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PREFACE

This is the seventh issue of the *Journal of International Business and Law* (JIBL), a joint effort by the students of the Law School and the Zarb School of Business of Hofstra University. As in the past years, the student editors and staff worked tirelessly on this edition to successfully publish yet another issue of JIBL.

JIBL continues to serve as a vehicle to disseminate the research findings of students, faculty and professionals in the areas of international business, international trade, transactional law, and other related interdisciplinary fields. By definition, globalization implies interdisciplinary activities and there is no better way to foster this than to have students from the disciplines of Business and Law collaborate on a journal that seeks out articles in both fields.

A major accomplishment of the Journal and its staff this year was hosting a one-day symposium on foreign exchange, made more relevant because of the declining dollar and its effects on businesses and policy makers. The symposium attracted many speakers with expertise in the field including Mr. Walter L. Lukken, Acting Chairman of the Commodity Futures Trading Commission, who delivered the keynote speech. The symposium was well attended and our students and faculty were able to listen to some interesting analysis of the current state of the dollar.

This issue contains seven articles covering a wide range of topics. Three of the articles were written by students of the Law School. The issue also includes articles by practitioners in the field of international business. Reflecting the broad scope of the Journal, the seventh issue features an eclectic collection of articles that cover such topics as global currency markets, ownership issues in international business, limitations in the regulation of unfair marketing practices, and an article on the Foreign Corrupt Practices Act.

For future issues, JIBL welcomes manuscripts on various international topics including the legal aspects of international business, corporate social responsibility, effects of outsourcing, global warming and its impact on businesses, emerging economies and their impact on international trade, exchange rate fluctuations and their impact on financial markets, and the cross-border issues that global companies need to address.

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Manuscripts sent to the Journal of International Business and Law should be original and not previously published or accepted for publication elsewhere.

We hope you find the journal useful. We encourage and seek your active participation and patronage in this endeavor.

James P. Neelankavil Ph.D.,
Professor of Marketing and International Business
Faculty Advisor

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ARTICLES

- GLOBAL MARKETS: CURRENCY VALUATION AND THE OUTLOOK
FOR THE US DOLLAR.....1
- THE FOREIGN CORRUPT PRACTICES ACT AND ITS APPLICATION
TO U.S. BUSINESS OPERATIONS IN CHINA.....13
- MANAGEMENT CONTROLLED FIRMS V. OWNER CONTROLLED
FIRMS: A HISTORICAL PERSPECTIVE OF OWNERSHIP
CONCENTRATION IN THE US, EAST ASIA AND THE EU.....49
- LIMITATIONS IN THE REGULATION OF UNFAIR MARKETING
PRACTICES IN HONG KONG.....77

NOTES

- THE IMPACT OF INTERNATIONAL ORGANIZATIONS ON THE
AIDS EPIDEMIC IN SUB-SAHARAN AFRICA.....115
- MASSACHUSETTS V. EPA: THE CAUSES AND EFFECTS OF
CREATING COMPREHENSIVE CLIMATE CHANGE
REGULATIONS.....145
- TO LEGISLATE OR TO ARBITRATE: AN ANALYSIS OF U.S.
FOREIGN INVESTMENT POLICY AFTER FINSA AND THE
BENEFITS OF INTERNATIONAL ARBITRATION.....167

GLOBAL MARKETS: CURRENCY VALUATION AND THE OUTLOOK FOR THE US DOLLAR

*Dr. Michael J. Woolfolk**

INTRODUCTION

Since 2001, the US dollar has lost more than 40% of its value against the Euro, 30% against the British Pound, and about 20% against the Japanese Yen. In November 2000 the US dollar traded at 1.16 Euro and today it is trading at 0.6582. As the US descends further and further into debt of several trillion dollars, the value of the US dollar is expected to decline further. What are the consequences of the declining dollar for US multinationals? Over the years, especially during the past seven years, US companies have carefully and successfully maneuvered their way through the volatile foreign exchange market.

The declining dollar is not a new phenomenon. During the mid 1970's because of elevated oil prices and the actions of Central banks that were torn between dealing with the threat of inflation and the downward risks of growth, the dollar faced similar pressures that it is facing now. One notable difference between then and now is the impact of high oil prices on US inflation. During the mid 1970's, heavy reliance on imported oil prompted a stronger pass through of oil prices into both Consumer Price Index (CPI) as well as inflation expectations. Today, the dependence on imported oil is materially less and the US Federal Reserve believes that inflation and inflation expectations can remain contained despite the recent rise in oil and commodity prices.

If true, the US is unlikely to succumb to stagflationary conditions as it did in the 1970's. However, the USD is nonetheless expected to remain weak for some time as both US growth and interest rates lag behind those in other major economies. Accurately forecasting a turnaround in the USD has been made more difficult by the spread of a popular market investment strategy called the "carry trade."

* Dr. Michael J. Woolfolk is the Senior Currency Strategist for the New York Bank Mellon in New York, New York.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

A STRATEGIC OPTION

United States' multinationals have many different options in dealing with the declining dollar. Over the recent decline in the dollar, the most consistently successful strategy in the currency markets has been the "Carry Trade". A carry trade is *"[a] strategy in which an investor sells a certain currency with a relatively low interest rate and uses the funds to purchase a different currency yielding a higher interest rate. A trader using this strategy attempts to capture the difference between the rates - which can often be substantial, depending on the amount of leverage the investor chooses to use."*

There are three basic conditions required to make these trades attractive:

- A sufficiently large interest rate differential must exist to make the trade worthwhile
- A funding currency that is stable to weakening. For example, the US dollar.
- A low volatility environment

Given that "carry trades" are run on an un-hedged basis from a currency perspective, the funding currency must not only have materially lower interest rates than the destination investment currency, but the funding currency must remain weak. If not, the currency's performance could undermine and even overwhelm the expected yield of the interest rate differential. For example, if overnight interest rates in the US were 2.0% and in Australia it was 7%, investors may wish to capture the 5% differential by borrowing US Dollars (USD) and buying AU Dollars (AUD). If, however, the USD rose in value against the AUD by more than 5% over this period, the investor would end up with a net loss. Consequently, "carry trades" require low volatility market conditions in which the funding currency (the USD in this instance) is expected to remain weak.

By the summer of 2007, the carry trade was the market's primary strategy. For example, the Bank of International Settlements (BIS) reported that the Japanese Yen denominated lending in the first quarter of 2007 topped one trillion US dollars. In late June, the net short Japanese Yen futures held by speculative players had reached an all time high. The BIS reported that foreign currency investments made by Japanese households increased on average by 1.2 trillion Japanese Yen per month in the first six months of 2007.

CURRENCY VALUATION AND THE US DOLLAR

UNDERLYING FORCES BEHIND THE SUCCESS OF THE “CARRY TRADE”

In order to determine what has been the most important driver for alpha creation in foreign exchange, we need to understand the underlying forces behind the success of the carry trade strategy. To understand this, requires an approach that encompasses four key areas. These are:

- Historical perspective
- Cross border financial politics
- Central bank intervention
- Behavior of different investor groups

In addition to the above four areas, the success of the strategy is also dependent on information. Specifically, information on how the asset markets are interacting with the currency markets as well as drawing inferences as to why it is happening.

Historical perspective

Although, no two periods of time are ever the same, however, there are a number of similarities between the backdrops to the current decline in the value of the dollar to the markets in the mid-to-late 1970. Once again, we are facing rising oil prices; people are acquiring more commodities such as gold and other minerals resulting in high rates of growth among countries with vast reserves of mineral deposits such as Australia, Canada, and Chile. The high growth attained by these countries is reflected in the ever increasing US trade deficit that last year topped \$700 billion.

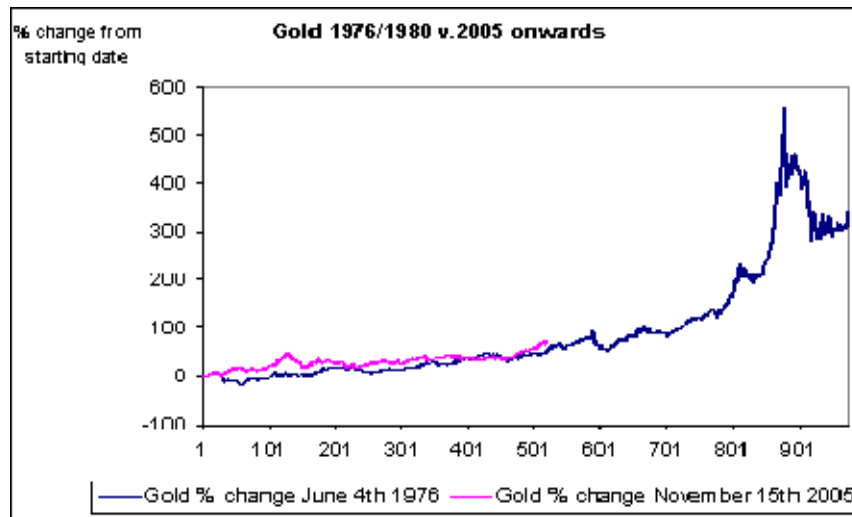
One key difference between the pressures on the US dollar in the late 1970's to the current situation is the impact of currency pegs. Countries have taken measures to contain inflationary pressures even as cost of food and energy has risen. For example, in the US, despite a 26% slide in the US dollar index compared to a decade ago, the consumer price index over the last eight years has remained the same. On the other hand, inflation in the gulf region has risen from below 4% in 2005 to above 12% in 2007. Similarly, there are inflationary pressures in China triggered by rising food prices and also because of the influx of money from abroad.

Although the circumstances are different in each of the cases, one common feature of all of these nations is that they either peg their currency to the US dollar, track a basket of currencies in which US dollar seemingly plays a significant role or actively manage their currency against the greenback. Rising food prices and high currency prices are a common feature of these countries. One suspects, that the currency policies of these countries are, effectively, importing inflation from the G7 nations.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

Comparing the performance of gold during the mid 1970's (Graph -1) and now shows some interesting similarities. Overlaying the performance of gold during 2005 to the present suggests that we may not have seen the top yet.

Graph -1
Gold Prices

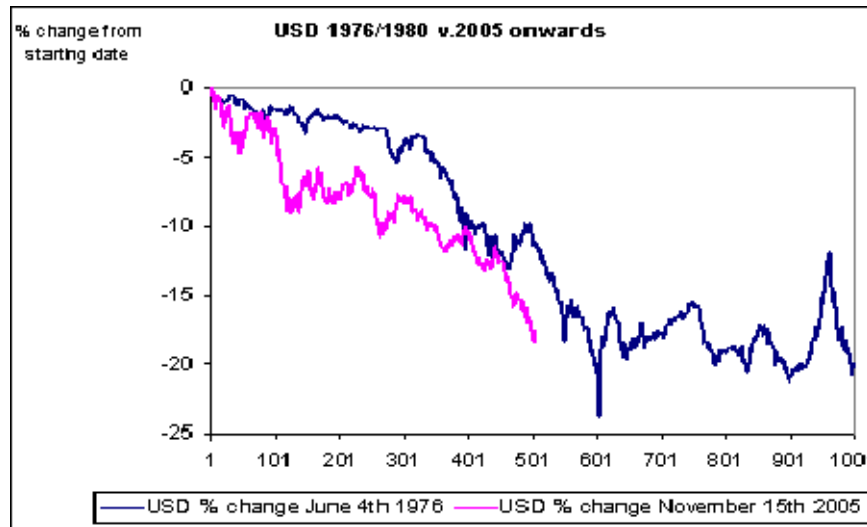


Source: <http://www.reuters.com>, February, 2008

During 1976-78 (Graph -2), gold began to accelerate in price at an accelerating pace as the USD continued to weaken. The question becomes, whether USD weakness will drive gold and other commodity prices significantly higher in the coming year?

CURRENCY VALUATION AND THE US DOLLAR

Graph - 2
US Dollar



Source: <http://www.reuters.com>, February, 2008

Cross border financial politics

Although the Federal Open Market Committee (FOMC) eased policy aggressively through 2001, by January of 2002 the US dollar stood at its strongest levels since 1986. Everything changed after this and some of the forces that affected this change are:

- International criticism of the Japanese Ministry of Finance's campaign of verbal intervention (and occasional fiscal intervention) and the Bank of Japan's policy of "quantitative easing," whereby interest rate were left at effectively 0% but more money was allowed to be borrowed at this rate.
- The US was not the only country to complain about the actions of the Japanese Central Bankers, its Asian Neighbors too voiced their strong disapproval of the Japanese policies, especially China. The call by the Bank of China's Governor on the Japanese to take measures directed at preventing the continued devaluation of the Japanese Yen that was causing widespread currency devaluations across many Asian countries.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

- The response from the Japanese Central Bank was more of an admonition of its Asian counterparts, especially the weakness in the Chinese Yuan rather than concrete actions to stabilize the Yen.

While China, Japan, and the US were squabbling about who should have the weakest currency, the Euro-zone was more concerned about the persistent weakness of its own currency.

- In an effort to shore up the value of the Euro and in response to the weakening of the dollar, some countries including China were in favor of using the Euro as an alternate reserve currency.

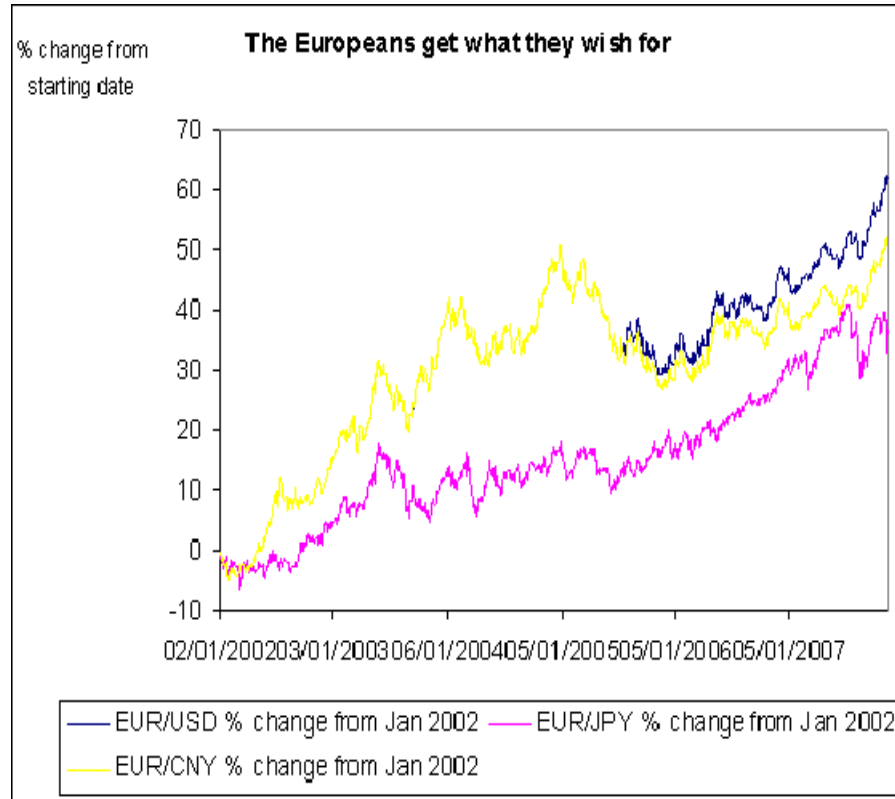
The result of the cross border politicking was:

- 1) Contrary to expectations of the Chinese, the US Treasury, and the US Congress, Japan seemed to be pursuing a policy of keeping the Japanese Yen as weak as possible.
- 2) On the other hand, the Europeans were taking the decline of their currency more seriously and were taking active steps to remedy the problem by promoting the increased use of the Euro as a reserve currency.
- 3) It appears that the Europeans got their wish and the Euro started to gain against the Japanese Yen and the US dollar.

European officials have effectively got what they wanted far back in 2002, a time when the Euro (EUR) currency was quite weak. The EUR has rallied against many major currencies including the USD (Graph – 3) based upon relatively high interest rates and the promotion of the EUR as a reserve currency.

CURRENCY VALUATION AND THE US DOLLAR

Graph – 3
The Rise of the Euro



Source: The Bank of New York Mellon

Central Bank behavior

According to IMF, at the start of 2002, total global foreign exchange reserves stood at just over 2 trillion US dollars. Of this total amount, about 1.57 trillion reserves had actually been allocated with 71% being held in US dollars and 19.7% in Euros. By the start of 2003, total reserves had grown by about 0.5 trillion US dollars. However, the US dollar now only represented 67% of the foreign exchange reserves while the Euro represented 24.6%. By the second quarter of 2007, just in five years, total foreign exchange reserves had more than tripled to 5.7 trillion dollars while the share of the dollar has decreased to

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

just 64.7% of known holdings. Meanwhile the Euros' share had risen to 25.5%.

All the available evidence indicates that the phenomenal growth in foreign exchange reserves over the past five years has been accompanied by a notable push to diversify away from US dollars into Euros. It seems clear that foreign exchange managers took the European pleas at the end of 2001 seriously. Following is a partial list of the foreign exchange managers that have expressed a preference for reducing their exposure to the US dollar over the past two years:

- 1) United Arab Emirates – is looking to convert up to 10% of its foreign exchange reserves from the US dollar to the Euro, doubling its Euro holdings.
- 2) Qatar – two years ago, used to invest about 99% of its portfolio in US dollars and now it is down to 40%. About 40% of the balance of Qatar's foreign reserves, estimated to be 50 billion US dollars is invested in the Euro and another 20% in other currencies including the British Pound.
- 3) Sweden – The Riksbank has boosted its level of Euro holdings from 37% to 50% meanwhile reducing the level of foreign reserve holdings in the US dollars from 37% to 20%.

The list goes on. The other countries that have joined the exodus of switching its foreign reserves from the US dollar to the Euro include Italy, New Zealand, Russia, Singapore, South Korea, and Thailand. Therefore, it is not surprising to see the appreciation of the Euro

IS THE CURRENT FOREIGN EXCHANGE STRATEGY REALLY CARRY
TRADE ACTIVITY?

Based on available data, it is not clear that some of the strategies followed in the foreign exchange market are really carry trade. For example, the one-year yield gaps between the South African Rand (ZAR), New Zealand dollar and Australian dollar against the Japanese Yen are substantial – 10.44%, 7.99%, and 6.526% respectively. The same cannot be said for the Canadian dollar and the Norwegian Kroner's interest rate advantage which are 3.9% and 4.72% respectively. It is clear that the yield pick up on the Kroner is noticeably less than that available on the British pound at 5.03%, while the Canadian dollar's one year yield is only just above that of the US dollar. In other words, the second best performing currency over the period actually had the third lowest yield of the group ahead of the US dollar and the Japanese Yen. Hence, it appears that the driving force here is not simply yield. This added to the fact that the rallies have also come at a time of the heightened volatility in financial markets suggests that characterizing these rallies as being the product of carry

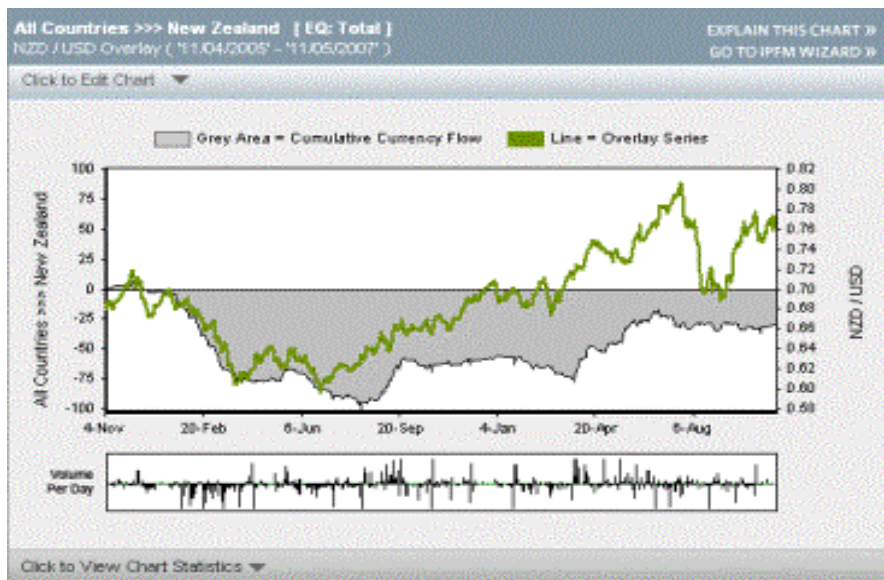
CURRENCY VALUATION AND THE US DOLLAR

trade activity might be overly simplistic.

INVESTOR APPETITE FOR UNDERLYING EQUITY MARKETS

Looking at the performances of the currencies mentioned here in terms of what has happened in their underlying equity markets provides ambiguous results. Although the NZD and AUD have put in healthy rallies so far (Graph – 4 and 5), it's difficult to argue that the performance of the respective currencies has been down to relative investor interest in local stock markets. Our own cross border custodial flow data seems to confirm this. Although we have registered healthy fresh inflows into South African equities, the same cannot really be said for Australia, New Zealand, Norway or Canada, where the flows have been modest at best.

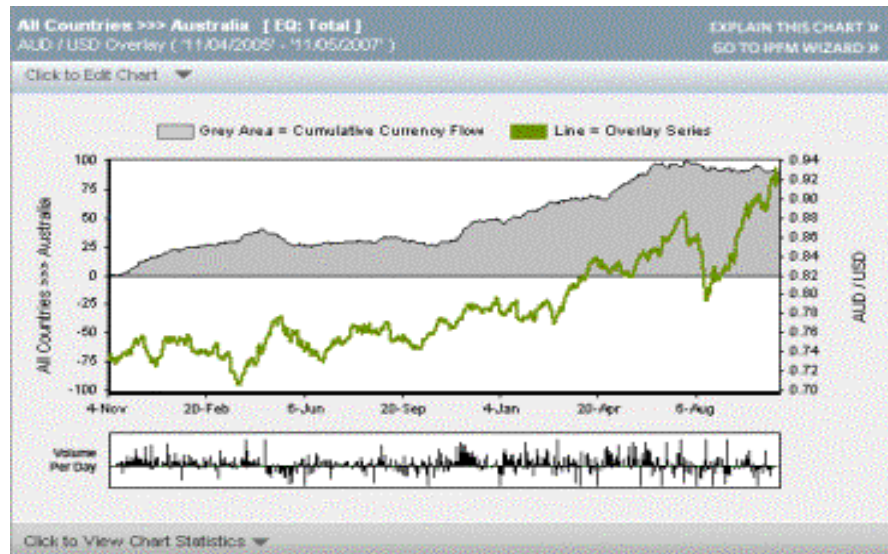
Graph – 4
New Zealand dollar



Source: The Bank of New York Mellon

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

Graph - 5 Australian Dollar



Source: The Bank of New York Mellon

A POSSIBLE EXPLANATION FOR HIGH FLYING GROUP OF CURRENCIES

There are two common elements to this high flying group of currencies; the first is the continued strong inflationary stance of their respective central banks. Australia, South Africa and Norway all still appear to be in tightening mode while New Zealand and Canada both remain on inflation watch. In contrast, despite the apparent neutral stance of the FOMC, US markets still expect two further rate cuts by the middle of next year. This is also consistent with British Pound's relative weakness, given that the market continues to price in at least one rate cut by the end of June 2008. The second and closely related common feature is that they are, in one form or another, commodity currencies.

It appears that in the circumstances that we are in, may be managers should stop thinking about the rally in Japanese Yen as being driven by "risk seeking" carry trade activity and, instead, look at it as a flight to safe haven currencies in the face of rising concerns about the threat of future inflation.

CURRENCY VALUATION AND THE US DOLLAR

CONCLUSION

Based on our analysis and reviewing the existing evidence, it seems the most consistently successful trading strategy of the past five years has been driven by inflationary concerns or rather, by concerns over certain currencies as “stores of value”, i.e., currencies that are traded around the clock, are considered a hard currency and have a history of maintaining their value. A similar argument can be made about what has driven the ongoing rally in gold price. As the USD has declined, USD-denominated commodities such as oil and gold have risen in value to maintain their value in foreign currency terms.

Similar arguments can also be made about the performance of the US dollar in recent years. The greenback has tended to outperform when oil prices have been their weakest and the Federal Reserve has been at its most hawkish. Given what has been observed, the driving force behind some of the currency concerns has been an aggressive and ongoing squabble between the US, China and Japan over who should have the weakest currency. Although it would be wrong to say that they have followed policies of “competitive devaluations,” the motivations were essentially the same.

In light of all these different scenarios and situations, it seems reasonable to conclude that a combination of structural economics and politics have proved the ultimate real driver of the most significant trends within the currency markets over the past five years.

THE FOREIGN CORRUPT PRACTICES ACT AND ITS APPLICATION TO U.S. BUSINESS OPERATIONS IN CHINA

*Eric M. Pedersen**

INTRODUCTION

As a result of globalization, “every public company, private domestic concern and private equity/hedge fund [is] in direct contact with a U.S. federal statute and, in many cases, with foreign laws as well that prohibit the offer, promise to pay, payment, or gift of money or anything of value—in other words, as the statute sees it: bribes—to a foreign government official.”¹ This is particularly true in the Asian-Pacific region, which is home to some of the most robust trade and security partners of the United States. With China quickly assuming a prominent place in the global community,² it has become extremely attractive to U.S. businesses and investors.³ Likewise, U.S. capital markets are the most attractive destination for Chinese initial public offerings.⁴

* The positions and opinions expressed in this article are those of the author and do not represent the views of the United States Government, the Department of Defense, or the United States Navy. The author (LL.M., Georgetown University Law Center, 2007; J.D., Gonzaga University School of Law, 2000; B.S., Sam Houston State University, 1996) is an active duty Navy Judge Advocate, presently serving as a Trial Counsel in the Pacific Northwest. The author would like to thank Professor Jonathan C. Drimmer, of the Georgetown University Law Center, for his invaluable guidance, comments, and patience on earlier drafts of this article, without which this article would never have come into being; Kimberly N. Dobson and the staff of the Hofstra University Journal of International Business and Law for all of their hard work and diligence in preparing the final draft of this article; his parents Tom and Sally Pedersen for their unwavering love and support and for making everything possible; his friends Chris Shaver, Jeff Wilser and Tania Krebs for being the positive role models that got him on the right path and inspired him to go to law school; his supervisor Kim Hinson for her support and mentorship during the writing of this paper; his children Gregory and Abigail who remind him every day what is truly important in life; and his wife and best friend Heather for her love, patience and understanding throughout both his legal education and career endeavors.

¹ Paul R. Berger & Bruce E. Yannett, *FCPA: What It Is and Why It Matters to You: Documentation and Accounting Controls Are Among the Business Practices Covered By the Foreign Corrupt Practices Act*, BANK ACCT. & FIN., Apr. 1, 2007, at 46.

² Michael Michalak, U.S. Senior Official for APEC, Remarks to the Asia Society’s Annual APEC 2005 Breakfast Briefing (Dec. 1, 2005) (transcript available at <http://www.asiasociety.org/speeches/michalak05.html>).

³ Peter S. Goodman, *China Market is Fertile Field for Bribes American Firms Run Afoul of Law*, SEATTLE TIMES, Aug. 28, 2005, at E1.

⁴ Kevin Hamilton, *Battling for China’s IPOs: The London Stock Exchange Wants a Piece of the*

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

Unfortunately, corruption in China is a significant issue⁵ and while China has recently adopted extensive anti-corruption measures, significant concern still remains over the extent to which these measures will be enforced.⁶ Given the fact that corruption in China is widespread,⁷ and the government still owns and manages the country's largest companies,⁸ compliance with the Foreign Corrupt Practices Act (hereinafter "FCPA") can be exceptionally challenging for U.S. corporations that conduct business operations in China.

The Securities and Exchange Commission (hereinafter "SEC") and the Department of Justice (hereinafter "DOJ") have recently begun an aggressive enforcement approach to the FCPA⁹ – which has its grounding in securities law¹⁰ and gives dual jurisdiction to both the SEC and DOJ¹¹ – due largely to “companies moving more aggressively into emerging markets like . . . China.”¹² In the wake of numerous domestic corporate scandals (e.g. Enron and WorldCom¹³), the new U.S. interest in the bolstering economy of China has led to increased international actions to combat corruption,¹⁴ as well as increased class action lawsuits against Chinese-based companies listed in the United States.¹⁵ With the recent increase in FCPA cases pursued by the DOJ and the SEC,¹⁶ it is imperative that U.S. companies conducting business operations in China comply with the FCPA.

Chinese Market, but State-Owned Enterprises are Shunning Overseas Listings. Does that Signal Flagging Support for Corporate Reform in China?, INSTITUTIONAL INVESTOR, Dec. 1, 2005, at 34.

⁵ See generally Don Dufree, *Corrupt or Careless?*, CFO MAGAZINE, Mar. 20, 2007, available at <http://cfo.com/article.cfm/8870064?f=search>.

⁶ *Corruption in China: Not the Best Way to Clean Up*, THE ECONOMIST, Apr. 19, 2007, available at http://www.economist.com/world/asia/PrinterFriendly.cfm?story_id=9040393.

⁷ Paul W. Boltz, Jr., *Are You Ready For China?: The World Has a New Player*, 16 ABA BUS. L. TODAY 27 (Jan./Feb. 2007), available at <http://www.abanet.org/buslaw/blt/2007-01-02/boltzjr.shtml>.

⁸ *The Long and Winding Road to Privatization in China*, KNOWLEDGE@WHARTON, May 10, 2006, available at <http://knowledge.wharton.upenn.edu/article.cfm?articleid=1472&specialid=53>.

⁹ Elliott Leary, Joseph P. Dooley & Nicole Stryker, *Trends in FCPA Enforcement*, 15 METROPOLITAN CORPORATE COUNSEL 5 (May 2007).

¹⁰ 15 U.S.C.A. § 78u(d)(1) (2002).

¹¹ 15 U.S.C.A. § 78u(h)(9)(b) (2002).

¹² William Olson, *Don't Let U.S. Focus Crimp Oversight Abroad: With Increased SEC and DOJ Scrutiny on U.S. Companies' Business Practices in Foreign Countries, a Myopic Focus on U.S. Policies and Procedures Can Detract from Oversight of FCPA Violations*, FINANCIAL EXECUTIVE, Jan. 1, 2007, at 24.

¹³ See generally Kathleen F. Brickey, *From Enron to WorldCom and Beyond: Life and Crime After Sarbanes-Oxley*, (June 1, 2003). 81 WASH. U. LAW QUARTERLY 357, (2003).

¹⁴ David M. Luna, Director for Anticorruption and Governance Initiatives, Remarks to the 2002 International Institute for Public Ethics Conference, (Oct. 4, 2002), available at <http://www.state.gov/p/inl/rls/rm/2002/13881.htm>.

¹⁵ Hamilton, *supra* note 4.

¹⁶ Leary et al., *supra* note 9.

FOREIGN CORRUPT PRACTICES ACT & U.S. BUSINESS OPERATION IN CHINA

This article will examine the Chinese economy and the FCPA's recent impact on U.S. corporations and investors who conduct, or are contemplating conducting, business operations in China. Part I of this paper will summarize the provisions of the FCPA. Part II will look at the economy of China and how its vast potential for economic growth has drawn U.S. businesses to the Far East. Part III will explore the problem China presently faces internally with corruption. Part IV will analyze several recent, high-profile FCPA cases brought against U.S. corporations that conducted business operations in China. Part V will highlight the unique application of the FCPA in China, including the heightened scrutiny the U.S.-half of a U.S.-China joint venture has to investigate activities of the Chinese-half. This section will also explore how the definition of a "foreign official" may differ in business dealings with communist China in contrast to other countries. Part VI will discuss the extent to which the FCPA puts U.S. businesses at a competitive disadvantage to their foreign counterparts who do not vigorously enforce anti-bribery laws. This paper concludes that the FCPA does, in fact, put U.S. businesses at a competitive disadvantage in China; a rapidly developing country with enormous investment potential, yet a considerable problem with corruption. However, this paper also recognizes that adherence to the FCPA remains critical in the current, ongoing, international battle against corrupt business activities. Part VII will explore two potential remedial measures that could modify and strengthen the FCPA to accomplish its worthy purposes without negatively impacting U.S. business activities abroad.

PART I: THE FOREIGN CORRUPT PRACTICES ACT

The FCPA was passed in the wake of the Watergate scandal in the 1970s.¹⁷ After its passage, SEC investigations uncovered over 400 cases of U.S. businesses involved in illegal or questionable payments to foreign government officials amounting to over \$300 million.¹⁸ This "included some of the largest and most widely held public companies in the United States."¹⁹ The discovered abuses ranged "from bribery of high foreign officials in order to secure some type of favorable action by the foreign government" to payments "made to ensure that government functionaries discharge certain ministerial [sic] or clerical duties."²⁰ Congress found the payment of bribes to influence the acts and decisions of foreign officials to be unethical, unnecessary and "bad business," as it "eroded public confidence in the integrity of the [American] free

¹⁷ Maki Hishikawa, *The FCPA: An Outgrowth of Corporate Scandals*, JAPAN COMMERCE ASSOCIATION OF WASHINGTON, DC, Mar. 2003.

¹⁸ Unlawful Corporate Payments Act of 1977, H.R. REP. NO. 95-640 (1977).

¹⁹ *Id.* at 4.

²⁰ *Id.*

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

market system.”²¹ Therefore, in 1977 Congress enacted the FCPA as a means of discouraging the bribery of foreign officials and restoring integrity to the American business system.²²

A. FCPA Provisions

The provisions of the FCPA can be broken down into two distinct parts: (1) the prohibition against the bribery of foreign officials by American corporations,²³ and (2) the requirements for record-keeping and accounting practices that prohibit the establishment of undercover accounts used to finance illegal payments.²⁴

The FCPA’s anti-bribery provisions prohibit people and corporations from engaging in a variety of activities and transactions. The statute explains that issuers of certain U.S. securities – or any officers, directors, employees, or agents of the issuers – cannot use the mails, phone systems, internet or any other instrumentality of interstate commerce “in furtherance of an offer, payment, promise to pay, or an authorization to make an offer, payment, or gift” to any *foreign official*, foreign political party, or candidate for a foreign political office.²⁵ This provision applies to any situation in which there is a “corrupt” purpose of either (i) influencing an act or decision of that foreign official, (ii) obtaining or retaining business, (iii) directing a business to a particular person, or (iv) to securing an improper advantage.²⁶ Simply put, the FPCA makes it unlawful for U.S. persons, U.S. companies and certain foreign issuers listed on U.S. securities exchanges, to make payments to foreign officials for the purpose of obtaining or retaining business for or with, or directing business to, any person.²⁷ A simple offer, promise, or authorization of a bribe will trigger a violation of the FCPA.²⁸

Although the FCPA does not apply directly to a foreign subsidiary of a U.S. business that engages in conduct that is prohibited by the FCPA, the U.S. parent business will be deemed to have violated the FCPA if they “authorized, directed, or controlled the activity in question.”²⁹ This form of “knowledge” is

²¹ *Id.*

²² Committee on Banking, Housing and Urban Affairs, Foreign Corrupt Practices and Domestic Foreign Investment Improved Disclosure Act of 1977, S. REP. NO. 95-114 (1977).

²³ 15 U.S.C.A. §§ 78dd-1, 78dd-2, and 78dd-3 (2000).

²⁴ 15 U.S.C. §§ 78m(a), 78m(b) (2000).

²⁵ *Id.* (emphasis added).

²⁶ *Id.*

²⁷ *See generally id.*

²⁸ 15 U.S.C. §§ 78dd-1(a), 2(a), 3(a) (2000).

²⁹ LAY-PERSON’S GUIDE TO FCPA, FOREIGN CORRUPT PRACTICES ANTIBRIBERY PROVISIONS, <http://www.usdoj.gov/criminal/fraud/docs/dojdocb.html>.

FOREIGN CORRUPT PRACTICES ACT & U.S. BUSINESS OPERATION IN CHINA

inferred under the FCPA if a corporation “is aware that such person is engaging in such conduct, that such circumstance exists, or that such result is substantially certain to occur; or such person has a firm belief that such circumstance exists or that such result is substantially certain to occur.”³⁰ “Knowledge” also includes “conscious disregard and deliberate ignorance.”³¹

The FCPA’s record-keeping and accounting provisions are the lesser known, but equally important, aspects of the FCPA which were added to the Securities and Exchange Act of 1934.³² These record-keeping provisions require U.S. corporations to keep books, records and accounts in reasonable detail, in a way that fairly reflects their transactions and the dispositions of their assets.³³ The FCPA’s accounting provisions require that every issuer of securities (i.e. businesses with securities registered with the SEC under section 12 or required to file reports under section 15(d) of the Securities and Exchange Act of 1934) to:

- (A) make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer;
- (B) devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that—
 - (i) transactions are executed in accordance with management’s general or specific authorization;
 - (ii) transactions are recorded as necessary (I) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and (II) to maintain accountability for assets;
 - (iii) access to assets is permitted only in accordance with

³⁰ 15 U.S.C. § 78dd-1(f)(2) (2000).

³¹ LAY-PERSON’S GUIDE TO FCPA, *supra* note 29.

³² Securities and Exchange Act of 1934 §13(b)(2), amended by Act of July 30, 2002, 15 U.S.C.A. §78m(b)(2) (2002) (“Every issuer which has a class of securities registered pursuant to section 12 and every issuer which is required to file reports pursuant to section 15(d) shall--A. make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer; B. devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that— i. transactions are executed in accordance with management’s general or specific authorization; ii. transactions are recorded as necessary (I) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and (II) to maintain accountability for assets; iii. access to assets is permitted only in accordance with management’s general or specific authorization; and iv. the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.”)

³³ 15 U.S.C. § 78m(b)(2)(a) (2000).

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

management's general or specific authorization; and
(iv) the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.³⁴

These provisions give "the SEC authority over the entire financial management and reporting requirements of publicly held United States corporations."³⁵ Their purpose is to prevent issuers from concealing bribes and, more specifically, to discourage fraudulent accounting and reporting practices. These provisions also provide a basis for ascribing liability to U.S. parent companies of foreign subsidiaries. Since these accounting provision violations do not require proof of criminal intent, a corporation can more easily be held strictly liable for the actions of a foreign subsidiary under the FCPA.³⁶

B. Exceptions to the FCPA's Anti-Bribery Prohibitions

The prohibitions of the FCPA are subject to three exceptions. The first, which came by way of an amendment to the FCPA in 1988, permits the use of "grease" or "facilitating" payments to foreign officials for the purpose of expediting or securing the performance of a routine governmental action.³⁷ "Grease" payments are usually small payments to minor government officials that provide extra incentive to perform routine governmental action.³⁸ The phrase "routine governmental action" refers to actions that a government official would regularly perform.³⁹ Examples of routine governmental action would include "obtaining permits, licenses, or other official documents to qualify a person to do business in a foreign country;" "providing police protection;" "loading and unloading cargo;" "processing governmental papers, such as visas and work orders;" and priority in scheduling inspections.⁴⁰ The second exception is for legitimate business purposes and allows a U.S. corporation to utilize its funds for the purpose of educating a foreign official about its business,

³⁴ 15 U.S.C. § 78m(b)(2) (2000).

³⁵ SEC v. World-Wide Coin Investments, Ltd., 567 F. Supp. 724, 746 (N.D. Ga. 1983).

³⁶ LAY-PERSON'S GUIDE TO THE FCPA, *supra* note 29.

³⁷ 15 U.S.C. § 78dd-1(b) (2000); see also Rebecca Koch, *The Foreign Corrupt Practices Act: It's Time to Cut Back the Grease and Add Some Guidance*, 28 B.C. INT'L & COMP. L. REV. 379, 379 (2005).

³⁸ See generally, Rebecca Koch, *The Foreign Corrupt Practices Act: It's Time to Cut Back the Grease and Add Some Guidance*, 28 B.C. INT'L & COMP. L. REV. 379 (2005).

³⁹ 15 U.S.C. § 78dd-1(f)(3)(A) (2000).

⁴⁰ *Id.*

FOREIGN CORRUPT PRACTICES ACT & U.S. BUSINESS OPERATION IN CHINA

product, or activities.⁴¹ The last exception to the prohibition of the FCPA allows for the payments of bribes in countries where bribery is legal.⁴² This exception requires that the law permitting bribery be in writing,⁴³ and is therefore rarely, if ever, invoked.

C. Inside Information

In 1998, the FCPA was amended again to implement the Organization of Economic Cooperation and Development (hereinafter “OECD”) on Combating Bribery of Foreign Public Officials in International Business Transactions.⁴⁴ This amendment made several significant changes in the FCPA, including broadening the jurisdictional reach of the FCPA to non-U.S. persons acting within the United States, as well as to U.S. persons outside of the United States.⁴⁵ The amendments also prohibited making corrupt payments to a foreign official for the purpose of “securing any improper advantage” to obtain or retain business.⁴⁶ As amended, the FCPA not only prohibits:

[P]ayments to foreign officials not just to buy any act or decision, and not just to induce the doing or omitting of an official function “to assist . . . in obtaining or retaining business for or with, or directing business to, any person,” but also the making of a payment to such a foreign official to secure an “improper advantage” that will assist in obtaining or retaining business.⁴⁷

U.S. corporations can still fall under the umbrella of the FCPA for making corrupt payments even if the purpose of such payments is not necessarily to obtain business. If a foreign, state-owned business was to solicit bids for a new business and kept certain information confidential, then anything provided or anything offered of value for the purpose of obtaining disclosure of that confidential information may result in an FCPA violation.⁴⁸

⁴¹ 15 U.S.C. §§ 78dd-1(c)(2), 2(c)(2), 3(c)(2) (2000).

⁴² 15 U.S.C. §§ 78dd-1(c)(1), 78dd-2(c)(1), 78dd-3(c)(1) (2000).

⁴³ *Id.*

⁴⁴ S. 2375, 105th Cong. (1998).

⁴⁵ FCPA International Initiatives, FCPA Enforcement: International Agreements, http://www.fcpaenforcement.com/documents/document_detail.asp?ID=713&PAGE=4.

⁴⁶ International Anti-Bribery and Fair Competition Act of 1998, sec. 2(a)(1)(A)(iii), § 78dd-1(a), 112 Stat. 3302, 3302 (1998).

⁴⁷ *United States v. Kay*, 359 F.3d 738, 754 (5th Cir. 2004).

⁴⁸ Judith A. Lee & James D. Slear, *Unique Problems with FCPA Compliance in the P.R.C.*, 2007 A.B.A. SEC. BUS. LAW vol. 16 No. 5, available at <http://www.abanet.org/buslaw/blt/2007-05-06/slear.shtml>.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

Use of inside information from a foreign official can subject a corporation to liability under Rule 10b-5 of the Securities and Exchange Act of 1934, which prohibits the use of material, non-public information for the purchase or sale of a security.⁴⁹ In addition, an employee of a U.S. corporation who makes a payment, or promises to make a payment to a Chinese foreign official for the purpose of obtaining confidential, non-public information may subject the business to liability under the FCPA.

