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THE CONFLICT BETWEEN UNITED STATES DISCOVERY RULES AND THE LAWS OF CHINA: THE RISKS HAVE BECOME REALITIES

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INTRODUCTION

The laws and policies of the People's Republic of China (PRC) create both legal and practical impediments to the production of documents located in PRC in response to United States civil discovery or government subpoenas. Documents that fit within the broad definition of "state secrets" under PRC law may not be produced without risk of substantial criminal penalties. On the other hand, the failure to produce documents subject to a valid legal request arising in the U.S. or another foreign country may itself lead to substantial civil penalties and sanctions. A company facing such a conflict in legal obligations and requirements is caught squarely in the middle of conflicting requirements.

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This is not a new issue. A series of opinions in the federal courts of the Southern District of New York over the last five years address the conflict between U.S. discovery requirements and Chinese law in some detail, although with differing and sometimes inconsistent results. However, in the absence of real-life and tangible examples of penalties or sanctions being imposed on a company arising from this conflict in either PRC or the U.S., the risks have remained largely theoretical. This sharply changed on January 22, 2014, when Securities and Exchange Commission (SEC) Administrative Law Judge Cameron Elliot released a heavily-redacted 112 page written order imposing significant sanctions on the Chinese units of five major accounting firms, including a censure and a six-month ban on practicing before the SEC, due to the companies' failure to produce audit work papers located in PRC in response to SEC subpoenas. Judge Elliot reached this conclusion despite evidence that the companies were specifically forbidden from complying with the SEC's requests by explicit order of government regulators in PRC.¹ The accounting firms appealed this initial ruling, and on February 6, 2015, four of the five firms agreed to a settlement with the SEC that involved a \$500,000 fine against each of the settling firms.²

While the opinion itself focuses on the unique problem of audit work papers, and therefore certain of the details will not

1. BDO China Dahua CPA Co. Ltd., Initial Decision Release No. 553, 2014 SEC LEXIS 234 (Public) (January 22, 2014) [hereinafter "Elliot Opinion"].

2. BDO China Dahua CPA Co. Ltd., Corrected Order on the Basis of Offers of Settlement of Certain Respondents Implementing Settlement, Release No. 74217 SEC (February 6, 2015), *available at* <https://www.sec.gov/litigation/admin/2015/34-74217.pdf> (last accessed July 19, 2015) [hereinafter "Settlement"]. Deloitte Touche, Ernst & Young, KPMG, and PricewaterhouseCoopers agreed to the Settlement; however, the original proceeding continues against BDO China.

apply to other types of companies, the order and Settlement should nonetheless serve as a wake-up call to any company with significant PRC-based operations. In particular, the opinion illustrates that despite a company's best efforts to comply with its obligations, when faced with an explicit order by the PRC government not to produce documents on the one hand and a government subpoena or valid discovery request in the U.S. on the other hand, the company will face a significant dilemma. While the Settlement tries to develop a compromise procedure for future document productions made by the settling firms' Chinese subsidiaries to the SEC, companies should still be worried about the risk of non-compliance with some portion of conflicting legal obligations.

This article begins by summarizing the key aspects of the Elliot Opinion, including highlighting the steps the audit companies tried to take to comply with their obligations, as well as a short summary of the Settlement. The article next summarizes certain of the Chinese laws that the audit companies relied on in asserting that they were unable to produce the work papers. Then the article explores the aforementioned line of cases in the Southern District of New York that address conflicts between U.S. discovery obligations and these and other Chinese laws as well as addressing the question of whether a litigant must follow the Hague Convention process for obtaining documents from PRC-based parties. Notably, the courts in these cases reach quite different conclusions. The article concludes by offering observations as to how a party might proceed when faced with this type of conflict, while acknowledging that there are no easy solutions.

ANALYSIS

1. A Review of the Elliot Opinion and the Settlement

The consolidated SEC enforcement action against the audit companies generally began with a request for audit work papers located in PRC related to Chinese companies that were under investigation by the SEC. In other words, the audit companies were not the focus of the investigations; rather, they were third parties in possession of potentially relevant documents related to the SEC's various investigations against the companies' clients or former clients. As a general matter, the SEC began with a voluntary request to the audit companies for the relevant documents, and when they each failed to respond in full, citing Chinese law as an impediment, the SEC followed up with a more formal subpoena issued under Sarbanes-Oxley §106.³

A few key and notable facts are common between all or most of the audit companies:

- In registering with the Public Company Accounting Oversight Board (PCAOB) in the United States, the audit companies noted their potential inability to comply with requests for documents or information due to Chinese law.⁴
- The audit companies replied relatively quickly to the requests and clearly cited concerns over

3. The Elliot Opinion lays out detailed facts with regard to each of the underlying investigations and the responses of each audit company. This article does not attempt to set forth or distinguish the unique facts and details of each company, but rather discusses their actions in a more general manner. Moreover, many paragraphs of the opinion, including certain legal analysis sections, are redacted in the public version and have therefore not been considered.

