, *The Night Our Hopes for Peace Died*, U.K. GUARDIAN, Nov. 3, 2005.

[289] *Towards the Endgame: The World Should Start Preparing for What Comes After Syria's President Bashar Assad*, ECONOMIST, July 21, 2012, at 9.

war or through negotiations.[290]

While the Druze populace left behind in the Golan Heights and under the authority of Israel have largely continued identifying with both Syria and the Assad family,[291] how the Druze will react to these changes in the long run is unclear, because pronounced divisions have arisen within the Druze community.[292] Viewing the situation more holistically, it remains equally unclear whether a breakdown in the Assad autocracy will result in problems of sabotage, terrorism, and other destabilization along the buffer that the Golan Heights provides between Syria and Israel.[293] As the BBC reporting has explained:

> Technically, the two countries have been in a state of war since 1948. Israel also continues to occupy the Golan Heights, Syrian territory which it captured in 1967 and later annexed, in a move that is not internationally recognised.
>
> Yet under President Bashar al-Assad, there has been a long-standing truce and for the past 40 years the border between the two countries has been relatively calm.
>
> Now Israeli leaders are revising their strategic assessments. There are worries that fleeing Syrian refugees could try to enter the Golan Heights and that Mr Assad's missiles and chemical weapons arsenal could fall into the wrong hands.[294]

---

[290] Isabel Kershner, *Buqata Journal: Echoes of Syria's War in the Golan Heights*, N.Y. TIMES, Aug. 8, 2012, at A6.

[291] *With Syria's Civil War Within Earshot, Golan Heights Druse Loyalty to Assad Begins to Fray*, WASHINGTON POST, July 28, 2012, http://www.washingtonpost.com/world/middle_east/with-syrias-civil-war-within-earshot-golan-heights-druse-loyalty-to-assad-begins-to-fray/2012/07/28/gJQAspJPFX_story.html.

[292] *Id.*; Isabel Kershner, *Buqata Journal: Echoes of Syria's War in the Golan Heights*, N.Y. TIMES, Aug. 8, 2012, at A6.

[293] Yolande Knell, *Syria Crisis Felt in Israel and Occupied Golan Heights*, BBC NEWS—MIDDLE EAST, Aug. 2, 2012, http://www.bbc.co.uk/news/world-middle-east-19017502.

[294] *Id.* ("As far as Israel was concerned this was the devil we knew. We knew it was an ally of Iran, we knew it supplied weapons to [the Lebanese militant group] Hezbollah and supported [the Palestinian militant group] Hamas but at the same time, this was a regime which kept the border with Israel very quiet for almost 40 years. Now there's uncertainty.") (quoting chairman of the Middle East department at Tel Aviv University, Eyal Zisser). The BBC goes on to report the Israeli concerns as of August 2012:

> The greatest fear is for the security of Syria's stockpiles of weapons. Israel believes that Hezbollah or rogue Islamist groups like al-Qaeda could try to seize advanced missile systems or chemical and biological weapons.
>
> "One can assume that if the Hezbollah can have a rocket equipped with chemical or biological

While Israel has made it plain that it does not want to ignite a regional war by unilateral intervention, and that it prefers coordinated international action, the Israeli government has not sought to secret the fact that it has contingency plans for military strikes against Syria's chemical weapons storehouses and military convoys suspected of transporting chemical weapons from those storehouses.[295]

Though the Golan Heights is quiet today—and the blades of wind-turbines may turn unimpeded in the winds of the Heights—the situation in Syria grows more volatile with each passing day, and the risk to people and property in the Golan Heights, as in other border areas with Syria, grows proportionately, as the *New York Times* has described it in a very compelling summary of the situation:

> The country appeared to be unraveling in what looks like a sectarian civil war. Sunni Muslims who have fled the country described a government crackdown that is more pervasive and more sectarian than previously understood, with civilians affiliated with Mr. Assad's Alawite sect shooting at their onetime neighbors as the military presses what many Sunnis see as a campaign to force them to flee their homes and villages.
>
> The conflict has become a war of attrition that grows more dangerous as it goes along. Tensions have spilled over borders into Lebanon, Iraq, Turkey and Jordan and raised fears that radical Islamic militants will find a new cause for recruitment.[296]

Even if the conflict is contained, and the fears of terrorist or insurrectionist infiltration (along with the nightmares of chemical and biological weapons falling into their hands) are abated, MNEs with the

---

> warhead they might very easily fire it against Israel," says Danny Yatom, former head of the Israeli intelligence agency, Mossad.
>
> "I assume that Israel will not sit idle and if we have information chemical agents or biological agents are about to fall into the hands of the Hezbollah we will not spare any effort to prevent it."
>
> . . . .
>
> Back in the Golan Heights, Israeli troops can be seen in locations on the rocky hillsides that they do not usually man.

*Id.*

295 *Id.* An excellent, regularly updated summary on the events in Syria surrounding the end of the Assad regime and the escalation of an internal civil war may be found at *Bashar al-Assad*, N.Y. TIMES—TIMES TOPICS, http://topics.nytimes.com/top/reference/timestopics/people/a/bashar_al_assad/index.html.

296 *Bashar al-Assad*, N.Y. TIMES—TIMES TOPICS, http://topics.nytimes.com/top/reference/timestopics/people/a/bashar_al_assad/index.html.

kinds of FDIs in the Golan Heights as Alstom is considering in our hypothetical still must worry about the status of the investment in the wake of a new government that may, once it is on its feet, take up the return of the Golan Heights as a central theme.[297]

If the Golan Heights were turned over to a future Syrian government, the question for an Alstom might well become whether their FDIs in the Heights—such as the wind-turbine farm that is the hypothesis of this article—will remain in the MNEs' possession and control, or whether the entire investment would be expropriated.

In addition, Alstom's ties to the U.S. in our hypothetical FDI might prove to be disadvantageous if the Golan Heights were to revert to Syrian control, even in the absence of an expropriation. Because the U.S. government designated Syria as a state sponsor of terrorism, Syria has been subject to the U.S. Department of Commerce's Export Administration Regulations (EAR) for over thirty years.[298] U.S. businesses find that FDIs in Syria are impracticable, due to the EAR prohibitions on the export of almost all U.S. products to Syria, and due to other restrictions, such as the Grassley Amendment's prohibitions on taking tax credits for taxes paid in Syria and the Syria Accountability Act (SAA) of 2004's authorization for the President to prohibit, under authority of the SAA, all U.S. business and investment activity in Syria at any time.[299]

As serious as the risks may be from both a Syrian civil war and an unpredictable aftermath,[300] another shadow looms over a wind-power FDI in Israel: the palpable potential for an armed conflict involving Israel and Iran. This set of risks is discussed in the next section, along with the ameliorative impact of political-risk insurance.

### 2. *The Impact of an Israel-Iran Armed Conflict on FDI in Israel—And the Role of Political Risk Insurance*

Any FDI in Israel—not just in the volatile Occupied Territories—

---

[297] *See, e.g.*, Fred Kaplan, *The Syrian Endgame: There are no Guarantees. But in Almost Every Scenario, the Violence Will Persist,* SLATE, July 20, 2012, http://www.slate.com/articles/news_and_politics/war_stories/2012/07/whether_bashar_al_assad_falls_or_not_the_fighting_in_syria_is_likely_to_persist_for_a_long_time_.html.

[298] U.S. COMMERCIAL SERV., U.S. DEP'T OF COMMERCE, *Investment Climate: Openness to Foreign Investment, in* DOING BUSINESS IN SYRIA: 2010 COUNTRY COMMERCIAL GUIDE FOR U.S. COMPANIES 26, 26-31 (2010).

[299] *Id.*

[300] *See, e.g.*, David D. Kilpatrick, *Egyptian President Warns Assad That "Your Time Won't Be Long",* N.Y. TIMES, Sept. 6, 2012, at A1.

carries with it a particular set of risks created by an arms race between Israel and Iran in the midst of what has been called "an Arab Cold War."[301] While Iran was the second Middle-Eastern nation to recognize Israel in the 1950s and maintained cooperative relations during the reign of Reza Pahlavi,[302] Iran after 1979 has been in a state of total hostility toward Israel, which post-Shah Iran does not recognize and which Iranian leaders have repeatedly vowed to destroy.[303] Such threats assumed a new urgency when it became clear that the production of nuclear fuel in Iran had proceeded to the point where uranium could be enriched to "weapons-grade" levels,[304] and, concomitantly, that the Iranian military

---

[301] Curtis Ryan, *The New Arab Cold War and the Struggle for Syria*, 42 MIDDLE E. REP. (Spring 2012), *available at* http://www.merip.org/mer/mer262.

[302] *See* SOHRAB SOBHANI, THE PRAGMATIC ENTENTE: ISRAELI-IRANIAN RELATIONS, 1948-1988, at 4-8 (1989).

[303] Quinton Cannon Farrar, *U.S. Energy Sanctions and the Race to Prevent Iran From Acquiring Weapons of Mass Destruction*, 79 FORDHAM L. REV. 2347, 2350-51 & nn.18-23 (2011).

[304] *Id. See, e.g.*, David E. Sanger, *Harder Push to Stop Iran from Making Nuclear Fuel,* N.Y. TIMES, Dec. 11, 2010, at A6; Cody Coombs, *Blue Morning-Glories in the Sky: Correcting Sanctions to Enforce Nuclear Nonproliferation in Iran*, 19 IND. INT'L & COMP. L. REV. 419 (2009). Mr. Coombs explains the American viewpoint on these events as follows:

> Over the past several decades, Iran has vigorously pursued nuclear technology under the pretense of its need for nuclear energy. However, increasing amounts of evidence have surfaced that suggests that Iran's nuclear program has not been entirely based on peaceful purposes. The International Atomic Energy Agency (IAEA), the enforcement agency behind the Nuclear Nonproliferation Treaty (NPT), has attempted to enforce the NPT provisions of nonproliferation through the use of various sanctions. So far, Iran has refused to comply with NPT provisions. Iran's refusal to comply with the provisions of the NPT, despite IAEA sanctions, has become a reoccurring theme among nuclear threat nations.

*Id.* at 419 (footnotes omitted). These views are echoed in the polite language of diplomacy that appears in the published reports and communiques of the International Atomic Energy Agency:

> As announced by the Director General earlier this week, we met today to discuss the structured approach paper. The Agency team came to the meeting in a constructive spirit with the desire and intention of finalising the paper. We presented a revised draft which addressed Iran's earlier stated concerns. However, there has been no progress and, indeed, Iran raised issues that we have already discussed and added new ones. This is disappointing. A date for a follow-on meeting has yet to be fixed.

*IAEA Statement After Iran Meeting*, IAES PRESS RELEASES, June 8, 2012, http://www.iaea.org/newscenter/pressreleases/2012/prn201216.html (statement by IAEA Deputy Director General Herman Nackaerts). One of the cornerstones of the IAEA Mission Statement is to "verif[y] through its inspection system that States comply with their commitments, under the Non-Proliferation Treaty and other non-proliferation agreements, to use nuclear material and facilities only for peaceful purposes." http://www.iaea.org/About/mission.html. As of April 2012, the IAEA has 154 member nations, including the United States (since 1957), Israel (since 1957), and Iran (since 1958). *See* "Member States of the IAEA," IAEA, http://www.iaea.org/About/Policy/MemberStates/ (last visited Nov. 15, 2012). For other points of view, see, e.g., Mehrzad Boroujerdi & Todd Fine, *Symposium, A Nuclear Iran: The Legal Implications of a Preemptive National Security Strategy*, 57 SYRACUSE L. REV. 619, 628 (2007), in which Professor Boroujerdi and Mr. Fine observe:

had successfully tested missiles that might be used to deliver a nuclear payload to Israel and other nations.[305] Most alarmingly to an MNE considering any new FDI in Israel, previous suggestions[306] of a "pre-emptive" military strike of some sort have resurfaced, and they include public statements by Israel's Prime Minister and Defense Minster that Israel is prepared to take unilateral, military action to thwart Iran's ability to develop nuclear weapons.[307] Indeed, some of the dialogue about the

---

> While the Iranian negotiating style is fierce and clever, the course of the nuclear crisis does not necessarily indicate that Iran is inherently untrustworthy. Iran is attempting to achieve what it can within the rules of a game that is stacked against it. One strange element of the current IAEA farce, for example, is that Iran has voluntarily offered much of the information that has now placed them in trouble. There is no doubt that any agreement with Iran must be accompanied by careful verification and skepticism, but the assumption that they can never be trusted for cultural reasons is discriminatory and borders on racism.

*Id.* at 628 (footnotes omitted), Boroujerdi & Fine also criticize the sanctions-policy as fueling the Iranian approach that the sanctioning nations criticize:

> By not treating the Iranian regime as a legitimate government, the United States excludes Iran from conventional markets and central international institutions. For example, Iran was forced to illicitly pursue nuclear components via the Khan network instead of pursuing normal channels that would appear more consistent with the NPT. The United States has essentially forced Iran to pursue its nuclear program in a way that will raise fears of its hostile intentions.
>
> At the very least, an engagement policy might minimize the security implications of Iran's development of nuclear weapons. Even limited cooperation means that Iran is less likely to fear that the United States aims to topple the regime, the one scenario where Iranian leaders might engage in high risk behavior. If we permit the assumption that their desire for nuclear weapons is not purely aggressive, some of the other motives behind their nuclear policy can be addressed in negotiations. It is precisely these assumptions, such as the inherent need for confrontation, that must be questioned. Once the rigid necessity of halting Iran's nuclear program at all costs is removed as the orienting assumption in the discussion, a number of other possibilities and interesting considerations are opened.

*Id.* at 634 (footnote omitted). For Iran's own articulation of its positions, see the listed Communiques from Iran's Permanent Mission to the IAEA at http://www.iaea.org/newscenter/focus/iaeairan/ms_communications.shtml, and the English-language pages at the website of the Atomic Energy Agency of Iran (AEAI), at http://www.aeoi.org.ir/Portal/Home/. For views that endeavor to walk a *via media*, see PBS—FRONTLINE TEHRAN BUREAU, http://www.pbs.org/wgbh/pages/frontline/tehranbureau/2010/11/iran-primer-timeline-of-irans-foreign-relations.html (last visited Nov. 15, 2012).

[305] *See, e.g.*, *Iran Tests Anti-Ship Missile*, UNITED PRESS INTERNATIONAL, Sept. 25, 2012, http://www.upi.com/Top_News/World-News/2012/09/25/Iran-tests-anti-ship-missile/UPI-95061348576527/; Uzi Rubin, *Showcase of Missile Proliferation: Iran's Missile and Space Program*, ARMS CONTROL TODAY (ARMS CONTROL ASSOCIATION), January/February 2012, http://www.armscontrol.org/act/2012_01-02/Showcase_of_Missile_Proliferation_Irans_Missile_and_Space_Program.

[306] *See*, *e.g.*, Gregory D. Koblentz, *Coercive Nonproliferation: Israel's Use of Coercive Diplomacy to Prevent the Proliferation of Weapons of Mass Destruction*, 2011 Am. Pol. Sci. Ass'n Ann. Meeting 1, *available at* http://ssrn.com/abstract=1900518.

[307] Israeli Prime Minister Netanyahu made the most recent, pointed warnings:

"pre-emptive' strike notion in reputable American sources has taken on a kind of *Dr. Strangelove* quality of surreality.[308]

The implications of armed conflict for FDIs in a conflict zone are obviously not propitious. Perhaps that is why there appears to be no studies published in English exploring the impact of an Israel-Iran conflict on FDI in Israel.[309] Recent studies have focused, however, on the negative impact the present conflicts and regional instability are having on FDI in

---

> In a bravura performance at the UN's General Assembly on September 27th, aimed at winning international support for an attack on Iran's nuclear facilities, he pulled out a picture of a cartoonish bomb intended to show how close the Islamic Republic is to being able to build the real thing.
>
> With a further flourish, he took out a red pen and drew a line near the bomb's neck. That, Mr Netanyahu said, represented the point when Iran would have sufficient 20%-enriched uranium to produce enough of the weapons-grade variety needed for a nuclear warhead. Sanctions, he pointed out, had done nothing to slow the pace of Iran's enrichment programme. On the basis of inspectors' reports by the UN's own nuclear watchdog, the International Atomic Energy Agency (IAEA), he forecast that Iran would get there by the spring or early summer of next year [i.e., in 2013]. When it did, it should be held to have crossed a red line that would trigger a military response, not just on Israel's part, but, by implication, on America's too.

*Iran's Nuclear Programme: A Red Line and a Reeling Rial—Sanctions May Be Taking Their Toll as Israel's Prime Minister Tries to Set a New Red Line to Block Iran's Nuclear Plans,* THE ECONOMIST, Oct. 6, 2012, http://www.economist.com/node/21564229; *see* David Isenberg, *Israeli Attack on Iran's Nuclear Facilities Easier Said than Done*, CATO INSTITUTE (Feb. 13, 2012), *available at* http://www.cato.org/publications/commentary/israeli-attack-irans-nuclear-facilities-easier-said-done.

308 What one might call "Exhibit A" is the article recently appearing in the estimable publication, *Foreign Affairs*: Matthew Kroenig, Essay *Time to Attack Iran: Why a Strike is the Least Bad Option*, 91 FOREIGN AFFS. 78 (2012). Mr. Kroenig's Essay drew a sharp rebuke: Colin H. Kahl, *Not Time to Attack Iran: Why War Should be a Last Resort*, 91FOREIGN AFFS. 16 (2012). The comparisons of Kroenig's article to Stanley Kubric's 1964 film, *Dr. Strangelove, Or How I Learned to Stop Worrying and Love the Bomb,* are striking. *See* Charles Maland, *Dr. Strangelove (1964): Nightmare Comedy and the Ideology of Liberal Consensus* 31 AM. Q. 697, 699-700, 703-05, 708 (1979) (discussing the perverse comedy of discussing "survivable" thermonuclear warfare in magazines "such as *U.S. News and World Report*," that "carried a cover article, 'If Bombs Do Fall,' which told readers that plans were underway to allow people to write checks on their bank accounts even if the bank were destroyed by nuclear attack.").

309 There have been recent studies, however, of the economic consequences of the "cold war" between Iran, Israel, and other Middle Eastern nations. *See* Mohammed Nuruzzaman, *Conflicts Between Iran and the Gulf Arab States: An Economic Evaluation*, 36 STRATEGIC AFFS. 542 (2012) (noting that "[s]cholars and experts have mostly analysed the conflicts through political and strategic prisms while neglecting their economic dimensions"). *See also* Ariel Cohen & Kevin DeCorla-Souza, *Eurasian Energy and Israel's Choices*, 88 MIDEAST SECURITY AND POLICY STUDIES at 3, 32-34 (The Begin-Sadat Center For Strategic Studies—Bar-Ilan University 2011) (observing that "[s]urrounded by unfriendly and unreliable neighbors, Israel is an energy island," and suggesting strategy for maintaining viability of energy infrastructures "to help Israel navigate . . . constantly shifting politics and security" issues). The general media have only recently started to run features considering the impact of an Israel-Iran armed conflict on the economy of Israel. *See, e.g.*, Jean-Luc Renaudie, *Is Israeli Economy Under Threat in case of Iran War?*, MIDDLE EAST ONLINE, Aug. 16, 2012, http://www.middle-east-online.com/english/?id=53931

Middle Eastern nations.[310] The impact of open warfare would be almost unimaginably devastating, especially to energy infrastructure targets such as windmill farms, solar energy arrays, and conventional power plants.[311] Various armed conflicts in the Middle East, Asia, and Africa over the last 50 years have demonstrated the extent of devastation to populations, as well as FDIs, that can occur when armed conflict destroys energy infrastructures.[312]

Some investment advisors have warned that corporate and individual investors should "probably think twice before investing in the Israeli economy until the rhetoric between Israel and Iran cools."[313] Israeli press coverage has included socio-economists who warn the cost of war would be massive, and the damage from an Iranian counterstrike "inestimable;" along with those who contend that "credit default swaps on Israeli bonds – 'a classic measurement of the risk the market assigns to a state' - have not risen," that "the possibility of Israel attacking Iran does not affect whether foreigners invest in the country," and that " a brief, successful Israeli strike could benefit the local economy."[314] Whether Alstom would—or should—share such a sanguine view is a difficult question to answer without a good deal more—and more reliable—data.[315]

---

310 *See, e.g.*, Sedik, *supra* note 29.

311 Alexander E. Farrell et al., *Energy Infrastructure And Security*, 29 ANN. REV. OF ENVIR. AND RESOURCES 421, 429-30 (2004); Karen Smith Stegena et al., *Terrorists Versus the Sun: Desertec in North Africa as a Case Study for Assessing Risks to Energy Infrastructure,* 14 RISK MGMT. 3 (2012); Ali Khajavi, *A Realistic Outlook for Iraq's Oil Production in 2030*, MIDDLE E. ECON. SURV., (July 3, 2012), http://www.mees.com/en/articles/1874-a-realistic-outlok-for-iraqs-oil-production-in-2030 (detailing damage to Iraq's energy infrastructure in the wakes of various wars); *see also* Brett van Niekerk & Manoj S. Maharaj, *Relevance of Information Warfare Models to Critical Infrastructure Protection*, 39 SCIENTIA MILITARIA: S. AFRICAN J. MIL. STUD. 99 (2012); Jennifer Giroux & Caroline Hilpert, *The Relationship Between Energy Infrastructure Attacks and Crude Oil Prices*, J. ENERGY SEC., (October 27, 2009), http://www.ensec.org/index.php?option=com_content&view=article&id=216:the-relationship-between-energy-infrastructure-attacks-and-crude-oil-prices&catid=100:issuecontent&Itemid=352.

312 Jenny Sin-hang Ngai, *Energy as a Human Right in Armed Conflict: A Question or Universal Need, Survival, and Human Dignity*; 37 BROOK. J. INT'L L. 579 (2012).

313 Sean Geary, *How Conflict with Iran would Affect the Israeli Economy*, EMERGING MONEY (Aug. 16, 2012), http://emergingmoney.com/technology/iran-israeli-economy-eis-teva-mlnx/. Mr. Geary continues:

> War with Iran would at minimum cost the Israeli government billions of shekels, and this is assuming that the conflict is confined to areas outside of Israeli sovereignty. If the Iranians were to counterstrike in Israeli territory, the potential pitfalls for the economy are massive.

*Id.*

314 Moti Bassok & Hagai Amit, *Lengthy Iran Conflict Likely To Cost Israeli Economy Billions of Shekels—Former Finance Ministry Director General says Nuclear Iran Involves Considerable Economic Cost to Israel, Adds that War with Iran Would be much more Expensive than Second Lebanon War*, HAARETZ, Aug. 16, 2012, http://www.haaretz.com/business/lengthy-iran-conflict-likely-to-cost-israeli-economy-billions-of-shekels-1.458060

315 As of this writing, the first hopeful note was sounded in many months, for peace rather than war. *See*

However, part of any answer that involves an Alstom FDI in Israel needs to include the availability of political-risk insurance (PRI) protection against the risk of losses on a wind-energy FDI in the event an Israeli-Iranian armed conflict.[316] Indeed, it has aptly been observed that "[a] company's ability to procure PRI is often crucial to its continuing investment in developing countries."[317] Private-market insurance for war and other force majeure-style investment risks exists, but may be prohibitively expensive.[318] As one commentator observed when surveying the availability of private sector political risk insurance in 1996, "[t]he private insurance industry has been called a boutique provider of specialized political risk products as opposed to the more substantial and uniform government programs," because, for example, they do not use "standardized rating schedules" but instead "individually appraise risks on a commercial basis, which is subject to supply and demand considerations

---

David E. Sanger & Eric Schmitt*, To Calm Israel, U.S. Offers Ways to Restrain Iran*, N.Y. TIMES, Sept. 3, 2012, at A1.

316 For a thorough discussion of the kinds of risks inherent to energy FDIs and strategies that have been developed to address those risks, see Erik J. Woodhouse, *The Obsolescing Bargain Redux? Foreign Investment in the Electric Power Sector in Developing Countries*, 38 N.Y.U. J. INT'L L. & POL'Y 121 (2006).

317 Jennifer M. DeLeonardo, Note, *Are Public and Private Political Risk Insurance Two of a Kind? Suggestions for a New Direction for Government Coverage*, 45 VA. J. INT'L L. 737, 739 (2005).

318 In 1996, Maura Perry described the daunting challenges facing private-market FDI insurers:

> There are several characteristics of the political risk insurance market that inhibit insurers' performance and increase the cost of the services they provide. In order to diversify risk, insurers must be able to form large pools of independent insurance contracts. "Independent" means that an event resulting in a claim under one contract must have no bearing on the likelihood of claims under any other contract. Political risk is difficult to diversify because of the relatively small number of political jurisdictions worldwide and the potentially wide-ranging impact of political risk events. The result is that, no matter how large a pool of political risk insurance contracts one may be able to form, a significant proportion of the portfolio is subject to a host of potential claims arising from the realization of a common political risk. The common risk of nationalization faced by oil producers in the Middle East in the 1970's is one example. An insurer will have difficulty achieving stable earnings from a portfolio of contracts subject to similar risks.
>
> The diverse nature of political risks and the non-random manner in which claims arise require insurers to expend resources on understanding the risks they assume. Just as there is a higher research burden imposed on the provider of insurance against death by car accident than on the provider of insurance against death by lightning strike, the provider of political risk insurance must investigate and understand the specific characteristics of each risk to be insured.
>
> A further consequence of carrying a portfolio of interdependent, non-homogeneous and non-random risks is that resources must also be devoted to portfolio management. The insurer must constantly be aware of the business it carries and must engage in hedging techniques, such as purchasing reinsurance, to avoid large simultaneous losses.

Maura B. Perry, *Model for Efficient Foreign Aid: The Case for the Political Risk Insurance Activities of the Overseas Private Investment Corporation*, 36 VA. J. INT'L L. 511, 545-46 (1996) (footnotes omitted).

as well as particular risk characteristics," and thus, the private sector "has never been a particularly robust or stable source of political risk insurance."[319] That is not to say, however, that there is any shortage of insurers and insurance syndicates who offer some form of political risk coverage; but it is not always easy to estimate what kinds of coverage limits and premiums will attend to PRI issued in the private sector.[320] Indeed, when the "Arab Spring" came to Egypt in 2011, PRI premiums for projects in Egypt quickly rose 12%-15%.[321]

For American businesses, the Overseas Private Investment Corporation (OPIC) has provided PRI for FDIs in countries specifically listed by Congress in the legislation authorizing OPIC:

> From its inception in 1971, OPIC has been charged with operating a political risk insurance business that both supplements the private sector and earns a profit. According to its authorizing legislation, the agency is to avoid competition with private sector sources of finance and political risk insurance by serving as the financier or insurer "of last resort." At the same time, OPIC is to earn sufficient revenue from its activities to operate on a self-sustaining basis.[322]

OPIC insurance has traditionally provided ten times the coverage limits for nearly seven times the policy duration limits for a wider range of risks than PRI offered in the private insurance markets.[323] However, OPIC strictly limits its policy holders to three categories of insureds, each

---

319 *Id.* at 536 (1996) (footnote omitted).

320 *See, e.g.*, Lijana Baublyte et. al., *Political Risk Underwriting in the London Insurance Market: How Do They Do It?* 11TH GLOBAL CONF. ON BUS. AND ECON. (2011) (demonstrating that "the basis of decision-making and risk selection [in the London Political Risk Insurance (PRI) market] is still largely based on a face-to-face approach with such factors as trust, reputation and intuition playing an important role"); *see, e.g*, *Political Risks Insurance,* LLOYD'S, http://www.lloyds.com/Redirect-pages/Risk_locator/Political_risks_insurance (discussing differences in location of risk, and thus ranges of premiums, for "political risks insurance," including "trade-related cover"; "other asset cover"; "insurance of assets against political violence"; and "global contract") (last visited Nov. 15, 2012).

321 Cyril Tuohy, *Egypt Causes Price Spike For Political Risk Insurance—Expert Sees a "Pause" in the Marketplace for Political Risk Insurance as Carriers Scramble to Reassess Middle East Exposures*, RISK & INS., Feb. 11, 2011, http://www.riskandinsurance.com/story.jsp?storyId=533329908.

322 Perry, *supra* note 318, at 513 (1995) (footnote omitted); Pablo M. Zylberglait, Note, *OPIC's Investment Insurance: The Platypus of Governmental Programs and Its Jurisprudence*, 25 L. & POL'Y INT'L BUS. 359 (1993).

323 Perry, *supra* note 318, at 534-36; Ashton B. Inniss, Note, *Rethinking Political Risk Insurance: Incentives For Investor Risk Mitigation*, 16 SW. J. INT'L L. 477, 488-90 (2010).

of which has a substantial nexus to the United States and each of which is essentially under American control:

> [1] a U.S. citizen;
> [2] a corporation, partnership, or other association created under the laws of the U.S., its states, or territories beneficially owned by U.S. citizens; or
> [3] a foreign business at least 95 % owned by U.S. citizens or by associations owned by U.S. citizens.[324]

Neither Alstom, nor its American subsidiary,[325] meet these definitions. Obviously, Alstom is unlikely to qualify for OPIC-issued insurance on a Golan Heights FDI, even considering the substantial involvement of Alstom's Texas-based nacelle production facility in such an undertaking. However, Alstom has at least two other sources of government-backed FDI political risk insurance—programs offered through the World Bank, and through its home state, France.

Indeed, it is precisely because "[m]any national insurance programs"—such as OPIC—"due to their respective national objectives, contain strict eligibility requirements that exclude many investors and investments" that the World Bank Group created the Multilateral Investment Guarantee Agency (MIGA),[326] an international financial institution offering political risk insurance guarantees for FDIs in developing-world countries, to "overcom[e] some of these shortcomings

---

324 Paul E. Comeaux & N. Stephen Kinsella, *Political Risk in Developing Countries: Bilateral Investment Treaties, Stabilization Clauses, and MIGA & OPIC Investment Insurance*, 15 N.Y.L. SCH. J. INT'L & COMP. L. 1, 36 (1994).

325 *See, e.g.*, Kathryn Gordon, *Investment Guarantees and Political Risk Insurance: Institutions, Incentives, & Developments*, OECD (Investment Division Working Papers 2009/1, at 8) (noting that only "[s]even PRI providers offer coverage for foreign corporations with domestic presence (Australia, Austria, Belgium, France, Netherlands, Turkey and the United Kingdom)"), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1718484. The Amarillo, Texas facility is owned by an entity loosely referred to as "Alstom Wind, North America" (AWNA) (http://www.ryancompanies.com/projects/Alstom-Wind-North-America/), but which appears to in fact be a limited-liability corporation called Alstom Wind Texas LLC, which is a Delaware corporation headquartered in Connecticut. *See, e.g.*, *Alstom Wind Texas LLC*, BIZAPEDIA, http://www.bizapedia.com/de/ALSTOM-WIND-TEXAS-LLC.html. Alstom's Amarillo facility is one of 37 it maintains in the U.S., divided among Grid,Transport, Power, and Corporate Headquarters segements of Alstom's businesses, which employ "10,000 employees in locations that span 47 states and the District of Columbia." *See supra* note 132.

326 MIGA was actually the product of the World-Bank sponsored Convention Establishing the Multilateral Investment Guarantee Agency, which opened for states' signatures in October 1985 and entered into force in April 1988. Malcolm D. Rowat, *Multilateral Approaches to Improving the Investment Climate of Developing Countries: The Cases of ICSID and MIGA*, 33 HARV. INT'L L.J. 103, 105 & n.9, 126-34 (1992).

and hel[p] to fill the gaps."[327] MIGA's PRI is structured and operated similarly to the PRI offered by OPIC; however, MIGA operates with a number of broad policy objectives beyond those that animate OPIC's activities.[328] For example, as one of the entities constituting the World Bank, MIGA is among—

> the Group's individual institutions [which] have also introduced programs dedicated to creating and promoting an ethical code for businesses. The Group's institutions have produced guidelines that concern several independent fields and outline certain requirements that must be satisfied before and during project financing. These guidelines and their underlying policies address environmental protection, sustainable development, and the protection of indigenous peoples and reflect general principles of international law although they do not explicitly refer to them. In order to strengthen the guidelines and increase borrower accountability, the Group provides two grievance mechanisms that allow for individual complaints concerning major projects. The Inspection Panel (Panel), established in 1994, receives complaints concerning loans under the IDA or IBRD. After the Group created the Panel, other development banks established similar accountability mechanisms. The establishment of a Compliance Advisor/Ombudsman (CAO) to govern complaints concerning the IFC and the MIGA followed the establishment of the Panel 1999.[329]

MIGA is, however, somewhat of an enigma. While since its inception some 175 nations have acceded to the MIGA Treaty, and MIGA has insured aggregate amount exceeding $21 billion of guarantees for over 600 projects, "[t]o date, MIGA has only paid out three claims" (while negotiating a resolution in "fifty disputes over its guaranteed investments

---

[327] Comeaux & Kinsella, *supra* note 324, at 40-45.

[328] Inniss, *supra* note 323, at 490-92; *see also* Lisa J. Laplante & Suzanne A. Spears, *Out of the Conflict Zone: The Case for Community Consent Processes in the Extractive Sector,* 11 YALE HUM. RTS. & DEV. L.J. 69, 78-79 & nn.50-55 (2008).

[329] Miriam Mafessanti , *Corporate Misbehavior & International Law: Are There Alternatives To "Complicity"?,* 6 S.C. J. INT'L. L. & BUS. 167, 224-24 & nn.382-87 (2010) (footnotes omitted). MIGA " has developed Environmental and Social Review Procedures and Safeguard Policies, modeled on the Performance Standards of the [International Finance Corporation], which bind its private sector clients." *Id.* at 229 & n.427.

to prevent claims filings").[330]

France, too, has its own national insurer of French firms seeking to protect their FDIs, an agency called Compagnie Française d'Assurance Pour Le Commerce Extérieur, known by the acronym COFACE.[331] Founded in 1946 as a French governmental agency and privatized in 1990, COFACE is an example of an export credit agency (ECA), which many countries have created[332] in the last 60 years to insure foreign sales transactions and longer-term FDI projects undertaken by home-state businesses.[333] COFACE offers political risk insurance along the general outlines of OPIC's program—and Alstom easily qualifies as one of those companies eligible to become insureds of COFACE.[334] Political risk can be insured for periods of 5 to 15 years, at premiums ranging from 0.7% to 1% of the total value of the investment.[335] How COFACE might go about assessing the risks posed by Alstom's hypothesized Golan Heights FDI is unknowable; COFACE "has a proprietary risk evaluation system."[336]

Similarly to COFACE (but in contrast to OPIC), Lloyd's of London, the world's most famous private insurance market, provides little transparency into premiums of its PRI product, the methodology for calculating premiums, the limits of financial exposure which Lloyd's syndicates are willing to assume, or how those limits are determined.[337] In

---

330 Sam Foster Halabi , *Efficient Contracting Between Foreign Investors And Host States: Evidence From Stabilization Clauses*, 31 NW. J. INT'L L. & BUS. 261, 274-75 (2011).

331 *Who We Are*, COFACE, http://www.coface.com/CofacePortal/COM_en_EN/pages/home/Who_we_are (last visited Nov. 15, 2012).

332 See the listings and details for numerous ECAs in Janet Koven Levit, *The Dynamics of International Trade Finance Regulation: The Arrangement on Officially Supported Export Credits,* 45 HARV. INT'L L.J. 65, 142-50 & nn.345-78 (2004).

333 *See, e.g.*, *id.*; *see also PRI Essentials*, POLITICAL RISK INSURANCE CENTER, http://www.pri-center.com/directories/priessentials.cfm (last visited Nov. 15, 2012) ("Most public providers are national export credit agencies (ECAs), which may cover both export credit/trade transactions, as well as longer-term investments. ECAs usually support investors and lenders from their home country going into developing countries, and may also have mandates to support development and be self-sustaining.").

334 Sidney Posel, *Factoring Accounts Receivable in France: Some Legal Aspects and American Comparisons*, 57 TUL. L. REV. 292, 326 n.124 (1982) (noting that COFACE offers credit insurance against "political risks" for foreign investors).

335 Perry, *supra* note 318, at 584 (table).

336 Gordon, *supra* note 325, at Annex Table 8.

337 LLOYD'S, *supra* note 320. Sagicor, one of the Lloyd's syndicates, states that its "program line" limit for political risk insurance is $7.5 million. *Political Risk, Credit, Surety and Terrorism*, SAGICOR AT LLOYD'S (2012), http://www.sagicoratlloyds.com/sagicor-lloyds/pecuniary-lines. *See also* Nathan Jensen, *Political Risk, Democratic Institutions, and Foreign Direct Investment*, 70 J. POL. 1040, 1043, n.36 (2008) (noting that "[p]olitical risk insurers charge premiums for political risk coverage against the confiscation of firms' assets (expropriation risk), restricting the repatriation of profits or other capital transactions (transfer risk) or risks associated with war or civil

2012, one of the Lloyd's brokers, RFIB Group, noted that the private market for PRI is centered in London, where 10 corporate entities—of which Chartis, Sovereign, and Zurich are dubbed "the 'big three' "—and 25 syndicates on Lloyd's market are involved in negotiating and issuing political risk insurance.[338] Fifteen London-based brokers interact with these insurers to create the bulk of the private pool of insurance contracts to cover credit and political risks.[339] The private-market PRI policies are limited in duration, as well as in coverage limits; most fall within the range of two to three years, and as the tenor is lengthened, the number of insurers with the capacity to insure decreases; the outermost private-market limits are 15 years, which are available from only a few of the private-market insurers.[340]

From this general information about PRI and insurance markets, we can make several observations regarding Alstom's hypothesized Golan Heights investment. First, it is likely that Alstom can find PRI coverage for its Golan Heights FDI from a number of different sources, both public and private. Second, Alstom must be scrupulously careful to avoid bribery of any government official, or even the arguable appearance of bribery, not only because of anti-bribery laws such as the Foreign Corrupt Practices Act[341] and the OECD Anti-Bribery Convention,[342] but also

---

disturbance (political violence risk)," but that it "does not cover all types of political risk, . . . coverage is expensive"; the "political risk insurance industry remains far less quantitative than other parts of the insurance industry"; [a] study commissioned by the Federal Reserve Bank of New York found that the cost of political risk insurance coverage was one of the major reasons why most firms don't purchase political risk insurance coverage"; "much of the political risk insurance coverage is essentially the same product used 50 years ago and . . . doesn't appropriately cover a number of important risks faced by multinationals.").

[338] TOBY HEPPEL, RFIB GROUP, THE PRIVATE INSURANCE MARKET FOR CREDIT AND POLITICAL RISKS 4 (2012), *available at* http://www.afdb.org/fileadmin/uploads/afdb/Documents/Generic-Documents/Toby%20Heppel%20Presentation.pdf.

[339] *Id.* at 5. Chubb Insurance Group withdrew from the credit and political risks market in May 2010. *Id.* at 8.

[340] *Id.* at 9; Nathan Jensen, *supra* note 337, at 1042-43 & nn.32-36.

[341] 15 U.S.C. §§ 78dd-1. Recent U.S. enforcement efforts have focused on foreign MNEs. *See* Leslie Wayne, *Foreign Firms Most Affected by a U.S. Law Barring Bribes*, N.Y. TIMES, Sept. 4, 2012, at B1 (noting that nine of the 10 MNEs that most recently have reached large settlements with the U.S. Justice Department have been foreign, including a French MNE, Alcatel-Lucent). In recent years, Alstom has had a number of serious allegations of bribery in FDI leveled against it. *See* Claudio Gatti, *Alstom at Center of Web of Bribery Inquiries*, N.Y. TIMES, April 29, 2010, http://www.nytimes.com/2010/03/30/business/global/30alstom.html. However, Alstom, S.A., may no longer be directly subject to the Act because, inter alia, its shares are no longer traded on U.S. stock exchanges, one of the bases for jurisdiction, and are now exclusively traded on the Paris Stock Exchange. *See supra* at §78-1(a); *see, e.g.*, *New York Stock Exchange to Suspend Trading in ALSTOM and Moves to Remove From the List*, NYSE EURONEXT, Aug. 13, 2004, http://www.nyse.com/press/1092392705795.html.