D. Penalties for FCPA Violations

Violations of either the accounting or bribery provisions of the FCPA can subject individuals and/or corporations to both criminal and civil penalties.⁵⁰ Individual officers, directors and employees of a company may be prosecuted for violations of the FCPA even if their company is not liable.⁵¹ Criminal violations can lead to substantial fines and prison terms.⁵² Civil liability can also result in considerable fines.⁵³ Additionally, the SEC has been increasingly ordering U.S. businesses to disgorge any profits made through violations of the FCPA,⁵⁴ which often results in businesses settling FCPA suits at practically double the cost of settlement.⁵⁵ In addition to civil and criminal penalties, an individual or corporation found to be in violation of the FCPA may be subject to additional governmental actions such as barring a corporation from conducting business with the federal government, refusing export licenses, and possible suspension or debarment from programs provided by the Commodity Futures Trading Commission and the Overseas Private Investment Corporation.⁵⁶

E. FCPA Enforcement

The FCPA has had a significant impact on the manner in which U.S. corporations conduct foreign business operations.⁵⁷ Since its enactment:

[s]everal firms that paid bribes to foreign officials have been the subject of criminal and civil enforcement actions, resulting in large fines and suspension and debarment from federal

⁴⁹ 15 U.S.C. § 78j(b) (2000).

⁵⁰ 15 U.S.C. §78ff (2000).

⁵¹ H.R. REP. NO. 100-576, at 923-24 (1988) (Conf. Rep.).

⁵² 15 U.S.C. §78ff(a) (2000).

⁵³ 15 U.S.C. §78dd-2(g)(2)(B) (2000).

⁵⁴ Leary et al., *supra* note 9; *see also*, 15 U.S.C. §78dd-2(g)(2)(B) (2000).

⁵⁵ Leary et al., *supra* note 9.

⁵⁶ *See* LAY-PERSON'S GUIDE TO THE FCPA, *supra* note 29.

⁵⁷ Leary et al., *supra* note 9.

FOREIGN CORRUPT PRACTICES ACT & U.S. BUSINESS OPERATION IN CHINA

procurement contracting, and their employees and officers have gone to jail. To avoid such consequences, many firms have implemented detailed compliance programs intended to prevent and to detect any improper payments by employees and agents.⁵⁸

Recently, the DOJ has affirmed its commitment to stamping out global corruption through aggressive enforcement of the FCPA.⁵⁹ This has been observed through a significant increase in investigations by the DOJ and SEC.⁶⁰ By 2006, 49 individual and corporate defendants had been prosecuted by the DOJ, resulting in over 27 plea agreements.⁶¹ In addition, over 38 cases were disposed of by the SEC, resulting in agreements to avoid further violations of the FCPA and disgorgements of profits received as a result of the corrupt activities.⁶² U.S. corporations that conduct business in China have been one of the focuses of recent FCPA investigations.⁶³

PART II: THE ECONOMY OF CHINA

During the era of Mao Tse-tung, the phrase “revolution is not a dinner party” illuminated the Maoist vision for the future of an internationally respected China.⁶⁴ Mao saw the concept of collective political consciousness as more important for the greater good of the nation than material incentive, which was the goal of the corrupt and economically disparate Nationalist regime of the time.⁶⁵

After the death of Mao Tse-tung, Deng Xiaoping became the leader of the Communist Party of China and greatly reformed the Chinese economy based on economic development and market-oriented policies.⁶⁶ These economic reforms, which began in the late 1970's, led to an increase in economic growth in China which has astonished the world. “Between 1979 and 1997, the growth

⁵⁸ See LAY-PERSON'S GUIDE TO THE FCPA, *supra* note 29.

⁵⁹ Alice S. Fisher, Assistant U.S. Att'y Gen. U.S. Dept. of Justice, Remarks to the A.B.A. on the Foreign Corrupt Practices Act (Oct. 16, 2006), http://www.usdoj.gov/criminal/pr/speeches/2006/10/2006_4810_10-16-06AAGFCPASpeech.pdf.

⁶⁰ Olson, *supra* note 12.

⁶¹ Tom Leander, *In China, You Better Watch Out*, Mar. 20, 2006, http://www.cfo.com/article.cfm/5622331/1/c_2984409?f=home_featured.

⁶² *Id.*

⁶³ Olson, *supra* note 12.

⁶⁴ Cheng Li, *Revolution Is No Dinner Party, But China's Reform Is*, <http://www.cnn.com/SPECIALS/1999/china.50/red.giant/communism> (last visited Feb. 20, 2008).

⁶⁵ *Id.*

⁶⁶ *Id.*

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

rate of China's Gross Domestic Product (GDP) was 9.8 percent annually."⁶⁷ Economic reforms have also led to a "gradual liberalization of prices," fiscal transference, increased independence for state enterprises, "development of stock markets," the "growth of the non-state sector," the groundwork for a "diversified banking system," and the overall "opening to foreign trade and investment."⁶⁸

The worldwide growth rate has received the largest contribution from China since it joined the World Trade Organization (WTO) in 2001.⁶⁹ Since 2003, China's economy has grown an astonishing 10 percent each year and will likely increase 7 percent annually until 2020, when it is predicted to become the second largest economy in the world, behind the United States.⁷⁰ In the year 2004:

Americans spent \$162 billion more on Chinese goods than the Chinese spent on U.S. products. And that gap has been growing by more than 25 percent per year, as China moves from building toys and tchotchkes into more-sophisticated appliances, auto parts, and semiconductors. China's consumer class, meanwhile, is spending like lottery winners on everything from bagels to Bentleys—and will soon outnumber the entire U.S. population. China's explosive growth "could be the dominant event of this century," says Stapleton Roy, former U.S. ambassador to China. "Never before has a country risen as fast as China is doing."⁷¹

Recent developments indicate that the economy of China sees no signs of slowing, nor does the government desire the tapering off of its incredible development. In 2003, Chinese leadership claimed it would "continue to focus on the country's economic development, with a goal to quadruple the country's gross domestic product (GDP) within 20 years."⁷² In 2006, the Chinese government announced its Five-Year Plan which states China's intention to

⁶⁷ *Id.*

⁶⁸ CENTRAL INTELLIGENCE AGENCY, THE WORLD FACT BOOK – CHINA, <https://www.cia.gov/library/publications/the-world-factbook/geos/ch.html#Econ> (last visited Feb. 19, 2008).

⁶⁹ *Chinese Economy to Contribute More to World Growth*, PEOPLE'S DAILY ONLINE, Sept. 20, 2006, http://english.people.com.cn/200609/20/eng20060920_304558.html.

⁷⁰ *Id.*, see also Richard J. Newman, *The Rise of a New Power*, U.S. NEWS & WORLD REP., June 20, 2005, at 40 (explaining that by 2020 China's progress in the global market could severely diminish the role of the U.S.).

⁷¹ See Newman, *supra* note 70.

⁷² Gang Lin, *China's Economy: Will the Bubble Burst?*, 111 ASIA PROGRAM SPECIAL REP. 1 (2003), <http://wwics.si.edu/topics/pubs/Chinese%20economy.pdf>.

FOREIGN CORRUPT PRACTICES ACT & U.S. BUSINESS OPERATION IN CHINA

pursue policies designed to improve the following five different areas of the Chinese society:

- (a) growth in domestic consumption and exports to international markets
- (b) development of inland and rural costal areas
- (c) development of rural and urban areas
- (d) promotion of a harmonious society and economic growth, and
- (e) the needs of both the environment and man.⁷³

Today China is the “fastest growing economy in the world,”⁷⁴ and with its economy flourishing in ways never imagined, China has become an attractive place for U.S. corporations to conduct operations and investments. This is due not only to China’s “low-cost manufacturing facilities” and its “market for high-technology goods,”⁷⁵ but also to its “good infrastructure, an educated workforce,” a soaring “rate of saving available to finance investment,” and its open economy.⁷⁶

A study conducted by the U.S.-China Business Council (USCBC), revealed that 81% of U.S. businesses reported that their China operations were profitable.⁷⁷ Additionally, more than half of those businesses claimed that profitability rates for their operations in China either met “or exceed[ed] their company’s global profit margin.”⁷⁸ Former White House Council of Economics Advisor Kristen Forbes noted that “[c]ompanies are seeing some of their fastest growth in China, and it’s profitable growth.”⁷⁹ Another commentator has noted that “China has become a magnet for investment and a huge potential market beckoning with growth.”⁸⁰

Deng’s shift away from Maoist principles significantly paved the way for the present state of the economy in China. Consequentially, the shift away from the Maoist principles of an economically equal and internationally respected China have been pushed aside in favor of a new aphorism; one that encapsulates China today: “To get rich is glorious.”⁸¹

⁷³ Boltz, *supra* note 7.

⁷⁴ *China’s Economy Believed to Catch Up with U.S.*, CHINA KNOWLEDGE PRESS, June 7, 2007, available at 2007 WLNR 10578282.

⁷⁵ William D. Greenlee, Jr., *Business Not as Usual in China*, NEV. LAW., Feb. 2006, at 11.

⁷⁶ *The Real Great Leap Forward*, THE ECONOMIST, Sept. 30, 2004, at 1.

⁷⁷ US-China Bus. Council Staff, *Companies Speak: The State of U.S. Business in China*, THE CHINA BUS. REV., Sept. 2006, available at <http://www.chinabusinessreview.com/public/0609/survey.html>.

⁷⁸ *Id.*

⁷⁹ Goodman, *supra* note 3.

⁸⁰ *Id.*

⁸¹ Li, *supra* note 64.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

PART III: CORRUPTION IN CHINA

United States businesses and investors seeking to take advantage of the lavish economic opportunities in China face challenging FCPA issues primarily because corruption is so widespread in China and its largest companies are owned and managed by the Chinese government. The battle against corruption in China, while not optimistically viewed, nevertheless seems to be an emerging theme of the Chinese government.

A. Climate of Corruption

Despite being an economy of unlimited economic potential, “[c]orruption in China is a significant issue.”⁸² While China has enacted many extensive anti-corruption laws, enforcement of these laws is ostensibly driven by political concerns rather than an effort to fix the problem.⁸³

Transparency International is a global organization, influential among investors and traders, that performs assessments and opinion surveys on the perceived levels of corruption in over 150 countries.⁸⁴ In its 2006 report, China was given a score of 3.3 on its 1 – 10 scale, with one being the most corrupt and ten being the least corrupt.⁸⁵ A study done by the Carnegie Endowment for International Peace revealed that corruption in China accounted for approximately 13-16% of its gross domestic product.⁸⁶ Angang Hu, of the Center for Chinese Study noted that “[c]orruption looms as one of the biggest political and economic challenges that faces China in the twenty-first century.”⁸⁷

Between December 2002 and November 2003, there had been 174,580 leading officials at various levels across China disciplined for violations of anti-corruption laws.⁸⁸ This figure includes 6,043 at the county level and 21 at the ministerial level. In the year 2004, over 500 Chinese suspects – most of whom were public officials - had violated various anti-corruption laws.⁸⁹ In the first

⁸² Boltz, *supra* note 7.

⁸³ *See id.* at 30-31.

⁸⁴ Transparency Int'l, the Global Coal. Against Corruption, TI Corruption Perceptions Index, http://www.transparency.org/policy_research/surveys_indices/cpi (last visited Feb. 17, 2008).

⁸⁵ *Id.*

⁸⁶ Angang Hu, Ctr. for China Study, Chinese Acad. of Sciences, Quinghua Univ., Corruption and Anti-Corruption Strategies in China, Presented at the Carnegie Endowment for Int'l Peace, Feb. 13, 2001, Summary prepared by Radha Kuppalli, Junior Fellow, <http://www.carnegieendowment.org/events/index.cfm?fa=eventDetail&id=284>.

⁸⁷ *Id.*

⁸⁸ ChinaDaily.com, *Party Watchdog Vows to Fight Corruption*, Feb. 23, 2004, <http://www.china.org.cn/english/2004/Feb/88114.htm>.

⁸⁹ ChinaDaily.com, *China to Ratify UN Convention Against Corruption*, http://www.chinadaily.com.cn/english/doc/2005-10/22/content_487050.htm (last visited Jan. 14,

FOREIGN CORRUPT PRACTICES ACT & U.S. BUSINESS OPERATION IN CHINA

ten months of 2006, China was faced with 8,010 cases involving commercial bribery, amounting to the equivalent of \$110 million U.S. dollars.⁹⁰

China has become “increasingly plagued by government officials and executives of state-owned companies who abscond with a large sum of public money and flee overseas to escape from prosecution and punishment.”⁹¹ Chen Liangyu, China’s Chief of Shanghai, was recently implicated in a corruption scandal involving the misuse of the Shanghai’s public social security fund.⁹² Tian Fengshan, former governor of Heilongjiang Province and former minister of land and resources in China, was recently sentenced to life in prison for accepting over 4.36 million yuan (approximately \$538,000) in bribes.⁹³ Both the former vice-mayor of Beijing and the former head of the National Statistics Bureau were also recently removed from their positions after corruption charges came to light.⁹⁴ Other high ranking Chinese officials caught in acts of corruption included the top procurator of Tianjin, former vice governor of Anhui and former deputy head of the Jiangsu provincial legislature.⁹⁵ The former vice director of China’s Assets Supervision and Administration Commission of Hainan Province, was recently tried and sentenced to life imprisonment for taking bribes totaling over 4 million yuan (approximately \$513,000).⁹⁶ Crimes committed by government officials in charge of state-owned enterprises have become a commonality in China, accounting for 41.5% of all corruption and bribery cases that were investigated in 2004.⁹⁷

The increasing issue of corruption in China has been blamed on a litany of factors. Some argue that the low pay of China’s government officials has driven them to illegally seek additional income.⁹⁸ Others argue that “China-based companies simply conclude that a certain amount of corruption is necessary to remain competitive, and they are willing to live with the risk of

2008).

⁹⁰ People’s Daily Online, *China’s Anti-Corruption Drive Fruitful*, http://english.people.com.cn/200701/09/eng20070109_339270.html (last visited Jan. 14, 2008).

⁹¹ *China to Ratify UN Convention Against Corruption*, *supra* note 89.

⁹² ChinaDaily.com, *President Hu Charts Path in Anti-Corruption Drive*, http://www.chinadaily.com.cn/china/2007-01/10/content_779107.htm (last visited Jan. 14, 2008).

⁹³ Liu Li, *Ex-Minister Sentenced to Life Term for Bribery*, CHINA DAILY.COM, Dec. 28, 2005, http://www.chinadaily.com.cn/english/doc/2005-12/28/content_507214.htm.

⁹⁴ *President Hu Charts Path in Anti-Corruption Drive*, *supra* note 92.

⁹⁵ *China’s Anti-Corruption Drive Fruitful*, *supra* note 90.

⁹⁶ Embassy of the People’s Republic of China in the United States of America, *China Tackles Commercial Bribery Cases Involving 4.5bln Yuan*, Feb. 15, 2007, <http://www.china-embassy.org/eng/xw/t298110.htm>.

⁹⁷ He Qinglian, *What Are the Effects of China’s Anti-Corruption Laws?*, THE EPOCH TIMES, Oct. 17, 2006, <http://en.epochtimes.com/news/6-10-17/47058.html>.

⁹⁸ Zengke He, *Corruption and Anti-Corruption in Reform China*, 33 COMMUNIST AND POST-COMMUNIST STUDIES 243, 251 (2000).

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

possible government action against them.”⁹⁹ Moreover,

[T]he most lucrative corruption occurs in the overlap of government or party authority with private enterprise, where business operators need official approval to acquire land, win contracts or make sales. Inducements in such transactions remain off the books, thus difficult for auditors to catch.¹⁰⁰

This places U.S. businesses in the complex dilemma of balancing the desire to take advantage of the lucrative Chinese economy with complying with the FCPA and thereby avoiding problems with the DOJ and SEC. Compliance is even more problematic in a nation where business deals typically involve gift-giving and entertaining.¹⁰¹ Several U.S. multinational corporations have admitted that “their firms routinely win [Chinese] sales by paying what could be considered bribes or kickbacks. . .to purchasing agents at government offices and state owned businesses.”¹⁰²

B. Anti-Corruption Efforts in China

In a recent address to the Chinese Communist Party (CCP), disciplinary body President Hu Jintao emphasized China’s anti- corruption efforts.¹⁰³ With the milieu of high-profile corruption cases which plagued China in early 2007,¹⁰⁴ investigations into the behavior of foreign officials and commercial businesses have significantly increased.¹⁰⁵ Chinese leadership has recognized that corruption is a problem, one that “could destroy the Communist Party.”¹⁰⁶

Corruption has a variety of significant effects on a country. It “distorts markets and competition, breeds cynicism among citizens, undermines the rule of law, damages government legitimacy, and corrodes the integrity of the private sector. It is also a major barrier to international development—systemic misappropriation by kleptocratic governments harms the poor.”¹⁰⁷ On October

⁹⁹ Boltz, *supra* note 7, at 31.

¹⁰⁰ Edward Cody, *Hundreds Are Reproved By China for Corruption*, WASH. POST, Dec. 17, 2004, at A25, available at <http://www.washingtonpost.com/wp-dyn/articles/A4412-2004Dec16.html>.

¹⁰¹ Meg Utterback, *Application of the Foreign Corrupt Practices Act in the PRC*, MONDAQ BUSINESS BRIEFING (May 16, 2007).

¹⁰² Goodman, *supra* note 3.

¹⁰³ *China Corruption: Power Tools*, EXECUTIVE BRIEFING CHINA (Feb. 14, 2007).

¹⁰⁴ *Id.*

¹⁰⁵ Kenneth J. DeWoskin & Ian J. Stones, *Facing the China Corruption Challenge*, FAR E. ECON. REV., Sept. 2006.

¹⁰⁶ *Corruption in China*, *supra* note 6.

¹⁰⁷ Ben W. Heineman, Jr. & Fritz Heimann, *The Long War Against Corruption*, FOREIGN AFF.,

FOREIGN CORRUPT PRACTICES ACT & U.S. BUSINESS OPERATION IN CHINA

31, 2003, the United Nations (UN) General Assembly adopted the Convention against Corruption,¹⁰⁸ which essentially acknowledged the aforementioned statement as a problem on a global scale. The Convention imposed numerous requirements on its signatories to take affirmative steps to criminalize corruption and implement mechanisms to combat international crimes of corruption.¹⁰⁹ The convention was “widely supported by developing countries”¹¹⁰ and was ratified by China in 2005 in an aggressive step to deal with its overwhelming problem with corruption.¹¹¹

China recently announced plans for the establishment of the Corruption Prevention Bureau as a means of fulfilling its obligations under the UN Convention against Corruption.¹¹² Unfortunately, these plans have been criticized for lack of investigative power and for providing too much objective governmental discretion as to which officials will be investigated and prosecuted.¹¹³ The Chinese government, overall, has faced wide-spread international criticism for taking little action to deal with foreign multinationals for making corrupt payments.¹¹⁴ Overall efforts to address the problem of corruption have been criticized as being “half-hearted.”¹¹⁵ One commentator noted that “many China-based companies operate on a day-to-day basis with a lot fewer restrictions than companies in the United States despite the existence of numerous laws and regulations in China.”¹¹⁶ China has complex anti-bribery laws that are very similar to the FCPA in that they prohibit corrupt payments to foreign officials and kickbacks in commercial transactions, but these laws are never consistently or rigorously enforced.¹¹⁷ In fact, a recent OECD report criticized China for its weak enforcement of its multinational anti-corruption covenants.¹¹⁸

Since corruption continues to be a more significant threat in China than in other nations, U.S. corporations conducting business operations in China are under constant exposure to FCPA actions initiated by either the DOJ or the SEC. The recent trend in enforcement activities illustrates the severity of

May-June 2006 at 76.

¹⁰⁸ G.A. Res. 58/4, ¶ 11, U.N. Doc. A/RES/58/4 (Nov. 21, 2003).

¹⁰⁹ *Id.*

¹¹⁰ Patrick X. Delaney, *Transnational Corruption: Regulation Across Borders*, 47 VA. J. INT'L L. 413, 429 (2007).

¹¹¹ China to Ratify UN Convention Against Corruption, *supra* note 89.

¹¹² *Corruption in China*, *supra* note 6.

¹¹³ *Id.* at 44.

¹¹⁴ Wu Chen, *View from China: Shanghai Confidential*, CFO MAG., Apr. 1, 2007, available at http://www.cfo.com/article.cfm/8885504/c_8910395?f=magazine_alsoinside.

¹¹⁵ *Corruption in China*, *supra* note 6.

¹¹⁶ Boltz, *supra* note 7 at 28.

¹¹⁷ Dufree, *supra* note 5.

¹¹⁸ DeWoskin & Stones, *supra* note 105.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

criminal and civil penalties arising from FCPA violations.

PART IV: RECENT FCPA ENFORCEMENT ACTIONS INVOLVING U.S.-
CHINA BUSINESS OPERATIONS

Several recent, high-profile cases illustrate how U.S. corporate undertakings with China have led to FCPA actions brought by the DOJ and SEC.¹¹⁹ As one commentator noted “China has not loomed large in the U.S. caseload, but that is changing fast.”¹²⁰ The FCPA violations involving Diagnostic Products Corp., Schnitzer Steel Industries, Lucent Technologies, Inc. and InVision Technologies, Inc. serve to highlight this growing trend.

A. Diagnostic Products Corporation

Diagnostic Products Corporation (hereinafter “DPC”) was a “producer and seller of diagnostic medical equipment” based in Los Angeles, California.¹²¹ DPC Tianjin Co. Ltd., was a wholly-owned subsidiary of DPC in China.¹²² From 1991 to 2002, DPC Tianjin made cash payments in the amount of \$1.6 million to physicians and laboratory personnel who controlled purchasing decisions at various state-owned hospitals in China.¹²³ The purpose of these payments was to obtain and retain business with these hospitals.¹²⁴ Payments were usually made in cash and delivered either by DPC Tianjin’s employees by way of mail or wire transfer.¹²⁵ This practice, which was authorized by the general manager of DPC Tianjin, involved transactions with personnel who met the definition of “foreign officials” under the FCPA because they were employed by hospitals owned by the Chinese government.¹²⁶ These corrupt payments were all recorded in DPC Tianjin’s books and records as legitimate sales expenses.¹²⁷

¹¹⁹ Leander, *supra* note 61.

¹²⁰ *Id.*

¹²¹ Press Release, Dep't of Justice, DPC (Tianjin) Ltd. Charged with Violating the Foreign Corrupt Practices Act (May 20, 2005), *available at* http://www.usdoj.gov/opa/pr/2005/May/05_crm_282.htm

¹²² *Id.*

¹²³ *Id.*

¹²⁴ *Id.*

¹²⁵ In the Matter of Diagnostic Products Corp, Admin. Proc., File No. 3-11933, (May 20, 2005), *available at* <http://www.sec.gov/litigation/admin/34-51724.pdf>.

¹²⁶ See Press Release, Dep't of Justice, (DPC), *supra* note 121.

¹²⁷ In the Matter of Diagnostic Products Corp., *supra* note 125.

FOREIGN CORRUPT PRACTICES ACT & U.S. BUSINESS OPERATION IN CHINA

DPC pled guilty to violating the FCPA's anti-bribery provisions and agreed to pay a criminal penalty of \$2 million.¹²⁸ As part of their plea agreement, DPC agreed to cooperate with ongoing DOJ and SEC investigations and to the appointment of an independent compliance consultant to monitor the implementation of "new internal policies and procedures."¹²⁹ In addition to action taken by the DOJ, the SEC ordered the DPC to cease and desist from further violations of the FCPA and to disgorge approximately \$2.8 million in ill-gotten gains, which represented DPC's net profit in China during DPC Tianjin's misconduct.¹³⁰

B. Schnitzer Steel Industries

In October 2006, SSI International Far East Ltd. (hereinafter "SSI Korea"), which was a subsidiary of Schnitzer Steel Industries Inc. (hereinafter "Schnitzer Steel"), pled guilty in federal district court to violations of the FCPA, including violations of the FCPA's anti-bribery and record keeping provisions.¹³¹ SSI Korea facilitated Schnitzer Steel's buying and reselling of metal, including the sale of scrap metal by Japanese suppliers, to steel mills in China and South Korea.¹³² Over a five-year period between September 1999 and August 2004, SSI Korea made approximately \$1.8 million dollars in corrupt payments "to officers and employees of nearly all of Schnitzer Steel's government-owned customers in China and private customers in China and South Korea."¹³³

SSI Korea wired money for the corrupt payments to secret bank accounts in South Korea, which were opened by the head of SSI Korea for the purpose of receiving such payments.¹³⁴ The funds were then used to make corrupt cash payments to the managers of Schnitzer's customers.¹³⁵ SSI also gave gifts to managers of their government-owned customers.¹³⁶ A senior official at Schnitzer Steel was aware of the corrupt payments and did, in fact, authorize the wire transfers of the money to the secret bank accounts.¹³⁷ Certain

¹²⁸ See Press Release, Dep't of Justice, (DPC), *supra* note 121.

¹²⁹ *Id.*

¹³⁰ In the Matter of Diagnostic Products Corp., *supra* note 125.

¹³¹ Press Release, Dep't of Justice, Schnitzer Steel Industries Inc.'s Subsidiary Pleads Guilty to Foreign Bribes and Agrees to Pay a \$7.5 Million Criminal Fine, (Oct. 16, 2006), *available at* http://www.usdoj.gov/criminal/pr/press_releases/2006/10/2006_4809_10-16-06schnitzerfraud.pdf.

¹³² *Id.*

¹³³ *Id.*

¹³⁴ In the Matter of Schnitzer Steel Industries, Inc., Admin. Proc., File No. 3-12456, (Oct. 16, 2006), *available at* <http://www.sec.gov/litigation/admin/2006/34-54606.pdf>.

¹³⁵ *Id.*

¹³⁶ *Id.*

¹³⁷ *Id.*

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

Japanese companies also provided SSI Korea with money to make corrupt payments to managers of the Chinese steel mills.¹³⁸ SSI Korea would then deliver the money to the managers of the Japanese steel mill customers.¹³⁹ Corrupt payments were made by SSI Korea, on behalf of their Japanese customers, to managers of Chinese government-owned steel mills in approximately eight different transactions.¹⁴⁰ These payments were recorded in Schnitzer Steel's books and records as refunds, rebates, sales commissions, and commission to the customer.¹⁴¹

The payments to managers of government-owned customers in China amounted to over \$204,000, while payments to private companies amounted to over \$1.6 million.¹⁴² These payments were made to "managers of private customers in South Korea and private and government owned customers in China to induce them to purchase, and to secure an improper advantage with respect to the purchase of scrap metal from Schnitzer Steel."¹⁴³ Profits derived from these corrupt payments included "realized gross revenue of approximately \$602,139,470 and profits of approximately \$54,927,319 on scrap metal sold to private sector Chinese and South Korean customers, and gross revenue of approximately \$96,396,740 and profits of approximately \$6,259,104, on scrap metal sold to government instrumentalities in China."¹⁴⁴

As part of a deferred prosecution agreement entered into with the DOJ, Schnitzer Steel agreed to pay a criminal fine of \$7.5 million and to "accept responsibility for the conduct of its employees, and the employees of its subsidiary, in making corrupt payments and aiding and abetting the making of false books and records entries; to adopt internal compliance measures; and to cooperate with ongoing criminal and SEC civil investigations."¹⁴⁵ Finally, given the fact that Schnitzer Steel had never provided training to its employees on the requirements of the FCPA and failed to monitor its employees,¹⁴⁶ the parent company also agreed to the appointment of an independent compliance consultant to review and monitor the implementation of a FCPA compliance program.¹⁴⁷

In addition to criminal penalties, Schnitzer Steel incurred civil penalties from the SEC. Schnitzer Steel was ordered by the SEC to "cease and

¹³⁸ *Id.*

¹³⁹ *Id.*

¹⁴⁰ *Id.*

¹⁴¹ *Id.*

¹⁴² Press Release, Dep't of Justice, (Schnitzer), *supra* note 131.

¹⁴³ *Id.*

¹⁴⁴ *Id.*

¹⁴⁵ *Id.*

¹⁴⁶ In the Matter of Schnitzer Steel Industries, Inc., *supra* note 134.

¹⁴⁷ Press Release, Dep't of Justice, (Schnitzer), *supra* note 131.

FOREIGN CORRUPT PRACTICES ACT & U.S. BUSINESS OPERATION IN CHINA

desist from committing or causing any violations and any future violations of Sections 13(b)(2)(A), 13(b)(2)(B), and 30A of the Exchange Act.”¹⁴⁸ Finally, Schnitzer Steel agreed to pay a civil fine in the amount of approximately \$7.7 million to the United States Treasury.¹⁴⁹

C. Lucent Technologies, Inc.

Lucent Technologies, Inc. (hereinafter “Lucent”) was a telecommunications equipment operator with operations in China that “accounted for 11 per cent of its revenue” for the 2003 fiscal year.¹⁵⁰ During an internal audit and subsequent investigation, Lucent discovered incidents and deficiencies in its internal control program for its operations in China that amounted to violations of the FCPA.¹⁵¹ Internal auditors also found that Lucent’s executive officials had bribed Chinese officials at state-owned telecommunications companies.¹⁵²

In September 2006, the SEC “warned Lucent Technologies to expect an ‘enforcement action’ over violations of the Foreign Corrupt Practices Act (FCPA) by executives at its Chinese operations.”¹⁵³ This came even after Lucent fired four executives of its Chinese operations including the president, the chief operating officer, marketing executive and a finance manager.¹⁵⁴ Like Schnitzer Steel, Lucent disclosed these violations to both the SEC and the DOJ.¹⁵⁵ As of this writing, final disposition in this matter is still pending.

D. InVision Technologies, Inc.

InVision Technologies, Inc. (hereinafter “InVision”) was a company based in California that sold airport security screening products that were designed to detect explosives in passenger luggage.¹⁵⁶ An investigation by the

¹⁴⁸ In the Matter of Schnitzer Steel Industries, Inc., *supra* note 134.

¹⁴⁹ *Id.*

¹⁵⁰ Mark O’Neill, *China’s Give-and-Take Traditions Strained by US Anti-Graft Efforts*, SOUTH CHINA MORNING POST, Apr. 18, 2005, available at http://www.chinawhys.com/img/SCMP_com%20-%20Archive%20Search%20-%20Main%20Search.htm.

¹⁵¹ Jeffrey Gold, *Lucent Says It May Face SEC Enforcement*, Sept. 6, 2006, <http://www.foxnews.com/wires/2006Sep06/0,4670,LucentSEC,00.html>.

¹⁵² Goodman, *supra* note 3.

¹⁵³ Sumner Lemon, *SEC Plans ‘Action’ Over Corruption at Lucent China*, Sept. 7, 2006, http://www.infoworld.com/article/06/09/07/HNcorruptionatlucent_1.html.

¹⁵⁴ Stephen Taub, *Lucent Fires Four on Bribery Suspicions*, CFO, April 7, 2004, <http://www.cfo.com/article.cfm/3013085?f=related>.

¹⁵⁵ Gold, *supra* note 151.

¹⁵⁶ Dep’t of Justice, *InVision Technologies Enters into Agreement with the United States*, (Dec. 6,

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

DOJ and SEC revealed that from June 2002 through June 2004, InVision was aware of the high probability that some of its foreign sales agents and independent distributors in China were paying bribes in the amount of \$95,000 to foreign government officials to obtain business for the company.¹⁵⁷ Despite this knowledge, InVision still authorized payments to these agents or distributors, and allowed them to conduct these transactions on InVision's behalf.¹⁵⁸ These corrupt payments were recorded in InVision's books and records as the cost of goods sold.¹⁵⁹

InVision paid a \$500,000 criminal penalty for their violations of the FCPA.¹⁶⁰ Additionally, the SEC issued a cease and desist order, directing InVision to pay disgorgement and mandating both independent consultation for management of InVision's books and records as well as the implementation of an FCPA compliance program.¹⁶¹

PART V: THE FCPA'S APPLICATION TO U.S. BUSINESS OPERATIONS IN CHINA

Recent enforcement actions by the DOJ and SEC illustrate how business operations in China present unique FCPA concerns for U.S. corporations hoping to take advantage of the booming Chinese economy. The corruption level in China substantially increases the duty of a U.S. corporation to investigate, and assume responsibility for, the Chinese-half of any U.S.-China joint venture. Additionally, with a great number of Chinese businesses still under the control or outright ownership of the Chinese government, U.S. corporations are constantly faced with the unique problem of determining who is a "foreign official" for purposes of the FCPA. These issues present very serious and significant challenges to U.S. corporations.

A. Joint Ventures in China

A joint venture is defined as "a business undertaking by two or more persons engaged in a single defined project. The necessary elements are: (1) an express or implied agreement; (2) a common purpose that the group intends to carry out; (3) shared profits and losses; and (4) each member's equal voice in

2004), http://www.usdoj.gov/opa/pr/2004/December/04_crm_780.htm.

¹⁵⁷ In the Matter of GE InVision, Inc. (formerly known as InVision Technologies, Inc.), Exchange Act Release No. 51, 199 (Feb. 14, 2005), *available at* <http://www.sec.gov/litigation/admin/34-51199.htm>.

¹⁵⁸ *Id.*

¹⁵⁹ *Id.*

¹⁶⁰ *Id.*

¹⁶¹ Exchange Act Release No. 51, 199, *supra* note 157.

FOREIGN CORRUPT PRACTICES ACT & U.S. BUSINESS OPERATION IN CHINA

controlling the project.”¹⁶² Usually joint ventures are formed when two parties have a unique contribution of resources to make towards the development of a commercial opportunity in a specific market, but neither party has all of the necessary resources to develop the opportunity.¹⁶³ The U.S.-half of the joint venture will usually contribute the resources it has available in its own domestic market such as capital, trademarks, technology, management and any expertise with regard to the particular opportunity.¹⁶⁴ The foreign-half of the joint venture may contribute the same resources as its joint U.S. counterparts. However, the foreign-half may contribute resources to the joint venture that would be expensive, if not impossible, for the U.S.-half to acquire. These resources may include insight into local customs and cultures, language skills, foreign business expertise, and most importantly, the right to pursue the foreign opportunity that would otherwise be limited by the laws of the foreign nation.¹⁶⁵

In 1979, China passed the Sino-Foreign Equity Joint Venture Law, which was followed by a flood of similar legislations designed to promote investment in China.¹⁶⁶ Joint ventures between U.S. and Chinese businesses are usually attractive ways for a U.S. business to take advantage of the Chinese market. Many U.S. businesses have come to the realization that in order to be competitive in domestic markets it is imperative to compete in global markets as well. The 1990’s saw a substantial increase in “foreign direct investment (FDI) and research and development (R&D)-related activity” by U.S.-owned businesses in China.¹⁶⁷ This was significantly noticeable in China’s information technology sector, which saw a number of businesses increasing their technology development activities, to exploit China’s technological capabilities.¹⁶⁸ The investments of U.S. corporations in China almost quadrupled between 1994 and 2001.¹⁶⁹ Companies such as Ford, DuPont, Ford, IBM, Lucent Technologies, General Electric, Microsoft, General Motors, Motorola, Intel, and Rohm and Haas have taken part in international joint ventures in China.¹⁷⁰ These joint ventures have provided opportunities for U.S. businesses to market directly to China. Unfortunately, these profitable opportunities have also led to heightened risk of violations of the FCPA.

¹⁶² BLACK’S LAW DICTIONARY (8th ed. 2004).

¹⁶³ Franklin C. Jesse, Jr. & Gary Plant Mooty, *International Joint Ventures*, SM053 ALI-ABA 457, 460 (2006).

¹⁶⁴ *Id.*

¹⁶⁵ *Id.*

¹⁶⁶ Kim Newby, *Doing Business in China: How the State of 1.3 Billion Can Tap the Nation of 1.3 Billion*, 19 ME. B.J. 238, 239 (2004).

¹⁶⁷ Francisco Moris, *U.S.-China R&D Linkages: Direct Investment and Industrial Alliances in the 1990s*, NAT’L SCI. FOUND., 1, 1 (Feb. 2004).

¹⁶⁸ *Id.*

¹⁶⁹ *Id.* at 2.

¹⁷⁰ *Id.*

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

A U.S.-China joint venture runs an unreasonably substantial risk of FCPA violations for three reasons. First, the U.S.-half of the joint venture will usually lack control of general business operations. Second, the joint venture will most likely be largely owned by a Chinese entity that is accustomed to making or receiving corrupt payments. Finally, there is always a substantial risk that the Chinese entity will have some level of government ownership or control, thus rendering it a “foreign official” for purposes of the FCPA.

B. “Foreign Officials” in China

The FCPA only deals with corrupt payments made to foreign government officials, thus excluding the making of such payments to foreign persons who are not governmental officials. One of the more complex problems a U.S. corporation faces when doing business in China is determining exactly who falls into the category of a “foreign official.” The FCPA defines a “foreign official” as:

[A]ny officer or employee of a foreign government or any department, agency, or instrumentality thereof, or of a public international organization, or any person acting in an official capacity for or on behalf of any such government or department, agency, or instrumentality, or for or on behalf of any such public international organization.¹⁷¹

In an FCPA opinion released in 1993 regarding a joint venture between a U.S. commercial organization and a commercial entity that was owned and supervised by a foreign government, the DOJ interpreted the phrase “officer or employee of a foreign government” to include government-owned businesses.¹⁷² This interpretation is also supported by the Organization for Economic Cooperation and Development Convention on Combating Bribery of Foreign Public Officials in International Business Transactions, which defined a “foreign public official” as:

[A]ny person holding a legislative, administrative or judicial office of a foreign country, whether appointed or elected; any person exercising a public function for a foreign country, including for a public agency or public enterprise; and any official or agent of a public international organization.¹⁷³

¹⁷¹ 15 U.S.C. §78dd-1(f)(1)(A) (2000).

¹⁷² U.S. Dep’t of Justice, *Foreign Corrupt Practice Act Review Opinion Procedure Release No. 93-01*, (Apr. 20, 1993), available at <http://www.usdoj.gov/criminal/fraud/fcpa/opinion/1993/9301.html>.

¹⁷³ Org. for Econ. Co-operation & Dev., OECD Convention on Combating Bribery of Foreign

FOREIGN CORRUPT PRACTICES ACT & U.S. BUSINESS OPERATION IN CHINA

This presents a significant problem for U.S. businesses seeking to conduct business in China where “state-owned firms. . . are among the largest in China and include more than half the country’s industrial assets.”¹⁷⁴ Most businesses that are listed on the Chinese stock exchanges are state owned enterprises with strong links to the government.¹⁷⁵ Moreover, there is a tendency in China for business personnel to simultaneously hold multiple positions in the government or political arena.¹⁷⁶ Thus, it is highly likely that the DOJ and SEC would view a senior executive of a large Chinese company as a “foreign official” for purposes of the FCPA.

The case involving Diagnostic Products (discussed in part IV, A) was a perfect example of the DOJ concluding that government-owned hospitals in China were government instrumentalities, thus rendering the physicians and laboratory personnel “foreign officials” under the FCPA.¹⁷⁷ Despite an apparent move by China to begin the privatization of state owned enterprises,¹⁷⁸ several questions still remain regarding a Chinese business that is not completely controlled by the state. Given the lack of clear guidance, U.S. corporations are forced into a precarious position where they must assume that everyone they deal with in China will fall into the category of a “foreign official.”

PART VI: IS THE FCPA PUTTING THE UNITED STATES AT A COMPETITIVE DISADVANTAGE IN CHINA?

One of the prevalent, on-going criticisms of the FCPA is that it puts U.S. businesses at a competitive disadvantage compared to their foreign counterparts who are under no such rigorous anti-bribery restrictions as the FCPA.¹⁷⁹ In 1998 Congress realized that since the enactment of the FCPA, U.S. businesses “operated at a disadvantage relative to foreign competitors

Public Officials in International Business Transactions (Nov. 21, 1997), *available at* http://www.oecd.org/documentprint/0,3455,en_2649_37447_2017813_1_1_1_37447,00.html.

¹⁷⁴ *The Long and Winding Road to Privatization in China*, *supra* note 8.

¹⁷⁵ Stoyan Tenev, Chunlin Zhang & Loup Brefort, CORPORATE GOVERNANCE AND ENTERPRISE REFORM IN CHINA: BUILDING THE INSTITUTIONS OF MODERN MARKETS 83 (Mar. 15, 2002), *available at*

[http://www.ifc.org/ifcext/publications.nsf/AttachmentsByTitle/CorpGovernanceinChinaFullReport/\\$FILE/CGinChina_FullReport.pdf](http://www.ifc.org/ifcext/publications.nsf/AttachmentsByTitle/CorpGovernanceinChinaFullReport/$FILE/CGinChina_FullReport.pdf).

¹⁷⁶ Samuel Porteous, *Foreign Corrupt Practice Act Issues in China*, BUSINESS GUIDE TO BEIJING AND NORTH-EAST CHINA, Mar. 2006, *available at* [http://www.navigantconsulting.com/A559B1/navigantnew.nsf/vGNCNTByDocKey/PPE3DF4B4F2030/\\$FILE/FCPA_issuesChina.pdf](http://www.navigantconsulting.com/A559B1/navigantnew.nsf/vGNCNTByDocKey/PPE3DF4B4F2030/$FILE/FCPA_issuesChina.pdf).

¹⁷⁷ Dep't of Justice, *supra* note 121.

¹⁷⁸ *How to Make China Even Richer*, THE ECONOMIST, May 25, 2006, at 11.

¹⁷⁹ Terry Collingsworth, “Corporate Social Responsibility” *Unmasked*, 16 ST. THOMAS L. REV. 669, 673 (2004).

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

who...continued to pay bribes without fear of penalty.”¹⁸⁰ With corporate protests over the FCPA growing, Congress directed the Executive Branch to begin negotiations with the Organization of Economic Cooperation and Development (OECD) to encourage the major trading partners of the United States to enact laws similar to the FCPA.¹⁸¹ Members of the Convention were required to implement laws criminalizing the bribery of foreign officials.¹⁸²

The end results of the OECD Convention have been criticized due to conflicting laws that were subsequently enacted by the member nations, and an overall lack of uniform enforcement of anti-bribery provisions.¹⁸³ Howard Weissman, Associate General Counsel-International of Lockheed Martin Corporation, noted:

I believe that some progress has been made in raising the awareness of non-U.S. companies of the need for anti-bribery compliance. I do not believe, however, that the “playing field” has been leveled yet for U.S. companies. I do not think this will happen until some of the other OECD countries have actually brought enforcement actions and imposed penalties on companies and individuals within their jurisdictions for directly or indirectly paying or offering bribes to foreign officials.¹⁸⁴

Critics of OECD, as well as other anti-corruption efforts, have been quick to point out the limited impact and enforcement of its measures and have also expressed pessimism on the prospects of any quick and efficient changes in the global business environment.¹⁸⁵ A study conducted by World Bank concluded that “US anti-corruption legislation and the OECD anti-bribery Convention, were not leading ‘to higher standards of corporate conduct among foreign investors’.”¹⁸⁶ The United States, therefore, remains at a competitive business disadvantage with other nations that conduct business operations in China and do not enforce the provisions of OECD or their own anti-bribery provisions as vigorously as the U.S. government enforces the FCPA. Moreover,

¹⁸⁰ S. REP. NO. 105-277, at 2 (1998).

¹⁸¹ Mark L. Tuft, *Foreign Corrupt Practices Act*, 701 PLI/LIT 167, 192 (2003).

¹⁸² See Org. for Econ. Co-op & Dev., *supra* note 173.

¹⁸³ Peter W. Schroth, *The United States and the International Bribery Conventions*, 50 AM. J. COMP. L., 593, 613-614 (2002).

¹⁸⁴ Homer E. Moyer, Jr., *Roundtable: The Foreign Corrupt Practices Act—Its Many Lives*, 1544 PLI/CORP 179, 321 May 2006.