4. See Elliot Opinion, *supra* note 1, at 10, 31.

Chinese law as a reason they would not be able to comply despite the fact that they otherwise would be willing to comply with the requests.⁵

- The companies had obtained advice of counsel on these issues to provide them with guidance on the restrictions and their obligations.⁶
- The companies quickly consulted with the relevant authorities in PRC, including Chinese securities regulators, to seek permission to produce the documents and understand the restrictions. They spoke with, wrote to, and met with the Chinese regulators. They were repeatedly told, however, that they may not produce the documents to the SEC and that the SEC would need to make requests through the Chinese regulators, something the SEC apparently was unwilling to do initially.⁷
- In some cases the companies worked out a procedure with the Chinese regulators to permit review and redaction of documents for submission to the regulators who would then consider sharing them with their U.S. counterparts. However, this process did not initially appear successful in resolving the dispute.⁸
- The companies provided substantial evidence to the SEC both as to the seriousness of the conflict they faced and the explicit direction of the Chinese regulators, as evidenced throughout the opinion.

5. *See id.* at 7.

6. *See id.* at 13.

7. *See id.* at 7, 15-18, 27, 44.

8. *See id.* at 19, 37-38.

- At the hearing, the companies produced substantial expert testimony as to, among other topics, Chinese legal requirements.⁹

Judge Elliot considered this information and evidence and concluded that, despite these facts, the companies' conduct in failing to produce the work papers constituted a "wilful refusal to comply" in violation of Sarbanes-Oxley §106(e).¹⁰ In reaching this conclusion, Judge Elliot determined that "good faith" was not relevant to the determination and that "choosing not to act after receiving notice that action was requested" was sufficient to constitute a violation.¹¹ In his view, "the motive for the choice is irrelevant, so long as the Respondent knew of the request and made a choice not to comply with it. Thus bad faith need not be demonstrated and good faith is not a defense."¹² Judge Elliot also rejected other arguments and affirmative defenses, including an argument that the fact that Sarbanes-Oxley permitted the SEC to seek the documents through a foreign counterpart or through the PCAOB meant that the SEC was required to do so: "[t]here exist multiple possible avenues for obtaining documents, some of which may be more effective than others. Nothing compels the Commission to use one avenue rather than another, and it should have discretion to seek documents in whatever fashion the law permits."¹³

Judge Elliot concluded that each of the companies had violated the law by failing to produce the documents. He found

9. *See id.* at 58, 64, 68.

10. *See id.* at 88.

11. *See id.*

12. *See id.* at 93.

13. *See id.* at 100.

that the parties' good faith or lack thereof was relevant to evaluating appropriate sanctions.¹⁴ Judge Elliot found that the companies had not acted with scienter: "their state of mind at the time of their respective violations was driven by their concerns over potentially draconian Chinese laws."¹⁵ However, he did not find that they had acted in good faith. He noted that each of the companies was aware of their obligations under U.S. law when they took on audit work for U.S. issuers, and each was aware they may not be able or willing to comply with a request for audit work papers due to Chinese law.¹⁶ Yet, they had the "gall" to take on the work anyway.¹⁷ As he stated, "to the extent the Respondents found themselves between a rock and a hard place, it is because they wanted to be there."¹⁸ A good faith effort to obey the law means a good faith effort to obey all law, not just the law that one wishes to follow."¹⁹ Judge Elliot took all of these factors into account and imposed significant sanctions, including censures and a six-month ban on practicing before the commission.²⁰

The audit companies immediately appealed the decision and continued to work with the SEC to reach an amicable solution. During the eighteen months after the Elliot Opinion, the companies worked with the Chinese regulators for the review and redaction of documents that could then be sent to the SEC. On February 6, 2015, the SEC agreed with four of the five audit companies to the Settlement, which found that the four settling companies wilfully violated Sarbanes-Oxley §106 and required

14. *See id.* at 103.

15. *See id.* at 106.

16. *See id.* at 105.

17. *See id.*

18. *See id.*

19. *See id.*

20. *See id.* at 110-11.

each company to pay a \$500,000 fine.²¹ The Settlement stayed the six-month ban on practicing before the Commission for four years if the companies followed specific procedures related to future document requests under Sarbanes-Oxley §106.²² The SEC agreed to dismiss the investigation if the companies complied with the document production requirements during those four years.²³ However, non-compliance with future SEC document requests could result in various penalties depending on the severity of the non-compliance, including: (i) a partial ban on practicing before the Commission for 6 months; (ii) a complete ban on practicing before the Commission for 6 months, which could be continued in six-month terms for multiple offenses; and (iii) a termination of the stay and restart of the current proceeding.²⁴

