INTERNATIONAL LAW — FOREIGN SOVEREIGN IMMUNITIES ACT — NINTH CIRCUIT HOLDS THAT NONPAYMENT IN THE UNITED STATES BY COUNTERPARTY IS NOT A DIRECT EFFECT OF FOREIGN STATE'S BREACH OF CONTRACTUAL DUTIES TO BE PERFORMED ABROAD. — *Terenkian v. Republic of Iraq*, 694 F.3d 1122 (9th Cir. 2012).

The Foreign Sovereign Immunities Act of 1976[1] (FSIA) is the exclusive means by which a U.S. court can assert jurisdiction over a foreign sovereign,[2] including the sovereign's instrumentalities and majority-owned corporations.[3] Under the FSIA, "a foreign state shall be immune from . . . jurisdiction," unless the state falls within an enumerated exception,[4] the "most significant" of which is the commercial exception.[5] This exception denies sovereign immunity for claims based:

> [1] upon a commercial activity carried on in the United States by the foreign state; or [2] upon an act performed in the United States in connection with a commercial activity of the foreign state elsewhere; or [3] upon an act outside the territory of the United States in connection with a commercial activity of the foreign state elsewhere and that act causes a direct effect in the United States.[6]

Sovereign immunity for commercial acts has become particularly relevant with the rise of firms that are majority state owned, especially in emerging markets.[7] Recently, in *Terenkian v. Republic of Iraq*,[8] the Ninth Circuit held that the commercial exception did not apply to a state-owned Iraqi oil company's breach of a contract to deliver oil because, under the circuit's narrow "legally significant act" test, the oil company's breach did not have a direct effect in the United States.[9] The legally significant act test, however, is muddled. Courts are inconsistent about which facts must be legally significant, and as a result, the test's fit with the FSIA and Supreme Court precedent is unclear. Further, the phrase "legally significant" is itself ambiguous. In light of these issues and a circuit split over the proper "direct effect" test, Congress or the Supreme Court should reject the legally significant act test.

After Iraq invaded Kuwait in 1990, the United Nations imposed a trade embargo on Iraq.[10] In 1995, the United Nations set up the Oil

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1 Pub. L. No. 94-583, 90 Stat. 2891 (codified as amended in scattered sections of 28 U.S.C.).
2 *See* Argentine Republic v. Amerada Hess Shipping Corp., 488 U.S. 428, 434 (1989).
3 *See* 28 U.S.C. § 1603(a)–(b) (2006).
4 28 U.S.C. § 1604.
5 Republic of Argentina v. Weltover, Inc., 504 U.S. 607, 611 (1992).
6 28 U.S.C. § 1605(a)(2).
7 *See The State and Business: Leviathan Inc*, ECONOMIST, Aug. 7, 2010, at 9, 9.
8 694 F.3d 1122 (9th Cir. 2012).
9 *Id.* at 1137–39.
10 *Id.* at 1126 n.1.

for Food Program: Iraq could sell a limited amount of oil, but payments had to be deposited into a U.N. escrow account in New York and used almost exclusively to meet the humanitarian needs of the Iraqi population.[11] Pursuant to this program, in 2000 and 2001 two Cypriot oil brokerages owned by Manuel Terenkian contracted to buy oil from the State Oil Marketing Organization (SOMO), an Iraqi firm wholly owned by Iraq.[12] Under the contracts, the brokerages agreed to accept delivery in Iraq or Turkey; the United States was listed as a possible destination for the oil.[13] According to Terenkian, after each of the two contracts had been signed in New York, Iraq demanded more money and, when Terenkian refused, SOMO cancelled each contract.[14] Terenkian, along with the brokerages, sued Iraq by and through SOMO in a California federal court for breach of contract.[15]

Iraq moved to dismiss, claiming sovereign immunity.[16] At various times, Terenkian asserted four reasons to apply the FSIA's commercial exception: Under the exception's first clause, Iraq had carried on commercial activity in the United States because (1) under Oil for Food, the United Nations administered the contracts in New York and (2) the contracts were executed in New York.[17] Under the exception's third clause, Iraq's breach had caused a direct effect in the United States because (3) the breach prevented payment from occurring in New York and (4) the breach prevented the delivery of oil, some intended for U.S. distribution.[18] The district court denied Iraq's motion, concluding that the third clause of the commercial exception applied: Iraq's alleged breach caused a direct effect in the United States by preventing Terenkian from paying in New York.[19] The court also transferred the case to the District of Columbia, holding that venue was improperly laid.[20] Under the collateral order doctrine, Iraq appealed the denial of the motion to dismiss.[21]