[342] *See OECD Convention on Combating Bribery of Foreign Public Officials in International Business*

because an allegation of bribery in connection with the FDI typically is itself grounds for retroactive cancellation of the PRI policy and denial of any coverage for an occurrence.[343] Third, Alstom must take heed of the moral-hazard clauses in FDI insurance that "exclude coverage of events that the insured entity might reasonably have been expected to avoid"[344]—such as undertaking an investment in areas during a time when armed conflict may, from a post hac perspective, have seemed imminent. Fourth, finding a PRI policy sufficient to satisfy the extent of coverage needed should war between Israel and one of it neighbors eventuate may be difficult, given the relatively modest coverage limits available in private markets. Even the higher limits available through an export credit agency such as COFACE (or OPIC, if an Alstom subsidiary were to qualify) may be taxed to compensate Alstom in the event war or terrorism destroys the hypothesized Golan Heights wind farm. Alstom's comparable wind-farm projects in other areas of the world are valued at least ten times greater than even the most generous coverage limit ($20 million) provided by OPIC.[345] Like many FDI projects, this one risks

---

*Transactions*, OECD (2011), http://www.oecd.org/daf/briberyininternationalbusiness/anti-briberyconvention/oecdconventiononcombatingbriberyofforeignpublicofficialsininternationalbusinesstransactions.htm. Both France, *France – OECD Anti-bribery Convention*, OECD, http://www.oecd.org/daf/briberyininternationalbusiness/anti-briberyconvention/france-oecdanti-briberyconvention.htm, and the United States, *United States – OECD Anti-Bribery Convention*, OECD, http://www.oecd.org/daf/briberyininternationalbusiness/anti-briberyconvention/unitedstates-oecdanti-briberyconvention.htm, have ratified the Convention and enacted implementing legislation, Prior to implementing the OECD Convention, France seemed to treat bribery of foreign officials as cost of doing business. *See, e.g.*, Scott D. Syfert, *Capitalism or Corruption? Corporate Structure, Western Investment and Commercial Crime in the Russian Federation*, 18 N.Y.L. SCH. J. INT'L & COMP. L. 357, 403 (1999) (observing that at the time, "payments in most of the world [we]re considered a routine cost of business," and citing the example of COFACE, which at the time "over[ed] foreign bribery as export risk"); Christopher F. Dugan & Vladimir Lechtman, *The FCPA in Russia and Other Former Communist Countries*, 91 AM. J. INT'L L. 378, 379 (1997) ("Essentially free from legal constraints, Japanese, European and Russian businesses are reported to rely freely on bribes to obtain what they want. The United States is virtually alone in outlawing bribery of foreign officials, in stark contrast to other states' conscious acquiescence in overseas "commissions." The French agency Coface, a government entity providing credit and insurance to French investors in the Third World, has been charged with active participation in such transactions.").

343 Gordon, *supra* note 325, at 9 (noting presence of such clauses in COFACE insurance contracts). The World Bank recently debarred two Alstom subsidiaries because their employees allegedly offered bribes to Zambian government officials in the early 2000s to win a contract for power plant construction. *See* Dionne Searcey & David Crawford, *World Bank Punishes Units of Alstom SA for Bribery*, WALL ST. J., Feb. 23, 2012, http://online.wsj.com/article/SB10001424052970203918304577238943984834040.html

344 Gordon, *supra* note 325, at 3.

345 Energix's predecessor, Multimatrix, aspired to build 160 wind turbines on the 18-acre area, and generate 450 MW of power. Ari Rabinovitch, *Israel Uses Golan To Build Wind Energy Industry,* REUTERS, Apr. 29, 2010, http://uk.reuters.com/article/2010/04/29/us-israel-energy-wind-idUKTRE63S37320100429. Comparably, recent Alstom projects provide a good gauge by which to measure the magnitude of the FDI value

being underinsured.[346] A challenge is therefore presented to Alstom as it seeks to protect its FDI. "[T]he limits of insurance and the number of deductibles are typically determined on a per occurrence basis," and "[i]f the per occurrence limit of insurance is adequate to cover the insured's loss, it does not matter whether a loss involves one occurrence or multiple occurrences"; but where the per occurrence limit of insurance does not fully compensate the insured for its loss, whether a loss constitutes one occurrence or multiple occurrences can be a significant issue."[347] Of course, Alstom might seek to deal with these limits by taking out multiple policies[348] of PRI,[349] and by seeking a definition of insurable "occurrence" or "loss" that would cover to policy limits the sub-units of the project, such as each wind turbine, rather than merely the project as an

---

for comparison to political risk coverage limits *See, e.g.*, *Alstom Builds Whitelee Onshore Wind Farm*, ALSTOM (Sept. 2010), http://www.alstom.com/uk/projects/power/whitelee/ (describing $250 million (_200 million) project for "Scottish Power Renewables . . . to build a 217 MW extension to the Whitelee wind farm in Scotland" of some 75 wind turbines under a contract including "supply, transportation, installation, commissioning, and operation [and] maintenance"); *Alstom Will Supply Equipment To Four Wind Farms In Brazil*, ALSTOM (SEPT. 4, 2012), http://www.alstom.com/press-centre/2012/4/85822/ (describing contract valued at $165 million (_130 million) in which, "[i]In addition to the [supply and installation of 40] wind turbines, Alstom will be responsible for the supply and installation of electrical systems and substations throughout the complex" located in the Brazilian State of Rio Grande do Sul). Even very modest wind-farm projects, such as Alstom's in Ethiopa, would appear to exceed even OPIC coverage limits. *See Alstom Grid Wins Subcontract With CYMI For Around _17 Million Project To Supply Equipment For Ethiopian Electric Power Corporation*, ALSTOM (June 12, 2012), http://www.alstom.com/press-centre/2012/6/alstom-grid-wins-subcontract-with-cymi-for-around-17-million-project-t ("Alstom has signed a subcontract with Spanish company CYMI (ACS Group), to supply and manufacture equipment for the Ethiopian Utility (EEPCO) as part of the Electricity Transmission System Improvement Project (ETSIP) in Ethiopia"); *see also Following a Planning Hitch, Ethiopia's First Wind Farm is Back on Track—After Some Three Years of Planning, Securing Financing, and Infrastructure Work, Sub-Saharan Africa's Largest Wind Farm is Poised for Completion in Ethiopia's Tigray Province*, RENEWABLES INTERNATIONAL, (Oct. 5, 2011), http://www.renewablesinternational.net/following-a-planning-hitch-ethiopias-first-wind-farm-is-back-on-track/150/505/30897/ (noting Alstom's supply of 54 turbines as part of _ 283 million project).

[346] Alex Khachaturian, *"Are We in Good Hands?" The Adequacy of American and Multilateral Political Risk Insurance Programs in Fostering International Development*, 38 CONN. L. REV. 1041, 1044, 1054-55, 1057-62 (2006) (noting gaps in political risk insurance coverage plans).

[347] Scott G. Johnson, *Ten Years After 9/11: Property Insurance Lessons Learned*, 46 TORT TRIAL & INS. PRAC. L.J. 685, 687 (2011) (footnotes omitted).

[348] Given Alstom's resources and ability to obtain the attention of government officials, it might be in a position to persuade public political risk insurers (such as OPIC and MIGA) to partner with private political risk insurers *as co-insurers* to increase coverage amounts, encourage more insurers to have confidence in insuring a particular risk, and to put their " real informational advantage" to work in "act[ing] as a superior sorter of risk. DeLeonardo, *supra* note 317, at 781-89.

[349] Insurance against terrorism risks will be required as well, and the insurability of those risks in the wake of highly organized terror-attacks against public infrastructure targets has tightened the market. *See* Andrew Gerrish, Note, *Terror CATs: TRIA's Failure to Encourage a Private Market for Terrorism Insuranceand How Federal Securitization of Terrorism Risk May Be a Viable Alternative*, 68 WASH. & LEE L. REV. 1825 (2011).

entirety.[350]

Thus, Alstom will have to make, as it and other MNEs that work in politically volatile regions must do before each FDI, a careful cost-benefit analysis:

> In addition to availability of particular political risk coverage, the cost of such coverage may be a factor. As a general rule, premiums for political risk coverage will be higher in certain countries than others. Private insurers tend to be more expensive, but can often be more flexible in the amount and types of coverage offered for particular risks than multilateral agencies, like MIGA, or export credit agencies (ECAs) sponsored by specific governments. The availability and cost of political risk insurance should be weighed against the benefits, after a careful review of deductible limits and exclusions offered by a given provider, the provider's payment history in the host country, and the availability of other mitigating factors. Such factors include the existence of a reliable bilateral

---

[350] An analogous issue was presented concerning property insurance on the World Trade Center towers, which were destroyed on September 11, 2001 and is detailed by World Trade Center Properties, LLC v. Hartford Fire Ins. Co., 345 F.3d 154 (2d Cir. 2003), *abrogated on other grounds by*, Wachovia Bank v. Schmidt, 546 U.S. 303 (2006). (The owners had obtained property insurance binders for the complex from some two dozen insurance companies, in the aggregate amount of $3.5 billion "per occurrence." When the owners made a $7 billion insurance claim—purporting to treat the destruction of each tower as a separate "occurrence"—the insurers insisted that the events constituted but one occurrence, limiting payment to $3.5 billion. Litigation ensued, and complications arose from the fact that "occurrence" was defined in draft policy language circulated to some of the insurers as "all losses or damages that are attributable directly or indirectly to one cause or to one series of similar causes."). For a discussion of the implications of this litigation for commercial insureds and insurers, see Scott M. Seaman & Jason R. Schulze, *World Trade Center Litigation*, *in* ALLOCATION OF LOSSES IN COMPLEX INSURANCE COVERAGE CLAIMS "at § 7.9 (2011); *see also* Irene S. Kaptzis, Note, *Looking Beyond the Sunset: International Perspectives on the Terrorism Risk Insurance Act of 2002 and the Issue of its Renewal*, 29 BROOK. J. INT'L L. 827, 855-56 & n.179 (2004); Scott G. Johnson, *Ten Years After 9/11: Property Insurance Lessons Learned*, 46 TORT TRIAL & INS. PRAC. L.J. 685, 686-87 (2011) (noting "myriad of coverage issues, including the number of occurrences, the period of indemnity for time element coverage, the meaning of physical loss or damage, civil authority and ingress and egress coverages, contingent business interruption coverage, insurable interest, contamination and consequential loss exclusions, terms of insurance binders, the scope of replacement cost, and salvage and recoveries, among others"). Eventually, some of the insurers were found to have bound themselves to a definition of occurrence that treated the destruction of each tower as a separate occurrence. SR Intern. Business Ins. Co., Ltd. v. World Trade Center Properties, LLC, 467 F.3d 107, 140 (2d Cir. 2006) (noting that "the jury's determination that the insurers provided different coverage is . . . a reflection of the fact that the parties were at various stages of negotiating coverage when the two hijacked airplanes destroyed the WTC"). For an excellent discussion of the problem more generally for the insurers and insureds, see Michael Murray, Note, *The Law of Describing Accidents: A New Proposal for Determining the Number of Occurrences in Insurance*, 118 YALE L.J. 1484 (2009), which would provide much food for thought to Alstom and its counsel when Alstom seeks to insure risks such as the ones emanating from a hypothesized Golan Heights FDI.

> investment treaty, the negotiation of an investment agreement for the project, the availability of international arbitration to enforce contractual obligations, an [MNE's] familiarity with the host country and its courts, and opinions of experienced counsel. Based on this type of comparative analysis, many [MNE]s will elect to self-insure or partially self-insure for all or certain elements of political risk in a given host country, or to rely on other forms of risk mitigation, particularly in exceptionally high-risk countries where insurance premiums will be high or the desired coverage either limited or unavailable.[351]

What makes Alstom's hypothesized FDI in Israel more complex and challenging is that it is not the host country's actions toward Alstom that pose the significant risks. Rather, the risks emanate from actions that Israel and the neighboring states of Syria and Iran may take against the other.

## IV. SUMMATION

In a recent interview, the Chair of the American Bar Association's House of Delegates, attorney Linda Klein, observed that "'U.S. lawyers are going to have to be part of the global economy and international legal industry, or they won't survive.'"[352] Similarly, MNEs in Europe will need to look outside the Euro Zone for FDIs, if they are to pursue a path of continuous growth. Using lessons from courses in International Business Transactions (IBT) and International Civil Litigation (ICL), we have constructed a framework within which European MNEs can make an initial evaluation of proposals for FDIs outside of the Euro Zone. We fleshed out that framework as we considered an hypothesized—yet, entirely plausible—investment by Alstom, S.A., in Israel's energy sector: joint-venturing with Israel's Energix-Renewable Energies, Ltd., to build a 75-turbine farm for generating electricity on the wind-swept Golan Heights.

A major energy infrastructure project in disputed territory within a politically volatile and strategic area of the world calls forth many of the key issues, with business and legal aspects intertwined, that IBT and ICL address: legal, regulatory and business environments of the host state;

---

[351] Randel R. Young & Richard Devine, *Managing Risk in Emerging Market Hydrocarbon Development Projects*, 55 ROCKY MTN. MINERAL L. INST. § 30.07 (2009).

[352] Meredith Hobbs, *Ideas Follow Klein from ABA Stint: After Chairing House of Delegates for Two Years, she Ponders Lawyers' Challenges Overseas and at Home*, DAILY REPORT, Aug. 17, 2012, at 3.

politics, diplomatic relations, as well as legal, regulatory, and business environments of the MNE's home state; and political, diplomatic, as well as legal, regulatory, and business environments of the home state's broader political affiliations (such as EU membership) as well as of third states that are seen to provide "magnet" fora for litigation (including Canadian courts and the U.S. federal courts, the latter used obiquitously by an array of plaintiffs in efforts to regulate MNE activities).

This article has demonstrated how a multi-stage paradigm might be applied to identify potential FDIs worth further investigation and more detailed development.

In Stage One, we analyzed the general business and regulatory environment for a proposed FDI, including a close, fact-intensively detailed examination of the host state, Israel; the MNE, Alstom, S.A.; the proposed FDI project, a greatly expanded and updated wind-power project on the Golan Heights to generate badly-needed electricity for Israel's rapidly increasing demand; the proposed form of the FDI, a joint venture with a host-state partner; and the proposed host-state joint venture partner, Energix, Ltd., a small Israel-based company traded on the Tel-Aviv Stock Exchange that purchased Multimatrix's stake in a two-decades old, outdated wind farm on the wind-swept Golan Heights in Israeli territory annexed from (but still claimed by) Syria after the 1967 "Six-Days' War," upon which it proposes to site numerous, modern electricity-generating wind turbines.

Having established the parameters of the FDI proposal, we next articulated, and evaluated critically, the three most significant arguments in favor of the MNE undertaking the proposed FDI project: [1] that Israel's need for electrical power currently exceeds supplies and will continue to grow; [2] that electricity generated by wind turbines is a sustainable energy source that has great room for growth in Israel and increases Israel's energy independence; and [3] that Israeli government support for wind-generated electrical power is growing, and Israel's FTA Agreement with the U.S. will permit Energix to import Alstom's American-made wind turbines duty-free. This evaluation included an objective evaluation of potential bias and interest in the sources used in formulating the FDI proposal, as well as an examination of other supporting reasons for the FDI, including Alstom's expertise in wind-turbines and wind-farm installation and management, as well as Alstom's familiarity with the region's politics and its unwavering commitment to a previously undertaken FDI in Israel, the Jerusalem Light Railway.

Having determined in Stage One that the Alstom's hypothesized FDI in Israel commands arguments of substance in its favor, we proceeded to the Stage Two analysis, in which we began with a deeper look at strategic advantage from the IBT perspective, particularly as to the specific provisions of relevant Free Trade Agreements (FTAs) and Bilateral Trade Agreements (BITs) among states relevant to the FDI. We discovered that the EU had superseded the 1983 France-Israel BIT with an EU-Israel Trade Association Agreement, and that latter agreement has already led to litigation in the European Court of Justice, *Brita GmbH v. Hauptzollamt Hamburg-Hafen,*[353] in which the ECJ confirmed that products originating in the Occupied Territories are excluded from the benefits of the Agreement. While this ECJ ruling does not necessarily prortend retorsion by Israel through heightened tariffs of EU-originated equipment (such as Alstom's wind turbines), the dispute around the legitimacy of Israel's commercial and development activities in the Occupied Territories poses potential complications for an FDI site in any of those lands. Thus, we observed that the Alstom's newly-established production facility in Texas may permit Alstom to build its turbines for a Golan Heights FDI in the United States, and thereby allow Alstrom to enjoy the advantages of the U.S.-Israel FTA while simultaneously opening a path to ensure importation of Alstom's wind turbines into Israel without ensnarement in escalating EU rhetoric, or in trade-related actions and rulings, designed to discourage Israel's continued exercise of sovereignty over the Occupied Territories.

Navigating the trade-agreement landscape may prove, however, the least of Alstom's problems with legal risk. We identified additional—and significant—legal risks using the analytic paradigms studied in International Civil Litigation. These paradigms enhanced our understanding of the deeper-seated legal and political risks involved in a proposed FDI, which include the nature and scope of litigation filed against MNEs over FDI-related issues. Municipal human-rights laws of various jurisdictions provide a potentially potent source of legal risk. Accordingly, Stage Two next penetrated deeply into various municipal legal systems whose laws may come into play in a variety of ways—e.g., because of the MNE's home state affiliation, the diplomatic relations and international political situation of the host state, and the connection of an FDI project to other states. Thus, we examined recent litigation against Alstom in the courts of Nanterre Province, France, challenging as a violation of international law its FDI in the Jerusalem Light Railway;[354] against another company's Occupied-Territory investment filed in the

---

353 *Brita Case*, *supra* note 169.

354 *August & Debouzy*, *supra* note 190.

courts of Québec Province in Canada, *Bil'In (Village Council) & Yassin v. Green Park International Inc.*;[355] and against Caterpillar, Inc. in the United States federal courts for the death of an activist protesting Israel's razing of Palestinian residences to make way for Israeli homes, in a highly-publicized case, *Corrie v. Caterpillar, Inc.,*[356] filed under the Alien Tort Statute[357] by the parents of the activist. Because of the escalation of federal court litigation against MNEs under the Alien Tort Statute, we devoted special and extended attention on the developing case-law in the area, culminating in a Circuit Court case currently before the U.S. Supreme Court, *Kiobel v. Royal Dutch Petroleum,*[358] which has the potential either to solidify some 32 years of judicial precedent expanding the scope of the Alien Tort Statute— or effectively to end Alien Tort Statute suits against most MNEseither on the ground that corporations are not juridical persons under the statute or that the statute does not reach MNE conduct that occurs outside of U.S. territory. In any event, the risks of Alien Tort Statute litigation against MNEs such as Alstom remains, for now, real and palpable; and pending cases such as *Sarei v. Rio Tinto, PLC*[359] —brought by citizens of Papua, New Guinea against an Anglo-Australian mining company alleged to have commited human rights violations occurring entirely in New Guinea— demonstrate the risks for Alstom and strongly suggest that MNEs need to become involved in the legislative, as well as judicial, processes which are reconsidering the ATS's scope if MNEs hope to see the extraterritorial application of this statute trimmed.

Finally, we examined the risks that the policital situations in Syria and Iran pose to Alstom's FDI in Israel. With the potential for damage to, or destruction of, a Golan Heights FDI should the Syrian conflict widen, or in the event Israel launches a preemptive strike against Iran's nuclear fuel enrichment facilities, we examined the concept of political risk insurance. In reviewing the paradigms of political risk insurance for FDIs available

---

355 *Bil'In*, *supra* note 195.

356 503 F.3d 974, 979 n.5 (9th Cir. 2007). *See supra* notes 249-257 and accompanying text.

357 28 U.S.C. § 1350. *See supra* notes 215-248 and accompanying text.

358 621 F.3d 111 (2d Cir. 2010), *reh'g denied* (with concurring opinion filed by Chief Judge Jacobs), 642 F.3d 468 (2d Cir. 2011), *reh'g en banc denied* (with concurring opinion filed by Chief Judge Jacobs and dissenting opinions by Judges Lynch and Katzmann), 642 F.3d 379 (2d Cir. 2011), *cert. denied*, 132 S. Ct. 248 (Sept. 3, 2011), *cert. granted*, 132 S. Ct. 472 (Oct. 17, 2011), argued Feb. 27, 2012 and set for reargument and supplemental briefing during October Term 2012, *see* Order List for 565 U.S., Case 10-1491, issued March 5, 2012, available from link at http://www.scotusblog.com/case-files/cases/kiobel-v-royal-dutch-petroleum-et-al/. See *supra* notes 258-283 and accompanying text.

359 671 F.3d 736 (9th Cir. 2011) (en banc), *petition for cert. filed*, 80 USLW 3335 (Nov 23, 2011) (NO. 11-649). *See supra* notes 258-260 and accompanying text.

under the international MIGA program, national programs such as OPIC and COFACE, and private insurance markets, we examined their various strengths and weaknesses in detail, and noted critical issues that Alstom would have to address both in negotiating for such coverage as well as in making the economic decision whether the Golan Heights project was worth the cost of adequate political risk insurance.[360]

The point in discussing the many FDI issues and actors that we have covered is not to reach a specific conclusion or to counsel a particular outcome. Particularly since the FDI itself is hypothetical only, deciding whether Alstom should undertake it, and if so, how it should be structured, is unnecessary for our purposes. Rather, the point is the intellectual journey itself that we made through these issues, and the rich array of resources that we have located, organized, and made available throughout the copious footnotes in this article, which will well serve future FDI analyses. As Jean-Yves Tadie said of Marcel Proust's *In Search of Lost Time* (*À la Recherche du Temps Perdu*), the "ability to fashion a general interpretation from ostensibly ephemeral events and characters is precisely what makes these events and characters free of any apparent staleness," because "we are able to slip into Proust's world and can apply his analyses to the company we find ourselves in or the situations we face."[361] So, too, are we able to slip into Alstom's world created by this hypothesized FDI; and once there, we can apply the analytic paradigms developed in this article to businesses we find ourselves advising, and to the FDI decisions they must make.

---

[360] *See supra* notes 284-353 and accompanying text.

[361] Jean –Yves Tadie, *Introduction*, *in* 1 MARCEL PROUST, IN SEARCH OF LOST TIME (Swann's Way) xii (C.K. Scott Moncrieff & Terence Kilmartin, trans., Folio Society 2000).

# "PACKAGE DEAL": THE CURIOUS RELATIONSHIP BETWEEN FIDUCIARY DUTIES AND THE IMPLIED COVENANT OF GOOD FAITH AND FAIR DEALING IN DELAWARE LIMITED LIABILITY COMPANIES

MONICA E. WHITE*

## ABSTRACT

*Since 1977, the popularity of the limited liability company ("LLC") has grown tremendously, overtaking the corporation and the partnership as the preferred business structure in many jurisdictions. Amidst this growth in popularity, a legal debate has sparked concerning the existence, nature, and extent of the fiduciary and contractual duties owed in the LLC context.*

*Drafters of LLC agreements can adjust fiduciary "norms" through limitation or, in certain jurisdictions like Delaware, through complete elimination of fiduciary duties. However, the implied contractual covenant of good faith and fair dealing (the "Implied Covenant" or the "Covenant") remains and cannot be waived by the parties. This delicate balance between waivable duties and an unwaivable covenant begs two key questions: What, if any, is the relationship between fiduciary duties and the Implied Covenant, and where is the boundary between the two? Further, how is the scope of the Implied Covenant affected when an LLC agreement eliminates fiduciary duties? The answers to these questions are critical in separating permissible acts under an LLC agreement from acts giving rise to causes of action for breach of contract.*

*The relationship between fiduciary duties and the Implied Covenant is marked by an inherent tension that the Delaware courts have yet to properly resolve. Rather, these courts have structured an extremely narrow view of the Covenant, and have sometimes conflated the Covenant with fiduciary duties, thereby reducing the effectiveness of the Covenant as an independent means of enforcing behavioral norms arising from contractual relationships. Consequently, parties to LLC agreements have been left to question whether the Implied Covenant has any significance independent of fiduciary duties. This Article attempts to shed light on this dilemma, but cautions that, in this unique context, protection under the Covenant appears to be illusory when fiduciary duties are no longer in play.*

* Associate (Corporate), Baker Botts L.L.P.; J.D., *magna cum laude*, University of Houston Law Center (2012); B.S., Economics and Political Science, *summa cum laude*, University of Houston (2009). Many thanks to Professor Douglas Moll for his invaluable insight and comments. Thanks also to the editors of the *University of Miami Business Law Review* for their efforts in preparing this Article for publication.

## Table of Contents

## I. INTRODUCTION

Until the late twentieth century, long-term business relationships were generally either structured as partnerships or corporations.[1] Each of these structures came with distinct benefits and disadvantages. For example, the partnership structure was easy to form, but had the potential to expose some or all of the partners to unlimited personal liability for the obligations of the partnership;[2] the corporate structure shielded shareholders, directors and officers from personal liability, but resulted in double taxation on the corporation's profits and dividends.[3] However, in 1977, a hybrid entity structure known as the limited liability company ("LLC") was introduced in Wyoming, arguably creating a business organization possessing the best features of the partnership and corporate forms.[4] Among other benefits, LLCs shielded the personal assets of their members and managers from liability, and offered partnership-style, pass-through taxation.[5] Since 1977, the popularity of the LLC has grown tremendously, overtaking the corporation and the partnership as the preferred business structure in many jurisdictions.[6] However, amidst this growth in popularity, a legal debate has sparked concerning the existence,

---

1 *See* Mary Szto, *Limited Liability Morality: Fiduciary Duties in Historical Context*, 23 QUINNIPIAC L. REV. 61, 63–64 (2004) (discussing the emergence of the limited liability company form).

2 A partnership is formed by an "association of two or more persons to carry on as co-owners a business for profit," UNIF. P'SHIP ACT § 6 (1914), whether the parties intended to form a partnership or not, REVISED UNIF. P'SHIP ACT § 202(a) (1997). No statutory formalities must be followed. Until the 1990s, no partnership structure provided completely unlimited liability. The general partnership form burdened all partners with unlimited personal liability for the obligations of the partnership. UNIF. P'SHIP ACT § 15; REVISED UNIF. P'SHIP ACT § 306(a). The limited partnership form, composed of general partners and limited partners, only provided limited liability for limited partners. However, depending on what statute applied, even the limited partners could lose their limited liability status if they participated in management and control of the business. *See, e.g.*, UNIF. LTD. P'SHIP ACT § 7 (1916) ("A limited partner shall not become liable as a general partner unless, in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business."). The limited liability partnership ("LLP") form, providing limited liability for all partners, was not conceived until well after the LLC form was in existence, when Texas enacted the first LLP statute in 1991. Fallany O. Stover & Susan Pace Hamill, *The LLC Versus LLP Conundrum: Advice for Businesses Contemplating the Choice*, 50 ALA. L. REV. 813, 815 (1999).

3 Edward D. Biggers, *Federal Taxation—Publicly Traded Partnerships Deemed Corporations for Federal Taxation Purposes: New Internal Revenue Code Section 7704*, 19 ST. MARY'S L.J. 1158, 1158 (1988).

4 Rita Cain & Larry R. Garrison, *The Limited Liability Company: When Is It the Right Choice?*, 11 J. ST. TAX'N 52, 52–53 (1993); Szto, *supra* note 1, at 61–65.

5 Szto, *supra* note 1, at 61–65.

6 *Id.* at 62; Rodney D. Chrisman, *LLCs are the New King of the Hill*, 15 FORDHAM J. CORP. & FIN. L. 459, 459–62 (2010); Mohsen Manesh, *Delaware and the Market for LLC Law: A Theory of Contractibility and Legal Indeterminancy*, 52 B.C. L. REV. 189, 219 (2011).

nature, and extent of the fiduciary and contractual duties owed by LLC members and managers to each other, and to the LLC itself.[7]

In the partnership and corporate contexts, the common law firmly established the significance of fiduciary duties as mechanisms to ensure the first priority of the interests of the individuals or entities to whom these duties were owed.[8] Later, statutory developments modified the extent to which the fiduciary duties would regulate certain conduct.[9] Now, ample precedent and statutory guidance endow the creators of partnerships and corporations with reasonable expectations regarding whether certain actions will violate standards of fiduciary conduct.[10]

In contrast, LLCs are considered "creatures of contract"[11]—the drafters of LLC agreements can adjust fiduciary "norms" through limitation or, in certain jurisdictions like Delaware, through complete elimination of fiduciary duties.[12] However, the implied covenant of good faith and fair dealing (the "Implied Covenant" or the "Covenant") remains and cannot be waived by the parties.[13] This delicate balance between waivable duties and an unwaivable covenant begs two key questions: What, if any, is the relationship between fiduciary duties and the Implied Covenant, and where is the boundary between the two? Further, how is the scope of the Implied Covenant affected when an LLC agreement eliminates fiduciary duties? The answers to these questions are not entirely clear, but they are critical in separating permissible acts under

---

[7] *See, e.g.*, Dennis S. Karjala, *Planning Problems in the Limited Liability Company*, 73 WASH. U. L. Q. 455, 477 (1995); Peter B. Ladig, *Intersection Between Fiduciary Duties and Contract Rights May Be Headed for a Showdown*, DEL. BUS. CT. INSIDER (Aug. 17, 2011), *available at* http://www.delawarebusinesslitigation.com/2011/09/articles/case-summaries/intersection-between-fiduciary-duties-and-contract-rights-may-be-headed-for-a-showdown/; Sandra K. Miller, *What Standards of Conduct Should Apply to Members and Managers of Limited Liability Companies?*, 68 ST. JOHN'S L. REV. 21, 28 (1994); Jean H. Toal & W. Bratton Riley, *Fiduciary Duties of Partners and Limited Liability Company Members Under South Carolina Law: A Perspective from the Bench*, 56 S.C. L. REV. 275, 276 (2004) (highlighting the debate between "fiduciarians" and "contractarians"); *cf.* Allan W. Vestal, *Fundamental Contractarian Error in the Revised Uniform Partnership Act of 1992*, 73 B.U. L. REV. 523, 523 (1993) ("In the contemporary debate . . . , the fundamental question is whether to adopt a contractarian or fiduciary view of partnerships.").

[8] *See* discussion *infra* Part II.

[9] *See* discussion *infra* Part II.

[10] *See* discussion *infra* Part II.

[11] *E.g.*, REVISED UNIF. LTD. LIAB. CO. ACT § 110 cmt. (2006).

[12] *See* DEL. CODE ANN. tit. 6, § 18-1101(c) (2005) (providing for the contractual elimination of member and manager fiduciary duties); Sandra K. Miller, *Legal Realism, the LLC, and a Balanced Approach to the Implied Covenant of Good Faith and Fair Dealing*, 45 WAKE FOREST L. REV. 729, 729–30 (2010); Szto, *supra* note 1, at 65–70.

[13] Miller, *supra* note 12, at 730; *e.g.*, tit. 6, § 18-1101(c).

an LLC agreement from acts giving rise to causes of action for breach of contract.

Delaware is one jurisdiction in which the boundary between fiduciary duties and the Implied Covenant is not readily apparent.[14] For decades, Delaware has had a preeminent reputation with respect to the formation of incorporated, unincorporated, and "alternative" business entities (including LLCs).[15] In particular, its LLC statute is favored among parties who value its flexibility, tax benefits, and minimal disclosure requirements.[16] In addition, Delaware's vast business-law precedent and chancery court system are added benefits should disputes arise.[17]

However, even in this sophisticated business-law state, the relationship between optional fiduciary duties and the mandatory Covenant is far from settled.[18] Curiously, as a result of the tension inherent in this relationship, a strange dilemma has developed. Rather than attempting to resolve the tension, the Delaware courts have instead structured a very narrow view of the Implied Covenant, and have conflated the Covenant with fiduciary duties, thereby reducing the effectiveness of the Covenant as an independent means of enforcing behavioral norms arising from contractual relationships.[19] Consequently, parties to LLC agreements have been left to question whether the Implied Covenant has any significance independent of fiduciary duties. This Article attempts to shed light on this dilemma by unwinding the intricacies that link and differentiate these two classes of obligations.

Part II explores the contours of fiduciary duties as they have developed from Judge Cardozo's iconic and open-ended pronouncement in *Meinhard v. Salmon* to the more defined boundaries of fiduciary duties in the uniform acts and corporate statutes. This Part also discusses the emergence of LLCs and the fiduciary law that applies to these entities,

---

14 *See* Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 438 (1991) (characterizing the relationship between fiduciary duties and the Implied Covenant as "a blur . . . not a line"); Ladig, *supra* note 7 (summarizing recent Delaware precedent and noting that the relationship between fiduciary duties and contract rights is yet to be clarified by the Delaware courts).

15 Manesh, *supra* note 6, at 218–19. The term "alternative entity" typically denotes "unincorporated business entities providing limited liability to their owners." Miller, *supra* note 12, at 729 n.1.

16 *Id.* at 252–53.

17 *See id.* at 215, 217–19.

18 *See In re* Emerging Commc'ns, Inc. S'holders Litig., No. 16415, 2004 Del. Ch. LEXIS 70, at *142 n.184 (Del. Ch. May 3, 2004) (stating that the corporate directors were liable for breaching their "dut[ies] of loyalty and/or good faith," and conceding that "the Delaware Supreme Court has yet to articulate the precise differentiation between the duties of loyalty and of good faith").

19 *See* discussion *infra* Parts III–VI.

focusing special attention on Delaware—a jurisdiction that allows not only modification of fiduciary duties, but also elimination of these duties in alternative-entity agreements.

Part III discusses the meaning, scope, and application of the Implied Covenant as it relates to fiduciary duties. Seeking to clarify the role of the Covenant, this Part proposes a model for analyzing the relationship between fiduciary duties and the Covenant with an eye towards determining the contexts in which certain conduct would theoretically be permitted as falling within provisions waiving fiduciary duties, but prohibited as violating the Implied Covenant.

Part IV argues that Delaware's approach to the Implied Covenant skews the relationship between the Covenant and fiduciary duties, and discusses the effect of Delaware's tort- and contract-based strands of good-faith jurisprudence on Covenant inquiries in the alternative-entity context. Through detailed analysis of key cases arising in this context, this Part also examines the importance of certain non-contractual factors in contributing to the narrow scope of the Implied Covenant, and illustrates that fiduciary waivers further reduce the Covenant's influence in Delaware.

Part V, drawing on the precedent discussed in Part IV, predicts that Delaware's approach to the Implied Covenant will not adequately accommodate the expectations of parties in the average LLC when fiduciary duties are eliminated. Part VI admits what the Delaware courts have yet to concede—namely, that all indicators in Delaware suggest that the Implied Covenant has no practical role when fiduciary duties have been foreclosed by contract. Finally, Part VII cautions that fiduciary waivers in this unique context risk leaving LLC parties with no recourse should disputes arise under agreements that rely on the Implied Covenant as their sole protective device.

## II. The Evolution of Fiduciary Duties

Because LLCs are hybrid entities combining select features from partnerships and corporations,[20] it is useful to briefly examine the evolution of fiduciary duties, first in the partnership and corporate contexts, and then in the context of alternative entities.

---

[20] Cain & Garrison, *supra* note 4, at 52–53.

### *A. The Starting Point: Fiduciary Duties in the Partnership Context*

A fiduciary duty is a "duty of utmost good faith trust, confidence, and candor owed by a fiduciary . . . to [a] beneficiary."[21] This duty mandates that the fiduciary "act with the highest degree of honesty and loyalty toward [the beneficiary] and in [their] best interests."[22] Unlike many other legally imposed duties, the relevance of fiduciary duties is not limited to discrete transactions. Rather, fiduciary duties concern the governance of certain status relationships, and reflect broad, equitable principles premised on trust, stewardship, and agency.[23]

The common law set an extremely high bar for the execution of fiduciary duties. In *Meinhard v. Salmon*,[24] the seminal case addressing fiduciary duties, then-Judge Cardozo made the following iconic pronouncement:

> Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arms' length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the "disintegrating erosion" of particular expectations. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd.[25]

The *Meinhard* standard is virtually, and perhaps intentionally, boundless. By failing to draw a clear line between acceptable and objectionable conduct of a fiduciary, *Meinhard* provided an incentive for fiduciaries to "aim high" in structuring their conduct to avoid findings that they had breached their fiduciary duties.[26] Although *Meinhard* clearly

---

21 BLACK'S LAW DICTIONARY 581 (9th ed. 2009).

22 *Id.*

23 *See* Szto, *supra* note 1, at 61.

24 Meinhard v. Salmon, 164 N.E. 545 (N.Y. 1928).

25 *Id.* at 546.

26 *See* Toal & Riley, *supra* note 7, at 276 (noting the difficulty in drafting agreements when the common law is unclear on the boundaries of fiduciary duty).

established a caliber of conduct that would ensure that the beneficiaries of fiduciary relationships were adequately protected, it also constituted a "non-standard" that was difficult for courts to grasp and apply.[27] Due to *Meinhard*'s lack of clarity,[28] courts responded by raising the fiduciary duty "floor" in an attempt to meet *Meinhard*'s unbending demands. One commentator coined the term "galloping Meinhardism"[29] to connote this "continuing extension of heightened, expansive, judicially-imposed fiduciary duties."[30]

Like the common law, the Uniform Partnership Act ("UPA"), which predated *Meinhard*, failed to define specific fiduciary duties owed by one partner to another, or by partners to the partnership itself.[31] In fact, the term "fiduciary" only appears in the title of UPA section 21.[32] However, UPA section 18 does list partners' rights and duties in relation to the partnership—including information, disclosure, and accounting—none of which can be modified via contract.[33] Rather than labeling section 18 as a discrete list of fiduciary duties, the drafters of UPA left the courts to determine the outer limits of fiduciary duties on a case-by-case basis.

Until 1997, UPA operated in a majority of jurisdictions in conjunction with an accumulating common law gloss that refined UPA's scope and application.[34] As did the common law, UPA exemplified the expansive view that fiduciary duties encompassed a notion of fairness that surpassed the four corners of the partnership agreement.[35] However, in most states, UPA and *Meinhard*-influenced common law notions of fiduciary duties were soon overtaken by increasingly contractarian conceptions of partnerships. Nothing exemplifies this trend more than the

---

27 Samuel J. Samaro, *The Case for Fiduciary Duty as a Restraint on Employer Opportunism Under Sales Commission Agreements*, 8 U. PA. J. LABOR & EMP. L. 441, 486 (2006) ("The extent to which Judge Cardozo's soaring rhetoric [in *Meinhard*] is or in fact ever was a correct statement of law is unclear. For many years, lawyers, judges and scholars have debated what [Cardozo's] pretty language means 'on the ground.'" (footnote omitted)).

28 Toal & Riley, *supra* note 7, at 276.

29 Barbara Ann Banoff, *Company Governance Under Florida's Limited Liability Company Act*, 30 FLA. ST. U. L. REV. 53, 59 (2002).

30 Sandra K. Miller, *What Fiduciary Duties Should Apply to the LLC Manager After More Than a Decade of Experimentation?*, 32 J. CORP. L. 565, 606 (2007) (quoting Banoff, *supra* note 29, at 59) (internal quotation marks omitted).

31 *See* Toal & Riley, *supra* note 7, at 278 (grouping UPA together with the common-law fiduciary duty regime). *See generally* UNIF. P'SHIP ACT (1914).

32 *See* UNIF. P'SHIP ACT § 21.

33 *Id.* § 18.

34 *See* Paul Powell, Comment, *Dissociating the Fiduciary: Duty Revisions and the Resulting Confusion in Idaho's New Partnership Law*, 36 IDAHO L. REV. 145, 147 (1999).

35 *See* UNIF. P'SHIP ACT § 21.

widespread enactment of the 1997 Revised Uniform Partnership Act ("RUPA"). In 1986, the first signs of disfavor with UPA emerged in an American Bar Association Business Law Section report hinting that UPA needed to be overhauled.[36] Between 1989 and 1997, the National Conference of Commissioners on Uniform State Laws ("NCCUSL") formulated multiple working drafts of RUPA, and in 1997, RUPA emerged in its final form and was subsequently adopted by a majority of the states.[37]

Generally, it can be said that RUPA introduced a heavy dose of contractarianism into the fiduciary-duty framework, and stripped away the effectiveness of the common-law gloss that had accumulated with respect to UPA. Under RUPA, fiduciary duties became exclusively statutory obligations that were capable of being reasonably modified by the partnership agreement.[38] Where UPA and the common law failed to set a limit on the expansiveness of fiduciary duties, RUPA section 404 announced that "[t]he *only* fiduciary duties a partner owes to the partnership and the other partners are the duty of loyalty and the duty of care."[39] This language stopped the unbounded expansion of the scope of fiduciary duties that characterized the common law.[40] Rather, if a court wanted to enforce a standard of conduct that surpassed section 404's statutory "floor," the agreement of the parties would be the sole means of establishing that standard.[41] Therefore, RUPA effectively converted fiduciary duty analysis from one solely based on status to one based, in part, on contract. Only RUPA section 103(b) saves fiduciary duties from complete elimination.[42]

Notably, the drafters of RUPA were fundamentally troubled with the term "fiduciary" because it was "subject to abuse in the hands of judges, academics, and others whose flow of satisfactions [was] derived in far too large part from imposing their personal values on the more productive

---

36 UPA Revision Subcommittee of the Committee on Partnerships and Unincorporated Business Organizations, *Should the Uniform Partnership Act Be Revised?*, 43 BUS. LAW. 121, 122 (1987).