The Settlement set forth procedures the settling firms must follow for future SEC document requests under Sarbanes-Oxley §106. The SEC agreed to issue such document requests first to the PRC Securities Regulatory Commission (CSRC) and then simultaneously provide the audit company with notice of the request.²⁵ Within ninety days of the initial request, the responding audit company must provide the SEC with an initial declaration stating that the company produced all responsive documents to the CSRC for eventual production to the SEC.²⁶ The responding company may create a privilege log and withhold documents under a claim of U.S. privilege, and the com-

21. See Settlement, *supra* note 2, at 3, 19.

22. See *id.* at 3, 21-23.

23. See *id.* at 4, 28.

24. See *id.* at 3-4, 24-27.

25. See *id.* at 21.

26. See *id.* at 22.

pany also may create a withholding log and withhold documents under a claim of Chinese state secrets.²⁷ The responding company must provide the SEC with a certification of completeness to signify that all documents responsive to the requests have been produced, aside from information withheld due to U.S. legal privilege or Chinese state secrets.²⁸

After the Settlement was published, the SEC issued a press release that discussed the main aspects of the Settlement and provided commentary from SEC officials about the agreement.²⁹ The Director of the SEC's Enforcement Division, Andrew Ceresney, stated, "This settlement recognizes the SEC's substantial recent progress in obtaining [audit firm's work papers] from registered firms in China."³⁰ The Associate Director of the SEC's Enforcement Division, Antonia Chion, added, "The settlement is an important milestone in the SEC's ability to obtain documents from China. Of course we hope that it is an enduring milestone."³¹

2. PRC State Secrecy Law Overview

When considering the impact and implications of the Elliot opinion, it is important to understand in more detail the potentially relevant PRC laws. This section provides a brief survey of some of the laws cited by the audit companies in defense of their position that they were unable to produce the work papers.

27. *See id.* at 22-23.

28. *See id.* at 23.

29. Press Release, U.S. Securities and Exchange Commission, SEC Imposes Sanctions Against China-Based Members of Big Four Accounting Networks for Refusing to Produce Documents (Feb. 6, 2015), *available at* <http://www.sec.gov/news/pressrelease/2015-25.html> (last accessed July 19, 2015).

30. *See id.*

31. *See id.*

A. Definition of State Secrets Law

PRC law imposes very strict limitations on disclosure of information related to PRC state secrets. Under PRC law, the concept of a state secret is broadly and vaguely defined. Specifically, under the *PRC State Secrets Protection Law*, effective Oct. 1, 2010 (“State Secrets Law”), “state secrets” are matters relating to national security or national interests whose disclosure could harm national security or national interests in the areas of politics, economy, national defense, and diplomacy. Article 9 of the State Secrets Law provides somewhat more specificity by stating that “state secrets” include the following types of information:

- 1) secret matters involved in major policy decisions on state affairs
- 2) secret matters involved in building up national defence and activities of the armed forces
- 3) secret matters involved in diplomatic and foreign affairs activities and matters for which a confidentiality commitment has been made to foreign entities
- 4) secret matters involved in national economic and social development
- 5) secret matters involved in science and technology
- 6) secret matters involved in activities to safeguard national security and in criminal investigations
- 7) other secret matters as determined by the state administration for state secrets protection

Besides the State Council’s *PRC State Secrets Protection Law Implementing Regulations*, there are dozens of other implementing regulations issued by ministries and bureaus under the State Council which more specifically define types of information that would be considered state secrets. They cover areas

such as military secrets, security, national statistics, health, land management, civil affairs, government personnel, education, and even sports.

The laws also define the levels of secrecy, with “top secret” being the highest, followed by “highly secret,” and finally just “secret.” These lists of types of information that could be considered state secrets appear to have been promulgated more for illustrative purposes than to provide a definite, exhaustive guideline on appropriate boundaries. For example, if anyone provides to an overseas organization or individual information whose level of secrecy is not clearly stipulated in any law or regulation, but which the person knew or should have known relates to the security and interests of the state, then it still would likely be considered a crime under Article 111 of the Criminal Law.

Additionally, a determination of whether information is a state secret can be made retroactively. In the course of a criminal case, if a question arises as to whether a piece of information should be considered a state secret or what its level of secrecy is, an appraisal of these issues can be done by a state secrets bureau official at the time of the trial.

It does not matter in what form state secrets are transmitted or whether they are copies. Regulations clearly provide that state secrets may not be transmitted on the Internet and may not even be stored on computers connected to the Internet, and that

they remain state secrets regardless of what medium they are stored on, be it disks, paper, images, or sound.³²

Separately, special caution should be exercised when handling information obtained from Central State-Owned Enterprises (CSOEs). The State Assets Supervision and Administration Commission issued the *Central Enterprises Trade Secrets Protection Interim Provisions* (“Interim Provisions”) on March 25, 2010, to regulate trade secrets protection for CSOEs. The Interim Provisions define the scope of CSOEs’ trade secrets. They also provide that a trade secret may be upgraded to a state secret by following statutory procedures for determining state secrets. Hence, if an internal investigation reveals any trade secrets of CSOEs that could potentially be deemed state secrets, the CSOE needs to impose strict scrutiny before transferring such information overseas.