¹⁸⁵ Cecil Hunt, *Recent Multilateral Measures to Combat Corruption*, SJ078 A.L.I.-A.B.A. 259, 265 (2004).

¹⁸⁶ Susan Hawley, *Briefing 30: Underwriting Bribery, Export Credit Agencies and Corruption*, THE CORNER HOUSE, Dec. 2003, at 2 (citing Joel S. Hellman, et al., *Far from Home: Do Foreign Investors Import Higher Standards of Governance in Transition Economies?*, (The World Bank, Policy Research Working Paper, 2002), <http://www.worldbank.org/wbi/governance/pdf/farfromhome.pdf>).

FOREIGN CORRUPT PRACTICES ACT & U.S. BUSINESS OPERATION IN CHINA

China is not an OECD member nation¹⁸⁷ and with the exception of a minor, distended corruption project of the Asia-Pacific Economic Cooperation (hereinafter “APEC”), Asia has no regional convention to deal with corruption.¹⁸⁸

The FCPA has not reduced corruption in other countries mainly because foreign countries that have no firm anti-corruption laws, or simply do not aggressively enforce the laws they do have, are eager to seize a business opportunity that a U.S. corporation could not take due to the FCPA.¹⁸⁹ As a result, U.S. business operations have been significantly curtailed in emerging countries such as China. In fact, a survey of 250 of the top 1000 businesses in the United States by the General Accounting Office resulted in 30% of the respondents claiming that the FCPA had a negative impact on its overseas business operations.¹⁹⁰ A study of the FCPA, conducted by the John F. Kennedy School of Government at Harvard University, revealed not only a significant decline in U.S. business operations in corrupt countries since the enactment of the FCPA, but also a shift from the U.S. to foreign countries that were more willing to make corrupt payments.¹⁹¹ The study concluded that:

The apparent relative decline of American business activity in the more-corrupt countries after 1977 does not necessarily imply US legislation reduced total levels of foreign business activity, of even bribe payments by foreign multinationals, in these countries. The reason is that foreign firms may simply have replaced American firms in the more bribery-intensive activities in these countries, either by acquiring US operations or through the withdrawal of US firms from the market. US

¹⁸⁷ Organisation for Economic Co-operation and Development, Ratification of the Convention on the OECD, http://www.oecd.org/document/58/0,2340,en_2649_201185_1889402_1_1_1_1,00.html (listing the OECD member nations as Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Spain, Sweden, Switzerland, Turkey, United Kingdom and United States).

¹⁸⁸ Lucinda A. Low, Owen Bonheimer & Negar Katirai, *Enforcement of the FCPA in the United States: Trends and the Effects of International Standards*, Practising Law Institute (citing APEC Course of Action on Fighting Corruption and Ensuring Transparency (Sept. 2004), http://www.apecsec.org.sg/apec/apec_groups/other_apec_groups/anti-corruption.html).

¹⁸⁹ See generally Shang-Jin Wei, BRIBERY IN THE ECONOMIES: GREASE OR SAND? (THE BROOKINGS INSTITUTION 2000), available at https://www.brookings.edu/~media/Files/rc/papers/2000/0115globalization_wei/20000115.pdf.

¹⁹⁰ Daniel Pines, *Amending the Foreign Corrupt Practices Act to Include a Private Right of Action*, 82 CAL. L. REV. 185, 208-9 (1994) (citing U.S. GEN. ACCOUNTING OFFICE, REPORT TO THE CONGRESS: IMPACT OF THE FOREIGN CORRUPT PRACTICES ACT ON U.S. BUSINESS, at 60 (1981)).

¹⁹¹ James Hines, *Forbidden Payment: Foreign Bribery and American Business After 1977*, NBER WORKING PAPER 5266, Sept. 1995, at 1.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

legislation in 1976 and 1977 changes the relative attractiveness of more-corrupt and less corrupt locations for US investors, thereby encouraging ownership substitution between American and foreign investors.¹⁹²

The evidence is conclusive that the FCPA does, in fact, cause U.S. corporations to lose significant business opportunities in transitional economies such as China.

Corruption remains an unsettling issue in China; one that is, according to Prime Minister Wen Jiabo, becoming “more and more serious” and one that Chinese leadership has been criticized for failing to aggressively pursue.¹⁹³ Nevertheless, if the United States is to remain competitive in a fast-paced, global environment, it cannot ignore or significantly reduce its business dealings in China. With a population of over 1.3 billion people¹⁹⁴ – amounting to roughly one-sixth of the world’s population¹⁹⁵ - and the expectation that China will be the world’s top trading nation in the next ten years,¹⁹⁶ U.S. businesses simply cannot afford to cut themselves out of that customer base. China’s transition from a non-capitalist regime to a modern economy raises questions as to whether the United States should continue in its lonely quest to discourage corrupt payments through enforcement of the FCPA.

PART VII: AMENDING, RELAXING OR REPEALING THE FCPA

The vagueness of the FCPA, the current trend in government enforcement actions, and the lack of clear guidance by which U.S. businesses can legally operate, renders the Act unworkable in China’s current climate of corruption. Therefore, the intricate conflict between the need to take advantage of the thriving Chinese economy and the competitive disadvantage the United States presently faces, requires that the FCPA be revisited to determine what steps, if any, should be taken to modify, strengthen or abolish the Act together.

¹⁹² *Id.* at 19-20.

¹⁹³ *Corruption in China*, *supra* note 6 at 44.

¹⁹⁴ Central Intelligence Agency, *The World Factbook*, *supra* note 68.

¹⁹⁵ *Id.* (stating that the world population as of July 6, 2007 was 6.6 billion which was used to derive this fraction) available at <https://www.cia.gov/library/publications/the-world-factbook/print/xx.html>.

¹⁹⁶ Eban Kaplan, *The Uneasy U.S. – Chinese Trade Relationship*, *Council on Foreign Relationships*, COUNCIL ON FOREIGN RELATIONS, Apr. 19, 2006, http://www.cfr.org/publication/10482/uneasy_uschinese_trade_relationship.html.

FOREIGN CORRUPT PRACTICES ACT & U.S. BUSINESS OPERATION IN CHINA

A. Repealing the FCPA: A Duplicitous Act

While a U.S. corporation may be at a competitive disadvantage with other nations that do not rigorously enforce their anti-corruption laws, FCPA compliance remains critical for three reasons, aside from avoiding DOJ and SEC criminal and civil liability. The first reason is the recent international recognition of the negative impacts of corruption on a global level and the subsequent efforts to curtail corrupt international business practices. Second, China is slowly beginning to witness the overall impacts of corruption on its own economy and now has incentive to either comply with, or implement new, anti-corruption regulations. Third is the necessity for the United States to continue its efforts to level the proverbial “playing field” in its anti-corruption efforts and set an example for other nations with regard to international business transactions.

Over the last decade, there has been a rather remarkable international interest in combating corruption which can be seen by numerous regional conventions such as the Inter-American Convention against Corruption,¹⁹⁷ the Criminal Law Convention on Corruption,¹⁹⁸ the Civil Law Convention on Corruption,¹⁹⁹ and the African Union Convention on Preventing and Combating Corruption.²⁰⁰ In addition to these various regional agreements, the United Nations (hereinafter “UN”) recently took action to combat corruption on a global level. In October of 2003, the UN General Assembly adopted the Convention against Corruption.²⁰¹ The Convention imposed numerous requirements on its signatories to take affirmative steps to criminalize corruption and implement mechanisms to combat international crimes of corruption.²⁰² The Convention, which was “widely supported by developing countries,”²⁰³ was ratified by China in 2005 in an aggressive step to manage its overwhelming problem with corruption.²⁰⁴

Recent studies indicate that despite its economic growth, China is being negatively affected by corruption.²⁰⁵ In the short run, corruption has

¹⁹⁷ Hunt, *supra* note 185, at 261.

¹⁹⁸ *Id.*

¹⁹⁹ *Id.* at 261-62.

²⁰⁰ *Id.* at 262.

²⁰¹ See G.A. Res. 58/4, *supra* note 108.

²⁰² See *id.*

²⁰³ Patrick X. Delaney, *Transnational Corruption: Regulation Across Borders*, 47 VA. J. INT'L L. 413, 429 (Winter 2007).

²⁰⁴ ChinaDaily.com, China to Ratify UN Convention Against Corruption, ChinaDaily.com, http://www.chinadaily.com.cn/english/doc/2005-10/22/content_487050.htm (last visited Oct. 23, 2005).

²⁰⁵ Andrew White, *The Paradox of Corruption as Antitheses to Economic Development in Indonesia and China and Why Are the Experiences Different in Each Country?*, 8 ASIAN-PAC. L. & POL'Y J. 1,

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

contributed to China's economic growth, however the long term effects of corruption may end up actually distorting the Chinese economy.²⁰⁶ Corruption has recently led to reduced economic output which has caused a drain on the Chinese economy.²⁰⁷ Professor Angang, an economist at Tsinghua University, noted that "China may very well be the country with the most enormous economic losses in the world caused by corruption."²⁰⁸ Thus, now more than ever, China has some incentive to deal with its corruption crisis.

The large number of countries that have signed on to the UN Convention against Corruption (including China) should be an unmistakable indication of the global willingness of nations to be subject to anti-corruption laws.²⁰⁹ As such, the United States must continue to set the global standard when regulating business operations in China by forcing U.S. corporations to comply with the provisions of the FCPA. The long term impacts of the failure to do so will greatly outweigh the short-term benefits of conducting business in China while utilizing corrupt practices.

In addition to undermining global efforts to curb corrupt practices, allowing corrupt payments would encourage U.S. businesses to develop effective bribery programs, rather than overall efficiency and a good work product. Prior to the enactment of the FCPA, the Senate Banking Committee noted:

[Bribery] short-circuits the marketplace by directing business to those companies too inefficient to compete in terms of price, quality or service, or too lazy to engage in honest salesmanship, or too intent upon unloading marginal products. In short, it rewards corruption instead of efficiency and puts pressure on ethical enterprises to lower their standards or risk losing business.²¹⁰

Abolishing the FCPA and allowing for corruption would undermine the economic interests of the United States by pressuring businesses to remain competitive through lowering their ethical standards rather than by encouraging competition based on quality products and services. As such, U.S. corporations must continue to set the global standard when conducting business operations in

2 (2006).

²⁰⁶ *Id.*

²⁰⁷ *See id.* at 32 (citing Charles Wolf, Jr., et al., FAULT LINES IN CHINA'S ECONOMIC TERRAIN 32-33 (2003), available at http://www.rand.org/pubs/monograph_reports/MR1686/MR1686.pref.pdf).

²⁰⁸ Hu Angang, *Public Exposure of Economic Losses Resulting from Corruption*, 4 CHINA & WORLD ECON., 44, 48 (2002).

²⁰⁹ Delaney, *supra* note 110, at 429.

²¹⁰ Unlawful Corporate Payment Act of 1977, H.R. REP. NO. 95-640 at 4-5 (1977).

FOREIGN CORRUPT PRACTICES ACT & U.S. BUSINESS OPERATION IN CHINA

China by complying with the provisions of the FCPA, even if that means operating at a competitive disadvantage with countries that do not aggressively enforce anti-corruption laws.

B. Strengthening the FCPA: Providing Real Time Guidance in a Fast-Paced Global Economy

The DOJ's FCPA opinion procedure allows a business or individual seeking to take part in a foreign business operation to make a specific inquiry to the DOJ as to whether the proposed business conduct would violate the FCPA. This process is designed to "enable issuers and domestic concerns to obtain an opinion of the Attorney General as to whether certain specified, prospective—not hypothetical—conduct conforms with the Department's present enforcement policy regarding the anti-bribery provisions of the Foreign Corrupt Practices Act of 1977."²¹¹ The DOJ has 30 days to respond to the inquiry and must either issue an opinion as to whether the proposed conduct would violate the FCPA, or request additional information regarding the business operation.²¹²

While the opinion procedure has the potential of being tremendously beneficial to U.S. corporations who have hesitations regarding a business transaction in China, the procedure, overall, is rarely utilized. In fact, the DOJ's recent aggressive stance on FCPA enforcement has been criticized as "all stick and no carrot," with criminal investigations on the rise, yet no increase in U.S. businesses' use of the procedure.²¹³ Since the procedure was enacted in 1980, there have been roughly 43 requests for guidance.²¹⁴ From 1993 to 2006 there were only 22 requests made by U.S. businesses for guidance, with four or less requests made each year.²¹⁵ The slow process of the opinion procedure was the most common criticism cited by U.S. businesses that are often in the position of having to put together complex business propositions for submission and do not have a month to wait for a DOJ opinion before engaging in an overseas transaction.²¹⁶

With China rapidly undergoing both social and economic change, the country is starting to witness consistent changes to its laws, region by region.²¹⁷

²¹¹ 28 C.F.R. § 80.1 (2003).

²¹² 28 C.F.R. § 80.8 (2003).

²¹³ Mark Miller, *More Carrot, Less Stick*, SAN FRANCISCO RECORDER, Dec. 15, 2006.

²¹⁴ *Id.*

²¹⁵ See Foreign Corrupt Practices Act Review, Opinion Procedure Releases, available at <http://www.usdoj.gov/criminal/fraud/fcpa/opinion> (listing twenty-two total Opinion Procedure Releases between 1993 and 2006) (last visited Mar. 12, 2008).

²¹⁶ Miller, *supra* note 213.

²¹⁷ Kevin Orfield, *Go East Young Executive: Doing Business in China is Finally Starting To Pay Off, But is the Time Right for Your Company?*, http://www.bus.wisc.edu/update/winter05/business_in_china.asp.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

The Chinese government “looks at rules as works in progress. So, business decisions based on rules may not be correct a couple months later.”²¹⁸ If the facts provided by a U.S. corporation regarding a foreign business transaction in the initial DOJ opinion procedure query are altered, then the DOJ opinion will not be binding on the U.S. business.²¹⁹ This severely limits the flexibility by which a U.S. business can operate abroad.

China, while not traditionally a cultural environment accustomed to quick business dealings, is rapidly becoming an economic environment where U.S. corporations are forced into a position of seizing a business opportunity promptly. China’s rapid transformation from a state controlled-planned economy to a market-based economy requires that U.S. corporations move quickly to implement business operations or potentially lose the opportunity to a foreign competitor.²²⁰ As one commentator observed, “[y]ou may think you have a deal [in China] and a day or two later something changes – that’s just the way it is.”²²¹ In this fast-paced Chinese economy, the 30-day opinion procedure of the DOJ (sometimes longer if additional information is requested) is simply too long for a U.S. corporation to wait before it can agree upon the terms of a Chinese business operation. Moreover, “companies are not likely to have complete information about a transaction until it is ready to go – which is usually the point when a company is least likely to be able to put it on hold while DOJ deliberates.”²²² This presents a problem for corporations that may greatly benefit from the DOJ opinion procedure. Once the opinion procedure is triggered, a U.S. business has no way to predict when the procedure will be concluded.

The DOJ currently has sufficient resources available to investigate and prosecute cases involving bribery.²²³ However, more resources need to be devoted to the opinion procedure to assist the DOJ in fulfilling its responsibilities of providing real-time guidance to businesses at the outset of an overseas operation. The procedure would operate more effectively if, absent a response by the DOJ within one week, the U.S. business is able to proceed with the business transaction with the understanding that the DOJ agrees that the transaction will not violate the FCPA.

In addition to its slow pace, the opinion procedure has “no application to any party which does not join in the request for the opinion”²²⁴ Moreover,

²¹⁸ *Id.*

²¹⁹ 28 C.F.R. Part 80.5 (2003).

²²⁰ Orfield, *supra* note 217.

²²¹ *Id.*

²²² Miller, *supra* note 213.

²²³ Daniel K. Tarullo, *The Limits of Institutional Design: Implementing the OECD Anti-Bribery Convention*, 44 VA. J. INT’L L. 665, 707 (2004).

²²⁴ 28 C.F.R. § 80.5 (2003).

FOREIGN CORRUPT PRACTICES ACT & U.S. BUSINESS OPERATION IN CHINA

there is very little case law on the FCPA²²⁵ which sets precedent for a U.S. business to operate legally. Problems with FCPA compliance are the result not only of its vague language, but also the lack of guidance provided to U.S. businesses.²²⁶ Therefore, rather than confining its opinions to a specific set of individual facts, the opinion procedure must create precedent and provide overall guidance to U.S. corporations.

Strengthening the opinion procedure through efficiency and overall FCPA education would be beneficial to both U.S. corporations and the U.S. government. First, it will encourage a U.S. corporation to take advantage of the already under-utilized DOJ opinion procedure if the corporation believes it can receive real-time FCPA guidance. Second, given the recent increase in FCPA investigations conducted by the DOJ and SEC and the costs incurred, the benefits of devoting more resources to strengthening the opinion procedure would be worth the costs.²²⁷ Finally, allowing the opinion procedure to serve as precedent for later decisions would be a substantial step in furtherance of eliminating the vagueness of the FCPA.

C. Amending the FCPA: Eliminate the Vagueness or Fortify the Red Flags

The legislative history of the FCPA supports the argument that the Act was not meant to punish a U.S. corporation for mere negligence.²²⁸ However, as of late, the DOJ has been increasingly willing to prosecute U.S. businesses for conduct that is not clearly actionable under a strict reading of the FCPA by utilizing many varying theories of liability.²²⁹ This was most notably observed in the DPC prosecution, where FCPA violations were charged based on the theory that Tianjin Co. was acting as a subsidiary of its California-based company.²³⁰

Employees of a U.S. corporation may “turn a blind eye and allow improper payments through third-party intermediaries under the misguided assumption that such payments will not violate U.S. law.”²³¹ While a foreign agent is not subject to the FCPA, the agent’s conduct may create FCPA exposure for a U.S. corporation. This poses a substantial problem in China,

²²⁵ Koch, *supra* note 38, at 400.

²²⁶ Jennifer Dawn Taylor, *Ambiguities in the Foreign Corrupt Practices Act: Unnecessary Costs of Fighting Corruption?*, 61 LA. L. REV. 861, 881 (2001).

²²⁷ Miller, *supra* note 213.

²²⁸ H.R. Rep. No. 100-576 at 920 (1988).

²²⁹ Justin F. Marceau, *A Little Less Conversation, A Little More Action: Evaluating and Forecasting the Trend of More Frequent and Severe Prosecutions Under the Foreign Corrupt Practices Act*, 12 FORDHAM J. CORP. & FIN L. 285, 309-10 (2007).

²³⁰ Press Release, Dep’t of Justice, *supra* note 121.

²³¹ Utterback, *supra* note 101.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

where conducting business operations generally requires the use of local agents and partners, and the “responsibility for dealing with local government officials and obtaining necessary approvals is typically not in the foreign investor’s hands but lies with the Chinese partner.”²³² The FCPA prohibits not only direct bribery, but also corrupt payments through the use of such an intermediary.²³³ A U.S. business can therefore be liable under the FCPA for corrupt payments made through an intermediary if they *knew* or *should have known* the payments would go to a foreign official.²³⁴ Specifically, a business can be held liable even if it “is aware. . . that such circumstance [for bribery] exists.”²³⁵ The requisite “knowledge is established if a person is aware of a high probability of the existence of such circumstance [for bribery].”²³⁶ This extraordinarily broad language affords the DOJ the advantage of having to prove only that a U.S. business knew of the “likelihood” of a corrupt payment, rather than an actual corrupt payment.

In a situation where a corporation should have *known* that an intermediary has made or will make a corrupt payment, the DOJ will look at whether the corporation was aware of any “red-flags” that would trigger knowledge of an FCPA violation, including:

[U]nusual payment patterns or financial arrangements, *a history of corruption in the country*, a refusal by the foreign joint venture partner or representative to provide a certification that it will not take any action in furtherance of an unlawful offer, promise, or payment to a foreign public official and not take any act that would cause the U.S. firm to be in violation of the FCPA, unusually high commissions, lack of transparency in expenses and accounting records, apparent lack of qualifications or resources on the part of the joint venture partner or representative to perform the services offered, and whether the joint venture partner or representative has been recommended by an official of the potential

²³² Patrick M. Norton, *The Foreign Corrupt Practices Act: A Minefield for US Companies in China*, CHINA LAW & PRACTICE, Nov. 2004,

<http://www.chinalawandpractice.com/Article.aspx?StoryID=4314>.

²³³ 15 U.S.C. §§ 78dd-1(a)(3), 78dd-2(a)(3) (2000).

²³⁴ 15 U.S.C. § 78dd-1(f)(2)(A) (2000) states that “[a] person’s state of mind is “knowing” with respect to conduct, a circumstance, or a result if-- (i) such person is aware that such person is engaging in such conduct, that such circumstance exists, or that such result is substantially certain to occur; or (ii) such person has a firm belief that such circumstance exists or that such result is substantially certain to occur.”

²³⁵ 15 U.S.C. § 78dd-1(f)(2)(A)(i) (2000).

²³⁶ 15 U.S.C. § 78dd-1(f)(2)(B) (2000).

FOREIGN CORRUPT PRACTICES ACT & U.S. BUSINESS OPERATION IN CHINA

governmental customer.²³⁷

While attention to the red flags will help shield a U.S. business from FCPA liability, the red flag provisions are extraordinarily subjective and impose a significantly greater restriction on U.S. businesses than other countries, especially since a U.S. business is subject to the provisions of the FCPA even if the corrupt payments made have no connection to the U.S. business.²³⁸

The general red flag provisions, coupled with the statutory language of the FCPA, places a U.S. corporation conducting business operations in China at a constant, unreasonably dangerous risk. Given the current level of corruption in China, U.S. business operations are likely to trigger general red flag provisions such as “a history of corruption in the country,”²³⁹ thereby giving the DOJ the advantage of easily proving beyond a reasonable doubt that the U.S. business knew that “such circumstance [for bribery] exists.”²⁴⁰ In China’s present climate of corruption such circumstances always exist. A U.S. corporation can be held liable for acts of an intermediary even if the business lacked knowledge, intent, or participation in the act just by nature of the fact that China is regarded as an environment where corruption is high, and the circumstances in which corrupt payments can be made always exist in such an environment. The general red flag provisions are, therefore, either meaningless or overly broad when applied to U.S. business operations in China.

The FCPA should be amended to remove the broad language that would give rise to expansive theories of civil and criminal liability. Specifically, the requirement that a person or a corporation has a “knowing” state of mind if “such circumstances exist,” should be removed from the statute.²⁴¹ An FCPA cause of action could still be initiated utilizing the knowledge inference of “aware that such person is engaging in such conduct,”²⁴² if a U.S. corporation was aware that an intermediary was taking part in corrupt payments. Furthermore, this amendment would not impede the government from pursuing an FCPA action against a U.S. corporation that turned a blind eye to corrupt activities, since the knowledge inference of “substantially certain to occur”²⁴³ would remain intact. Thus, the “bury the head in the sand” approach

²³⁷ LAY-PERSON’S GUIDE TO FCPA, *supra* note 29 (emphasis added).

²³⁸ Paul W. Boltz, CORPORATE GOVERNANCE: SO, YOU’VE SET THE TONE AT THE TOP – NOW WHAT?, PRACTICAL CONSIDERATIONS IN IMPLEMENTING GOOD CORPORATE GOVERNANCE AT THE MIDDLE MANAGEMENT AND STAFF LEVELS IN YOUR CHINA OPERATIONS, <http://www.mofo.com/docs/PDF/060401CorporateGovernance.pdf>.

²³⁹ LAY-PERSON’S GUIDE TO THE FCPA, *supra* note 29.

²⁴⁰ 15 U.S.C.A. §§ 78dd-2(f)(2)(A)(i); 78dd-2(f)(2)(A)(ii); 78dd-2(f)(3)(A)(i) & 78dd-2(f)(3)(A)(ii) (2000).

²⁴¹ See 15 U.S.C.A. § 78dd-2 (2000).

²⁴² 15 U.S.C. § 78dd-1(f)(2) (2000).

²⁴³ *Id.*

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

to corrupt payments made by intermediaries would remain a non-defense to the FCPA.

In the absence of an amendment to the FCPA removing the overly broad scienter requirement for FCPA liability if “such circumstance (for bribery) exists,” a common middle ground must be established with regard to the red flag provisions of the FCPA. This middle ground would contain two distinct factors essentially augmenting the red flag provision which is triggered when “history of corruption in the country”²⁴⁴ exists. First, since the DOJ’s opinion procedure provides little guidance or precedent, the provision should be modified in a manner which would specifically construe the phrase “such circumstances” to include specific enumerated acts of a foreign country that would put a U.S. business on notice of a strong possibility of corrupt payments being made, as opposed to simply looking at the annual Transparency International report²⁴⁵ to determine the general corruption level in the country. Second, if specific acts do exist, a U.S. business would then be required to have adequate and enforceable corporate controls in place, the absence of which would lead to a greater level of FCPA exposure. Removing the overly broad language of the FCPA would eliminate much of its ambiguity and thereby allow U.S. corporations with business operations in China to operate with less concern of DOJ or SEC action, while still requiring those corporations to exercise due diligence in corporate operations.

Alternatively, augmenting the red flag “history of corruption” provision to provide more detailed criteria of its triggering mechanisms would allow U.S. corporate compliance policies to be modified in a manner that would reflect a new legal framework for avoiding FCPA liability. Neither course of action would hinder the FCPA’s ability to effectuate its overall purpose of combating corrupt payments abroad and instilling public confidence in the global business environment.

CONCLUSION

The FCPA continues to be one of the most controversial U.S. laws²⁴⁶ due largely in part to the perception that U.S. businesses are not on an even playing field in a competitive, global environment. Nonetheless, despite its many shortcomings and less than practicable application to U.S. business operations in China, the FCPA is essential in maintaining the stance of the United States on eliminating corruption and preserving the integrity of the

²⁴⁴ LAY-PERSON’S GUIDE TO FCPA, *supra* note 29.

²⁴⁵ Transparency Int’l, the Global Coal. Against Corruption, TI Corruption Perceptions Index *supra* note 84.

²⁴⁶ Richard Cassin, *U.S. Bribery Law Poses a Threat*, FIN. TIMES, Dec. 14, 2005, at 12.

FOREIGN CORRUPT PRACTICES ACT & U.S. BUSINESS OPERATION IN CHINA

global market. The FCPA is capable of achieving these advantages, without putting U.S. businesses at a competitive disadvantage in transitional nations such as China, with more guidance by the DOJ and less ambiguity in the statute.

While both U.S. corporations and the U.S. government would like to witness the elimination of China's corruption problem during this time when the Chinese economy continues to thrive, the problem is not one that is subject to a quick fix. As one commentator noted:

Viewed from the ground, one often finds sympathy for the cause of reducing corruption, but pessimism about the prospects. Some officials in private simply say that corruption is so deeply rooted in the fast-growing economy and its fabric so tightly interwoven, that it is difficult to discern whether things are improving or degrading. Most agree that this is not a battle to be won in some definable time frame; rather, it is a very long march.²⁴⁷

Corruption in China is not a problem that is going to disappear anytime in the near future. Developing methods to curb the problem with corruption will be a long arduous process. If China maintains some level of control of its corruption problem and witnesses a decrease in corruption overall, the level of governmental scrutiny faced by U.S. businesses will most likely decrease as well. However, at the present time, while the perception of China continues to be that of a corruption-plagued nation, the DOJ and SEC will continue to be increasingly focused on U.S. corporations with business operations in China.²⁴⁸

Recent FCPA enforcement actions should be an unmistakable indication to U.S. corporations that when conducting business operations in China, they must have a rigorous FCPA compliance program in place that will shield them from the appearance of impropriety. As one commentator noted, "[t]here is a common misperception that when 'no one is watching,' U.S. law does not apply. As the FCPA demonstrates, nothing could be further from the truth. Companies that believe otherwise, do so at their own peril."²⁴⁹ Recent cases and the continued focus on potential FCPA violations in China should be an indication to all U.S. businesses that someone is, in fact, always watching closely.

²⁴⁷ DeWoskin, *supra* note 105.

²⁴⁸ Utterback, *supra* note 101.

²⁴⁹ Olson, *supra* note 12.

**MANAGEMENT CONTROLLED FIRMS v. OWNER
CONTROLLED FIRMS: A HISTORICAL PERSPECTIVE
OF OWNERSHIP CONCENTRATION IN THE US,
EAST ASIA AND THE EU**

Andrew C. Spieler & Andrew S. Murray***

ABSTRACT

This paper will present a historical perspective on the relationship between owner controlled firms and management controlled firms in the US, Europe, and East Asia, and the degree to which concentration of ownership correlates with higher firm valuation. We will discuss how agency theory defines the degree to which owner and manger interests diverge. We will also discuss how that divergence as well as the costs of aligning the interests contributes to lower valuations for these firms. In addition, we present theories as to why the US financial structure and corporate governance structure contribute to reducing owner's ability to reign in ineffective management. Finally, we present aspects of the German corporate governance system as a solution to many of the issues that contribute to lower valuations for management controlled firms.

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THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

I. INTRODUCTION

Corporate governance in the modern corporation is based on the assumption that the objective of each corporation is to maximize the value of its owners. Thus, the primary purpose for the existence of a corporation is to maximize shareholder value through the maximization of shareholder profits, and the distribution of those profits back to the owners after payment to the firm's debtors. Since the first case law established the corporation as a separate legal entity¹, there exist two broad forms of corporate structure. The first falls in the category Owner Controlled (hereinafter OCs) firms and the second falls into the category of manager controlled firms (hereinafter MCs). On the surface, the distinction may not seem dramatic or economically relevant. However, the decision to retain the day to day control over a firm, or delegate his powers to a professional manager to act in his stead, is one of the most important decisions of the entrepreneur in the life cycle of the firm. Regardless of corporate ownership distribution, the end goal of the corporation remains the same: maximize owner(s) wealth. However, debates on the optimal of ownership concentration and managerial autonomy have been debated for over 80 years. In part one of this paper we will analyze the relative advantages and disadvantages of owner and manager controlled firms in the US, Europe, and Asia. In Part two of this paper we discuss the following questions:

- (1) Do owner-controlled firms produce profits and returns on investment that are superior to manager-controlled firms?
- (2) If so, what agency costs do owners incur to maintain control over managers who fail to provide satisfactory returns?
- (3) Why is the market for control of large publicly traded corporations not efficient enough to smooth out any real differences in the returns on investment between OCs and MCs?
- (4) What structural and regulatory features of our financial system contribute to these inefficiencies?

II. COMPARISON OF OCs AND MCs

A. Defining Owner Control and Manager Control

In any analysis of the effects of manager and owner based control, the key questions becomes one of defining owner and manager control. In a broad sense, owner control occurs where the equity holders of a firm maintain

¹ Trustee of Dartmouth College v. Woodward, 17 U.S. (4 Wheat.) 518 (1819).

MANAGEMENT CONTROLLED FIRMS V. OWNER CONTROLLED FIRMS

sufficient control over the board of directors to have a measurable influence on policy either by direct control of votes on the board of directors, or indirectly through a sufficiently large share of the voting stock. Therefore, manager control exists in a firm where the shareholders fail to achieve sufficient board representation or voting stock control allowing managers to exercise more judgment than would be possible under OC regime.

The Temporary National Economic Committee² defines control as the power to select or change management. An owner exercises this power by using his voting power to nominate the board of directors. Monsen, Chiu and Cooley argue that the relevant question in determining whether a firm is management controlled or owner controlled is determined by the percentage of control exercised by an investor or group of investors.³

As the remainder of the stock becomes more widely and thinly held a smaller proportion of the total is required to retain control of the firm.

Monsen, Chiu and Cooley article analyze return on investment (ROI) between OC and MC firms. The control distinction criteria were as follows:⁴

Owner Control

- (1) One party owning 10 percent or more of the voting stock is represented on the board or in management or is otherwise known to be in control
- (2) One party owns 20 percent or more of the voting stock ‘Party’ herein indicates an individual, family, family holding company, etc.

Management Control

- (1) No single block greater than 5 percent of the voting stock exists
- (2) There is no evidence of recent control

² TNEC Bureaucracy and Trusteeship in Large Corporations”, Monograph No. 11 p. 27 (Washington, DC: US Government Printing Office, (1940)).

³ Monsen, R.J., Chiu, J.S., and Cooley, D.E., “The Effect of Separation of Ownership and Control on the Performance of a Large Firm”, *Quarterly Journal of Economics*, (1967).

⁴ *Id.*

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

B. Early Studies

Berle and Means through their seminal work on corporate governance *The Modern Corporation and Private Property* (1932); the authors initiated a debate in the academic and financial world that still has far reaching implications today. Berle and Means wrote:

We must conclude that the interests of control are different from and often radically opposed to those of ownership; that the owners most emphatically will not be served by a profit seeking control group. In the operation of the corporation, the controlling group, even if they own a large block of stock can serve their own pockets better by profiting at the expense of the company than by making profits for it.⁵

Berle and Means argued that the interest of managers in manager-controlled firms tend more towards “empire building”, or maintaining the status quo that provided them with high salaries and excessive perquisites and benefits of control. While they would be mindful of their obligation to provide ownership with profits that were commensurate with the level of risk they were taking, any profits gained above that could be redirected towards the managers and justified as a necessary business expense. In the popular book highlighting Wall Street greed, *Barbarians at the Gate* describes the dramatic events leading up to what was at the time, the largest leveraged buy out (LBO) in history. Russ Johnson was described as CEO who never met a perk he did not like. The book describes the lavish compensation package that RJR Nabisco’s executives possessed, as well as the companies exorbitant spending on things such as 5 private jets, or as the authors described it “the RJR Air Force”. The stock price of RJR Nabisco languished at the time (Fall 1988) around \$60 per share despite RJR’s string of strong quarterly profit results.⁶

As the mid-20th Century approached the conventional means of restraint that owners held on the managers of their corporations began to breakdown. This mechanism is the corporation’s board of directors. The board of directors in US Corporate Law is voted in by and bound to represent the interest of the shareholders. However, by the early 1960s the boards of directors fell under the sway of the CEOs that they were supposed to be holding

⁵ Berle, A. and Means, G., “*The Modern Corporation and Private Property*” New York: Harcourt, Brace & World, (1932).

⁶ Burrough, B. and Heylar, J., “*Barbarians at the Gate: The Fall of RJR Nabisco*”, Harper Collins Publishers (2003).

MANAGEMENT CONTROLLED FIRMS V. OWNER CONTROLLED FIRMS

accountable.

After World War II, the trend was for the top executive managers of widely held corporations to anoint themselves chairmen and place their subordinates and friendly outsiders on their boards of directors. Internally, the ranks of middle managers swelled, as corporate offices grew to accommodate more and more managerial functions-few of which were eliminated . . . As labor costs rose, they also pushed up middle management salaries and perquisites.⁷

As the economies of Asia and Europe began to fully recover from World War II, the complacency and stagnation brought on by overly cautious managers left corporate America unable to cope with the economic downturn. There are many factors that lead to the economic stagnation in the 1970s and early 1980s, but one of the most important was the reluctance of managers to innovate or invest in relatively risky investments. Once again the very nature of their position as managers made them unwilling to risk benefits associated with their positions.

The reluctance of managers to implement the needed changes to corporate America does not account for poor performance of the US economy during this period. Ownership failed to provide adequate oversight over management and the breakdown in the neutrality of the corporate board inhibited their ability to hold managers accountable. In any event the economic slowdown of the 1970s combined with the failure of shareholders to remove poorly performing management demonstrates that owners and managers do indeed have divergent interests.

1. Owner Control

One of the most important questions in modern corporate governance is how can the interests of professional managers can be aligned with those of the shareholders. With the onset of the industrial revolution in the United States especially after the American Civil War, the practice of the entrepreneur/owner being able to manage all aspects of his vast and growing corporation were coming to an end. Admittedly, icons of the era like Andrew Carnegie, John D. Rockefeller, and J.P. Morgan would continue to exercise substantial control over their corporations and over the US economy until the 1920s. In hindsight it

⁷ Baker, G.P. and Smith, G.D., *"The New Financial Capitalists"*, Cambridge University Press (1998).

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

is easy to see how the interest of owners and managers began to diverge.

Most corporate lifecycles have three distinct phases: Growth Phase, Stability Phase, and Decline Phase. During the initial growth phase a corporation is most in need of its original owner, who as the promoter and entrepreneur is best positioned to exploit the market opportunities provided by the demand for the company's product or service. During the growth phase the corporation is likely to spend large sums of money on capital expenditures. Net working capital needs are also likely to increase as the corporation grows and uses infusions of capital to expand its market position. Typically, during this phase the company's P/E ratios are higher than they will be at any other time during its life cycle. This is the time period that a company benefits the most by having its owner and founder in control.

An owner/entrepreneur first identifies an opportunity to profitably provide a new good or service or to provide an existing good or service of superior quality or for a cheaper price. Because his contribution to profitability is the greatest, many academics have argued that the OC is more productive and thus more accountable to the owner's wishes. However, as the industrial revolution required companies to obtain ever larger amounts of capital to fund their investments in future growth, owner/managers faced an important financing choice: raise capital through an equity offering – initial public offering (IPO) or through debt (loan or bond issue). The disadvantage for both of these approaches is that any potential equity or debt investor is going to require a higher level of control over the company. An equity investor by the very nature of their voting rights will be able to influence corporate decisions as they acquire a controlling interest in the company. Similarly, debt investors through either bond covenants or loan restrictions limit the financial and operational flexibility of the company by restricting additional levels of debt or investments that are deemed to be too risky.

The OC possesses the advantage of aligning the interests of the owner and the manager by default. The junction point and the means of control that owners use to monitor and discipline the managers of a corporation is the board of directors. Corporations with relatively simple operations in the early phases of their life cycle tend to thrive under the owner/manager model. As previously discussed, these companies tend to have a greater need for the close supervision provided by the company's founder.

Another advantage of OCs for owners is that the owners retain the ability to control the future direction of the company including directing future investments and risk levels. The basic financial model for valuation, the capital asset pricing model (CAPM), takes into account an investor's expected and

MANAGEMENT CONTROLLED FIRMS V. OWNER CONTROLLED FIRMS

desired return per unit of risk which is measured by the corporation's Beta⁸. For example, suppose a US manufacturer of widgets is currently experiencing an increased demand for its product that is likely to last for the next 5-10 years. Further, assume that the company management is lead by the original owner of the corporation. Most owners after taking their companies public are likely to be more risk averse than a manager in a similar position of control. This difference in risk aversion can lead to investment outcomes that are suboptimal.

2. Market for Control

Peter Holl (1977) discusses the impact of the market for corporate control when considering whether OC produce superior returns relative to MC firms. Holl theorizes that if the market for control is efficient, then all firms whether MC or OC should exhibit similar holding period returns and valuation ratios.⁹ Holl uses a valuation ratio (predecessor to the eventual Tobin's q - the measure of the value of the firms equity shares divided by the value of the company's assets) to determine how efficiently managers are utilizing the assets of a company to generate value for shareholders. The lower the valuation ratio, the less the current owners are receiving from their investment in the company and the greater their incentive to exercise the power of their voting stock to remove the current managers. A lower valuation ratio would also increase the likelihood that outside suitors would contest the current incumbents for control over the corporation. Therefore, if the market for control is efficient, the phenomenon of poorly performing management controlled firms should be relatively rare and self correcting. Holl describes two methods that an efficient market may use to discipline inefficient management: Punitive Discipline and Corrective Discipline.¹⁰

The most obvious example of punitive discipline is when the valuation ratio of a corporation becomes so low that outside bidders for a corporation see the potential to realize a large upside in bidding for control of the firm. However, most major US corporations possess defensive mechanisms known as poison pills¹¹ that reduce the ability of outside bidders to obtain a controlling quantity of voting stock in a target corporation.

⁸ Fama, E., "Efficient Capital Markets: A Review of Theory and Empirical Work", *Journal of Finance*, No.2 (1970).

⁹ Holl, P., "Control Type and the Market for Corporate Control in Large US Corporations", *Journal of Industrial Economics* Vol. XXV (1977).

¹⁰ Holl, P., "Control Type and the Market for Corporate Control in Large US Corporations", *Journal of Industrial Economics* Vol. XXV (1977) at

¹¹ Other entrenchment devices include supermajority voting, staggered boards, change of control provisions, white knights and counterattacks (pacman defense).

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

The threat of takeover and ousting from their positions and damage to their personal reputation serves as a countervailing force to maintain a valuation ratio relatively close to its theoretical maximum. Hence, the management team in a corporation aims to prevent the current owner from tendering their stock to the outside bidders by increasing dividends to current shareholders and reallocating resources and profits toward projects that are likely to increase the valuation ratio of the firm thereby satisfying the current owners and reducing the potential upside for any outside bidders. This “counterattack” by the firm’s managers then becomes a benefit to the owners known as the market’s “corrective discipline”.

Hindley (1970) conducted a study whereby he compared the valuation ratios for US Fortune 500 companies who had experienced an attempt from outside bidders to obtain control of the firm, and compared those valuation ratios with those of a control group of US firms that had not experienced a takeover attempt. Not surprisingly, Hindley finds that valuation for the group subject to takeovers was lower than those of the control group suggesting that lower valuation ratios do tend to attract outside bidders for takeover. This however does not resolve the question as to how much corrective/long term discipline improves the long term financial results of the firm. Holl introduces an equation to determine the long term effect of corrective discipline. As stated earlier, if the market can have a long term influence on the behavior and returns of MCs, then the market for control is efficient and there should be relatively little difference between the valuation ratios within the same industry. The valuation ratio is empirically tested using the following equation, $VR_{it} = a + b \times VR_{it-1}$, where VR_{it} is the valuation ratio of the i th firm in a given industry and t and $t-1$ are long run time periods and a and b are constants.

By comparing firms with valuation ratios that were below average (based on their position in the Fortune 500) in time $t-1$ compared with the degree in which the firm’s valuation ratio comes closer to the average in time t , Holl captures the impact of the corrective discipline in the long term value of firms. Estimates of the coefficients a and b vary according to the firms in the sample. Holl’s results found that imperfections in the market for control allow some management controlled firms to consistently maintain lower valuation ratios, while allowing the underperforming management team to avoid the guillotine of the market. Although as a whole the market’s influence tends to minimize the return differences between MCs and OCs, there is still a level of inefficiency in the market for control that permits some management teams to stay in control of poorly performing firms.

MANAGEMENT CONTROLLED FIRMS V. OWNER CONTROLLED FIRMS

C. Later Studies in Manager Control and the Problem of Agency

Jensen and Meckling (1977) and Anderson and Reeb (2003) conducted further studies of MC and OC firms. These studies discuss other factors that tend to influence the performance of Management Controlled firms with diffuse ownership relative to those of Owner Controlled Firms. The relationship between the owner of a firm and its managers is of the most basic -agent relationship; the owners (principal) contract with the manager (agent) to carry out the day-to-day decision making of the firm. The basic premise of agency theory is that the managers and shareholders interests will naturally diverge as managers seek job security (assuming earning at least their reservation wage) while shareholders seek maximum profits. Jensen and Meckling (1977) demonstrate that owners incur not just reduced returns that occur from the failure of management to maximize the owners wealth, but also incur increased agency costs because of the owners need to reduce the degree that a managers divert from the owners interest.¹² These increased agency costs include the cost of monitoring managers to ensure that they act in the interest of the owners and reduce the managers' ability to act in their own self interest. Managers will expend bonding efforts, e.g. external audit, to provide assurances to shareholders that further increase agency costs.