37 Powell, *supra* note 34, at 147–48.

38 REVISED UNIF. P'SHIP ACT §§ 103, 404 (1997).

39 *Id.* § 404 (emphasis added).

40 Allan W. Vestal, *"Wide Open": Nevada's Innovative Market in Partnership Law*, 35 HOFSTRA L. REV. 275, 277 (2006).

41 *See* REVISED UNIF. P'SHIP ACT § 103(a) ("Except as otherwise provided . . . relations among the partners and between the partners and the partnership are governed by the partnership agreement.").

42 *See id.* § 103(b).

members of society."[43] Perhaps it was this line of reasoning that caused RUPA to rarely use the term "fiduciary" explicitly.[44] After all, RUPA fundamentally altered the types of conduct that would satisfactorily execute fiduciary duties, and therefore, indirectly changed the definition of fiduciary duty itself.

For example, self-interested conduct—the very antithesis of conduct becoming a fiduciary under UPA and the common law[45]—was no longer strictly prohibited under RUPA.[46] In spite of the fact that RUPA's duty of loyalty provision provides that partners must "refrain from dealing with the partnership . . . as or on behalf of a party having an interest adverse to the partnership," RUPA section 404(e) states that a "partner does not violate a duty of obligation under [this Act] or under the partnership agreement merely because the partner's conduct furthers the partner's own interest," and RUPA section 404(f) states that a "partner may lend money to and transact other business with the partnership."[47] In addition, RUPA completely eliminated fiduciary duties during the phases prior to the partnership's formation and after the partnership's dissolution.[48] Further, the parties' ability to agree, after-the-fact, that certain activities would not breach fiduciary duties remained as it did under UPA and the common law, providing yet another escape valve for parties wishing to weaken these duties.[49]

RUPA's fiduciary duty provisions proved to be controversial at best. RUPA satisfied most contractarians by supporting freedom of contract principles and deferring to the intent of the parties forming the

---

[43] Donald J. Weidner, *The Revised Uniform Partnership Act Midstream: Major Policy Decisions*, 21 U. TOL. L. REV. 825, 849 (1990).

[44] The vast majority of RUPA's explicit references to fiduciary duty are in the commentary, not in RUPA's main sections. *Compare* REVISED UNIF. P'SHIP ACT §§ 404 cmt. 1, 405 cmt. 1, 603 cmt. 2, 803 cmt. 6, 807 cmt. 3, *with* REVISED UNIF. P'SHIP ACT § 404(a) (providing that the only fiduciary duties owed are the duties of loyalty and care).

[45] *See* Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879, 882 ("The fiduciary must avoid acts that put his interests in conflict with the beneficiary's.").

[46] REVISED UNIF. P'SHIP ACT § 404(a).

[47] *Id.* § 404(b)(2), (e)–(f).

[48] *See id.* § 404(b)(3) ("A partner's duty of loyalty to the partnership and the other partners is limited to the following: . . . to refrain from competing with the partnership in the conduct of the partnership business *before* the dissolution of the partnership." (emphasis added)). *Contra* UNIF. P'SHIP ACT § 21 (1914) ("Every partner must account to the partnership for any benefit, and hold as trustee for it any profits derived by him without the consent of the other partners from any transaction connected with the *formation, conduct, or liquidation* of the partnership." (emphasis added)).

[49] Vestal, *supra* note 7, at 559.

partnership.[50] However, some contractarians argued that RUPA was overly paternalistic and did not go far enough in honoring partnership agreements.[51] In contrast, RUPA outraged traditionalists who thought that fiduciary duties should not be governed by black-letter rules and bright-line tests, but should evolve based on morals, fairness, and societal context. One commentator contended that RUPA's reformulation of fiduciary duties was "pinched and almost mean spirited."[52] Regardless, RUPA's push to transform fiduciary duties from a general manner of conduct to a discrete set of amendable defaults had an influence on the duties that would apply in the context of non-partnership entities.[53]

At bottom, RUPA contained the free-floating fog that was fiduciary duty under the UPA–common-law regime. This containment eliminated duties previously considered fiduciary in nature, and therefore opened a gap between the "old" and "new" conceptions of fiduciary duty by treating the partnership as a conglomeration of contracts rather than a unique type of relationship.[54] This gap—which RUPA allowed to be expanded and contracted by the parties—arguably created a trap for the unsophisticated or inadequately represented. This void would later be widened by the uniform LLC Acts, and various state LLC statutes.[55]

### *B. The Corporate Fiduciary Standard*

The corporate context has its own unique fiduciary duty paradigm. Broadly speaking, corporate directors and officers, like partners in a partnership, owe two fiduciary duties to the corporation—the duties of care and loyalty.[56] The duty of care is bifurcated into two separate

---

[50] *See* Donald J. Weidner, *RUPA and Fiduciary Duty: The Texture of Relationship*, 58 L. & CONTEMP. PROBS. 81, 81–82 (1995) (noting that RUPA "represent[ed] a major and sufficient move toward a contractarian statement of the law").

[51] *Id.* at 81; *see also id.* at n.3 (citing Professor Larry Ribstein, a leading contractarian in this arena, who stated that RUPA "change[d] decades of prior law under the UPA," by explicitly making fiduciary duties mandatory among partners).

[52] Vestal, *supra* note 40, at 280 & n.40 (citing Letter from Melvin A. Eisenberg to The Commissioners on Uniform State Laws, at 1 (July 27, 1992)).

[53] *See* Stephanie Buck, *Sanctioning Lawlessness: The Need to Apply Whistleblower and Wrongful Discharge Protections to Members of Limited Liability Companies*, 38 U. TOL. L. REV. 711, 717–18 (2007) (noting that "[t]he typical state LLC act is a combination of provisions from partnership and corporate law."); Szto, *supra* note 1, at 66, 106 (noting similarities between RUPA and the Uniform Limited Liability Company Act).

[54] Powell, *supra* note 34, at 165.

[55] *See* discussion *infra* Part II.C.

[56] *See* Carter G. Bishop, *Directorial Abdication and the Taxonomic Role of Good Faith in Delaware Corporate Law*, 2007 MICH. ST. L. REV. 905, 914–27.

contexts. In the oversight context, directors and officers of a corporation must discharge their duties in good faith as ordinary prudent people would under similar circumstances and in like positions.[57] In the decisionmaking context, directors and officers of a corporation must make the types of substantive and procedural decisions that prudent directors or officers would make under similar circumstances.[58]

However, this decisionmaking duty is tempered by the business judgment rule—a standard of review that validates the decisions of directors and officers as long as those decisions were made in good faith and according to a reasonable decisionmaking process free of bias or conflicts of interest.[59] The business judgment rule is the most lenient standard of review used by courts in assessing the propriety of business decisions.[60] The rule is often phrased as a presumption that "sound business judgment" was exercised if the decision "can be attributed to *any* rational business purpose."[61] The business judgment rule is not derived from the parties' contract. Rather, it is based on the idea that some degree of risk-taking is desirable in commercial enterprise, and that judges should not scrutinize honest business decisions out of market context.[62]

In addition, other protections may be found in some corporate statutes which contain exculpatory provisions that shield directors from liability for violating the duty of care.[63] Even though exculpation statutes and the business judgment rule are not available for violations of loyalty or good faith,[64] these protections do for directors and officers what RUPA does for partners accused by traditionalists of breaching their fiduciary duties—they narrow the scope of conduct that is considered objectionable under a duty of care analysis.

### *C. Fiduciary Duties in the LLC*

The rise of the LLC created an entirely new framework for the application and analysis of fiduciary and contractual duties. The LLC

---

57 *See id.* at 916–21.

58 *See id.*

59 *See, e.g.*, Brehm v. Eisner, 746 A.2d 244, 264 n.66 (Del. 2000) (articulating the fundamentals of the business judgment rule).

60 Heath P. Tarbert, *Merger Breakup Fees: A Critical Challenge to Anglo-American Corporate Law*, 34 LAW & POL'Y INT'L BUS. 627, 651 (2003).

61 Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971) (emphasis added).

62 Tarbert, *supra* note 60, at 652.

63 *E.g.*, DEL. CODE ANN. tit. 8, § 102(b)(7) (2005).

64 *E.g.*, *id.*

structure originated in Germany in 1892, and LLCs soon began to appear in other civil law countries around the world.[65] The emergence of the LLC in the United States occurred relatively late, but response to the LLC grew stronger as it became clearer how the LLC would fit into the established framework of business entities. The immense popularity of the LLC structure can be traced to favorable tax laws promulgated by the Internal Revenue Service (IRS) and the needs of businesses in an increasingly globalized economy.[66]

In 1977, the first American LLC statute was enacted in Wyoming, in response to an oil company's need to assume a structure similar to the Latin American LLC equivalent.[67] The Wyoming LLC statute was a patchwork of provisions from the Wyoming corporate statute, the Uniform Limited Partnership Act, and UPA.[68] However, due to the IRS's initial treatment of LLCs, this business structure was not an immediate success. Until 1997, the IRS imposed corporate-style taxation on LLCs if these entities possessed a "preponderance of corporate characteristics"—continuity of life, centralized management, limited liability, and free transferability of interests.[69] Conversely, LLCs were taxed as partnerships if they possessed a preponderance of partnership characteristics.[70] Further, the IRS proposed that LLCs would be taxed as corporations if their members were not personally liable for LLC debts.[71] The lack of clarity and simplicity in LLC tax policy complicated LLC formation and stunted the popularity of the LLC structure.[72]

In 1997, the IRS streamlined the taxation of LLCs by instituting a "check-the-box" regime whereby an LLC could elect to be taxed as a partnership without regard to the number of corporate characteristics it possessed.[73] Three years earlier, the Uniform Limited Liability Company Act ("ULLCA") was promulgated.[74] However, the IRS's unpredictable treatment of LLCs prior to 1997 meant that, in response, most states had

---

65 Szto, *supra* note 1, at 63–65.

66 *Id.*

67 *Id.* at 64.

68 William J. Carney, *Close Corporations and the Wyoming Business Corporation Act: Time for a Change?*, 12 LAND & WATER L. REV. 537, 581 (1977).

69 *See* 26 C.F.R. §§ 301.7701-1 to -4 (1997); I.R.S. Priv. Ltr. Rul. 8106082 (Nov. 17, 1980).

70 I.R.S. Priv. Ltr. Rul., *supra* note 69.

71 45 Fed. Reg. 75,709 (proposed Nov. 17, 1980) (proposal withdrawn at 48 Fed. Reg. 14389-02 (Apr. 4, 1983)).

72 Szto, *supra* note 1, at 64–65.

73 *See* 26 C.F.R. §§ 301.7701-1 to -4.

74 Buck, *supra* note 53, at 718.

already enacted and amended their own LLC statutes by the time ULLCA reached its final form.[75] Therefore, unlike partnerships under state-adopted versions UPA and RUPA, LLCs are largely a product of uniquely tailored state law.[76]

Nevertheless, a brief look at ULLCA and the Revised Uniform Limited Liability Company Act ("RULLCA") is helpful as a baseline against which to compare the Delaware LLC statute. Fiduciary duties are implicated with respect to managers in an LLC,[77] and ULLCA largely mirrors RUPA's narrow formulation of fiduciary defaults—the only duties owed by an LLC member–manager to other members and the company are the duties of care and loyalty.[78] As under RUPA, these duties are subject to reasonable modification by the parties under ULLCA.[79] Non-manager members are not subject to any fiduciary constraints under ULLCA, yet are given virtually unrestricted access to company information.[80] Disclosure obligations remain non-fiduciary in nature, as under RUPA.[81] However, ULLCA was not widely adopted.[82]

In 2006, NCCUSL took another bite at the apple by enacting RULLCA. Interestingly, RULLCA reverted to a UPA-type conception of fiduciary duties—one that included, but was not limited to the duties of loyalty and care.[83] Therefore, RULLCA provided direction with regard to LLC fiduciary duties without hindering the development of the common law. Nevertheless, like ULLCA, RULLCA does not impose fiduciary duties on non-manager members.[84] However, unlike ULLCA, RULLCA does subject non-manager members to the obligation of good faith and fair dealing.[85]

Due to the limited adoption of ULLCA and RULLCA, individual state LLC statutes carry more weight in the analysis of fiduciary duties in the LLC setting.[86] Because limited partnerships are alternative entities that

---

75 *Id.* at 717–18.

76 *See id.*

77 *See, e.g.*, DEL. CODE ANN. tit. 6, § 18-1101 (2005).

78 UNIF. LTD. LIAB. CO. ACT § 409 (2003).

79 *See id.* § 103(b)(2)(i).

80 *Id.* § 409(h)(1). *See generally* J. William Callison & Allan W. Vestal, *Taming the Mandibles of Death*, 59 CATH. U. L. REV. 183 (2009) (discussing the consequences of this set-up).

81 REVISED UNIF. LTD. LIAB. CO. ACT § 410(b)(2) (2006).

82 *See supra* text accompanying notes 74–76.

83 *See* REVISED UNIF. LTD. LIAB. CO. ACT § 409.

84 Callison & Vestal, *supra* note 80, at 186.

85 *Id.*

86 Buck, *supra* note 53, at 717–20.

are analogous to LLCs for purposes of this Article, two Delaware statutes merit attention—the Delaware Limited Liability Company Act ("DLLCA") and the Delaware Limited Partnership Act ("DRULPA"). Both statutes are founded on strong contractarian policy, with a joint aim to "give the *maximum* effect to the principle of freedom of contract and to the enforceability of [LLC and limited partnership] agreements."[87]

When alternative entities became popular in Delaware, courts were forced to make significant doctrinal adjustments to accommodate the DLLCA and DRULPA frameworks. However, these adjustments did not come naturally—after decades of developing partnership and corporate law, the Delaware courts were accustomed to defaulting to fiduciary duties given that these duties are mandatory, in some degree, in both the partnership and corporate contexts.[88]

One example of this tendency to default to fiduciary norms in the context of limited partnerships is the Delaware Supreme Court's decision in *Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.*[89] In that case, a series of transactions proposed to Hallwood's board of directors were at issue. The transactions were contingent on financing via the purchase of units generated in the transaction by Hallwood's corporate parent.[90] Gotham, a limited partner unitholder in Hallwood, brought action against Hallwood's general partner, alleging that the general partner breached its fiduciary duties.[91] When *Gotham* was decided, DRULPA allowed partnership agreements to expand or restrict partner duties, but did not explicitly provide for the elimination of fiduciary duties.[92]

Although traditional fiduciary duties would have applied in the absence of explicit contractual provisions to the contrary, the parties in *Gotham* contracted to allow the conduct that the plaintiffs later claimed had breached the limited partnership's fiduciary duty to its unitholders.[93] On this contractual basis, the chancery court rejected Gotham's fiduciary

---

87 DEL. CODE ANN. tit. 6, §§ 18-1101(b), 17-1101(c) (2005) (emphasis added).

88 *See* Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 DEL. J. CORP. L. 1, 16 (2007).

89 Gotham Partners, L.P. v. Hallwood Realty Partners, L.P., 817 A.2d 160 (Del. 2002).

90 *Id.* at 164–65.

91 *Id.* at 164, 166.

92 DEL. CODE ANN. tit. 6, § 17-1101(d)(2) (2000) (amended 2004) ("[T]he partner's or other person's duties and liabilities may be expanded or restricted by provisions in the partnership agreement.").

93 *See id.* at 24 (noting that the partnership agreement "occup[ied] all the territory traditionally covered by fiduciary duty doctrine").

duty claims.[94] However, in a surprising turn of events on appeal, the Delaware Supreme Court reverted to an "adherence to fiduciary duties . . . normally expected,"[95] even though such adherence ran contrary to the contractual and applicable statutory language. Although the court conceded that the partnership agreement "became the sole source of protection for [Gotham],"[96] the court was clearly uncomfortable with the concept of abandoning a corporate-style fiduciary duty analysis in favor of a statutory regime that allowed parties to govern their own conduct apart from the pronouncements of the common law: "[W]e note the historic cautionary approach of the courts of Delaware that efforts by a fiduciary to escape a fiduciary duty, whether by a corporate director or officer or other type of trustee, should be scrutinized searchingly."[97] Therefore, the court insisted that the parties' status took precedence over the parties' contract as an "underlying general principle in [Delaware] jurisprudence."[98]

After seeing that the Delaware Supreme Court was not recognizing the legislative intent behind DRULPA, the Delaware legislature amended DRULPA and preemptively amended DLLCA to expressly permit the complete contractual elimination of fiduciary duties.[99] These amendments gave rise to a unique and challenging issue. Now, with the blessing of the Delaware legislature, parties could avoid unfavorable court treatment when they eliminated fiduciary duties. However, it was unclear what meaningful protections would remain once the possibility of fiduciary liability was foreclosed. Although the Implied Covenant remained mandatory, the Delaware courts retained the power to determine whether specific conduct would violate the Covenant, and thereby retained the power to define the general scope of the Covenant's application. Thus far, these courts have chosen to exercise this power to significantly reduce the Covenant's significance.[100]

---

[94] Gotham Partners, L.P. v. Hallwood Realty Partners, L.P., 795 A.2d 1, 24–26 (Del. Ch. 2001), *aff'd in part, rev'd in part*, 817 A.2d 160.

[95] *Gotham*, 817 A.2d at 167.

[96] *Id.* at 171.

[97] *Id.* at 168.

[98] *Id.* at 167.

[99] DEL. CODE ANN. tit. 6, §§ 17-1101(d), 18-1101(c) (2005).

[100] *See* discussion *infra* Parts IV–V.

## III. The Role of the Implied Covenant of Good Faith and Fair Dealing

"Good faith and fair dealing" is one of the most commonly used phrases in the legal lexicon, yet the conceptual framework behind it is incredibly abstract and has yet to be precisely defined.[101] After all, "attempt[s] to capture in a set of normally necessary and sufficient conditions some characteristic or characteristics common to all things that are or could be called 'good faith' is doomed to failure."[102] Whereas fiduciary duties are defined in positive terms, the Implied Covenant is generally defined in negative terms. For example, in *Meinhard*, then-Judge Cardozo set a high, albeit vague, standard of "undivided loyalty" and the "punctilio of an honor most sensitive;"[103] UPA section 18 creates a basic framework of partnership rights and duties upon which courts have built; and RUPA section 404 provides, as a default matter, that the fiduciary duties of loyalty and care are owed in the partnership context.[104] In contrast, the Implied Covenant lacks an established general meaning,[105] and courts have routinely defined good faith as something akin to "not bad faith," rather than set specific standards of conduct that would satisfy the Covenant's boundaries.[106] To complete the circular reasoning, case law has often defined bad faith as a lack of good faith.[107]

Nevertheless, at bottom, the Implied Covenant seeks to give effect to the contemplations and intentions of the parties.[108] On one hand, the parties can promote private expectations during the negotiation phase of contract formation.[109] On the other hand, once that agreement is reached, good faith and fair dealing mandates that the parties adhere to the bargain that was struck and refrain from taking opportunistic advantage of fellow parties.[110] In general, the Implied Covenant requires parties to

---

101 Robert M. Phillips, Comment, *Good Faith and Fair Dealing Under the Revised Uniform Partnership Act*, 64 U. COLO. L. REV. 1179, 1184–85 (1993).

102 Robert S. Summers, *The General Duty of Good Faith—Its Recognition and Conceptualization*, 67 CORNELL L. REV. 810, 828 n.89 (1982).

103 Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928).

104 *See* UNIF. P'SHIP ACT § 18 (1914); REVISED UNIF. P'SHIP ACT § 404(a)–(c) (1997).

105 Summers, *supra* note 102, at 820.

106 *See* Dunlap v. State Farm Fire & Cas. Co., 878 A.2d 434, 442 (Del. 2005).

107 Steele, *supra* note 88, at 16.

108 Andrew S. Gold, *On the Elimination of Fiduciary Duties: A Theory of Good Faith for Unincorporated Forms*, 41 WAKE FOREST L. REV. 123, 136 (2006).

109 *See* Allied Capital Corp. v. GC–Sun Holdings, L.P., 910 A.2d 1020, 1024 (Del. Ch. 2006) (suggesting that it is the parties' responsibility to extract substantive rights during contract negotiations).

110 Gold, *supra* note 108, at 134.

avoid "arbitrary or unreasonable conduct which has the effect of preventing the other party to the contract from receiving the [contract's] fruits."[111]

These principles are fairly straightforward. However, when the analysis of a dispute involves both fiduciary duties and the Implied Covenant in a hybrid entity like the LLC, the relationship between the two obligations becomes highly complex because neither obligation is conducive to discrete measurement.[112]

### *A. How Does the Implied Covenant Relate to Fiduciary Duties?*

While outlining the contours of fiduciary duties has been made easier with the development of the Uniform Acts and state statutes,[113] defining the Implied Covenant in a vacuum is a much more challenging endeavor with little practical significance.[114] Worse still, attempting to glean a relationship between fiduciary duties and the Implied Covenant is almost impossibly abstract.[115] Nevertheless, whether "some portion of traditional fiduciary duties [can] be preserved through the enforcement of good faith duties"[116] is a question that the Delaware courts have generally answered in the negative. Therefore, if an LLC agreement eliminates fiduciary duties, it is important to determine what types of conduct will or will not violate the Implied Covenant in spite of this elimination. In order to make this determination, an analysis of the relationship between fiduciary duties and the Implied Covenant is critical.

There are a number of approaches to fiduciary duties in the alternative entities. The fiduciary duties of care and loyalty can be mandatory, or these duties can be treated as defaults that can be altered but not eliminated.[117] Alternatively, a more contract-based approach treats the duties of loyalty and care as fiduciary defaults that can be altered or

---

[111] Wilgus v. Salt Pond Inv. Co., 498 A.2d 151, 159 (Del. Ch. 1985) (interpreting RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981)).

[112] DeMott, *supra* note 45, at 879; Summers, *supra* note 102, at 827.

[113] *See* discussion *supra* Part II.A.

[114] John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618, 1654 (1989); Manesh, *supra* note 6, at 244.

[115] *See* Gold, *supra* note 108, at 135 (emphasizing the importance of context in defining contractual good faith obligations).

[116] *Id.* at 126.

[117] *E.g.*, N.Y. LTD. LIAB. CO. LAW § 417 (McKinney 2011) (allowing for alteration, but not elimination, of fiduciary duties); *see* Miller, *supra* note 12, at 732–33; Miller, *supra* note 30, at 600 (noting that "a significant number of states now prevent the elimination of fiduciary duties"); *see also* Gotham Partners, L.P. v. Hallwood Realty Partners, L.P., 817 A.2d 160 (Del. 2002) (taking this approach prior to the 2004 DLLCA

eliminated.[118] Delaware takes this latter approach. A Delaware court will presume that "traditional" fiduciary duties of loyalty and care will govern the relationship between the parties unless the parties' agreement provides otherwise.[119]

Before parties contemplate a fiduciary opt-out, however, it is critical that they consider the types of conduct that might breach the Implied Covenant. As a general matter, to successfully argue that the defendant breached the Implied Covenant, a plaintiff must prove that the defendant acted in bad faith by conducting themselves "arbitrarily or unreasonably" such that the plaintiff was prevented from reaping the benefits of the contract.[120] For example, courts have found that bad faith conduct includes "evasion of the spirit of the bargain, lack of diligence and slacking off, willful rendering of imperfect performance, abuse of a power to specify terms, and interference with or failure to cooperate in the other party's performance."[121]

Given this basic landscape, a few observations can be made regarding the Implied Covenant as it relates to fiduciary duties. Fiduciary duties and the Implied Covenant are close relatives.[122] After all, "both types of duties seek to prevent opportunism where a contract is silent," and can therefore be characterized as mere "variations on a theme."[123] However, what differentiates fiduciary duties from the Implied Covenant is their scope of

---

amendment); *supra* text accompanying notes 89–99 (discussing *Gotham* and the 2004 amendment in greater detail).

118 Miller, *supra* note 12, at 732–33. A more extreme contractarian view (yet to be adopted by the courts) assumes that the fiduciary duties of loyalty and care are not defaults at all, but rather must be affirmatively contracted for by the parties. *Id.* at 733.

119 Auriga Capital Corp. v. Gatz Properties, 40 A.3d 839, 853 (Del. Ch. 2012); *see* DEL. CODE ANN. tit. 6, § 18-1101 (2005). The contractual elimination of fiduciary duties, known as "fiduciary waiver" or "fiduciary opt-out," is subject to a fairly high standard of review by the Delaware courts. *See, e.g.*, R.S.M. Inc. v. Alliance Capital Mgmt. Holdings, 790 A.2d 478, 497 (Del. Ch. 2001) (noting that fiduciary waiver will be judicially recognized only in circumstances when a contract clearly disclaims the applicability of fiduciary defaults, and the court's application of these defaults "would intrude upon the contractual rights or expectations" of the parties).

120 Nemec v. Shrader, 991 A.2d 1120, 1126 (Del. 2010).

121 RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. d (1981); *see, e.g.*, *In re* Walt Disney Co. Derivative Litig., 825 A.2d 275 (Del. Ch. 2003) (suggesting that willful abdication of corporate responsibilities is indicative of bad faith).

122 Gale v. Bershad, No. CIV. A. 15714, 1998 WL 118022, at *5 (Del. Ch. Mar. 4, 1998) ("The function of the implied covenant of good faith and fair dealing in defining the duties of parties to a contract, is analogous to the role of fiduciary law . . . ."); Easterbrook & Fischel, *supra* note 14, at 426–27 ("A fiduciary relation is a contractual one . . . ."); *see also id.* at 438 (characterizing the relationship as nonlinear, but arguing that the Implied Covenant best approximates the contours of fiduciary duties).

123 Gold, *supra* note 108, at 134; *see also* Larry E. Ribstein, *Fencing Fiduciary Duties*, 91 B.U. L. REV. 899, 909 (2011) (suggesting that good faith and fiduciary duty may be synonymous).

application. At most, the Implied Covenant merely "binds the parties to an agreement."[124] In contrast, a fiduciary is required to act affirmatively to put the interests of the beneficiary ahead of his own interests, even if neither individual's interests were considered in an explicit contractual reference.[125] Moving from good faith and fair dealing towards fiduciary duties, the relationship between the parties evolves from strictly contractual to status-based, the applicable standard of conduct is raised, and courts become more likely to impose liability.

Because the Implied Covenant exists in all contracts and cannot be waived, the Covenant lies at the core of all contractual relationships. Even statutes that allow for the modification or elimination of fiduciary duties leave the Implied Covenant untouched. For example, DLLCA and DRULPA allow the expansion and contraction of fiduciary duties provided that the Implied Covenant is not eliminated.[126] However, even though the Implied Covenant is indispensable, it is narrower in scope than are fiduciary duties, which encompass a broad notion of fairness governing certain status relationships "characterized by unusually high costs of specification and monitoring."[127] Further, it is easier to breach a fiduciary duty than to breach the Implied Covenant.[128] Fiduciary duties often seek to prevent parties from placing their own interests ahead of the interests of the individual or entity to whom the fiduciary duty is owed.[129] In contrast, this is not the fundamental goal of the Implied Covenant.[130] Rather, "the key question is abuse, not benefit to the actor."[131]

---

[124] Brinckerhoff v. Enbridge Energy Co., No. 5526–VCN, 2011 WL 4599654, at *11 (Del. Ch. Sept. 30, 2011).

[125] *See* D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399, 1409–10 (2002) ("In the fiduciary context, the duty of loyalty requires the fiduciary to adjust her behavior on an ongoing basis to avoid self-interested behavior that wrongs the beneficiary. By contrast, the implied obligation of good faith and fair dealing requires loyalty to the other contracting party only to the extent that the terms of the contractual relationship reasonably contemplate the actions in question.").

[126] DEL. CODE ANN. tit. 6, §§ 18-1101(c), 17-1101(d) (2005).

[127] Easterbrook & Fischel, *supra* note 14, at 426–27.

[128] Gold, *supra* note 108, at 150; *see* Hillary A. Sale, *Delaware's Good Faith*, 89 CORNELL L. REV. 456, 488 (2004) ("Good faith based liability . . . moves the bar from negligent behavior to deliberately indifferent, egregious, subversive, or knowing behavior, and thereby raises issues related to the motives of the actors."); Christopher Hanno, Comment, *The Other "F" Word: Fiduciary Duties, Fiduciary Waivers, and the Delaware Limited Liability Company*, 52 S. TEX. L. REV. 101, 116 (2010) (noting that "the standard to find a breach of a covenant is much higher than that of a fiduciary duty").

[129] Gold, *supra* note 108, at 135. Note that certain statutory schemes do not prohibit all self-interested behavior of fiduciaries. *See* REVISED UNIF. P'SHIP ACT § 404(e)–(f) (1997).

[130] Gold, *supra* note 108, at 135.

[131] DeMott, *supra* note 45, at 900.

Therefore, because fiduciary duties impose more exacting standards of behavior, they are more easily breached. This suggests that fiduciary duties lie on the outskirts of the Implied Covenant and are, therefore, more "accessible" under the theory that "inequitable action does not become permissible simply because it is legally possible."[132]

### *B. The Nested-Sphere Model: A Way to Conceptualize the Relationship Between the Implied Covenant and Fiduciary Duties*

In light of the observations made above, this Article suggests building a "nested-sphere" model—an analytical model of the relationship between fiduciary duties and the Implied Covenant that interlocks these two classes of obligations together. One can graphically represent this model as a sphere within a sphere, where the Implied Covenant occupies the innermost sphere, fiduciary duties occupy the outer sphere, and a nearly infinite range of permissible conduct surrounds both spheres.[133] In a purely contractual relationship, the outer sphere of fiduciary duties is not at issue, thereby expanding the scope of a party's permissible conduct. This means that although the inner core of good faith and fair dealing always remains, it is somewhat more difficult to breach.

Nevertheless, when a party unilaterally attempts to recoup an opportunity that was relinquished during contract formation, that party may have breached the Implied Covenant.[134] If a party breaches the inner core of good faith, a court, in theory, should hold that party liable if the contract suggests that, had the parties envisioned the breach, they would have negotiated express terms covering the disputed conduct.[135] If the parties have a fiduciary relationship, any breach of the Implied Covenant would theoretically satisfy the requirements of a breach of fiduciary duty claim simultaneously.[136] In other words, commonly cited conduct constituting bad faith—for example, "evasion of the spirit of the bargain, lack of diligence and slacking off, willful rendering of imperfect performance, abuse of a power to specify terms, and interference with or

---

132 Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437, 439 (Del. 1971).

133 *See infra* app. A.

134 Steven J. Burton, *More on Good Faith Performance of a Contract: A Reply to Professor Summers*, 69 IOWA L. REV. 497, 499–500 (1984).

135 *See* Dunlap v. State Farm Fire & Cas. Co., 878 A.2d 434, 441 (Del. 2005).

136 *See* Bay Ctr. Apartments Owner, LLC v. Emery Bay PKI, LLC, No. 3658-VCS, 2009 WL 1124451, at *5–8 (Del. Ch. Apr. 20, 2009) (the plaintiff asserted fiduciary and Covenant claims, but asserted the Covenant claim "in the alternative" to the fiduciary claim).

failure to cooperate in the other party's performance"[137]—would breach fiduciary duties, because all of these behaviors necessarily run counter to the broad, external fairness norms that these duties seek to impose.[138] In spite of this overlap, the Covenant is designed to provide a separate avenue of relief.[139]

Thus, the nested-sphere model sets the initial framework for discussing a dispute involving fiduciary duties and the Implied Covenant. In order to further clarify the Covenant's role and application, the next step is to determine how much territory the Covenant covers within the nested sphere, as well as the effect, if any, of a fiduciary opt out on the Covenant's scope. This determination will assist in predicting the chances of a plaintiff's success on an Implied Covenant claim.

## IV. Reality Is More Complicated Than Theory: The Nested-Sphere Model in Action

At a minimum, the Implied Covenant cannot be used to revive or re-strengthen fiduciary duties that were partially or completely relinquished during contract negotiation.[140] In addition, a plaintiff cannot bring a de facto fiduciary duty action under the guise that the defendant breached the Implied Covenant.[141] These points are noncontroversial, and are supported by the nested-sphere model.[142]

However, in Delaware, the joint operation of fiduciary duties and the Implied Covenant is not as straightforward in practice as the nested-sphere model would initially suggest. Two distinct patterns that alter the nested-sphere model are apparent in Delaware. First, the Delaware courts have given rise to a growing body of alternative-entity case law that mixes contractualism[143] with various external factors to account for the very narrow initial scope of the Implied Covenant.[144] Second, there are

---

137 Restatement (Second) of Contracts § 205 cmt. d (1981).

138 *See supra* Part II (discussing the contours of fiduciary duties). For example, "lack of diligence and slacking off" would likely give rise to duty of care claims, and "willful rendering of imperfect performance, abuse of a power to specify terms, and interference with or failure to cooperate in the other party's performance" would likely give rise to duty of loyalty claims. In addition, fiduciaries are presumably not allowed to breach contracts with the beneficiaries of their fiduciary duties because this action would harm the beneficiary.

139 *See Bay Ctr.*, 2009 WL 1124451, at *5.

140 *E.g.*, *In re* Atlas Energy Res., LLC, No. 4589-VCN, 2010 WL 4273122, at *13 (Del. Ch. Oct. 28, 2010).

141 Lonergan v. EPE Holdings, 5 A.3d 1008, 1016 (Del. Ch. 2010).

142 *See infra* apps. A, C.

143 *See supra* Part III.B.2–3.

144 *See infra* Part IV.A–B; app. B.

indications that, in situations where Delaware parties eliminate fiduciary duties by contract, the scope of the Implied Covenant will be narrowed even further, thereby rendering the Covenant functionally meaningless.[145]

The overall result of the courts' hesitancy to trigger the Covenant is that fiduciary duties and the Implied Covenant have essentially become a "package deal"—neither obligation can apply without the other in situations where fiduciary duties were originally available to regulate the parties' relationship: First, when fiduciary duties are maintained between the parties, they necessarily operate in conjunction with the Covenant given that the Covenant inheres in every contract.[146] Second, because contract claims based solely on the Implied Covenant are rarely successful, and because Delaware has indicated that these claims would be deemed superfluous if fiduciary duties have not been eliminated by the parties,[147] the Implied Covenant has little to no significance as an independent remedial tool.[148]

### A. *Incorporating Fairness, Contract, or Both?: The Role of Conflicting Strands of Implied Covenant Analysis in Contributing to the Covenant's Narrow Initial Scope in Delaware*

While it is clear is that the Implied Covenant is derived from the notion that, in commercial dealings, a certain level of conduct should be expected from the parties,[149] what is not as clear is whether this level of

---

145 *See infra* Part IV.C; app. D.

146 *See* Coffee, Jr., *supra* note 114, at 1653–64.

147 For example, the Delaware Chancery Court in *Lonergan v. EPE Holdings*, 5 A.3d 1008, 1018 (Del. Ch. 2010) labeled fiduciary duties as "the most powerful of a court's remedial and gap-filling powers." Of course, the Implied Covenant also serves as a contractual gap-filler. Therefore, it follows that in a situation in which fiduciary duties have been retained in an agreement, an Implied Covenant claim arising from that agreement would be deemed redundant.

148 *See* Gold, *supra* note 108, at 131 (arguing that, unless the Implied Covenant is deemed functionally separate from fiduciary duty, contracts eliminating fiduciary duties would be illusory and DLLCA's Implied Covenant provision would be rendered meaningless).

149 *See* Allied Capital Corp. v. GC–Sun Holdings, L.P., 910 A.2d 1020, 1032 (Del. Ch. 2006) (stating that the Implied Covenant is the embodiment of a legal "*expectation*" (emphasis added)); J. William Callison & Allan W. Vestal, *"They've Created a Lamb with Mandibles of Death": Secrecy, Disclosure, and Fiduciary Duties in Limited Liability Firms*, 76 IND. L.J. 271, 306 (2001) ("The law . . . establish[es] both socially appropriate default rules and limits on party modifications of such default rules . . . assur[ing] that specific business organizations are both socially appropriate and consistent with party and social expectations."); *cf.* Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735, 1742–43 (2001) (arguing that fiduciary duties are important in signaling society's expectation of trustworthiness to the parties); Sandra Chutorian, Note, *Tort Remedies for Breach of Contract: The Expansion of Tortious Breach of the Implied Covenant of Good Faith and Fair Dealing into the Commercial Realm*, 86 COLUM. L. REV. 377, 405 (1986)

conduct should be established only through reference to the parties' contract (thereby rendering the Covenant a tool for contract interpretation), or whether this level of conduct should be set with any reference to external fairness norms (thereby rendering the Covenant a tool for governing the parties' relationship). Whether a court chooses to incorporate fairness considerations into its inquiry affects the initial scope of the Covenant within the nested-sphere model—if fairness is incorporated, the Covenant's scope is wider than if the court does not consider fairness because a fairness inquiry in a Covenant case would necessarily align the Covenant more with the equitable objectives of fiduciary duties.[150]

Because good faith comes into play in both the contractual and tort contexts, the obligation takes on different characteristics accordingly. In Delaware, there is authority supporting a fairness-tinged interpretation of the Implied Covenant, and there is authority supporting a contractual interpretation of the Covenant. Further, some of Delaware's contract cases confuse the issue by using language from Covenant cases in the tort context, thereby conflating the contractual analysis of the Covenant with the fairness inquiry of fiduciary duties.

### 1. *Good Faith in the Tort Context.*

In the tort context, many case-law inquiries into good faith and fair dealing are concentrated in the insurance and employment arenas.[151] Because tort law necessarily concerns the imposition of external standards of equitable conduct,[152] these cases naturally inquire into the fairness of the defendant's conduct in light of the special, or quasi-fiduciary relationship between the plaintiff and the defendant.[153] In contrast, in a purely contractual good faith and fair dealing inquiry, only the parties' contract should influence the outcome of the dispute.[154]

---

("Although the duties implied under the covenant of good faith and fair dealing are derived from the particular contract, they nonetheless reflect social standards of fair conduct . . . ."). *See generally* Peter H. Huang, *Trust, Guilt, and Securities Regulation*, 151 U. PA. L. REV. 1059, 1061–62 (2003) (discussing the power of law in compelling parties to comply with social norms).

150 *See supra* Parts II, III.A (noting the role of fairness in fiduciary inquiries).

151 *See* Howard L. Fink, *The Splintering of the Implied Covenant of Good Faith and Fair Dealing in Illinois Courts*, 30 LOY. U. CHI. L.J. 247, 249–55 (1999).

152 *See generally* David G. Owen, *Expectations in Tort*, 43 ARIZ. ST. L.J. 1287, 1311 (2011) ("[T]ort law is and ought to be grounded in the fair expectations of actors, victims, and broader society.").

153 *See, e.g.*, Fink, *supra* note 172.

154 *See* Daniel S. Kleinberger, *Careful What You Wish for—Freedom of Contract and the Necessity of Careful Scrivening*, 24 PUBOGRAM 19, 19 (2006), *available at* http://apps.americanbar.org/buslaw/newsletter/0054/

While plaintiffs' purely contractual Implied Covenant claims are rarely successful,[155] this is not the case in the tort arena. For example, in the insurance tort context, the "special relationship" between the insurer and the insured has given rise to liability under the Implied Covenant more often than any other context[156] because courts imply a high level of trust into insurance contracts, and because the relationship between the parties deemed "quasi-fiduciary."[157]

*Dunlap v. State Farm Fire & Casualty Co.* is illustrative of the tort-law approach to the Implied Covenant. In *Dunlap*, after suffering injuries in a car accident, the plaintiff sued her insurer, claiming that the insurer acted in bad faith by refusing to guarantee that it would continue its coverage of the plaintiff even if she settled with the alleged tortfeasor.[158] State Farm moved to dismiss the complaint for failure to state a claim, and the trial court granted the motion.[159]

In the prelude to its partial reversal, the Delaware Supreme Court outlined the 300-plus year history of the Implied Covenant in the insurance context.[160] Characterizing the application of the Covenant as "quasi-reformation," the court emphasized that such an application "governed solely by issues of compelling *fairness*."[161] The question in *Dunlap* was whether or not such issues existed.

The court concluded that the plaintiff may have had a cognizable Implied Covenant claim.[162] Interestingly, the court rejected the notion that a finding of lack of good faith on the part of the defendant necessarily meant that the defendant acted in bad faith.[163] Rather, a lack of good faith encompassed a broader range of conduct, according to the *Dunlap* court.[164] If State Farm had simply improperly failed or refused to pay the plaintiff's insurance claim, this conduct would have constituted bad

---

materials/pp7.pdf ("[W]here contract is deity, you shall know the fruit [of the bargain] by reading narrowly the words of the contract.").