B. Severe Legal Consequences

Under PRC Criminal Law anyone who “illegally provides” an overseas institution, organization, or individual a state secret may be sentenced to a jail term of between five and ten years. In exceptionally serious cases, the jail term may be from ten years to life imprisonment. In relatively minor cases, the person may be sentenced to a term of less than five years

32. Regulations for the Administration of the Maintenance of Secrets in the International Networking of Computer Information Systems (promulgated by the St. Secrecy Bur., Jan. 25, 2000, effective Jan 1, 2000) Art. 7; Measures for Administration of Protection of the Security of International Networking of Computer Information Networks (计算机信息网络国际联网安全保护管理办法) (promulgated by the Ministry of Public Sec., Dec. 16, 1997, effective Dec. 30, 1997), Art. 5 (9); State Secrets Law, Art. 20.

criminal detention, control, or deprivation of political rights.³³ “Exceptionally serious” is defined as disclosing to an overseas party any “top secret” information, or three pieces of “highly secret” information (one level below “top secret”), or any other state secrets which have an especially severe harmful effect on national security or interests.³⁴

Anyone who provides “highly secret” state secrets to an overseas party, discloses three pieces of “secret” information (the third and lowest level of secrecy) to an overseas party, or discloses state secrets that have a severe harmful effect on national security or interest may receive between five and ten years in prison. Other lesser offenses would be considered “relatively minor.”³⁵ If a violation does not constitute a crime in terms of level of harm to the country, administrative penalty fines may still be imposed.

Under the Criminal Law, the individual that actually transfers the information overseas could be found guilty of a crime. Additionally, if a unit (e.g., a company) is deemed guilty of a crime, then it may be fined, and the Persons in Charge who

33. PRC Criminal Law, Art. 111 (adopted by the Second Session of the Fifth Nat'l People's Cong. on July 1, 1979, and amended by the Fifth Session of the Eighth Nat'l People's Cong. on March 14, 1997) [hereinafter Criminal Law].

34. Interpretation of the Supreme People's Court on Several Issues Concerning Specific Application of the Law to Trial of Cases Involving Theft, Illegal Gathering and Purchase of State Secrets and Intelligence for and Illegally Providing Them to Foreign Organizations or Persons (最高人民法院关于审理为境外窃取、刺探、收买、非法提供国家秘密、情报案件具体应用法律若干问题的解释) (effective Jan. 22, 2001), Doc. 4, Art. 2 available at http://www.hrichina.org/sites/default/files/PDFs/State-Secrets-Report/HRIC_StateSecrets-Report.pdf (last accessed July 19, 2015) [hereinafter Criminal Law Interpretation].

35. Criminal Law Interpretation, *supra* note 34, Arts. 3, 4.

are directly responsible for that crime may be sentenced to criminal punishment.³⁶ This does not mean any senior management official in the relevant company would automatically be found guilty of a criminal offense; however, a manager whose actions were directly related to the particular crime or who was so negligent in his or her duties that it led to the crime could be considered a Person in Charge for purposes of criminal liability.

3. *Restrictions on Disclosure of Audit Working Papers*

As detailed in the Elliot Opinion, the various auditing firms cited the following provisions (among others) as obstacles to the direct production of the requested documents to the SEC:

A. State Secrets Law

The provision cited by the accounting firms was Article 21 of the old *PRC State Secrets Protection Law* (effective from May 1, 1989, to October 1, 2010, when the current law came into effect): “When state secrets have to be furnished for the benefit of contacts and cooperation with foreign countries, approval must be obtained beforehand in line with the prescribed procedures.”

Separately, Article 22 of the *PRC State Secrets Protection Law Implementing Measures*, effective from May 25, 1990 (which was replaced by the current *PRC State Secrets Protection Law Implementing Regulations*, effective March 1, 2014) provides: “In foreign contacts and cooperation, when the other party requests state secrets for a justifiable reason and through a justifiable channel, such request shall be submitted to the competent authority for approval as stipulated on an equal and mutual benefit basis, and the other party shall be required to assume a non-disclosure obligation in a certain form.”

36. Criminal Law, *supra* note 33, Art. 31.

The current State Secrets Law further clarifies the procedures for disclosing state secrets information during the course of foreign cooperation. Article 30 provides: “Where an organ or entity needs to provide any state secret in foreign contacts or cooperation or any overseas person appointed or employed by an organ or entity needs to have access to any state secret due to his work, the organ or entity shall report to the competent department of the State Council or the people’s government of the relevant province, autonomous region or municipality directly under the Central Government for approval, and enter into a confidentiality agreement with the other party.”