The Ninth Circuit reversed, vacated the transfer, and remanded with instructions to dismiss.[22] Writing for the panel, Judge Ikuta[23]

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[11] *Id.*; S.C. Res. 986, ¶¶ 1, 8, U.N. Doc. S/RES/986 (Apr. 14, 1995).

[12] *Terenkian*, 694 F.3d at 1126. Terenkian was a U.S. citizen who also served as the companies' president. *Id.*; *id.* at 1140 (Noonan, J., dissenting).

[13] *Id.* at 1126 (majority opinion).

[14] *Id.* at 1126–27.

[15] *Id.* at 1127, 1129.

[16] *Id.* at 1128. Iraq additionally contended that the contracts required arbitration. *Id.*

[17] *Id.* at 1128, 1135.

[18] *Id.*

[19] *Id.* at 1128–29. The court also concluded that Iraq's argument for mandatory arbitration lacked evidentiary support. *Id.* at 1129.

[20] *Id.* (citing 28 U.S.C. § 1391(f) (2006 & Supp. V 2011)).

[21] *Id.* at 1130.

[22] *Id.* at 1139.

[23] Judge Ikuta was joined by Judge Gould.

began by holding that the Ninth Circuit had jurisdiction over the appeal.[24] She then reviewed and rejected Terenkian's arguments in favor of invoking the commercial exception. The court first discussed whether the claim was based on commercial activity undertaken by Iraq. A sovereign's activity is considered commercial based on its nature, rather than its purpose,[25] and based on whether the state "exercises 'those powers that can also be exercised by private citizens,' . . . [as opposed to] those powers 'peculiar to sovereigns.'"[26] Judge Ikuta determined that participation in Oil for Food was not commercial activity because the program implicated Iraq's role as sovereign in meeting the humanitarian needs of its people.[27] In contrast, the court held that the contracts themselves constituted commercial activity.[28]

Reviewing precedent on the first clause of the commercial exception — commercial activity by the foreign state in the United States — the court distilled two criteria: first, the commercial activity in the United States must be "a necessary element of . . . the plaintiff's claim," and second, the "commercial activity must be significant and have substantial contact with the United States."[29] Turning to the facts, the court noted that U.N. oversight was neither commercial activity nor an element of the claim.[30] Further, the contracts' execution in New York was not sufficiently significant to allow the conclusion that the commercial activity occurred in the United States.[31]

The court then analyzed Terenkian's argument that Iraq's breach satisfied the third clause — an act abroad, in connection with commercial activity of the foreign state, that causes a direct effect in the United States. The court noted the test from *Republic of Argentina v. Weltover, Inc.*[32]: "[A]n effect is 'direct' 'if it follows as an immediate consequence of the defendant's . . . activity.'"[33] Ninth Circuit precedent added that "immediate" means without an intervening cause,[34] and that the state must make a "legally significant" act in the United States.[35] From these precedents, Judge Ikuta concluded that, to satisfy

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[24] *See Terenkian*, 694 F.3d at 1129–30.

[25] *Id.* at 1132 (citing 28 U.S.C. § 1603(d) (2006)).

[26] *Id.* (quoting Saudi Arabia v. Nelson, 507 U.S. 349, 360 (1993)).

[27] *Id.* at 1136 & n.6.

[28] *Id.* at 1136.

[29] *Id.* at 1133.

[30] *Id.* at 1136.

[31] *Id.* at 1136–37. Terenkian also failed to produce evidence that the contracts were executed in New York. *Id.* at 1136.

[32] 504 U.S. 607 (1992).

[33] *Terenkian*, 694 F.3d at 1133 (quoting *Weltover*, 504 U.S. at 618 (alteration in original)).

[34] *Id.* (citing Lyon v. Agusta S.P.A., 252 F.3d 1078, 1083 (9th Cir. 2001)).