155 *See* discussion *infra* Part IV.A.2.

156 Phillips, *supra* note 101, at 1210.

157 *See, e.g.*, Gruenberg v. Aetna Ins. Co., 510 P.2d 1032, 1038 (Cal. 1973); *see also* Phillips, *supra* note 101, at 1210; *supra* text accompanying notes 21–23 (noting the role of trust in the concept of fiduciary duties).

158 Dunlap v. State Farm Fire & Cas. Co., 878 A.2d 434, 437 (Del. 2005).

159 *Id.* at 438.

160 *Id.* at 440–41.

161 *Id.* at 442 (emphasis added) (internal quotation marks omitted).

162 *Id.* at 445.

163 *Id.* at 442.

164 *Id.*

faith.[165] However, because the conduct in question was State Farm's failure to pay in reliance on a provision in the insurance contract requiring the plaintiff to exhaust remedies provided in other insurance policies before obtaining underinsurance benefits from State Farm,[166] a pure bad faith analysis would not have covered State Farm's conduct.[167] Nevertheless, in the court's view, State Farm's actions could have fallen within the Implied Covenant's boundaries under a "lack of good faith" analysis.[168] Therefore, the court reversed the lower court's granting of State Farm's motion to dismiss and remanded on the question of whether State Farm violated the Implied Covenant.[169]

*2. Good Faith in the Contractual Context.*

In contrast with the tort-law approach to the Implied Covenant, the Seventh Circuit's decision in *Kham & Nate's Shoes No. 2, Inc. v. First Bank* is illustrative of a purely contractual conception of the Implied Covenant (i.e., one that does not consider external notions of fairness to resolve the dispute).[170] In that case, the debtor (a shoe corporation) and a bank entered into a loan agreement that established a $300,000 line of credit and allowed creditors to draw on letters of credit.[171] When the debtor entered bankruptcy, creditors began drawing on the letters of credit and the debtor failed to repay the bank in full.[172] Subsequently, the bank discontinued all advances to the debtor.[173] Under a fourth plan of reorganization under Chapter 11 of the Bankruptcy Code, the debtor proposed that the bank be demoted to unsecured creditor status.[174] The bankruptcy judge confirmed the proposed plan under the theory that the bank's conduct was inequitable.[175]

The Seventh Circuit vacated the bankruptcy court's decision.[176] Judge Easterbrook delivered the opinion of the court, and his contractarian

---

165 *Id.*

166 *Id.* at 437.

167 *Id.* at 442.

168 *Id.* at 442–43.

169 *Id.* at 445.

170 Kham & Nate's Shoes No. 2, Inc. v. First Bank, 908 F.2d 1351, 1357 (7th Cir. 1990).

171 *Id.* at 1353–54.

172 *Id.* at 1354.

173 *Id.*

174 *Id.*

175 *Id.*

176 *Id.* at 1363.

philosophy was apparent:[177]

> "Good faith" is a *compact* reference to an implied undertaking not to take opportunistic advantage in a way that could not have been contemplated at the time of drafting, and which therefore was not resolved explicitly by the parties. When the contract is silent, principles of good faith—such as the UCC's standard of honesty in fact and the reasonable expectations of the trade . . . —fill the gap. They do not block use of terms that actually appear in the contract.[178]

When tort claims are not at issue, *Kham* makes the Covenant's role clear. It is merely a contractual gap-filler, where the contract itself controls whether a court can locate gaps in the first place. Further, Judge Easterbrook's reference to good faith as "compact" reinforces the notion that good faith is conceptually narrower than fiduciary duty. The philosophy of Judge Posner, Judge Easterbrook's colleague on the Seventh Circuit, further supports this idea: "Contract law does not require parties to behave altruistically toward each other; it does not proceed on the philosophy that I am my brother's keeper. That philosophy may animate the law of fiduciary obligations but parties to a contract are not each other's fiduciaries."[179]

### *3. Delaware's Contractual Approach to the Implied Covenant as Influenced by Tort-Law Precedent.*

The approach of the Delaware courts is similar to that of the *Kham* court.[180] Because Delaware's alternative-entity statutes explicitly label the Implied Covenant as "contractual" in nature,[181] Delaware courts have taken a contractualist tack, emphasizing that the Implied Covenant is not a "free-floating duty unattached to the underlying legal documents," and that the Covenant is "best understood as a way of implying terms in [an]

---

177 *See, e.g.*, Easterbrook & Fischel, *supra* note 14, at 427 ("Fiduciary duties . . . are the same sort of obligations, derived and enforced in the same way, as other contractual undertakings.").

178 *Kham*, 908 F.2d at 1357 (citation omitted) (emphasis added).

179 Original Great Am. Chocolate Chip Cookie Co. v. River Valley Cookies, Ltd., 970 F.2d 273, 280 (7th Cir. 1992).

180 *See* Dunlap v. State Farm Fire & Cas. Co., 878 A.2d 434, 441 n.22 (Del. 2005). *See generally* Kleinberger, *supra* note 154.

181 *E.g.*, DEL. CODE ANN. tit. 6, § 18-1101(c) (2005). In contrast, the Uniform Acts do not explicitly label the Implied Covenant as contractual.

agreement."[182] In other words, independent fairness considerations play no role.

However, even though Delaware's overall approach to the Implied Covenant is contractual, some Delaware cases addressing the contractual Implied Covenant have imported language from good faith and fair dealing cases in the tort context, and this language often references external notions of fairness. For example, multiple non-tort cases in Delaware have cited *Dunlap* (or similar cases) for the proposition that Implied Covenant cases should be governed solely by "issues of compelling fairness."[183] However, the use of this tort language is highly problematic in the contractual setting: If a court believes that the Implied Covenant should not involve fairness considerations, then the use of language from tort cases (that consider fairness) as a standard against which the parties' conduct should be evaluated *necessarily* hinders a plaintiff's ability to succeed on a purely contractual claim based on the Covenant. This approach may also cause courts to permanently associate the Covenant with tort- or fiduciary duty-like fairness inquiries, leading to increased hesitancy to trigger the Covenant, especially when parties contractually eliminate fiduciary duties.[184]

### B. *Examining Delaware Precedent to Further Explain the Implied Covenant's Narrow Scope*

Even though Delaware courts often claim to merely extrapolate from the spirit of the contract when deciding whether to imply a covenant into a contract,[185] in reality, their Implied Covenant analyses do not always strictly interpret the contents of the parties' contract. Rather, Delaware courts also appear to use a combination of contractual, relational, and motivational factors to place these contracts in context, and to reduce the territory that the Implied Covenant can cover.[186] These factors can be used to organize relevant case law and to obtain a better understanding of

---

182 Lonergan v. EPE Holdings, 5 A.3d 1008, 1017 (2010) (quoting *Dunlap*, 878 A.2d at 441) (internal quotation marks omitted). This strict contractual approach is likely attributable to the stark change of direction imposed on the courts by the Delaware legislature in the wake of *Gotham*. *See supra* text accompanying notes 89–99.

183 *E.g.,* Nemec v. Shrader, 991 A.2d 1120, 1126 n.16 (Del. 2010); *Lonergan*, 5 A.3d at 1018; *In re* Broadstripe, LLC, 435 B.R. 245, 263 & n.73 (Bankr. D. Del. 2010).

184 *See* discussion *infra* Part IV.C.

185 *See, e.g.*, Kelly v. McKesson HBOC, Inc., No. 99C-09-265 WCC, 2002 WL 88939, at *10 (Del. Super. Ct. Jan. 17, 2002).

186 *See infra* app. B.

the reasoning behind the Delaware's narrow reading of the Implied Covenant.

*1. Sophistication of the Parties.*

Among the nuanced factors that differentiate one Implied Covenant case from another, the sophistication of the parties arguably plays the biggest role. A general guideline emerges: The more sophisticated the parties are, the less likely they are to prevail under an Implied Covenant theory because sophisticated parties will theoretically have difficulty arguing that a court should imply one or more terms into a contract that appears to have been designed to cover all reasonably foreseeable contingencies.[187]

To shed light on this generalization, it helps to revisit the cases that influenced Delaware's Implied Covenant jurisprudence. Many of the cases that jumpstarted Delaware's conception of the Implied Covenant addressed disputes in the employment and insurance contexts—arenas in which courts deem a "special relationship" to exist between the parties.[188] These relationships are marked by inherently unequal bargaining power, and this inequality provides a convenient basis for triggering the Implied Covenant.[189] However, when equally-sophisticated parties negotiate an agreement on mutually-agreeable terms, no such inequality is presumed to exist, meaning that a plaintiff's Implied Covenant claim is less likely to succeed.

This principle was illustrated in *Airborne Health, Inc. v. Squid Soap, LP*.[190] In that case, Squid Soap, counseled by Vinson & Elkins, and Airborne, counseled by Weil, Gotshal & Manges, entered into an asset purchase agreement providing for potential earn-out payments to Squid Soap under which Airborne agreed to purchase $1 million of Squid Soap's assets, Squid Soap's brand name, goodwill and intellectual property upon the achievement of certain sales and marketing goals.[191] The agreement obligated Airborne to transfer the purchased assets back to Squid Soap if Airborne stopped selling or marketing Squid Soap products at any time, or did not incur $1 million in advertising and marketing costs and obtain $5

---

187 *See, e.g.*, Bay Ctr. Apartments Owner, LLC v. Emery Bay PKI, LLC, No. 3658-VCS, 2009 WL 1124451, at *7 (Del. Ch. Apr. 20, 2009).

188 *See* Steele, *supra* note 88, at 14–15.

189 James Mabry Vickery, Note, *A Special Relationship: The Use of the Duty of Good Faith and Fair Dealing to Impose Tort Damages in Contracts Between Lender and Borrower*, 9 REV. LITIG. 93, 95–96, 125–26 (1990).

190 Airborne Health, Inc. v. Squid Soap, LP, 984 A.2d 126, 145–46 (Del. Ch. 2009).

191 *Id.* at 132.

million in net sales of Squid Soap products.[192]

After the agreement was signed, Airborne failed to meet these benchmarks and suffered significant setbacks with respect to its consumer credibility including a class action lawsuit. Squid Soap learned of the pending class action and claimed that Airborne and Weil were aware of the lawsuit at the time Airborne signed the agreement with Squid Soap.[193] As part of its "damage control" efforts, Airborne sought to return the purchased assets to Squid Soap.[194] However, Squid Soap refused to accept the assets.[195]

When Airborne sought a declaratory judgment that it was not liable under the asset purchase agreement, Squid Soap counterclaimed against Airborne under a variety of theories, including the Implied Covenant.[196] Its Implied Covenant claim centered on Airborne's failure to disclose the pending lawsuit against it to Squid Soap, and Airborne's failure to meet the marketing, advertising, and sales targets set forth in the agreement.[197] However, the Delaware Chancery Court swiftly rejected Squid Soap's Covenant claim. Characterizing this claim as a "fall[ ] back" that merely "recast[ ] . . . Squid Soap's basic complaints," the court reasoned that the Implied Covenant would not apply to impose liability on Airborne because the asset purchase agreement expressly covered the subject of the dispute—namely, the marketing, advertising, and sales goals, and Airborne's representation regarding litigation.[198] However, the court conceded that "Squid Soap understandably question[ed] what it obtained under the [asset purchase agreement] if Airborne had no obligation actually to expend resources" under the agreement's marketing and advertising provisions.[199]

If there ever was an agreement that would presumably fit within the Implied Covenant's specific criteria, it was the Airborne–Squid Soap agreement. First, the provisions of the agreement setting forth the specific targets that Airborne would have to meet in order to retain the Squid Soap assets provided a basis for gleaning and interpreting the parties' intentions. By signing the agreement, was Squid Soap implicitly agreeing

---

192 *Id.*

193 *Id.* at 134.

194 *Id.* at 135.

195 *Id.*

196 *Id.* at 136.

197 *Id.* at 145.

198 *Id.*

199 *Id.* at 146.

that Airborne could arbitrarily fail to promote Squid Soap's products and deny Squid Soap the earn-out payments? Squid Soap argued, reasonably, that it did not.[200] Second, the Implied Covenant does not apply if the agreement addresses the subject of the dispute. Here, the agreement did not address the subject of the dispute because it did not obligate Airborne to expend resources to market Squid Soap's products.[201] The question was whether the court could—or would be willing to—imply a covenant by finding a strong enough connection between the agreement's explicit provisions and its lack of clarity regarding Airborne's role in executing these provisions.

Under the plain language of the agreement, Airborne had complete discretion to either expend or fail to expend its resources for the benefit of Squid Soap. Airborne was not under an explicit obligation to expend resources. Rather, it had the option to return the assets to Squid Soap if it chose not to market Squid Soap's products; Airborne attempted to exercise this option in lieu of marketing the assets. However, in discretion-type cases, the party exercising discretion must not do so in bad faith or arbitrarily to the detriment of the other party. The *Airborne* court recognized that this principle has support in Delaware law.[202] Squid Soap may have had a plausible argument that Airborne acted in bad faith by failing to market the products simply because it was in the midst of a corporate crisis and it wanted to conserve its resources. However, the court contended that Squid Soap mistakenly failed to specifically allege bad faith or arbitrariness on Airborne's part.[203]

Certainly, Squid Soap did not bring its strongest case to court. However, the facts and the merits of the court's holding in *Airborne* are less important than the reasoning behind the holding. The court's characterization of Squid Soap as a sophisticated party was key:

> Squid Soap's position is also undercut by the ease with which Squid Soap could have insisted on specific contractual commitments from Airborne regarding the expenditure of resources, or some form of "efforts" obligation for Airborne. These provisions are familiar to any transactional lawyer, and Squid Soap was a *sophisticated party represented by able counsel*. . . . Squid Soap could have insisted on a provision binding Airborne.

---

200 *Id.*

201 *Id.*

202 *Id.* at 146–47.

203 *Id.* at 147.

> Rather than holding out for these types of contractual protections, Squid Soap accepted earn-out provisions that [were] expressly phrased in conditional terms.[204]

The court characterized the agreement as a reasonable contract that just happened to sour due to Airborne's business difficulties.[205] In the court's view, this was a risk that was willingly assumed by Squid Soap.[206] Therefore, the court did not view the facts presented as an appropriate context in which to consider the Implied Covenant.[207] The alternative, contractarian argument would be that the court actually considered the Implied Covenant, but found that it had not been breached because the conduct in question did not violate the spirit of the agreement. However, when a court acts to define the spirit of the agreement by reference to one or more characteristics of the parties, an *Airborne*-type result is virtually inevitable because, in theory, sophisticated parties should be capable of drafting contracts that are substantially "complete."

On one hand, the court made some plausible arguments—namely, that it would have been easy enough to draft an agreement that specifically obligated Airborne to expend resources, and that it was not for the court to intervene after-the-fact to save Squid Soap from a rational contract that was later affected by unforeseen business downturns. On the other hand, the court's language begs the question: When the Implied Covenant is relevant in a certain situation, isn't it usually the case that the parties could have included the disputed matter in their contract on explicit terms? Further, didn't Squid Soap have a reasonable expectation that Airborne would actually expend resources in furtherance of the contract? It cannot be reasonably contended that Squid Soap entered into the agreement for the eventual return of its assets. Rather, it entered into the agreement to earn money, the bulk of which was to come from the earn-out when Airborne met the targets stipulated in the agreement.

The court's emphasis on the sophistication of Squid Soap cuts both ways. Certainly, Squid Soap may have intended to agree to whatever was explicitly included in the contract—no more, and no less. However, perhaps it was precisely *because* Squid Soap was a sophisticated party that it assumed that the language of the agreement would be sufficient to induce Airborne to expend resources. If the latter is true, then the agreement

---

204 *Id.* (emphasis added).

205 *Id.* at 147–48.

206 *Id.* at 147.

207 *Id.*

would arguably come within the Implied Covenant's "narrow band" under the theory that Airborne's "duty" to expend resources and to make a good faith effort to market was consistent with the "purposes reflected in the express language of the contract."[208]

The influence of the "sophisticated parties" factor on the court's analysis severely limits the general effectiveness of the Implied Covenant in cases where a court deems that one or more parties "should have known" to draft a more thorough, dispute-preventing agreement. The logic seems to unfold in the following way: (1) The Implied Covenant operates "where the contract as a whole speaks sufficiently to suggest an obligation and point to a result, but does not speak directly enough to provide an explicit answer."[209] (2) The Implied Covenant applies only when it is "clear from what was expressly agreed upon that the parties who negotiated the express terms of the contract would have agreed to proscribe the act later complained of as a breach . . . had they *thought to negotiate* with respect to that matter."[210] (3) Sophisticated parties are more likely to negotiate matters thoroughly than non-sophisticated parties. (4) Courts should be hesitant about implying contractual protections, especially "when the contract easily could have been drafted to expressly provide for [these protections]."[211] (5) If the parties are sophisticated, then they are more likely to be aware of the obligations that should be included in the agreement to protect their contractual expectations. (6) If certain obligations are not included in the agreement, then it is more likely than not that the parties, being sophisticated, did not intend for these obligations to attach at the time the agreement was signed.

Although the court did not view the Airborne–Squid Soap agreement as "irrational" or "unreasonable," the outcome of the case itself suggests that the contract was risky at best and unwise at worst, especially for a party represented by reputable counsel. And, as Delaware cases have shown, Delaware courts will not intervene to mitigate the consequences of entering into unwise contracts.[212]

*Allied Capital Corp. v. GC–Sun Holdings, L.P.*[213] provides another

---

208 *Id.* at 146 (quoting Alliance Data Sys. Corp. v. Blackstone Capital Partners V L.P., 963 A.2d 746, 770 (Del. Ch.), *aff'd*, 976 A.2d 170 (Del. 2009)) (internal quotation marks omitted).

209 *Id.*

210 *Id.* (emphasis added) (quoting Katz v. Oak Indus., Inc., 508 A.2d 873, 880 (Del. Ch. 1986)) (internal quotation marks omitted).

211 *Id.* (quoting Allied Capital Corp. v. GC–Sun Holdings, L.P., 910 A.2d 1020, 1035 (Del. Ch. 2006)) (internal quotation marks omitted).

212 *See* Nemec v. Shrader, 991 A.2d 1120, 1128 (Del. 2010).

213 *Allied Capital*, 910 A.2d 1020.

example of the "sophisticated party" factor in action. In that case, Allied sued GC (among other defendants), a limited partnership and one of Allied's debtors, to collect on a promissory note.[214] Allied claimed that, although the limited partnership itself was insolvent, it could have repaid Allied had GC's general partner refrained from subordinating Allied's claim on the promissory note to a new equity investment made by an affiliate of the general partner.[215] In what the Delaware Chancery Court termed "a jurisprudentially-intergalactic campaign to recover on the note," Allied brought no fewer than eight causes of action, including a claim for breach of the Implied Covenant, against a myriad of directly and remotely connected defendants.[216]

The defendants successfully moved to dismiss.[217] Faulting Allied for failing to secure certain substantive rights during the negotiation process, the court brushed off Allied's Implied Covenant claim as "another in a long line of [unsuccessful Covenant] cases"[218] in which plaintiffs attempt to make up for the consequences of certain contract drafting deficiencies. Allied alleged that it had been robbed of the fruits of the contract (repayment on the promissory note) because it had a reasonable expectation that no investments by the defendants would take priority over the note.[219] Allied's case was not helped by the fact that the promissory note explicitly forbade certain types of investments, but did not restrict the type of investment giving rise to Allied's claim.[220]

However, Allied may have had a cognizable argument based on its reasonable expectations. Allied argued that because the agreement prohibited unsubordinated debt investments, the agreement implied that unsubordinated equity investments (the type of investment made by the defendants) were also prohibited because otherwise, Allied would not have had any meaningful protection against "intentional evasions" of the debt-investment restriction.[221] In other words, Allied relied on the implication that, because "equity by its very nature has a lower priority than debt," the debt-investment restriction was the practical equivalent of an equity-investment restriction.[222]

---

214 *Id.* at 1023.

215 *Id.*

216 *Id.* at 1023–24.

217 *Id.* at 1045.

218 *Id.* at 1024.

219 *Id.* at 1032.

220 *Id.* at 1024.

221 *Id.* at 1032.

222 *Id.* at 1031.

While it is unclear whether this argument would have withstood court scrutiny had the parties been unseasoned, it is clear that the fact that the sophistication of Allied and GP played a role in the court's rejection of Allied's Implied Covenant claim. Premising its analysis on the fact that the Implied Covenant is "intrinsically counterfactual and [prone to] hindsight-bias," the court was unwilling to give Allied the benefit of the doubt because it had ample opportunity to negotiate for explicit contractual protections. One clear sign of the court's lack of sympathy was its citation to *Shenandoah Life Insurance Co. v. Valero Energy Corp.*, 1988 WL 63491, at *8 (Del. Ch. June 21, 1988)—another case involving sophisticated business entities—for the proposition that where "a specific, negotiated provision [like the debt-investment restriction] directly treats the subject of the alleged wrong and has been found to have not been violated, it is quite unlikely that a court will find by implication [that] a contractual obligation of a different kind [like an obligation to refrain from equity investments] . . . has been breached."[223]

However, the "sophisticated party" analysis can be troublesome in the alternative-entity context. A court may assume that because the parties chose an alternative-entity structure for their enterprise, the parties are necessarily sophisticated.[224] This assumption was illustrated by the Delaware Chancery Court's language in *Abry Partners V, L.P. v. F & W Acquisition LLC*: "In the alternative entity context[,] . . . it is more likely that sophisticated parties have carefully negotiated the governing agreement . . . ."[225] Courts may improperly assume sophistication among parties in alternative entities because these entities are riskier structures compared to the more "traditional" corporate and partnership forms which are supported by larger bodies of judicial precedent.[226] However, empirical evidence does not support this assumption of sophistication—the vast majority of LLCs are created without much negotiation by parties that are not necessarily skilled contract drafters.[227]

Would the outcome in *Airborne* have changed if the parties had not been sophisticated and represented by counsel from two top-notch law

223 *Id.* at 1033 n.25.

224 *See* Clancy v. King, 954 A.2d 1092, 1100 n.14 (Md. 2008) ("Limited partnership agreements are more likely to be the result of extensive arm's-length negotiations and thus involve business venturers in a better position to bargain for various terms . . . ."); *see also id.* ("The fact that the present case deals with a limited partnership rather than a corporation provides even greater reason to defer [solely] to the provisions of the various contracts.").

225 Abry Partners V, L.P. v. F & W Acquisition LLC, 891 A.2d 1032, 1063 (Del. Ch. 2006).

226 *See* Sale, *supra* note 128, at 457 (calling Delaware the "mother of all corporate law" jurisdictions).

227 *See* Hanno, *supra* note 128, at 113–14.

firms? *Clancy v. King* involved a partnership dispute between divorcing spouses.[228] Although *Clancy* is a Maryland Supreme Court case, it provides some useful insight regarding how a Delaware court might approach an Implied Covenant case in which the litigants are individuals rather than business entities.[229] Clancy, a successful author, and his wife, King, each held a 1% general partnership interest and a 49% limited partnership interest in their book-franchise limited partnership.[230] While the parties were still married, King obtained the right to manage the limited partnership through a court order.[231] The partnership then entered into a joint venture and the joint venture acquired the rights to convert Clancy's books into a television show and a series of paperback books.[232]

The joint venture agreement stated that key decisions regarding the "development, use and exploitation" of the television show proposal would be made by Clancy and a third party, but that if they failed to agree, Clancy's decision would control.[233] When Clancy and King divorced, a marital property agreement was incorporated into the divorce decree.[234] This agreement stated that Clancy would be the managing partner of the limited partnership, and that he would have the right to enter into contracts to exploit the literary assets of the joint venture.[235]

After Clancy and King's divorce was finalized, Clancy revoked his permission to the joint venture to use his name in marketing future books.[236] As a result, the limited partnership's share of the joint venture's profits plummeted from 75% to 25%, thereby proportionately affecting King's interest in the limited partnership.[237] King sued Clancy, alleging breach of fiduciary duty.[238] While the trial and intermediate appellate courts ruled in King's favor, the Maryland Court of Appeals reversed.[239]

---

[228] *Clancy*, 954 A.2d at 1095.

[229] Maryland's approach is similar to Delaware's contractual approach to the Covenant when fiduciary duties have been modified. *See id.* at 1100–01. Further, the *Clancy* court cited multiple Delaware cases throughout its analysis. *See generally id.* at 1092–1115.

[230] *Id.* at 1095.

[231] *Id.* at 1099.

[232] *Id.* at 1095 & n.3.

[233] *Id.* at 1096 & n.6.

[234] *Id.* at 1096 & n.5.

[235] *Id.*

[236] *Id.* at 1097.

[237] *Id.* at 1097 n.8.

[238] *Id.* at 1097.

[239] *Id.* at 1111.

Like the Delaware courts, the court of appeals heavily focused its attention on the role of the limited partnership agreement and the joint venture agreement in governing the relationship between the parties, and largely disregarded the role of fiduciary duties. In the court's view, fiduciary duties had been modified by the portions of the limited partnership agreement allowing the partners to compete with the partnership, and by the portions of the joint venture agreement giving Clancy final decisionmaking authority—provisions "that otherwise would be flagrant violations of common law and statutory fiduciary duties."[240]

However, the next step in the court's analysis was to view Clancy's conduct through the lens of the Implied Covenant. The court emphasized that Clancy had an obligation to exercise his discretion in good faith,[241] and cited multiple cases standing for the proposition that the Implied Covenant assumes even greater importance in the context of discretionary decisionmaking.[242] The issue was whether Clancy's decision to withdraw permission to use his name was made in bad faith. The court stated that "[a] general or managing partner acts in bad faith where the primary motivation of his or her conduct is to injure either the firm/venture or his or her business partners."[243] While conceding that, as an artist, Clancy had the right to "seek to retain creative control over a project that bore his . . . name,"[244] the court ultimately found that Clancy owed a duty of good faith, apart from fiduciary duties.[245]

Although *Clancy* appears to lend more significance to the Implied Covenant than Delaware cases, this case does not necessarily provide a complete template for Delaware. For example, *Clancy* differs from *Airborne* because in *Clancy*, King did not have a real opportunity to prevent the arbitrary exercise of Clancy's discretion. Clancy's discretion could not have been subject to an "efforts" obligation—either Clancy would continue to grant permission to use his name or he would not. In contrast, Squid Soap could have obligated Airborne to either expend a certain amount of its resources in marketing Squid Soap's products, or make a good-faith effort to market and advertise before returning the purchased assets to Squid Soap.[246] And, whereas the parties in *Allied* could

---

240 *Id.* at 1102 n.18.

241 *Id.* at 1106.

242 *Id.* at 1107.

243 *Id.* at 1108.

244 *Id.* at 1106.

245 *Id.* at 1110. The case was remanded to determine whether Clancy had acted in good faith. *Id.*

246 *But see* Karen Eggleston et al., *The Design and Interpretation of Contracts: Why Complexity Matters*, 95

have drafted an express provision prohibiting equity investments, parties like those in *Clancy* are not likely to include an express provision prohibiting the arbitrary exercise of discretion, given that discretely defining "arbitrary" conduct in a contract would be impractical and would leave parties free to engage in potentially arbitrary conduct that was not explicitly listed.

*Clancy* also differs from *Airborne* and *Allied* because Squid Soap, Airborne, Allied and GC were sophisticated business entities that had ample opportunity to negotiate for contractual protections at arm's length, whereas Clancy and King were individuals whose contractual relationship was intertwined with their disintegrating personal relationship, thereby giving Clancy a motive to harm King financially. In this respect, motivational considerations provide an independent basis for Implied Covenant analyses.

*2. Motives.*

The motive underlying the actions giving rise to the complaining party's claim plays a role in the outcome of Implied Covenant disputes. As a general matter, if the plaintiff can demonstrate (or even just suggest) that the defendant's actions were spiteful or malicious, the plaintiff is more likely to prevail on his Implied Covenant claim.[247] In contrast, if the defendant simply took an action that fell within the bounds of the agreement, or if the plaintiff's injury was merely a consequence of the plaintiff's entry into a "bad" contract, the plaintiff is less likely to prevail on his Implied Covenant claim.[248]

For example, the general implication in *Clancy* was that the timing of Clancy's withdrawal—after divorce proceedings—was indicative of Clancy's potential bad faith and desire to harm King by reducing her profit share:

> If a significant motive for Clancy exercising his contractual right to withdraw his name from the Op–Center series was to

---

NW. U. L. REV. 91, 120 (2000) (noting that "best efforts" obligations are not only vague, but also pose the risk of the judicial imposition of less-than-ideal terms).

[247] *See, e.g.*, *Clancy*, 954 A.2d at 1108 (citing Desert Equities, Inc. v. Morgan Stanley Leveraged Equity Fund, II, L.P., 624 A.2d 1199 (Del. 1993)).

[248] For example, in *Fisk Ventures, LLC v. Segal*, No. 3017–CC, 2008 WL 1961156, at *10–11 (Del. Ch. May 7, 2008), *aff'd*, 984 A.2d 124 (Del. 2009), the plaintiff essentially alleged that the mere exercise of a contractual right violated the Implied Covenant. This claim was swiftly rejected by the court. *Id.* at *11; *see also infra* Part IV.C (discussing *Fisk* in greater detail).

> decrease the profitability of the series, thereby denying his JRLP partner and ex-wife revenue, because he desired to spite or punish King for or as a consequence of their divorce, it reasonably could be maintained that he acted in bad faith towards both the Op–Center Joint Venture and JRLP. One certainly breaches the promise of good faith owed in contract and as fiduciary in a partnership by working actively to decrease directly the profits of the business venture.[249]

The deteriorating marital relationship between the parties in *Clancy* clearly had an influence on the lens through which the court evaluated Clancy's conduct because Clancy had a personal motive to harm the plaintiff.[250] In this vein, the plaintiff is more likely to prevail under an Implied Covenant theory if he can support the conclusion that the contract must be interpreted more liberally to adequately protect the plaintiff—such as when the defendant has engaged in some egregious conduct that is far outside the bounds of the agreement. However, this is an extremely high bar for the plaintiff to meet.[251]

Delaware courts view a defendant's conduct as arbitrary, unreasonable, or egregious, and therefore in violation of the Implied Covenant, when "the other contracting party is thereby disadvantaged *and* no legitimate interest of the party exercising the right is furthered by doing so."[252] In other words, if a plaintiff can only show that he was injured by the defendant's conduct, this will not necessarily persuade a Delaware court to imply contractual protections. This is a major disadvantage of the Implied Covenant when it stands unaccompanied by fiduciary duties. Unlike in the fiduciary duty context, the Implied Covenant allows a fairly full range of self-interested behavior.[253] Therefore, the "no legitimate interest" prong is necessary to differentiate permissible and impermissible conduct under the Covenant. If the defendant's conduct disadvantages the plaintiff but helps the defendant in

---

249 *Clancy*, 954 A.2d at 1109.

250 *See* Sale, *supra* note 128, at 488 (positing that good faith inquiries necessarily raise issues regarding the parties' motives).

251 *See* Gold, *supra* note 108, at 127–28 ("[B]arring egregious cases, such as unconscionability, fraud, or misappropriation of assets, contract doctrine mandates few restrictions on the discretion of nonfiduciaries.").

252 Nemec v. Shrader, 991 A.2d 1120, 1134 (Del. 2010) (emphasis added).

253 *See* Ribstein, *supra* note 123, at 909 ("In contrast to fiduciary duties, the implied covenant enables contracting parties to act selfishly as long as this conduct is at least broadly consistent with the parties' ex ante expectations based on the contract.").

the process, then the defendant's actions are presumably reasonable.[254] It is only when the defendant disadvantages the plaintiff *and* does not legitimately benefit the defendant in the process that the court will consider getting involved under a narrow conception of the Implied Covenant. For example, in *Clancy*, the defendant's refusal to allow his name to continue to be used not only reduced the plaintiff's share of distributions, but it also impaired the general success of the business while failing to render any apparent benefit to the defendant.

### *3. Complexity of the Agreement or Governance Scheme.*

Another important factor that can be gleaned from Implied Covenant decisions is the nature of the agreement or the structure that is sought to be established by the agreement. If either of these elements is particularly complex, the complaining party is less likely to prevail under an Implied Covenant theory. According to the Delaware Chancery Court, "Delaware courts rightly employ the implied covenant sparingly when parties have crafted detailed, complex agreements, lest parties be stuck by judicial error with duties they never voluntarily accepted."[255]

For example, *Lonergan v. EPE Holdings LLC* addressed an Implied Covenant claim in a class action brought by a unitholder in a master limited partnership ("MLP").[256] The plaintiff challenged a proposed merger between Enterprise GP Holdings ("Holdings") and Enterprise Products Partners L.P. ("Partners") because Holdings was the sole owner of Partners' general partner.[257] For this reason, the plaintiff alleged conflicts of interest and certain disclosure violations.[258]

Holdings and Partners were both MLPs, creating a two-tiered structure in which (1) Partners' distributions would trigger Holdings'

---

[254] For example, see *Nemec*, 991 A.2d at 1127–28, where the court opted to avoid "moral questions" based on the appearance of the defendant's actions, and stated that the "directors made a rational business judgment to exercise the Company's contractual right for the $60 million benefit." Notably, this language is similar to that found in cases applying the business judgment rule—a standard of review that is used in breach of fiduciary duty cases. *See supra* notes 59–62 and accompanying text. However, the *Nemec* court had already foreclosed the application of fiduciary duties because the plaintiff's claim arose from the contractual right to redeem. *See Nemec*, 991 A.2d at 1129. This is another example of Delaware's reversion to fiduciary duty principles in contractual inquiries. *See also supra* text accompanying notes 89–99.

[255] Bay Ctr. Apartments Owner, LLC v. Emery Bay PKI, LLC, No. 3658-VCS, 2009 WL 1124451, at *7 (Del. Ch. Apr. 20, 2009); *cf. In re* Lear Corp. S'holder Litig., 967 A.2d 640, 655 (Del. Ch. 2008) (listing the defendant's hiring of "reputable advisors" as a factor in denying fiduciary liability).

[256] Lonergan v. EPE Holdings, 5 A.3d 1008, 1011 (Del. Ch. 2010).

[257] *Id.*

[258] *Id.*

incentive distribution rights ("IDRs") and generate a certain percentage of Partners' distributions as cash for Holdings, and (2) Holdings would then distribute this cash to its unitholders.[259] Because the IDRs were directly linked to the performance of Partners, Holdings had an incentive to manage Partners in a way that would increase the cash available for distribution to Holdings' unitholders and attract investors.[260]

The complexity of the facts underlying the plaintiff's claim was not lost on the Delaware Chancery Court. According to the court, the two-tiered Holdings–Partners structure "create[d] a web of conflicts" that Holdings had to unwind in order to legitimize the proposed transaction before it was approved.[261] Holdings' general partner's member interests were solely owned by an LLC whose member interests were owned by three voting trustees. These trustees, through control of a closely-held corporation that owned the majority of Holdings' outstanding units, controlled the entire two-tier Holdings–Partners structure.[262]

The trustees also occupied positions on Holdings' general partner's eight-person board of directors.[263] Another member of the board had served in various executive capacities at the closely-held corporation owned by the trustees.[264] Only the remaining half of the board was facially disinterested.[265] Before the proposed merger was considered, an audit committee was created and one of the three trustees was replaced with a disinterested board member.[266] The merger would have eliminated the second tier by cancelling Holdings' interests in Partners.[267] With the counsel of a reputable legal team and the financial advice of Morgan Stanley,[268] and with the power to approve or reject the transaction resting solely with the independent audit committee, the proposed merger was approved.[269]

The plaintiff brought an Implied Covenant claim based on the conflicting interests of the merging parties, alleging that the proposed

---

259 *Id.* at 1012.

260 *Id.*

261 *Id.* at 1013.

262 *Id.*

263 *Id.*

264 *Id.*

265 *Id.*

266 *Id.* at 1013–14.

267 *Id.* at 1014.

268 Here, notice the overlap between the "complex agreement or governance scheme" and "sophisticated parties" factors.

269 *Lonergan*, 5 A.3d at 1015.

merger should not have been approved until a majority of Holdings' minority unitholders had also approved the transaction.[270] The court rejected the plaintiff's claim,[271] and this rejection may have had some connection to the complexity of the agreement.

To illustrate, the logic underlying the "complexity factor" is somewhat similar to the logic underlying the "sophistication of the parties" factor:[272] (1) The Implied Covenant operates "where the contract as a whole speaks sufficiently to suggest an obligation and point to a result, but does not speak directly enough to provide an explicit answer."[273] (2) The Implied Covenant applies only when it is "clear from what was expressly agreed upon that the parties who negotiated the express terms of the contract would have agreed to proscribe the act later complained of as a breach . . . had they *thought to negotiate* with respect to that matter."[274] (3) Parties to a "simple" LLC agreement, may not engage in extremely detailed contract drafting because they may either expect the probability of a dispute to be low, or they may fail to anticipate the myriad of ways that a dispute could arise. However, parties who are either drafting a particularly complex agreement, or drafting an agreement creating a particularly complex governance structure, are more likely to have thought through and negotiated for the contractual provisions that, in their respective views, would best protect their interests in light of the intricate nature of their prospective relationship. (4) Courts should be hesitant about implying contractual protections, especially "when the contract easily could have been drafted to expressly provide for [these protections]."[275] (5) If certain obligations are not included in the agreement, then it is more likely than not that the parties did not intend for these obligations to attach at the time the agreement was signed.

In sum, a plaintiff is not likely to be successful on an Implied Covenant claim because the Covenant covers very little territory under Delaware's contractarian approach, especially when the parties are sophisticated, when the defendant does not exhibit a personal motive for harming the plaintiff, or when the agreement at issue is complex.[276] The

---

[270] *Id.* at 1016.

[271] *Id.* at 1019.

[272] *See supra* Part IV.D.1.

[273] Airborne Health, Inc. v. Squid Soap, LP, 984 A.2d 126, 146 (Del. Ch. 2009).

[274] *Id.* (emphasis added) (quoting Katz v. Oak Indus., Inc., 508 A.2d 873, 880 (Del. Ch. 1986)) (internal quotation marks omitted).

[275] *Airborne*, 984 A.2d at 146 (quoting Allied Capital Corp. v. GC–Sun Holdings, L.P., 910 A.2d 1020, 1035 (Del. Ch. 2006)) (internal quotation marks omitted).

[276] *See infra* app. B.

following section discusses why a plaintiff's chances of success are even slimmer when the parties have contractually eliminated fiduciary duties.[277]

### C. *The Failure of the Nested-Sphere Model in Delaware in the Context of Fiduciary Waivers*

When parties have eliminated fiduciary duties or have opted to make an Implied Covenant claim instead of a breach of fiduciary duty claim, the Delaware Chancery Court has indicated that especially extreme hesitancy to find that a party has breached the Implied Covenant is warranted, without exception for situations that would appear to deny the complaining party the benefits of the contract.[278] This hesitancy has skewed the natural operation of the nested-sphere model by shrinking the scope of the Implied Covenant.[279] Therefore, parties should take care not to rely solely on the Implied Covenant to fill in when fiduciary duties have been eliminated, especially when their particular situation involves the factors contributing to Delaware's restrictive approach to the Covenant.[280]

*Lonergan* clearly lends credence to this warning because it does more than clarify the role of contractual complexity in Delaware's narrow reading of the Implied Covenant. This case is also critical because it involves an Implied Covenant claim following an express fiduciary opt-out. In the Delaware Chancery Court's first paragraph analyzing the plaintiff's Implied Covenant claim, the court noted that "the complaint contain[ed] the types of allegations commonly advanced by stockholder plaintiffs when challenging a merger involving a corporation" and that, presumably, "[i]n such a pleading, the plaintiff [will] assert[ ] claims for breaches of fiduciary duty."[281]

Here, the court suggested the following: If the plaintiff cannot allege the breach of a fiduciary duty, then the plaintiff will not prevail under another theory if the plaintiff's claim mirrors that of other plaintiffs who have sued successfully under fiduciary theories. With this suggestion in mind, the plaintiff's claim was greatly disadvantaged by the fact that Holdings' limited partnership agreement completely eliminated fiduciary duties—in the court's view, the plaintiff had not sufficiently alleged bad

---

277 *See infra* app. D.

278 *See infra* Part V.A (discussing *Cincinnati SMSA Ltd. P'ship v. Cincinnati Bell Cellular Sys. Co.*, 708 A.2d 989 (Del. 1998) as an example of the downsides of this approach).

279 *See infra* app. D.