B. CSRC Notice No. 29 of 2009

On October 20, 2009, the CSRC, State Secrecy Protection Bureau, and State Archive Bureau jointly issued *Regulations on Strengthening Secrecy and Archive Administration Work for Issuing Securities and Listing Overseas* (“Notice No. 29”). Notice No. 29 imposes a general restriction on disclosing information that may be classified as state secrets. Article 3 of Notice No. 29 provides that during the course of issuing securities and listing overseas, any company listed or seeking to list overseas (“listing company”) who provides or discloses to any securities company, securities service agency, or overseas regulatory institution any document, material, or other property involving state secrets must first seek approval from the competent authority and file with the relevant secrecy administration bureau. If there is any dispute on the scope of state secrecy, the dispute must be resolved by the secrecy administration authority.

Notice No. 29 explicitly addresses the audit work papers issue. According to its Article 6, during the course of issuing securities and listing overseas, all work papers produced by the securities companies or securities service agencies during the course of issuing securities and listing overseas must be kept in PRC. Notice No. 29 clarifies that if the working paper involves

state secrets, national security, or essential national interests, it cannot be stored, processed, or transmitted in a computer information system. Without prior approval from the competent authority, such work papers cannot be taken, transmitted abroad, or passed on to any overseas entity or individual through information technology or any other means.

Article 8 of Notice No. 29 further provides that if overseas securities regulatory institutions or other relevant authorities request on-site inspections within PRC, the relevant listing company, securities company, or securities service agencies must report this request to the CSRC and other relevant departments and obtain prior approval from the competent authority for any matters requiring such approval before proceeding with the inspection. The on-site inspection must be led by Chinese regulatory authorities or rely upon inspection results provided by Chinese regulatory authorities.

For an off-site inspection relating to state secrets matters, the relevant listing company, securities company, and securities service agency must seek approval from the competent authority and file with the secrecy administration authority. If the situation involves archive matters, the company must obtain approval from the State Archives Bureau.

C. Memorandum of Understanding on Enforcement Cooperation

On May 10, 2013, the CSRC, the PRC Ministry of Finance ("MOF") and the PCAOB entered into a Memorandum of Understanding on Enforcement Cooperation (MOU). The MOU has no legally binding force and can be terminated with 30 days' notice.

According to the MOU, the three authorities, namely the CSRC, MOF, and PCAOB, seek to improve the accuracy and reliability of audit reports so as to protect investors and to help

promote public trust in the audit process and investor confidence in their respective capital markets, and accordingly agree to cooperate by responding on a timely basis to requests for assistance on exchanging information for the purpose of complying with the applicable laws and regulations in their respective jurisdictions.

This assistance includes: (i) documents sufficient to identify all audit review or other professional services performed by audit firms related to matters set forth in the request for assistance; (ii) audit work papers or other documents held by audit firms, if they relate to audit work subject to the regulatory jurisdictions of the PCAOB and/or CSRC and MOF; and (iii) documents sufficient to identify firms' quality control systems including organizational structures and policies and procedures to provide assurance of compliance with professional standards.

However, requests for assistance are subject to some restrictions. In particular, the requested party cannot be required to act in a manner that would violate domestic law, which seems to imply that the CSRC and MOF cannot be required to provide information in violation of PRC state secrecy laws. In addition, the request for assistance can be denied on grounds of public interest or essential national interest.

4. Recent PRC Cross-border Case Law

As noted earlier, while the Elliot Opinion is perhaps the first case to impose severe sanctions on a party for failure to comply with a production requirement based on Chinese law, the Southern District of New York has issued a series of opinions related to discovery of information from certain Chinese banks, in which they apply the Second Circuit's seven-factor comity test (the five-factor *Aerospatiale* test as well as two addi-

tional factors: (1) any hardship the responding party would suffer if it complied with the discovery demands, and (2) whether the responding party has proceeded in good faith).³⁷

A. *Milliken*—an Overview

In *Milliken & Co. v. Bank of China* (S.D.N.Y. Dec. 6, 2010), the Court ordered Bank of China (BOC) to produce bank records and held that *Aerospatiale* does not provide relief from the initial disclosure requirements of F.R.C.P. 26(a)(1)(A)(ii).³⁸ Milliken sued BOC to collect on a \$4 million judgment against certain Chinese manufacturers originally obtained in the District of Nevada.³⁹ BOC asserted as an affirmative defense that all of the debtors' assets held by the bank were subject to the bank's superior security interest.⁴⁰ Rather than disclosing records related

37. *Societe Nationale Industrielle Aerospatiale v. U.S. Dist. Ct. for the Southern Dist. of Iowa*, 482 U.S. 522 (1987), held that the Hague Convention does not provide exclusive or mandatory procedures for obtaining evidence located in a foreign jurisdiction, adopting instead a five-factor balancing test. See RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW OF THE UNITED STATES § 442(1)(c) ("In deciding whether to issue an order directing production of information located abroad, and in framing such an order, a court or agency in the United States should take into account the importance to the investigation or litigation of the documents or other information requested; the degree of specificity of the request; whether the information originated in the United States; the availability of alternative means of securing the information; and the extent to which noncompliance with the request would undermine important interests of the United States, or compliance with the requests would undermine important interests of the state where the information is located."). The Second Circuit recognizes two additional factors. *Strauss v. Credit Lyonnais, S.A.*, 249 F.R.D. 429 (E.D.N.Y. Mar. 10, 2008) ("Courts in the Second Circuit also consider the hardship of compliance on the party or witness from whom discovery is sought and the good faith of the party resisting discovery") (quotation marks omitted).