[35] *See id.* at 1134, 1138; *see also id.* at 1134–35 ("[T]he requirement that an effect be 'direct' indicates that Congress did not intend to provide jurisdiction whenever the ripples caused by an

the third clause, there must be no intervening causalities between the act giving rise to the suit and the effect in the United States, the latter of which must be "legally significant and non-trivial."[36]

Judge Ikuta rejected each of Terenkian's arguments regarding a direct effect. She concluded that even though the contract had required Terenkian to pay in New York, his not paying was not a direct effect of Iraq's breach. Under the contract, Iraq had to deliver oil abroad; only Terenkian's side of the bargain required payment in New York.[37] Thus, the "legally significant" act giving rise to the claim was nondelivery in Iraq; depriving a U.S. bank of funds was merely a "ripple effect[]."[38] Judge Ikuta distinguished *Weltover*, in which the Supreme Court held that Argentina's breach of a contract to pay bondholders in New York had a direct effect in the United States.[39] In *Weltover*, the sovereign's performance was to be in New York, whereas here, Iraq's performance was to be in Iraq.[40] Judge Ikuta also rejected the argument that Terenkian's inability to deliver oil to potential customers in the United States caused a direct effect, citing a lack of evidence that U.S. delivery was intended.[41] Having concluded that neither the first nor third clause of the commercial exception applied, the court held that Iraq was entitled to sovereign immunity.[42]

Judge Noonan dissented, arguing that Iraq's participation in Oil for Food was commercial: "Iraq was doing . . . what any private player could do, trading oil to obtain money for food."[43] Oil for Food's humanitarian goals were irrelevant, as activity is evaluated by its nature (selling oil), not its purpose (meeting humanitarian needs).[44] Thus, either the first or third clause of the commercial exception provided a sufficient nexus to the United States to deny Iraq sovereign immunity: the program was administered in New York, the contracts were signed in New York, and payment would have occurred in New York.[45]

The Ninth Circuit's conclusion that there was no direct effect relied largely on the "legally significant act" test. The legally significant act giving rise to the claim did not occur in the United States, because

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overseas transaction manage eventually to reach the shores of the United States." (quoting United World Trade, Inc. v. Mangyshlakneft Oil Prod. Ass'n, 33 F.3d 1232, 1238 (10th Cir. 1994)) (internal quotation marks omitted)).

[36] *Id.* at 1135.

[37] *Id.* at 1138.

[38] *Id.*

[39] *Id.* (discussing Republic of Argentina v. Weltover, Inc., 504 U.S. 607, 618–19 (1992)).

[40] *See id.* ("[T]he act that forms the basis of plaintiffs' lawsuit, Iraq's cancellation of the contracts, occurred in Iraq.").

[41] *Id.* at 1138–39.

[42] *See id.* at 1139.

[43] *Id.* at 1140 (Noonan, J., dissenting).

[44] *See id.*

[45] *Id.*

Iraq's breach occurred abroad. However, this test suffers from multiple problems. First, courts differ over what aspect of the foreign state's conduct must be legally significant. Second, as a result, the test's fit with the FSIA and *Weltover* is murky. Third, the phrase "legally significant" is itself ambiguous. As the test is unclear and its narrow interpretation of direct effect differs from broader interpretations in other circuits, either Congress or the Supreme Court should resolve the circuit split and reject the legally significant act test.

The origins of the test have influenced its current frailties. In 1952, noting that governments increasingly acted like private market participants, the State Department shifted from the historical practice of granting almost all requests for foreign sovereign immunity to granting requests in suits concerning sovereign, but not commercial, activities.[46] The FSIA codified this "restrictive theory of sovereign immunity" and transferred immunity decisions from the executive to the courts.[47] Under the FSIA, engaging in commercial activity that has a sufficient U.S. nexus satisfies the commercial exception and overcomes the statutory presumption in favor of immunity.[48]