Given these disadvantages, it may seem puzzling that there has been a dramatic expansion in the number of Owner Controlled firms over the past century. Mizruchi (2004) points out that as the complexity, scale, and scope of a company's operations expand, the owner's ability to steer his business through the various financial, legal, and technical minefields that it may face diminishes. This was the original reason why managerial capitalism became the norm for US corporations by the beginning of the 20th Century.¹³ In companies that produce and use complex goods and services, or whose scope of operations require a level of expertise in general management beyond that of the typical owner/entrepreneur, a professional manager is the ideal option.¹⁴

Recent research highlights the potential advantages that independent Managers and Directors bring to a firm. Since owner and manager interests sometimes diverge, independent managers may provide an important check to protect minority shareholders from aggressive majority shareholders. At first glance the agency conflict between Owners and Managers does tend to create the potential for a lower level return for management controlled firms with

¹² Jensen, M. and Meckling, W., "Agency Costs and the Theory of the Firm" *Journal of Financial Economics* (1977).

¹³ Mizruchi, M., "Berle and Means Revisited: The Governance and Power of Large US Corporations" *Theory and Society* (2004).

¹⁴ *Id.*

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

diffuse ownership. Anderson and Reeb (2003) argue that independent managers and directors play an important role preventing majority owners from expropriating the assets of the firm for themselves at the expense of the minority shareholders. Anderson and Reeb's results show that while there is a positive relationship between family control and firm market value but that the correlation begins to taper off above ownership concentration levels of 30%. Anderson and Reeb note:

One mechanism that outside shareholders can employ to mitigate family opportunism is an independent board of directors. Independent directors contribute expertise and objectivity that ostensibly minimizes insider entrenchment and the expropriation of firm resources.¹⁵

On the opposite end of the spectrum, Jensen (1983) discusses the substantial agency costs that are incurred by owner/entrepreneurs who monitor managers. He argues that the net effect decreases the value of the firm. Further, this reduced value also results in reduced liquidity among those firms whose ownership is diffuse.

D. Answering the Obvious Objection

Fama and Jensen (1983)¹⁶ in their study, attempt to answer a fundamental question that the reader may have. If the separation of ownership and control can lead to increased agency costs and lower returns, then why do firms choose to employ an ownership structure that allows managers a great range of autonomy? Clearly there are some benefits to granting professional managers the decision making authority they need to run the firm the way they see fit. Fama and Jensen postulate two overarching justifications for the existence of management controlled firms. First, not only are most modern corporations extremely complex, effective management may require specific knowledge and education that the owners do not possess. Second, since investors prefer liquidity, they are unlikely to have high concentrations of their wealth tied up in any one firm. Hence, ownership in these firms is likely to be diffusing not because the owners see that structure as advantageous for the businesses they establish, but rather because owners find it cheaper to protect their wealth through diversification. Firms therefore are becoming more and more diffused

¹⁵ Anderson, R. and Reeb, D. "Who Monitors the Family?"

¹⁶ Fama, E. and Jensen, M. "Separation of Ownership and Control" *Journal of Law and Economics* (1983).

MANAGEMENT CONTROLLED FIRMS V. OWNER CONTROLLED FIRMS

in their ownership, which creates the potential for increased conflict among the owners. This increases the need for independent managers who can make decisions based on their expertise and neutrality among the firm's owners.

III. DISCUSSION OF RETURNS STUDIES OF OC AND MC FIRMS IN THE US, EU, AND EAST ASIA

A. Europe

The results of the Monsen, Chiu and Cooley analysis find statistically significant differences between OCs and MCs. In particular, to the following metrics differed between the OC and MC firms: Sales to Total Assets (S/TA), Net Income to total assets (NI/TA), Net Income to Sales (NI/S) and Long Term Debt to Total Capitalization (LTD/TC). It seems clear from the results in Table 1 that in the period between 1952 and 1963 OC firms performed better than MCs.¹⁷

These results tend to broadly affirm the results of the Hindley study which suggests that the market for control of major US firms is not completely efficient. After all, if inefficient managers tend to be replaced either through the punitive or corrective discipline of the market, then there should be no serious long term difference between the returns of OCs and MCs. As Hindley suggests, the very existence of a statistically significant difference in performance between OCs and MCs indicates that there are some managers whose underperformance goes unpunished by the market. In the final part of this paper we present two hypotheses to explain the residual inefficiency in the market. Put quite simply, there are two explanations as to why the market for shareholder control retains inefficiencies (1) owners lack the information to contest management decisions or (2) owners lack the legal recourse to do so. The factors that help create the inefficiency in the market for control are equity market liquidity, informational asymmetry, the Business Judgment Rule and the *Unocal* anti-takeover rule.

Grosfield (2006)¹⁸ studied the effect of owner concentration and productivity for firms in the Warsaw Stock Exchange on an annual basis for the 12 year period 1991-2003. In this study Grosfield employed regression analysis to predict the Tobin's q which can be used as a proxy for determining the relative value of the firms. This study reports that owner concentration and productivity were positively correlated. The author argues that in those firms

¹⁷ See Monsen, Chiu and Cooley data sheet (Table 1).

¹⁸ Grosfield, I., "Ownership Concentration and Firm Performance: Evidence from an emerging market" *William Davidson Institute Working Paper No. 834*.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

were managers tend to possess specialized highly valued skill, such as IT firms, excessive ownership may actually stifle productivity. Although she provides no direct evidence to prove this theory, she does show that the IT firms that are more likely to exhibit low concentration of ownership.

La Porta, Lopez-de-Silanes, F. and Shleifer (1999) document that a majority of Western European publicly owned firms are family controlled. Therefore it is useful to determine the effect of family concentration on Western European firms. Maury (2004) used a sample of 1,672 Western European firms. His results show that valuations (measured by Tobin's q) and return on assets are 7% and 16% larger for family owned western European firms, respectively.¹⁹

B. East Asia

Faccio, Lang and Young (2001)²⁰ discuss the effects of ownership concentration in East Asian firms. As is the case in Europe a majority of East Asian firms are family controlled. East Asian firms tend to conform to the scenario described by Anderson and Reeb whereby family ownership becomes too concentrated and entrenched and feels free to expropriate the assets of the firm even during period of substantial economic loss. This paper focuses on the differences in dividend payments in these East Asian family owned firms. To the extent that these dividend payments are higher in Europe, Faccio et al. argue that this would be symbolic of these firms's intention to pay out dividends to all investors before it can be expropriated by a significant owner group. Faccio theorizes that there will be a tendency of East Asian family owned firms to expropriate assets of the firm and minority shareholders. Unlike in the US and Europe, the concept of an independent board of directors is still an anathema in Korea and Japan. Additionally, most Japanese and Korean firms are less mature compared to their US counterparts. Since the majority of Korean industrialization occurred between the 1960s and the 1980s, most of these firms are still owned by the original entrepreneurs or controlled by family interests, typically second generation. The Faccio study compiles the accounting data of over 5000 firms with ownership concentrations at the 5%, 10%, and 20% levels in France, Germany, Hong Kong, Indonesia, Italy, Japan, Malaysia, Philippines, Singapore, South Korea, Spain, Taiwan, Thailand, and the United Kingdom. The study documents a higher level of dividend payouts to European firms

¹⁹ Maury, B., "Family ownership and firm performance: Empirical evidence from Western European corporations" *Journal of Corporate Finance* (2002).

²⁰ Faccio, M, Lang, LHP, Young, L., "Dividends and Expropriation" *American Economic Review* (2001).

MANAGEMENT CONTROLLED FIRMS V. OWNER CONTROLLED FIRMS

relative to East Asian firms. The results are consistent with the theory that European firm management curtails expropriation more effectively through higher dividends to all shareholders, majority and minority.

IV. EXPLANATIONS FOR RESIDUAL MARKET INEFFICIENCY

A. The Limits of Owner Activism: A Preference for Liquidity over Control

Modern corporate finance is dominated by the Efficient Capital Markets hypothesis.²¹ This hypothesis states that an investor's return on capital must be commensurate with a premium over the market risk free rate, or the rate of return the investor could receive by investing his money in an asset with a guaranteed rate of return. The diffuse and largely atomistic nature of individual shareholdings significantly reduces the incentive to change management behavior. Inevitably, most owners come to the conclusion that it is easier and less costly to simply liquidate their ownership stake in an underperforming company, rather than to launch a concerted effort to remove management via a proxy fight.

This preference also stems from the simple fact that replacing management through the board of directors is no simple task, even for an owner with a substantial stake in the company. Throughout the 1980s and 1990s, owner activism seemed to be making a comeback via institutional investors such as banks and pension funds and private investors like Carl Icahn. California Public Employees' Retirement System (CalPERS), the largest US pension fund, is famous for its list of poorly governed firms that made the front page of USA Today. Their large shareholdings often precluded selling their stakes. On the other hand, private investors were probably motivated by the substantial returns obtained by LBO firms in the 1980s. Firms such as KKR and then upstart Blackstone Group engaged in bootstrap deals or highly leveraged purchases of underperforming companies with large amounts of cash.²² They then used their substantial control of the firm to implement strict changes in the way the firm is run, driving up the valuation ratio, allowing them to sell the firm back to the public for profit.

It was not long however until institutional investors began to realize that the cost of organizing a campaign against an incumbent management far outweighed the benefits. As long as there are firms out there that are run

²¹ Fama, E., "Efficient Capital Markets: A Review of Theory and Empirical Work", *Journal of Finance*, No.2 (1970).

²² Baker, G.P. and Smith, G.D., "*The New Financial Capitalists*", Cambridge University Press (1998).

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

prudently owners and institutional investors are more likely to perceive “cashing out” as the most cost efficient option. Bainbridge (2006) in his article in *UCLA Law Review* discusses the inherent problems for an owner looking to start an “uprising” against incompetent managers:

Outside the unlikely limiting case in which the activist institution controls a majority of the stock, such measures necessarily require the support of other shareholders, which makes a shareholder insurrection against inefficient but entrenched managers a costly and difficult undertaking. Despite the considerable institutionalization of U.S. equity markets, stock ownership of domestic corporations remains relatively widely dispersed. A shareholder insurrection therefore requires support from a relatively large number of investors.

Putting together a winning coalition will require, among other things, ready mechanisms for communicating with other investors. Unfortunately, SEC rules on proxy solicitations, stock ownership disclosure, and controlling shareholder liabilities have long impeded communication and collective action. Even though the 1992 SEC rule amendments somewhat lowered the barriers to collective action, important impediments remain²³

B. Informational Asymmetry in Management Controlled Firms

In any market where there are buyers and sellers of a given product or service, the most important factor in the maintenance of market efficiency is information. In the US equity and debt markets, large bureaucratic regulatory bodies such as the SEC and self regulatory agencies, such as the NASD, NYSE, and FINRA have been erected for the chief purpose of ensuring that the information gap between buyers and sellers is minimal. Disclosure rules, accounting standards, rules on the initial offer and sale of securities all require parties on both sides of a transaction to have access to the same information. After all, if the average investor seeks to maximize his return for every unit of risk he takes on; a failure to accurately gauge the risk of an investment through

²³ Bainbridge, S.M., “The Case for Limited Shareholder Voting Rights”, *UCLA Law Review* 53 *UCLA L. Rev.* 601 (2006).

MANAGEMENT CONTROLLED FIRMS V. OWNER CONTROLLED FIRMS

lack of information reduces investing to the luck rather than informed decision-making.

Salamon and Smith (1979) tested the theory that MC's are more likely to alter their financial results to satisfy the owners rather than the OCs. Salamon and Smith called this theory the "information misrepresentation hypothesis" (IMH). The authors tested this hypothesis by measuring the degree that MCs security returns and accounting earnings correlate with years in which the firm announced changes in their accounting policies. In other words, if the security returns for an MC were related more toward changes in accounting policy than changes in the accounting returns of the firm to a greater extent than OCs, this would provide support for the IMH. Second, the authors measured the timing of accounting policy changes for MC firms. Therefore, if there was a significant difference between the security returns for MC in years where there were no accounting policy changes, relative to differences in security returns for OCs, it is likely the MCs have instituted the accounting policy changes for the purpose of altering the appearance of their earnings reports during low performing years.

Table 2 displays the authors' main findings.²⁴ To test their conjecture, the authors use standard Cumulative Abnormal Return (CAR) and Unexpected Earnings (UE) methodologies. CAR denotes the sum of abnormal returns (standardized by historical volatility) relative to a benchmark. If the number of instances where the return on a security (CAR) is at variance with the actual earnings of the firm during years in which a firm underwent a significant change in accounting policy is greater for MCs than OCs, then the findings would support the IMH. Such a finding would confirm that MCs tend to owe their higher returns during years of accounting policy changes more to those changes than to actual earnings. If this phenomenon occurs, more often with MCs than OCs, then the study would provide strong evidence that managers in these MC are deliberately hiding information from the owners. The results of the Salamon study indicate that there is a significant difference in the proportion of cases where the CAR and UE are inconsistent with MCs as compared with OCs.

Table 3²⁵ tests the timing of the accounting policy change decisions. Specifically, the statistical tests detect if there is a difference between MC and OC performance for years with and without accounting policy changes. The results in Table 4 do not find significant differences between years with and without an accounting policy change. For MCs, however, there is a substantial difference in the security returns for accounting policy change years and normal years. These results provide evidence that a management team is more likely to

²⁴ See Salamon and Smith Data Sheet (Table 2).

²⁵ See Salamon and Smith Data Sheet (Table 3).

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

alter financial earnings reports during accounting years to artificially maintain or inflate share price. The implications of this study lend credence to the thesis of this paper that although MCs tend to provide a lower level of return than OCs, outside factors create inherent inefficiencies in the market for control.

V. LEGAL AND REGULATORY HURDLES TO AN EFFICIENT MARKET
FOR CONTROL

A. Unocal and the Business Judgment Rule

The Delaware Corporate code 8 Del. C. § 141 has had the greatest effect on the market for control and its inefficiency than any other factor. It has fostered a culture of impunity and has seriously weakened the basis of the principal-agent relationship that the Directors and Owners of a corporation are supposed to represent. The code reads in part:

- (a) The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation. If any such provision is made in the certificate of incorporation, the powers and duties conferred or imposed upon the board of directors by this chapter shall be exercised or performed to such extent and by such person or persons as shall be provided in the certificate of incorporation.²⁶

- (e) A member of the board of directors, or a member of any committee designated by the board of directors, shall, in the performance of such member's duties, be fully protected in relying in good faith upon the records of the corporation and upon such information, opinions, reports or statements presented to the corporation by any of the corporation's officers or employees, or committees of the board of directors, or by any other person as to matters the member reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation.²⁷

²⁶ The Delaware Corporate code; 8 Del. C. § 141(a).

²⁷ The Delaware Corporate code; 8 Del. C. § 141(e).

MANAGEMENT CONTROLLED FIRMS V. OWNER CONTROLLED FIRMS

The Delaware Court of Chancery has interpreted the Delaware Corporate code as endorsing a “Business Judgment Rule”. This rule creates a legal protection for the board of directors that allows them to use their business judgment to benefit the shareholders as they see fit. The problem is that the term “benefit” is not adequately defined and that these “benefits” can be conferred on shareholders against their will. In the seminal case on the Business Judgment Rule, *Sinclair Oil Corp v. Levien*,²⁸ the Delaware Supreme Court held:

[A] Court will not interfere with the judgment of a board of directors unless there is a showing of gross and palpable overreaching. *Meyerson v. El Paso Natural Gas Co.*, 246 A.2d 789 (Del.Ch.1967). A board of directors enjoys a presumption of sound business judgment, and *its decisions will not be disturbed if they can be attributed to any rational business purpose*. A court under such circumstances will not substitute its own notions of what is or is not sound business judgment.²⁹

Later in the *Unocal v. Mesa Petroleum*³⁰ the court did erect an extra hurdle for a board of directors to overcome. According to the Unocal standard a Board must “show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed because of another person’s stock ownership...Furthermore, such proof is materially enhanced, as here, by the approval of a board comprised of a majority of outside independent directors who have acted in accordance with the foregoing standards.” The court then indicated that after demonstrating that the transaction was fair and reasonable, the business judgment rule would apply:

When a board addresses a pending takeover bid it has an obligation to determine whether the offer is in the best interests of the corporation and its shareholders. In that respect a board’s duty is no different from any other responsibility it shoulders and its decisions should be no less entitled to the respect they otherwise would be accorded in the realm of business judgment.³¹

²⁸ *Sinclair Oil Corp v. Levien*, Del Supr., 280 A.2d. 717; (1971); *see also*, *Meyerson v. El Paso Natural Gas Co.*, 246 A.2d 789 (1967).

²⁹ *Sinclair Oil Corp.*, 280 A.2d. at 720 (emphasis added).

³⁰ *Unocal Corp. v. Mesa Petroleum Co.*, Del. Supr., 493 A.2d 946 (1985).

³¹ *Id.*

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

After going through this initial analysis the courts then apply the business judgment rule discussed in Sinclair. In sum, a board of directors wishing to resist an outside takeover bid need only show:

- (1) That they had a reasonable fear that the bidder or potential owner posed a threat
- (2) That such a threat is shared by the majority of “disinterested” directors (people without a conflict of interest in the deal)
- (3) That the actions be rationally related to a business purpose.

B. Anti-Takeover Provisions (Poison Pills)

In response to the takeover and LBO wave in the 1980s, firms erected provisions in the by laws and certificates of incorporation that were designed to make it more difficult for a potential bidders to gain control of a target firm against its will. Many of these provisions provide for expensive “golden parachutes” (lavish executive retirement packages) or trigger provisions where the firms stock splits into two when a bidder purchases a substantial amount of stock. The latter known as a “flip in” provision would make it more costly for a bidder to purchase a controlling majority of the stock in the firm. Originally these anti-takeover provisions were designed to deter 1980s takeover raiders and greenmailers, but it is not hard to see how these provisions would also make it hard for an efficient market for control to develop. The same provisions that can be used by a board of directors to fend off coercive and unfair tender offers from the raiders and force more attractive counteroffers, came to be used as a means for the board to entrench itself in its management position.

In *Unocal*, the Delaware court created a two step analysis for deciding if an anti-takeover provision is valid. First the court stated that a board of directors may not create an anti-takeover provision “solely or primarily out of a desire to perpetuate themselves in office.”³² The second test, the court argued, is one of balancing the nature of the threat from the bidder with the severity of the defense against such action. “A further aspect is the element of balance. If a defensive measure is to come within the ambit of the business judgment rule, it must be reasonable in relation to the threat posed.”³³ Some examples of a threat that a bidder may pose are (1) price inadequacy, (2) Nature and timing of the offer, (3) Questions of illegality, (4) impact on constituencies other than shareholders, (5) risk of non-consummation of the deal and (6) inadequacy of the quality of the securities offered in exchange.

³² *Id.* at 955.

³³ *Id.* at 956.

MANAGEMENT CONTROLLED FIRMS V. OWNER CONTROLLED FIRMS

The *Unocal* standard, though adequate in theory, in practice may have become unworkable. Courts have had trouble determining whether under the facts of a given case a board of directors has erected an anti-takeover provision for the purpose of entrenching itself, or for the purpose of defending the owner's interests in the corporation. The *Unocal* standard also raises questions of agency. The very nature of a tender offer, where a bidder bypasses management and approaches the owners with an offer to purchase the shares of an underperforming corporation, brings into question whether a board is truly representing the wishes and interests of the owners by resisting a tender offer that they may approve of. Furthermore, as the Monsen study has shown, a corporation is likely to be target for a tender offer if its valuation ratio has dropped to a level where a bidder sees an opportunity to make a profit by improving the management of the firm. What is also questionable is the interested director standard, where the court implies that a vote by a majority of uninterested directors approving an anti-takeover defense would imply its fairness. Since the *Unocal* case was decided in 1985 there have been many cases that have come along where a board of directors has erected defenses, and whose motives are questionable, that the facts of the case do not meet *Unocal's* stringent "solely or primarily out of a desire to perpetuate themselves in office" standard. With such a high hurdle, it is likely the boards of directors will continue to use anti-takeover measures as a means to entrench themselves in offices, thus frustrating the desire among owners for an efficient market for control.

Given the preference for liquidity it is useful to determine if the existence of a poison pill in a corporate charter has the effect of lowering the overall value of a firm. The rationale of the *Unocal* decision was that the courts wanted to empower a board of directors to repel a bidder whose plans for the firm would be destructive to the interests of the shareholders. It is clear however that since the *Unocal* court has failed to provide any standards separating actions that are taken to defend the shareholders interests from those taken to entrench the corporate management, the decision may become a legal bulwark protecting management from the owners they are in place to serve.

Ryngaert (1989)³⁴ studied the effect of poison pills on the share prices of the firms. If the Efficient Capital Markets Hypothesis is correct, then the market price of a security should reflect all known information that would impact the value of the underlying firm. Ryngaert posits two possible results consistent with opposing theories on poison pills.

³⁴ Ryngaert, M. "Firm Valuation, Takeover Defenses, and the Delaware Supreme Court", *Journal of Financial Management* (1989).

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

If the value of firms rose during and after the period of the Unocal decision, then the markets subscribed to the “Shareholder Interest” hypothesis. This hypothesis states that the poison pill provisions will be used to protect the shareholder’s interests against aggressive bidders, who underbid the price of the firm, either through lack of a competitive bidding process or through a two-tiered tender offer. A two tiered offer usually involves a bidder offering a higher premium on the current price for the first group of shareholders to tender their shares (such as the first 60%) and a lower premium for a second group (such as the last 40%). This is meant to coerce the shareholders by “herding” them and taking advantage of the reduced bargaining power that a minority shareholder would have after the completion of the first phase of the tender offer.

The “Management Entrenchment” hypothesis posits that the managers are likely to use a poison pill provision to entrench themselves and make it more difficult to purchase the company. This results in both extending the tenure of the poorly performing management team, but also reduces the value of the shares of the firm, making the shares harder to sell on the market without a loss.

The results of the Ryngaert study indicated that the Unocal decision had in fact lower the value of publicly traded firms incorporated in Delaware who had already adopted poison pills before the *Unocal* decision. The results did not indicate any statistically significant negative movement in stock price for those Delaware firms that adopted poison pills after the *Unocal* decision.

VI. A REVIEW OF GERMAN CORPORATE GOVERNANCE AND A SOLUTION TO THE AGENCY CONUNDRUM

Recall that in Section 3 of this paper we discussed the relationship between ownership concentration and profitability in Poland and by comparing the relative dividend payouts in Western European and East Asian firms. In this section we discuss the aspects of the German system of Corporate Governance that may make supervision of management by owners more effective and help to reduce agency costs. The corporate governance structures in the US and UK are founded on the idea that the officers and directors of a corporation represent the owners, but are granted wide latitude to make business decisions, even in the face of objections from the shareholders. In the US, the majority of firms in the S&P 500 have boards who are elected on staggered years so that an entire intransigent board cannot be removed for poor performance in once shareholder meeting. Therefore, in the absence of a breach of their fiduciary duties of care and loyalty, the average investor has no recourse against ineffective management other than the liquidation of his shares. Adaptation of the German two-tiered board model may provide the answer.

MANAGEMENT CONTROLLED FIRMS V. OWNER CONTROLLED FIRMS

The underlying philosophy of the German corporate structure reflects the European belief that all persons who have a “stake” in a firm’s policy should have a role in the management of the firm. Whereas, the ultimate authority to manage a firm ultimately lies in the owners in Anglo-Saxon countries, Germany focuses on giving non-owners such as employees and suppliers the ability to influence firm policy. In keeping with that philosophy, Germany incorporates a two-tier board consisting of a Management Board (Vorstand) and a Supervisory Board (Aufsichtsrat). The Management Board is charged with the actual operational decisions of the enterprise. Their role is analogous to the traditional board of directors in the US in that sense the Management Board represents the interests of the owners of the firm. The Supervisory Board is appointed by shareholders and employees of the company. It appoints non-managing members of the supervisory board and is designed to represent the interests of outside stakeholders. The Supervisory Board is governed by German tradition of labor codetermination. This concept means that a firm’s labor and management plays a strong role in the Supervisory Board, which in turn supervises the management board.³⁵

Recall that in the previous section we posited for the fundamental governance issues related to liquidity, information asymmetry, the *Unocal* decision, the business judgment rule, and the increased use of poison pills. Admittedly the German system of corporate governance is no panacea in the effort to align the interests of ownership and management. However, a US adaptation of the supervisory board will solve some of the issues below.

- (1) **Preference for Liquidity**-The Supervisory Board will provide supervision of the management board on behalf of shareholder’s whose focus would otherwise be strictly on being able to liquidate their interest.
- (2) **Information Asymmetry**-The Supervisory Board’s role in representing shareholder interests will give them access to inside information on firm performance and reduce information asymmetry issues.
- (3) **Business Judgment Rule and Poison Pills**-The Business Judgment Rule is a legal construction by the Delaware Court limiting the ability of shareholders to pursue the drastic and draconian measure of a lawsuit if they disagree with the decisions of management or the board of directors. A supervisory board will allow shareholders to have more direct representation, while still

³⁵ Mintz, S “A Comparison of Corporate Governance Systems in the US, UK, and Germany” *Corporate Ownership & Control* Vol. 3 Issue 4 (2006).

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

keeping agency costs low. The supervisory board's only role will be to supervise and monitor the decisions of the board of directors and management and to intervene when necessary. This authority will in effect eliminate the need for shareholder derivative lawsuits by giving owners recourse to monitor management outside of the courts. A US based Supervisory board will have the authority to approve revisions to the corporate charter, and to review the fairness of a tender offer.

VII. SUMMARY

In this paper, we have summarized the differences between OCs and MCs, and the relative advantages of each type of firm. Additionally, evidence was provided to demonstrate that OCs provide superior returns as measured by the valuation ratio (Tobin's q and several accounting performance metrics) of the respective firms. As far back as Berle and Means in 1932, authors have theorized that OCs provides returns that are superior to those of MCs because of the inherent difference between the interests of the owners and management. We discussed the apparent contradiction between a completely efficient market for control and a discrepancy in the valuation ratios of OCs and MCs. If the market for control of US firms was efficient, then Berle and Means' theory should be proven false. We have seen that clearly there are real differences in the returns between OCs and MCs, and that those differences do relate to diverging interests. Managers have an interest in at least partially diverting the profits of the corporation for themselves, and in advocating policies that help to entrench the incumbent management. On the other hand, the directors of a firm are charged with representing the owners, but in the modern firm, directors are more likely to be personally connected to the officers. This creates some inherent conflicts for a board that in theory should act as an agent for the shareholders but in practices is another tool that the officers use to entrench themselves.

Why are managers able to avoid the accountability of sub-par performance? The liquidity and diffuseness of the modern US equity market makes it more cost effective for an owner/investor to liquidate his holdings ("vote with your feet") in a poorly performing firm than to launch an insurgency against an entrenched and poorly performing management. Additionally, there are legal and regulatory disadvantages to any investor who tries to coerce poorly performing management through the legal system. While the "business judgment rule" and the "Unocal" anti-takeover have their merits, and on net benefit our system of corporate governance, the management of modern US firms have used these legal doctrines to entrench themselves in ways predicted

MANAGEMENT CONTROLLED FIRMS V. OWNER CONTROLLED FIRMS

by Berle and Means. It is incumbent on policy makers and business leaders to try to develop a new legal doctrine that strikes a better balance between the needs of a firm's management to be able to take risks on behalf of firm owners and the needs of those owners to retain control over the management of the firms that they own. Ultimately, until such a doctrine is established, the diverging interests of managers and owners, and the inherent difficulty in removing poorly performing management, will continue to drag down the returns of management controlled firms in the US.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

TABLE 1
COMPARISON OF FINANCIAL PERFORMANCE OF OCs AND MC's

S=Sales

TA=Total Assets

NI=Net Income

LTD=Long Term Debt to Equity

	S/TA	NI/TA	NI/S	LTD
CONTROL TYPE				
Owner Controlled	180.1	7.65	5.86	15.5
Manager Controlled	159.3	6.09	5.29	16.3
INDUSTRY				
Meat Products	504.7	2.96	0.69	16.2
Canning and Preserving	164.2	5.48	3.32	20.1
Industry Chemicals	101.1	9.11	9.47	16.6
Drugs	109.9	11.71	10.8	4.9
Oil Refiners	96.2	6.84	7.55	17.8
Iron and Steel	106.9	6.12	5.72	16.4
Nonferrous	70.0	5.57	8.21	25.8
Electrical	172.3	6.26	3.63	22.1
Motor Vehicles	187.9	5.40	3.02	11.6
Aircraft	246.4	6.97	2.95	11.3
Industrial Machines	140.7	6.58	4.55	14.4
Business Machines	136.3	9.45	6.96	13.1
YEAR				
1963	161	5.63	5.12	15.6
1962	159.7	6.41	5.41	15.4
1961	157.3	5.57	5.03	16.0
1960	160.4	6.17	5.28	15.5
1959	160.3	7.50	6.04	16.2
1958	157.8	6.22	5.4	16.9
1957	168.9	7.56	6.1	17.6
1956	174.9	7.61	6.16	17.0
1955	182.1	8.48	6.42	15.7
1954	177.8	7.00	5.38	15.4
1953	193.7	7.37	5.17	14.4
1952	182.9	6.93	5.43	14.8

MANAGEMENT CONTROLLED FIRMS V. OWNER CONTROLLED FIRMS

TABLE 2: CAR-UE CONSISTENCY (SALOMAN AND SMITH)

EARNINGS FORECAST MODEL	MANAGEMENT CONTROLLED	OWNER CONTROLLED	SIGNIFICANCE
MARTINGALE EPS MODEL			
CONSISTENT CASES	61	56	
INCONSISTENT CASES	42	23	0.072
EXPONENTIAL SMOOTHING MODEL			
CONSISTENT CASES	57	55	
INCONSISTENT CASES	46	24	0.035

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

TABLE 3: CAR DURING POLICY DECISION YEARS COMPARED TO OTHER YEARS (SALAMON AND SMITH)

<u>MANAGEMENT CONTROLLED</u>	<u>SIGNIFICANCE OF CAR</u>		<u>SIGNIFICANCE LEVEL</u>
	+	-	
Policy Decision Years	44	59	
Other Years	107	76	0.01
<u>OWNER CONTROLLED</u>			
Policy Decision Years	39	40	
Other Years	110	96	0.32

MANAGEMENT CONTROLLED FIRMS V. OWNER CONTROLLED FIRMS

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- [23] Trustees of Dartmouth College v. Woodward, 17 U.S. (4 Wheat.) 518 (1819).

LIMITATIONS IN THE REGULATION OF UNFAIR MARKETING PRACTICES IN HONG KONG

*Stefan Lo**

INTRODUCTION

The scope of consumer protection laws in Hong Kong is relatively limited compared with major international economies such as the United States, Australia and European countries. Additionally, the laws that do exist in Hong Kong in this field are fragmented and lack cohesion. This paper will analyze the deficiencies and gaps in the regulatory regime in Hong Kong in the particular area of business-to-consumer marketing practices.

Part I discusses the problems that exist in Hong Kong in relation to the misleading of consumers and other unfair marketing practices. Part II examines the extent to which common law and statutory law provide civil regulation in the areas of contract law, misrepresentation and unconscionable conduct. Part III explores the existing criminal regulations in Hong Kong and their limitations. Part IV analyzes industry specific codes of conduct with a discussion of both the advantages and disadvantages to self regulation. Finally, Part V provides a comparative analysis of Hong Kong laws and the applicable laws of Australia and the United Kingdom. This paper argues that the laws on unfair marketing practices require comprehensive reform in order to provide adequate protection for Hong Kong consumers.

PART I: PROBLEMS OF UNFAIR MARKETING PRACTICES IN HONG KONG

Incidents of unfair marketing practices are frequently reported in the Hong Kong media. In the real estate sector, problems arising from developers' unscrupulous marketing of newly released flats relating to sales results,¹ prices² and flat sizes,³ have caused a significant amount of controversy. In the health

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¹ See Chloe Lai, *Big Developers Argue Against Tighter Rules on Internal Sales*, S. CHINA MORNING POST, May 20, 2005; see also May Chan, *Investor Attacks Developer Over Peak 'Lies'*, S. CHINA MORNING POST, Apr. 25, 2006.

² See Agnes Lam, *Two-tier Pricing Riles Flat Buyers*, S. CHINA MORNING POST, Apr. 10, 2007.

³ See Yvonne Tsui & Agnes Lam, *Deal on Flats Sparks Call for Public Debate Consumer Council*

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

and beauty industry, unsubstantiated or false claims in relation to various weight loss and slimming techniques⁴ or products⁵ are notoriously common in Hong Kong. Alarming, the real estate and health industries represent only a small portion of the areas where problems have been reported.⁶

Complaint statistics compiled by the Hong Kong Consumer Council⁷ (hereinafter “the Council”) reveal the extent of the problems false advertisements have created. In 1999, the Council observed that more than half of the advertisements published in newspapers and magazines in Hong Kong “made outrageous claims about products or used misleading statements to lure buyers into bad deals.”⁸ In 2001, the Council released a report on misleading and unfair practices in consumer transactions.⁹ The Council noted that the major problems reported by consumers were: (1) “misleading indication as to price”

Wants Focus on Developers' Calculations, S. CHINA MORNING POST, June 5, 2007; *see also* Agnes Lam, *What Exactly Are You Buying? It Depends on Who Does the Sums*, S. CHINA MORNING POST, June 5, 2007.

⁴ *See* Donald Asprey, *Slimming Fads Cut Down to Size Exercise, Good Diet Only Way to Lose Weight: Consumer Body*, S. CHINA MORNING POST, Nov. 16, 2005.

⁵ *See* Elaine Wu, *Electronic Exercise Belts Fail to Fight the Flab: But Manufacturers Are in the Clear Because They don't Make Medical Claims*, S. CHINA MORNING POST, Jan. 16, 2004.

⁶ Other sectors where problems have also been reported include: (1) the telecommunications sector (*see, e.g.*, Vivienne Chow, *Watchdog Warns of Telecoms' Sales Tricks Consumer Council Wants Code of Practice to Pull Service Providers Into Line*, S. CHINA MORNING POST, Jan. 11, 2005); (2) misleading food labelling (*see, e.g.*, Barclay Crawford, *Teas No Better Than Soft Drinks, Experts Warn Bottled Brews Can Be High in Sugar and Low in Benefits: Study*, S. CHINA MORNING POST, Aug. 16, 2006); (3) misrepresentations in relation to discount dining schemes (*see, e.g.*, Agnes Lam, *Dining Club Named Over Misleading Practices Consumer Watchdog Lists Complaints Against Discount Restaurant Scheme*, S. CHINA MORNING POST, Dec. 21, 2005); (4) misleading advertising as to rates by travel agents (*see, e.g.*, Duncan Hughes, *Protection 'Adequate' Against Tour Scams*, S. CHINA MORNING POST, Jan. 8, 1998); (5) deceptive conduct by shopkeepers and the selling of counterfeit goods to tourists (*see, e.g.*, Agnes Lam, *No Fakes Scheme Violators May Be Named Options Weighed After Sweep of Jewelry Shops Nets Member of Anti-Counterfeit Pledge Campaign*, S. CHINA MORNING POST, Sept. 29, 2005); and (6) practices of forced shopping imposed on members of tour groups (*see, e.g.*, Dennis Eng & Zoe Mak, *Complaints Against Package Tours Up 20% Consumers More Aware of Rights When Holidays Go Wrong*, S. CHINA MORNING POST Aug. 10, 2007).

⁷ *See* Consumer Council Ordinance (2000) Cap. 216, § 4(1). (H.K.) (stating that the functions of the Council include protecting and promoting the interests of consumers in Hong Kong). *See also* Consumer Council Mission,

http://www.consumer.org.hk/website/ws_en/profile/mission/mission.html (stating that the Council is not invested with any powers of investigation nor is it vested with powers to commence legal action on behalf of consumers, but has functions of giving advice to and assisting consumers in resolution of their disputes with traders; disseminating information about products and services and empowering consumers to help themselves; and facilitating discussion and promulgation of pro-consumer policies).

⁸ Jo Pegg, *Deceptive Ads on the Rise, Warns Council*, S. CHINA MORNING POST, July 27, 1999.

⁹ CONSUMER COUNCIL, REGULATING DECEPTIVE MISLEADING AND UNFAIR PRACTICES IN CONSUMER TRANSACTIONS (2001).

REGULATION OF UNFAIR MARKETING PRACTICES IN HONG KONG

and other “false or misleading representation[s]”; (2) traders “accepting payment without intention to supply”; (3) “bait and switch”; and (4) “undue harassment or coercion.”¹⁰ The Council observed that such misrepresentations have not only damaged the interests of consumers and honest competitors, but have also “tainted Hong Kong’s image”.¹¹ Following the publication of that report, such problems have continued to exist in Hong Kong, with the number of complaints made to the Council increasing by approximately 50% from 2002 to 2007.¹² Problems relating to sales tactics and prices represent some of the highest number of complaints by category.¹³ The Council has more recently observed that the complaints it receives from consumers “represent only the tip of the iceberg”.¹⁴

PART II: EXISTING CIVIL REGULATIONS

Presently there are a number of different civil remedies under the common law, supplemented by statute, which can provide consumers with redress for many of the problems outlined in Part I. The delicate interplay between these remedies and their limitations is clear when analyzing how deceptive advertisements may be treated differently under contract law principles, the misrepresentation doctrine and the doctrine of unconscionable conduct.

¹⁰ *Id.*

¹¹ *Id.*

¹² See Consumer Council, *Annual Report 2006-07*, at 11, http://www.consumer.org.hk/website/ws_en/profile/annual_reports/list.html (reporting 23,610 cases in 2002/2003 and 35,752 cases in 2006/2007).

¹³ See *id.* at 13 (reporting sales tactics and prices as representing 20% of consumer complaints each); see Consumer Council, *Annual Report 2005-06*, at 19, http://www.consumer.org.hk/website/ws_en/profile/annual_reports/list.html (reporting sales tactics representing 21% of consumer complaints and prices representing 17% of all consumer complaints); see Consumer Council, *Annual Report 2004-05*, at 17, http://www.consumer.org.hk/website/ws_en/profile/annual_reports/list.html (reporting sales tactics representing 20.27% of consumer complaints and prices representing 16.95% of all consumer complaints); see Consumer Council, *Annual Report 2003-04*, at 92, http://www.consumer.org.hk/website/ws_en/profile/annual_reports/list.html (reporting prices representing 19.29% of all consumer complaints and sales tactics representing 14.77% of all consumer complaints).

¹⁴ Consumer Council, *Fairness in the Marketplace for Consumers and Business*, (2008), at 13. see also http://www.consumer.org.hk/website/ws_en/competition_issues/competition_studies/2008022501.html (providing the executive summary for the report).

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

A. Contract Law

1. Common Law

Existing legal doctrines on contractual warranties and conditions do, in principle, provide consumers with a potential remedy against businesses in relation to unfair marketing practices. If a statement amounting to a contractual term turns out to be false, then there is a breach of contract. This gives the consumer a right to seek damages and to terminate the contract where the term amounts to a condition of the contract.¹⁵ For example, oral statements made by salespersons, as well as written statements contained in promotional material or on packaging provided at the point of sale, could be construed as terms of a contract with the consumer under ordinary contract law principles. Matters such as the importance of the content of the statement¹⁶ and the relative knowledge and expertise of the maker of the statement¹⁷ would be relevant considerations to the issue of incorporation of said terms.

2. Statutory Law

The above common law principles are supplemented by the Sale of Goods Ordinance.¹⁸ Under this statute, all consumer contracts for the sale of goods possess the following unwaivable conditions:¹⁹ (1) where goods are purchased by description, the goods must correspond with the description;²⁰ (2) goods must be of merchantable quality;²¹ and (3) goods must be fit for the purpose for which they are purchased.²² On occasion, consumers have successfully relied upon both the common law and statutory principles to seek redress in Hong Kong. For example, a false oral representation about the date of manufacture of a motor vehicle has been held to be a condition of the contract giving the purchaser the right to terminate.²³ In *Wong Hiu Ling v. MP Hong Kong Ltd.*, false representations as to the health benefits of bed sheets and

¹⁵ Where the term is a warranty, then the consumer can seek damages but would not be able to terminate the contract.

¹⁶ See generally *Couchman v. Hill*, [1947] 1 KB 554.

¹⁷ See generally *Dick Bentley Productions Ltd. v. Harold Smith (Motors) Ltd.*, [1965] 1 W.L.R. 623.

¹⁸ Sale of Goods Ordinance, Cap. 26 (H.K.).

¹⁹ Control of Exemption Clauses Ordinance, Cap. 71, §11(2). (H.K.) (stating that such implied terms cannot be excluded or restricted by reference to any contract term as against a person dealing as a consumer).

²⁰ Sale of Goods Ordinance, §15. (H.K.).

²¹ *Id.* at §16(2).

²² *Id.* at §16(3).

²³ *Wang Kah-Lam v. Concord Ltd.*, [1979] H.K.L.R. 184.

REGULATION OF UNFAIR MARKETING PRACTICES IN HONG KONG

mattresses amounted to a breach of the implied conditions of fitness for purpose and correspondence with description where the representations were contained in promotional leaflets of the seller.²⁴

3. Limitations

In many situations, the common law contract principles and the Sale of Goods Ordinance provide redress for consumers. However, there are still significant limitations in these protections. The first limitation is that the consumer cannot assume that every statement or representation made by a seller is automatically incorporated into a contract. For example, when an advertisement is made through print, television, radio or internet, advertisers are given some latitude in providing mere “puffery”²⁵ to enhance the effectiveness of their advertisements. The second limitation is temporal. Even in situations where the alleged false advertisements provide specific misleading promises, the consumer may nevertheless be without recourse as the lapse in time between the advertisement and the contractual formation could prevent a finding that the promises are intended to form part of the contract.²⁶

B. Misrepresentation

1. Common Law

Representations not amounting to terms of the contract could nonetheless give rise to remedies in the law of misrepresentation. Where false information is given by one party (“representor”) inducing another (“representee”) to contract, and the representee relies on the information to enter into the contract with the representor, then the representee is prima facie entitled to rescind the contract under the common law.²⁷ In a variety of different settings, there have been cases in Hong Kong where the representee was allowed to rescind the contract based on pre-contractual misrepresentations under common law principles. A common scenario where this doctrine is invoked is where the representor induced the consumer to purchase land based

²⁴ *Wong Hiu Ling v. MP Hong Kong, Ltd.*, [2004] H.K.E.C. 485.

²⁵ *See generally* *Heilbut Symons and Co. v. Buckleton*, [1913] A.C. 30, 51 (L.R.H.L.Sc. 1912) (appeal taken from Eng.).

²⁶ *Cf. Routledge v. McKay* (1954) 1 W.L.R. 615 (App. Cas.) (holding that a statement at the first meeting between the parties for the sale of a motor-cycle regarding the age of the motor-cycle was not intended as a warranty in the contract when the contract was formed some time after the first meeting).

²⁷ *Abram SS Co. Ltd. v. Westville Shipping Co. Ltd.*, [1923] A.C. 773 (H.L.) (appeal taken from Eng.).