38. 758 F. Supp. 2d 238.

39. *Id.* at 240.

40. *Id.* at 240-41.

to the debtors' assets or liens, BOC ignored the initial disclosure requirement of the F.R.C.P. and delayed complying with discovery requests and court orders, ultimately seeking a protective order requiring all discovery proceed pursuant to the Hague Convention.⁴¹ The Court considered whether BOC's lack of diligence resulted in a forfeiture of its Hague Convention rights, but declined to find forfeiture in light of the interest of the foreign state in which discovery would occur.⁴² The Court weighed the seven comity factors, finding that BOC had acted in bad faith.⁴³ In considering the "alternative means" factor, the Court found persuasive a State Department document asserting that discovery via the Hague Convention in PRC has "not been particularly successful in the past" and held that the information requested could not be "easily obtained" via the Hague Convention.⁴⁴ The Court recognized the U.S.'s interest in enforcing judgments was "not as substantial" as some other interests that could entail cross-border discovery, but nonetheless outweighed PRC's interest in enforcing its bank privacy laws.⁴⁵ The Court was not persuaded by BOC's "hardship of compliance" assertion that it would expose itself to penalties, as there was no evidence that PRC would enforce its laws against BOC.⁴⁶ In sum, the Court found that "each of the relevant factors, with the exception of the location of the information, favors discovery without resort to the Hague Convention on Evidence."⁴⁷ The Court also precluded BOC from introducing evidence related to its lien against the debtors' assets, stating that because it could do

41. *Id.* at 241-42.

42. *Id.* at 242-43.

43. *Id.* at 249.

44. *Id.* at 246-47.

45. *Id.* at 247-48.

46. *Id.* at 248-49.

47. *Id.* at 249.

so without compelling production, the comity interests recognized in *Aerospatiale* are “attenuated.”⁴⁸ The Court found no indication that the drafters of the Hague Convention or the *Aerospatiale* Court “intended the Convention to be used by a party to avoid producing information underlying the very claims that it positively asserts.”⁴⁹

B. Counterfeiting Cases

In *Tiffany (NJ) LLC v. Qi Andrew* (S.D.N.Y. July 25, 2011), the Court ordered discovery to proceed through the Hague Convention as a first resort.⁵⁰ Plaintiffs sought bank records related to Defendants’ counterfeiting operation from three Chinese banks—BOC, China Merchants Bank (CMB), and Industrial and Commercial Bank of China (ICBC).⁵¹ The Court recognized that the information sought was “important to plaintiffs’ claims” because the records could help Plaintiffs identify additional members of the counterfeiting organization.⁵² The Court discussed at length the viability of obtaining discovery via the Hague Convention and ultimately decided that this factor weighed in favor of the banks because Plaintiffs could not show an attempt at the Hague Convention discovery would be “futile.”⁵³ Specifically, the Court considered the fact that the State Department had revised its guidance to omit the harsh language the *Milliken* Court found persuasive and relied on outdated evidence.⁵⁴ The Court also criticized Plaintiffs’ expert report and an ABA paper submitted by Plaintiffs for relying on

48. *Id.* at 243-44.

49. *Id.* at 244.

50. 276 F.R.D. 143.

51. *Id.*

52. *Id.* at 151-52.

53. *Id.* at 152-56.

54. *Id.* at 153-54.

the prior version of the State Department circular.⁵⁵ Further, the Court noted that there was no evidence that PRC had ever rejected a request in a similar case (i.e., a request submitted by a “trademark owner in a counterfeiting case”).⁵⁶ In considering the interests of the states, the Court found that PRC’s interest in protecting bank secrecy (as a matter of encouraging adoption of a modern banking system) outweighed the U.S.’ interest in enforcing trademark rights.⁵⁷ When considering the potential hardship to the responding parties, the Court was persuaded by the fact that BOC had previously been sanctioned for violation of the privacy laws in certain domestic matters.⁵⁸ Ultimately, the Court invited the parties to revisit the issue should discovery via the Hague Convention prove “futile.”⁵⁹

In *Gucci Am. Inc. v. Weixing Li* (S.D.N.Y. Aug. 23, 2011), the Court faced a virtually identical scenario as the *Andrew* Court but reached the opposite conclusion.⁶⁰ The *Gucci* Court differed on the alternative means, state interests, and potential hardship factors and ultimately found that a balancing weighed strongly in favor of Plaintiffs.⁶¹ The Court disagreed that discovery via the Hague Convention must be “futile” before ordering direct discovery.⁶² The Court also considered whether the State Department’s backpedalling on the viability of discovery via the Hague Convention was persuasive; however, “without concrete evidence suggesting that PRC’s compliance with Hague Con-

55. *Id.* at 153-55.