280 *See supra* Part IV.B (analyzing these factors in detail).

281 Lonergan v. EPE Holdings, 5 A.3d 1008, 1016 (Del. Ch. 2010).

faith within the framework of the limited partnership agreement.[282]

Separating the court's reasoning from the merits of the court's ultimate decision, observe the language of the court which strongly indicates that a fiduciary opt-out should cause the scope of the Implied Covenant to narrow even further:

> When parties exercise the authority provided by the LP Act to eliminate fiduciary duties, they take away the most powerful of a court's remedial and gap-filling powers. As a result, parties must draft an LP agreement as completely as possible, and *they bear the risk of incompleteness*. If the parties have agreed how to proceed under a future state of the world, then their bargain naturally controls. But when parties fail to address a future state of the world—and they *necessarily* will because contracting is costly and human knowledge imperfect—then the elimination of fiduciary duties implies an agreement that losses should remain where they fall. After all, if the parties wanted courts to be in the business of shifting losses after the fact, then they would not have eliminated the most powerful tool for doing so.[283]

This language is extremely significant because it eliminates the possibility of loss reallocation under the Implied Covenant when fiduciary duties are waived for two reasons. First, the court imposed an additional burden on parties to draft a complete agreement to avoid bearing the risk of incompleteness.[284] However, the court then predicted the failure of this endeavor, stating that parties will "necessarily" be unable to address all future contingencies. Second, the court rejected the notion that parties can separate fiduciary duties from the Implied Covenant and obtain protection from the latter after eliminating the former.

Under *Lonergan*, once the parties significantly alter or eliminate fiduciary duties, this action operates as a signal that the Implied Covenant no longer holds remedial significance for the parties. This signal then appears to play a role in how courts will interpret contracts at issue.[285]

---

282 *Id.* at 1016–17, 1021–22.

283 *Id.* at 1018.

284 *See* Willie Gary LLC v. James & Jackson LLC, No. Civ.A. 1781, 2006 WL 75309, at *2 (Del. Ch. Jan. 10, 2006) ("With the contractual freedom granted by the LLC Act comes the duty to scriven with precision."), *aff'd*, 906 A.2d 76 (Del. 2006).

285 *Cf.* Larry E. Ribstein, *Fiduciary Duty Contracts in Unincorporated Firms*, 54 WASH. & LEE L. REV. 537, 544, 584 (1997) (arguing that fiduciary waivers affect the interpretation of partnership agreements in good-faith analyses).

Unfortunately, however, this signaling effect can cause courts to improperly fuse fiduciary duty and the Implied Covenant, resulting in an "all-or-nothing" approach where one obligation cannot be modified without proportionally affecting the other.[286]

Although the Implied Covenant is a matter of statutory law in Delaware, *Lonergan* essentially allows the parties to control the effectiveness of the Covenant by the manner in which they address fiduciary duties. Thus, the problem with the nested-sphere model reveals itself. While, in theory, the parties should be able to remove the outer layer of fiduciary duty without compromising the inner core of the Implied Covenant,[287] in reality, *Lonergan* suggests that the remedial importance or "accessibility" of the Implied Covenant can be altered by courts based on the parties' alteration of fiduciary duties in the contract.[288] Instead of "peeling away" fiduciary duties and leaving the Implied Covenant untouched, *Lonergan* exerts inward pressure on the Covenant's inner sphere, thereby reducing the Covenant's already narrow scope even further until the conduct complained of no longer falls within the Covenant's territory.[289]

*Lonergan* suggests that if the parties severely reduce the scope of fiduciary duties, then the Implied Covenant would theoretically apply only to egregious conduct that violates the essence of the agreement.[290] However, if the parties eliminate fiduciary duties altogether, then the Implied Covenant will retain little to no residual significance in a court's view because the parties will have failed to retain the strongest tools available to courts to save one party from the commercial misconduct of another.[291] In other words, the Delaware courts will not help those who do not help themselves—if the parties choose to eliminate the courts'

---

286 *E.g.*, Douzinas v. Am. Bureau of Shipping, 888 A.2d 1146, 1149–50 (Del. Ch. 2006) ("[I]n the alternative entity context, it is frequently impossible to decide fiduciary duty claims without close examination and interpretation of the governing instrument of the entity giving rise to what would be, under default law, a fiduciary relationship."). This proposition suggests that the governing instrument can have an impact on fiduciary duty inquiries, and vice versa.

287 *See infra* app. C.

288 *See* Gold, *supra* note 108, at 153 (arguing that a precisely tailored fiduciary waiver allows courts to better determine whether the conduct at issue falls within the Implied Covenant's boundary).

289 *See infra* app. D.

290 *See* Steele, *supra* note 88, at 30; *cf.* Sale, *supra* note 128, at 485 (noting that only "egregious or conspicuous" conduct may be subject to liability under a fiduciary conception of good faith). As mentioned previously, however, such claims could likely be framed as fiduciary duty claims. *See supra* notes 136–39 and accompanying text.

291 Ribstein, *supra* note 123, at 900 (classifying the duty of good faith and fair dealing as a "lesser" duty). Interestingly, while the standard for fiduciary waiver is fairly strict (presumably to ensure that the parties are aware

most effective method of regulating the parties' relationship, then the courts will lose sympathy for the plaintiff who attempts to use the Implied Covenant as a means of imposing liability for conduct that could otherwise have been addressed under a fiduciary analysis. Given Delaware courts' comfort with the well-established fiduciary duty framework, and given their historical "tendency to default to . . . fiduciary duty principles,"[292] this phenomenon may be all the more acute.[293]

The history of Delaware's good faith jurisprudence sheds some light on this tendency. The Delaware Supreme Court first identified the duty of good faith as an independent fiduciary duty in *Cede & Co. v. Technicolor Inc.*[294] Strangely, the court did not discuss why the good faith duty was worthy of elevation to the status of a fiduciary duty when previous cases merely referenced good faith as the absence of bad faith (where bad faith was limited to tortious or borderline-tortious conduct).[295] Regardless, because Delaware has a history of classifying good faith as either a fiduciary duty or a subset of the fiduciary duty of loyalty,[296] it is not surprising that Delaware courts would take the view that an agreement eliminating fiduciary duties is practically equivalent to a hypothetical agreement that eliminates good faith requirements.

So, what exactly is the purpose of the Implied Covenant when parties eliminate fiduciary duties? If parties retain traditional fiduciary duties in an LLC agreement, for example, then reliance on the Implied Covenant is unnecessary—a court can simply use a fiduciary duty analysis to allocate losses. Revisiting the nested-sphere model, because fiduciary duties impose liability for a broader range of conduct than the Implied Covenant, conduct violating the Implied Covenant would also violate traditional fiduciary duties. This is a factor that makes fiduciary duties attractive to Delaware courts—fiduciary duties are relatively easy to apply because they cover broad territory, and because the fiduciary rubric is

---

of what they are waiving), once this standard is met, Delaware courts are not hesitant to eliminate the significance of the Implied Covenant. *See, e.g.*, Auriga Capital Corp. v. Gatz Properties, 40 A.3d 839, 853 (Del. Ch. 2012).

292 Steele, *supra* note 88, at 17.

293 *See supra* notes 86–98 and accompanying text.

294 Cede & Co. v. Technicolor Inc., 634 A.2d 345 (Del. 1993); Steele, *supra* note 88, at 29.

295 Steele, *supra* note 88, at 29.

296 *E.g.*, *Cede*, 634 A.2d at 361; *In re* Gaylord Container Corp. S'holders Litig., 753 A.2d 462, 475 n.41 (Del. Ch. 2000). Delaware courts have not taken into account the fact that one can act loyally and in bad faith simultaneously. Sale, *supra* note 128, at 484. There is not necessarily an overlap between the duty of loyalty and the duty of good faith. For example, a disinterested fiduciary can approve a transaction that no other person would have approved in good faith, or can act with "deliberate indifference" without the presence of a conflict of interest. *Id*. In both situations, the fiduciary's good faith is implicated although his loyalty is not. *Id*.

well-cemented in Delaware jurisprudence.[297] Fiduciary characterizations assist courts not necessarily because they assume the total lack of self-interest of the parties, but because they allow the court to assess whether the parties "subordinate[d] their immediate self-interest to their long-term collective interest."[298] Without such an assessment, a court can determine that an LLC is no longer a "vehicle[ ] for the *collective* pursuit of long-term, individual, self-interest" (requiring at least some consideration for the interests of the other parties).[299] Rather, the LLC would become a vehicle for the *individual* pursuit of long-term, individual, self-interest akin to an extended series of discrete, arms-length transactions (requiring little to no consideration for the interests of the other parties).[300] Therefore, it seems that the Implied Covenant is practically inaccessible in Delaware, whether or not the parties choose to eliminate traditional fiduciary duties.[301]

This inaccessibility can trigger significant consequences because while LLCs arise from contracts, they are also highly relational entities characterized by complex, fluid, long-term relationships.[302] Therefore, LLC operating agreements devoid of fiduciary duties potentially pose difficulties in situations where the Implied Covenant is no longer sufficient to meet the changing expectations of the parties. While, in theory, the nested-sphere model is applicable in Delaware via DLLCA,[303] the *way* in which the Delaware courts subscribe to this model creates the potential for results that could not be predicted by the model in its unaltered form.[304]

Notably, the *Lonergan* court observed that, unlike discrete transactions, relational contracts can be renegotiated if the parties are

---

297 *See generally* Manesh, *supra* note 6 (discussing the benefits of entity formation in Delaware).

298 Vestal, *supra* note 7, at 550 (discussing fiduciary duties in the partnership context).

299 *Id.* (emphasis added); *see also* Callison & Vestal, *supra* note 149, at 304 ("[P]articipants only join [a] firm if they expect their long-term self-interest . . . to be maximized.").

300 *See* Kleinberger, *supra* note 154, at 22 (noting that in jurisdictions that take the contractual approach to the Implied Covenant, "contractual permission to compete with the LLC as a business mean[s] (implicitly) that the members [are] at arm's length"); *see also* Clancy v. King, 954 A.2d 1092, 1100 n.13 (Md. 2008) ("A limited partnership is essentially . . . a series of contracts."); Vestal, *supra* note 7, at 524 (discussing the partnership context, and contending that under the contractarian view, "the partnership relation is simply a shorthand for a bundle of mutable contractual rights and obligations").

301 *See* Gold, *supra* note 108, at 153 ("[T]here is uncertainty as to precisely when an implied good faith term will preclude conduct otherwise covered by fiduciary duties.").

302 *See* Miller, *supra* note 12, at 740–41; Miller, *supra* note 30, at 607.

303 DLLCA is designed to give independent effect to retained fiduciary duties and the Implied Covenant. *See* DEL. CODE ANN. tit. 6, §§ 17-1101(d), 18-1101(c) (2005).

304 *Compare infra* app. C, *with infra* app. D.

unsatisfied with where economic losses will fall under their existing agreement.[305] This is certainly true. However, given that the majority of long-term contracts are incomplete contracts,[306] these contracts will likely remain incomplete, even after renegotiation. Because the Implied Covenant is a gap-filling tool, and because LLCs mainly consist of gaps when viewed contractually,[307] the Implied Covenant is critical.[308] It is doubtful that a single renegotiation will resolve the fundamental problem, which is Delaware's consistently hesitant approach to the Implied Covenant, and its increased reluctance to trigger the Covenant when fiduciary duties are waived.[309] The only truly effective renegotiation would be one involving the reinstatement of fiduciary duties to govern the parties' relationship.[310] Anything less would merely increase both parties' transactions costs without proportionally increasing the protection of either party.[311]

### D. *Fisk Ventures, LLC v. Segal: The LLC-Specific Implied Covenant Case That Is the Exception, Not the Rule*

There is limited Delaware case law directly addressing the fiduciary

---

305 Lonergan v. EPE Holdings, 5 A.3d 1008, 1018 & n.4 (Del. Ch. 2010).

306 Benjamin Means, *A Contractual Approach to Shareholder Oppression Law*, 79 FORDHAM L. REV. 1161, 1187 (2010).

307 *See* Easterbrook & Fischel, *supra* note 14, at 426–27 ("When the task is complex, when efforts will span a substantial time, . . . a detailed contract would be silly."); *cf.* Charles R. O'Kelley, Jr., *Filling Gaps in the Close Corporation Contract: A Transaction Cost Analysis*, 87 NW. U. L. REV. 216, 216 (1992) (making this argument in the context of closely-held corporations); Weidner, *supra* note 50, at 82 ("[I]ndividuals rarely 'bargain' as equals for partnership agreements that completely define their relationship. The law should assume that the completely defined partnership relationship is the exception rather than the norm.").

308 Mkt. St. Assocs. Ltd. P'ship v. Frey, 941 F.2d 588, 595 (7th Cir. 1991) (stating that the doctrine of good faith is designed to minimize performance costs and advance the mutual goals of the parties).

309 Cincinnati SMSA Ltd. P'ship v. Cincinnati Bell Cellular Sys. Co., 708 A.2d 989, 992 (Del. 1998) (warning that the application of the Implied Covenant should be a "cautious enterprise").

310 *See* Easterbrook & Fischel, *supra* note 14, at 427 ("The duty of loyalty replaces detailed contractual terms."); *see also* Morey W. McDaniel, *Bondholders and Corporate Governance*, 41 BUS. LAW. 413, 447 (1986) (arguing that "[f]iduciary duties are a substitute for costly contracts."); Miller, *supra* note 30, at 606 (arguing that prohibiting the elimination of fiduciary duties would be best to protect contractual freedom while guarding against opportunistic conduct). Especially in light of Delaware's restrictive approach to the Implied Covenant, a contract retaining fiduciary duties would be a more efficient choice than a contract that would be subject to a constant and costly cycle of dispute and renegotiation. *See* Eggleston et al., *supra* note 246, at 120 (contending that simple contracts are beneficial in reducing enforcement costs and the risk of improper judicial interpretation).

311 *See* Means, *supra* note 306, at 1189 (noting that transactions costs limit parties' ability to rectify contractual gaps).

duty–Implied Covenant relationship in the LLC context.[312] *Fisk Ventures, LLC v. Segal*[313] is Delaware's current template for addressing the Implied Covenant in light of a fiduciary opt-out in the LLC context. In that case, Fisk Ventures LLC was a member of Genetrix LLC, a company with an extended history of fundraising difficulties.[314] The Genetrix LLC agreement eliminated fiduciary duties and required the approval of 75% of the Genetrix board of directors to implement certain financing proposals.[315] Segal, the president of Genetrix, presented certain financing proposals to the Genetrix board, but failed to obtain the requisite 75% vote of approval.[316]

When Fisk Ventures attempted to dissolve Genetrix, Segal responded by alleging, among other things, that Fisk breached its fiduciary duty as well as the Implied Covenant by undermining Segal's proposal for Genetrix.[317] The Delaware Chancery Court swiftly rejected Segal's claims in light of the LLC agreement, under which Genetrix's board members could freely vote in favor or against Segal's (or any individual's) financing proposals.[318] According to the court, the mere exercise of contractual rights could never constitute a bad faith violation of the Implied Covenant.[319] Rather, the court maintained that Segal failed to state a claim by making the conclusory allegation that the board had acted in bad faith by failing to approve Segal's plan.[320] The Delaware Supreme Court later affirmed the chancery court's ruling.[321]

If there was any lingering confusion regarding the limited scope of the Implied Covenant under Delaware law, the chancery court eliminated it:

---

312 Robert R. Keatinge et al., *Limited Liability Entities—2005 Developments in Limited Liability Companies and Limited Liability Partnerships*, ALI–ABA VIDEO L. REV. (March, 17, 2005) ("[I]t cannot be stated with confidence how the Delaware courts will interpret the limitation imposed by [DLLCA] section 18-1101(e) that waivers of fiduciary duties may not extend to bad faith violations of the covenant of good faith and fair dealing."); Manesh, *supra* note 6, at 244 (noting that the tension between fiduciary duties and the Implied Covenant have planted the "latent seeds of indeterminacy" in Delaware LLC law); Scott Gordon Wheeler, Comment, *LLC Fiduciaries: Where Has All the Good Faith Gone?*, 59 U. KAN. L. REV. 1063, 1074 (2011).

313 Fisk Ventures, LLC v. Segal, No. 3017–CC, 2008 WL 1961156, at *2–3 (Del. Ch. May 7, 2008), *aff'd*, 984 A.2d 124 (Del. 2009).

314 *Id.*

315 *Id.* at *2, *11.

316 *Id.* at *5–6

317 *Id.* at *6.

318 *Id.* at *2, *10–11.

319 *Id.* at *11.

320 *Id.*

321 Segal v. Fisk Ventures, LLC, 984 A.2d 124 (Del. 2009).

> Although occasionally described in broad terms, the implied covenant is not a panacea for the disgruntled litigant. In fact it is clear that that a court cannot and should not use the implied covenant of good faith and fair dealing to fill a gap in a contract with an implied term unless it is clear from the contract that the parties would have agreed to that term had they thought to negotiate the matter. Only rarely invoked successfully, the implied covenant of good faith and fair dealing protects the spirit of what was actually bargained and negotiated for in the contract. Moreover, because the implied covenant is, by definition, implied, and because it protects the spirit of the agreement rather than the form, it cannot be involved where the contract itself expressly covers the subject at issue.[322]

The court's language begs the question of whether the Implied Covenant has been reduced to a mere formality. It would certainly appear so, given the court's language.

However, it is clearly poor strategy for a litigant to claim that conduct breached either fiduciary duties or the Implied Covenant when that conduct was well within the scope of conduct allowable under the LLC agreement, especially when the agreement eliminated fiduciary duties.[323] In the context of the nested-sphere model, there is nothing exceptional about the *Fisk* decision. Rather, the outcome in *Fisk* was unremarkable given the weakness of Segal's counterclaim—Segal was improperly attempting to use a bad faith allegation to avoid the LLC agreement and to obtain unilateral control over the direction of Genetrix's financing.[324]

Therefore, *Fisk* is entirely outside the bounds of the nested-sphere model, and is an exception to this Article's observations regarding the two effects of Delaware Covenant law on the nested-sphere model—the

---

322 *Fisk*, 2008 WL 1961156, at *10 (citations and internal quotation marks omitted).

323 *See id.* at *11; Terry A. Lambert Plumbing Inc. v. W. Sec. Bank, 934 F.2d 976, 983 (8th Cir. 1991) ("Acting according to express terms of a contract is not a breach of good faith and fair dealing."); Price v. Wells Fargo Bank, 261 Cal. Rptr. 735, 742 (Cal. Ct. App. 1989) (holding that good faith and fair dealing "does not impose any affirmative duty of moderation in the enforcement of legal rights"). There are two arguments regarding whether the LLC agreement eliminated fiduciary duties, or just modified them. On one hand, the agreement purported to eliminate fiduciary duties by stating that members would not have any duties that had not been "expressly articulated," and fiduciary duties were not expressly articulated in the agreement. *See Fisk*, 2008 WL 1961156, at *11. On the other hand, the agreement still held members responsible for fraud, gross negligence, and intentional wrongdoing, lending credence to the argument that the agreement merely modified fiduciary duties. *See id.* at *9. The former argument seems more persuasive than the latter.

324 *See Fisk*, 2008 WL 1961156, at *11.

Covenant's initially narrow scope and its reduced scope after a fiduciary waiver. First, *Fisk* is outside the bounds of this Article's previous discussion of the factors influencing Delaware's narrow view of the Implied Covenant. Although the parties in *Fisk* could accurately be portrayed as sophisticated, this factor did not appear to have any effect on the court's decision. In fact, the claim was bound to fail regardless of the Implied Covenant's initial scope. Revisiting the nested-sphere model and disregarding the parties' fiduciary waiver, the mere exercise of explicitly-granted contractual rights fails to give rise to an action for breach of the Implied Covenant.[325]

Second, *Fisk* appears to be the exception to the "*Lonergan* rule" because the *Fisk* decision did not condition loss allocation under the Covenant on the parties' treatment of fiduciary duties. In other words, the conduct at issue fell within a range of permissible conduct, necessarily precluding a breach of fiduciary duty claim.[326] No alteration of the model was necessary to achieve this result, even though the parties eliminated fiduciary duties. In contrast, the *Lonergan* court did not say that the plaintiff's claim would have failed under a fiduciary duty analysis. Therefore, while the *Lonergan* court's interpretation of the effect of a fiduciary waiver on the Implied Covenant can be categorized as a major alteration of the nested-sphere model, the *Fisk* court's interpretation of the same waiver cannot be similarly categorized.

However, parties relying solely on the Implied Covenant should not overfocus on the specific facts of *Fisk*—taken together, the rule in *Lonergan* combined with the chancery court's language in *Fisk* are indicative of Delaware's likely future approach to the Implied Covenant in the LLC context.

## V. Delaware Is Set to Take the Wrong Approach to the Implied Covenant in the LLC Context

Undoubtedly, it *should* be more difficult to prevail under the Implied Covenant than fiduciary duties. Otherwise, every contractual relationship would be a fiduciary relationship, and vice versa. However, the Covenant must be given some meaning independent of fiduciary duties. Otherwise, the elimination of fiduciary duties risks leaving parties completely unprotected from the opportunistic behavior of their fellow parties.[327]

325 *See infra* app. A.

326 *See Fisk*, 2008 WL 1961156, at *11.

327 In this respect, an approach to the contractual Covenant that considers a certain degree of fairness is

An agreement that relies solely on the Implied Covenant provides little by way of analogy to partnership and corporate law—two arenas in which Delaware courts have enjoyed considerable comfort. This is precisely where the problem arises with Delaware's approach arises. As mentioned previously, Delaware's corporate law paradigm has historically conflated the duty of good faith and the fiduciary duty of loyalty.[328] However, at least in the corporate context, the duty of loyalty cannot be eliminated,[329] meaning that, even in a jurisprudential regime that conflates the two obligations, the duty of good faith can never be eliminated. Therefore, there is no practical need to distinguish between fiduciary duties and the duty of good faith under Delaware corporate law. In contrast, Delaware's alternative-entity paradigm allows fiduciary duties to be completely eliminated, while by statute, the Implied Covenant cannot be eliminated.[330] Therefore, there *is* a need to distinguish the Covenant from fiduciary duties in this context.

As the following sections discuss, while Delaware courts addressing Covenant claims purport to consider the contemplations of the parties during the negotiation and drafting processes, their failure to consider the Covenant independently of fiduciary duties leads these courts to neglect parties' reasonable, post-agreement expectations in deciding whether to trigger the Covenant. This approach is especially problematic after the parties have opted out of fiduciary duties. Further, this approach does not properly accommodate average LLCs, which are typically formed without extensive negotiation.

### *A. The Consequences of Favoring Party Contemplations over Party Expectations in an Implied Covenant Inquiry*

Delaware requires the parties to contemplate—but fail to express—a resolution to the matter in dispute before the Implied Covenant can apply.[331] To the extent that it is impossible for parties to "negotiate and

---

preferable. *See, e.g.*, Dunlap v. State Farm Fire & Cas. Co., 878 A.2d 434, 444 (Del. 2005) ("[A]lthough the obligation of good faith does not require the insurer to relieve the insured of all possible harm that may come from his choice of policy limits, it does obligate the insurer not to take advantage of the unequal positions in order to become a secondary source of injury to the insured." (internal quotation marks omitted)).

[328] *See* Cede & Co. v. Technicolor Inc., 634 A.2d 345, 361 (Del. 1993); *supra* text accompanying notes 294–96.

[329] *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (2005).

[330] *See* tit. 6, § 18-1101(c).

[331] *E.g.*, Airborne Health, Inc. v. Squid Soap, LP, 984 A.2d 126, 146 (Del. Ch. 2009); Danby v. Osteopathic Hosp. Ass'n of Del., 101 A.2d 308, 313–14 (Del. Ch. 1953), *aff'd*, 104 A.2d 903 (Del. 1954).

describe within their contract all of the possible provisions that could be included,"[332] this requirement is justifiable. However, while all long-term contracts are incomplete to some extent,[333] Delaware court treatment of the Implied Covenant creates a perverse incentive to draft contracts that are "uncomfortably" incomplete: To successfully make an Implied Covenant claim, the parties must have entered an agreement that is silent on a matter that they clearly contemplated and could have expressed,[334] but they must not have entered an agreement that will be deemed "intentionally silent," in which case the Covenant will not apply at all.[335]

However, if the parties clearly contemplated a matter, it would seem that the matter contemplated would be the *most* likely to be actually included in the contract, and that Implied Covenant protection would therefore be unnecessary. So why are Delaware courts seemingly willing to reward parties with the protection of the Implied Covenant for drafting "half-baked" contracts that fail to mention basic matters that are within the parties' contemplation? Arguably, the matters that should be the subject of the Implied Covenant are those that are just outside of the parties' contemplations, but are within the realm of the parties' reasonable expectations.

Instead, in applying Implied Covenant analyses, Delaware courts have neglected the reasonable expectations of the parties in favor of the parties' unexpressed contemplations.[336] The Delaware Chancery Court illustrated this phenomenon in *Danby v. Osteopathic Hospital Ass'n of Delaware*,[337] a case that was later affirmed by the Delaware Supreme Court:

> The law will imply an agreement by the parties to contract and to do and perform those things which according to reason

---

Compare this approach with that of the Seventh Circuit in *Kham*, where the court labeled good faith as "an implied undertaking not to take opportunistic advantage in a way that *could not have been contemplated at the time of drafting*, and which therefore was not resolved explicitly by the parties." Kham & Nate's Shoes No. 2, Inc. v. First Bank, 908 F.2d 1351, 1357 (7th Cir. 1990) (emphasis added). *See also* discussion *supra* Part IV.A.2.

332 Paul M. Altman & Srinivas M. Raju, *Delaware Alternative Entities and the Implied Contractual Covenant of Good Faith and Fair Dealing Under Delaware Law*, 60 BUS. LAW. 1469, 1476 (2005) (citing Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., Civ. A. No. 12150, 1991 WL 277613 (Del Ch. Dec. 30, 1991)).

333 *Cf.* O'Kelley, Jr., *supra* note 306 (closely-held corporation context); Weidner, *supra* note 50, at 82 (partnership context).

334 *See In re* Broadstripe, LLC, 435 B.R. 245, 263 (Bankr. D. Del. 2010).

335 *See* Dave Greytak Enters. v. Mazda Motors, 622 A.2d 14, 23 (Del. Ch. 1992).

336 *See generally* Means, *supra* note 305 (arguing that contractarian theory does not protect party expectations as well as the application of equitable contract principles).

337 Danby v. Osteopathic Hosp. Ass'n of Del., 101 A.2d 308 (Del. Ch. 1953), *aff'd*, 104 A.2d 903 (Del. 1954).

> and justice they should do in order to carry out the purpose for which the contract is made. However, such promise can be implied only where it can be rightfully assumed that it would have been made if attention had been directed to it. A promise will not be read into a contract unless it arises by necessary implication from the provisions thereof. Terms are to be implied in a contract *not because they are reasonable* but because they are necessarily involved in the contractual relationship so that the *parties must have intended them and have only failed to express them because they are too obvious to need expression*.[338]

This language suggests that when parties contemplate terms, they can get the protection of the Implied Covenant when they stop short of including explicit evidence of their contemplation in their agreement, so long as the matter contemplated is sufficiently obvious.[339] However, by stating that "[t]erms are [not] to be implied in a contract . . . because they are reasonable," the court suggested that the Implied Covenant will not protect expectations that were not contemplated, that were non-obvious, or that arose after the agreement was complete, even if it would be reasonable to do so.[340] This reasoning is necessarily incomplete because it fails to consider certain unique instances in which the Implied Covenant should be triggered—such as when parties form expectations without contemplating the precise instances in which those expectations will be undermined.

*Cincinnati SMSA v. Cincinnati Bell Cellular Systems Co.*[341] illustrates the consequences of this approach. In *Cincinnati*, the parties formed a limited partnership for the purpose of providing one type of cellular service.[342]

---

338 *Id.* at 313–14 (emphasis added) (citations omitted).

339 There is a separate argument here that if an issue or term is sufficiently obvious, there is no need to contemplate it in the first place.

340 *Lonergan* cited *Dunlap* (an insurance torts case discussed *supra* Part III.B.1) for the proposition that "[i]mplying contract terms is an occasional necessity . . . to ensure [that] parties' reasonable expectations are fulfilled." Lonergan v. EPE Holdings, 5 A.3d 1008, 1018 (Del. Ch. 2010) (second alteration in original) (quoting Dunlap v. State Farm Fire & Cas. Co., 878 A.2d 434, 442 (Del. 2005)) (internal quotation marks omitted). As discussed *supra* Part III.B, using language from tort cases while taking a contractual stance in an Implied Covenant inquiry is problematic. Because a contractual approach does not consider fairness, it can be concluded that Delaware courts would view the consideration of the parties' reasonable expectations—a standard imported from the tort context—as unnecessary and irrelevant in a contract case. In other words, *Lonergan*'s citation to *Dunlap* implies that the "occasional necessity" to trigger the Covenant to protect reasonable expectations only arises in the tort context.

341 Cincinnati SMSA Ltd. P'ship v. Cincinnati Bell Cellular Sys. Co., 708 A.2d 989 (Del. 1998).

342 *Id.* at 991.

The limited partnership agreement contained a noncompete clause prohibiting the parties from providing any competing services within the FCC's existing two-license framework.[343] The plaintiff sued for breach of the Implied Covenant based on the defendant's provision of a new type of cellular service that was not included in the noncompete clause (because the new type of service did not exist at the time of the limited partnership agreement), but which resulted in competition with the plaintiff.[344]

The Delaware Supreme Court affirmed the chancery court's ruling that the competing partner did not breach the Implied Covenant on the grounds that the competitive conduct was not covered under the limited partnership agreement.[345] However, when the limited partnership agreement at issue was drafted, the complaining party could not have anticipated that a new type of cellular service—one falling outside of the FCC's licensing framework available at the time of the agreement—would serve as a means for the other party to compete with the partnership in spite of the agreement's noncompete clause.[346] Therefore, the new form of cellular service could not truly be classified as "too obvious to need expression." This is the "contemplation" prong of the analysis that caused the *Cincinnati* court to decline to trigger the Implied Covenant to prevent the competing partner from continuing to offer the competitive cellular service.

But what about the role of reasonable expectations? In Implied Covenant cases, courts "must extrapolate the *spirit* of the agreement

---

343 *Id.*

344 *Id.* In *Cincinnati*, it was not apparent whether or not the parties had retained, modified, or eliminated fiduciary duties in their agreement. On one hand, it could be argued that the noncompete clause merely reinforced the duty of loyalty. On the other hand, it could be argued that the inclusion of the clause indicated that the duty of loyalty had been modified to cover only the matters included in the clause. However, this point is not critical to the analysis in this section because not only must fiduciary waivers be express, *see supra* note 119 and accompanying text, but also the plaintiff did not bring a breach of fiduciary duty claim against the defendant for competing with the limited partnership. As shown in Appendix B, a fiduciary duty of loyalty claim could have substituted for the Implied Covenant claim in *Cincinnati*. *See infra* app. B. However, if a party chooses not to bring a fiduciary duty claim when such a claim is available to them, then this is the functional equivalent of a situation in which the parties eliminated fiduciary duties. *See infra* app. D. Therefore, in light of *Lonergan*, the outcome in *Cincinnati* presumably would have been the same, with or without a fiduciary waiver, due to *Lonergan*'s conflation of fiduciary duties with the Covenant.

345 *Cincinnati*, 708 A.2d at 994.

346 *See id.* at 991. Here, an approach to the Covenant that incorporates fairness considerations is preferable, because it uses the Covenant as a tool to imply contractual terms in light of "unanticipated developments." *See* Dunlap v. State Farm Fire & Cas. Co., 878 A.2d 434, 441 (Del. 2005) ("The covenant is 'best understood as a way of implying terms in the agreement,' whether employed to analyze unanticipated developments or to fill gaps in the contract's provisions.").

through the express terms and determine the terms that the parties would have bargained for to govern the dispute had they foreseen the circumstances under which their dispute arose."[347] However, the *Cincinnati* court failed to independently include the expectations of the complaining party in its analysis. Prevention of competition was the fundamental purpose of the *Cincinnati* noncompete clause. By restricting *all* existing methods of providing competing services at the formation of the partnership, the complaining party clearly had a reasonable expectation that the other party would not compete with the partnership. Therefore, it is reasonable to conclude that had the new form of competition existed during negotiations, the parties would have included it in the noncompete clause. It cannot be logically contended that the complaining party—by signing an agreement that prohibited cellular service under the two-license framework in existence at the time of the agreement—was granting permission to the other party to compete with the partnership in the future by using a new form of competition that had not been conceived when the agreement was signed. However, this is essentially the proposition that was suggested by the court's decision.

It is often noted that the Implied Covenant cannot be used to override one or more express contractual provisions.[348] Does this restriction justify the outcome in a case like *Cincinnati*? The answer depends on what it means to "override" a contractual provision. A contractualist would say that any attempt to impose liability under the Implied Covenant for conduct falling outside the bounds of the noncompete clause would constitute an improper override. This is the strict contractual approach that was taken by the *Cincinnati* court. On the other hand, there is an argument that implying a general covenant not to compete would not have overridden the noncompete clause, but rather would have been complementary to the contractual provision that was already in place. This is an argument supporting a broader reading of the Implied Covenant's role.[349] In this respect, *Cincinnati* is unique because, although the parties addressed the issue of competition in their agreement, the timing of their

---

[347] Kelly v. McKesson HBOC, Inc., No. 99C-09-265 WCC, 2002 WL 88939, at *10 (Del. Super. Ct. Jan. 17, 2002) (emphasis added).

[348] *See* Gilbert v. El Paso, 575 A.2d 1131, 1143 (Del. 1990).

[349] *See* Dunlap v. State Farm Fire & Cas. Co., 878 A.2d 434, 444 (2005) ("[T]he implied covenant of good faith is the obligation to preserve the spirit of the bargain rather than the letter, the adherence to substance rather than form. . . . It requires more than just literal compliance with [contracts] and statutes. The implied covenant of good faith and fair dealing requires that [one party] act in a way that honors the [the other party's] reasonable expectations." (citation omitted) (internal quotation marks omitted)).

agreement prevented them from foreseeing and addressing the *type* of competition that would give rise to their future dispute.

Not all courts are quite as strict as Delaware courts are when applying (or failing to apply) the Implied Covenant in the contractual setting. For example, a Texas court observed that a party breaches the Implied Covenant by performing a contract "in a manner that is unfaithful to the purpose of the contract and *justified expectations* of the other party are thus denied."[350] This approach not only examines the four corners of the contract, but also gives weight to the complaining party's reasonable expectations of what protections the contract would likely provide should a dispute arise.[351] This broader reading arguably accommodates the relational nature of the LLC better than Delaware's purely contractual approach.[352]

In contrast, an extremely narrow interpretation of the Implied Covenant, leads to *Cincinnati*-type outcomes, and allows parties to circumvent the purpose of a contract by conducting themselves in a manner that falls just outside of the four corners of the agreement. In contrast, a broader interpretation better protects the purpose of the Implied Covenant by ensuring that the reasonable expectations of the complaining party are met.[353] Essentially, the difference between these two approaches to the Implied Covenant is marked by what the court chooses to emphasize—the purpose and substance of the parties' interactions giving rise to the parties' expectations, or the form of the contract evidencing the parties' contemplations.

Would party expectations be better protected by the Implied Covenant in situations allowing one or more parties to exercise discretion under a contractual term? The issue in this context is whether and when a court will limit the exercise of discretion when a contract itself does not.[354] There are two ways of interpreting a discretion-granting clause: either it is complete and "gapless" (and therefore, precludes application of the Implied Covenant if the defendant's conduct was not unreasonable), or it leaves one or more gaps by failing to set concrete parameters for the

---

350 Kira, Inc. v. All Star Maint., No. A-03-CA-950 LY, 2006 WL 2193006, at *14 (W.D. Tex. July 31, 2006) (internal quotation marks omitted).

351 This approach is similar to the approach taken by the Restatement. *See* RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. a (1981).

352 *See* discussion *infra* Part VI.

353 *See* Altman & Raju, *supra* note 332, at 1469, 1474 ("The Implied Covenant . . . serves as a method of protecting the reasonable expectations of the parties, and is best understood in that sense.").

354 *Id.* at 1480–81.

discretion-exercising party (in which case the Implied Covenant would theoretically apply to a wider range of conduct).[355] Delaware cases have occasionally utilized the Implied Covenant to deny defendants' motions to dismiss with respect to discretionary decisions including stock valuation at "fair value,"[356] and modification of preferred stockholders' conversion rights.[357]

Overall, however, a plaintiff's luck in a discretion-type case is not much better than in any other context.[358] In *Nemec v. Shrader*, the Delaware Supreme Court failed to utilize the Implied Covenant in the corporate context to impose liability on a defendant who redeemed the plaintiffs' stock the day before the defendant planned to sell a portion of its business to a private equity firm for four times the stock's book value.[359] Although the defendants had a contractual right to redeem the plaintiffs' stock at the defendant's discretion, the supreme court did not take the timing of the redemption into consideration in evaluating whether the defendant's discretion was exercised in good faith and whether the plaintiff was stripped of his reasonable expectations. Notably, the *Nemec* court highlighted that because the plaintiff's claim arose from the defendant's exercise of contractually-granted discretion, fiduciary duty claims had been fully foreclosed.[360]

The *Nemec* holding mirrors holdings in the alternative-entity context.[361] For example, in the limited partnership context, the court in *Desert Equities, Inc. v. Morgan Stanley Leveraged Equity Fund II, L.P.* noted that the defendant–general partner's contractual right to exercise discretion in deciding whether to include the plaintiff–limited partner in the partnership's new investments was subject to a standard of reasonableness, but failed to impose liability based on the duty of good

---

355 *See* Michael P. Van Alstine, *Of Textualism, Party Autonomy, and Good Faith*, 40 WM. & MARY L. REV. 1223, 1287 (1999).

356 Gale v. Bershad, No. CIV. A. 15714, 1998 WL 118022, at *4 (Del. Ch. Mar. 4, 1998).

357 Winston v. Mandor, 710 A.2d 835, 843–44 (Del. Ch. 1997).

358 *E.g.*, Airborne Health, Inc. v. Squid Soap, LP, 984 A.2d 126, 146 (Del. Ch. 2009).

359 Nemec v. Shrader, 991 A.2d 1120, 1124–25 (Del. 2010).

360 *Id.* at 1129. Note that *Nemec* closely parallels cases in which fiduciary duties and the Implied Covenant would apply to the dispute, but in which the parties have chosen to eliminate fiduciary duties. *See supra* Part IV.D (discussing *Fisk*, a case in which the plaintiff brought an Implied Covenant claim when the parties had agreed to eliminate fiduciary duties).

361 SANDRA K. MILLER, LIMITED LIABILITY COMPANIES: A COMMON MODEL OF FIDUCIARY DUTIES § 5.22 (2011).

faith.[362] Rather, the court granted the defendant's motion for judgment on the pleadings.[363] The Supreme Court reversed (instructing that the parties be given a chance to conduct discovery), but maintained that while a standard of reasonableness applied to the defendant's conduct, the plaintiff would need to prove that the defendant had a tortious state of mind if the parties reached trial.[364] Notably, neither the chancery court nor the supreme court addressed the fact that the defendant could have acted unreasonably without acting tortiously, and that the defendant could have thereby defeated the plaintiff's case while simultaneously violating the applicable standard of conduct.

### *B. Delaware's Conception of the Implied Covenant Does Not Adequately Protect Parties in the "Average" LLC*

Proponents of a strict contractarian view may have a viable argument that without accompanying fiduciary duties, "good faith as a lens through which judges scrutinize past acts does no more than encourage subjective conclusions in hindsight based upon events never anticipated much less assumed by the parties who initiated the conduct the court must scrutinize."[365] However, this is not a necessary conclusion. At best, this view limits the role of the Implied Covenant to those cases "where abject and inexcusable inaction in the face of a known duty to act has been established."[366] At worst, this view demotes the Implied Covenant to the status of a mere "labeling tool" or "rhetorical device."[367]

According to the contractarian perspective, if a jurisdiction adopts a broader conception of the Implied Covenant, courts run the risk of blocking parties' abilities to truly define the entire scope of their interactions through their contractual expressions.[368] For example, a contractualist might support the decision of the *Cincinnati* court by arguing that it was possible that the parties intended to limit the range of prohibited competition to exactly what was provided for in the limited

---

362 Desert Equities, Inc. v. Morgan Stanley Leveraged Equity Fund II, L.P., No. 12449, 1992 WL 181718, at *2 (Del. Ch. July 28, 1992), *rev'd on other grounds*, 624 A.2d 1199 (Del. 1993).