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

on misrepresentations.²⁸ In *Green Park Properties Ltd. v. Dorku Ltd.*, the Hong Kong Court of Appeal allowed the purchaser to rescind the contract where the real estate agent, who was acting on behalf of the vendor, gave a false impression that a yard area was part of the property to be sold.²⁹ After weighing the evidence, the Court agreed with the purchaser's accusations and found the contract formed as a direct result of the misrepresentation.³⁰

A representee may also seek damages in the tort of deceit for fraudulent misrepresentations at common law. Fraud is found where the representor knew the information to be false or was reckless as to the truth of the information.³¹ Where the representor was not fraudulent but merely negligent, then he or she may be liable for damages in the tort of negligence where there existed a special relationship between the representor and representee so as to give rise to a duty on the part of the representor to take care that the information provided is accurate.³²

There are, however, various limitations to the availability of common law remedies for misrepresentation that present difficulties for consumers to be successful in bringing actions. Where the action is in deceit, the consumer is required to prove that the misrepresentation was fraudulent. Proving fraud is always difficult in practice as there must be compelling evidence to convince the court that a person was acting fraudulently.³³ Where the action is for damages in negligence, there are limitations under the common law requiring the consumer to establish a duty of care based on a special relationship between the parties. The precise contours of the concept of a special relationship are perhaps not entirely clear, but the concept includes situations where the representor can be regarded as having assumed responsibility to the representee for the accuracy of the statement.³⁴ This relationship requirement is satisfied when the representor holds himself out as having some special knowledge or

²⁸ *Green Park Properties, Ltd. v. Dorku Ltd.*, [2001] 1 H.K.L.R.D. 139, *aff'd*, [2002] 1 H.K.C. 121 (C.F.A.).

²⁹ *Id.*

³⁰ *Id.*, see also *Welltech Inv. Ltd. v. Easy Fair Indus. Ltd.*, [1996] 4 H.K.C. 711 (H.C.) (stating, in relation to the facts of that case, "[t]hat the representations were made with the purpose of inducing the purchaser to enter into the sale and purchase agreement and the purchaser was influenced by the representations are beyond doubt").

³¹ See *Derry v. Peek*, (1889) 14 App. Cas. 337 (H.L.) (appeal taken from Ch.D.) (stating that where an individual "makes a statement to be acted on by others which is false, and which is known to be false, or is made by him recklessly, or without care [to] whether it is true or false, that is without any reasonable ground for believing to be true," that individual is "liable to an action of deceit").

³² See *Hedley Byrne & Co. Ltd. v. Heller and Partners Ltd.*, [1964] A.C. 465 (H.L.) (appeal taken from Eng.).

³³ See *Aktieselskabet Dansk Skibsfinansiering v. Bros.*, [2000] 1 H.K.C. 511 at 536 (holding that the court would not review the evidence for a third time in the absence of special circumstances to find a finding of fraud).

³⁴ *Williams v. Natural Life Health Foods Ltd.*, [1998] 1 WLR 830 (H.L.) (appeal taken from Eng.).

REGULATION OF UNFAIR MARKETING PRACTICES IN HONG KONG

skill and makes a statement to that effect with the intention of inducing the representee into contract.³⁵ However, these elements might not be present in many types of consumer transactions.

2. *Statutory Law*

Section 3(1) of the Misrepresentation Ordinance (hereinafter “Section 3(1)”) addresses some of the difficulties consumers face in bringing actions under the common law. Section 3(1) imposes liability where: (1) the representee entered into a contract following a misrepresentation; (2) the representee suffered loss as a result; and (3) the representor is unable to prove that he or she “had reasonable grounds to believe[,] and did believe up to the time the contract was made[,] that the facts represented were true” at the time the contract was made.³⁶ In stark contrast to the common law, the onus is now on the representor to prove that he was not fraudulent. Section 3(1) also takes a contrasting approach to the common law in cases of negligent misrepresentation. Under the statute there is no need to establish any special relationship or duty of care, and the burden is now again on the representor to show that he had reasonable grounds for the belief and was accordingly not negligent. There are examples of cases in Hong Kong where purchasers or lessees of flats have been able to obtain damages under Section 3(1) in relation to misrepresentations on matters ranging from the size of the flat³⁷ to whether the carpark being sold was covered or uncovered.³⁸

3. *Limitations*

Despite the possibilities for successful remedies under either the common law of misrepresentation or Section 3(1)³⁹ there are still a number of limitations under the existing law. Firstly, under both the general common law

³⁵ *Esso Petroleum Co. Ltd. v. Mardon*, [1976] Q.B. 801, 820 (stating that “duty only arises where the representor carries on the business of giving advice, or holds himself out as possessing the necessary skill and competence”). See also *Customs and Excise Comm’rs v. Barclay Bank PLC*, [2007] 1 A.C. 181 (H.L.) (appeal taken from Eng.) (stating that “the test is objective, the relevant question being whether the defendant, by his words or conduct, should be held to have assumed responsibility for the claimant”).

³⁶ Misrepresentation Ordinance, Cap. 284, § 3(1). (H.K.).

³⁷ *Pepsi-Cola Int’l Ltd. v. Charles Lee*, [1974] H.K.L.R. 13 (H.C.) (regarding the size of an adjacent plot of land for lease); *Chan Kit Yee v. The United Inv. of Hong Kong and Singapore Ltd.*, [1989] H.K.L.Y. 137 (H.C.).

³⁸ *Long Year Dev. Ltd. v. Tse Fuk Man Norman*, [1991] 2 H.K.C. 393 (H.C.).

³⁹ Compare Misrepresentation Ordinance, Cap. 284, § 3(2). (H.K.), (allowing an order for damages in lieu of rescission in cases of innocent misrepresentation) and the general law where there is no opportunity for the representee to seek damages purely for innocent misrepresentations.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

and Section 3(1), there must be a “misrepresentation” involved. This means that mere silence or non-disclosure, even of material information, would not give rise to any remedy.⁴⁰ The requirement of misrepresentation also means that mere “puffery” would not be grounds for remedy, as vague promotional language or exaggerated sales talk is not regarded as amounting to any representation of fact as required by the common law.⁴¹ Thus, there have been cases where statements made in advertising material have been held to be mere “puffery” rather than statements of fact capable of amounting to an actionable misrepresentation. In one Hong Kong case, the Court of First Instance held that the phrase “regal surroundings for the select few” contained in a brochure advertising a property development was mere “puff” and did not amount to any representation that the property would be constructed to a high standard of luxury.⁴²

A second limitation of the existing law on misrepresentations is the requirement that the plaintiff be a person or member of a class of persons whom the representation was intended by the representor to reach.⁴³ It also appears that the representor must have intended the representee to act on the representation. In other words, the representor must have made the representation with the intent of inducing the representee to enter into the contract.⁴⁴ In many situations, these requirements would not cause any real difficulties for the plaintiff as the court can readily infer the element of inducement from the nature of the representation and the context in which it was made.⁴⁵ For example, the inference of inducement can be made where an

⁴⁰ See *Aktieselskabet Dansk Skibsfinansiering* 1 H.K.C. at 528; see also *Inchcape NRG HK Ltd. v. Hotel Amenities Int'l Ltd.*, [2000] H.K.E.C. 644 (C.A.). Cf. *Aktieselskabet Dansk Skibsfinansiering*, 1 H.K.C. at 528, (stating that there would be a misrepresentation as a result of omissions only where statements made are partially true or where statements are “literally true but may give a misleading impression”).

⁴¹ *Dimmock v. Hallett*, [1866] L.R. 2 Ch. App. 21 (holding that “the statement that the land is fertile is a mere advertising flourish, which cannot affect the contract”).

⁴² *Chan Yeuk Yu v. Church Body of Hong Kong Sheng Kung Hui*, [2001] 1 H.K.C. 621 (C.F.I.). See also *Chartered Trust PLC v. Davies*, [1997] 76 P. & C.R. 396, 396 (A.C.) (holding that “[t]he advertising literature...could not be said to constitute an implicit representation”). Oral sales talk might also be regarded as mere puffery: *Mok Lai Kuen v. Will Rise Ltd.*, [2003] H.K.E.C. 757 (C.F.I.) (holding that a statement that a flat was “a very good flat” made by a real estate agent to a prospective purchaser who was viewing show flats was incapable of amounting to a representation of quality in the circumstances of the case).

⁴³ See *Peek v. Gurney*, [1873] L.R. 6 H.L. 377.

⁴⁴ *Smith v. Chadwick*, [1884] L.R. 9 App. Cas. 187, 196 (stating that “[i]n an ordinary action of deceit the plaintiff alleges that false and fraudulent representations were made by the defendant to the plaintiff in order to induce him, the plaintiff, to act upon them”). While there is generally acceptance of this principle, the matter is not entirely beyond doubt. See Michael Bridge, *Innocent Misrepresentation in Contract*, 57 C.L.P. 277, 285-287 (2004).

⁴⁵ See, e.g., *Smith v. Kay*, [1859] 11 Eng. Rep. 299 (A.C.); *Gould v. Vaggelas*, (1984) 157 CLR 215.

REGULATION OF UNFAIR MARKETING PRACTICES IN HONG KONG

oral representation is directed to a customer by a salesperson at the point of sale where the salesperson is encouraging or enticing the customer to contract. However in some cases, the requirements would pose a difficulty. In *Peek v. Gurney*, the House of Lords held that the purchasers of shares on the secondary market could not seek a remedy for misrepresentations contained in a prospectus issued by promoters of a company because the prospectus was only intended by the promoters to be relied upon by the initial subscribers to the company, and not subsequent purchasers.⁴⁶ Therefore, if a property developer made false statements in brochures promoting its new residential flats, and subsequently a purchaser on the secondary market relies on the brochure provided by a real estate agent, the purchaser might well be deprived of any remedies against the developer under the principles in *Peek*.⁴⁷

A third area of difficulty for consumers under the existing law is the operation of exclusion clauses in the contract. The courts do provide some protection to plaintiffs under the common law⁴⁸ by: (1) ensuring that exclusion clauses are properly incorporated into the contract before they can take effect; (2) interpreting such clauses strictly against the *proferens*; and (3) declining to allow exclusion clauses to exempt liability from fraud.⁴⁹ Further protection is provided under legislation in Section 4 of the Misrepresentation Ordinance. Under this section, advertisers can exclude or restrict liabilities or remedies in relation to a misrepresentation only if the clause itself is reasonable in light of the circumstances.⁵⁰ However despite the above protections, exclusion clauses can sometimes deny a plaintiff a remedy even though the defendant made a misrepresentation that would otherwise be actionable.⁵¹ For example, in *Cheng Kwok-Fai v. Mok Yiu-Wah Peter*, where it was alleged that a real estate agent made misrepresentations concerning the size of the flat for sale, the court held that an exclusion clause in the contract was reasonable and therefore effective.⁵² The court found reasonableness based on the fact that the vendor had done nothing to mislead the purchaser and the purchaser should have arranged for the flat to be measured himself.⁵³

⁴⁶ *Peek*, L.R. 6 H.L. 377.

⁴⁷ *Id.*

⁴⁸ See ELIZABETH MACDONALD, EXEMPTION CLAUSES AND UNFAIR TERMS, 5-84 (Tottel Publishing 2nd ed. 2006) (1999) (providing an overview).

⁴⁹ *S. Pearson & Son v. Dublin Corp.*, [1907] A.C. 351 at 356, 362, 365.

⁵⁰ See Misrepresentation Act, 1967, c.7, §3 (Eng.) and Unfair Contract Terms Act, 1977, c.50, §11(1) (Eng.) (stating analogous provisions). See also Law Reform Commission of Hong Kong, *Report on the Control of Exemption Clauses* (Topic 13), Dec. 1986; J.W.C. Richardson, *Contract Law: Control of Exemption Clauses Ordinance* (1990), 1 INT'L CO. & COMMERCIAL LAW REVIEW at c.41 (providing background of the Control of Exemption Clauses Ordinance).

⁵¹ *Toomey v. Eagle Star Ins. Co. Ltd.* (No. 2), (1995) 2 Lloyd's Rep. 88 at 91 (U.K.).

⁵² *Cheng Kwok-Fai v. Mok Yiu-Wah*, [1990] 2 H.K.L.R. 440 (H.C.).

⁵³ *Id.*; see also *Green Park Properties Ltd. v. Dorku Ltd.*, [2002] 1 H.K.C. 121, 128-129 (C.F.A.).

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

A further difficulty for consumers under the present law of misrepresentation is that the right to rescind is not an absolute contractual right.⁵⁴ The common restrictions apply when *restitutio in integrum* is not possible,⁵⁵ or where a third party has acquired rights in the subject matter of the voidable contract.⁵⁶ If rescission is not permitted, then there is still the possibility for the plaintiff to seek redress by way of damages for fraudulent or negligent misrepresentations. However damages might not be available for innocent misrepresentations under Misrepresentation Ordinance section 3(2) where the right to rescind has been lost. The balance of authority supports the view that the power of the court to award damages under Section 3(2) is dependent upon there being in existence the right to rescind.⁵⁷ Although the misrepresentation may have been made innocently and without fault, it might be thought that leaving the loss entirely on the representee who acted on the misrepresentation may not be desirable as the representor has, in a sense, benefited from the misrepresentation at the expense of the representee.⁵⁸

C. Unconscionable Conduct

1. Common Law

Common law remedies allow a party to seek rescission of a contract where the other party to the contract acted unconscionably or has notice of a third party who engaged in unconscionable conduct. Hong Kong courts have not established any unifying principle or comprehensive requirements for the

(regarding the test of reasonableness). The case of *Cheng Kwok-Fai* also illustrates another problem of the existing law because the purchaser of the flat could not obtain any remedy against the vendor in relation to the misrepresentation of the agent on the ground that the agent had neither actual nor apparent authority from the vendor to make the representation. See *Wocom Commodities Ltd. v. Texuna Int'l Ltd.*, [1986] 1 H.K.C. 392 (C.A.); and David Harland, *The Statutory Prohibition of Misleading or Deceptive Conduct in Australia and Its Impact on the Law of Contract*, 111 L. Q. REV. 100, 130-131 (1995).

⁵⁴ See generally, e.g., HUGH BEALE, *CHITTY ON CONTRACTS*, §§ 6-120-6-130 (29th ed., Sweet & Maxwell 2004) (1826).

⁵⁵ See, e.g., *Erlanger v. New Sombrero Phosphate Co.*, (1878) 3 App. Cas. 1218 at 1278, 1279 (H.L.).

⁵⁶ See, e.g., *Babcock v. Lawson* (1880) LR 5 Q.B.D. 284 (C.A.).

⁵⁷ *Zanzibar v. British Aerospace (Lancaster House) Ltd.* (2000) 1 W.L.R. 2333 (U.K.). Cf. *Dandy Malet, Section 2(2) of the Misrepresentation Act 1967*, 117 L. Q. REV. 524 (2001) (where the principle is criticized); and *Thomas Witter Ltd. v. TBP Ind. Ltd.*, (1996) 2 All ER 575 (Ch.) (where the court also preferred the alternative view that damages would still be available despite the representee having lost the right to rescind).

⁵⁸ See Hugh Beale, *Damages in Lieu of Rescission for Misrepresentation*, 111 L. Q. REV. 60, 65 (1995) (stating that “[t]he ‘unjust enrichment’ of the misrepresentor is none the less because one of the bars to rescission has occurred, and this restriction is hard to justify”).

REGULATION OF UNFAIR MARKETING PRACTICES IN HONG KONG

operation of the unconscionable dealings doctrine. However, it has been accepted that the doctrine can apply where a weaker party was under a special disadvantage known to, and exploited by, the stronger party in a morally culpable manner, with the resulting transaction being not merely hard or improvident, but overreaching and oppressive.⁵⁹ A person can be regarded as being subject to a special disadvantage by reason of “age, poverty, ignorance, lack of assistance or independent advice or inability to judge what is in his best interest.”⁶⁰ Thus, the taking advantage of vulnerable consumers could potentially allow a court to refuse to enforce oppressive contracts on the basis of unconscionability.⁶¹ However, the court’s intervention is exceptional,⁶² as the elements of unconscionability under the common law are not easy to establish.

2. *Statutory Law*

Following recommendations of the Law Reform Commission in 1990, the legislature in Hong Kong enacted the Unconscionable Contracts Ordinance (hereinafter “UCO”), modelled on what is now section 51AB of the Trade Practices Act 1974 in Australia.⁶³ Under UCO Section 5, where a contract or any part of a contract for the sale of goods or supply of services is unconscionable in the circumstances at the time of entry into the contract, the court may refuse to enforce the contract or any part of the contract, or modify the terms of the contract to avoid the unconscionable result.⁶⁴ Factors which the court may consider in deciding whether or not a contract is unconscionable

⁵⁹ See *Wong Yung v. Hui Kwok Nam*, [2003] H.K.C. 337 (explaining that “an unconscionable bargain in this context would be a bargain of an improvident character made by poor or ignorant person acting without independent advice which cannot be shown to be a fair and reasonable transaction.”). See also *Semana Bachicha v. Poon Shiu Man*, [2000] 2 H.K.L.R.D. 833, 841 (C.A.) (holding unconscionability to be present because “[n]either party was legally represented when the agreement was signed. The plaintiff was a person with an economic and social disadvantage, and with a marked inequality of bargaining power, when compared with her employer.”; *Hart v. O’Connor*, (1985) A.C. 1000 (P.C.) (holding that the court would look to the bargaining positions of the parties including age, physical health and experience to determine the viability of a contract); *Commercial Bank of Australia Ltd. v. Amadio*, (1983) 151 C.L.R. 447 (holding that “a transaction will be unconscientious within the meaning of the relevant equitable principles only if the party seeking to enforce the transaction has taken unfair advantage of his own superior bargaining power, or of the position of disadvantage in which the other party was placed.”).

⁶⁰ *Lo Wo v. Cheng Chan Ka*, [2000] 2 H.K.L.R.D., 370, 381.

⁶¹ See, e.g., *id.*

⁶² See *Ming Shiu Chung v. Ming Shiu Sum*, [2006] 2 H.K.L.R.D. 831,859 (C.F.A.) (stating “[i]t remains the case that there is no general jurisdiction to set aside transactions either because of inequality of bargaining power between the parties or because the transaction was improvident”).

⁶³ LAW REFORM COMMISSION OF HONG KONG, REPORT ON SALE OF GOODS AND SUPPLY OF SERVICES, §§7.7.1-7.7.5, (Feb. 1990).

⁶⁴ Unconscionable Contracts Ordinance, Cap. 458, § 6. (H.K.).

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

include:

- (a) the relative strengths of the bargaining positions of the consumer and the other party;
- (b) whether, as a result of conduct engaged in by the other party, the consumer was required to comply with conditions that were not reasonably necessary for the protection of the legitimate interests of the other party;
- (c) whether the consumer was able to understand any documents relating to the supply of the goods or services;
- (d) whether any undue influence or pressure was exerted on, or any unfair tactics were used against, the consumer or a person acting on behalf of the consumer by the other party or a person acting on behalf of the other party in relation to the supply or possible supply of the goods or services; and
- (e) the amount for which, and the circumstances under which, the consumer could have acquired identical or equivalent goods or services from a person other than the other party.⁶⁵

The statutory provision is not limited by the common law doctrine of unconscionability,⁶⁶ and thus the UCO potentially provides greater protection to consumers.

Where the contractual terms are particularly harsh and not reasonably necessary for the protection of the interests of the trader, and where the consumer has a lack of bargaining power and deals with the trader on the basis of a standard form contract, then the conduct of the trader in persuading the consumer to contract without highlighting the existence of harsh terms in the contract, or without affording the consumer a realistic opportunity to peruse the contractual terms, could well lead the court to find the contractual provisions unconscionable.⁶⁷ In relation to whether the consumer understood the terms of the contract, the courts have taken a realistic approach, and the mere fact that the consumer could have read the terms or that the standard form contract contains an acknowledgement that the consumer has read the terms would not be sufficient to show that the consumer was aware of all the contractual terms in

⁶⁵ Unconscionable Contracts Ordinance, § 6(1).

⁶⁶ *Hang Seng Credit Card Ltd. v. Tsang Nga Lee*, [2000] 3 H.K.L.R.D. 33, 41 (C.F.I.) (holding that “[i]n applying the UCO, the court is not shackled by the traditional or classic theories in contract law”).

⁶⁷ *Cheung Kam Sing v. Int’l Resort Dev. Ltd.*, [2003] 2 H.K.L.R.D. 113 (holding a holiday timeshare agreement to be unconscionable where claimants were enticed to attend the defendants’ premises by claims that they had won holiday prizes and where the claimants were then subjected to 3 hours of persistent persuasion to contract and were not given an opportunity to discuss and consider the matter calmly between themselves).

REGULATION OF UNFAIR MARKETING PRACTICES IN HONG KONG

circumstances where the parties did not really intend for the consumer to read clearly all the terms prior to contracting.⁶⁸

3. *Limitations*

While the provisions in the UCO are important in providing remedies for consumers, there are still some limitations in the legislation. Firstly, the UCO deals with unconscionable terms in contracts, and although conduct of the trader is relevant when ascertaining whether the contract is unconscionable, the UCO cannot be relied upon in relation to unconscionable promotional conduct per se.⁶⁹ Moreover, unconscionability under the UCO is assessed with reference to the circumstances relating to the contract at the time when it was made, and so post-contractual unconscionable conduct is not caught.⁷⁰ By contrast, the Australian provision in the Trade Practices Act 1974 Section 51AB, applies generally to unconscionable “conduct” and is not restricted in the above ways.

Secondly, the concept of unconscionability might be too narrow in its application such that the UCO would not cover all types of unfair or unjust conduct. In *Shum Kit Ching v. Caesar Beauty Centre Ltd.*, the court explained that the term “unconscionability” denotes a lack of conscience, and accordingly held that under both the UCO and the common law, the doctrine requires that the consumer be under some form of weakness which is known to the other party and which is exploited by the other party.⁷¹

The weakness requirement on the part of the consumer was not expressly examined by the court in *Hang Seng Credit Card Ltd. v. Tsang Nga Lee*. The court simply examined the factors set out in Section 6 of the UCO and was prepared to accept that the relevant terms were unconscionable without specific investigation of any particular circumstances of weakness of the consumers.⁷² Assuming that there is a blackletter requirement for the consumer to suffer from some sort of weakness, that requirement can be established at least on the basis of the inequality of bargaining power when coupled with the consumer’s lack of understanding or awareness of the terms. The reasoning in

⁶⁸ See *Hang Seng Credit Card*, 3 H.K.L.R.D. at 39 (C.F.I.); see also *Shum Kit Chung v. Caesar Beauty Ctr., Ltd.*, [2003] 3 H.K.L.R.D. 422, 433-434.

⁶⁹ Consumer Council, *Regulating Deceptive Misleading and Unfair Practices in Consumer Transactions*, § 3.21 (2001).

⁷⁰ Unconscionable Contracts Ordinance, § 5(1). (H.K.) (stating that the court may provide a remedy if “the court finds the contract or any part of the contract to have been unconscionable in the circumstances relating to the contract at the time it was made”). Under section 6(3), the court may take into account the conduct of the parties in relation to the performance of the contract since it was made when considering the exercise of its powers under section 5, however this provision only applies after the court has already made a finding that the contract was unconscionable.

⁷¹ *Caesar Beauty Ctr. Ltd.*, 3 H.K.L.R.D. at 432.

⁷² See generally *Hang Seng Credit Card*, 3 H.K.L.R.D. at 33-41.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

Caesar Beauty Centre Ltd. clearly indicates that the weakness requirement is easier to satisfy in the UCO than it is under the common law.⁷³ In *Caesar Beauty Centre Ltd.*, the court found the purchaser of a health club membership was in a position of weakness.⁷⁴ The court explained that the purchaser was easily persuaded to spend money, that she did not have a clear understanding of all the terms in the contract and had some reservations in deciding to enter into the contract.⁷⁵ Nonetheless, while the statutory provision is wider than the common law principles, to some extent, the concept of unconscionability still narrows the scope of the UCO compared with a concept of unfair or unjust conduct.⁷⁶

Thirdly, the application and practical effects of the UCO present yet another limitation for consumers. Once again, *Caesar Beauty Centre Ltd.* highlights the limitation. The consumer paid HK\$48,060 in advance to receive 267 facial treatments.⁷⁷ On the day after entering into the contract and making that payment, the consumer sought to withdraw from the contract and to recover the monies paid.⁷⁸ Despite the fact that the court found the contractual clause denying refunds to be unconscionable, it did not order the consumer be refunded the money paid.⁷⁹ The crux of the court's position was that the trader did not accept the consumer's request to terminate the contract.⁸⁰ As a result, the contract remained valid and therefore no legal basis existed for the consumer to recover the \$48,060.⁸¹ Interestingly, if the contract was terminated, the trader would not have been able to enforce the non-refund clause, and the consumer could have recovered the \$48,060 under restitutionary principles or pursuant to a court order under Section 5(1)(c) altering the unconscionable part of the contract. This application of the UCO highlights an obscure result which shows that the Hong Kong laws intended to protect consumers still possess significant gaps.

⁷³ *Caesar Beauty Ctr. Ltd.*, 3 H.K.L.R.D. at 422.

⁷⁴ *Id.*, at 432-33.

⁷⁵ *Id.*

⁷⁶ See John Carter and David Harland, (3d Ed., Butterworths 1996), at § 1527; cf. Contracts Review Act, 1980, No. 16, §7(1), (N.S.W.) (Austl.) (where the wider concept of "unjust" contracts is used instead of "unconscionable" contracts).

⁷⁷ *Caesar Beauty Centre Ltd.*, 3 H.K.L.R.D. at 422.

⁷⁸ *Id.*, at 436.

⁷⁹ *Id.*, at 437-439.

⁸⁰ *Id.* at 437.

⁸¹ *Id.*, at 439 (the judge stated that: "Notwithstanding that I have considerable sympathy for the [consumer] who had entered into an unwise bargain beyond her means, my decision is that the appeal must be dismissed").

REGULATION OF UNFAIR MARKETING PRACTICES IN HONG KONG

PART III: EXISTING CRIMINAL REGULATIONS

Apart from civil remedies for consumers under the common law and under particular statutory provisions, there are a number of statutes in Hong Kong creating criminal offences in relation to misleading advertising or marketing. Similar to the analysis of civil law, an analysis of the statutory protections and existing limitations is required.

A. Trade Descriptions Ordinance

The main legislation of general application across different industries is the Trade Descriptions Ordinance (hereinafter “TDO”). Section 7 of the TDO prohibits a person in the course of any trade or business from applying a false trade description to any goods, or supplying or offering to supply any goods, to which a false trade description is applied.⁸² The term “trade description” refers to a description of goods as to: (1) quantity; (2) method of manufacture, production, processing or reconditioning; (3) composition; (4) fitness for purpose, strength, performance, behaviour or accuracy; (5) any other physical characteristics not included in the above; (6) testing by any person and results thereof; (7) approval by any person or conformity with a type approved by any person; (8) place or date of manufacture, production, processing or reconditioning; (9) person by whom manufactured, produced, processed or reconditioned; and (10) other history, including previous ownership or use.⁸³

Section 7 of the TDO provides a broad scope of protection for consumers against false or misleading marketing. The statute catches general advertising of goods which contain false trade descriptions,⁸⁴ as well as both oral⁸⁵ and written trade descriptions given at the point of sale. Moreover, the following are guiding principles that have developed through case law: the fact that no one was in fact deceived does not mean that there cannot be a contravention;⁸⁶ intention to deceive is not a requisite element of the offence;⁸⁷

⁸² Trade Descriptions Ordinance, Cap. 362, § 7. (H.K.) (equivalent to former section 1(1) of the Trade Descriptions Act 1968 (UK) (repealed by the Consumer Protection from Unfair Trading Regulations 2008 (UK) Sch 2)); *id.* at § 18 (providing a maximum penalty of a HK \$500,000 fine and imprisonment for 5 years for an offense under section 7). *See generally* RICHARD J. BRAGG, TRADE DESCRIPTIONS: A STUDY OF THE TRADE DESCRIPTIONS ACT 1968 AND PART III CONSUMER PROTECTION ACT 1987, 6-50 (1991).

⁸³ Trade Descriptions Ordinance, § 2(1). (H.K.) (“False trade description” is also defined in section 2, and includes trade descriptions which are misleading or “false to a material degree”).

⁸⁴ *See id.* at, Cap.362, 1, § 8(1-2).

⁸⁵ *Id.* at § 6(2).

⁸⁶ *The Queen v. Keening Indus. Ltd.*, [1995] 1 H.K.C. 276, 285 (C.A.); *Chidwick v. Beer*, [1974] R.T.R. 415, 421 (D.C.).

⁸⁷ *Keening Indus. Ltd.*, 1 H.K.C. at 285-86.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

“omissions can render a description misleading”,⁸⁸ and opinions can be caught as well.⁸⁹ In Hong Kong, prosecutions have been brought under the TDO in relation to counterfeit goods⁹⁰ and false descriptions as to the place of manufacture of goods.⁹¹

B. Industry Specific Legislation

Beyond the TDO, other legislation in Hong Kong creates criminal offences in relation to misleading advertising or marketing in specific industries. The Weights and Measures Ordinance prohibits persons who supply goods in the course of trade from knowingly making any false or misleading statement regarding the quantity of goods supplied.⁹² In the food and drug industry, the Public Health and Municipal Services Ordinance creates offences for providing false or misleading labels on food⁹³ or drugs.⁹⁴ In the financial services sector, the Securities and Futures Ordinance contains a number of criminal provisions dealing with deceptive information which is likely to induce persons to: acquire or sell securities or interests in collective investment schemes, or to deal in futures contracts, or leveraged foreign exchange contracts.⁹⁵ Section 40A of the Companies Ordinance also imposes criminal liability for untrue or misleading statements in prospectuses on persons who authorized the issue of the prospectus.⁹⁶

⁸⁸ See COLIN SCOTT & JULIA BLACK, *CRANSTON'S CONSUMERS AND THE LAW* 229 (William Twining & Christopher McCrudden eds., 3d Ed., Butterworths 2000).

⁸⁹ *Holloway v. Cross*, [1981] R.T.R. 146, 151 (D.C.).

⁹⁰ See e.g., *HKSAR v. Lau Lap Kin*, [2006] 2 H.K.C. 497, 500, 502, 506 (C.F.I.); *Sec'y for Justice v. Lam Chi Wah*, [1999] 4 H.K.C. 343, 345-346 (C.A.); *Sec'y for Justice v. Yip Chi Tung*, [1998] 3 H.K.C. 214, 214 (C.A.); *HKSAR v. Lau Wing*, [1998] 2 H.K.C. 747, 749, 751 (C.F.I.); *HKSAR v. Lai Wing Hung*, [2006] H.K.E.C. 588, 588 (C.F.I.); *HKSAR v. Ng Wing Fai*, [2001] H.K.E.C. 449, 449 (C.A.).

⁹¹ See *Keening Indus. Ltd.*, 1 H.K.C. at 285-86; *R v. Pang Sai Sang*, [1987] 1 H.K.C. 481, 482-83 (H.C.).

⁹² *Weights and Measures Ordinance*, Cap. 68, §18. (H.K.). See also *Weights and Measures Ordinance*, §32(2) (making the maximum penalty a fine of HK\$20,000). Cf. *Weights and Measures Act*, 1985, c. 72, § 30 (U.K.).

⁹³ *Public Health and Municipal Services Ordinance*, (Cap. 132) § 2 (stating that food includes drinks).

⁹⁴ *Id.* at § 61(1). See also *id.* at §150 and Sch. 9 (making the maximum penalty a level 5 fine of HK\$50,000 and 6 months imprisonment).

⁹⁵ *Securities and Futures Ordinance*, Cap. 571, §§ 107, 298, 300, 301 and 303. (H.K.). (outlining the criminal provisions. For example, the maximum penalties range from HK\$1,000,000 and 7 years imprisonment (§ 107(2)) to HK\$10,000,000 and 10 years imprisonment: § 303(1)). See *id.* at §§ 108, 252, 277, 281 (for civil liability provisions).

⁹⁶ See also *Companies Ordinance*, Cap. 32, 1, § 40(1). (H.K.) (addressing civil liability).

REGULATION OF UNFAIR MARKETING PRACTICES IN HONG KONG

C. Limitations

The above legislative provisions are important within their scope of operation. However, it is clear that there are significant gaps in coverage. While the above Ordinances cover misleading advertising or marketing of goods and certain financial products, there is no statutory regulation dealing with misstatements in a number of problem areas in Hong Kong outlined in Part I, including advertising by property developers, and those in the weight loss, slimming and beauty industries. There is outright prohibition on advertising of medical treatments or products under the Undesirable Medical Advertisements Ordinance, which can address problems of advertisements in relation to unproven medical treatments, including sexual virility.⁹⁷ However, the Ordinance does not cover information contained in package inserts in products,⁹⁸ and moreover does not extend to all types of health products,⁹⁹ nor slimming and beauty treatments. The lack of statutory regulation of misstatements in many service industries in Hong Kong has been described as constituting a “major deficiency”¹⁰⁰ of Hong Kong law.

There are even limitations in the TDO in its application to goods.¹⁰¹ For instance, there are gaps in the definition of “false trade description” in Section 2, so misleading statements about matters such as the identity and standing of businesses; authorship of books; films and music recordings; and environmental claims are not caught.¹⁰² Misleading information in advertisements as to pricing is also missing from the list in Section 2.¹⁰³ In addition, the courts have held that an incorrect statement that goods are available does not amount to a false trade description as to any goods,¹⁰⁴ and there is also a suggestion that misdescriptions contained in after-sale statements are not within the Ordinance where the statements are not associated with the

⁹⁷ Undesirable Medical Advertisements Ordinance, Cap. 231, Sch. 2. (H.K.).

⁹⁸ John D. Ho, *In Search of the Level Playing Field: Asymmetries and Consumer Protection in Hong Kong*, 36 HONG KONG L.J. 61, 73 (2006).

⁹⁹ Undesirable Medical Advertisements Ordinance, Schs. 1 and 2 (setting out the treatments which are covered by the legislation).

¹⁰⁰ Consumer Council, *supra* note 9, at § 19; *see also* The Law Reform Commission of Hong Kong, *Sale of Goods and Supply of Services*, § 8.3.4 (Feb. 1990) available at www.hkreform.gov.hk/en/docs/rservices-e.doc (where the Commission expressed similar concerns).

¹⁰¹ Consumer Council, *Trade Descriptions (Amendment) Bill 2007*, (Feb. 18, 2008), available at http://www.consumer.org.hk/website/ws_en/competition_issues/policy_position/2008021801.html (addressing some, but not all, of the limitations discussed).

¹⁰² SCOTT & BLACK, *supra* note 38, at 295, 301.

¹⁰³ *Cf.* Trade Descriptions (Amendment) Ordinance 2008, § 7. (H.K.) (which purports to amend the Trade Descriptions Ordinance to give some protections in relation to misleading price indications).

¹⁰⁴ *Robins and Day Ltd. v. Kent CC Trading Standards Dep't.*, [1996] CLY 1168. *Cf.* *Sweeting v. Ne. Upholstery* (1983) 2 Tr LR 5.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

actual sale or supply of the goods.¹⁰⁵ A further difficulty in Hong Kong appears to be that criminal prosecutions have mainly been brought in relation to counterfeiting problems only and thus there is limited enforcement as to general problems of misstatements and false descriptions even in relation to matters that could come within the Ordinance.¹⁰⁶

PART IV: INDUSTRY CODES OF CONDUCT

Apart from the civil and criminal laws discussed in Parts II and III, respectively, there is a significant degree of self-regulation in Hong Kong in relation to advertising and marketing practices. Codes of conduct exist in a number of industries, with the status of codes ranging from those which are entirely voluntary to those supported by statutory backing resulting in legal sanctions for non-compliance.

A. Non-Statutory Codes of Conduct

The Real Estate Developers Association of Hong Kong has issued Guidelines for Sale Descriptions of Uncompleted Residential Properties¹⁰⁷ to deal with the types of malpractices outlined earlier in this paper. The Guidelines require that sales brochures and price lists be made available to prospective purchasers at least 24 hours before flats are put for sale; that sales brochures should contain essential information, including matters such as floor areas, prominent fittings and finishes, salient conditions of the government lease and the DMC, anticipated completion date, and management fee details; and that any information provided about sales results should be as accurate as possible.¹⁰⁸

In June 2006, a voluntary Code of Practice for the beauty industry was issued by the Consumer Council in conjunction with various trade and professional organizations in the industry.¹⁰⁹ The Code contains a number of detailed provisions aimed towards eradicating misleading advertising and promotional conduct including claims regarding the health or medical benefits

¹⁰⁵ *Hall v. Wickens Motors Ltd.*, [1972] 1 WLR 1418, 1419; and *see also* SCOTT & BLACK, *supra* note 38 at 298; *but cf.* BENJAMIN GUMPERT & JONATHAN KIRK, *TRADING STANDARDS: LAW AND PRACTICE* 68-69 (Jordan Pub., Ltd. 2001) (stating a more liberal approach that any trade description applied to goods in the course of a trade or business can be caught by the statute).

¹⁰⁶ *Sale of Goods and Supply of Services*, *supra* note 100 at § 8.3.7; Consumer Council, *supra* note 9 at § 3.9.

¹⁰⁷ Consumer Council, *Guidelines for Sale Descriptions of Uncompleted Residential Properties*, (H.K.) (Aug. 25, 2006).

¹⁰⁸ *Id.*

¹⁰⁹ Consumer Council, *Voluntary Code of Practice to Usher in New Era of Self-Regulation in Beauty Industry*, (H.K.) (June 7, 2006).

REGULATION OF UNFAIR MARKETING PRACTICES IN HONG KONG

of treatments and products, and the pricing and terms of contracts with customers.¹¹⁰ Apart from misleading conduct, the Code also deals with other aspects of marketing activities, including requirements for beauty salons not to exert undue pressure in selling products to customers, and for salons to ensure that they have the capacity to fulfil service obligations under contracts for pre-paid treatments.¹¹¹

In some other industries, codes exist which bind members of an association contractually as a condition of membership or through articles of association of the body. In the insurance sector, the two main associations of brokers in Hong Kong – the Hong Kong Confederation of Insurance Brokers (hereinafter “CIB”) and the Professional Insurance Brokers Association (hereinafter “PIBA”) - each have a Code of Conduct for its members which prohibits members from making advertisements or statements which are misleading or extravagant.¹¹² Brokers are contractually bound to these requirements through the conditions of membership.¹¹³ Breach of the code provisions can lead to disciplinary action by the association, with the possibility of the imposition of sanctions including reprimands, fines, or expulsion.¹¹⁴ For brokers, expulsion has significant ramifications because a person can only act as an insurance broker if the person is a member of an authorized body of insurance brokers or is otherwise authorized by the Insurance Authority.¹¹⁵

For insurance agents, there are obligations under their agency agreements which prohibit them from making inaccurate or misleading statements about the insurer for whom they act and about the policies of the insurer. Persons can only act as agents pursuant to an appointment by an authorized insurer,¹¹⁶ and the above restrictions on misleading statements are required by the mandatory agency agreement under the Code of Practice for the

¹¹⁰ *Id.* at Pt 2.

¹¹¹ *Id.* at Pt 3.

¹¹² Professional Insurance Brokers Association, Rules and Regulations, Code of Conduct § e, <http://www.piba.org.hk/section030503.html>.

¹¹³ Hong Kong Confederation of Insurance Brokers, Membership Regulations §3.1, <http://www.hkcib.org/main.htm>; Hong Kong Confederation of Insurance Brokers, Articles of Association, art. 5A, 23, <http://www.hkcib.org/main.htm>; Professional Insurance Brokers Association, Application for Membership, <http://www2.piba.org.hk/pdf-form/mbrapp.pdf>.

¹¹⁴ Hong Kong Confederation of Insurance Brokers, Membership Regulations §§ 3.8, 3.9, <http://www.hkcib.org/main.htm>; Hong Kong Confederation of Insurance Brokers, Articles of Association arts. 28, 28D, 29, <http://www.hkcib.org/main.htm>; Professional Insurance Brokers Association, Rules and Regulations, Misconduct §§ 3(b), 3(f) and Disciplinary Matters §7(f).

¹¹⁵ Insurance Companies Ordinance, Cap. 41, §2 (defining “authorized insurance broker”), §65 (discussing insurance agents and insurance brokers), §69, (requiring insurance brokers to be authorized) and §70 (concerning approval of bodies of insurance brokers). (H.K.) §4 (making the Insurance Authority the statutory regulator in the insurance industry under the Insurance Companies Ordinance).

¹¹⁶ *Id.* at § 2 (defining “appointed insurance agent”).

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

Administration of Insurance Agents, with which insurers are bound to comply under the Insurance Companies Ordinance.¹¹⁷

Insurers are also subject to a code known as the Code of Conduct for Insurers. This Code is issued by an industry body known as the Hong Kong Federation of Insurers.¹¹⁸ Clause 8 of this Code requires insurers to guarantee that information in sales materials are not misleading.¹¹⁹ Breaches of the Code are to be taken into account by the self-regulatory body, the Insurance Claims Complaint Bureau, when resolving disputes between policy holders and insurers.¹²⁰

Marketing activities of real estate agents are regulated through a combination of non-statutory guidelines and subsidiary legislation. Under Circular 06-05 on *First Sales of Residential Properties* issued by the Estate Agents Authority (EAA),¹²¹ real estate agents are required to provide developers' price lists to customers where they have been supplied with such lists, to issue advertisements and to make representations with respect to the property only if authorized by the developer, and to ensure the accuracy of any such advertisements and representations.¹²² Estate agents are effectively required to comply with the circular as they can only carry on business with a license under the Estate Agents Ordinance,¹²³ and the EAA has power under the Ordinance to fine agents or to suspend or revoke licenses where the agent does not satisfy the requirements of being fit and proper.¹²⁴ In addition to the circular, the Estate Agents Practice (General Duties and Hong Kong Residential Properties) Regulation prohibits estate agents from: providing false and misleading information when seeking instructions from clients; issuing advertisements which are false or misleading; misrepresenting the value of properties; and exercising undue influence over clients.¹²⁵

¹¹⁷ *Id.* at § 67(4) (stating that “[A]n insurer is required to comply with a code of practice approved under

this section in its administration of insurance agents.”).

¹¹⁸ See The Hong Kong Federation of Insurers website, <http://www.hkfi.org.hk>.

¹¹⁹ The Code of Conduct of Insurers, Pt. 2, cl. 8, available at http://www.hkfi.org.hk/en_tips_customer_conduct.htm#part2 (stating that “[i]nsurers shall endeavour to ensure that all information contained in their sales materials and illustrations is current, correct, expressed in plain language and not misleading to the public.”)

¹²⁰ Articles of Association of the Insurance Claims Complaint Bureau, Art. 82 (stating that the Complaints Panel, in making its ruling “shall have regard to ... any codes and guidelines issued from time to time by the Hong Kong Federation of Insurers”).

¹²¹ Estate Agents Ordinance, Cap. 511, §4, Pt. II(1). (H.K.) (establishing the Estate Agents Authority).

¹²² Estate Agents Authority, *First Sales of Residential Properties Circular No. 06-05 (C.R.)*, ¶¶ 1, 3, 4, 5, 6 available at http://www.eaa.org.hk/practice/circulars_06-05.htm.

¹²³ Estate Agents Ordinance, §§ 15, 16.

¹²⁴ *Id.* at §§27, 30; see also Circular 06-05 *supra* note 146.