While whether a foreign state's activity causes "a direct effect in the United States" is only one of three possible nexuses, it has produced the most litigation and the most vexing interpretive problems.[49] Following the FSIA's passage, courts interpreted "direct effect" narrowly, taking two general approaches[50]: Some circuits interpreted the legislative history to require the effect to be substantial and foreseeable.[51] Others held that a direct effect required a "legally significant act[]" in the United States.[52] In *Weltover*, the Supreme Court's only case interpreting "direct effect," the Court explained that neither was the language intended to allow jurisdiction due to "purely trivial effects" nor did the FSIA "contain[] any unexpressed requirement of 'substantiality' or 'foreseeability.'"[53]

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[46] *See* Letter from Jack B. Tate, Acting Legal Adviser, Dep't of State, to Att'y Gen. (May 19, 1952), *reprinted in* Alfred Dunhill of London, Inc. v. Republic of Cuba, 425 U.S. 682, app. 2 at 711–15 (1976).

[47] *See* Verlinden B.V. v. Cent. Bank of Nigeria, 461 U.S. 480, 488 (1983); H.R. REP. NO. 94-1487, at 7 (1976), *reprinted in* 1976 U.S.C.C.A.N. 6604, 6605–06.

[48] *See* 28 U.S.C. §§ 1604, 1605(a)(2) (2006).

[49] *See* JOSEPH W. DELLAPENNA, SUING FOREIGN GOVERNMENTS AND THEIR CORPORATIONS § 4.12, at 229 (2d ed. 2003).

[50] Policy bases for a narrow interpretation include avoiding diplomatic conflicts, *see id.* § 4.12, at 233, and protecting U.S. courts "from becoming small international courts of claims," Heidi L. Frostestad, Note, Voest-Alpine Trading v. Bank of China*: Can a Uniform Interpretation of a "Direct Effect" Be Attained Under the Foreign Sovereign Immunities Act (FSIA) of 1976?*, 34 VAL. U. L. REV. 515, 536 (2000); *cf.* Smith Kline & French Labs. Ltd. v. Bloch, [1983] 1 W.L.R. 730 (C.A.) at 733 (Eng.) ("As a moth is drawn to the light, so is a litigant drawn to the United States.").

[51] *See, e.g.*, Am. W. Airlines, Inc. v. GPA Grp., Ltd., 877 F.2d 793, 798–99 (9th Cir. 1989).

[52] *See, e.g.*, Weltover, Inc. v. Republic of Argentina, 941 F.2d 145, 152 (2d Cir. 1991), *aff'd on other grounds*, 504 U.S. 607 (1992).

[53] *Weltover*, 504 U.S. at 618.

Instead, "an effect is 'direct' if it follows 'as an immediate consequence of the defendant's . . . activity.'"[54]

Weltover established "immediate consequence" as the test for direct effect, displacing the prior jurisprudence. However, the *Weltover* decision failed to clarify the direct effect analysis: soon after the decision came down, the circuits began to splinter yet again.[55] Some circuits, notably the Second and Ninth, narrowly interpreted the holding of *Weltover* to affirm the requirement of a "legally significant act" in the United States.[56] However, several circuits rejected the legally significant act requirement, arguing that *Weltover* precludes grafting onto the FSIA any test that narrows "direct effect."[57]

The impact of the varying tests is clearest in cases alleging a foreign sovereign's breach of contract where the only connection to the United States is that the contract obligated the sovereign to pay via a U.S. bank.[58] Hewing closely to the facts of *Weltover*, the Second and Ninth Circuits have held that the contract must expressly designate payment to a U.S. bank or the plaintiff must exercise an explicit contractual right to select a U.S. payment locale.[59] Other circuits, including the Sixth, have explicitly rejected the legally significant act test, but with unclear effect: it appears that the demand for U.S. payment is sufficient even if the right to make such a demand comes from a background default rule — for example, the choice of law — rather than an express provision.[60] Taking a more expansive view, the Fifth Circuit has held that the failure of a foreign bank to remit payment to a U.S. company was a direct effect "[b]ecause a financial loss was incurred in the United States by an American plaintiff as an immediate conse-

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[54] *Id.* (alteration in original) (quoting *Weltover*, 941 F.2d at 152).

[55] One circuit expressed confusion with the "immediate consequence" test. *See* United World Trade, Inc. v. Mangyshlakneft Oil Prod. Ass'n, 33 F.3d 1232, 1237 (10th Cir. 1994) (noting the test's ambiguity, especially without the "guideposts" of substantiality and foreseeability).