363 *See Desert Equities*, 624 A.2d at 1208.

364 *Id.*

365 Steele, *supra* note 88, at 30.

366 *Id.*

367 *Id.*

368 Van Alstine, *supra* note 355, at 1292 ("There is persuasive force in the argument that informed parties should be able to agree at the formation stage on a contractual power whose exercise is not subject to subsequent review under external standards of 'fair' and 'reasonable' conduct.").

partnership agreement's noncompete clause.[369] In addition to eliminating fiduciary duties, parties may actually *want* to reduce the risk that one party or another will later sue successfully under an Implied Covenant theory. This is likely the reasoning behind Delaware's overwhelming aversion to imposing liability under the Implied Covenant when fiduciary duties are eliminated—"[t]he capacity to achieve contractual certainty and contractual control over the business relationship is . . . an important policy goal when the parties have chosen to form an LLC and to enter into an LLC operating agreement."[370]

However, this policy choice cuts both ways: Why should a court be permitted to determine that the parties did not want to both eliminate fiduciary duties *and* retain the full protection of the Implied Covenant?[371] This is a question that the Delaware courts have yet to answer. Thus, Delaware's approach, while arguably defensible in theory, is not ideal in practice. The fact that LLCs are contractual creatures creates a significant downside for parties that eliminate fiduciary duties under a narrow reading of the Implied Covenant because this approach fails to properly take the relational nature of LLCs into consideration by improperly equating an LLC agreement with a transaction in which the parties are disinterested in the future evolution of their relationship.[372] However, as the frequency and significance of the interactions between parties increase, so do the parties' reasonable expectations and reliance interests.[373] Therefore, when a court intervenes but disregards the unique nature of an LLC by adhering solely to the parties' contract and reading the Implied Covenant too narrowly, that court neglects the Implied Covenant's

---

369 *See* Means, *supra* note 306, at 1185 (stating that a "decision to waive certain protections is not an oversight; it is a specific choice").

370 Miller, *supra* note 12, at 741.

371 *See* Eggleston et al., *supra* note 246, at 120 (noting that simple contracts are beneficial in reducing enforcement costs and the risk of improper judicial interpretation); George G. Triantis, *The Efficiency of Vague Contract Terms: A Response to the Schwartz-Scott Theory of U.C.C. Article 2*, 62 LA. L. REV. 1065 (2002) (noting the benefits of contractual vagueness in preventing evidence overinvestment). *But see* Bay Ctr. Apartments Owner, LLC v. Emery Bay PKI, LLC, No. 3658-VCS, 2009 WL 1124451, at *7 (Del. Ch. Apr. 20, 2009) (assuming the propriety of Delaware's sparing application of the Implied Covenant to prevent the parties from being involuntarily burdened by judicial error).

372 *See supra* text accompanying notes 302–04.

373 Miller, *supra* note 12, at 741; *cf.* Phillips, *supra* note 101, at 1205–06 ("The duty of good faith and fair dealing has been invoked by courts in creditor–debtor disputes on grounds that the *continuing and established course of relations* between the parties may give rise to expectations of the parties beyond that in their express agreement." (emphasis added)); Means, *supra* note 306 (discussing this point in the context of the unlimited life span of corporations).

potential for flexible application.[374]

It can be assumed that the parties, by entering into an LLC agreement, are seeking mutual benefit by allocating risk and minimizing performance costs.[375] However, in situations marked by unequal bargaining power, more powerful parties may be able to alter this balance of mutuality and promote a greater level of allowable self-interest by eliminating fiduciary duties to the detriment of the weaker party.[376] Referring to the partnership setting, one commentator argued that "[w]hen coupled with a duty of good faith, eliminating mandatory fiduciary duties will allow efficient agreements with maximum certainty."[377] Notably, however, this statement was tempered by the commentator's presumption that the parties would have equal bargaining power, identical powers and rights once the entity was formed, and sufficient reputational constraints to support greater freedom of contract.[378] Without these factors, certainty is compromised. Further, the presumption of equal bargaining power is unrealistic given that the typical "bargaining process involves human foible and important information asymmetries, if not outright fraud."[379]

Regardless of the relative bargaining power of the parties, the pattern of Delaware's Implied Covenant jurisprudence warns parties that an agreement that eliminates fiduciary duties constitutes a "bad" bargain because it will necessarily fail to protect against the broadest possible range of objectionable conduct.[380] And if a dispute arises under a bad bargain in Delaware, then the court has a legitimate reason to refuse to enforce the Implied Covenant in favor of the complaining party—it is well recognized that the Implied Covenant is not designed to rescue parties from unfair, unwise, or unreasonable agreements, or to "rebalance[ ] economic

---

374 *See* Means, *supra* note 306, at 1190–91 (advocating for the use of "equitable contract principles" and noting that courts can use contract law to reduce transactions costs by preventing opportunistic behavior).

375 Mkt. St. Assocs. Ltd. P'ship v. Frey, 941 F.2d 588, 595 (7th Cir. 1991); *see* Hanno, *supra* note 128, at 105 (noting that, under the traditional view, LLC parties are not just contractual cooperators, but their relationship is "inherently fiduciary" (internal quotation marks omitted)).

376 Miller, *supra* note 12, at 732 (warning that "judicial monitoring and statutory constraints [are needed] to address the hazards of power imbalances" during LLC formation). *But cf.* Wartski v. Bedford, 926 F.2d 11, 20 (1st Cir. 1991) (stating that privately ordered corporate exculpatory provisions do not create a "license to steal" (internal quotation marks omitted)).

377 J. Dennis Hynes, *An Inquiry Into Freedom of Contract*, 58 L. & CONTEMP. PROBS. 29, 53 (1995).

378 *Id.*

379 Weidner, *supra* note 50, at 82.

380 *See infra* app. D.

interests" after-the-fact.[381] Therefore, under this line of reasoning, advocates of the contractarian approach to the Implied Covenant would construe these "strict" court decisions as the mere enforcement of bad contracts.[382]

Although parties can protect themselves from similar findings by raising their customized standard of good faith above the "floor," in a context in which the parties have chosen to eliminate fiduciary duties, it is unlikely that they would make their standard of good faith more rigorous in the same agreement.[383] This situation creates a substantial degree of risk, especially for unsophisticated parties.[384] Empirical evidence shows that the vast majority of LLCs are created with uncomplicated agreements or basic forms, and that a substantial percentage of LLCs are formed without a written agreement at all.[385] Further, many drafters are unaware of changes in Delaware fiduciary duty law,[386] and small LLCs may initially rely on trust as a substitute for incurring the exponential transaction costs associated with drafting detailed agreements.[387] Consequently, many drafters may not realize that by eliminating fiduciary duties, they are actually damaging their chances of prevailing under the Implied Covenant—moreover, they may not know that they never had a high probability of prevailing under the Implied Covenant in the first place.

Delaware courts' treatment of parties who eliminate fiduciary duties is better suited to large, sophisticated LLCs that have adequate legal representation[388] and the desire to reduce negotiation costs by "effectively mak[ing] a public good of the private complexity, . . . alienation, and suspicion" of traditional fiduciary duties.[389] However, "[t]he contractarian approach misses the mark . . . if the goal is to meet the reasonable expectations of *typical* [entities] and society."[390] Small

---

381 *See* Nemec v. Shrader, 991 A.2d 1120, 1128 (Del. 2010).

382 *See* Means, *supra* note 336, at 1185 ("[C]ourts routinely enforce unwise contractual bargains . . . .").

383 *See* Hynes, *supra* note 377, at 48.

384 *See* Miller, *supra* note 12, at 739 ("[T]he contractarian approach to fiduciary duties presupposes perfect market conditions—that is, the existence of [parties] who are equally poised to bargain for optimal fiduciary duty protections.").

385 Hanno, *supra* note 128, at 113–14.

386 *See id.* at 114; *see also* Miller, *supra* note 12, at 739 (discussing studies showing that many lawyers are not fully informed with respect to relevant LLC law); Miller, *supra* note 12, 734, 737–38 & nn.41–59 (suggesting that the representation of legal counsel in the LLC context is less than optimal in a substantial number of LLC arrangements and that most LLC agreements are insufficiently tailored).

387 Means, *supra* note 305, at 1164.

388 Hanno, *supra* note 128, at 114.

389 Vestal, *supra* note 7, at 572–73.

390 *Id.* at 573 (emphasis added).

businesses or unsophisticated parties may mistakenly rely on the Implied Covenant as a suitable "catch-all" protection. Moreover, given that there are varying levels of sophistication among LLC members, unequal bargaining power can leave less-sophisticated members with unprotected and ultimately unrealized expectations.[391] For this reason, one commentator noted that Delaware's "[u]nbridled 'freedom of contract' [policy] is little more than the law of the jungle."[392]

## VI. Admitting That the Current Role of the Implied Covenant Is No Role at All

Delaware's statutory scheme is designed to impart independent significance to fiduciary duties and the Implied Covenant.[393] The nested-sphere model is representative of this design.[394] However, because the reasoning of the Delaware courts has improperly skewed the model, the "implied covenant of good faith and fair dealing" has become a deceivingly grandiose phrase that suggests so much in theory but accomplishes so little in practice.[395] An extremely high evidentiary standard combined with an extremely limited willingness to invoke the Covenant has resulted in complete failure of alternative-entity Covenant claims in Delaware.[396] Ultimately, therefore, the Implied Covenant is not sufficient to replace or emulate the protections that fiduciary duties provide.[397]

Part V argued that Delaware's current approach to the Implied Covenant is less than ideal. However, assuming that Delaware continues with this approach, one is left to question why the Delaware courts cling to the Implied Covenant's "unbecomingly ostentatious moniker."[398] One

---

391 *See* Hanno, *supra* note 128, at 114.

392 Edwin W. Hecker, Jr., *Fiduciary Duties in Business Entities*, 54 U. Kan. L. Rev. 975, 1019 (2006).

393 Del. Code Ann. tit. 6, §§ 17-1101(d), 18-1101(c) (2005); *see* Steele, *supra* note 88, at 14.

394 *See infra* app. A.

395 *See* Mkt. St. Assocs. Ltd. P'ship v. Frey, 941 F.2d 588, 595 (7th Cir. 1991) (arguing that the Implied Covenant does not actively serve to inject morality in the contracting process); Wheeler, *supra* note 312, at 1076 (arguing that the Implied Covenant does little to protect parties in Delaware).

396 Wheeler, *supra* note 312, at 1076.

397 *See* Miller, *supra* note 30, at 606–11 (providing reasons why the Implied Covenant does not sufficiently check opportunistic behavior in LLCs); Hanno, *supra* note 128 (arguing that the Implied Covenant is an "inadequate substitute" for fiduciary duties). *But see* Manesh, *supra* note 6, at 244 ("[The] universality, unwaivability, and contextual evolution [of the Implied Covenant]—suggest that [it] is well-suited to serve as a doctrinal substitute for the fiduciary duties of corporate law, to deal with the ongoing relational context of LLCs, and to ensure equitable results." (footnotes omitted)).

398 Wheeler, *supra* note 312, at 1076.

reason could be that the Delaware courts dislike change. After all, it took a statutory amendment to nudge the courts away from the fiduciary-based analyses that had become second nature in the corporate and partnership contexts.[399]

However, because the Delaware alternative-entity statutes are designed to promote maximum contractual freedom, on some level, the Implied Covenant does not fit with the Delaware legislature's extreme bent in favor of contractual freedom. Certainly, the outcomes of Delaware Covenant cases have resolved this lack of synchronicity in favor of the portion of the statutory provisions emphasizing contractual freedom. However, while the courts' resolutions thus far have suggested a complete lack of regard for the relevancy of the Implied Covenant, the courts' language deceivingly suggests that the Implied Covenant may apply in future, sufficiently "worthy" cases containing the perfect mixture of factors and circumstances that the courts have deemed critical to the success of Covenant claims. In the meantime, while Delaware courts continue to wait for the "ideal" Implied Covenant case, ambiguity and uncertainty will continue to taint the contract-negotiation process as many parties may be lulled into eliminating fiduciary duties, believing that the Implied Covenant will provide adequate protection should disputes arise.[400]

Because the Implied Covenant is unwaivable as a matter of statutory law, Delaware courts cannot explicitly render the Implied Covenant toothless, lest they find themselves repeating the mistakes that were made in *Gotham*. However, the Delaware statutes do not enumerate exactly what protections the Covenant provides, thereby opening a loophole for the courts.[401] Therefore, the courts have retained the Implied Covenant paradigm, but have made it clear that the Covenant has no role in an analysis that strictly interprets the elimination of fiduciary duties as a signal that the parties intended to be unhindered by the limitations of external behavioral norms (including the norms that would be imposed by the courts themselves). Although the courts' current approach to the Covenant facially honors the prohibition on the contractual elimination of

---

[399] *See supra* text accompanying notes 89–99 (discussing *Gotham, L.P. v. Hallwood Realty Partners, L.P.*, 817 A.2d 160 (Del. 2002) and the 2004 DLLCA amendment).

[400] *See Frey*, 941 F.2d at 593 ("The particular confusion to which the vaguely moralistic overtones of 'good faith' give rise is the belief that every contract establishes a fiduciary relationship."); Phillips, *supra* note 101, at 1188 ("When the lines between acceptable and unacceptable conduct are bright, . . . parties can effectuate valid bargains between themselves because they know in advance what behavior will be deemed acceptable. But the line is not so bright between actions that are in good faith and those that are not.").

[401] *See* DEL. CODE. ANN. tit. 6, § 18-1101(c), (e) (2005).

good faith and fair dealing, the courts' restrictive tack has preemptively eliminated the effectiveness of the Covenant. As a result, parties to LLC agreements in which fiduciary duties have been waived have a perverse incentive to misbehave in the "right" way, knowing that the Implied Covenant does not pose a genuine threat to curtail their conduct.[402] This could not have been the intent of the Delaware legislature—if it was, then there would not have been a need to independently reference the Implied Covenant in the alternative-entity statutes.

In *Gotham*, the Delaware Supreme Court zealously guarded fiduciary duties, supposedly for the *benefit* of the complaining party in spite of contrary statutory language. However, the Delaware courts are now engaging in reverse *Gotham*-type analyses in which their holdings sometimes undercut the legislature's intent to limit absolute contractual freedom, to the *detriment* of the complaining party. Thus, the pendulum has swung too far, and the courts' attempts to extract the parties' intent through the narrowest of lenses is no more faithful to parties' true intent than if the courts were to reinstate fiduciary duties after parties had eliminated them.[403]

It is unclear whether a Delaware court will give meaningful practical effect to the Implied Covenant protections afforded by the Delaware statutes in the future.[404] To do so would mean to broaden the scope of the Covenant by engaging in an inquiry that is completely separate from

---

[402] *See* Miller, *supra* note 30, at 604 (noting the "trail of opportunistic behavior created by the past decade of LLC litigation"); *see also* Keatinge, *supra* note 312 (listing opportunistic behavior as one of the issues that is most likely to arise in an LLC).

[403] *Cf.* Means, *supra* note 306, at 1189–90 ("Although the hypothetical contract approach purports to advance the parties' own autonomy interests by helping them to avoid economically irrational outcomes, it actually gets no closer to the parties' real bargain than does the blanket imposition of fiduciary duties drawn from partnership law." (footnote omitted)); *see* Phillips, *supra* note 101, at 1188 ("Courts may frame the expectations of the parties with no or only slight deference to the parties' express expectations in the relationship. The result is often counter to the purpose of effectuating the parties' expectations in the relationship, leaving the bargaining process and the negotiated contract unnecessarily bereft of certainty. It is the intrusion of the societal interest, and the possibility of overriding contractual terms or even the entire contract, that creates the complexity and risk of uncertainty in contractual relationships when the standard of conduct is unclear." (footnotes omitted)). Current good faith analyses in Delaware are prone to subjectivity because they are merely "stab[s] at approximating the terms the parties would have negotiated had they foreseen the circumstances that have given rise to their dispute." *Frey*, 941 F.2d at 595.

[404] Another revision of the Delaware statute may be necessary to achieve this goal. *Cf.* Catherine M. Rogers, *Business Organizations—Staying Afloat with a Hole in the Wyoming LLC Act: Default Rules in a Contractual LLC World:* Lieberman v. Wyoming.com LLC*, 82 P.3d 274 (Wyo. 2004)*, 5 WYO. L. REV. 351, 383–84 & n.210 (2005) (predicting the need for specialized statutory provisions in Wyoming to prevent majority opportunism and abuse).

fiduciary duties. As it stands, it would take the perfect storm to succeed on an Implied Covenant claim: unsophisticated parties, an uncomplicated agreement, ill will, unintentional silence on a contemplated matter, and sufficient detail to suggest, but not reveal, the precise nature of the parties' contemplations.[405] It would be remarkable, indeed, if such a unique combination of facts ever arose.

## VII. Conclusion

The LLC is an attractive conglomeration of features, doctrines, and laws from the partnership and corporate models of business organization. However, Delaware's clear policy of contractual flexibility and independence in the arena of alternative-entity creation and governance has transformed LLCs into entities that resist attempts to uniformly classify, characterize, or predict the outcomes of disputes. It is precisely because individualized contracts govern LLC disputes that a myriad of widely-varying results is possible within one body of law.

When it comes to the Implied Covenant, a three-dimensional tension arises. In one plane, Delaware law sanctions nearly absolute freedom of contract. In another plane, fiduciary defaults operate in full, absent contractual modification or elimination. In a third plane, the Implied Covenant persists as a dormant obligation that applies to all contracts. However, the Covenant only activates when it is triggered by the Delaware courts, which have, as a general matter, opted to avoid interfering with the natural effects of private ordering. In a hypothetical situation in which the plane of fiduciary duties has been removed, the courts' contractual bent will likely lead them to interpret this removal as a manifestation of intent to manage losses where they fall. However, this narrow treatment has encouraged a curious misalignment between the theoretically ideal operation of the Implied Covenant, and the practical effectiveness of the Covenant as a means of re-allocating losses in a breach of contract action. Moreover, there are no indications that this approach

---

[405] Perhaps the lack of a fiduciary relationship could also be added to this list. As discussed *supra* Part IV.C, when parties have a fiduciary relationship, *Lonergan* provides that they must retain fiduciary duties if they want the court to conduct a loss re-allocation. Therefore, it appears that parties will not have any chance of success on an Implied Covenant claim unless their relationship was not governed by fiduciary duties in the first place. *See* Allied Capital Corp. v. GC-Sun Holdings, L.P., 910 A.2d 1020, 1024 (Del. Ch. 2006) ("Although other legal doctrines—such as equitable principles of fiduciary duty . . . —might condemn the equity investment if its terms were unfairly advantageous . . . , the plain terms of the [contract] preclude the notion that the [contract] itself forbade that investment.").

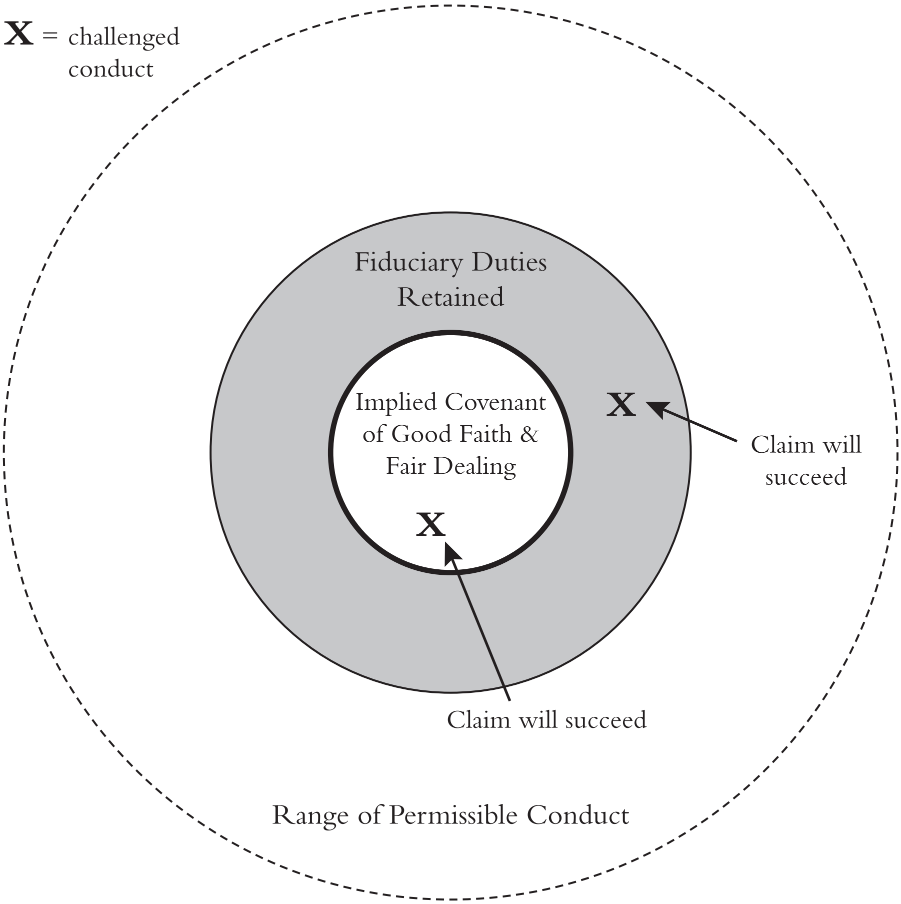
helps courts come any closer to approximating the parties' actual intentions than a broader interpretation of the Covenant.

Parties who rely on the Implied Covenant to pick up where fiduciary duties leave off are at a significant disadvantage because Delaware courts have "trapped" the Implied Covenant between fiduciary duties and express, contractually permitted conduct. First, an Implied Covenant claim is deemed redundant if a plaintiff can sue for breach of fiduciary duty under an agreement that retains these duties, which are wider ranging, more likely to be breached, and better synchronized with Delaware's vast body of fiduciary-duty law. Second, not only is the Covenant's scope narrow to begin with, but because Delaware courts have also conflated the Covenant with fiduciary duties, parties functionally destroy the Covenant's usefulness when they eliminate fiduciary duties because Delaware courts will address the dispute as if the parties had essentially eliminated the Covenant as well.

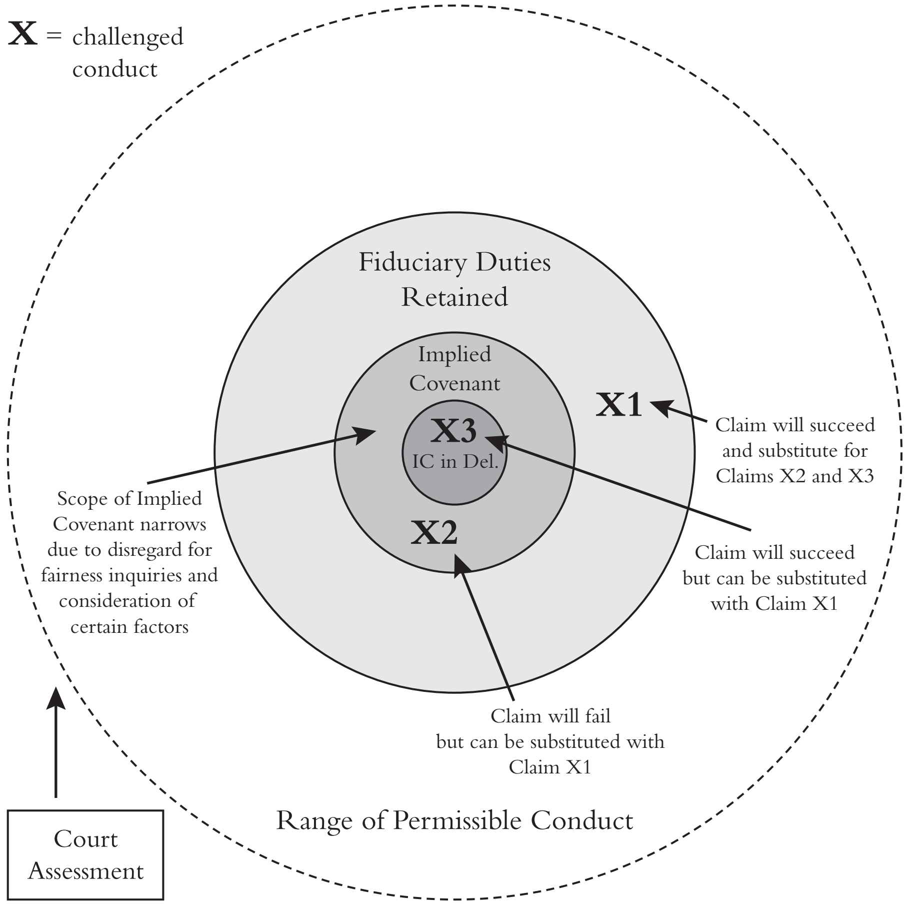
Ultimately, Delaware parties must beware of the consequences of fiduciary waivers in this unique setting.[406] The Implied Covenant and fiduciary duties are obligations that operate in tandem. Attempting to isolate the Covenant is a futile exercise—it can be done, but when relationships sour, parties should not expect the Delaware courts to find any sweetness in their deal.

---

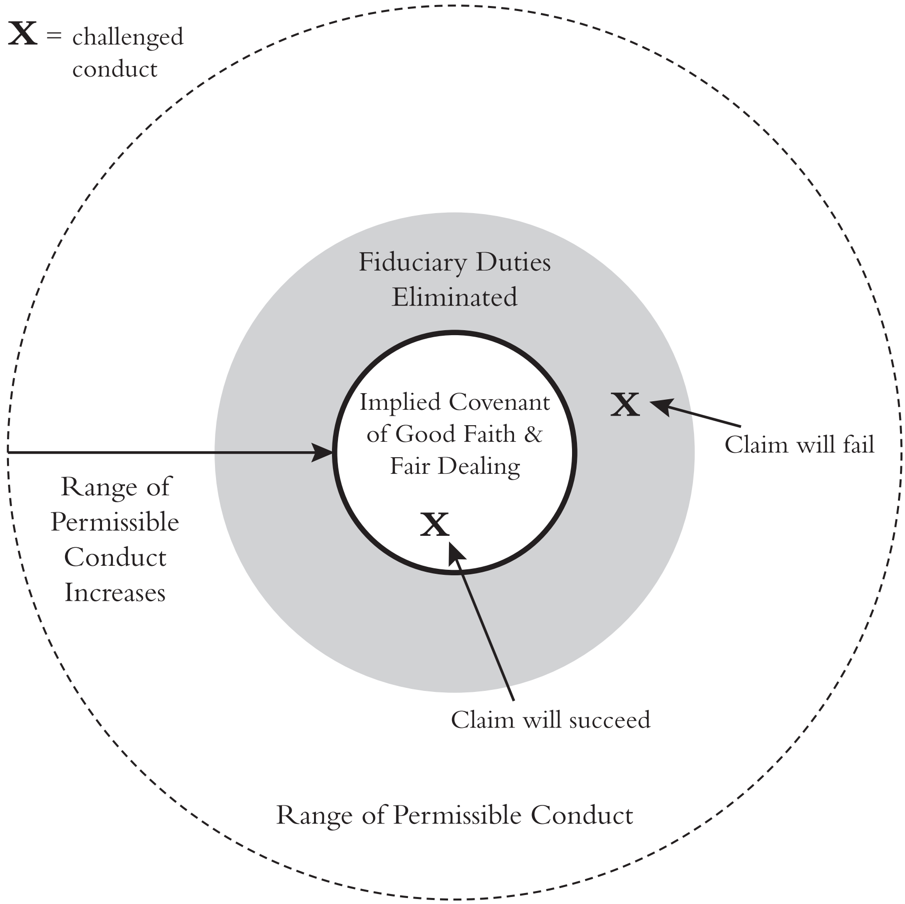
[406] Kleinberger, *supra* note 154, at 19 ("Freedom [of contract] has its risks, and . . . he who lives by the contractarian sword can get skewered by that sword . . . ." (internal quotation marks omitted)).



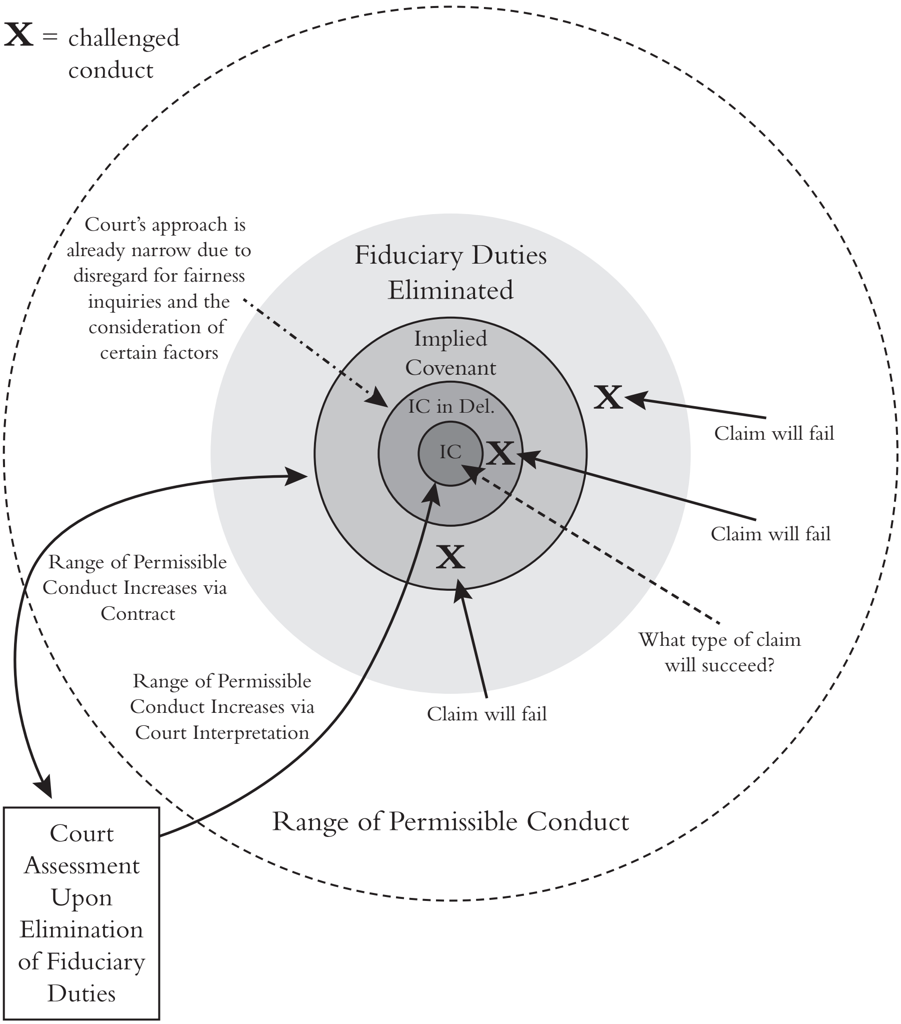

**APPENDIX A: THE "NESTED-SPHERE" MODEL WHEN HYPOTHETICAL PARTIES RETAIN FIDUCIARY DUTIES**




**Appendix B: The "Nested-Sphere" Model When Delaware Parties Retain Fiduciary Duties**




**APPENDIX C: THE "NESTED-SPHERE" MODEL WHEN HYPOTHETICAL PARTIES ELIMINATE FIDUCIARY DUTIES**




**APPENDIX D: THE "NESTED-SPHERE" MODEL WHEN DELAWARE PARTIES ELIMINATE FIDUCIARY DUTIES**

# "COMPLY OR EXPLAIN"—A FLEXIBLE MECHANISM TO COUNTERVAIL BEHAVIORAL BIASES IN M&A TRANSACTIONS

GERRIT M. BECKHAUS*

**ABSTRACT:**

*Mergers and acquisitions (M&A) are a common phenomenon of great importance in today's business world. However, the majority of them fail to achieve the aspired objectives. These failures can be attributed to various circumstances, inter alia decision-makers' vulnerability to behavioral biases due to the complexity, uncertainty, and time pressure characteristic of M&A transactions. Such biases often lead to predictable irrational behavior resulting in momentous misjudgments. Despite numerous psychological studies proving that people systematically tend to make irrational decisions under uncertainty, neither the transactional practice nor its current legal framework address this problem. Instead, the present law shields decision-makers from potential liability through the business judgment rule leaving shareholders largely unprotected in order to preserve the freedom of good faith business decisions.*

*While upholding this freedom the article suggests the implementation of a best practice framework containing feasible strategies—several of which are developed in the article—against irrational behavior. This framework shall be enforced through a "comply or explain" mechanism imposing liabilities for nonobservance. "Comply or explain," meaning that companies may choose whether to comply with the framework's recommendations but have to publicly explain their reasons for non-compliance, is a regulatory approach adopted by several European corporate governance codes. Contrary to common legislative "one size fits all" mechanisms, it ensures maximum flexibility and minimizes interference with the business judgment itself.*

* Associate in the Hamburg office of Freshfields Bruckhaus Deringer LLP; LL.M., Yale Law School, Ph.D. (*Dr. iur.*), EMBA, University of Muenster, Germany. I would like to express my deep gratitude to Gesa Beckhaus, Lennart Beckhaus, and Richard Brooks for their thoughtful and valuable comments.

**TABLE OF CONTENTS**

## Introduction

Mergers and acquisitions (M&A)[1] are a common phenomenon of great importance in today's business world. M&A are typically motivated by synergetic, strategic, and efficiency-oriented considerations, aiming at increasing competitiveness, growth, and profitability.[2] Other reasons include assumed inefficiencies within the target company causing it to be undervalued.[3] Particularly large corporate mergers will quite often determine the involved companies' success in the near future, if not, their entire existence. Failure can have devastating consequences for the companies' employees, shareholders, and business partners. Hence, M&A involve significant risks. Despite what is at stake and in contrast to what one would expect based on the large number of M&A transactions, the aspired objectives are not achieved in many cases. Respective studies have concluded that only 30% to 50% of all M&A transactions prove to be a success in retrospect,[4] though these studies are not based on a uniform

---

1 While the term mergers and acquisitions is predominantly understood broadly to capture all forms of buying, selling, dividing and combining different companies or similar entities, the following will focus on the acquisition of a company or its shares mainly from the buyer's perspective.

2 Steven M. Bragg, Mergers & Acquisitions—A Condensed Practitioner's Guide 1-4 (2009); Richard A. Brealey, Stewart C. Myers & Franklin Allen, Principles of Corporate Finance 873 *passim* (9th ed. 2009); Patrick A. Gaughan, Mergers, Acquisitions, and Corporate Restructurings 14-15, 125-79 (5th ed. 2011); Stephan A. Jansen, Mergers & Acquisitions – Unternehmensakquisitionen und -kooperationen – Eine strategische, organisatorische und kapitalmarkttheoretische Einfuehrung 135-36 (5th ed. 2008) (Ger.); Stephen A. Ross, Randolph W. Westerfield & Jeffrey F. Jaffe, Corporate Finance 802 (7th ed. 2005); Randall Schuler & Susan Jackson, *HR Issues and Activities in Mergers and Acquisitions*, 19 Eur. Mgmt. J. 239, 240 (2001).

3 Brealey et al., *supra* note 2, at 875-76; Timothy J. Galpin & Mark Herndon, The Complete Guide to Mergers and Acquisitions – Process Tools to Support M&A Integration at Every Level 5 (2d ed. 2007); Gaughan, *supra* note 2, at 15, 174-75.

4 *See* Vicki Bogan & David Just, *What Drives Merger Decision Making Behavior? Don't Seek, Don't Find, and Don't Change Your Mind*, 72 J. Econ. Behavior & Org. 930, 930-32 (2009); Robert F. Bruner, Applied Mergers and Acquisitions 30 (2004); Robert F. Bruner, Deals from Hell: M&A Lessons that Rise Above the Ashes *passim* (2009); Don de Camara & Punit Renjen, *The Secrets of Successful Mergers: Dispatches from the Front Lines*, 25 J. Bus. Strategy 10, 10 (2004); J. Robert Carleton & Claude S. Lineberry, Achieving Post-Merger Success: A Stakeholder's Guide to Cultural Due Diligence, Assessment, and Integration 13 (2004); Jansen, *supra* note 2, at 336; Sara B. Moeller, Frederike P. Schlingemann & René M. Stulz, *Wealth Destruction on a Massive Scale? A Study of Acquiring-Firm Returns in the Recent Merger Wave,* 60 J. Fin. 757 *passim* (2005); Jeffery S. Perry & Thomas J. Herd, *Mergers and Acquisitions: Reducing M&A Risk Through Improved Due Diligence*, 32 Strategy & Leadership 12, 13 (2004); David M. Schweiger, M&A Integration – A Framework for Executives and Managers 4 (2002); *see also* Marc J. Epstein, *The Determinants and Evaluation of Merger Success*, 48 Bus. Horizons 37, 37-41 (2005).

standard[5] with regard to what constitutes success.

The significant number of failed M&A transactions can be attributed to various circumstances. Distinguishing between "hard" and "soft" factors, the former include easily measurable elements or quantifiable variables such as lack of potential synergies, high transaction costs or legal obstacles.[6] The latter, the so-called "soft factors," are comprised essentially of psychological aspects—those factors which are difficult to ascertain but are no less significant.[7] Also among them are insufficient personal, cultural and organizational integration, and deficient planning processes.[8]

Technical mistakes by the participants and decision-makers' misjudgments are the main causes for the aforementioned aspects. While it is comparably easy to countervail technical incapacities, for instance in the planning process, contractual design, or in the evaluation of legal issues by implementing control mechanisms, avoiding misjudgments is significantly more difficult. Evaluating the prospects of success of an M&A transaction constitutes a highly complex process, influenced by a variety of data and interdependent circumstances and considerable reliance on predictions.[9] Moreover, the information regarding the target company is commonly incomplete. Against this background, it seems virtually impossible to qualify an assessment of potential synergies or certain integration efforts as right or wrong.

Obtaining further data about the target company or regulating risks through specific contractual design are common recommendations to decrease the danger of misjudgments with far-reaching consequences.[10] However, insights from psychology regarding human behavior in perceiving information and decision-making are widely disregarded, though these considerations have found their way into the economic and legal discourse through behavioral economics and behavioral law. A vast

---

[5] Olimpia Meglio & Annette Risberg, *The (Mis)measurement of M&A Performance – A Systematic Narrative Literature Review*, 27 SCANDINAVIAN J. MGMT. 418 *passim* (2011).

[6] Robert G. Eccles, Kersten L. Lanes & Thomas C. Wilson, *Are You Paying Too Much for That Acquisition? – The Key is Knowing What your Top Price Is – and Having the Discipline to Stick to It*, HARV. BUS. REV. 136, 138 et. seqq. (July-Aug. 1999); ROSS ET AL., *supra* note 2, at 807-08; Schuler & Jackson, *supra* note 2, at 241.

[7] *See generally* Camara & Renjen, *supra* note 4, at 11.

[8] Ronald N. Ashkenas, Lawrence J. DeMonaco & Suzanne C. Francis, *Making the Deal Real: How GE Capital Integrates Acquisitions*, 76 HARV. BUS. REV., Jan. 1998, at 165, 172-175; Marc J. Epstein, *The Drivers of Success in Post-Merger Integration*, 33 ORGANIZATIONAL DYNAMICS 174, 175-79 (2004); GALPIN & HERNDON, *supra* note 3, at 3-4; Schuler & Jackson, *supra* note 2, at 241.

[9] ROSS ET AL., *supra* note 2, at 796.

[10] *See generally* JANSEN, *supra* note 2, at 276; Perry & Herd, *supra* note 4, at 12-18.

number of studies have proven that people systematically tend to act irrationally in decision-making processes under uncertainty with regard to perceiving and processing information as well as the decision-making itself.

In this article, I argue that decision-makers'—directors' and officers'—predictable irrational behavior in different phases of a transaction are a significant factor contributing to momentous misjudgments in M&A transactions and thus to their low success rates. Nonetheless, transactional practices, as well as the current legal framework, fail to address this problem. The present law rather shields decision-makers from a potential liability through the business judgment rule leaving shareholders, who are—besides employees—typically harmed the most by failed M&A transactions, largely unprotected. The underlying rationale for this approach is the protection of the freedom of good faith business decisions that should not be scrutinized by courts. While essentially upholding this freedom and avoiding a *re*biasing instead of a debiasing, this article suggests the implementation of a best practice framework that contains certain general strategies against irrational behavior and is to be enforced through a "comply or explain" mechanism imposing liabilities for nonobservance. The specific area of M&A is chosen for several reasons. First, the danger of irrational decision-making is particularly high due to the vast amount of information, the significant uncertainties and the time pressure. Second, the clear and widely similar structure of transaction processes facilitates the development of common strategies to approach the problem. Third, M&A transactions typically have a considerable and immediate impact on the involved companies and are particularly difficult and costly to unwind in case of failure.