¹²⁵ Estate Agents Practice (General Duties and Hong Kong Residential Properties) Regulation, §§ 8,

REGULATION OF UNFAIR MARKETING PRACTICES IN HONG KONG

A Code of Conduct applies to travel agents in Hong Kong pursuant to the requirements of the Travel Industry Council.¹²⁶ Travel agents who are members of the Council are contractually bound to the Code under the Articles of Association of the Council, and infringements of the Code may lead to the imposition of fines or termination of the agent's membership.¹²⁷ Effectively, all travel agents are covered by the Code as agents must be a member of the Council in order to be licensed to carry on business under the Travel Agents Ordinance.¹²⁸ The Code is comprised of a number of specific codes, including a Code of Advertising Practice and a Code of Business Practice on Inbound Travel Service. The Code of Advertising Practice requires advertising of travel agents to be honest and truthful, and descriptive claims and comparisons which relate to matters of ascertainable fact to be capable of substantiation.¹²⁹ Specific material information is also required to be set out in package tour brochures published by travel agents.¹³⁰ The Code of Business Practice on Inbound Travel Service requires travel agents to ensure that the tourist guides whom they use in Hong Kong comply with another code, the Code of Conduct for Tourist Guides.¹³¹ Various obligations are imposed on tourist guides under this latter Code. For example, guides must not coerce or mislead visitors into purchasing goods, and must not exhibit dissatisfaction or provide sub-standard service because few or no gratuities are received.¹³² Tourist guides in Hong Kong are effectively required to comply with this Code as they can only be used by tourist agents if they are accredited under the TIC's Tourist Guide Accreditation System.¹³³

B. Statutory Codes of Conduct

In the television broadcasting sector, the Generic Code of Practice on Television Advertising Standards, issued by the Broadcasting Authority

9, 11 available at <http://www.legco.gov.hk/yr98-99/english/subleg/negative/ln124-e1.pdf>.

¹²⁶ Travel Industry Council of Hong Kong, <http://www.tichk.org>.

¹²⁷ See Travel Industry Council of Hong Kong, Code of Advertising Practices for TIC Members, §7, http://www.tichk.org/public/website/en/codes/codes_of_conduct/part_two_3/print.html.

¹²⁸ Travel Agents Ordinance, (1997) Cap. 218, §§ 9, 11(1)(a), 19(2), Schedule 1. (H.K.) available at <http://www.legislation.gov.hk/eng/index.htm>.

¹²⁹ See Code of Advertising Practices for TIC Members, *supra* note 127 at §§ 2.1, 3.2, 3.3.

¹³⁰ *Id.* at § 5.1

¹³¹ Travel Industry Council of Hong Kong, Code of Business Practice on Inbound Travel Service, § 3.6, http://www.tichk.org/public/website/en/codes/codes_of_conduct/part_two_4/html.

¹³² Travel Industry Council of Hong Kong, Code of Conduct for Tourist Guides, §§ 7, 9, http://www.tichk.org/public/website/en/codes/codes_of_conduct/part_two_3/print.html

¹³³ Travel Industry Council of Hong Kong, Tourist Guide Accreditation System, http://www.tichk.org/public/website/en/guides/cert_system/html.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

pursuant to the Broadcasting Ordinance,¹³⁴ imposes restrictions on providers of television broadcasting services¹³⁵ in relation to advertising that is broadcasted. For example, there are provisions in the Code which require that advertising must be honest and truthful;¹³⁶ that advertising should not unduly play on fear;¹³⁷ and that factual claims and best-selling claims in advertising should be capable of substantiation.¹³⁸ More specific restrictions are provided in relation to particular categories of advertising, such as advertisements for medical preparations and treatments, credit services, and real estate.¹³⁹ Licensees have a statutory obligation to comply with the Code, and breaches can lead to the Authority imposing fines on the licensee or suspension or cancellation of licences.¹⁴⁰

C. Advantages and Disadvantages of Self Regulation

Much has been written by commentators in relation to the desirability, or otherwise, of the use of industry codes and self-regulatory schemes in consumer protection.

1. Advantages of Self-Regulation

Advantages of self-regulation are said to include the following:¹⁴¹ (1) non-legal codes are flexible in that they can be amended faster than laws to deal with changes in the market place; (2) codes being drawn up by industry members can cater to the specific needs and circumstances of the particular

¹³⁴ See Broadcasting Ordinance, Cap 562, §3. (H.K.).

¹³⁵ *Id.* at § 5 (containing provisions directing who must be licensed under the Ordinance).

¹³⁶ General Code of Practice on Television Advertising Standards, ch. 3, General Advertising Standards, §§ 1, 9 (2007), available at http://www.hkba.hk/en/doc/code_tvad_e.pdf.

¹³⁷ *Id.* at §11.

¹³⁸ General Code of Practice on Television Advertising Standards, ch. 4, Factual and Best-selling Claims, § 1, available at http://www.hkba.hk/en/doc/code_tvad_e.pdf.

¹³⁹ General Code of Practice on Television Advertising Standards, ch. 6, Specific Categories of Advertisement, §§11, 30, 39, available at http://www.hkba.hk/en/doc/code_tvad_e.pdf.

¹⁴⁰ Broadcasting Ordinance, Cap. 562, §§ 23, 25, 31, 32. (H.K.).

¹⁴¹ See, e.g., GORDON BORRIE, *THE DEVELOPMENT OF CONSUMER LAW AND POLICY: BOLD SPIRITS AND TIMOROUS SOULS* 75 (1984); PETER CARTWRIGHT, *CONSUMER PROTECTION AND THE CRIMINAL LAW: LAW, THEORY, AND POLICY IN THE UK*, 54-56 (2001); David Clarke, *The Use of Insurance Codes of Practice – Are Consumers Getting a “Fair Go,”* 26 VICTORIA U. WELLINGTON L. REV. 717 at 729 (1996); Deborah L. Parry, *The Future of Voluntary Regulation of Advertising*, 8 CONSUMER L. REV. 137, 155-156 (2000); see also REIN RIJKINS & GORDON E. MIRACLE, *EUROPEAN REGULATION OF ADVERTISING* 41-42 (1986); David J. Harland, *The Legal Concept of Unfairness and the Economic and Social Environment: Fair Trade, Market Law and the Consumer Interest*, UNFAIR ADVERTISING AND COMPARATIVE ADVERTISING 15, 44-45 (Eric Balate, Ed., 1988); SCOTT & BLACK, *supra* note 38.

REGULATION OF UNFAIR MARKETING PRACTICES IN HONG KONG

industry; (3) self-regulation is less costly both in terms of the use of public resources¹⁴² and in terms of the costs to individuals in seeking redress;¹⁴³ and (4) codes can provide for matters which might be inappropriate for legal regulation or can provide guidelines for best practice that go beyond requirements that might be imposed by law.

The first two factors should not be over-emphasized as it is possible for a statutory scheme to provide for flexibility with industry involvement generally catered to in the legislative process,¹⁴⁴ while industry-specific codes can be implemented under a statutory regime as well. The third and fourth of the suggested arguments in favor of the use of codes arguably have more merit. However, cost savings alone cannot be decisive if the self-regulatory scheme does not actually work.

2. *Disadvantages of Self-Regulation*

Conversely, it has often been pointed out that there are various disadvantages to self-regulatory schemes including:¹⁴⁵ (1) that codes promulgated by industry associations are not applicable for non-members; and (2) there may either be no sanctions for non-compliance or the sanctions that exist may be insufficient or ineffective.¹⁴⁶

Some of the existing codes in Hong Kong deal with the first problem by effectively requiring compulsory memberships of industry associations through statutory licensing requirements.¹⁴⁷ However, licensing is not appropriate for every industry, and any imposition of a code on all traders in an industry would require statutory provisions of some sort. Regarding the second problem of effective compliance or enforcement in relation to traders subject to codes, there may be a difference depending upon whether the code is entirely voluntary or whether traders are bound by contract or under statute. Problems of non-compliance due to the voluntary nature of a code or due to lax enforcement by the industry body can be dealt with by giving responsibility to a statutory body to enforce the code, such as in the use of the Estate Agents Authority in Hong Kong. However, the question of whether there are problems with

¹⁴² As government involvement is nil or minimal.

¹⁴³ As an industry scheme for dispute resolution could be provided free of charge to consumers who would not need to incur legal and/or court expenses.

¹⁴⁴ European Consumer Law Group, *Non-legislative Means of Consumer Protection* 6 J CONSUMER POL'Y 209, 212 (1983); CARTWRIGHT, *supra* note 142, at 55.

¹⁴⁵ See, e.g., BORRIE, *supra* note 142, at 75; Clarke, *supra* note 142; SCOTT & BLACK, *supra* note 38, at 46-49, 59.

¹⁴⁶ For example, because the industry association is insufficiently objective or proactive in protecting the interests of consumers, sanctions such as cancellation of memberships might not necessarily have much impact for the particular trader.

¹⁴⁷ For example, travel agents, real estate agents, and insurance agents.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

compliance and enforcement can only be answered on the basis of empirical data. A more systematic empirical study may be needed to draw firm conclusions for the various codes in Hong Kong, but the possible limitations, at least with voluntary codes, are illustrated by the fact that some of the problems noted earlier in the real estate sector have arisen despite the existence of REDA's voluntary guidelines.

Any difficulties with self-regulatory schemes are not necessarily solved by legislative intervention, as even statutory bodies might be too lax in enforcing laws.¹⁴⁸ However, the trend in overseas jurisdictions, including England where there has been a long tradition in the use of industry codes, has been to recognize that while such codes can have an important role to play, they cannot operate effectively as a total replacement for legal regulation. Rather, what is needed is either the use of codes against a backdrop of minimum legal standards set out under legislation, or a type of co-regulation where public enforcement mechanisms are harnessed to provide teeth to industry codes.¹⁴⁹ As one scholar noted: “[t]he key to [the] effective [use of self-regulation] is in the design of a system of oversight which obviates the less desirable risks of self-regulation but recognises the advantages that can result.”¹⁵⁰

PART V: COMPARATIVE ANALYSIS

The limitations of the Hong Kong regulatory regime outlined in Parts II, III and IV, are further illuminated through comparison with two overseas regimes: the Australian regime under the Trade Practices Act 1974 (hereinafter “TPA”) and the European Community Directive 2005/29/EC Concerning Unfair Business-to-Consumer Commercial Practices in the Internal Market (hereinafter “UCP Directive”).¹⁵¹

A. Misleading Conduct – General Prohibitions

Section 52 of the TPA in Australia prohibits misleading or deceptive conduct in trade or commerce.¹⁵² In the European Community, the UCP

¹⁴⁸ See, e.g., Vivienne Chow, ‘Lets Off’ Four Big Telecoms Firms for Misleading Customers, S. CHINA MORNING POST, Mar. 30, 2005; Chloe Lai, False Advertising Costs Centaline Branch \$100,000, S. CHINA MORNING POST, July 27, 2005 (criticisms of the Estate Agents Authority).

¹⁴⁹ See, e.g., SCOTT & BLACK, *supra* note 38, at 66-69 see also European Consumer Law Group, *supra* note 145, at 222 (observing that codes have often been unsuccessful in promoting the interests of consumers, as they are usually drawn up in the interests of traders, usually to avoid legislation).

¹⁵⁰ CARTWRIGHT, *supra* note 142, at 60.

¹⁵¹ Implemented in the United Kingdom pursuant to the Consumer Protection from Unfair Trading Regulations (Eng.) 2008.

¹⁵² Compare Trade Practices Act (which for constitutional reasons, prohibits “corporations” from engaging in the impugned conduct) with Fair Trading Act, 1987, Pt. 5, (Austl.) (extending the

REGULATION OF UNFAIR MARKETING PRACTICES IN HONG KONG

Directive prohibits unfair commercial practices, which is defined to include misleading actions and omissions.¹⁵³ Examples of conduct which can be caught by the Australian or European Community provisions but not under the laws in Hong Kong,¹⁵⁴ are discussed below.

1. *Omissions or Non-Disclosures By the Trader*

Under the Hong Kong common law principles of misrepresentation¹⁵⁵ and under the TDO,¹⁵⁶ “half-truths,” or statements literally true but which give rise to a false or misleading impression, can amount to a misrepresentation or a false trade description. However, Section 52 of the Australian TPA provides wider coverage in catching omissions, as the concept of “conduct” is wider than the concept of a “representation” or “trade description”.¹⁵⁷ Section 52 does not impose a general duty of disclosure of material information, but failure to disclose certain information can be misleading where the circumstances give rise to the reasonable expectation that if some relevant fact exists it would be disclosed.¹⁵⁸ Where the trader fails to disclose information to correct the misleading impression arising from his actions then the conduct can be misleading even though no representation is made.

For example, it could be argued that where a beauty salon promotes a facial package comprised of 100 sessions for an upfront payment, with the package expiring in 12 months, the actions in promoting this package can lead a consumer to believe that he or she would not have major difficulties in making appointments so as to use up the facial sessions in the 12 month period. If the beauty salon has “blackout” periods, or the salon already has a high number of customers committed to such packages so as to make appointments difficult, the

provisions to natural persons in Australia via state legislation).

¹⁵³ Unfair Commercial Practices (UCP) Directive, Arts. 5, 6 & 7 (2007).

¹⁵⁴ Except in relation to the telecommunications sector, where the Telecommunications Ordinance, Cap. 106, §7M. (H.K.), adopts the TPA type of prohibition of misleading or deceptive conduct in the telecommunications industry.

¹⁵⁵ *Cf.* R v. Kylsant, [1932] 1 KB 442 (stating that a written statement can be regarded as false not only because of what it states, but also because of what it conceals, omits or implies).

¹⁵⁶ See SCOTT & BLACK, *supra* note 38, at 299.

¹⁵⁷ Compare *e.g.*, R v. Ford Co. Ltd., [1974] 3 All ER 489 at 491-492 (decided under the Trade Descriptions Act 1968 (UK)) with ACCC v. Pacific Dunlop Ltd., [2001] ATPR 41-823, (decided under TPA § 52). See also SCOTT & BLACK, *supra* note 38, at 299-300.

¹⁵⁸ *Demagogue Pty., Ltd. v. Ramensky*, (1992) 39 FCR 31 (judge Gummow, J. approving of the statement that “unless the circumstances are such as to give rise to the reasonable expectation that if some relevant fact exists it would be disclosed, it is difficult to see how mere silence could support the inference that the fact does not exist”); *Software Integrators Pty., Ltd. v. Roadrunner Couriers Pty., Ltd.*, (1997) ATPR (Digest) 46-177 (stating that “[c]ontemporary authority approaches the question from the perspective of whether the circumstances are such that they give rise to a reasonable expectation that if a relevant fact exists, it will be disclosed”).

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

failure to disclose of these difficulties could render the promotional conduct as being misleading.

Under the UCP Directive, there is a specific prohibition on misleading omissions.¹⁵⁹ A commercial practice¹⁶⁰ is regarded as “misleading” if it omits material information that the consumer needs to make an informed transactional decision¹⁶¹ and thereby causes the consumer to make a transactional decision that he would not have otherwise made.¹⁶²

2. *Where No Intention for Consumer to Rely on the Conduct*

In Australia, intention is not required for a contravention of TPA Section 52 and under the UK provisions implementing the UCP Directive, intention is also not a necessary element for contravention of the prohibitions on misleading acts or omissions.¹⁶³ Although intention is not required for a contravention of the TDO¹⁶⁴ under existing Hong Kong law, in order to establish misrepresentation under the common law, there may be a need to establish an intention for the representee to rely on the representation.¹⁶⁵ Usually this element of intention will not be difficult to establish under the common law, however as noted earlier, it can give rise to problems in particular circumstances.¹⁶⁶ Take, for example, the situation presented earlier in this paper of a real estate developer making available brochures to real estate agents: if the brochure contains false statements and the agent has passed on the brochure to a purchaser on the secondary market, it may be that the developer can be liable

¹⁵⁹ UCP Directive, Art. 5(4) and 7.

¹⁶⁰ UCP Directive, Art. 2 (defining a “commercial practice” as “any act, omission, course of conduct, representation or commercial communication (including advertising and marketing) by a trader, which is directly connected with the promotion, sale or supply of a product to or from a consumer, whether occurring before, during or after a commercial transaction in relation to a product”). *See also id.* (defining “consumer”, “trader” and “product”).

¹⁶¹ *Id.* (defining a “transactional decision” as “any decision taken by a consumer concerning whether to act or to refrain from acting concerning – (a) whether, how and on what terms to purchase, make payment in whole or in part for, retain or dispose of a product; or (b) whether, how and on what terms to exercise a contractual right in relation to a product”). *See also* GERAINT HOWELLS, HANS-W. MICKLITZ & THOMAS WILHELMSSON, EUROPEAN FAIR TRADING LAW: THE UNFAIR COMMERCIAL PRACTICES DIRECTIVE, 123, 136-138, Ashgate Pub., (2006).

¹⁶² Howells et al., *supra* note 162, at 136-138.

¹⁶³ *See* Consumer Protection from Unfair Trading Regulations 2008 §§ 9, 10 (Eng.); *see also* DEP’T OF TRADE & INDUST., IMPLEMENTATION OF THE UNFAIR COMMERCIAL PRACTICES DIRECTIVE: CONSULTATION ON THE DRAFT CONSUMER PROTECTION FROM UNFAIR TRADING REGULATIONS 2007 § 2.14 (2007) (Eng.), <http://www.berr.gov.uk/files/file39705.pdf>.

¹⁶⁴ *See* discussion *supra* Part IIIA.

¹⁶⁵ *See* discussion *supra* Part IIB.

¹⁶⁶ *See* discussion *supra* Part IIB.

REGULATION OF UNFAIR MARKETING PRACTICES IN HONG KONG

for losses suffered by the purchaser under TPA section 52.¹⁶⁷ Under the UCP Directive, the absence of the element of intention to induce would also not be a bar to a finding that the statements in the brochure amount to a misleading act.¹⁶⁸

3. *Post-Contractual Conduct*

In both Australia and the European Community, the TPA Section 52¹⁶⁹ and the UCP Directive,¹⁷⁰ respectively, cover post-contractual conduct that is misleading. On the other hand, the general law of misrepresentations only deals with pre-contractual representations, while there is some uncertainty as to whether the TDO covers post-contractual trade descriptions that are not made in relation to the supply of a product.¹⁷¹

4. *Puffery*

Puffery is not prohibited by TPA Section 52 as hyperbolic claims or statements that consumers would not take seriously are not regarded as misleading conduct. However, the scope for a defense of puffery under a provision such as TPA Section 52 might be narrower than under the common law principles of misrepresentation.¹⁷² Thus, for example, a claim by a real estate agent that a flat is a “very good flat” could well be regarded as being misleading under TPA Section 52 if, in fact, the flat contains serious hidden

¹⁶⁷ See also Harland, *supra* note 53, at 131.

¹⁶⁸ Query whether in this particular example, the definition of “commercial practice” in UCP Directive Art. 2 might mean that the statements in the brochure would not give rise to a contravention where the brochure has been passed on to secondary purchasers by the agent. The developer is not involved with the promotion or supply of the property any more in the case of a secondary sale, and it might be argued that the developer is thus not “directly connected” with the sale to consumers as is required by Art 2. On the other hand, the reference to “directly connected” might be thought to be intended to distinguish between business to consumer practices from business to business practices, and thus it could be argued that it should not be read in a way that excludes application of the UCP Directive to a situation such as the present. On this latter approach, the developer can be regarded as being directly connected to the sale to the consumer in circumstances where the developer has made available the brochures to the agents without any restriction on the distribution of the brochures to secondary purchasers.

¹⁶⁹ See TPA §52.

¹⁷⁰ See UCP Directive, Art. 3(1).

¹⁷¹ See discussion *supra* Part IIIC. The Trade Descriptions (Amendment) Bill seeks to expand the definition of “trade description” so as to catch misstatements in connection with after-sale repair or maintenance services, however the proposed amendments do not cover post-contractual representations generally.

¹⁷² See *Hosp. Contribution Fund of Austl. Ltd. v. Switz. Austl. Health Fund Pty. Ltd.*, (1987) 78 A.L.R. 483 (Austl.); *Byers v. Dorotea Pty. Ltd.*, (1986) F.C.A. 442 (Austl.).

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

defects.¹⁷³ The UCP Directive also expressly permits the “common and legitimate advertising practice of making exaggerated statements or statements which are not meant to be taken literally.”¹⁷⁴ However, the same consumer protection concerns underlying the Australian legislation in leading to a stricter approach in assessing whether statements are mere puffs might also be said to underlie the EC provisions.

5. *Use of Exclusion Clauses and Disclaimers*

The possibility of relying on exclusion clauses or disclaimers would be more limited under a statutory prohibition such as TPA Section 52 compared with the existing law in Hong Kong. For example, take the facts in *Cheng Kowk-Fai v. Mok Yiu-Wah Peter*, discussed in Part IIB. If this case was decided under TPA Section 52, it is likely that the conduct would be misleading or deceptive, because the mere fact that the exclusion clause in the contract might be regarded as being reasonable would not prevent the false statements as to the size of the flat from being characterized as misleading and from preventing a finding that the statements did, in fact, mislead the purchaser into contracting. Under the EC Directive, it is also unlikely that the courts will allow contracting out of statutory prohibitions, particularly where the prohibitions are implemented as criminal provisions, as in the UK.¹⁷⁵

6. *Conduct of Third Parties*

In Hong Kong, the TDO can catch false descriptions made by manufacturers of goods, though the public only deals with the retailers. However, there is no general prohibition on misleading conduct by third parties who are not party to the contract with the consumer. The difficulties in this regard arising from the limitations of the common law principles¹⁷⁶ of misrepresentation and privity of contract do not arise under TPA Section 52,¹⁷⁷ nor under the UCP Directive¹⁷⁸ Thus, for example, under the Australian and EC regulation, false or misleading information contained in promotional literature of a franchisor about services provided by franchisees which is acted upon by a

¹⁷³ Compare *Mok Lai Kuen v. Will Rise Ltd.*, [2003] 2003 WL 1953759 (C.F.I.) (decided under the common law in Hong Kong) with *Byers v. Dorotea Pty. Ltd.*, (1986) F.C.A. 422 (Austl.) (decided under TPA § 52).

¹⁷⁴ UCP Directive, Art 5(3).

¹⁷⁵ See Consumer Protection from Unfair Trading Regulations (2008) (Eng.) available at http://www.opsi.gov.uk/si/si2008/draft/ukdsi_9780110811574_en_1.

¹⁷⁶ See discussion *supra* Part II(B)(1) (relating to the common law position).

¹⁷⁷ Harland, *supra* note 38, at 130-131.

¹⁷⁸ See HOWELLS ET AL., *supra* note 162, at 69-70 (so long as the commercial practice is a “business to consumer” practice rather than a “business to business” practice).

REGULATION OF UNFAIR MARKETING PRACTICES IN HONG KONG

customer of a franchisee might well be impugned without any need to deal with the difficulties facing the customer in pursuing a common law remedy against the franchisor.

7. *Unfair conduct*

The Hong Kong provisions under the Unconscionable Contracts Ordinance are narrower than the counterpart provisions in TPA Section 51AB in Australia in that the Hong Kong provisions: (1) do not cover unconscionable conduct *per se*;¹⁷⁹ and (2) do not extend to post-contractual conduct. Thus for instance, undue harassment or coercion of a consumer into making a purchase would not be caught by the legislation unless the resultant purchase was made under terms which are unconscionable. It was also noted earlier that a general limitation of the Hong Kong and the Australian TPA provisions is that they are based on the concept of unconscionability, which is a narrower concept than unfair or unjust conduct.

By contrast, the UCP Directive prohibits unfair commercial practices generally. A commercial practice is unfair if it is contrary to the requirements of professional diligence, and it materially distorts the economic behaviour of the average consumer or of the average member of the group when a commercial practice is directed to a particular group of consumers.¹⁸⁰ Professional diligence means “the standard of special skill and care which a trader may reasonably be expected to exercise towards consumers, commensurate with honest market practice and/or the general principle of good faith in the trader’s field of activity.”¹⁸¹ Unfair commercial practices include “aggressive practices.”¹⁸² as defined in Arts 8 and 9: see Art 5(4)(b). A commercial practice is regarded as aggressive if, in its factual context, taking into account of all its features and circumstances, by harassment, coercion, including the use of physical force, or undue influence, it significantly impairs or is likely to impair the average consumer’s freedom of choice or conduct and thereby causes, or is likely to cause, him to take a transactional decision that he would not have taken otherwise.¹⁸³ Article 9 then sets out factors which are to be taken into account when assessing whether a commercial practice uses harassment or coercion, including, the timing, location, nature or persistence of the conduct; the use of threatening or abusive language or behavior; and the exploitation of any specific

¹⁷⁹ See *supra* Part IIC (discussing the fact that the Hong Kong provisions only proscribe such conduct indirectly where the conduct has led to the consumer contracting under unconscionable terms).

¹⁸⁰ UCP Directive, Art. 5(2).

¹⁸¹ *Id.* at Art. 2(h).

¹⁸² *Id.* at Art. 5(4)(b).

¹⁸³ *Id.* at Art 8.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

misfortune or circumstance of the consumer.¹⁸⁴

The precise scope¹⁸⁵ of these provisions and the concept of unfairness will need to be worked out by the courts, however it would seem that the concepts in the UCP Directive would be wider than the concept of unconscionability in Hong Kong and Australia. In relation to the situation in the case of *Caesar Beauty Centre Ltd.*, it was noted in Part IIC of this paper, that the court did not regard the contractual provisions requiring an upfront payment and the committing to 267 facial treatments to be unconscionable.¹⁸⁶ It is likely that under the provisions of the UCP Directive, a court would be more willing to impugn the trader's conduct in circumstances similar to the above case where the consumer was, as the court had accepted, in a position of weakness because of her vulnerability to persuasion and because of her financial circumstances. Psychological pressure that exploits "a conflict between an individual's short term and long term preferences"¹⁸⁷ might well be regarded as involving coercion that impairs the consumer's choice so as to amount to an aggressive commercial practice, or alternatively might be contrary to the standards of honest market practice or good faith so as to amount to an unfair commercial practice within the general prohibition in Art 5(2).¹⁸⁸

B. Specific Prohibitions

Consumer protection statutes often use a general prohibition on misleading or unfair conduct supplemented by specifically defined types of proscribed conduct.¹⁸⁹ This is the approach under the TPA¹⁹⁰ and under the UCP Directive.¹⁹¹ Some of these specific prohibitions are discussed below by way of comparison with the position in Hong Kong.

Many of the prohibitions deal with particular categories of misleading conduct. Various false representations specifically prohibited can give rise to a remedy for consumers under the law of misrepresentation in Hong Kong¹⁹² and might also come within the scope of the Trade Descriptions Ordinance.¹⁹³

¹⁸⁴ *Id.* at Art. 9.

¹⁸⁵ See generally HOWELLS ET AL., *supra* note 162, Chpts. 4, 6.

¹⁸⁶ *Caesar Beauty Centre*, 3 H.K.L.R.D. at 422.

¹⁸⁷ See IAIN RAMSAY, CONSUMER LAW AND POLICY: TEXT AND MATERIALS ON REGULATING CONSUMER MARKETS 325 (Hart Publications, 2nd ed., 2007).

¹⁸⁸ *Id.*, at 321-326; Office of Fair Trading, DRAFT GUIDANCE ON THE UK IMPLEMENTATION OF THE UNFAIR COMMERCIAL PRACTICES DIRECTIVE: CONSULTATION DOCUMENT 45-52 (2007) (Eng.).

¹⁸⁹ David Harland, *The Control of Advertising – A Comparative Overview*, 1 COMPETITION & CONSUMER L.J. 95, 99 (1993).

¹⁹⁰ See generally Trade Practices Act, Pt. V & Pt. VC Div 2.

¹⁹¹ UCP Directive, Art. 5 and Annex I.

¹⁹² For example false representation as to the standard of services covered.

¹⁹³ For example, false representations that goods are of a particular quality.

REGULATION OF UNFAIR MARKETING PRACTICES IN HONG KONG

However, some of the matters covered under the TPA or UCP Directive might not necessarily be prohibited under the law in Hong Kong. For example, bait advertising or bait and switch tactics are specifically prohibited under both the TPA¹⁹⁴ and the UCP Directive,¹⁹⁵ but are not regulated generally under Hong Kong law. Where, for example, a consumer has been enticed into the shop by bait advertising, the consumer might acquire other products promoted to him or the consumer might simply leave without purchasing any items. In either situation, there would not have been any misrepresentation inducing a transaction.

Additionally, false representations concerning the exclusion of rights or remedies of the consumer are specifically prohibited in Australia.¹⁹⁶ However in Hong Kong, use of a “no refund” sign in the premises of the store would not, in general, be prohibited. In this case, there is no remedy in the law of misrepresentation because the sign is not a representation that induces the consumer to contract. Such a sign may, however, mislead consumers into thinking that they would not have any remedies even if the product turns out to be defective, although the seller may, in fact, be subject to liability for breaches of certain implied terms under the Sale of Goods Ordinance.¹⁹⁷

As for other forms of unfair marketing practices, again some of the specific prohibitions in Australia and the EC might be addressed under the existing law in Hong Kong. For instance, the promotion of pyramid selling schemes in Hong Kong is prohibited.¹⁹⁸ Hong Kong also has regulations to cover the unsolicited commercial messages made to mobile phones, to phones via pre-recorded voice messages, or via fax or email.¹⁹⁹ However other specific categories of conduct may not be covered under Hong Kong law. Take a situation where a trader randomly telephones a person and indicates to the person that he has won some prize but will need to go to the trader’s premises

¹⁹⁴ *Id.* at Part VC §§ 56 and 75AZJ.

¹⁹⁵ UCP Directive, Annex I, 5 (dealing with bait advertising) and 6 (dealing with bait and switch).

¹⁹⁶ TPA Part V, Div. 1 § 53(g), and Part VC, Div. 2, § 75AZC(1)(k) (both prohibiting the making of “a false or misleading representation about the existence, exclusion or effect of any condition, warranty, guarantee, right or remedy”).

¹⁹⁷ *See* Control of Exemption Clauses Ordinance, Cap.71, § 11. (H.K.) (liability of a seller under various implied terms under the Sale of Goods Ordinance cannot be excluded where the seller deals with a consumer).

¹⁹⁸ Pyramid Selling Prohibition Ordinance, Cap. 355, (H.K.); *see also* TPA §§ 65AAA-65AAE (prohibition on pyramid selling schemes); UCP Directive, Annex I, cl. 14 (prohibition on pyramid selling schemes).

¹⁹⁹ *See* Unsolicited Electronic Messages Ordinance, Cap. 593. (H.K.) (stating that consumers must be given an opportunity to opt out of receiving the messages, and there are prohibitions on sending messages to persons who have requested not to receive the messages); *see also* UCP Directive, Annex I, cl. 26; and Spam Act of 2003 (Austl.) *available at* <http://www.comlaw.gov.au/ComLaw/Legislation/ActCompilation1.nsf/0/E9920A4E670D0FC8CA25702600124DC5>.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

for collection. It may be that no prize in fact would be given or the claiming of the prize might be conditional on the consumer paying money or incurring some cost. While the consumer is at the premises, the trader may engage in coercive tactics in selling some product or service to the consumer and through psychological pressure, preventing the consumer from leaving the premises until a contract is formed. If the individual is particularly vulnerable, then the individual may well succumb to the sales conduct and agree to some purchase just so that he can leave the premises. There might not be any misrepresentation actually made to the consumer inducing the consumer to contract, and there might not be any terms in the contract that are clearly unfair to the consumer. Thus, there might not be any remedy for the consumer under the law in Hong Kong.²⁰⁰ However, such conduct is specifically prohibited under the UCP Directive.²⁰¹ In Australia, the conduct might come within the provisions of the TPA prohibiting the use of physical force or undue harassment or coercion in the supply of goods or services to a consumer²⁰² and prohibiting the offering of prizes without the intention of supplying them.²⁰³

C. Enforcement and Remedies

The existing regulatory scheme in Hong Kong involves a combination of civil remedies for consumers under the common law (as supplemented in some areas by statutory remedies), criminal sanctions, self-regulation by the industry, and administrative enforcement in particular industries. Limitations in the existing regulations arise not only in relation to gaps in coverage of the existing laws, but also in relation to enforcement mechanisms and the available remedies.

For example, the main piece of legislation of general application in this area, the TDO, relies on criminal enforcement. However, some have commented that the use of the criminal law as an instrument of consumer protection is not always satisfactory. This may be because enforcement agencies

²⁰⁰ See *Int'l Resort Dev. Ltd.*, 2 H.K.L.R.D. at 113 (holding that misrepresentations were made and the contract placed the consumer at a special disadvantage. The consumer succeeded in obtaining remedies on the basis of misrepresentation and under the Unconscionable Contracts Ordinance (HK), but it would seem that no remedy would have been forthcoming in the absence of the misrepresentations inducing the contract and in the absence of the harsh terms in the contract).

²⁰¹ UCP Directive, Annex I, cl. 31 (“creating the false impression that the consumer has already won, will win, or will on doing a particular act win, a prize or other equivalent benefit, when in fact either there is no prize or other equivalent benefit, or taking any action in relation to claiming the prize or other equivalent benefit is subject to the consumer paying money or incurring a cost”) and UCP Directive Annex 1, cl. 24 (“creating the impression that the consumer cannot leave the premises until a contract is formed”).

²⁰² TPA §§ 60 and 75 AZN.

²⁰³ TPA §§ 54 and 75AZG.

REGULATION OF UNFAIR MARKETING PRACTICES IN HONG KONG

might be reluctant to bring action except in the most clear cut cases as a result of uncertainties in the application of general standards in consumer protection legislation, and also because of the higher standard of proof in criminal cases.²⁰⁴ Such factors may well be significant in Hong Kong where, as noted earlier, prosecutions under the TDO have generally been made in relation to counterfeit cases and not false advertising or false representations made to consumers generally.²⁰⁵ Another possible difficulty with relying on the criminal law is that there might be a tendency for courts to regard consumer offences as lesser crimes with the result that the fines imposed might not be sufficiently heavy and might simply be treated by traders as a cost of business.²⁰⁶ Despite its shortcomings, a common view is that criminal provisions are still important for consumer protection, at least for more serious conduct, to emphasize the egregious nature of the conduct and to deter traders from engaging in said conduct.²⁰⁷ Under the Australian TPA, the general prohibition on misleading conduct under Section 52 does not give rise to criminal liability, however there is criminal liability for the specifically prohibited conduct.²⁰⁸ The UCP Directive leaves enforcement mechanisms to be determined by the member states and the approach in the UK is to create criminal offences for contraventions of both the general prohibition on unfair commercial practices as well as the particular categories of proscribed conduct.²⁰⁹

It is recognized both in the UK and Australia, however, that the limitations in relying solely on criminal enforcement do mean that other mechanisms of enforcement are required, including administrative enforcement by a public agency. The ability of a public enforcement authority to seek, for example, injunctions to restrain contraventions is seen as attractive in protecting the public from the continuation of the wrongful conduct while at the same time meeting the objection that businesses should not be punished for conduct not previously labelled clearly as illegal.²¹⁰ In Australia, the TPA allows the government regulator, the Australian Competition and Consumer Commission (hereinafter "ACCC"), standing to seek injunctions against breaches of any of the provisions prohibiting unconscionable or misleading conduct in Pt. IVA and

²⁰⁴ SCOTT & BLACK, *supra* note 38, at 289-290; *see also* Harland, *supra* note 190, at 113. Note however that often consumer protection offences are created as strict liability offences without the need to prove mens rea.

²⁰⁵ *See* discussion *supra* Part IIIC.

²⁰⁶ SCOTT & BLACK, *supra* note 38, at 335.

²⁰⁷ *See, e.g.*, Harland, *supra* note 190, at 113; BORRIE, *supra* note 142, at 45-50; CARTWRIGHT, *supra* note 142, at 63-125.

²⁰⁸ *See* TPA, Pt. VC, Div 2.

²⁰⁹ *See* The Consumer Protection from Unfair Trading Regulations 2008, Pt. 3 (Eng.) available at http://www.opsi.gov.uk/si/si2008/draft/ukdsi_9780110811574_en_1; DEP'T OF TRADE & INDUST., *supra* note 164, at 10-12; Office of Fair Trading, *supra* note 189, at 58-62.

²¹⁰ Harland, *supra* note 190, at 113(44).

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

Pt. V of the Act.²¹¹ The ACCC may also seek a range of other orders, including orders for corrective advertising or for remedies on behalf of consumers who have suffered loss.²¹² In the UK, the Regulations implementing the UCP Directive can be enforced not only via the criminal provisions but also via civil injunctive action taken by the Office of Fair Trading or by local Trading Standards Officers under Pt. 8 of the Enterprise Act 2002.²¹³

The limitations of the existing civil remedies for consumers have been discussed earlier in Part II. Under the TPA in Australia, persons who have suffered loss as a result of the proscribed conduct may seek compensation or other relief.²¹⁴ The wide range of remedies available to consumers under the Act is recognition of the limitations of the general law in dealing with modern marketing and promotional practices.²¹⁵ The UCP Directive does not deal with private rights of consumers to seek legal address,²¹⁶ and the UK provisions implementing the Directive do not purport to create such rights in consumers. There is much to be said for the view that consumers should be given statutory legal remedies so that they can be compensated for losses arising from the proscribed conduct.²¹⁷ However, individual rights of action might not be effective in practice if transaction costs for consumers in seeking redress are high,²¹⁸ and thus issues in relation to access to justice must also be addressed.²¹⁹

The advantages and disadvantages of self-regulation have been discussed in Part IVC.²²⁰ In certain industry sectors in Australia, there are codes which incorporate redress mechanisms for consumers.²²¹ The UCP Directive also allows for the possibility of the use of codes of conduct in controlling unfair commercial practices, however there must still be a legal backstop for enforcement.²²² In the UK, there will be a continued role for industry self-regulation,²²³ though that is to operate in tandem with the criminal and administrative enforcement mechanisms under the Consumer Protection From Unfair Trading Regulations 2008. While industry codes are not necessarily

²¹¹ TPA, Part VI § 80.

²¹² *Id.* at §§ 86C, 86D, 87.

²¹³ See Consumer Protection from Unfair Trading Regulations 2008, Pt. 4; DEP'T OF TRADE & INDUST., *supra* note 164, at 11.

²¹⁴ TPA, §§82 and 87.

²¹⁵ Harland, *supra* note 190, at 115.

²¹⁶ HOWELLS ET AL., *supra* note 162, at 220.

²¹⁷ SCOTT & BLACK, *supra* note 38, at 336.

²¹⁸ *Id.*, at 105.

²¹⁹ Harland, *supra* note 190, at 115.

²²⁰ See discussion *supra* Part V.

²²¹ See Vijaya Nagarajan, *Reconceiving Regulation: Finding a Place for the Consumer*, 15 COMPETITION & CONSUMER L.J. 93 (2007)..

²²² See UCP Directive, Arts. 10 & 11; HOWELLS ET AL., *supra* note 162, at 211-212.

²²³ See Office of Fair Trading, *supra* note 189.

REGULATION OF UNFAIR MARKETING PRACTICES IN HONG KONG

effective on their own, codes can be important not only in setting best practice guidelines and standards which might be higher than those under legislative provisions, but also in providing cheaper and quicker dispute resolution processes for aggrieved consumers that could be utilized before seeking redress through the courts.

D. General Regulation or Sector by Sector Regulation

The discussion in the previous section regarding the Australian and EC regulation illustrates the common use in many jurisdictions of general prohibitions on misleading or unfair marketing practices. In Hong Kong, while there is no such general prohibition presently, there are prohibitions on misleading conduct across many industries through either particular legislative provisions or through industry codes. It might be argued that there is no need to enact broad prohibitions under a general consumer protection statute but rather, any limitations in the existing law can be dealt with by plugging the gaps via specific legislative provisions or greater use of industry codes with statutory backing on a sector by sector approach.

There are two aspects to the above objection to a general consumer protection statute. The first is in relation to the use of a broad prohibition of misleading or unfair conduct. This is often criticized on the basis that such a provision creates uncertainty as to the scope of the legislative prohibition. In Australia, the Swanson Committee, which reviewed the operation of the TPA in the initial years after its enactment, took the view that the criticisms of uncertainty arising from the general prohibition in Section 52 were overstated and had recommended the maintaining of the general provision.²²⁴ The benefit of a general provision is that it provides flexibility in dealing with new practices that emerge, thereby avoiding the possibility of traders devising strategies to get around specific prohibitions.²²⁵ The need for a general prohibition is now largely recognized internationally,²²⁶ and even the UK, which originally objected to a general clause in the UCP Directive, has now accepted this approach. Any difficulties arising from uncertainty in the operation of a general provision can be ameliorated to an extent through guidance via codes of conduct or guidance notes published by the regulator, and through education of

²²⁴ Committee to Review the Trade Practices Act 1974 (1976), *Report to the Minister for Business and Consumer Affairs (Swanson Report)*, at 66, available at tpareview.treasury.gov.au/content/report/downloads/RTF/Chapter8.rtf.

²²⁵ Harland, *supra* note 141, at 19; HUGH COLLINS, *EC Regulation of Unfair Commercial Practices in THE FORTHCOMING EC DIRECTIVE ON UNFAIR COMMERCIAL PRACTICES: CONTRACT, CONSUMER AND COMPETITION LAW IMPLICATIONS* 1, 25 (Kluwer Law Int'l 2004).

²²⁶ GERAINT G. HOWELLS & STEPHEN WEATHERILL, *CONSUMER PROTECTION LAW* 74, 435 (2d Ed., Ashgate Publishing 2005).

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

traders.

The second aspect to the above objection to a general consumer protection statute is the view that misleading or unfair conduct can be dealt with through a sector by sector approach. Examples were given earlier in this paper of prohibitions on misleading advertising or marketing practices set out in codes in particular industries. It might be argued that this type of regulation can be extended to other industry sectors without the need for some overarching piece of legislation. In this author's view however, there is merit in simplifying and systemizing the law and regulatory scheme. The Department of Trade and Industry²²⁷ in the UK has rightly pointed out that an important benefit of the new regulations implementing the UCP Directive is that it provides for a simplified and modern legal framework to replace the existing regime, which is complicated and fragmented.²²⁸ If the same provision prohibiting misleading advertising is to be contained in different codes applying to different industries, then why not simply have the one provision in the one statute applying to all industry sectors?²²⁹ Consumers seeking legal redress would find enough obstacles in navigating through the court system and to have redress mechanisms set out in a range of different codes or Ordinances would unjustifiably create complexity for, and add to the difficulties of, consumers who wish to seek a remedy for their loss.

PART VI: CONCLUSION

It has been argued in this paper that problems for consumers resulting from misleading sales tactics and other forms of unfair marketing practices of businesses in Hong Kong continue to exist. While there are various existing civil remedies for consumers, criminal sanctions prohibiting certain types of conduct, and industry codes of conduct proscribing particular practices, it is submitted that the existing regulatory regime does not adequately deal with all of the problems presently faced by consumers in Hong Kong. The scope of protection in Hong Kong is limited compared with the regimes that exist, for example, in Australia and in the UK and European Community. In its report in 2001,²³⁰ the Hong Kong Consumer Council had already suggested that amendments to the law of unfair marketing practices in Hong Kong would be desirable to better protect consumers, however no action was taken by the government at the time to implement the recommendations. It does appear that

²²⁷ Now the Department for Business Enterprises and Regulatory Reform.

²²⁸ See DEP'T OF TRADE & INDUST., *supra* note 164.

²²⁹ Of course, codes can still be useful in setting out specifically the type of conduct arising in the particular industry that might be regarded as misleading conduct in breach of a general statutory provision.