56. *Id.* at 156.

57. *Id.* at 158.

58. *Id.* at 158-59.

59. *Id.* at 160-61.

60. 2011 WL 6156936.

61. *Id.* at 13.

62. *Id.* at 9.

vention has, in fact, dramatically improved," it ultimately deferred to the same expert report and an ABA paper that the *Andrew* Court dismissed, recognizing that both authorities relied on an abundance of evidence beyond the State Department.⁶³ Regarding state interest, the Court viewed the privacy law's weak protection against Chinese government action as mitigating.⁶⁴ The Court was further persuaded by PRC's failure to expressly take a position on the matter and by BOC's choosing to do business in New York and to avail itself of the benefits of U.S. banking law.⁶⁵ The Court also considered whether BOC would face any hardship in compliance and determined that it could not reach such a conclusion in light of the fact that no Chinese bank had been sanctioned for complying with a similar court order.⁶⁶ BOC subsequently moved the Court to reconsider in light of new evidence, specifically a letter received by BOC from its regulators stating that BOC might face sanctions were it to comply with the order.⁶⁷ The Court found that the new evidence, were it admissible, would not have changed their prior assessment of the comity factors.⁶⁸ Specifically, since none of the regulators had "actually imposed sanctions or even made an actual determination as to whether BOC will face any sanctions aside from a 'severe warning,' nothing change[d] the Court's conclusion that BOC's 'representation of the liability that it faces . . . [is] unduly speculative'."⁶⁹

63. *Id.* at 9-10.

64. *Id.* at 10-11.

65. *Id.* at 11.

66. *Id.* at 11-12.

67. *Gucci Am. Inc. v. Weixing Li*, 2012 WL 1883352 (S.D.N.Y. May 18, 2012).

68. *Id.* at 4-5.

69. *Id.* at 4.

In another counterfeiting matter, *Tiffany (NJ) LLC v. Forbse* (S.D.N.Y. May 23, 2012), the Court reached a split decision.⁷⁰ The Court, siding mostly with the *Andrew* Court, ordered Plaintiffs to proceed under the Hague Convention as to CMB and ICBC, but ordered F.R.C.P. discovery from BOC due to its relationship as the “acquiring bank” for one of Defendants’ websites.⁷¹ This distinction “strengthens the importance of the information sought” and “suggests potential bad faith on behalf of BOC.”⁷² When examining the viability of discovery via the Hague Convention, the Court was persuaded by recent assurances from Chinese banking regulators that they were “committed to actively coordinating with the PRC Ministry of Justice and judicial organs in the PRC” to ensure timely satisfaction of Hague requests.⁷³

C. *Wultz*—Terrorism

In *Wultz v. Bank of China Ltd.* (S.D.N.Y. Oct. 9, 2012), BOC stood accused of facilitating terrorism in violation of U.S. law by failing to act upon notice that terrorist operatives were funneling money through certain BOC accounts.⁷⁴ Plaintiffs’ pro-pounded discovery requests to BOC not only for records of certain accounts but also for broad categories of information that

70. 2012 WL 1918866.

71. *Id.* at 10-11. An acquiring bank, directly or indirectly, facilitates credit card transactions. *Id.* at 2. BOC declared that Defendants gained access to the credit card network through the unauthorized act of an intermediary. *Id.* at 2. BOC claimed that it “shut down” the intermediary’s access but provided no further information. *Id.* at 2.

72. *Id.* at 11.

73. *Id.* at 6-7.

74. 910 F. Supp. 2d 548.

could be used to support their assertions of BOC's breach of statutory duty, negligence, and vicarious liability.⁷⁵ The parties agreed to proceed under the Hague Convention but received only a limited response after thirteen months.⁷⁶

Plaintiffs moved to compel discovery under the F.R.C.P.⁷⁷ The Court considered whether it would be appropriate to limit the scope of foreign discovery to "information [that is] necessary to the action" rather than that which could lead to admissible evidence, but declined in light of the significant U.S. interest in eliminating sources of funding for terrorism.⁷⁸ Further, the Court found that the Hague Convention was not a viable alternative for receiving the type of broad discovery appropriate to this matter, citing PRC's earlier rejection of a request in this matter and certain public statements indicating PRC would only entertain requests for information "directly and closely related" to a particular case.⁷⁹ When weighing the state interests, the Court found that the U.S. had a "profound and compelling interest in combatting terrorism at every level, including disrupting the financial underpinnings of terrorist networks" which heavily outweighed any Chinese interest in banking privacy as well as "the abstract or general assertion of sovereignty."⁸⁰ Since BOC was not "meaningfully sanctioned" for complying with orders in *Forbse* and *Weixing Li* to produce in contravention of Chinese banking privacy laws, the Court could not find that producing would entail "significant hardship."⁸¹

75. *Id.* at 551.