Part I of the article provides an overview of insights from behavioral economics relevant to M&A. Part II identifies potential dangers of irrational decision-making in the different phases of an ideal M&A transaction. Part III deals with the current legal framework sanctioning misjudgments—in particular the decision-makers' potential liability. Part IV develops strategies against irrational decision-making in M&A, which form the basis for their suggested regulatory implementation in Part V. This regulatory model draws on experiences with U.K. and German corporate governance law.

## I. Insights from Behavioral Economics

Besides providing some background on fundamental psychological findings regarding the handling of information and human needs relevant to decision-making processes, this section enumerates behavioral biases potentially influencing decision-making processes in M&A transactions and discusses the transferability of scientific findings on the specific situation of M&A with its highly sophisticated actors compared to the general public.

To begin with, empirical studies stipulate that people of average talent can only process seven pieces of information at a time—illustrating people's limited cognitive capabilities.[11] To nevertheless overcome complex moments of decision-making people—consciously or subconsciously—rely on heuristics, or rules of thumb, to simplify the circumstances taken into account.[12]

The need for avoiding cognitive dissonance, an aspect explored in-depth by psychology, also matters in this context.[13] People are discomforted by conflicting cognitions. Thus, they try to completely avoid them, amongst others by manipulation, or to eliminate them as fast as possible. These consequences are subject to the theory of cognitive dissonance.

The need for control is another fundamental need regulating human behavior. The theoretical conception presumes that every person wants to perceive himself as the initiator of changes in his environment to gain the feeling of competence and to preserve his self-esteem.[14] The satisfaction of the need for control does not depend on the objective facts but rather on the individual's subjective perception.[15]

Finally, psychology points to the fact that people in principal evaluate circumstances on decision-making processes relative to a point of reference.[16]

The following provides an overview on behavioral biases potentially

---

[11] George A. Miller, *The Magical Number Seven, Plus or Minus Two: Some Limits on our Capacity for Processing Information*, 63 PSYCHOL. REV. 81 *passim* (1956).

[12] Gerd Gigerenzer & Wolfgang Gaissmaier, *Heuristic Decision Making*, 62 ANN. REV. PSYCHOL. 451, 454-455.

[13] LEON FESTINGER, A THEORY OF COGNITIVE DISSONANCE *passim* (1957).

[14] RICHARD DE CHARMS, PERSONAL CAUSATION – THE INTERNAL AFFECTIVE DETERMINANTS OF BEHAVIOR *passim* (1968); Robert W. White, *Motivation Reconsidered: The Concept of Competence*, 66 PSYCHOLOG. REV. 297 *passim* (1959).

[15] Lauren A. Leotti, Sheena S. Iyengar, Kevin N. Ochsner, *Born to Choose: The Origins and Value of the Need for Control*, 14(10) TRENDS COGN. SCI. 457, 457-58 (2010).

[16] This observation constitutes an integral part of the prospect theory developed by Daniel Kahneman and Amos Tversky. *See* Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision under Risk*, 47 ECONOMETRICA 263, 274 (1979); *see generally* Daniel Kahneman & Amos Tversky, *Advances in Prospect Theory: Cumulative Representation of Uncertainty*, 5 J. RISK & UNCERTAINTY 297 *passim* (1992).

influencing decision-making in M&A transactions. Phenomena relevant for irrational behavior regarding the perception of information are primarily confirmation bias,[17] availability bias,[18] focus on the present or myopia,[19] framing,[20] contrast effect,[21] herding,[22] and hindsight bias.[23] With regard to processing of information the following heuristics or biases

---

[17] Bogan & Just, *supra* note 4, at 932; Jack W. Brehm, *Postdecision Changes in the Desirability of Alternatives*, 52 J. ABNORMAL & SOC. PSYCHOL. 384 *passim* (1956); David Hirshleifer, *Investor Psychology and Asset Pricing*, 56 J. FIN. 1533, 1550 (2001); Dan Lovallo et al., *Deals Without Delusions*, HARV. BUS. REV., Dec. 2007, at 92, 94; Mark Snyder & William B. Swann, Jr., *Hypothesis-Testing Processes in Social Interaction*, 36 J. PERSONALITY & SOC. PSYCHOL. 1202 *passim* (1978).

[18] Amos Tversky & Daniel Kahneman, *Availability: A Heuristic for Judging Frequency and Probability*, 5 COGNITIVE PSYCHOL. 207 *passim* (1973); Amos Tversky & Daniel Kahneman, *Judgment under Uncertainty: Heuristics an Biases – Biases in Judgments Reveal Some Heuristics of Thinking under Uncertainty*, 185 SCI. 1124, 1127-1128 (1974) [hereinafter Tversky & Kahnerman, *Judgment under Uncertainty*]; *see also* Kent Daniel, David Hirshleifer, Siew Hong Teoh, *Investor Psychology in Capital Markets: Evidence and Policy Implications*, 49 J. MONETARY ECON. 139, 169-170 (2002); Terrence Odean, *Volume, Volatility, Price, and Profit – When All Traders Are Above Average*, 53 J. FIN. 1887, 1889 (1998); Cass R. Sunstein, *What's Available? Social Influences and Behavioral Economics*, 97 NW. U.L. REV. 1295, 1301, 1305 (2003).

[19] See George Loewenstein & Drazen Prelec, *Anomalies in Intertemporal Choice: Evidence and an Interpretation*, 107 Q.J. ECON. 573 *passim* (1992); Samuel M. McClure et al., *Separate Neural Systems Value Immediate and Delayed Monetary Rewards*, 306 SCI. 503 *passim* (2004); Samuel M. McClure et al., *Time Discounting for Primary Rewards*, 27 J. NEUROSCI. 5796 *passim* (2007); Ted O'Donoghue & Matthew Rabin, *Doing It Now or Later*, 89 AM. ECON. REV. 103 *passim* (1999); *see also* George Ainslie, *Specious reward: A Behavioral Theory of Impulsiveness and Impulse Control*, 82 PSYCHOL BULL. 463, 464 et seqq. (1975); George A. Akerlof, *The Short-Run Demand for Money: A New Look at an Old Problem*, 72 AM. ECON. REV. 35 *passim* (1982); B. Douglas Bernheim & Antonio Rangel, *Addiction and Cue-Triggered Decision Processes*, 94 AM. ECON. REV. 1558 *passim* (2004).

[20] Daniel Kahneman & Amos Tversky, *Choices, Values, and Frames*, 39 AM. PSYCHOL. 341, 343-44 (1984); Amos Tversky & Daniel Kahneman, *The Framing of Decisions and the Psychology of Choice*, 211 SCI. 453 *passim* (1981); Amos Tversky & Richard H. Thaler, *Anomalies – Preference Reversals*, 4 J. ECON. PERSP. 210 *passim* (1990).

[21] Peter H. Farquhar & Anthony R. Pratkanis, *Decision Structuring with Phantom Alternatives*, 39 MGMT. SCI. 1214 *passim* (1993).

[22] Sushil Bikchandani, Davird Hirshleifer & Ivo Welch, *Learning from the Behavior of Others: Conformity, Fads, and Informational Cascades*, 12 J. ECON. PERSP. 151, 152-153 (1998); Laurens Rook, *An Economic Psychological Approach to Herd Behavior*, 40 J. ECON. ISSUES 75 *passim* (2006); David S. Scharfstein & Jeremy C. Stein, *Herd Behavior and Investment*, 80 AM. ECON. REV. 469, 476 (1990); ROBERT J. SHILLER, IRRATIONAL EXUBERANCE 148 (2000).

[23] Baruch Fischhoff, *Hindsight ? Foresight: The Effect of Outcome Knowledge on Judgment under Uncertainty*, 104 J. EXPERIMENTAL PSYCHOL.: HUM. PERCEPTION & PERFORMANCE 288 *passim* (1975); Baruch Fischhoff, *An Early History of Hindsight Research*, 25 SOC. COGNITION 10 *passim* (2007); Baruch Fischhoff & Ruth Beyth, *"I Knew it Would Happen" – Remembered Probabilities of Once-Future Things*, 13 ORGAN. BEH. & HUM. PERFORMANCE 1 *passim* (1975).

should be considered: simplification,[24] mental accounting,[25] anchoring,[26] inside view,[27] and representativeness.[28] Decision-making itself is particularly vulnerable to the effects of overconfidence[29] and sunk cost.[30]

Apparently, the described insights from psychology and behavioral economics do not apply to everyone in every situation in a way that behavior could reliably be predicted. The occurrence of biases and heuristics as well as their extent and impact rather depend on the individual person and the specific situation. However, the vast amount of studies in that area at least proves an existing tendency that people are subconsciously influenced in their decision-making processes.

Due to the sophistication of the decision-makers in M&A transaction as well as the involvement of numerous specialized consultants, one can expect these actors to be less susceptible to the described psychological phenomena and therefore to act more cognitively adept and rational than

---

[24] Kahneman & Tversky, *supra* note 16, at 271.

[25] Richard H. Thaler, *Toward a Positive Theory of Consumer Choice*, 1 J. ECON. BEHAV. AND ORG. 39 *passim* (1980); Richard H. Thaler, *Mental accounting and consumer choice*, 4 MKTG. SCI. 199 *passim* (1985); Richard H. Thaler, *Mental Accounting Matters*, 12 J. BEHAV. DECISION MAKING 183 *passim* (1999).

[26] Tversky & Kahneman, *Judgment under Uncertainty*, *supra* note 18, at 1128; *see also* Nicholas Epley & Thomas Gilovich, *The Anchoring-and-Adjustment Heuristic: Why the Adjustments Are Insufficient*, 17 PSYCHOL. SCI. 311 *passim* (2006); Dan Lovallo & Daniel Kahneman, *Delusion of Success – How Optimism Undermines Executives' Decisions*, HARV. BUS. REV., July-Aug. 2003, at 56, 60.

[27] Daniel Kahneman & Dan Lovallo, *Timid Choices and Bold Forecasts: A Cognitive Perspective on Risk Taking*, 39 MGMT. SCI. 17, 24 (1993); Lisa M. Sedor, *An Explanation for Unintentional Optimism in Analysts' Earnings Forecasts*, 77 ACC. REV. 731, 739 (2002); *see also* Arnold C. Cooper, Carolyn Y. Woo & William C. Dunkelberg, *Entrepreneurs' Perceived Chances for Success*, 3 J. BUS. VENTURING 97 *passim* (1988); Kathryn Kadous, Susan D. Krische & Lisa M. Sedor, *Using Counter-Explanation to Limit Analysts' Forecast Optimism*, 81 ACCT REV. 377, 378 (2006).

[28] Daniel Kahneman & Amos Tversky, *Subjective Probability: A Judgment of Representativeness*, 3 COGNITIVE PSYCHOL. 430 *passim* (1972); Tversky & Kahneman, *supra* note 18, at 1124 *passim*.

[29] *See* Mark D. Alicke, *Global Self-Evaluation as Determined by the Desirability and Controllability of Trait Adjectives*, 49 J. PERSONALITY & SOC. PSYCHOL. 1621 *passim* (1985); Mark D. Alicke et al., *Personal Contact, Individuation, and the Better-than-Average Effect*, 68 J. PERSONALITY & SOC. PSYCHOL. 804 *passim* (1995); Colin F. Camerer & Dan Lovallo, *Overconfidence and Excess Entry: An Experimental Approach*, 89 AM. ECON. REV. 306 (1999); Kent Daniel & Sheridan Titman, *Market Efficiency in an Irrational World*, 55 FIN. ANALYSTS J. 28, 28-29 (1999); Odean, *supra* note 18 at 1892-93; Ola Svenson, *Are We All Less Risky and More Skillful than Our Fellow Drivers?*, 47 ACTA PSYCHOLOGICA 143 *passim* (1981); Neil D. Weinstein, *Unrealistic Optimism About Future Life Events*, 39 J. PERSONALITY & SOC. PSYCHOL. 806 *passim* (1980).

[30] Hal R. Arkes & Catherine Blumer, *The Psychology of Sunk Cost*, 35 ORGAN. BEHAV. & HUM. DECISION PROCESSES 124 *passim* (1985); George Loewenstein & Samuel Issacharoff, *Source Dependence in the Valuation of Objects*, 7 J. BEHAV. DECISION MAKING 157 *passim* (1994); Richard H. Thaler, *Toward a Positive Theory of Consumer Choice*, 1 J. ECON. BEHAV. & ORG. 39, 47 (1980); Barry M. Staw, *Knee-Deep in the Big Muddy: A Study of Escalating Commitment to a Chosen Course of Action*, 16 ORGAN. BEHAV. & HUM. DECISION PERFORMANCE 27 *passim* (1976).

the general population.[31] Nonetheless, it seems highly unlikely that they are immune to irrational decision-making. In particular with regard to overconfidence as well as some other phenomena, there even are strong indications for managers being affected in their decisions and decision-making processes.[32] In light of that, albeit hard scientific proof so far does not exist, the present state of knowledge constitutes "at least a prima facie case" that these findings provide potentially further references on how to improve decision-making processes in M&A transactions.[33] Hence, despite remaining doubts and a considerable amount of speculation, the occurrence of behavioral biases influencing the decision-making processes in M&A transactions is too conclusive and the potential gains given the importance of M&A transaction for the involved companies too significant to ignore the existing research.

## II. Dangers of Irrational Decision-Making Processes in an Ideal M&A Transaction

This section illustrates how the insights of behavioral economics relate to M&A transactions by describing the structure of an ideal transaction in the form of an acquisition of a company or its shares and examining specific situations that pose the risk of irrational behavior.

In general, M&A transactions involve a multitude of typically highly complex decisions, which are made under great uncertainty and time pressure.[34] The complexity is above all caused by the amplitude of relevant information and the confusing amount of interconnected processes. In addition, there are interdisciplinary tasks and the natural divergence of interest among the involved actors. The significant uncertainty is based on the information asymmetry among the involved parties as well as the need of forecasting future developments. The time pressure results from the costs of the transaction process, potential competitors for the target company, the respective market situation, a fixed time frame or the need for secrecy. Given that complexity, uncertainty, and time pressure increase the probability of irrational behavior in decision-making processes,[35] particular attention is paid to these aspects.

---

31 *See* Donald C. Langevoort, *The Behavioral Economics of Mergers and Acquisitions*, 12 TENN. J. BUS. L. 65, 71 (2011).

32 *See, e.g.*, Ulrike Malmedier & Geoffrey Tate, *Who Makes Acquisitions? CEO Overconfidence and the Market's Reaction*, 89 J. FIN. ECON. 20 *passim* (2008).

33 Langevoort, *supra* note 31, at 74.

34 *See* ROSS ET AL., *supra* 2, at 796.

35 *See, e.g.*, Tversky & Kahneman, *Judgment under Uncertainty*, *supra* note 18, at 1124.

With regard to M&A transactions in general, there is one structural problem worth mentioning in this context. Executive compensation and perquisites are typically more closely linked to a company's growth than to its efficiency, not least due to the focus on short term instead of long-term success.[36] Thus, managers are incentivized to favor acquisitions—independent of their value-adding potential—over efficiency and profitability, creating a considerable agency cost problem and amplifying the risk and frequency of irrational decision-making.[37]

An ideal M&A transaction can be subdivided into three phases, which do not run chronologically but rather integrative and iterative.[38] These are the planning, transaction, and integration phases. The following describes the different phases' elements and identifies at what point, respectively, the above-mentioned phenomena of behavioral economics are of particular importance due to the increased risk of irrational behavior in perceiving and processing information—as well as the decision-making process itself.

### *A. Planning Phase*

The planning phase sets the groundwork for the future M&A transaction and is of crucial importance for its success. Decision-makers' misjudgments in this phase can often have a fatal impact on the transaction process as a whole and are difficult to adjust in later stages.

#### *1. Main Elements of the Planning Phase*

The planning phase initially contains an analysis of the individual company, in particular with regard to the company's objectives, internal potentials capable of being influenced, and the pursued strategy.[39] Relevant diagnostic instruments one can resort to are value chain analysis, strength and weaknesses analysis, factors for success analysis, diversification

---

[36] Langevoort, *supra* note 31, at 70; Troy A. Paredes, *Too Much Pay, Too Much Deference: Behavioral Corporate Finance, CEOs, and Corporate Governance*, 32 FLA. ST. U. L. REV. 673, 684-686 (2005).

[37] Langevoort, *supra* note 31, at 70. With respect to overconfidence, see Paredes, *supra* note 36.

[38] JANSEN, *supra* note 2, at 249; Reinhard Meckl, *Organising and Leading M&A Projects*, 22 INT'L J. PROJECT MGMT. 455, 456-57 (2004). For further models see: DONALD DEPAMPHILIS, MERGERS, ACQUISITIONS, AND OTHER RESTRUCTURING ACTIVITIES: AN INTEGRATED APPROACH TO PROCESS, TOOLS, CASES, AND SOLUTIONS 135-232 (6th ed. 2012); FLORIAN FRENSCH, THE SOCIAL SIDE OF MERGERS AND ACQUISITIONS – COOPERATION RELATIONSHIPS AFTER MERGERS AND ACQUISITIONS 64-65 (2007); GALPIN & HERNDON, *supra* note 3, at 9-19.

[39] DEPAMPHILIS, *supra* note 38, at 139-40 (6th ed. 2012); JANSEN, *supra* note 2, at 250.

tests, portfolio tests, or core competence analysis.[40] In addition to this examination of internal aspects, an analysis of the business environment is required. For instance, one might distinguish between analysis and forecast in the areas of politics, society, economy, technology, industry analysis, and the company's position in the industry.[41]

Based on these findings one attempts to determine gaps between actual and potential performance that is deemed realistic, particularly with regard to the environment analysis (so called Gap Analysis).[42] Having detected gaps, one now has to consider various ways to close them. In case decision-makers identify an M&A transaction as the most promising measure, one should determine motive, objective, form and time frame of the intended transaction as well as criteria for a potential target company.[43] Finally, developing a detailed strategy for the transaction is necessary.[44]

### 2. *Dangers of Irrational Behavior in the Planning Phase*

During the planning phase of an M&A transaction the decision-makers are confronted with various situations in which there are risks that some of the above-mentioned behavioral biases[45] occur subconsciously and result in irrational behavior.

The initial self-analysis of a company is carried out on the basis of a vast amount of information that is virtually impossible to overlook. Despite the much more comprehensive—though still incomplete—availability of records compared to the information on a potential target company it is typically difficult to reach unambiguous results. In addition to the complexity of the diagnostic tools and the interrelation of various data, this can be explained with the dependence on external aspects that are difficult to precisely detect as well as numerous forecasts. Moreover, the significant costs of a thorough analysis lead to time pressure.

The inspection of the data from one's own company bears the risk of confirmation bias. It is hardly avoidable to approach the inspection without certain expectations. As a consequence, decision-makers could

---

[40] David Hussey, *Company Analysis: Determining Strategic Capability*, 11 STRAT. CHANGE 43, 43, 50 (2002); JANSEN, *supra* note 2, at 250.

[41] DEPAMPHILIS, *supra* note 38, at 137-41; JANSEN, *supra* note 2, at 253-254.

[42] *See* JANSEN, *supra* note 2, at 253-54; JOHN E. TRIANTIS, CREATING SUCCESSFUL ACQUISITION AND JOINT VENTURE PROJECTS 95 (1999).

[43] DEPAMPHILIS, *supra* note 38, at 153-54; JANSEN, *supra* note 2, at 256.

[44] DEPAMPHILIS, *supra* note 38, at 158-60; JANSEN, *supra* note 2, at 264.

[45] *See supra* Part I.

disregard information not conforming to their expectations. For instance, they might miss data indicating a negative development of a currently successful branch. In addition, ambivalent information is often interpreted correspondingly to one's expectations. This problem is significantly likely to occur in cases where the decision-makers initiate the analysis with the aspiration of a transaction.

In order to process the vast amount of data, the involved individuals might also resort to simplification, specifically by suppressing information qualified as insignificant. Besides difficulties in determining which information is insignificant in the individual case, information, once excluded from further analysis, will probably not be returned to when it appears to be relevant later in the process. Rounding might also result in distortion, especially if it concerns multiple variables.

Forecasts regarding strategic objectives tend to be particularly vulnerable to irrational behavior. Overconfidence poses the greatest danger in this context. Given the tendency to overestimate the individual capabilities and the level of control, decision-makers might misjudge future developments, attach too much weight to their own interpretations and stipulate unrealistic goals (planning fallacy). Another bias that has to be considered is the inside view which could lead decision-makers to ignore statistical data and basic probabilities. Representativeness poses a similar risk.

With regard to in what way gaps identified in the Gap Analysis shall be approached, herding has to be taken into account. If there is a general trend among M&A transactions, such as toward acquisitions, in a respective industry or by competitors, decision-makers could be strongly influenced by this fact. Therefore, they might fail to seriously consider other alternatives or specifics of their own situation. Decisions could also be affected by confirmation bias, for instance if decision-makers themselves or their competitors recently had positive experience with an acquisition. In that case they might overestimate the probability of success.

### *B. Transaction Phase*

The transaction phase describes the actual deal-making—starting with the first contact with the target until the formation of the purchase agreement.[46] While a company mainly focuses on itself in the planning

---

[46] JANSEN, *supra* note 2, at 265; *see also* David R. Willensky, *Making it Happen: How to Execute an Acquisition*, 28 BUS. HORIZONS 38, 42-43 (1985).

phase, the transaction phase concentrates on one or more other companies.

### *1. Main Elements of the Transaction Phase*

Pursuing the strategy developed in the planning phase, the transaction phase begins with contacting companies that match the respective criteria of a pre-selection prior to entering into negotiations.[47] Typically, the parties conclude a confidentiality agreement right at the beginning in order to protect sensitive data and to keep the transaction a secret.[48] In the course of the negotiations the target company provides potential buyers with some basic information on the company in a teaser or—if more detailed—an information memorandum.[49] Usually, potential buyers then render a term sheet or a more detailed letter of intent (LoI) setting out the results of the previous negotiations and indicating their willingness to come to an agreement on this basis.[50]

The LoI is followed by the due diligence, a thorough analysis and investigation of the target company that is meant to provide decision-makers with information and assess risk and opportunities on the economic and legal level in preparation for a M&A transaction.[51] The due diligence has various functions. Besides risk assessment and valuation, it typically prepares for the composition of the contractual representations and warranties.[52] Moreover, the due diligence serves the purpose of later evidence on the information asymmetry at the time of the formation of the contract as well as the decision-makers' exculpation.[53] One can distinguish between commercial, financial, tax, legal, human resources,

---

47 JANSEN, *supra* note 2, at 265; *see also* DEPAMPHILIS, *supra* note 38, at 174-75.

48 DEPAMPHILIS, *supra* note 38, at 176; DONALD DEPAMPHILIS, MERGERS AND ACQUISITIONS BASICS: NEGOTIATION AND DEAL STRUCTURING 13-14 (2011) [hereinafter DEPAMPHILIS, NEGOTIATION AND DEAL STRUCTURING].

49 *See* Jana P. Fidrmuc et al., *One Size Does Not Fit All: Selling Firms to Private Equity Versus*, 18 J. CORP. FIN. 828, 833 (2012).

50 DEPAMPHILIS, *supra* note 38, at 173-75; DEPAMPHILIS, NEGOTIATION AND DEAL STRUCTURING *supra* note 48, at 14-15 (2011); JANSEN, *supra* note 2, at 273-274.

51 DEPAMPHILIS, *supra* note 38, at 180-183.

52 Heinrich Pack, *Due Diligence*, *in* Handbook of International Mergers and Acquisitions 153, 156 (Gerhard Picot ed., 2002); LINDA S. SPEDDING, DUE DILIGENCE HANDBOOK: CORPORATE GOVERNANCE, RISK MANAGEMENT AND BUSINESS PLANNING 11 (2009).

53 BORIS BECKMANN, DUE DILIGENCE DURING COMPANY MERGERS & ACQUISITIONS 10 (2006); JANSEN, *supra* note 2, at 276.

and environmental due diligence.[54] For this often essential phase to overcome information asymmetries, the target company typically provides a data room with a selection of information about the company for a limited period of time.[55] Due to the pre-selection of the data and the tight schedule, the due diligence by no means leads to the decision-makers being exhaustively informed about the target.

Another component of the transaction phase is the valuation of the company, which has crucial impact on the determination of the purchase price.[56] There are various concepts to assess the value of a company.[57] However, the most common ones are discounted cash flow (DCF) or relative value models.[58] DCF models rely on estimating and discounting all future cash flows to determine the net present value.[59] The relative value models rest on the fair market value and rely on the assumption that a company value cannot be assessed by solely considering the company itself but requires the inclusion of external factors, relations and market data as well as a comparison to the other companies, such as known purchase prices.[60] The significance of the valuation concepts largely depends on quality and extent of the available data. Evidently, the greatest weakness of all described valuation models lies in the necessity of predictions of future developments.[61]

The final important aspects of the transaction phase are the actual negotiations as well as signing of the purchase agreement and the closing of the transaction. For the purposes of this article the negotiations are of particular interest. Especially in cases of more than one potential buyer or a tendering procedure, oftentimes a difficult to control dynamic develops due to the competitive situation and the time pressure.[62]

---

[54] *See, e.g.*, GALPIN & HERNDON, *supra* note 3, at 14; GARY M. LAWRENCE, DUE DILIGENCE IN BUSINESS TRANSACTIONS §§ 3-4 to 3-14 (2004).

[55] DEPAMPHILIS, *supra* note 38, at 181-182 n.9.

[56] JANSEN, *supra* note 2, at 278.

[57] *See generally* DEPAMPHILIS, *supra* note 38, at 235-405; JOHN B. VINTURELLA & SUZANNE M. ERICKSON, RAISING ENTREPRENEURIAL CAPITAL 153-188 (2004).

[58] SCHWEIGER, *supra* note 4, at 20.

[59] GAUGHAN, *supra* note 2, at 542-543.

[60] HANDBOOK OF MARKETING AND FINANCE 68-70 (Shankar Ganesan ed., 2012).

[61] *Id.* at 68-69; IAN RATNER ET AL., BUSINESS VALUATION AND BANKRUPTCY 41 (2009).

[62] Deepak Malhotra et al., *When Winning is Everything*, HARV. BUS. REV., May 2008, at 78 *passim*; *see generally* Paul R. Milgrom & Robert J. Weber, *A Theory of Auctions and Competitive Bidding*, 50 ECONOMETRICA 1089 *passim* (1982) (describing a new model of competitive bidding with greater risk aversion and more complete information).

### 2. *Dangers of Irrational Behavior in the Transaction Phase*

Similar to the planning phase there are manifold situations posing risks of irrational behavior in the transaction phase. Compared to the planning phase, the decision-makers uncertainty is even intensified, as less data are available for the target company. Simultaneously, complexity and time pressure increase. Potential competitors, the negotiation situation, or the public learning about the transaction may lead to further difficulties.

In general, one has to consider that decision-makers, particularly in the case of acquisitions, tend to be too positive in their outlooks, which can influence future decision-making processes. Besides the publicly available information especially the teaser or the information memorandum provide the agents of the target company with an opportunity to influence the potential buyers. In particular, framing and contrast effect should be considered.

For clarity reasons the following is limited to identifying the risks of behavioral biases in the core elements of the transaction phase: due diligence, business valuation and purchase price determination, as well as negotiations.

#### *a) Due Diligence*

In the course of the due diligence, the involved actors usually grasp as much new information as possible, which will most likely influence the rational perception of information. Due to prior information and respective instructions, the actors will have a rough image of the target company. In consequence they might tend towards confirmation bias[63] and disregard data that does not confirm the expectations—or even refrain from searching for such data.[64] For instance, with regard to confusing information or information difficult to understand availability bias could occur subconsciously. Selection and presentation of the available data—for example, either by framing or contrast effect—might also contribute to irrational behavior. Contrast effect could also have an effect on the evaluation of recent deviations from long-term continuous developments.

#### *b) Business Valuation and Purchase Price Determination*

With regard to the business valuation of the target and, closely related,

---

[63] Lovallo et al., *supra* note 17, at 94-95.

[64] *See also* Bogan & Just, *supra* note 4, at 932-934 (focusing on the costs of confirmation bias on merger integration).

the purchase price determination, overconfidence poses the central problem. Predicting the target's future profits or efficiency and cost gains due to intended synergies might well be too positively forecasted.[65] Frequently, decision-makers overestimate their influence on increasing the target's profitability and their capabilities compared to the present management. This might result in overrating the target's value and determining too high of a price. Inside view could contribute to this effect, for instance, by disregarding statistical data of comparable transactions and therefore overestimating probabilities. The same applies for representativeness.

Besides overly optimistic forecasts—as in the analysis of one's own company[66]—simplification might lead to distortions in processing information. Mental accounting could result in decision-makers failing to incorporate into their evaluation relationships among different product divisions. The valuation concepts are not able to display this aspect.

In the context of the purchase price determination anchoring and sunk-cost should be paid attention to. The purchase price preliminary stipulated in the Letter of Intent or the Memorandum of Understanding on the basis of the teaser and the publicly available information might function as the "anchor." Being drawn to this anchor could lead decision-makers to inadequately adjust the price with regard to new information discovered in the due diligence process.[67] The sunk cost effect, in the form of considering the already made investments, is likely to occur because of the significant efforts and resources attributed to planning a transaction and conducting the due diligence.

#### *c) Negotiations*

Irrational behaviors that have already occurred in the transaction continue to affect the process during the negotiations. In addition, further biases are likely to specifically influence behavior in this phase.

In particular, mental accounting might lead decision-makers to overlook connections between the amount of the purchase price and possible provisions on representations and warranties, arrangements with important employees and suppliers, the transfer of loss-making branches, or pricing in risks that contribute to a debit of the "money account." In

---

[65] *See also* Lovallo et al., *supra* note 17, at 95-96; *see generally* Roberto A. Weber & Colin F. Camerer, *Cultural Conflict and Merger Failure: An Experimental Approach*, 49 MGMT. SCI. 400 (2003).

[66] *See supra* Part II.A.2.

[67] Lovallo et al., *supra* note 17, at 99.

case several accounts are kept relative to a point of reference, the decreasing sensitivity for values may result in overpayments. For instance an additional sum of $5 million seems to hardly matter in an overall purchase price of $300 million.

Furthermore, the sunk cost effect is of particular relevance. At a certain point decision-makers tend to close a deal at all costs given the significant investments already made for the transaction.[68] This problem is even more aggravated in case the public knows about the efforts to acquire the target company as—at least allegedly—the participants' reputation is at stake. If the transaction is structured as a tendering procedure this might lead to proper bidding wars raising the purchase price far beyond the initial valuation.[69] Tendering procedures are likely to maximize revenues also due to this aspect.[70] In this context one might allude to the winner's curse, describing the fact that the successful actor in a negotiation with an asymmetric allocation of information and uncertainty about the actual value of the object of purchase oftentimes overpays.[71] The seller typically possesses the most meaningful information and therefore is in the best position to assess the real value. Hence, he will rarely sell under value, unless he is forced to sell for some reason.

### C. *Integration Phase*

The integration phase describes the planning and implementation of the actual merging of the target company with the acquiring company.[72] A successful integration is of crucial importance for the overall success of an M&A transaction.[73] In light of this, it is astonishing that comparably little attention is attached to this aspect.

#### 1. *Main Elements of the Integration Phase*

The integration phase begins in an early stage of the transaction process as it requires intense planning that has to be incorporated in the

---

68 *Id.*

69 Malhotra et al., *supra* note 62; Patrick J. Meister & Kyle J. Anderson, *Lessons from a Failed Airline Auction*, 44 ECON. INQUIRY 311 *passim* (2006).

70 Milgrom & Weber, *supra* note 62 *passim*.

71 Audra L. Boone & Harold J. Mulherin, *Do Auctions Induce a Winner's Curse? New Evidence from Corporate Takeover Market*, 89 J. FIN. ECON. 1 *passim* (2008); Barry Lind & Charles R. Plott, *The Winner's Curse: Experiments with Buyers and with Sellers*, 81 AM. ECON. REV. 335 *passim* (1991).

72 *See, e.g.*, Meckl, *supra* note 38.

73 Epstein, *supra* note 8; GALPIN & HERNDON, *supra* note 3, at 3-4; Lovallo et al., *supra* note 17, at 96; Weber & Camerer, *supra* note 65 *passim*.

considerations regarding the business strategy.[74] Moreover, there are strong tendencies towards a cultural due diligence to better organize the integration process and predict potential risks.[75] Predominantly, in corporate acquisitions, integration measures are commonly distinguished between organizational, strategic, administrative, operative, cultural, and external levels.[76] Finally, instruments to measure the success of an M&A transaction are attributed to the integration phase.[77]

### 2. *Dangers of Irrational Behavior in the Integration Phase*

The danger of irrational behavior already exists within the scope of the integration planning. Due to overconfidence decision-makers often underestimate the potential for conflict among the different corporate cultures and the loss of efficiency caused by the integration of the targets' employees.[78] In consequence, decision-makers develop unrealistic objectives (planning fallacy).[79] Inside view might also contribute to this problem, such as if experience and statistical data of similar procedures are not attached with the necessary weight.

Moreover, irrational behavior might occur in the context of necessary adjustments to the original planning after the execution of the transaction. In case the integration does not work as expected, prompt measures are required to countervail these undesirable developments. Following the need for avoiding cognitive dissonance, decision-makers could tend to conformation bias, such as disregarding early indicators of undesirable developments and instead focusing on information affirming prior decisions or interpret ambiguous facts respectively. The need for action will then be discovered too late and this might then lead to a momentous delay. This effect is amplified by self-attribution bias as adjusting the original integration planning which constitutes the uncomfortable admission of a previous misjudgment, which can hardly be reconciled with a self-conception characterized by overconfidence.

---

[74] Epstein, *supra* note 8, at 175-176; JANSEN, *supra* note 2, at 318-20; JENS KIRCHNER, PASCAL R. KREMP, MICHAEL MAGOTSCH, KEY ASPECTS OF GERMAN EMPLOYMENT AND LABOUR LAW 251-252 (2010).

[75] *See, e.g.*, Spedding, *supra* note 52, at 286-288. *But see* JANSEN, *supra* note 2, at 323-24.

[76] JANSEN, *supra* note 2, at 318.

[77] Epstein, *supra* at 8, at 178-179; JANSEN, *supra* note 2, at 330.

[78] Lovallo et al., *supra* note 17, at 95.

[79] *Id.* at 96.

## III. Liability for Failed M&A Transactions

The legal framework basically fails to address the described dangers of irrational[80] decision-making. Courts usually assume that directors and officers of a company act rationally.[81] Executives and board members can rarely be held liable for their misjudgments irrespective of how severe the consequences of a failed M&A deal are for the company. According to section 4.01 of the ALI's Principles of Corporate Governance, the relevant fiduciary duty of care requires directors and officers to perform their functions in good faith, in a manner they reasonably believe to be in the best interest of the corporation, and with the care "that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances."[82] More specifically, the duty of care obliges directors and officers, amongst others, to "inform themselves, prior to making a business decision, of all material information reasonably available to them."[83] Despite this demanding standard of conduct,[84] directors and officers in practice are only held liable for gross negligence due to the not very stringent standard of review applied by the courts under the business judgment rule in contrast to the strict duty of loyalty.[85]

The doctrinal classification of the business judgment rule is still

---

[80] *Irrational* decision-making by some authors is understood as indication for liability with regard to the business judgment rule in contrast to mere *unreasonable* decisions. *See, e.g.*, William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Function over Form: A Reassessment of Standards of Review in Delaware Corporate Law*, 56 Bus. Law. 1287, 1296 (2001); Melvin Aron Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 Fordham L. Rev. 437, 443 (1993). However, the term irrational decisions caused by the described biases in the context of this article does not follow this understanding, particularly given that most biases subconsciously influence decision-making. Rather, it is even questionable whether irrational decisions of this type will be classified as unreasonable under the present definition of the fiduciary duty of care.

[81] James A. Fanto, *Quasi-Rationality in Action: A Study of Psychological Factors in Merger Decision-Making*, 62 Ohio St. L. J. 1333, 1381-86 (2001).

[82] American Law Institute, Principles of Corporate Governance: Analysis and Recommendations 138-39 (1994); *see also* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. 1963).

[83] *See* Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) (quoting Aronson, 473 A.2d at 812).

[84] Distinguishing between a standard of conduct and a standard of review assumes that the business judgment rule constitutes a standard of liability.

[85] Allen et al., *supra* note 80; Eisenberg, *supra* note 80, at 440-41; Paredes, *supra* note 36, at 747.

disputed.[86] While some perceive it as a standard of liability,[87] shielding directors from liability as long as they act in good faith,[88] others view it as raising the liability bar from negligence to gross negligence.[89] Again others suggest qualifying the rule as an abstention doctrine that establishes a presumption against judicial review of duty of care claims unless the plaintiff can challenge that the defendant acted in good faith.[90] For the purposes of this article, however, there is no need to determine which classification is favorable given the general consensus regarding the required elements of the business judgment rule.

The business judgment rule stipulates four requirements. A business judgment in good faith, first, has to be made by a director or officer who is, second, not interested in the subject of the decision, third, "informed with respect to the subject of the business judgment to the extent" he "reasonably believes to be appropriate under the circumstances," and, fourth, "rationally believes that the business judgment is in the best interest of the corporation."[91] In case these conditions are fulfilled, the business judgment rule shields directors and officers from personal liability for negligent conduct that would otherwise have constituted a violation of the fiduciary duty of care.[92] Thereby, judicial review is focused on the procedural aspects of corporate decision-making rather than its substance.[93]

---

86 *See* Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 89 (2004); *see also* R. Franklin Balotti & James J. Hanks, Jr., *Rejudging the Business Judgment Rule*, 48 BUS. LAW. 1337, 1342 (1993); Franklin A. Gevurtz, *The Business Judgment Rule: Meaningless Verbiage or Misguided Notion?*, 67 S. CAL. L. REV. 287, 287-88 (1994); Henry G. Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259, 270-71 (1967).

87 Cede & Co. v. Technicolor, Inc., 634 A.2d 345 (Del. 1993); Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 927 (Del. 2003); *see also* Wayne O. Hanewicz, *When Silence Is Golden: Why the Business Judgment Rule Should Apply to No-Shops in Stock-for-Stock Merger Agreements*, 28 J. CORP. L. 205, 217 (2003).

88 William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of* Van Gorkom *and its Progeny as a Standard of Review Problem*, 96 NW. U. L. REV. 449 *passim* (2002); Eisenberg, *supra* note 80, at 444-45.

89 FRANKLIN A. GEVURTZ, CORPORATION LAW 284-86 (2000).

90 *See* Brehm v. Eisner, 746 A.2d 244, 264 n.66 (Del. 2000); Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 64 (Del. 1989); Shlensky v. Wrigley, 237 N.E.2d 776 (Ill. App. Ct. 1968); Bainbridge, *supra* note 86 *passim*; Lyman Johnson, *The Modest Business Judgment Rule*, 55 BUS. LAW. 625, 632 (2000).

91 AMERICAN LAW INSTITUTE, *supra* note 82, at 139; *see also* Rosenfield v. Metals Selling Corp., 643 A.2d 1253, 1262 (Conn. 1994); Omnibank of Mantee v. United S. Bank, 607 So. 2d 76, 85 (Miss. 1992); Cuker v. Mikalauskas, 692 A.2d 1042, 1045-46 (Pa. 1997).

92 *See, e.g.*, Joy v. North, 692 F.2d 880, 885 (2d Cir. 1982); Kamin v. Am. Express Co., 383 N.Y.S.2d 807, 811 (Sup. Ct. 1976); Bayer v. Beran, 49 N.Y.S.2d 2, 6 (Sup. Ct. 1944); Bainbridge, *supra* note 86, at 88.