²³⁰ CONSUMER COUNCIL, *supra* note 9.

REGULATION OF UNFAIR MARKETING PRACTICES IN HONG KONG

there is now a greater willingness on the part of the government to examine possible law reforms, with the Financial Secretary in 2007 requesting the Consumer Council to re-examine this area, and with the Council having now proposed recommendations to amend the laws in Hong Kong.²³¹ This paper has argued that reform is needed in light of the continuing problems for consumers in Hong Kong. It is submitted that there is merit in devising a consumer protection statute of general application in prohibiting misleading and other forms of unfair marketing practices, with enforcement through a combination of criminal, administrative, and self-regulatory measures, coupled with the availability of civil remedies for consumers.

²³¹ CONSUMER COUNCIL, *supra* note 14.

THE IMPACT OF INTERNATIONAL ORGANIZATIONS ON THE AIDS EPIDEMIC IN SUB-SAHARAN AFRICA

*Christopher Richins**

INTRODUCTION

Since the acquired immunodeficiency virus (AIDS) was first identified in 1981, over sixty-five million people have been infected worldwide and an estimated twenty-five million people have lost their lives to the virus.¹ The human immunodeficiency virus (HIV), the virus responsible for causing AIDS, has spread at an exponential rate throughout the developing world. Estimates project that if the current trend continues, another forty-five million people will be infected worldwide by the year 2010.²

In the twenty-seven years since the discovery of AIDS, numerous international organizations have been selected to combat the spread of the virus. In 1985, the World Health Organization was the first agency delegated with the responsibility of accomplishing this task.³ Roughly ten years later, the Joint United Nations Programme on HIV/AIDS was established for the same purpose.⁴ These intergovernmental organizations have been the developing world's primary weapon in its war against HIV/AIDS.

Although these organizations have been efficient in slowing the spread of the virus throughout most of the world, there are certain geographic areas which seem impervious to the efforts of these agencies. In several developing African countries, for example, the infection rate among adults is greater than 30%, and in these countries, life expectancy has dropped to a level unknown to

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¹ Joint United Nations Programme on HIV/AIDS [UNAIDS], *2006 Report on the Global AIDS Epidemic: 10th Anniversary Special Edition*, at 4, UNAIDS/06.20E (May 2006) available at <http://www.unaids.org/en/KnowledgeCentre/HIVData/GlobalReport/Default.asp>.

² *Slowing the AIDS Plague*, N.Y. TIMES, Jul 8, 2002, at A18.

³ 2006 Global Report, *supra* note 1, at 2.

⁴ Erica Haber, *The United Nations' Response to HIV/AIDS in Africa*, 18 N.Y.L. SCH. J. HUM. RTS. 467, 468 (2002).

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

advanced civilizations since medieval times.⁵ The geographic area hit hardest by the epidemic, sub-Saharan Africa, is home to only 10% of the world's population, but accounts for greater than 60% of the world's HIV and AIDS infections.⁶

The continued proliferation of HIV in areas such as sub-Saharan Africa, however, cannot necessarily be attributed to the purported failures of international organizations. The countries themselves are primarily responsible for enacting policies that effectively slow the progression of HIV/AIDS. Developing countries, however, are incapable of combating this epidemic unilaterally. Only through a concentrated effort by both domestic and international actors can the transmission of HIV be substantially reduced.

Part I of this paper will consist of an examination of the efforts put forth by international organizations to curb the spread of HIV. Part II will focus on two sub-Saharan African countries: one which has experienced a marked increase in HIV prevalence in recent years and one which has experienced a marked decrease. That section will focus on the actions taken by international organizations in these countries, the domestic law of these countries, and specific cultural and societal factors that may influence the proliferation of the virus in these countries.

Part III will examine the cultural, social, and legal differences between the countries examined in Part II. Ultimately, that section will explain why the virus has continued to spread in one country while concomitantly decreasing in prevalence in another. Part IV will elucidate the effect that international organizations have had on the proliferation of HIV in these two countries. This paper will conclude with a proposal on how international organizations can better curb the proliferation of HIV in sub-Saharan Africa.

I. EFFORTS OF INTERNATIONAL ORGANIZATIONS

Though not discovered until 1981, AIDS had already established a foothold on several continents many years before.⁷ By 1986, over 75,000 AIDS cases had been reported to the World Health Organization.⁸ This number rose

⁵ Press Release, World Food Programme, WFP appeals for \$308 million for southern Africa as HIV/AIDS undermines recovery, July 2, 2003, available at <http://www.wfp.org/english/?ModuleID=137&Key=683>.

⁶ Noah Benjamin Novogrodsky, *The HIV/AIDS Pandemic and Human Society*, Speech Before the American Society of International Law Proceedings (March 31, 2006), in 100 AM. SOC'Y INT'L L. PROC. 345, (2006).

⁷ John G. Culhane et al., *Dealing with International AIDS: A Case Study in the Challenges of Globalization*, 35 J. MARSHALL L. REV. 381, 389 (2002).

⁸ World Health Organization [WHO] Global Programme on AIDS [GPA], *Final Report with Emphasis on 1994-1995 Biennium*, at 7, WHO/ASD/97.1 (1997), available at http://whqlibdoc.who.int/hq.1997/WHO_ASD_97.1.pdf.

INTERNATIONAL ORGANIZATIONS AND THE AIDS EPIDEMIC

six-fold over the next several years, increasing the total number of worldwide infections to 460,000.⁹ By 2006, the number had increased exponentially, with over twenty-five million AIDS-related deaths occurring worldwide.¹⁰

Developed countries, with advanced health care systems and established social welfare programs, have been successful in combating the spread of HIV/AIDS. Many of these countries have a prevalence rate far lower than 1%.¹¹ Antiretroviral drugs are readily available,¹² and AIDS has not affected the life expectancy rates of these countries. The developing world, however, faces a far different reality, and the statistics are startling.

Sub-Saharan Africa, with only 10% of the world's total population, is home to greater than 60% of all HIV and AIDS infections.¹³ AIDS is the leading cause of death in Africa¹⁴ and the fourth leading killer worldwide.¹⁵ In some African countries, experts predict that life expectancy will drop below thirty years of age by 2010.¹⁶ It is estimated that 25% of the sub-Saharan population will die from AIDS-related illnesses by 2014.¹⁷

As quickly as the virus was discovered, however, the international community mobilized forces in an attempt to stop it. The United Nations quickly realized the effect AIDS could have on the human population, and over the last twenty-five years it has delegated the responsibility of reducing the spread of HIV to two of its intergovernmental agencies: the World Health Organization and the Joint United Nations Programme on HIV/AIDS.

A. The World Health Organization Global Programme on AIDS

In 1981 the World Health Organization (WHO) began publishing information available on AIDS in the *Weekly Epidemiological Record*.¹⁸ The WHO used information gathered from studies to educate some of its member

⁹ *Id.*

¹⁰ 2006 Global Report, *supra* note 1.

¹¹ See Lawrence O. Gostin, *The Global Reach of HIV/AIDS: Science Politics, Economics, and Research*, 17 EMORY INT'L L. REV. 1, 29 (2003) (noting that in Germany, the HIV prevalence rate is only .1%).

¹² *Id.* at 22 (citing Karen A. Stanecki, U.S. Census Bureau, *The AIDS Pandemic in the 21st Century*, at 11 (2002)).

¹³ Novogrodsky, *supra* note 6.

¹⁴ Allegra A. Jones, *The "Mexico City Policy" and its Effects on HIV/AIDS Services in Sub-Saharan Africa*, 24 B.C. THIRD WORLD L.J. 187, 190 (2005).

¹⁵ The Millennium Development Goals Report 2005 at 24, U.N. Sales No. E.05.116 (2005) available at <http://unstats.un.org/unsd.mi.pdf/MDG%20Book.pdf>.

¹⁶ Gostin, *supra* note 11, at 6.

¹⁷ Jones, *supra* note 14, at 208.

¹⁸ Final Report, *supra* note 8, at 1.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

states on the characteristics of the virus.¹⁹ In 1985, the United Nations (UN) asked the WHO to “recommend a global strategy [for] prevention and control” of AIDS,²⁰ and a few short year later, the UN adopted a resolution confirming that the WHO “should continue to direct and co-ordinate the urgent global battle against AIDS.”²¹ Acting pursuant to this decree, the WHO Special Programme on AIDS (SPA) was established in 1987, and in 1988 the program’s name was changed to the Global Programme on AIDS (GPA).²²

In pursuance of its mission statement, “to mobilize an effective, equitable and ethical response to the (HIV/AIDS) epidemic,” the GPA established three primary objectives: to prevent the transmission of HIV; to reduce the social impact of HIV; and to “unify national and international effort[s] against AIDS.”²³ Mindful of differences in social, religious and political perspectives, the GPA instituted a regionalized structure whereby factors specific to particular countries would be taken under consideration when determining which programs to implement.²⁴

Through this regionalized structure, the GPA assisted developing countries in a myriad of ways. Specifically, it helped UN member states establish better testing methods for transfused blood;²⁵ it developed programs to reduce mother-to-child transmission of HIV;²⁶ and it distributed and promoted the use of male condoms throughout the developing world.²⁷ Through the efforts of the GPA, condom sales in Africa, which were totaling fewer than 1 million per annum in 1988, eclipsed 110 million in 1994 “by one social marketing firm alone.”²⁸

On the global level, the GPA collaborated with the pharmaceutical industry to develop drugs which would suppress the virus.²⁹ The GPA developed quality assurance standards and extensively researched different strains of HIV for the purpose of assisting the pharmaceutical industry in developing antiretroviral drugs.³⁰ The GPA also provided financial support to pharmaceutical companies who were engaged in the development of vaginal

¹⁹ *Id.*

²⁰ 2006 Global Report, *supra* note 1, at 2.

²¹ G.A. Res. 42/8 ¶ 2, U.N. Doc. A/RES/42/8 (Oct. 26, 1987).

²² Final Report, *supra* note 8.

²³ *Id.* at 5, 72.

²⁴ *Id.* at 4.

²⁵ *Id.* at 23.

²⁶ *Id.* at 29.

²⁷ *Id.* at 19.

²⁸ *Id.* at 20.

²⁹ World Health Organization [WHO] Global Programme on AIDS [GPA], *Potential for WHO-Industry Collaboration on Drug and Vaccine Development for HIV/AIDS*, at 3, WHO/GPA/RES/93.1 available at http://whqlibdoc.who.int/hq/1993/WHO_GPA_RES_93.1.pdf.

³⁰ *Id.* at 3, 5.

INTERNATIONAL ORGANIZATIONS AND THE AIDS EPIDEMIC

microbicides and other prophylactic devices which could be used by women to ward off the virus.³¹

Importantly, the GPA undertook to end social discrimination against people infected with HIV/AIDS. To achieve this goal, the GPA promulgated international standards requesting member states to enact legislation banning discrimination.³² The GPA also instituted an internal policy which barred the WHO from attending and contributing to conferences in countries that placed short-term travel restrictions on people infected with HIV.³³ At the regional level, the GPA actively assisted member states in drafting legislation intended to end discrimination³⁴ against HIV positive individuals.³⁵

Through the years, the GPA accomplished several objectives: it raised awareness of the threat of HIV/AIDS; helped countries establish and strengthen their domestic AIDS programs; significantly contributed to assuring the safety of blood transfusions; advocated for the rights of individuals infected with HIV; and assisted in the development of antiretroviral drugs and prophylactic devices.³⁶ While the GPA was accomplishing these goals, other agencies within the UN were contemporaneously involved in arresting the spread of HIV.³⁷ Members of the UN were well aware of the difficulties inherent in attacking the HIV epidemic through multiple intergovernmental bodies. In fact, at the SPA's Fourth Meeting of Participating Parties in 1987, it was suggested that the SPA enter "into arrangements with agencies such as the United Nations Development Programme (UNDP) and possibly the World Bank to ensure a sufficiently broad approach to the problem."³⁸ In an attempt to "avoid overlap and competition," the GPA was dissolved in 1995 to make way for the next program responsible for combating the AIDS epidemic: the Joint United

³¹ Final Report, *supra* note 8, at 25, 27.

³² *Id.* at 40.

³³ *Id.* at 41.

³⁴ *Id.* at 41, 43.

³⁵ I have designated the ending of discrimination against HIV positive individuals as highly important for the following reason: individuals who fear potential discrimination for HIV positive status are unlikely to undergo testing for the presence of the virus; individuals who are unaware of their seropositive status are unlikely to receive appropriate medical treatment for HIV infection; individuals who do not receive appropriate medical treatment have larger amounts of HIV in their system and are thus more apt to transmit the virus than individuals who are receiving proper treatment. Had the GPA not actively sought to end discrimination against HIV positive individuals, they would have been less efficient in accomplishing their overall goal of eradicating HIV.

³⁶ Final Report, *supra* note 8, at 68-70.

³⁷ See Elizabeth A. Preble, *Women, Children, and AIDS in Africa, An Impending Disaster*, 23 N.Y.U. J. INT'L L. & POL. 959, 971-74 (1991) (noting that the United Nations Children's Fund (UNICEF) had established guidelines on educating individuals about the dangers of HIV in 1988).

³⁸ World Health Organization [WHO] Special Programme on AIDS [SPA], *Report of the Fourth Meeting of Participating Parties*, at 4, WHO/SPA/GEN/87.5 (1987), available at http://whqlibdoc.who.int/hq/1987/WHO_SPA_GEN_87.5.pdf.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

Nations Programme on HIV/AIDS.³⁹

B. Joint United Nations Programme on HIV/AIDS

Established in 1996, the Joint United Nations Programme on HIV/AIDS (UNAIDS) initially consisted of six intergovernmental departments within the UN.⁴⁰ Over the last several years, the number has increased to ten.⁴¹ The purpose of combining these agencies, as noted *supra*, was to “avoid overlap and competition” between the several UN departments delegated with the responsibility of combating the AIDS epidemic.⁴² Along with performing the functions that had initially been delegated to the GPA, UNAIDS was charged with the responsibility of accomplishing several other goals, including, *inter alia*, educating individuals about the virus.⁴³

Although there are various UN declarations⁴⁴ that address the AIDS epidemic,⁴⁵ UNAIDS derives its mandate from the Declaration of Commitment on HIV/AIDS, adopted by the UN General Assembly in 2001. The Declaration assigns several responsibilities to the program: to establish national prevention targets;⁴⁶ to implement “prevention and care programs”;⁴⁷ to develop AIDS-

³⁹ Barbara Crossette, *U.N. Picks A Leader For Fight on AIDS*, N.Y. TIMES, Dec. 13, 1994, at C12 (referring to statement of Dr. Peter Piot, Executive Director of UNAIDS).

⁴⁰ Haber, *supra* note 4, at 468 (noting that the United Nations Children’s Fund (UNICEF), the United Nations Development Programme (UNDP), the United Nations Population Fund (UNFPA), the United Nations Educational, Scientific and Cultural Organization (UNESCO), the World Health Organization (WHO), and the World Bank were the initial cosponsors of UNAIDS).

⁴¹ See Joint United Nations Programme on HIV/AIDS [UNAIDS], *Annual Report; Making the Money Work*, at 16, UNAIDS/07.19E/JC1306E (June 2007) available at http://data.unaids.org/pub/Report/2007/2006_unaids_annual_report_en.pdf (noting that, along with the UN departments mentioned *supra*, note 35, the Office of the United Nations High Commissioner for Refugees (UNCHR), the World Food Programme (WFP), the United Nations Office on Drugs and Crime (UNODC), and the International Labour Organization (ILO) are all cosponsors of UNAIDS).

⁴² Crossette, *supra* note 39.

⁴³ Making the Money Work, *supra* note 41, at 16.

⁴⁴ See Declaration of Commitment on HIV/AIDS, G.A. Res. S-26/2, ¶ 6, U.N. GAOR, 26th Sess., 8th plen. mtg., U.N. Doc A/RES/S-26/2 (Aug. 2, 2001) available at <http://www.un.org/ga.aids/docs/aress262.pdf> (noting that the UN has adopted numerous policies for the purpose of reducing the transmission of HIV, including the United Nations Millennium Declaration, the World Summit for Social Development, the Beijing Declaration and Platform for Action, and the Programme of Action of the International Conference on Population and Development).

⁴⁵ See also Culhane, *supra* note 1, at 426-27 (noting that “the Universal Declaration of Human Rights (UDHR), the International Covenant on Civil and Political Rights (ICCPR), and the International Covenant on Economic, Social, and Cultural Rights (ICESCR), apply to persons affected by HIV.”)

⁴⁶ Declaration of Commitment, *supra* note 44.

INTERNATIONAL ORGANIZATIONS AND THE AIDS EPIDEMIC

related educational programs;⁴⁸ to improve access to antiretroviral drugs;⁴⁹ to end AIDS-based discrimination;⁵⁰ to “increase investment in and accelerate research on the development of HIV vaccines”;⁵¹ to develop special strategies for confronting the epidemic in war torn countries;⁵² and to provide financial counseling to member states.⁵³

Along with these responsibilities, UNAIDS periodically establishes international guidelines⁵⁴ which advise member states on how to combat the epidemic.⁵⁵ For example, Guideline 5 stresses that member states enact or strengthen existing antidiscrimination legislation,⁵⁶ and Guideline 3 asserts that member states should promulgate health legislation that “addresses public health issues raised by HIV.”⁵⁷

One of the Programme’s the most important functions of is to gather data. Over the last several years, UNAIDS has compiled data from member states on, *inter alia*, the percentage of the adult population (ages fifteen through forty-nine) infected with HIV, deaths caused by AIDS, the percentage of pregnant women infected with HIV, and the percentage of the total population that can identify HIV’s primary modes of transmission (i.e. AIDS education).⁵⁸ Using this data, UNAIDS is able to track the progression of the virus within individual countries. Tracking prevalence rates, educational statistics and similar variables allows UNAIDS to concentrate their efforts on the areas in which particular member states need the most assistance.

Since its inception, UNAIDS has assisted developing countries by establishing national reduction targets.⁵⁹ Through data gathering, UNAIDS has identified modes of transmission that are increasing in frequency in particular geographic regions and has assisted countries in establishing programs for the

⁴⁷ *Id.* ¶ 49.

⁴⁸ *Id.* ¶ 52.

⁴⁹ *Id.* ¶ 55.

⁵⁰ *Id.* ¶ 58.

⁵¹ *Id.* ¶ 70.

⁵² *Id.* ¶ 75.

⁵³ *Id.* ¶ 88.

⁵⁴ The guidelines were first promulgated in 1996 and were subsequently revised in 2002. In 2006, UNAIDS consolidated these guidelines into one document.

⁵⁵ See *International Guidelines on HIV/AIDS and Human Rights: 2006 Consolidated Version*, U.N. Sales No. E.06.XIV.4 (2006).

⁵⁶ *Id.* ¶ 21.

⁵⁷ *Id.* ¶ 19.

⁵⁸ See Joint United Nations Programme on HIV/AIDS [UNAIDS], *AIDS Epidemic Update: December 2000*, UNAIDS/00.44E (Dec. 2000) available at http://aegis.com/files/unais/WADDecember2000_epidemic_report.pdf.

⁵⁹ Making the Money Work, *supra* note 41, at 19.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

purpose of addressing these concerns.⁶⁰ Similar to its predecessor, UNAIDS provides some financial support to developing countries for the purpose of combating the spread of HIV.⁶¹

In recent years, UNAIDS has identified certain social groups, primarily women and children, that are especially vulnerable to HIV infection. In response, UNAIDS has advocated for gender equality by instituting programs designed to increase the woman's role in reproductive relations.⁶² For example, UNAIDS has promoted the use of the female condom in several countries and has financed pharmaceutical research for other prophylactic devices⁶³ that can be used by women.⁶⁴ For the protection of children, UNAIDS has provided supportive environments for children who have been infected and affected⁶⁵ by HIV/AIDS.⁶⁶

UNAIDS has also assisted countries in managing funds distributed by other groups, such as the Global Fund.⁶⁷ In the healthcare setting, UNAIDS has advocated for the development of an effective AIDS vaccine and helped secure financial assistance to companies pursuing the development of such a vaccine.⁶⁸ Likewise, UNAIDS has been instrumental in educating healthcare providers in member states on how to reduce the transmission of the virus.⁶⁹

Although assistance from UNAIDS has been essential for the reduction of HIV prevalence in developing countries, many of these countries have nonetheless witnessed a substantial increase in the incidence of HIV over the

⁶⁰ *Id.* at 10 (noting that HIV rates are increasing in some sub-Saharan countries due to an increased use of injection drugs).

⁶¹ *Id.* at 21.

⁶² *Id.* at 24.

⁶³ As with the WHO, UNAIDS has devoted funds to and promoted research for the development of vaginal microbicides. Similar to spermicide, the microbicide is intended to be injected into the vagina prior to sexual intercourse. The purpose of the microbicide is to kill HIV carrying agents (such as blood and semen) before these agents can be absorbed by the mucous membranes of the cervix. To date, however, no effective vaginal microbicide has been developed.

⁶⁴ Making the Money Work, *supra* note 41, at 24.

⁶⁵ The primary manner in which children have been 'affected' by the AIDS epidemic is through the loss of either one or both of their parents. Although this comment will only briefly explore the topic, a substantial number of children, primarily in sub-Saharan Africa, have been orphaned due to the AIDS-related death of their parents.

⁶⁶ Declaration of Commitment, *supra* note 44, at ¶ 65.

⁶⁷ Making the Money Work, *supra* note 41, at 52-53 (noting that UNAIDS cosponsor, the United Nations Development Programme, manages 58 grants issued by the Global Fund). For an explanation of the role played by the Global Fund, see David P. Fidler, *Racism or Realpolitik? U.S. Foreign Policy and the HIV/AIDS Catastrophe in sub-Saharan Africa*, 7 J. GENDER RACE & JUST. 97, 137 (2003).

⁶⁸ 2006 Global Report, *supra* note 1, at 71.

⁶⁹ See Making the Money Work, *supra* note 41, at 25 (noting that male circumcision substantially reduces a man's risk of infection).

INTERNATIONAL ORGANIZATIONS AND THE AIDS EPIDEMIC

last several years. If one were to examine the success of UNAIDS through a cursory review of worldwide HIV/AIDS statistics, one may come to the conclusion that UNAIDS has not been effective in reducing the spread of the virus. A cursory review, however, would fail to consider factors specific to individual UN member states; factors which, in the end, may substantially outweigh the benefits bestowed on member states by international organizations.

II. COUNTRY ANALYSIS

To determine whether international organizations have been effective in combating the proliferation of HIV/AIDS, it is important to look beyond raw statistics. For instance, a statistical reduction in the number of infected persons may be the result of genocide or war, and not the result of effective legislation or international assistance. Moreover, a statistical increase in HIV prevalence may stem from a population influx rather than feckless regulations. As such, one must account for state-specific factors before the impact of international organizations can be adequately assessed.

This section will examine state laws along with cultural and social factors that may impact the spread of the virus. Since these factors vary from state-to-state, two sub-Saharan countries have been chosen for an in-depth analysis: Swaziland and Ethiopia. The remainder of this paper will be primarily devoted to analyzing the progression of the virus in these two countries and the responses employed by the respective states.

Swaziland and Ethiopia were chosen for analysis because they, at present, lie at opposite ends of the spectrum. From 1999 to 2005, the years for which the most reliable data is available, Swaziland's prevalence rate *increased* by nearly 8%, the most of any sub-Saharan country. Ethiopia, on the other hand, experienced a near 4% *decrease* in HIV prevalence, one of the largest decreases in sub-Saharan Africa. By examining these two countries, one with an increase in HIV prevalence and one with a decrease, it is possible to control for any state specific factors which may influence the spread of HIV. In doing so, the actual impact of international organizations on the HIV epidemic in sub-Saharan Africa can be observed.

A. Swaziland

Although the effects of AIDS have been felt throughout the world, no region has fared worse than sub-Saharan Africa.⁷⁰ Of the roughly 33.2 million

⁷⁰ Novogrodsky, *supra* note 6.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

people currently infected with HIV/AIDS, 22.5 million live in this region.⁷¹ Some of the countries in sub-Saharan Africa, however, are faring far worse than others.

Swaziland is a landlocked country which is bordered to the north, south, and west by South Africa and to the east by Mozambique.⁷² This mountainous country has a total area of 17,360 square kilometers⁷³ and a current population of slightly over 1,133,000.⁷⁴ The Central Intelligence Agency estimates the per capita Gross Domestic Product (GDP) of Swaziland to be only \$4,800 dollars,⁷⁵ roughly one-tenth of the United States' per capita GDP.⁷⁶ In recent years, Swaziland's unemployment rate has reached 40%, and nearly 66% of the population is living on less than eleven dollars per month.⁷⁷

HIV and AIDS in Swaziland

This high level of poverty, however, is not the greatest threat to the Swazi people. In 1999, UNAIDS estimated that 13.5% of the country's population was infected with HIV or AIDS.⁷⁸ By 2005 the population had increased by 7%.⁷⁹ The virus, however, had spread more rapidly. Though the population had risen by 72,000 people over the six-year span, UNAIDS estimated that an additional 90,000 people had been infected with the virus.⁸⁰ Swaziland's population had increased by 7% while the prevalence rate increased by nearly 8%. At the end of 2005, it was estimated that 21.3% of the

⁷¹ Joint United Nations Programme on HIV/AIDS [UNAIDS], *AIDS Epidemic Update*, at 1, 15, UNAIDS/07.27E (Dec. 2007) available at http://data.unaids.org/pub/EPISlides/2007/2007_epiupdate_en.pdf.

⁷² United States Central Intelligence Agency, *The World Factbook: Swaziland*, available at <https://www.cia.gov/library/publications/the-world-factbook/geos/wz.html>.

⁷³ See Michael Wines et al., *Hut by Hut, AIDS Steals Life in a Southern African Town*, N.Y. TIMES, Nov. 28, 2004, Sec. 1, at 1 (noting that Swaziland is roughly the size of New Jersey).

⁷⁴ CIA, *supra* note 72 (estimated population as of July 2007).

⁷⁵ *Id.*

⁷⁶ United States Central Intelligence Agency, *The World Factbook: United States*, <https://www.cia.gov/library/publications/the-world-factbook/geos/us.html> (reporting the US per capita GDP to be \$46,000).

⁷⁷ Michael Wines, *For His Subjects, 5,227 Years' Wages*, N.Y. Times, Dec. 14, 2004, at A6.

⁷⁸ Joint United Nations Programme on HIV/AIDS [UNAIDS], *AIDS in Africa: Country by Country*, at 205, 208, UNAIDS/00.30E (Sept. 2000) available at http://data.unaids.org/Publications/IRC-pub05/AIDSAfrica2000_en.pdf (reporting that 130,000 of the 960,000 Swazi citizens were infected with HIV/AIDS).

⁷⁹ Joint United Nations Programme on HIV/AIDS [UNAIDS], *2006 Report on the Global AIDS Epidemic: 10th Anniversary Special Edition, Annex 1*, at 460, UNAIDS/06.20E (May 2006) available at http://data.unaids.org/pub/GlobalReport/2006/2006_GR_ANN1M-Z_en.pdf.

⁸⁰ *Id.*

INTERNATIONAL ORGANIZATIONS AND THE AIDS EPIDEMIC

total population was infected with HIV or AIDS,⁸¹ designating Swaziland as the country with the world's highest infection rate.⁸²

Along with the world's highest infection rate, 56% of pregnant women ages twenty-five through twenty-nine were HIV positive in 2004.⁸³ In 2005, estimates projected that 56.3% of *all people* ages twenty-five through twenty-nine were infected with HIV or AIDS.⁸⁴ Roughly fifty thousand Swazi citizens died from AIDS by the year 2001.⁸⁵ It is currently estimated that another seventeen thousand continue to die each year.⁸⁶ In recognition of the devastation caused by HIV/AIDS, Swaziland's King, Mswati III, declared AIDS a natural disaster in 1999.⁸⁷

International Organizations in Swaziland

The increase in the prevalence of HIV/AIDS in Swaziland cannot necessarily be attributed to a lack of effort on the part of international organizations. As noted *supra*, the UNDP, the WHO, the United Nations Children's Fund (UNICEF) and the United Nations Educational, Scientific and Cultural Organization (UNESCO) are all cosponsors of UNAIDS.⁸⁸ Over the last several years, these organizations have actively assisted the Kingdom of Swaziland in its battle against the epidemic.

For example, the UNDP has been working with the government of Swaziland to make antiretroviral therapy more accessible.⁸⁹ This is of special importance for two reasons: first, experts predict that Swaziland's life expectancy will drop to thirty years of age by 2010.⁹⁰ With a high percentage of Swazi citizens perishing before their fortieth birthdays, Swaziland is quickly losing its workforce. Antiretroviral therapy prolongs the lives of individuals

⁸¹ *Id.*

⁸² Subjects, *supra* note 77.

⁸³ Alan Brody, *In One Country, AIDS on the Rampage...*, N.Y. TIMES, Aug. 12, 2006, at A15.

⁸⁴ Swaziland National Emergency Response Council on HIV/AIDS [NERCHA], *2003-2005*

UNGASS Indicators Country Report, at 4, (Dec. 2005) available at

http://data.unaids.org/pub/Report/2006/2006_country_progress_report_swaziland_en.pdf.

⁸⁵ *Swaziland: Enlisting Tradition In AIDS Fight*, N.Y. TIMES, Sep. 15, 2001, at B3.

⁸⁶ Brody, *supra* note 83.

⁸⁷ Swaziland Ministry of Health and Social Welfare [MOHSW], *8th HIV Sentinel Serosurveillance Report*, at 11, (Dec. 2002) available at

<http://www.fhi.org/NR/rdonlyres/e3ce637nxcwectyxmng7fznofqyq6viarycufbcbs73bxvzbbpb73x57jbxfrosc6c5fvo4d4a6n/swazilandaidreport1.pdf>.

⁸⁸ Haber, *supra* note 4.

⁸⁹ United Nations Development Program [UNDP], *HIV and AIDS in Swaziland*, available at

<http://www.undp.org.sz/documents/HIV%20and%20AIDS.pdf>.

⁹⁰ Hut by Hut, *supra* note 73.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

infected with HIV/AIDS.⁹¹ Widespread use of antiretroviral therapy will increase life expectancy, which, in turn, will help promote the economic vitality of Swaziland.

Second, only 23% of the country's population resides in urban areas, thus rendering delivery of antiretroviral drugs quite difficult.⁹² The UNDP is helping to combat this problem by advising the Swazi government on ways to make antiretroviral therapy more readily available to the country's rural residents.⁹³

The UNDP has also worked with nongovernmental organizations, including Swaziland's largest church group, on developing community level HIV programs.⁹⁴ As mentioned *supra*, over 70% of Swaziland's population resides in rural areas.⁹⁵ With a vast majority of Swazi citizens residing in rural areas, the establishment of community level programs is necessary to reduce the transmission of HIV in Swaziland. The UNDP has also collaborated with Swaziland's national and regional governments on ways to reduce stigma and discrimination against people infected with HIV.⁹⁶

UNESCO has assisted Swaziland by developing a program designed for strengthening HIV and AIDS education.⁹⁷ Additionally, UNICEF has assisted by "establishing a framework" for preventing mother-to-child transmission of the virus⁹⁸ and has "supported training for more than 1,500 child protection workers" in Swaziland.⁹⁹

The WHO has also been active in Swaziland. It has provided "technical assistance in finalizing the national framework for scaling up antiretroviral therapy," has helped the government establish guidelines on antiretroviral therapy, and has supported the government's effort to improve "access to and [the] quality of voluntary testing and counseling services" within the country.¹⁰⁰

Despite these efforts, it is the member states, rather than international organizations, that are primarily responsible for enacting regulations intent on

⁹¹ The Government of the Kingdom of Swaziland, *The National Multisectoral HIV and AIDS Policy*, at 8, (June 2006) available at <http://www.nercha.org.sz/publications/National20%HIV20%AIDS20%POLICY20%FINAL.pdf>.

⁹² *Id.* at 1.

⁹³ UNDP Swaziland, *supra* note 89.

⁹⁴ *Id.*

⁹⁵ See Swaziland Multisectoral Policy, *supra* note 91, at 1.

⁹⁶ *Id.*

⁹⁷ 2006 Global Report, *supra* note 1, at 263.

⁹⁸ United Nations Children's Fund [UNICEF], *Swaziland-Background*, http://www.unicef.org/infobycountry/swaziland_937.html.

⁹⁹ The issue of child protection will be discussed in greater detail *infra*.

¹⁰⁰ World Health Organization [WHO], *Swaziland: Summary Country Profile for HIV/AIDS Treatment Scale-Up*, at 3, (Dec. 2005), available at http://www.who.int/hiv/HIVCP_SWZ.pdf.

INTERNATIONAL ORGANIZATIONS AND THE AIDS EPIDEMIC

combating the proliferation of HIV/AIDS. From the language employed by UNAIDS and its cosponsors, it is clear that UNAIDS operates primarily in an advisory capacity. The WHO has provided *assistance* to and *supported* Swaziland;¹⁰¹ an educational program was established within the country “under the *leadership* of UNESCO”;¹⁰² UNICEF has “*supported training*” for child protection workers;¹⁰³ and the UNDP has “*worked with*” nongovernmental organizations on establishing community level HIV programs.¹⁰⁴ UNAIDS itself offers advice through developing guidelines and goals for the member states, such as the International Guidelines on HIV/AIDS and Human Rights¹⁰⁵ and the Millennium Development Goals.¹⁰⁶ Since UNAIDS and its cosponsors operate primarily in an advisory capacity, the member state itself is responsible for promulgating and enforcing regulations addressing the AIDS epidemic.

Domestic Regulations of Swaziland

Since the first case of AIDS was reported in Swaziland in 1986,¹⁰⁷ the government of the Kingdom of Swaziland has been slow to respond to the crisis. Prior to 2001, Swaziland did not have an organized local government response to the HIV/AIDS epidemic.¹⁰⁸ In fact, Swaziland failed to formally update its national health policy, adopted in 1983, until 2007.¹⁰⁹ However, although the government did not formally adopt a new health policy immediately, steps were taken to curb the proliferation of the virus.

In December of 2001, Swaziland established the National Emergency Response Council on HIV/AIDS (NERCHA).¹¹⁰ Since its establishment, NERCHA has been the government body primarily responsible for combating the proliferation of the virus in Swaziland.¹¹¹ From 2001 onward, the Swazi government has enacted several programs focused on combating the spread of HIV and AIDS. The government established the Behavior Change

¹⁰¹ *Id.*

¹⁰² See 2006 Global Report *supra* note 1, at 263 (emphasis added).

¹⁰³ See UNICEF Swaziland, *supra* note 98 (emphasis added).

¹⁰⁴ See UNDP Swaziland, *supra* note 89 (emphasis added).

¹⁰⁵ International Guidelines, *supra* note 55.

¹⁰⁶ See 2005 MGD Report, *supra* note 15.

¹⁰⁷ UNGASS, *supra* note 84, at 4.

¹⁰⁸ 2006 Global Report, *supra* note 1, at 263.

¹⁰⁹ Swaziland Ministry of Health and Social Welfare [MOHSW], *National Health Policy*, at 1, (2007) available at <http://www.gov.sz/home.asp?PID=13848ToolID=68ItemID=5206>.

¹¹⁰ Joint United Nations Programme on HIV/AIDS [UNAIDS], *Helping Ourselves: Community Responses to AIDS in Swaziland*, at 12, UNAIDS/06.22E (June 2006) available at http://data.unaids.org/publications/IRC-pub07/jc1259-swaziland_en.pdf.

¹¹¹ *Id.*

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

Communication to promote abstinence among the youth.¹¹² Programs have been developed to target high-risk populations, such as prostitutes, factory workers, and long distance truck drivers.¹¹³ Educational programs have been established for children attending school,¹¹⁴ and in 2003 the government established a national antiretroviral therapy program.¹¹⁵

Some of these programs have positively impacted the country: by September 2005, over eleven thousand Swazi citizens were receiving antiretroviral therapy from seventeen different facilities.¹¹⁶ Programs designed to prevent mother-to-child transmission of HIV, which were instituted in 2003, were responsible for the counseling of over 10,500 pregnant women in 2005.¹¹⁷ Lastly, in 2005, over ninety thousand children were exposed to media sources advocating for safer sex practices.¹¹⁸

Along with national programs, the Swazi government has established programs at the community level for the purpose of curbing the proliferation of HIV and AIDS. For example, many communities have established Neighbourhood Care Points, which “provide day-to-day support to orphaned and vulnerable children.”¹¹⁹ Providing support to these children is of extreme importance. Due to the high number of AIDS-related deaths, the orphan population of Swaziland has skyrocketed in recent years.¹²⁰ Many of these children turn to relatives for care, but the number of orphans has increased so drastically that relatives are often unable to provide support.¹²¹ Children are thus forced to care for themselves at a young age, and many turn to prostitution to acquire the necessities of life.¹²² Some of these children, in fact, choose to have *unprotected* sex for money, due to the larger sum they can charge.¹²³ Heterosexual intercourse is the primary mode of HIV transmission in sub-Saharan Africa,¹²⁴ and thus prostitution only precipitates the spread of HIV.

The Neighbourhood Care Points program assists in ending this cycle. For instance, orphaned children are given plots of land to grow food.¹²⁵ With nourishment readily available, children are less likely to turn to prostitution for

¹¹² UNGASS, *supra* note 84, at 14.

¹¹³ *Id.*

¹¹⁴ *Id.* at 20.

¹¹⁵ *Id.* at 7.

¹¹⁶ *Id.* at 7.

¹¹⁷ *Id.* at 8.

¹¹⁸ *Id.* at 16.

¹¹⁹ Helping Ourselves, *supra* note 110, at 17.

¹²⁰ Hut by Hut, *supra* note 73.

¹²¹ *Id.*

¹²² *Id.*

¹²³ *Id.*

¹²⁴ Multisectoral Policy, *supra* note 91, at 1.

¹²⁵ Helping Ourselves, *supra* note 110, at 18.

INTERNATIONAL ORGANIZATIONS AND THE AIDS EPIDEMIC

sustenance. Neighbourhood Care Points also identifies orphaned children who are not attending school and helps place those children in formal school,¹²⁶ where AIDS education is readily available.¹²⁷

Another community initiative established by Swaziland is the KaGogo center. KaGogo centers have become places where the community gathers to discuss potential responses to the spread of the virus.¹²⁸ These centers also assist in the distribution of food and are generally responsible for collecting data on orphaned children residing within the community.¹²⁹ In essence, KaGogo centers operate as a town hall, acting as a distribution point for certain goods and providing the public with a place to voice their concerns.

Within some communities, volunteers have been selected to act as Rural Health Motivators.¹³⁰ These individuals are equipped with first aid kits and are responsible for providing care to sick and dying individuals in their community.¹³¹ Rural Health Motivators bring sick individuals to hospitals when necessary and generally visit twenty households each.¹³² There were 4,500 Rural Health Motivators in 2006,¹³³ roughly one per every fifty HIV positive Swazi.¹³⁴

On the national level, the Kingdom of Swaziland updated its 1983 health policy in 2007 to reflect the changing times. The new health policy announces that a patient's inability to pay will not bar the receipt of health services.¹³⁵ This policy even dictates that "eligible children, elderly persons, orphans and persons with disability" be provided health services free of charge.¹³⁶ Responding to the great likelihood of death from mother-to-child transmission of HIV, the *National Health Policy* requires that all births "be attended by skilled physicians."¹³⁷

Recognizing the need for a policy designed to combat HIV and AIDS specifically, the Kingdom of Swaziland promulgated the *National Multisectoral HIV and AIDS Policy* in 2006. The policy advocates for consistent condom use among the youth,¹³⁸ directs that formal schools educate children on HIV and

¹²⁶ *Id.* at 19.

¹²⁷ UNGASS, *supra* note 84, at 20.

¹²⁸ Helping Ourselves, *supra* note 110, at 30.

¹²⁹ *Id.*

¹³⁰ *Id.* at 31.

¹³¹ *Id.*

¹³² *Id.*

¹³³ *Id.*

¹³⁴ See Annex 1, *supra* note 79, at 460 (noting that an estimated 220,000 people were living with HIV/AIDS in Swaziland in 2005).

¹³⁵ National Health Policy, *supra* note 109, at 11.

¹³⁶ *Id.* at 17.

¹³⁷ *Id.* at 20.

¹³⁸ Multisectoral Policy, *supra* note 91, at 5.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

AIDS,¹³⁹ stipulates that certain forms of contraception be made available and affordable to all citizens,¹⁴⁰ and encourages couples to undergo HIV testing and disclose HIV test results to one another.¹⁴¹

Swaziland's HIV/AIDS policy also asserts that basic human rights, including the right to privacy and confidentiality, will be afforded to all persons infected with HIV/AIDS.¹⁴² The Policy directs that laws be adopted to prevent HIV discrimination in employment, education, and the receipt of health care.¹⁴³ Lastly, the policy promotes the equality of the sexes, declaring that young women and other "vulnerable groups" be protected from gender-based violence.¹⁴⁴

Culture, Society, and AIDS in Swaziland

Formal legislation, however, is not the only factor that may affect HIV prevalence in Swaziland. Cultural and social influences also dictate the ebb and flow of a country's prevalence rate. For instance, the controlling law of Swaziland is an amalgamation of common law, statutory law, and customary law.¹⁴⁵ Under customary law, Swaziland's monarch is granted power to issue orders without receiving prior approval from Parliament.¹⁴⁶ One such order revived a chastity rite under which "girls wear woolen tassels of different colors depending on their ages. 'A man who dares touch a lady wearing a woolen tassel will find himself having the tassels thrown at him...'" and girls will subsequently congregate at the man's home and "demand an animal which they will feast on."¹⁴⁷ Many Swazis find the rite antiquated and refuse to adhere to it.¹⁴⁸ Old customs and traditions, though firmly rooted in Swazi society and law, may not have the desired effect of reducing HIV transmission.

Another social factor that may affect Swaziland's prevalence rate is the practice of multiple concurrent sex partners. Polygamy is widely practiced in Swaziland, it being rumored that the King's father himself had more than 100 wives.¹⁴⁹ Evidence demonstrates that having multiple concurrent sex partners

¹³⁹ *Id.*

¹⁴⁰ *Id.* at 6.

¹⁴¹ *Id.*

¹⁴² *Id.* at 9.

¹⁴³ *Id.*

¹⁴⁴ *Id.*

¹⁴⁵ Buhle Dube and Alfred Magagula, *The Law and Legal Research in Swaziland* (2007), <http://www.nyulawglobal.org/globalex/Swaziland.htm>.

¹⁴⁶ *Id.*

¹⁴⁷ Tradition, *supra* note 85.

¹⁴⁸ Henri E. Cauvin, *To Fight AIDS, Swaziland's King Orders Girls to Avoid Sex for 5 Years*, N.Y. TIMES, Sep. 29, 2001, at A5.

¹⁴⁹ Suzanne Daley, *Tradition-Bound Swazis Chafing Under Old Ties*, N.Y. TIMES, Dec. 16, 1995, at

INTERNATIONAL ORGANIZATIONS AND THE AIDS EPIDEMIC

substantially increases the risk of HIV infection.¹⁵⁰ Considering that heterosexual intercourse is the primary mode of HIV transmission in sub-Saharan Africa,¹⁵¹ the practice of polygamy likely has a drastic effect on the proliferation of the virus.