[56] *See* Adler v. Fed. Republic of Nigeria (*Adler I*), 107 F.3d 720, 726–27 & n.4 (9th Cir. 1997); Antares Aircraft, L.P. v. Fed. Republic of Nigeria, 999 F.2d 33, 36 (2d Cir. 1993). The Second Circuit reasoned that *Weltover* "used a similar analysis." *Antares*, 999 F.2d at 36. Examples of legally significant acts include using U.S. communications to induce a U.S. citizen to pay bribes, Adler v. Fed. Republic of Nigeria (*Adler II*), 219 F.3d 869, 876 (9th Cir. 2000), and shutting down a nuclear reactor, causing a severe shortage of medical isotopes needed by a U.S. firm and U.S. patients, Lantheus Med. Imaging, Inc. v. Zurich Am. Ins. Co., 841 F. Supp. 2d 769, 791 (S.D.N.Y. 2012).

[57] *See, e.g.*, Orient Mineral Co. v. Bank of China, 506 F.3d 980, 998–99 (10th Cir. 2007); Keller v. Cent. Bank of Nigeria, 277 F.3d 811, 817–18 (6th Cir. 2002).

[58] *See generally* Y. David Huang, Note, *"Direct Effect in the United States" Under the Foreign Sovereign Immunities Act After* Cruise Connections v. Attorney General of Canada, 3 GEO. MASON J. INT'L COM. L. 179, 185–91 (2011) (describing the circuit split on the interpretation of "direct effect" in the context of contractual payment location obligations).

[59] *See, e.g.*, Hanil Bank v. PT. Bank Negara Indon., (Persero), 148 F.3d 127, 131–33 (2d Cir. 1998); *Adler I*, 107 F.3d at 726–30; *see also* Huang, *supra* note 58, at 186–87.

[60] *See* DRFP L.L.C. v. Republica Bolivariana de Venezuela, 622 F.3d 513, 515–18 (6th Cir. 2010).

quence of the foreign state's commercial activity abroad."[61] The Fifth Circuit has thus seemingly held that the lack of a contracted-for U.S. payment locale is not dispositive.[62] The D.C. Circuit has taken an even broader view, holding that a foreign state's breach of contract had a direct effect because it caused the U.S. counterparty to breach a third-party agreement in the United States.[63]

The Ninth Circuit's decision in *Terenkian* highlights this indeterminacy in the direct effect analysis. The court reasoned that the legally significant act that gave rise to the claim was Iraq's failure to deliver oil abroad, not Terenkian's nondeposit in New York.[64] However, had the court not applied the legally significant act test and relied instead on the "immediate consequences" language of *Weltover*, as interpreted by other circuits, it is not clear the same result would have followed. If one party to a contract refuses to perform, nonperformance by the counterparty is arguably an immediate nontrivial consequence.[65] Thus, the fact that Iraq's breach stopped Terenkian from paying in New York could support the existence of a direct effect. Indeed, a district court not subject to the legally significant act test has suggested that payment to a foreign sovereign using the sovereign's U.S. bank account is a direct effect.[66] If payment in the United States to the foreign sovereign is a direct effect, withholding of payment would likely be as well.

Besides contributing to a circuit split, the legally significant act test suffers from internal issues. First, because courts differ in their descriptions of the test, its precise requirements are unclear. At one extreme, courts have required a legally significant *act* in the United States.[67] At the other extreme, courts (sometimes in the same opinion, as in *Terenkian*) have said the test turns on the legal significance of either the *conduct abroad* or its *effect* in the United States.[68]

Second, given this inconsistency, it is unclear how, if it all, the test fits with *Weltover* or the FSIA. If the test requires more than a non-

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[61] Voest-Alpine Trading USA Corp. v. Bank of China, 142 F.3d 887, 890 (5th Cir. 1998). The Fifth Circuit also expressly rejected the legally significant act test. *Id.* at 894–95.

[62] *See* Matthew Bensen, Comment, *The All New (International) "People's Court": The Future of the Direct Effect Clause After* Voest-Alpine Trading USA Corp. v. Bank of China, 83 MINN. L. REV. 997, 1013 (1999); Frostestad, *supra* note 50, at 533–35.

