

Client Alert

International Arbitration Practice Group

November 7, 2016

Second Circuit Addresses Expropriation and Imputation Issues under FSIA

Introduction¹

On October 14, 2016, the U.S. Court of Appeals for the Second Circuit (Second Circuit) issued a decision in *Arch Trading Corp. v. Republic of Ecuador*, a case addressing the expropriation exception to sovereign immunity under the Foreign Sovereign Immunities Act (FSIA), which abrogates the immunity of foreign states from U.S. judicial proceedings in cases involving the taking of property in violation of international law.² Relatively few appellate decisions have explored the expropriation exception – likely because so many expropriation cases today are resolved through treaty arbitrations – and the Second Circuit’s decision in *Arch Trading* provides a significant addition to the jurisprudence construing the exception, while also providing useful insight into the FSIA’s treatment of agents and alter egos and the showings necessary to impute jurisdictional facts between a sovereign and other entities with whom the sovereign may be related.

FSIA and the Expropriation Exception

The FSIA was enacted in 1976 with the principal purpose of codifying American sovereign immunity law and eliminating the executive branch’s involvement in determinations of foreign sovereign immunity and give that role to the judiciary, which had come to be viewed as potentially inconsistent and subject to political considerations. Section 1604 of the FSIA provides that foreign states are presumptively immune from the jurisdiction of U.S. state and federal courts. This immunity extends not only to the state itself, but also to any “agency or instrumentality” of the foreign state.³ Consistent with the global trend favoring “restrictive” immunity, which seeks to preserve immunity for governmental acts while leaving sovereigns subject to suit for their non-governmental acts, the FSIA’s grant of immunity is subject to a number of exceptions, set forth in Section 1605 of the Act. Where a case brought against a foreign state falls into one of the exceptions, the foreign state will not be immune, and a U.S. court will have subject matter jurisdiction to hear it.

One of the exceptions set forth in Section 1605(a) is the “expropriation exception,” codified at Section 1605(a)(3). Under this exception, a foreign state (including its agencies and instrumentalities) is not immune in any case

For more information, contact:

James E. Berger
+1 212 556 2202
jberger@kslaw.com

Charlene C. Sun
+1 212 556 2107
csun@kslaw.com

King & Spalding
New York

1185 Avenue of the Americas
New York, New York 10036-4003
Tel: +1 212 556 2100
Fax: +1 212 556 2222

www.kslaw.com

where “rights in property taken in violation of international law” are at issue, and where one of the following two sets of circumstances are present:

- The taken property, or any property exchanged for the taken property, is *present* in the United States in connection with commercial activity carried on in the U.S. by a foreign state; or
- The taken property, or any property exchanged for the taken property, is *owned or operated* by an agency or instrumentality of the foreign state, and that instrumentality is engaged in a commercial activity in the U.S.⁴

In turn, the FSIA defines “commercial activity” as “either a regular course of commercial conduct or a particular commercial transaction or act.” The commercial character of an act is to be determined by reference to the *nature* of the act, rather than by reference to its purpose.⁵

In *Arch Trading*, the Second Circuit evaluated only the second prong of the expropriation exception, as it was undisputed that none of the taken property was “present in the United States.” The court was thus required to determine whether Ecuador or two of its instrumentalities had engaged in sufficient “commercial activity” in the U.S. to meet that element of the exception.

The *Bancec* Presumption

The Supreme Court’s decision in *First National City Bank v. Banco Para El Comercio (Bancec)* governs the circumstances under which the acts of foreign states and their instrumentalities may be imputed to one another. *Bancec* established a strong presumption that government instrumentalities created as distinct juridical entities should be treated as legally separate from the sovereigns that created them. The Court observed that by recognizing the legal distinctions between entities drawn by another nation’s laws, courts accord “due respect for the actions taken by foreign sovereigns and for principles of comity between nations.”⁶

The Second Circuit has been strict in its application of the *Bancec* presumption, observing in 2015 that “both *Bancec* and the FSIA legislative history caution against too easily overcoming the presumption of separateness.”⁷ The *Bancec* presumption may be overcome only where an entity is “so extensively controlled” by another that a relationship of principal and agent is created, or where respecting separateness would work fraud or injustice.⁸ More specifically, the “extensive control” required to overcome the *Bancec* presumption must entail “significant repeated control” by a foreign sovereign over an instrumentality’s day-to-day operations.⁹

The *Bancec* presumption thus sets a high bar for disregarding the legal separateness of sovereigns and their instrumentalities and for imputing acts – and resulting jurisdiction and liabilities – between them. This presumption has important implications for plaintiffs seeking to establish jurisdiction under the FSIA. As the *Arch Trading* case illustrates, it may preclude plaintiffs from relying on the commercial activities of instrumentalities or their subsidiaries to meet the requirements of the expropriation exception.

The *Arch Trading* Decision

In *Arch Trading*, five entities incorporated in the British Virgin Islands sought US\$ 1 billion in damages from the Republic of Ecuador and two Ecuadorian instrumentalities – the Corporación Financiera Nacional (CFN) and Fideicomiso AGD-CFN No Más Impunidad (the “Trust”). The five Plaintiffs claimed that 133 companies they owned in Ecuador had been unlawfully seized by the Government without compensation. Further, this property had been turned over to CFN and the Trust.