93 A classic example for the procedural focus can be seen in the *Van Gorkom* case. *See* Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985); *see also* Christopher M. Bruner, *Good Faith, State of Mind, and the Outer*

The underlying considerations behind the business judgment rule are, amongst others, that judges tend to be rather ill-equipped for reliably second-guessing the quality of business decisions—not least due to the fact that judges are typically quite risk-averse—and, moreover, their decisions will likely be influenced by hindsight bias knowing the negative outcome of the challenged corporate behavior.[94] In addition, a substantive judicial review of business decisions would require significant resources, which the courts are not willing to provide.[95] The business judgment rule basically tries to strike the balance between the competing values of authority—including the incentives for assuming that role—and accountability.[96] It expresses an economic policy embracing economic freedom and encouraging informed risk-taking and apparently presumes that the benefits from entrepreneurial risk-taking exceed the costs resulting from wrong business decisions.[97]

The third element, the requirement to be reasonably informed, is of particular interest with regard to good faith misjudgments in M&A transactions based on the described dangers of irrational decision-making. Focusing on information that humans subconsciously tend to disregard could probably prevent most of the mentioned biases' influence on decision-making.[98] Hence, given that the existence of these biases is widely accepted and, because of the emerging field of behavioral economics, commonly known to business practitioners, one might argue that failing to gather and consider the relevant information to actively counteract the biases does not suffice as informing oneself "reasonably." While the courts might very well redefine what constitutes being "reasonably informed"[99]—and have even recognized the relevance of

---

*Boundaries of Director Liability in Corporate Law*, 41 WAKE FOREST L. REV. 1131, 1133-1134 (2006); Lynn A. Stout, *In Praise of Procedure: An Economic and Behavioral Defense of* Smith v. Van Gorkom *and the Business Judgment Rule*, 96 NW. U.L. REV. 675 *passim* (2002).

94 Allen et al., *supra* note 80; Langevoort, *supra* note 31, at 76; Paredes, *supra* note 36, at 735; Stout, *supra* note 93, at 676; *see also* Lewis v. Vogelstein, 699 A.2d 327, 336 (Del. Ch. 1997).

95 WILLIAM T. ALLEN & REINIER KRAAKMAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 248 (2003); STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 208 (2002); Bruner, *supra* note 93, at 1134; Langevoort, *supra* note 31, at 76.

96 Bainbridge, *supra* note 86, at 84.

97 *See* Allen et al., *supra* note 88, at 451; Douglas M. Branson, *The Rule that Isn't a Rule – The Business Judgment Rule*, 36 VAL. U.L. REV. 631, 632 (2002); Bruner, *supra* note 93, at 1134.

98 *See supra* Part IV.

99 For example, the former Chief Justice of the Delaware Supreme Court, E. Norman Veasey, suggested that directors should be expected to "completely understand . . . every aspect of a company's business and legal issues." *See* Paredes, *supra* note 36, at 751 (citing Alison Carpenter, *Records Inspections: Delaware's Veasey Highlights Merits of Books and Records Inspections,* 2 Corp. Accountability Rep. (BNA), May 21, 2004, at 535).

psychological factors in individual cases[100]—the prevailing legal norms clearly apply a less restrictive understanding.[101] The described situation would only fail to satisfy the business judgment rule if actual indications of managerial misconduct had been ignored.[102]

There is an important and potentially outcome-determinative difference worth mentioning between the business judgment rule in its version in section 4.01(c) of the ALI's Principles of Corporate Governance, which has been adopted by the highest courts of several states, and the way it is applied in Delaware and other jurisdictions following Delaware law: while the former lays the burden of establishing the rule's elements on the challenged directors, the latter, by presuming the rule's fulfillment, requires the opposite.[103] Plaintiffs have to demonstrate that it has not been satisfied.[104]

Concluding, despite the significant and potentially preventable risks of irrational decision-making that lead to misjudgments and bad business decisions contributing to the failure of M&A transactions, directors and officers practically cannot be held liable under the current law. In combination with rewarding executives for non-value-enhancing growth,[105] this setting provides little incentive to develop strategies challenging the described dangers.

## IV. Strategies Against Irrational Decision-Making Processes

Having identified the dangers of irrational behavior in perceiving and processing information as well as in decision-making and having dealt with the lack of potential liability for such behavior, this section will develop strategies against such irrational decision-making processes. General considerations on how the described behavioral anomalies should be counteracted are followed by suggestions of mechanisms against specific phenomena.

---

[100] *In re* Oracle Corp. Derivative Litig., 824 A.2d 917, 938-39 (Del. Ch. 2003).

[101] *See* Brehm v. Eisner, 746 A.2d 244, 256 (Del. 2000).

[102] *See, e.g.*, Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125 (Del. 1963); *In re* Caremark Int'l, 698 A.2d 959 (Del. Ch. 1996).

[103] *See, e.g.*, Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); Cede & Co. v. Technicolor, 634 A.2d. 345, 361; Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1162 (Del. 1995); *In re* Walt Disney Co. Derivative Litigation, 906 A.2d 27 (Del. 2006); Orman v. Cullman, 794 A.2d 5, 19-20 (Del. Ch. 2002).

[104] Branson, *supra* note 97, at 635-36, 645-647.

[105] *See supra* Part II.

### *A. General Considerations*

When thinking of strategies against irrational decision-making processes, it is crucial to bear in mind that the described phenomena by no means shall be demonized per se given humans' cognitive limitations and natural psychological needs. Most phenomena are rather essential for an efficient decision-making process.[106] Biases concerning the perception of information, for instance, enable people to actually grasp complex circumstances in a reasonable time frame. Studies have shown that in individual cases limited information can lead to equal or even better decisions compared to including extensive data.[107] With regard to processing information, simplification and anchoring are suitable mechanisms for speedy decision-making. Finally, the tendency to overconfidence also entails positive aspects. Overconfidence contributes to motivation, persistence, and readiness to assume risk.[108] Particularly for CEOs, overconfidence—of course within certain boundaries—seems not only desirable but also a defining feature of a successful performance in this position.[109] Overconfidence specifically boosts self-esteem as well as the overall psychological well-being and has ego-protecting and anxiety-easing implications.[110] This presumably prevents CEOs from being too tentative and deliberate and at the same time enhances visionary, clear-cut and risk-seeking decision-making.[111] Projecting confidence also tends to be beneficial for the external appearance, such as towards competitors or

---

[106] *See generally* Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797 (2001); Jeffrey J. Rachlinski, *The "New" Law and Psychology: A Reply to Critics, Skeptics, and Cautious Supporters*, 85 CORNELL L. REV. 739, 753 (2000).

[107] GERD GIGERENZER, PETER M. TODD, ABC RESEARCH GROUP, SIMPLE HEURISTICS THAT MAKE US SMART *passim* (1999); Gerd Gigerenzer & Daniel Goldstein, *Reasoning for the Fast and Frugal Way: Models of Bounded Rationality*, 103 PSYCHOL. REV. 650 *passim* (1996).

[108] Lovallo & Kahneman, *supra* note 26, at 63; Malmendier & Tate, *supra* note 32, at 21; Eric van den Stehen, *Organizational Beliefs and Managerial Vision*, 21 J.L. ECON. ORG. 256 *passim* (2005).

[109] *See* David Hirshleifer et al., *Are Overconfident CEOs Better Innovators?*, J. FIN. (forthcoming 2012); *see also* David A. Hofman, *Self-Handicapping and Managers' Duty of Care*, 42 WAKE FOREST L. REV. 803, 810 (2007); Anand M. Goel & Anjan V. Thakor, *Overconfidence, CEO Selection, and Corporate Governance*, 63 J. FIN. 2737 *passim* (2008); *see also* Donald C. Langevoort, *The Organizational Psychology of Hyper-Competition: Corporate Irresponsibility and the Lessons of Enron*, 70 GEO. WASH. L. REV. 968, 969-71 (2002); Paredes, *supra* note 36, at 684-685, 719-720.

[110] *See generally* Andrew D. Brown, *Narcissism, Identity, and Legitimacy*, 22 ACAD. MGMT. REV. 643 (1997); Lisa Farwell & Ruth Wohlwend-Lloyd, *Narcissistic Processes: Optimistic Expectations, Favorable Self-Evaluations, and Self-Enhancing Attributions*, 66 J. PERSONALITY 65 *passim* (1998).

[111] Paredes, *supra* note 36, at 699-700.

investors.[112] Therefore, in developing strategies against the described behavioral biases it is important to find a balance that implements boundaries to prevent potentially harmful excesses in irrational decision-making but at the same time—at least with regard to most phenomena—does not result in a complete *de*biasing or, even worse, a *re*biasing.

Misjudgments and bad business decisions are considerably more likely if the identified psychological phenomena occur subconsciously. An essential step towards avoiding disadvantageous consequences from irrational behavior therefore means to alert directors and officers at what point in decision-making processes they are vulnerable to these phenomena.[113] For instance, when there is a specific danger of disregarding potentially important information, attaching too much value to certain circumstances, wrongly interpreting ambiguous data, failing to diligently analyze individual characteristics in contrast to other market participants, or vastly overestimating potential synergies. However, insights from empirical studies indicate that recognizing behavioral anomalies does not automatically lead to their avoidance.[114] Humans appear to be considerably resistant against behavior changes in this respect.

The obvious way to make someone aware of the dangers associated with the irrational handling of information is to specifically deal in detail with the above mentioned phenomena[115] and their occurrence in the M&A transaction process. Potential measures could be creating handouts and brochures or providing workshops held, for instance, by psychologists, in which decision-makers are introduced to the subject matter. Due to the different roles of the various decision-makers in M&A transactions, especially with regard to directors and executives, it seems desirable to address them according to their specific function. For instance, directors should specifically learn about which biases potentially influence managers' decisions in what way as well as their own biases.[116] In

---

[112] Brown, *supra* note 110, at 643; Farwell & Wohlwend-Lloyd, *supra* note 110; Paredes, *supra* note 36, at 701.

[113] *See* Joan MacLeod Heminway, *A More Critical Use of Fairness Opinions as a Practical Approach to the Behavioral Economics of Mergers and Acquisitions*, 12 TENN. J. BUS. L. 81, 81-82 (2011); Langevoort, *supra* note 31, at 78-79; Paredes, *supra* note 36, at 739-740; *see also* further Lovallo & Kahneman, *supra* note 26, at 61; J. Edward Russo & Paul J.H. Schoemaker, *Managing Overconfidence*, 33 SLOAN MGMT. REV. 7, 8-11, 13-15 (1992); Barry M. Staw & Jerry Ross, *Knowing When to Pull the Plug*, 65 HARV. BUS. REV., Mar.-Apr. 1987, at 68, 71.

[114] *See* HERSH SHEFRIN, BEHAVIORAL CORPORATE FINANCE 15-16 (2007); *see also* Edward Teach, *Watch How You Think – Insights from Behavioral Finance Could Change the Way Companies Approach Mergers and Acquisitions*, 20 CFO MAG. 55, 57 (2004).

[115] *See supra* Part II.

[116] With regard to this differentiation, see Paredes, *supra* note 36, at 740.

particular, this should suffice to contain the implications of framing, the contrast effect, or the decreasing sensitivity for values due to the increasing amount in question that comes from mental accounting.

A considerable number of decision-makers will likely deem that they are not affected by behavioral biases given their level of sophistication. To countervail this possible reaction, it should be emphasized that the findings of cognitive psychology in principle apply to all humans, albeit more or less distinctive, and that biases have been proven to specifically occur among managers.[117] One might also conduct small experiments with the workshop participants to illustrate individual irrational behavior.[118]

Another measure could be developing and introducing standardized checklists for specific situations, which would allow a review of one's own behavior with regard to possible influences of subconscious factors. Standardized checklists have been proven beneficial to more efficiently organizing the due diligence and thus are familiar as a supporting tool in the M&A context. A checklist for investment decisions in capital markets developed by Fromlet[119] could function as a reference point. Relying on insights from behavioral finance, Fromlet, amongst others, recommends questioning new information with regard to whether they are reported in a positive, neutral, or negative way and how they align with one's own position.[120] In addition, he suggests to specifically consider arguments from the opposing side.[121] Moreover, one should put the information in a broader context[122] and take into account the quality of the information source. When using checklists it is crucial to ensure that they do not constitute a mere formality or "check-the box" approach[123] but actually contribute to a more transparent, manifold, and informed decision-making process.

Furthermore, one should consider introducing a person responsible for raising awareness of the dangers stemming from behavioral biases. A proposal of Troy Paredes points in that direction: To challenge specifically CEO's overconfidence in M&A transactions, he has suggested appointing

---

117 *See supra* Part I.

118 *See* Teach, *supra* note 114.

119 Hubert Fromlet, *Behavioral Finance – Theory and Practical Application*, 38 BUS. ECON. 63, 68 (2001).

120 *Id.*

121 *Id.*

122 *See* ANDREAS LASCHKE & MARTIN WEBER, DER ÖVERCONFIDENCE BIAS ÜND SEINE KONSEQUENZEN IN FINANZMAERKTEN 9 (1999).

123 With regard to the "naysayer," see Paredes, *supra* note 36, at 745.

a devil's advocate or "chief naysayer" to institutionalize dissent within the company aiming for a more deliberative process of corporate decision-making.[124] That person's task would basically be to ensure that the opposite to the intended strategy is contemplated, e.g. by asking probing questions, challenging key assumptions, focusing on counterfactuals or presenting other opinions.[125] According to Paredes, respected, term-limited, independent directors or shareholder nominees could fill out that role, and if needed, be supported by an independent staff of professional advisors.[126] The proposal relies on practical experience with the devil's advocate function in other settings[127] as well as studies that have proven negative feedback,[128] and considering counterarguments[129] as effective debiasing techniques, particularly with regard to overconfidence. To account for the naysayer's own vulnerability to biases as well as to prevent a "check-the-box" approach, e.g. asking only standard questions, Paredes recommends adopting procedures for monitoring and evaluating his performance.[130]

While this approach can surely contribute to a more balanced and deliberative decision-making process, in my opinion there remain shortcomings particularly with regard to specifically addressing the dangers of behavioral biases. Hence, I suggest to implement an external expert specialized in the effects of behavioral biases' and to make him part of the M&A team. Psychologists with the necessary economic knowledge

---

124 Paredes, *supra* note 36, at 740-747.

125 *Id.* at 740-41.

126 *Id.* at 745-46.

127 For how it works in the European Commission with regard to antitrust decisions, or in the Pentagon, see Paredes, *supra* note 36, at 744.

128 *See, e.g.*, Ward Edwards & Detlof von Winterfeldt, *Cognitive illusions and Their Implications for the Law*, 59 S. CAL. L. REV. 225, 239-242; Howard Garland et al., *De-Escalation of Commitment in Oil Exploration: When Sunk Costs and Negative Feedback Coincide*, 75 J. APPLIED PSYCHOL. 721 *passim* (1990); Jeffrey Rachlinski, *The Uncertain Case for Paternalism*, 97 NW. U.L. REV. 1165, 1212 (2003); Russo & Schoemaker, supra note 113, at 10-12; *see also* William K. Balzer et al., *Effects of Cognitive Feedback on Performance*, 106 PSYCHOL. BULL. 410 *passim* (1989); William Remus et al., *Does Feedback Improve the Accuracy of Recurrent Judgmental Forecasts?*, 66 ORG. BEHAV. & HUM. DECISION PROCESSES 22 *passim* (1996).

129 *See, e.g.*, Hal R. Arkes, *Costs and Benefits of Judgment Errors: Implications for Debiasi*ng, 110 PSYCHOL. BULL. 486, 494 (1991); Stephen J. Hoch, *Counterfactual Reasoning and Accuracy in Predicting Personal Events*, 11 J. EXPERIMENTAL PSYCHOL.: LEARNING MEMORY & COGNITION 719 *passim* (1985); Charles G. Lord et al., *Considering the Opposite: A Corrective Strategy for Social Judgment*, 47 J. PERSONALITY & SOC. PSYCHOL. 1231 *passim* (1984); Russo & Schoemaker, *supra* note 113, at 12-13; Charles R. Schwenk & Richard A. Cosier, *Effects of the Expert, Devil's Advocate, and Dialectical Inquiry Methods on Prediction Performance*, 26 ORGAN. BEHAV. & HUM. PERFORMANCE 409 *passim* (1980).

130 Paredes, *supra* note 36, at 746.

or economists trained about the psychological effects would be possible options. In contrast to an internal solution, this approach could particularly prevent personal ties or the aspiration for higher positions within the company influence how the expert exercises his role. Such an expert could particularly be consulted for fundamental decisions within the transaction process, for instance configuring the transaction strategy, selecting the target, developing the integration plan, determining the purchase price, or preparing the due diligence and contract negotiations. Simply initiating decision-makers to reconsider their handling of information in specific situations with questions and comments might suffice as a guard against irrational behavior. Detailed knowledge of all circumstances concerning a specific decision would not be necessary for this purpose. The expert does, however, have to be granted access to the respective information and responsible people to more accurately exercise his function. In order to ensure that the expert efficiently fulfills his role, a control and review mechanism with regard to his performance shall be installed. In addition, he should be incentivized to aim for the company's long-term success.[131] As a side note, the expert might not only be valuable to shield from irrational decision-making processes but could also advise the management on how to exploit the opponent's vulnerability to behavioral biases.

Despite all the described approaches making directors and officers aware of the negative effects of subconscious behavioral biases, it is important to be attentive that the introduction of these measures does not lead to the misperception that simply knowing about the dangers will shield someone from irrational decision-making.[132] It rather requires a thorough, continuous exploration of this topic and a serious application of the insights with regard to one's individual decision-making processes to achieve what Timur Kuran and Cass Sunstein would call "comprehensive rationality."[133]

### *B. Strategies Against Specific Phenomena*

In addition to the described general strategies against irrational decision-making, the following will develop further measures to avoid

---

[131] For instance, using the long-term success as the basis for a considerable bonus, instead of pleasing his client by e.g. encouraging the execution of the M&A deal independent of its potential value for the company.

[132] With regard to the naysayer and CEO overconfidence compare Paredes, *supra* note 36, at 745-746.

[133] *See* Timur Kuran & Cass R. Sunstein, *Availability Cascades and Risk Regulation*, 51 STAN. L. REV. 683, 746 (1999).

specific phenomena of behavioral economics from detrimentally affecting decision-making processes.

#### *1. Strategy Against Confirmation Bias*

Beyond merely envisioning the danger of conformation bias, this phenomenon should be countervailed by actively searching for information not conforming with or even contradicting personal expectations. [134] Thereby, decision-makers can learn about information that deviates from original expectations in time and consider them accordingly in the course of the transaction. This approach is also favorable as a retrospective method to identify and respond to undesirable developments as soon as possible.

#### *2. Strategy Against Herding*

To avoid that the phenomenon of herding potentially affects a decision in favor of an M&A transaction, decision-makers in the planning phase should specifically take into account whether increasing numbers of acquisitions of their competitors influence their own considerations and intentions in that regard, especially in case of a market trend towards acquisitions as a strategy for growth. They should thoroughly assess whether an acquisition is in fact the most promising strategy for their company. The same applies for a situation in which a potential target is deemed particularly interesting by several competitors at the same time. In such a case the positive evaluation could also in part rest upon unconsciously wanting to benefit from the others' search efforts.

#### *3. Strategy Against Anchoring*

The occurrence of anchoring can hardly be avoided for those involved in the determination of an original value. To prevent an inadequate adjustment of the original value after learning of new information, one should consult external experts that have not been participating in the previous process.[135] Their function is to undertake an evaluation on the basis of the available data by pricing in newly discovered risks—such as those found in the due diligence—without knowing about the "anchor."

---

[134] Lovallo et al., *supra* note 17, at 94-95. *See also* SHEFRIN, *supra* note 114, at 54.

[135] Lovallo et al., *supra* note 17, at 99.

### 4. *Strategy Against Inside View and Overconfidence*

The danger of misjudgments due to inside view and—closely connected—the tendency towards overconfidence shall be countervailed by consulting statistical data of a reference class, hence by taking an outside view.[136] For this purpose, one first needs to determine a reference class with similar transaction projects. A second step requires one to closely examine these projects with regard to success, outcome, process, characteristics, etc. Based on this understanding, an intuitive prediction shall be made in a third step to where the intended project at hand would fall among the reference class transactions. To adjust a potentially too optimistic prediction its reliability shall be assessed in a fourth step to arrive at a more accurate forecast. Dan Lovallo and Daniel Kahneman suggest expressing the correlation between forecast and actual outcome with a coefficient between 0 and 1, 0 indicating no and 1 indicating complete correlation. [137] Complex calculations might require an expert statistician. In a fifth step, the prediction made in step three shall be adjusted by using the coefficients developed in step four. For instance, in case the expected synergy gains have been specifically quantified, the adjustment is undertaken by adding to this amount (SG)[138] the difference[139] of the average synergy gains of the reference transactions (GR)[140] and the individual estimate (IE)[141] multiplied by the developed coefficient (C). Hence, such determination of an adjusted probability of success (PS)[142] relies on the following formula: PS = SG + [C * (IE-GR)]. [143]

This process could be facilitated by consulting an expert who introduces the method, monitors the process and supervises the individual steps. In doing so he should also question the prediction of probabilities in

136 Bent Flyvbjerg et al., *Delusion and Deception in Large Infrastructure Projects: Two Models for Explaining and Preventing Executive Disaster*, 51 CAL. MGMT. REV. 170, 186 (2009); Kahneman & Lovallo, *supra* note 27, at 25-26; Lovallo & Kahneman, *supra* note 26, at 61; SHEFRIN, *supra* note 114, at 47; *see also* Fanto, *supra* note 81, at 1389-1401.

137 Lovallo & Kahneman, *supra* note 26, at 61 *passim*.

138 Acronym derived from (S)ynergy (G)ains

139 Assuming that due to over-optimism the individual estimate is higher than the average of the reference transactions.

140 Acronym derived from Average Synergy (G)ains (R)eference Transaction. .

141 Acronym derived from (I)ndividual (E)stimate.

142 Acronym derived from Adjusted (P)robability of (S)uccess.

143 *See generally* Flyvbjerg et al., *supra* note 136; Lovallo & Kahneman, *supra* note 26, at 62; *see also* Daniel Kahneman & Amos Tversky, *Intuitive Predictions: Biases and Corrective Procedures*, *in* TIME'S STUDIES IN THE MANAGEMENT SCIENCES VOL. 12 313 *passim* (Spyros G. Makridakis & Steven C. Wheelwright eds. 1979).

the fourth step to countervail potential tendencies towards overconfidence.[144] Thereby the expert could contribute to adjust overly positive forecasts due to control illusion by pointing at the non-existence of possibilities to influence outcomes or at dependencies on external circumstances. Moreover, by requesting a plausible rationale for the assumption that specific tasks will probably take considerably less time than in a reference transaction, he might countervail the planning fallacy.

#### 5. *Strategy Against Sunk Cost*

Similar to dangers due to anchoring,[145] the risk of decisions being affected by the sunk cost effect can be countervailed by consulting an external expert to evaluate the available data.[146] In addition, if feasible, decision-makers should not focus on one acquisition object only but keep other options open as long as possible and reasonably affordable.[147] Such a back-up plan facilitates ending negotiations, which do not any longer live up to the original expectations. Decision-makers should determine an absolute price limit[148] in any case to mark the moment when negotiations should be terminated beforehand. That way they diminish the risk of participating in so-called bidding wars, which often, especially in auctions, drive up the price to inadequate amounts.[149] Moreover, this constitutes an effective measure to avoid the winner's curse.[150]

## V. REGULATORY IMPLEMENTATION OF DEVELOPED STRATEGIES

Having described potential strategies against irrational decision-making processes in M&A transactions, this section will discuss possible forms of implementation as well as potential risks and, on this basis, suggest a specific regulatory approach relying on a "comply or explain" model. Given that insights from behavioral economics, despite their publicity, have still not been truly incorporated into decision-making processes in M&A transactions, the following considerations presume that a legislative intervention instead of a mere informative approach is needed to change this situation. Ultimately, I deem the deterrent of liability the

---

144 *See also* SHEFRIN, *supra* note 114, at 47.

145 *See supra* Part IV.A.3.

146 Lovallo et al., *supra* note 17, at 99.

147 *Id.*

148 Compare, with regard to determining the price limit, Eccles et al., *supra* note 6, at 139.

149 Lovallo et al., *supra* note 17, at 99.

150 *Id.*

most efficient mechanism to implement the strategies developed above—of course, carefully balanced with embracing economic freedom in making business decisions.

### *A. Intensity of Interference*

When considering possible forms of implementing the strategies against irrational decision-making, one first has to determine to what extent and level of detail directors and officers shall be obliged to apply the suggested mechanisms. The more paternalistic approach would specify in detail—and impose liability in case of violations—which measure has to be taken at what phase of a transaction up to the point to dictate, for instance, what type of questions a consulted external expert[151] would have to ask and what issues he would have to raise. Instead of such an intervention that would considerably restrict the economic freedom with regard to internal decision-making processes, one might also think of a mere procedural implementation stipulating, for instance, that there have to be institutionalized meetings scheduled at specific moments during a transaction where the board and managers are supposed to discuss new information and their implications for the transactions. The decision of whether to follow a rather substantive or more procedural approach largely depends on how one wants to strike a balance between the decision-makers' interest in economic freedom on the one hand and the shareholders'—as well as in part the public—interest in preventing potentially disadvantageous irrational decision-making processes in M&A transactions on the other.

As mentioned above,[152] the overall objective of the suggested strategies is to shield decision-makers from vulnerability to behavioral biases in cases where these biases lead to harmful decisions. Managers and directors, however, shall not be deterred from innovative but risky endeavors. Although the developed mechanisms do not directly affect the capacity to come to a specific business decision, by introducing new aspects into the decision-making process they are likely to result in further deliberations and reflections influencing decisions. Hence, it is a fine line between raising enough awareness to prevent harmful decisions caused by behavioral biases and spreading doubts in decision-makers slowing down or even precluding courageous, promising undertakings.

It seems hardly possible to define, on a general level, which intensity

---

151 *See supra* Part IV.A.

152 *See supra* Part IV.A.

of consultation on the biases' effects is needed to provide every individual decision-maker with the necessary awareness. It rather depends heavily on the characteristics of the specific person as well as the concrete circumstances in question. Therefore, stipulating detailed provisions on when, to what extent, and how the danger of irrational decision-making shall be addressed lacks the necessary flexibility and might do more harm than good. For instance, adding an external expert on behavioral biases to the team[153] might serve the intended purpose well in one context but lead to a desirable project's failure in others. In addition, given the remaining need for further research with regard to the behavioral biases, such a legislative intervention would be particularly difficult to justify. Accounting for the specific characteristics of each individual case, the suggested implementation shall take place on a rather abstract level by requiring procedural safeguards complemented by suggestions to introduce certain information and evaluations into the decision-making process. This approach in the end relies on the presumption that awareness of the dangers of behavioral biases will lead to a more rational and conscious handling of the potential risks resulting in better decision-making. Decision-makers' economic freedom would be widely ensured and the level of questioning the decision-makers conduct would largely remain within the individual company's—more precisely the shareholders'—power, providing a reasonable degree of protection.

### *B. Possible Forms of Implementation*

The legal implementation of such a mechanism could be designed in several different ways. One possibility would be to redefine the elements of the fiduciary duty of care or the business judgment rule respectively for instance with regard to the premise requiring directors and officers to "inform themselves, prior to making a business decision, of all material information reasonably available to them" or being reasonably informed according to the business judgment rule.[154] An adjustment might oblige decision-makers to gather and consider the relevant information to actively countervail the above-described biases and establish statutory requirements in this regard. The duty of care would impose personal liability in case of a violation. While this approach would clearly determine directors and officers to carefully address the dangers of irrational decision-making, possible side effects might be less desirable. In

153 *See supra* Part IV.A.

154 *See generally* Paredes, *supra* note 36, at 747-757.

order to avoid liability, those responsible could tend to exaggerate protective measures by including too much information and too many eventualities into the decision-making process. This might foster risk-aversion to a level not favorable to the company's advancement[155] and in addition could result in an inefficient expansion of the internal information and reporting system or other internal control mechanisms. It also seems difficult to define a generalized set of rules substantiating the duty of care requirements that fits all different types of companies and their business models. For instance, the organization of a decision-making process will look entirely different in a small company focusing on high-risk investments compared to a large company looking to buy a reasonable supplement for their product range. This aspect is likely to lead to uncertainty among the relevant parties, which would probably further enhance the disadvantageous cautionary measures.

One might also indirectly initiate decision-makers to counteract the dangers resulting from behavioral biases by enhancing shareholder control over M&A transactions, such as allowing shareholders to specifically vote on acquisitions.[156] However, while this is likely to result in a more controversial questioning of the intended transaction's prospects, this alone is not sufficiently focused on the specific problem of behavioral biases' role in M&A transactions to structurally change the current approach. In addition, shareholder involvement poses risks to the confidentiality of important information with regard to the transaction, such as strategy, target valuation, etc. It further leads to greater uncertainty in the transaction process and in general causes significant costs.[157] Shareholders might also lack the necessary sophistication to meaningfully contribute to a more effective M&A process[158] and will themselves be subject to certain biases.

Another potential form of implementation has been suggested by James Fanto: To enhance the decision-making process in M&A transactions with regard to behavioral biases, he proposes to introduce a disclosure obligation, in particular illustrating the board's assignment of numerical weight and order of importance to each of the enumerated reasons in favor and against the transaction.[159] Evidently, this disclosure obligation would presuppose the creation of such a document requiring

---

155 *See supra* Part IV.A.

156 *See* Langevoort, *supra* note 31, at 75; Paredes, *supra* note 36, at 757-761.

157 *See* Langevoort, *supra* note 31, at 75.

158 *See id.* at 75-76.

159 Fanto, *supra* note 81, at 1396-97.

the board to conduct a thorough and deliberate examination of the acquisition's prospects. While the disclosure obligation conveys a more rational and especially more transparent decision-making process, its introduction only addresses specific aspects of the suggested strategies.

Furthermore, accompanying measures would be necessary. First, enabling shareholders to meaningfully make use of the disclosed information would require revealing considerably more information than the mere weighting of arguments. Rather, details of the transaction, the underlying strategy and the target would be needed. Evidently, this would constitute considerable risks to the confidentiality of the information made available. Second, to increase the suggestion's impact on the decision-making process, the shareholders should be allowed to vote on the acquisition after an obligatory debate on the transaction in light of the disclosed document. The approach also raises practical concerns given that it is difficult to assess whether the disclosed considerations are complete. Finally, by involving the shareholders at a point where at least the due diligence supposedly took place, significant costs could already have been generated.

As a final approach, introduced in a comparable discussion by James Fanto[160] and further specified by Joan Heminway[161], one could require the issuance of a so-called fairness opinion. Fairness opinions are common instruments in M&A transactions, prepared by external financial advisers, usually investment bankers, to evaluate whether a specific transaction can be considered fair from a financial point of view.[162] The purpose is to establish an impartial review of decision-makers potential deviations from acting in the company's interest. However, fairness opinions are often formulated in rather vague terms, possibly to prevent liability by overemphasizing one factor and disregarding another.[163] In order to make use of fairness opinions as a response against the behavioral biases, Fanto and—in greater detail—Heminway suggest several modifications. First, fairness opinions could be extended so that the authors have to consider potential negative consequences and costs resulting from the transaction and have to address the deal's rationality.[164] Besides these content-based

---

160 *Id.* at 1397-98.

161 Heminway, *supra* note 113, at 88-97.

162 *See, e.g.*, Steven M. Davidoff, *Fairness Opinions*, 55 AM. U. L. REV. 1557 *passim* (2006); Heminway, *supra* note 113, at 83-85; Michael B. Rizik, Jr. & Matthew M. Wirgau, *Fairness Opinions: No Longer a Laughing Matter*, 25 T.M. COOLEY L. REV. 233 *passim* (2008).

163 Fanto, *supra* note 81, at 1397-98.

164 Fanto, *supra* note 81, at 1398; Heminway, *supra* note 113, at 88-89.

changes, Heminway proposes increasing the authors' accountability to shareholders and committing them to processes rather than outcomes to foster their independence from the company's directors and officers.[165] As a third step, the way fairness opinions are used and assessed by the boards shall be modified, specifically by requiring the board members to pose a series of questions with regard to the fairness opinions in order to raise awareness to potential flaws in the decision-making process.[166] These questions deal with the qualification of the authors of the fairness opinions, the reliability of the underlying data, the basis for assumptions, the treatment of inconsistent facts and the consideration of alternatives.[167] This approach would most likely contribute to a more deliberate and rational decision-making process and it addresses a number of the above-described behavioral biases. It would require considerably greater resources, however, to provide clearer and more detailed opinions as well as additionally consider and quantify negative scenarios, not to ask whether investment banks are at all qualified particularly for the latter issue. Significantly more information would be needed and would have to be made available to the external authors. In addition, the fairness opinions are drafted at a comparably late point of the M&A transaction so that disadvantageous consequences might already have occurred. Moreover, fairness opinions modified accordingly fail to specifically address behavioral biases and rather indirectly raise awareness of their consequences but not for the origin. Finally, standardized fairness opinions might lack the necessary degree of individualization to investigate the specifications of the individual transaction, at least without significantly greater efforts of the authoring investment banks.

### C. *"Comply or Explain"*

Given that all potential forms of implementation described so far displayed weaknesses, the following will introduce a new and additional approach that I opine to provide a more balanced and effective solution. At the core of the proposal lies the development of a best practice guide—introduced by the SEC—containing specific suggestions on what strategies could constitute a best practice regarding decision-making processes depending on the individual case. Instead of obliging companies

---

165 *See* Heminway, *supra* note 113, at 89-93.

166 *See id.* at 93-97.

167 Heminway, *supra* note 113, at 94-97 (citing Robert M. Lloyd, *Proving Lost Profits After Daubert: Five Questions Every Court Should Ask Before Admitting Expert Testimony,* 41 U. RICH. L. REV. 379, 380 (2007)).

to implement some or all of these suggestions, the proposal relies on a "comply or explain" mechanism, requiring decision-makers to provide their shareholders and, with regard to certain non-confidential aspects, the public, with specific reasons on all those best practice measures that have not been implemented in the M&A transaction at hand. This shall apply to every M&A transaction that is of relevant size, determined either by the estimated purchase price exceeding a certain percentage of the company's overall turnovers or a specific amount. Thereby, every transaction of considerable importance should be captured while also considering the individual relevance for the respective company.

"Comply or explain" is a regulatory approach first introduced in the field of corporate governance in the United Kingdom in the 1992 Cadbury Report.[168] Based upon the recommendations of the Cadbury Report, the U.K. Corporate Governance Code[169] contains principles and provisions on what is deemed to be a minimum standard of good governance specifically with regard to the separation of CEO and Chairman, the composition of boards, and board review.[170] Instead of providing a binding set of rules, companies may comply with the provisions in the Corporate Governance Code but they are not obligated to do so. In case of non-compliance, however, a company is required to provide an annual public explanation as to why it decided differently. The code only applies to companies listed on the stock exchange but is envisioned to also encourage private companies to comply. The "comply or explain" approach is meant to let the shareholders and the market decide what is seen as the most important aspects of good governance.[171] Due to its flexibility it is also understood to be superior to any of the common "one size fits all" mechanisms. Other European countries as well as Australia and Canada have followed this approach.[172] In particular, Germany added a considerable new aspect. The German Corporate Governance Codex distinguishes between recommendations and

---

168 Sridhar Arcot, Valentina Bruno & Anoine Faure-Grimaud, *Corporate Governance in the UK: Is the Comply or Explain Approach Working?*, 30 INT'L REV. L. ECON. 193, 194 (2010); James E. Cicon, Stephen P. Ferris & Armin J. Kammel, *European Corporate Governance: A Thematic Analysis of National Codes of Governance*, 18 EUR. FIN. MGMT. 620, 623 (2010); Iain MacNeil & Xiao Li, *"Comply or Explain": Market Discipline and Non-Compliance With the Combined Code*, 14 CORP. GOVERNANCE: AN INT'L REV. 486, 486 (2006); Paul Sanderson et al., *Flexible or Not? The Comply-or-Explain Principle in UK and German Corporate Governance* 4-5 (Ctr. for Bus. Res., Univ. of Cambridge, Working Paper No. 407, 2010), *available at* www.cbr.cam.ac.uk/pdf/wp407.pdf.

169 UK CORPORATE GOVERNANCE CODE, FINANCIAL REPORTING COUNCIL (2010).

170 *Id.*

171 Arcot et al., *supra* note 168, at 194-195, 198, 200-01.

172 Cicon et al., *supra* note 168, at 623; MacNeil & Li, *supra* note 168, at 486.

suggestions.[173] Only the former require an explanation for non-compliance. The latter merely serve to illustrate what is seen as best practice. The "comply or explain" concept is widely seen as a success.[174]

The underlying rationale of the "comply or explain" mechanism in the context at hand would be that the shareholders themselves and the market shall decide which safeguards against the dangers of behavioral biases are desirable and should be implemented. Shareholders could simply demand the respective procedures or initiate changes to the articles of the company; the market could favor those companies with a certain standard of safeguards in place. This would allow the implementation of strategies specifically tailored to the individual company and even the individual transaction, offering maximal flexibility. Moreover, even if decision-makers are not determined to implement any of the suggested strategies, the mere existence of the obligation to explain ensures that the described strategies are at least considered, which alone would raise the level of awareness towards the dangers of irrational decision-making. This mechanism would also come at relatively low cost, as the mere explanation requires a limited and presumably reasonable amount of time and effort.

Personal liability of the directors and officers could basically only occur if the obligation to explain is violated or if the specific strategies are disregarded although they were previously incorporated in the articles of the company or otherwise stipulated as a binding standard. In the long run it might also be possible that a wide implementation of the suggested strategies changes the general corporate governance culture leading to a market standard for decision-making processes that would redefine what constitutes being "reasonably informed." However, liability could only be imposed on directors and officers if clear procedural obligations are disregarded. This would provide certainty and in particular prevent an expansion of the internal information processing systems to an inefficient and disadvantageous level due to the fear of personal liability. With regard to requests for specific strategies by shareholders as well as market developments, it would be entirely in the hands of the decision-makers

---

173 *See, e.g.*, Rules 3.10, 4.2.4, 5.1.2, 5.3.4, 5.3.5 DEUTSCHER CORPORATE GOVERNANCE KODEX (2010); *see also* Christian Andres & Erik Theissen, *Setting a Fox to Keep the Geese – Does the Comply-or-Explain Principle Work?*, 14 J. CORP. FIN., 289, 289-290 (2008).

174 Gerhard Cromme, *Corporate Governance in Germany and the German Corporate Governance Code*, 13 CORP. GOVERNANCE 362, 364-365 (2005); HENRIK-MICHAEL RINGLEB, THOMAS KREMER, MARCUS LUTTER ET AL., KOMMENTAR ZUM DEUTSCHEN CORPORATE GOVERNANCE KODEX 1638-45 (4th ed. 2010); Sanderson et al., *supra* note 168, at 11. *But see* Arcot et al., *supra* note 168, at 196-201 (pointing at the importance of the quality of explanations in case of non-compliance); MacNeil & Li, *supra* note 168, at 493-494 (same).

whether to be exposed to liability by approving an implementation or not, of course accepting the risk of not being reelected in the latter case.

The content and structure of the best practice guide should be developed after consultation with all parties typically involved in M&A transactions as well as academics to create a catalogue of feasible, reasonably detailed strategies that will hopefully be widely accepted. The catalogue might include most of the above-suggested measures, especially the consultation of external experts. It appears desirable to distinguish—similar to the German Corporate Governance Codex—between recommendations and suggestions. Thereby, one could ensure that all sensible strategies are included in the catalogue to best countervail irrational decision-making while focusing the legally obligatory part on the most important strategies to guarantee a more efficient application. Moreover, the best practice guide should in particular include an explanatory section in the beginning describing the specific biases and their risks but also their significant positive effects.[175] Explanations on why certain strategies were not implemented could be manifold. One might think of substantive objections but also just a lack of resources or time pressure. However, it is important that the explanations provide meaningful content relating to the specific case at hand instead of general abstract excuses. The quality standard will mainly depend on what shareholders and the market demand.

Concluding, this approach provides a flexible, cautious mechanism with little external interference that embraces the decision-makers' economic freedom but still ensures that the awareness of behavioral biases is raised and specific strategies to counteract these dangers are available. It bears another important advantage worth mentioning, namely that changing and improving the decision-making processes would entirely come from within the company.

## Conclusion

The article has outlined a new regulatory model to improve decision-making processes in M&A transactions by challenging the potential risks of subconscious behavioral biases influencing decision-makers. Presuming that decision-makers, despite their high level of sophistication, are nonetheless susceptible to behavioral biases, in particular given the complexity, the uncertainty, and the time pressure characteristic of M&A transactions, the article recommends the introduction of a best practice

---

175 *See supra* Part IV.A.

guide developed by an expert panel containing feasible strategies—several of which have been described above—to countervail irrational behavior. The suggested enforcement by a "comply or explain" mechanism ensures maximum flexibility and interferes as little as possible with the business judgment itself. Ensuring that the way and the extent of implementation of the respective strategies comes from within each individual company shall prevent the imposition of an excessive and inhibiting liability risk on decision-makers as well as a complete debiasing—or even rebiasing. In light of the significant number of failed—especially large scale—M&A transactions and their potentially devastating impacts as well as the strong indications from behavioral economics, it appears to be about time that the legislator intervenes by providing an innovative regulatory framework.