[63] *See* Cruise Connections Charter Mgmt. 1, LP v. Att'y Gen. of Can., 600 F.3d 661, 664–66 (D.C. Cir. 2010).

[64] *See Terenkian*, 694 F.3d at 1137–39.

[65] *See, e.g.*, RESTATEMENT (SECOND) OF CONTRACTS § 253(2) (1981).

[66] *See* Oceanic Exploration Co. v. ConocoPhillips, Inc., No. 04-332 (EGS), 2006 WL 2711527, at *5 (D.D.C. Sept. 21, 2006).

[67] *See Terenkian*, 694 F.3d at 1134; Antares Aircraft, L.P. v. Fed. Republic of Nigeria, 999 F.2d 33, 36 (2d Cir. 1993).

[68] *See Terenkian*, 694 F.3d at 1135 (effect in the United States); Filetech S.A. v. France Telecom S.A., 157 F.3d 922, 931 (2d Cir. 1998) (conduct abroad).

trivial immediate consequence, it adds an unexpressed requirement akin to those rejected in *Weltover*.[69] Further, the requirement of a legally significant *act* in the United States seems to repeat the second clause of the commercial exception: "an act performed in the United States in connection with a commercial activity of the foreign state elsewhere."[70] If, however, the test requires only immediate legally significant *effects*, and "legally significant" means nontrivial, the test adds little to the Court's requirement of an "immediate consequence."

Third, however applied, the meaning of "legally significant" is not clear. The ambiguity of the phrase has confused courts without giving meaningful guidance.[71] As a result, courts have broad discretion to determine what is legally significant and thus a direct effect. For example, Judge Noonan argued in dissent in *Terenkian* that the court's analysis improperly considered motive and equity,[72] suggesting that courts may use this discretion to consider potentially irrelevant factors.

Together, these issues suggest a fundamental lack of clarity in the legally significant act test. In light of the prevailing circuit split over direct effect analysis, the time is ripe for reconsideration of the doctrine,[73] especially due to the growing commercial importance of foreign states and their corporations. Ideally, Congress would amend the FSIA, addressing the underlying question regarding "the ideal amount of immunity,"[74] determining what types of commercial activity, with what nexus to the United States, should allow courts to deny sovereign immunity. However, in the absence of congressional action, the Supreme Court should revisit its *Weltover* decision to address the circuit split.[75] In either case, the legally significant act test should be replaced with a more determinate standard for identifying the connections between a foreign sovereign's commercial acts and the United States that justify a U.S. court's jurisdiction.

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[69] *See* Voest-Alpine Trading USA Corp. v. Bank of China, 142 F.3d 887, 894 (5th Cir. 1998).

[70] 28 U.S.C. § 1605(a)(2) (2006); *see Voest-Alpine*, 142 F.3d at 895.

[71] *See* Orient Mineral Co. v. Bank of China, 506 F.3d 980, 999 (10th Cir. 2007) ("[T]he phrase 'legally significant act' is vague and ambiguous, adding nothing to the analysis.").

[72] *See Terenkian*, 694 F.3d at 1140–41 (Noonan, J., dissenting).

[73] The decision in *Cruise Connections Charter Management 1, LP v. Attorney General of Canada*, 600 F.3d 661 (D.C. Cir. 2010), which applied a broad interpretation of direct effect, may increase the need for resolution. Because venue is proper in the District of Columbia in all actions against foreign states (although not their instrumentalities), 28 U.S.C. § 1391(f)(4), plaintiffs may now have stronger incentives to engage in intercircuit forum shopping.

[74] Huang, *supra* note 58, at 216.

[75] Commentators have proposed several options that either Congress or the Court could pursue. *See, e.g.*, DELLAPENNA, *supra* note 49, § 4.12, at 240 (advocating the use of international law in direct effect analysis); Joseph F. Morrissey, *Simplifying the Foreign Sovereign Immunities Act: If a Sovereign Acts like a Private Party, Treat It like One*, 5 CHI. J. INT'L L. 675, 701–03 (2005) (proposing direct effect be interpreted to use personal jurisdiction's minimum contacts analysis); Huang, *supra* note 58, at 217 (suggesting foreseeability as a factor in finding a direct effect).