The U.S. District Court for the Southern District of New York dismissed the case in 2015. In relevant part, it found that Plaintiffs failed to demonstrate that the two instrumentalities in question, CFN and the Trust, had engaged in any commercial activity in the U.S. The district court considered that Plaintiffs had merely outlined examples of commercial activities that *subsidiaries* of CFN and the Trust had engaged in. Applying the *Bancec* presumption, the Southern District found that the activities of these subsidiaries could not be imputed to CFN or the Trust, and therefore the requirements of the FSIA's expropriation exception were not met. The court thus had no jurisdiction.

On appeal, the Second Circuit first found that *Bancec* could be applied for purposes of determining whether to pierce the veil between a foreign state instrumentality and corporate subsidiaries that may not be entitled to immunity, despite the fact that *Bancec* itself had only examined the relationship between a foreign sovereign and one of its instrumentalities (both of which are presumptively entitled to immunity under the FSIA).

In so finding, the Second Circuit explained that “[f]reely ignoring the separate legal status of foreign government instrumentalities vis-à-vis distinct non-governmental legal entities would create uncertainties closely resembling, if not identical to, those that the Court cited as necessitating the *Bancec* presumption in the first place.”

The court went on to examine Plaintiffs' specific allegations related to the commercial activities of CFN and the Trust within the United States. First, the court denied that CFN's ability to appoint or remove officers or directors of certain U.S.-based subsidiaries constituted sufficient day-to-day control to overcome the *Bancec* presumption. It further found that CFN's “nonspecific” oversight of and participation in contractual negotiations undertaken by its American subsidiaries was also not enough. Rather, the Second Circuit suggested that the presumption could only have been overcome by a showing that the subsidiaries were “mere shells for corporate activity more appropriately attributable to CFN.” Additionally, the Second Circuit suggested that CFN's involvement in contractual negotiations may have overcome the *Bancec* presumption had its subsidiaries lacked the capacity to decline such involvement, or had the benefits of these contracts inured solely to CFN. However, the Plaintiffs had made no such allegations in the case at hand. Finally, the court drew a distinction between the theoretical possibility that CFN might exercise control over its American subsidiaries and the actual reality of such control, finding that only the latter is sufficient to overcome the *Bancec* presumption.

The Second Circuit thus determined that CFN and the Trust must be considered legally separate from their American subsidiaries. Since the Plaintiffs had not shown that either of the two instrumentalities (or Ecuador itself) had engaged in commercial activities within the U.S., they had not met the requirements of the FSIA's expropriation exception.

The court then turned to Plaintiffs' final effort to salvage their case. Plaintiffs had argued that the Southern District had erred in dismissing their claims without either conducting an evidentiary hearing or allowing for jurisdictional discovery. The Second Circuit rejected these arguments in strong terms, finding that “[t]he FSIA protects defendants from a fishing expedition that seeks to examine the details of the relationships between them and a number of distinct legal entities without any non-speculative basis for believing that those details would establish jurisdiction.” The court noted that in the FSIA context, Plaintiffs must articulate a “reasonable basis” to assume jurisdiction before discovery could be granted. Plaintiffs had not done so, and in any event had not specified what discovery they would seek. The court thus held that the district court did not abuse its discretion in dismissing the case without conducting an evidentiary hearing or allowing for jurisdictional discovery.

Conclusion

Arch Trading is notable for its application of the *Bancec* presumption to commercial activities. By explicitly applying this presumption to the relationship between instrumentalities and their non-governmental commercial subsidiaries, the

Second Circuit's decision, while applied in the case before it to the expropriation exception, is instructive as well to parties litigating under the commercial activities exception, the most frequently-invoked exception under the FSIA, as it shows that commercial activities undertaken by foreign states through U.S.-based non-governmental affiliates may not ordinarily be imputed to the state for purposes of creating jurisdictional contacts with the United States. Given the complexity of modern commercial transactions and the layered manner through which many such transactions are structured, the analysis in *Arch Trading* may be properly applied to any case in which a sovereign's U.S.-related commercial activities are at issue.

* * *

Celebrating more than 130 years of service, King & Spalding is an international law firm that represents a broad array of clients, including half of the Fortune Global 100, with 900 lawyers in 18 offices in the United States, Europe, the Middle East and Asia. The firm has handled matters in over 160 countries on six continents and is consistently recognized for the results it obtains, uncompromising commitment to quality and dedication to understanding the business and culture of its clients. More information is available at www.kslaw.com.

This alert provides a general summary of recent legal developments. It is not intended to be and should not be relied upon as legal advice. In some jurisdictions, this may be considered "Attorney Advertising."

¹ The authors would like to thank Timothy McKenzie, an associate in the Global Disputes practice at King & Spalding, for his contributions to this article.

² 28 U.S.C. § 1604.

³ 28 U.S.C. § 1603(a)-(b).

⁴ 28 U.S.C. § 1605(a)(3) (emphasis added).

⁵ 28 U.S.C. § 1603(d).

⁶ *Bancec*, 462 U.S. at 626.

⁷ *EM Ltd. v. Banco Cent. De la República Argentina*, 800 F.3d 78, 90 (2d Cir. 2015).

⁸ See *Kirschenbaum v. 650 Fifth Ave. & Related Props.*, 830 F.3d 107, 128 (2d Cir. 2016).

⁹ *EM*, 800 F.3d at 91.