76. *Id.* at 551.

77. *Id.*

78. *Id.* at 556 (quoting RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW OF THE UNITED STATES § 442, cmt. a).

79. *Id.* at 558 (quoting Letter from Chinese banking regulators).

80. *Id.* at 558-59 (quoting *Strauss* at 443-44).

81. *Id.* at 559-60.

Ultimately, the Court held that the balance of the factors weighed in favor of Plaintiffs and ordered discovery under the F.R.C.P.

Instead of complying fully with the order, BOC moved the Court to reconsider and weigh the comity factors with due deference to certain Chinese laws and state interests not necessarily related to banking privacy.⁸² Specifically, BOC asserted that: (i) certain communications between BOC and the Chinese government and internal to BOC were protected by Chinese laws related to anti-money laundering and counter-terrorist financing, and (ii) certain communications between BOC and Chinese bank regulators were protected under the State Secrets Law.⁸³ The Court found that production would be contrary to PRC law and thus reconsidered the seven-factor comity test.⁸⁴ It did not explicitly revisit each factor but did analyse Chinese interests and recognized the risk that ordering BOC to produce “could have a chilling effect on future communications by Chinese banks, leaving suspicious transactions to go unreported” and “would risk infringing China’s sovereignty and violating the spirit of international comity.”⁸⁵ Further, the Court found that BOC had shown bad faith in failing to promptly present arguments regarding anti-money laundering and state-secrets.⁸⁶ In weighing all of the comity factors, the Court compelled production in part but ordered *in camera* review of: (i) documents purported to be communications from the Chinese Government containing state secrets, and (ii) documents purported to be cer-

82. *Wultz v. Bank of China Ltd.*, 942 F. Supp. 2d 452 (S.D.N.Y. May 1, 2013).

83. *Id.* at 462-63.

84. *Id.* at 466.

85. *Id.* at 467.

86. *Id.* at 467-70.

tain types of communications (i.e., “Suspicious Transaction Reports” and “Large-value Transaction Reports”) specifically prohibited from production under Chinese and U.S. law.⁸⁷

CONCLUSION

Perhaps the most striking aspect of the Elliot opinion is the fact that a review of the detailed events contained in the opinion suggests that the parties took many of the steps that a cross-border eDiscovery practitioner would likely recommend in these circumstances, including:

- responding quickly and in writing to the requesting party and identifying in detail the conflict and the legal basis for it;
- obtaining early advice from local counsel;
- working with local regulators on a possible compromise or solution;
- developing a detailed factual and documentary record as to the efforts taken to comply;
- suggesting that production be made through the local regulator, including a redaction review; and
- retaining legal experts to explain the foreign legal requirements to the judge.

However, these sensible and practical steps failed to avoid significant penalties in this case. The suggestion of the judge was essentially—if you do not like the rules, stop doing business in the U.S. This conclusion fails to accept, however, the realities faced by multi-national businesses, including audit

87. *Id.* at 473. The Court found that Chinese law prohibiting the production of Suspicious Transaction Reports and Large-value Transaction Reports was analogous to the “SAR Privilege” that prohibits production of Suspicious Activity Reports in U.S. courts. *Id.* at 473.

companies and their clients, who operate in today's global and integrated economy.

Ultimately, this situation may call for a political solution. The MOU between Chinese authorities and the PCAOB discussed herein is perhaps an example of the type of compromise and cooperation that may be feasible. However, such arrangements only serve as real solutions if they are effectively implemented and followed by all parties. For example, while the Settlement appears to provide an effective solution for the production of the audit companies' documents in China to the SEC, the effectiveness of the solution certainly will be challenged if political "gamesmanship" results in either the CSRC or the SEC making assessments about the production of documents merely to spite one another politically.

Until definitive cross-border discovery solutions are agreed upon between the PRC and the U.S. that balance PRC state secrets interests with U.S. discovery interests, companies will continue to find themselves "between a rock and a hard place." Due to serious penalties in PRC, broadly worded state secret language, and little current cooperation between the governments, it is likely many companies will continue to err on the side of resisting production. The line of cases from the Southern District of New York discussed herein shows that a company may have some hope in the context of civil discovery of persuading a court that following the Hague Convention is the proper route; however, those cases also illustrate that success with this argument is far from certain.

If more courts and regulatory agencies follow the path laid forward in the Elliot opinion without any room for compromise that the Settlement may offer in the short term, the consequences of the failure to produce documents from PRC could prove severe in the U.S. Hopefully, it will not take multiple jail

sentences to demonstrate the reality of the possible consequences for a state secrets violation in PRC, and this incident will lead to fruitful discussions between all stakeholders as opposed to a hardening of positions.