The preferred policy of Swaziland “is that orphaned and vulnerable children should be cared for in their communities.”¹⁵² Currently, the Swazi government lacks the resources to finance institutional care.¹⁵³ Even if the resources were available, however, institutional care would not be provided. Swazi custom dictates that *communities*, not the government, care for orphaned and vulnerable children.¹⁵⁴ As mentioned *supra*, the orphan population has grown so rapidly that communities have been unable to adequately care for these children.¹⁵⁵ In turn, some children are forced to live on the streets and to engage in prostitution to support themselves.¹⁵⁶ The inability of the government to provide financial assistance, combined with the Swazi custom of relying on communities to care for orphaned children, may have a profound effect on Swaziland’s prevalence rate.

Lastly, a rise in sexual abuse of children has been reported in Swaziland.¹⁵⁷ Evidence indicates that “one of the driving forces for [that practice] is a persistent belief that if an infected person has sexual intercourse with a virgin he or she will be cured of HIV.”¹⁵⁸ This mistaken belief undoubtedly contributes to the proliferation of HIV. In fact, roughly “55% of the cases handled by Swaziland’s Director of Public Prosecution involve sexual offenses.”¹⁵⁹

B. Ethiopia

Swaziland is not the only sub-Saharan country struggling in a battle against HIV/AIDS. Roughly 4%¹⁶⁰ of the 22.5 million people living with HIV/AIDS in sub-Saharan Africa reside in Ethiopia.¹⁶¹ The epidemic is so

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¹⁵⁰ Florence Shu-Acquaye, *The Legal Implications of Living with HIV/AIDS in a Developing Country: The African Story*, 32 SYRACUSE J. INT’L L. & COM. 51, 56-60 (2004).

¹⁵¹ Multisectoral Policy, *supra* note 91, at 1.

¹⁵² Helping Ourselves, *supra* note 110, at 17.

¹⁵³ *Id.*

¹⁵⁴ *Id.*

¹⁵⁵ Hut by Hut, *supra* note 73.

¹⁵⁶ *Id.*

¹⁵⁷ Helping Ourselves, *supra* note 110, at 43.

¹⁵⁸ *Id.*

¹⁵⁹ *Id.* at 45.

¹⁶⁰ See Annex 1, *supra* note 79, at 355.

¹⁶¹ In 2005, UNAIDS estimated that between 420,000 and 1.3 million people were infected with

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

severe that the Central Intelligence Agency was recently advised that the Ethiopian AIDS epidemic posed a security threat to the United States.¹⁶²

Ethiopia is a landlocked country with a total area of 1.1 million square kilometers.¹⁶³ Seventy-seven million people reside in Ethiopia,¹⁶⁴ and in 1995 it was estimated that over 75% of the population survived on less than two dollars per day.¹⁶⁵ For every 1,000 children born, 123 will die before reaching the age of five,¹⁶⁶ and for every 100,000 births, an estimated 871 mothers will perish.¹⁶⁷ Agriculture provides over 80% of the country's employment,¹⁶⁸ and Ethiopia's per capita GDP is only seven hundred dollars,¹⁶⁹ approximately 1.5% of the United States' per capita GDP.¹⁷⁰

HIV and AIDS in Ethiopia

As with Swaziland, poverty is not necessarily Ethiopia's greatest threat. In 1999, UNAIDS estimated that three million Ethiopians were infected with HIV/AIDS, representing nearly 5% of the total population.¹⁷¹ In 2001, the estimate had lowered to 2.1 million infections,¹⁷² due, in part, to the 160,000 deaths caused by AIDS that year.¹⁷³ By the end of 2002, 1.7 million Ethiopians had perished from AIDS since the beginning of the epidemic.¹⁷⁴

Although these statistics are staggering, there is a silver lining: in 2003, the estimated number of people living with HIV/AIDS decreased to 1.5 million people.¹⁷⁵ In 2005, UNAIDS estimated that only 1.1% of Ethiopia's

HIV/AIDS in Ethiopia. Whenever the 2005 UNAIDS statistics are cited, the midpoint of those two numbers, 860,000, will be used for the purposes of this paper.

¹⁶² Lawrence K. Altman, *AIDS in 5 Nations Called Security Threat*, N.Y. TIMES, Oct. 1, 2002, at A12.

¹⁶³ Federal Democratic Republic of Ethiopia, *Report on Progress Towards Implementation of the UN Declaration of Commitment on HIV/AIDS*, at 15 (Jan. 2008) available at http://data.unaids.org/pub/Report/2008/ethiopia_2008_country_progress_report_en.pdf.

¹⁶⁴ *Id.*

¹⁶⁵ Lisa Garbus, *Country AIDS Policy Analysis Project: HIV/AIDS in Ethiopia*, at 38, 39 (April 2003) available at <http://ari.ucsf.edu/programs/policy/countries/Ethiopia.pdf> (amount is in United States' dollars).

¹⁶⁶ 2008 Report, *supra* note 163, at 15.

¹⁶⁷ Garbus, *supra* note 165, at 43.

¹⁶⁸ *Id.*

¹⁶⁹ United States Central Intelligence Agency, *The World Factbook: Ethiopia*, <https://www.cia.gov/library/publications/the-world-factbook/geos/et.html>.

¹⁷⁰ The World Factbook: United States, *supra* note 74.

¹⁷¹ AIDS in Africa; Country by Country, *supra* note 78, at 85, 88.

¹⁷² Garbus, *supra* note 165, at 13.

¹⁷³ Multisectoral Issue Brief (2003), <http://www.etharc.org/infokit/Sectorbr.htm>.

¹⁷⁴ Garbus, *supra* note 165, at 10.

¹⁷⁵ Ethiopia Federal Ministry of Health, Disease Prevention and Control Department, *AIDS in*

INTERNATIONAL ORGANIZATIONS AND THE AIDS EPIDEMIC

population was infected with HIV/AIDS, decreasing the number to roughly 860,000.¹⁷⁶ Though the estimate for the total number of people living with HIV/AIDS decreased substantially from 1999 to 2005, AIDS has left its indelible mark, potentially overshadowing the decrease in HIV prevalence.

By 2003, roughly 539,000 children had lost one or both parents to AIDS.¹⁷⁷ This number increased to 656,058 by 2006.¹⁷⁸ In 2004 it was estimated that there were roughly five million orphans living in Ethiopia.¹⁷⁹ By 2007, the estimate had risen to 5.4 million.¹⁸⁰ Of this 5.4 million, it is estimated that nearly one million were orphaned by AIDS-related deaths.¹⁸¹ Life expectancy at birth has decreased to fifty-four years of age,¹⁸² and “AIDS is now recognized as the leading cause of adult morbidity and mortality in the country.”¹⁸³

International Organizations in Ethiopia

Though the people of Ethiopia have suffered greatly from the AIDS epidemic, international organizations have offered and continue to offer support to the country. Several international organizations, including the WHO, the UNDP, and UNICEF, have all actively assisted Ethiopia in combating the AIDS epidemic.¹⁸⁴

For instance, UNICEF launched a program in 1998 for the purpose of providing care to homeless children.¹⁸⁵ The program was initiated in six towns, providing children with educational support and basic health care, such as vaccinations.¹⁸⁶ As of 2003, the program was operational in fourteen towns, and by April 2002, nearly two thousand homeless children from the program

Ethiopia, Fifth Report, (June 2004) available at <http://www.etharc.org/spotlight/AIDSinEth5th.pdf>.

¹⁷⁶ Annex 1, *supra* note 79, at 355.

¹⁷⁷ Federal Democratic Republic of Ethiopia, *Report on Progress Towards Implementation of the Declaration of Commitment on HIV/AIDS*, at 26 (Feb. 2006) available at http://data.unaids.org/pub/Report/2006/2006_country_progress_report_ethiopia_en.pdf

¹⁷⁸ Ethiopia HIV/AIDS Prevention and Control Office [HAPCO], *Multisectoral Plan of Action for Universal Access to HIV Prevention, Treatment, Care and Support in Ethiopia*, at 2 (Dec. 2007) available at http://etharc.org/publications/eth_multi_plan_action2007.pdf

¹⁷⁹ *Strained by AIDS Orphans, Ethiopia Eases Adoptions by Foreigners*, N.Y. TIMES, Dec. 26, 2004, at N14.

¹⁸⁰ 2008 Report, *supra* note 163, at 52.

¹⁸¹ World Health Organization [WHO], *Ethiopia: Summary Country Profile for HIV/AIDS Treatment Scale-Up*, at 2 (June 2005) available at http://www.etharc.org/publications/june2005whoestimate_eth.pdf.

¹⁸² 2008 Report, *supra* note 163, at 15.

¹⁸³ Garbus, *supra* note 165, at 9.

¹⁸⁴ This is not an exclusive list of UNAIDS cosponsors that have been active in Ethiopia.

¹⁸⁵ Garbus, *supra* note 165, at 85.

¹⁸⁶ *Id.*

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

had been enrolled in school.¹⁸⁷

The program is of great importance for three primary reasons. First, “[a]wareness of HIV and how it is transmitted remains extremely low among the vast majority of Ethiopia’s largely rural population.”¹⁸⁸ In fact, only 16% of women and 29% of men have comprehensive knowledge on how to avoid HIV infection.¹⁸⁹ Second, in-school Ethiopian youth have greater knowledge of how to avoid HIV infection than their out-of-school counterparts.¹⁹⁰ As such, enrollment in formal school increases the likelihood that a child will learn how to avoid HIV infection. Finally, Ethiopia currently has no program designed to support orphaned children.¹⁹¹

The WHO has assisted Ethiopia by “[s]upporting the development of national and regional road maps for scaling up antiretroviral therapy.”¹⁹² As of 2007, only 37% of Ethiopians in need of antiretroviral therapy were receiving it,¹⁹³ and thus WHO assistance in this area is crucial. The WHO has also reviewed Ethiopia’s guidelines and policies for antiretroviral therapy and recently supported the establishment of two HIV counseling and testing sites.¹⁹⁴

The UNDP has supported Ethiopia by launching a media campaign spreading the message on the dangers of HIV.¹⁹⁵ It has also assisted the Ethiopian government by assessing country laws relating to the protection of people living with HIV/AIDS.¹⁹⁶ Importantly, the UNDP has sought to address sexual inequalities between men and women by “work[ing] to...address women’s inheritance and property rights in Ethiopia.”¹⁹⁷

In an effort to address the AIDS epidemic through other mediums, the UNDP is also working closely with faith-based organizations.¹⁹⁸ Religious beliefs dissuade many Ethiopians from using condoms,¹⁹⁹ and the UNDP is seeking to garner support from faith-based organizations to help amend these beliefs. Approximately 62% of males and 77% of females in Ethiopia have no

¹⁸⁷ *Id.*

¹⁸⁸ Multisectoral Issue Brief, *supra* note 173.

¹⁸⁹ 2008 Report, *supra* note 163, at 12.

¹⁹⁰ *Id.* at 25.

¹⁹¹ *Id.* at 33.

¹⁹² WHO, Ethiopia Country Profile, *supra* note 181, at 3.

¹⁹³ 2008 Report, *supra* note 163, at 12.

¹⁹⁴ WHO, Ethiopia Country Profile, *supra* note 181, at 3.

¹⁹⁵ United Nations Development Programme [UNDP], *Ethiopia and the HIV/AIDS Epidemic*, <http://www.et.undp.org/hiv/hiv.htm>

¹⁹⁶ *Id.*

¹⁹⁷ Making the Money Work, *supra* note 41, at 13.

¹⁹⁸ UNDP Ethiopia, *supra* note 195.

¹⁹⁹ Yemane Berhane et al., *HIV/AIDS*, http://www.etharc.org/publications/ch26_HIV-Epidemiology_eth.pdf

INTERNATIONAL ORGANIZATIONS AND THE AIDS EPIDEMIC

formal education,²⁰⁰ most people having learned of HIV/AIDS through community meetings.²⁰¹ Support from faith-based organizations operating at the community level may result in increased condom use and higher HIV/AIDS awareness throughout Ethiopia.

Although UNAIDS cosponsors have been active in Ethiopia, they do not promulgate binding regulations, but rather operate primarily in an advisory capacity. As with Swaziland, Ethiopia has enacted numerous regulations for the purpose of curbing the proliferation of the virus. Unlike Swaziland, however, the prevalence rate in Ethiopia has decreased in recent years.

Domestic Regulations of Ethiopia

Though the first case of AIDS was not officially reported in Ethiopia until 1986, the Ethiopian government had already begun to address the forthcoming epidemic.²⁰² In 1985, Ethiopia established a national HIV/AIDS task force.²⁰³ Two years later, the government officially established an AIDS department within the Ministry of Health.²⁰⁴ In 1989, the government adopted a four-point HIV/AIDS policy,²⁰⁵ “far earlier than most other countries.”²⁰⁶ A national HIV/AIDS policy was drafted in 1991, but the policy was not adopted until 1998,²⁰⁷ taking much longer to complete than in other countries.²⁰⁸

The 1998 Ethiopian HIV/AIDS policy sought to accomplish several objectives, with an overall goal to “provide an enabling environment for the prevention and control of HIV/AIDS in the country.”²⁰⁹ The policy also declared that persons living with HIV/AIDS should be free from discrimination;²¹⁰ that HIV/AIDS education be promoted at all educational levels;²¹¹ and that all donated blood be screened for the virus.²¹²

Prevention of mother-to-child transmission was also promoted, the policy declaring that “[e]fforts shall be made to promote safe home delivery by

²⁰⁰ Garbus, *supra* note 165, at 48.

²⁰¹ *Id.* at 51.

²⁰² Multisectoral Plan of Action, *supra* note 178, at 2.

²⁰³ *Id.* at 3.

²⁰⁴ *Id.*

²⁰⁵ *Id.*

²⁰⁶ Garbus, *supra* note 165, at 78.

²⁰⁷ Multisectoral Plan of Action, *supra* note 178, at 3.

²⁰⁸ Garbus, *supra* note 165, at 78.

²⁰⁹ Policy on HIV/AIDS of the Federal Democratic Republic of Ethiopia (Aug. 1998), <http://www.estc.gov.et/Health%20Policy.pdf>.

²¹⁰ *Id.* at 5.

²¹¹ *Id.* at 7.

²¹² *Id.* at 9.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

traditional birth attendant.”²¹³ The policy endorsed the view that only married couples should engage in sexual relations, holding that one-to-one sexual relationships would be promoted by the government.²¹⁴ However, for those individuals choosing to engage in non-marital sexual relations, the government declared that proper education on condom use would be promoted.²¹⁵

The most interesting provision of the 1998 policy addressed partner notification. Under the policy, persons living with HIV/AIDS were encouraged to inform sexual partners of their seropositive status.²¹⁶ In some countries, the privacy of persons living with HIV/AIDS is strongly protected. In those countries, a persons’ seropositive status will be kept completely confidential, and not even the persons’ sex partner will be notified.²¹⁷ The 1998 policy rejects that notion, holding that under certain circumstances “the endangered partner shall have the right of direct access to the information regarding the sero-status of the partner.”²¹⁸ Lastly, the policy encouraged Ethiopians to undergo voluntary testing and screening for HIV.²¹⁹

In 2002, Ethiopia adopted a national policy providing a tax exemption for antiretroviral drugs.²²⁰ The program was launched in 2005²²¹ and has already generated positive results: the number of people “ever started on” antiretroviral therapy increased from 8,276 in June 2005, to 117,970 by December of 2007.²²² The number of sites dedicated to preventing mother-to-child transmission also increased; from 71 in June 2004, to 428 in June of 2007.²²³ Considering that more than fourteen thousand Ethiopian children were born with HIV in 2007,²²⁴ the expansion of these sites is of great importance.

Ethiopia has also adopted a national strategy for the distribution of condoms, which has increased condom distribution from 41.8 million in 1999 to over 70 million between June 2004 and June 2005.²²⁵ This has correlated into an increase in condom use among males; from roughly 30% in 2000 to 51.9% in 2005.²²⁶ Heterosexual intercourse accounts for nearly 90% of all new infections

²¹³ *Id.* at 10.

²¹⁴ *Id.* at 8.

²¹⁵ *Id.*

²¹⁶ *Id.* at 11.

²¹⁷ See Brody, *supra* note 83 (referring to Swaziland’s privacy policy circa 2006).

²¹⁸ Ethiopia 1998 Policy, *supra* note 209, at 11.

²¹⁹ *Id.* at 9.

²²⁰ WHO, Ethiopia Country Profile, *supra* note 181, at 1.

²²¹ *Id.* at 1.

²²² 2008 Report, *supra* note 163, at 11.

²²³ *Id.*

²²⁴ *Id.* at 17.

²²⁵ 2006 Report, *supra* note 177, at 20.

²²⁶ 2008 Report, *supra* note 163, at 11.

INTERNATIONAL ORGANIZATIONS AND THE AIDS EPIDEMIC

in Ethiopia.²²⁷ Thus, as long as condoms are used correctly, the increase in condom use may assist in curbing the proliferation of the virus.

Along with national programs, Ethiopia has also established community-level programs to battle the epidemic. Mass media campaigns,²²⁸ the building of youth centers,²²⁹ and the institution of educational programs²³⁰ have all been established at the local level. Similar to Swaziland's Rural Health Motivators, Ethiopia established the Health Extension Program, whereby individuals are trained to provide health care to persons living with HIV/AIDS.²³¹

Ethiopia has also established a program similar to Swaziland's KaGogo Centers. The Community Conversation Program operates as a forum for individuals to both learn about HIV/AIDS and express their thoughts on how to combat the epidemic.²³² Currently, 86% of women and 72% of men in Ethiopia have no exposure to mass media.²³³ For a majority of Ethiopians, community meetings are thus the only forum in which HIV/AIDS education is readily available.²³⁴

In December 2007, Ethiopia updated its HIV/AIDS policy to address issues unresolved under the previous policy. The new policy addresses ways to combat the epidemic on both the community as well as the national level. It asserts that three Community Conversation sessions will be held every fifteen days for ten months at the 'Kebele'²³⁵ level,²³⁶ that financial support must be provided to community media programs,²³⁷ that school attendance among orphans be increased,²³⁸ and that new health centers be constructed.²³⁹

The policy also orders the expansion of antiretroviral therapy outlets²⁴⁰ and advocates for the provision of physical and emotional support to orphaned and vulnerable children.²⁴¹ Lastly, the policy purports to "[u]ndertake [a] media

²²⁷ 2006 Report, *supra* note 177, at 7.

²²⁸ *Id.* at 19.

²²⁹ *Id.* at 20.

²³⁰ *Id.* at 28, 29.

²³¹ *Id.* at 9.

²³² 2008 Report, *supra* note 163, at 36.

²³³ Garbus, *supra* note 165, at 80.

²³⁴ *Id.* at 51.

²³⁵ <http://www.reference.com/browse/wiki/Kebele> (defining Kebele as "the smallest administrative unit of Ethiopia similar to a ward, a [neighborhood] or a localized and delimited group of people").

²³⁶ Multisectoral Plan of Action, *supra* note 178, at 13.

²³⁷ *Id.* at 30.

²³⁸ *Id.* at 44.

²³⁹ *Id.* at 48.

²⁴⁰ *Id.* at 15.

²⁴¹ *Id.* at 16.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

campaign on [the] female condom,”²⁴² and commands that judges, social workers, educators and the like receive training on the rights of persons living with HIV/AIDS.²⁴³

Culture, Society, and AIDS in Ethiopia

As noted above, cultural and social issues have the ability to greatly influence the proliferation of HIV. Of great concern in Ethiopia is the practice of Female Genital Mutilation, also known as female circumcision,²⁴⁴ whereby the clitoris and other portions of the exterior female genitalia are removed.²⁴⁵ The practice causes permanent damage to the female genitalia and carries with it a heightened risk of HIV infection.²⁴⁶ It is estimated that approximately 80% of all Ethiopian women have undergone the procedure.²⁴⁷ As heterosexual intercourse is the primary mode of HIV transmission in Ethiopia,²⁴⁸ the cultural practice of Female Genital Mutilation may substantially contribute to the proliferation of the virus.

Evidence demonstrates that “[i]n times of conflict, girls and women are even more vulnerable to sexual violence, HIV and AIDS.”²⁴⁹ Rape is frequently used as a “weapon of war,” and it is during these times that the virus tends to spread.²⁵⁰ For several years, Ethiopia and Eritrea were entangled in a bloody war.²⁵¹ The existence of conflict between these countries may have influenced, and continue to influence, the prevalence of HIV in Ethiopia.

Moreover, conflicts in other nations may induce individuals to seek refuge in neighboring countries.²⁵² An HIV survey conducted at Ethiopia’s Dima Refugee Camp in 2005 revealed a prevalence rate of 13%, well above the national average.²⁵³ According to the United Nations High Commissioner for

²⁴² *Id.* at 35.

²⁴³ *Id.* at 47.

²⁴⁴ See Garbus, *supra* note 165, at 8.

²⁴⁵ World Health Organization [WHO], *Female Genital Mutilation: Policy Guidelines for Nurses and Midwives*, at 5, WHO/FCH/GWH/01.5 (2001), available at http://whqlibdoc.who.int/hq/2001/WHO_FCH_GWH_01.5.pdf.

²⁴⁶ Multisectoral Plan of Action, *supra* note 178, at 2.

²⁴⁷ Garbus, *supra* note 165, at 8.

²⁴⁸ 2006 Report, *supra* note 177, at 7.

²⁴⁹ Dan Thomas, *AIDS 2006: Conflict Makes Girls and Women Even More Vulnerable to HIV* (2006), http://www.unicef.org/aids/index_35317.html.

²⁵⁰ *Id.*

²⁵¹ Garbus, *supra* note 165, at 7.

²⁵² Thabo Sabela, *Trans-boundary Migrancy in Southern Africa: Studies from Mozambique, South Africa and Swaziland*, in *MIGRANTS, CITIZENS AND THE STATE IN SOUTHERN AFRICA*, 105, 109 (Jim Whitman ed., 2000).

²⁵³ 2008 Report, *supra* note 165, at 20.

INTERNATIONAL ORGANIZATIONS AND THE AIDS EPIDEMIC

Refugees, over one million refugees entered Ethiopia between 1999 and 2005.²⁵⁴ If the statistics gathered at the Dima Refugee Camp are indicative of refugees entering Ethiopia as a whole, the influx of refugees into Ethiopia may have a profound effect on the proliferation of HIV in the country.

Lastly, it is estimated that roughly 14% of all married Ethiopian women are members of polygamous marriages.²⁵⁵ As noted *supra*, evidence demonstrates that having multiple concurrent sex partners substantially increases the risk of HIV infection.²⁵⁶ With heterosexual intercourse accounting for nearly 90% of all HIV transmission in Ethiopia,²⁵⁷ the practice of polygamy may substantially affect the spread of the virus.

III. COUNTRY COMPARISON

As noted *supra*, UNAIDS operates primarily in an advisory capacity. Thus, decisions regarding the expenditure of funds and the implementation of policy are left primarily to the member states. A cursory statistical examination of HIV prevalence in Ethiopia and Swaziland may lead to the conclusion that the former has been efficient in curbing the proliferation of the virus while the latter has not. However, a more detailed examination of the countries reveals that the legal, cultural and societal differences seem too remote to account for the disparity in HIV prevalence. In fact, similarities between the countries render it difficult to determine why a difference in HIV prevalence exists at all.

One of the most striking similarities between Ethiopia and Swaziland is the lack of legislation criminalizing intentional transmission of HIV. Although Swaziland intends on criminalizing intentional transmission,²⁵⁸ to date no formal legislation has been enacted.²⁵⁹ In fact, much of Swaziland's penal code is antiquated, with criminal statutes enacted during colonial rule still governing today.²⁶⁰ Similarly, Ethiopia has no law officially criminalizing intentional transmission of HIV.²⁶¹

²⁵⁴ United Nations High Commissioner for Refugees [UNHCR], *2005 UNHCR Statistical Yearbook*, at 328 (April 2007) available at <http://www.unhcr.org/cgi-bin/texis/vtx/statistics/opendoc.pdf>.

²⁵⁵ Garbus, *supra* note 165, at 8.

²⁵⁶ Legal Implications, *supra* note 150.

²⁵⁷ 2006 Report, *supra* note 177, at 7.

²⁵⁸ Multisectoral Policy, *supra* note 91, at 5.

²⁵⁹ E-mail from Angelo Dube to Chris Richins (Feb. 11, 2008, 06:14:00 EST) (on file with author) (noting that a Sexual Offences and Domestic Violence Bill *was being developed* which would lengthen time of confinement for persons who rape with the intent of causing infection).

²⁶⁰ See Criminal Law and Procedure: Act 39/1920 (enacted in 1920); Criminal Law and Procedure: Act 67/1938 (enacted in 1938); and The Crimes Act (enacted in 1889).

²⁶¹ Report of the Federal Democratic Republic of Ethiopia on the Implementation of the AU Solemn Declaration on Gender Equality in Africa, at 4 (Aug. 2006) available at <http://www.africa->

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

For several years, however, there was a noticeable difference in the HIV/AIDS policies of the respective countries. Though Swaziland “encourages” couples to disclose HIV test results, this provision was not formally adopted until 2006.²⁶² Ethiopia, on the other hand, encouraged the disclosure of seropositive test results in its 1998 HIV/AIDS policy.²⁶³ At first glance, the fact that Ethiopia adopted this policy earlier than Swaziland seems to provide some explanation for the difference in HIV prevalence. Yet due to the low rates at which Ethiopians are being tested for HIV, this eight-year gap provides little, if any, explanation at all.

Another similarity shared by Ethiopia and Swaziland is the percentage of the national budget spent combating HIV/AIDS. Though Ethiopia spends substantially more on HIV/AIDS- \$18.9 million during the 2004/2005 fiscal year²⁶⁴ compared to Swaziland’s \$3.9²⁶⁵ million in 2005²⁶⁶- both countries spend roughly 7%²⁶⁷ of their national budgets on HIV and AIDS prevention.²⁶⁸

Both countries also suffer from poor doctor-to-patient ratios, with Ethiopia providing one doctor for every 45,651 people²⁶⁹ and Swaziland providing one doctor for every 5,953. Though Ethiopia’s doctor-to-patient ratio is far lower than Swaziland’s, both ratios are poor considering that industrialized countries tend to have one doctor for every 500 people.²⁷⁰

There are a plethora of other similarities shared by the countries: both have experienced difficulty in expanding HIV/AIDS education to rural populations; antiretroviral therapy programs were only recently adopted; programs aimed at prevention of mother-to-child transmission are still in their infancy; and the practice of polygamy is widespread. Thus, these factors cannot adequately explain why Swaziland’s prevalence rate has increased in recent years while Ethiopia’s has diminished.

There are, however, some differences between the countries that seem

union.org/root/au/Conferences/Past/2006/October/WG/Report-Ethiopia.doc (“[A]rticle 514 of the Penal Code makes any deliberate or negligent act to transmit any kind of disease to a person punishable by law. Efforts are underway to enact specific law for HIV/AIDS”).

²⁶² Multisectoral Policy, *supra* note 91, at 6.

²⁶³ Ethiopia 1998 Policy, *supra* note 209, at 11.

²⁶⁴ 2006 Report, *supra* note 177, at 15.

²⁶⁵ United States Central Intelligence Agency, *The World Factbook: Field Listing- Exchange Rates*, <https://www.cia.gov/library/publications/the-world-factbook/fields/2076.html> (converting Swaziland’s currency (emalangen) to United States dollars).

²⁶⁶ UNGASS Report, *supra* note 84, at 10 (reporting twenty-five million emalangen allocated to health care for 2005).

²⁶⁷ Multisectoral Issue Brief, *supra* note 173 (reporting that Ethiopia spent 7% of its budget on health care in 2001).

²⁶⁸ National Health Policy, *supra* note 109, at 5 (reporting that for a majority of the 21st century, Swaziland has allocated 7% of its national budget to health care).

²⁶⁹ Garbus, *supra* note 165, at 43.

²⁷⁰ *Africa’s Health-Care Brain Drain*, N.Y. TIMES, Aug. 13, 2004, at A20.

INTERNATIONAL ORGANIZATIONS AND THE AIDS EPIDEMIC

to explain the gap in the infection rate. For instance, although the Swazi government is comprised of democratic institutions, the country's monarch, King Mswati III, essentially retains ultimate control over the country.²⁷¹ In 2002, the government took forty-five million dollars earmarked for economic development and instead purchased the King a luxury jet.²⁷² This amount represents approximately eleven times the total domestic expenditure on HIV/AIDS in 2005.²⁷³ This inefficient use of funds was demonstrated again in 2004, when \$600,000 was spent on the King's thirty-sixth birthday party, while \$2.8 million earmarked for orphan's education remained locked in the Treasury.²⁷⁴

Although these expenditures may indicate that the government values the King's comfort more than the health of its citizens, there is no concrete evidence that the government of Swaziland has used funds earmarked for combating AIDS for any purpose other than to combat AIDS. Moreover, both Ethiopia and Swaziland allocate roughly 7% of their national budgets to combating HIV/AIDS. Absent some evidence that the Swazi government has misused funds earmarked for combating HIV/AIDS, the Swazi government's otherwise poor use of funds does not adequately explain the gap in the infection rate.

Ethiopia's decrease in HIV prevalence might be partially attributable to statistical error. In 1999, it was estimated that three million Ethiopians were living with HIV/AIDS.²⁷⁵ UNAIDS estimated that between 420,000 and 1.3 million were infected in 2005.²⁷⁶ There were no HIV/AIDS programs in Ethiopia between 1999 and 2005 that can account for such a drastic decrease in the number of infected persons. Moreover, the decrease cannot be fully attributed to deaths caused by AIDS related illnesses.

Prior to 2001, a testing site located in the town of Estie was classified as rural.²⁷⁷ In 2001, however, the site was reclassified as urban.²⁷⁸ The reclassification, "according to the [Ministry of Health], is the primary reason why national adult HIV prevalence reported in 2001 is less than that reported in 2000."²⁷⁹ The reclassification of the site at Estie, however, does not sufficiently explain the decrease in Ethiopia's prevalence rate. In fact, the Ethiopian

²⁷¹ See Law and Legal Research, *supra* note 139.

²⁷² Swaziland: *Uproar over king's new jet*, available at <http://irinnews.org/report.aspx?ReportId=33253>.

²⁷³ See UNGASS Report, *supra* note 84, at 10.

²⁷⁴ Hut by Hut, *supra* note 73.

²⁷⁵ AIDS in Africa; Country by Country, *supra* note 78, at 85.

²⁷⁶ Annex 1, *supra* note 79, at 355.

²⁷⁷ Garbus, *supra* note 165, at 17-18.

²⁷⁸ *Id.*

²⁷⁹ *Id.*

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

Ministry of Health explicitly stated that the decrease observed at the Estie site did not indicate “that the HIV epidemic in Ethiopia is declining.”²⁸⁰ As such, the reclassification of the Estie site does not adequately account for the disparity in HIV prevalence between Ethiopia and Swaziland.

IV. THE IMPACT OF INTERNATIONAL ORGANIZATIONS

International organizations have engaged in substantially similar activity in both Ethiopia and Swaziland. Thus, the efforts of international organizations cannot adequately explain the disparity in HIV prevalence between Ethiopia and Swaziland. The UNDP has forged alliances with non-governmental organizations in both countries, the WHO has worked with both governments on scaling-up antiretroviral therapy programs, and UNICEF has been similarly active in both countries. There is, in fact, no readily ascertainable difference in the actions taken by international organizations that can adequately account for the vast disparity in HIV prevalence between Ethiopia and Swaziland.

Moreover, there appears to be no direct correlation between international funding and HIV prevalence in Ethiopia and Swaziland. For instance, in 2003, the Global Fund distributed over eight million dollars in funds to Swaziland and another forty-five million dollars to Ethiopia.²⁸¹ Although Ethiopia received far more than Swaziland in total dollars, due to the vast difference in population, Swaziland received roughly eight dollars per capita while Ethiopia received less than one dollar per capita. Assuming *arguendo* that these funds were spent on HIV/AIDS programs, there appears to be no direct correlation between international funding and HIV prevalence.

Although the impact of international organizations on HIV prevalence in Swaziland and Ethiopia is unclear, undoubtedly the number of infected persons residing in sub-Saharan Africa²⁸² would be higher without the involvement of international organizations. Developed countries generally have the finances and technology available to halt the spread of HIV without international assistance. Many developing countries, and most sub-Saharan countries, lack the technology, finances, and infrastructure required to address the AIDS epidemic unilaterally. As such, Swaziland, Ethiopia, and other sub-Saharan countries must rely on international assistance to effectively curb the

²⁸⁰ *Id.*

²⁸¹ Global Fund Disbursements, <http://www.theglobalfund.org/en/files/disbursementdetails.pdf>.

²⁸² The sub-Saharan countries included are Angola, Benin, Botswana, Burkina Faso, Burundi, Cameroon, Central African Republic, Chad, Comoros, Congo, Cote d'Ivoire, Democratic Republic of the Congo, Djibouti, Equatorial Guinea, Ethiopia, Gabon, Gambia, Ghana, Guinea, Guinea-Bissau, Kenya, Lesotho, Madagascar, Malawi, Mali, Mauritania, Mozambique, Namibia, Niger, Nigeria, Rwanda, Senegal, Sierra Leone, South Africa, Swaziland, Tanzania, Togo, Uganda, Zambia, and Zimbabwe.

INTERNATIONAL ORGANIZATIONS AND THE AIDS EPIDEMIC

proliferation of the virus.

Lastly, it must be noted that international organizations have been combating the AIDS epidemic since it first began, and thus it would be impossible to determine whether a country receiving international assistance would have been successful combating the virus on its own. Once again, though, given that most sub-Saharan countries lack the necessary resources, it can be safely assumed that HIV prevalence in sub-Saharan Africa would be higher absent involvement from international organizations.

PROPOSAL

Although assistance from international organizations has been essential to the reduction in HIV prevalence in sub-Saharan Africa,²⁸³ more can be done by international organizations to reduce the proliferation of the virus in the region. For instance, although international organizations have recognized the global pervasiveness of discrimination against people living with HIV/AIDS,²⁸⁴ more studies must be conducted to determine the impact of discrimination on the AIDS epidemic.

International organizations should conduct studies to determine the impact of discrimination on HIV testing, HIV counseling, and AIDS-related education. By conducting these studies, international organizations will have a greater chance of designing programs that effectively address the underlying causes of discrimination against people living with HIV/AIDS. The development of these programs may diminish the pejorative impact of AIDS-related discrimination and subsequently lead to greater HIV testing, HIV counseling, and expanded enrollment in AIDS-related educational programs.

On a related issue, international organizations must improve the efficiency of statistical gathering. In 2005, UNAIDS estimated that anywhere from 420,000 to 1.3 million people were infected with HIV/AIDS in Ethiopia.²⁸⁵ The vast disparity in this estimate is primarily a result of inefficient data gathering in rural areas.²⁸⁶ Absent correct statistics, it is difficult for international organizations to determine the number of persons requiring antiretroviral therapy, the number of mothers in need of childbirth assistance, and the amount of money necessary to combat the proliferation of the virus.

Increased investment in statistical gathering may lead to a decrease in HIV prevalence. For example, if statistics indicated a high prevalence rate in a particular region of a country and a contemporaneous low prevalence rate in another region, international organizations may advise member states to allocate

²⁸³ Across the region HIV prevalence decreased by nearly 1% from 1999 to 2005.

²⁸⁴ 2006 Global Report, *supra* note 1, at 86-88.

²⁸⁵ Annex 1, *supra* note 79, at 355.

²⁸⁶ *See* Garbus, *supra* note 165, at 25-26.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

more resources to the area with the higher rate. Allocating more resources may have the effect of reducing the infection rate in that area. Absent efficient data gathering, however, international organizations are incapable of accurately advising member states on how best to allocate their resources.

At present, UNAIDS cosponsors seem to be placing more emphasis on remedial care, primarily the distribution of antiretroviral therapy, than on preventative care. Although the implementation of remedial measures is necessary to curb the proliferation of the virus, international organizations should nonetheless increase investment in educational programs. The vast rural sub-Saharan population has strained local governments. International organizations have the resources and technology available to reach even the most isolated populations. Studies have demonstrated that substantial investment in AIDS-related educational programs leads to a decrease in HIV infections.²⁸⁷ Increased investment in educational programs will lead to a decrease in the infection rate, thereby diminishing the need for investment in remedial care.

CONCLUSION

For sub-Saharan Africa to prevail against the AIDS epidemic, continued assistance from international organizations is paramount. Sub-Saharan states simply do not have the technology or resources that are required to effectively curb the proliferation of the virus. Even though UNAIDS operates primarily in an advisory capacity, the Programme brings to sub-Saharan Africa all the benefits of the developed world. Without these benefits, the recent 1% decrease in sub-Saharan HIV prevalence would not have transpired.

Although a close examination of Ethiopia and Swaziland does not clearly illustrate the importance of international organizations, continued assistance from international organizations is essential to sub-Saharan Africa's success against the virus. Despite their importance, however, international organizations can provide greater assistance to sub-Saharan countries. Although a concentrated effort by both domestic and international actors is necessary to reduce HIV prevalence, increased investment in statistical studies, statistical gathering, and AIDS-related education from international organizations can further reduce the transmission of HIV in sub-Saharan Africa.

²⁸⁷ See generally Legal Implications, *supra* note 150, at 66 (noting that large investment in HIV prevention and awareness programs in Senegal have led to a decrease in HIV prevalence).

MASSACHUSETTS v. EPA: THE CAUSES AND EFFECTS OF CREATING COMPREHENSIVE CLIMATE CHANGE REGULATIONS

*Colin H. Cassedy**

INTRODUCTION

In November 2007, the United Nations Secretary General described climate change as “the defining challenge of our age.”¹ Those comments came shortly after the United Nations Intergovernmental Panel on Climate Change (“IPCC”) released its latest report urging the nations of the world to immediately reduce greenhouse gases (“GHGs”) in order “to avert a global climate disaster, which could leave island nations submerged and abandoned, reduce African crop yields by 50 percent, and cause a 5 percent decrease in global gross domestic product.”² As the debate in the United States over global warming and its effects continues to grow and influence domestic politics, the international community has taken significant steps towards mitigating the damage with international instruments such as the Kyoto Protocol.³ Despite progress on the international stage towards reducing greenhouse gases, domestic governmental progress toward GHG reduction in the United States has been sluggish at best. Because the United States government has consistently refused to ratify the Kyoto Protocol the treaty has no binding internal effect and the United States is not required to abide by its terms. Although many Americans agree that ratifying the Kyoto Protocol would have been a significant and beneficial first step for the United States, some scholars argue that much more drastic measures are needed to curb the problems posed by global warming.⁴ Specifically, they argue that vital to the reduction of GHG emissions is the adoption of a comprehensive federal government scheme and a coordinated international plan that includes all major industrialized nations,

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¹ Elisabeth Rosenthal, *U.N. Chief Seeks More Climate Change Leadership*, N.Y. TIMES, Nov. 18, 2007, at A3.

² *Id.*

³ United Nations, Kyoto Protocol to the United Nations Framework Convention on Climate Change, U.N. Doc FCCC/CP/1997/7/Add.1, 37 I.L.M. 22 (Dec. 11, 1997).

⁴ See Richard J. Pierce, Jr., *Energy Independence and Global Warming*, 37 ENVTL. L. 595 (2007).

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

including the United States.⁵

Individual state efforts to take climate change action at a regional level have successfully forced the United States federal government into taking the first steps towards creating mandatory GHG emissions reduction legislation. The reluctance of the United States federal government to address global climate change provoked the state of Massachusetts, along with several other states, to sue the federal Environmental Protection Agency (“EPA”). The basis of the suit was to challenge the EPA’s persistent refusal to regulate greenhouse gas emissions under their statutory authority found in the Clean Air Act (“CAA”).⁶ Many states have recognized the need for such regulation and out of frustration with waiting for the federal government to act, several states have decided to pass their own regulations placing limits on greenhouse gas emissions.⁷ State regulation is a significant first step, but global climate change and the need to reduce GHGs are also international problems that require not only a unified domestic approach, but also a global approach in order to have any significant impact. In that spirit, the Bush Administration has recently taken steps that are directly attributable to the United States Supreme Court’s landmark decision in *Massachusetts v. EPA*.

In *Massachusetts v. EPA*, several states recognized the growing need for universal regulation of GHG emissions and decided to challenge the EPA’s refusal to regulate GHG emissions. The Supreme Court held that states may sue a federal agency for failure to regulate emissions of greenhouse gases.⁸ The importance of the decision and its impact on various industries throughout the United States, and the world at large, cannot be overstated. The Wall Street Journal declared the Court’s decision a possible “turning point in the national debate over climate change.”⁹ The Wall Street Journal characterized this decision as “the latest sign that greenhouse gases are about to affect U.S. industry and the economy in a big way.”¹⁰ The Court’s decision in *Massachusetts v. EPA* has validated the rights of states to act as a check on the federal government, ultimately strengthening The United States’ federal system of government by ensuring accountability at the federal level.

This note first examines and analyzes the Supreme Court’s decision in *Massachusetts v. EPA*. Section II analyzes state regulatory responses to the Supreme Court’s decision in *Massachusetts v. EPA* and section III analyzes the federal responses. Section IV provides a brief overview of the United States’

⁵ *Id.*

⁶ See *Massachusetts v. Environmental Protection Agency*, 127 S. Ct. 1438, 1446 (2007).

⁷ Regional Greenhouse Gas Initiative, <http://www.rggi.org/about.htm> (last visited Apr. 22, 2008).

⁸ *Massachusetts*, 127 S. Ct. at 1446.

⁹ Jess Bravin, *Court Rulings Could Hit Utilities, Auto Makers*, WALL ST. J., Apr. 3, 2007, at A1.

¹⁰ Jeffrey Ball & Mike Spector, *Industries Showing Uncertainty Over Ruling’s Impact*, WALL ST. J., Apr. 3, 2007, at A10.

MASSACHUSETTS V. EPA: CLIMATE CHANGE REGULATIONS

approach to climate change regulation. Section V examines the recent trends and activities in the effort to create an international climate change policy. Finally, this note concludes that since it is no longer debatable that man's energy activities contribute to global climate change, it is the United States' responsibility to take the lead and demonstrate to the rest of the world that a coordinated and meaningful international climate change treaty that includes all major industrialized nations is attainable.

I. MASSACHUSETTS V. EPA

The Supreme Court's decision in *Massachusetts v. EPA* originated with a 2003 EPA decision in which the agency specifically declined to regulate greenhouse gas emissions from motor vehicles.¹¹ The EPA relied on several different arguments for its refusal to regulate GHGs, including foreign policy concerns and the agency's lack of statutory authority under the CAA.¹² In addition, the EPA explained that "establishing GHG emission standards for U.S. motor vehicles at this time would require EPA to make scientific and technical judgments without the benefit of the studies being developed to reduce uncertainties and advance technologies," which, in turn "would result in an inefficient, piecemeal approach to addressing the climate change issue."¹³ In essence, the EPA was trying to put their decision on hold in order to allow the President's plan and the current initiatives a chance to be effective.¹⁴ The EPA concludes its decision by specifically supporting the President's "global climate change policy" which "sets the U.S. on a path to slow the growth of GHG emissions and, as the science justifies, to stop and then reverse the growth."¹⁵ However, the EPA fails to acknowledge its potential role in the President's plan and on September 8, 2003, the EPA issued its decision refusing to promulgate rules that regulate motor vehicle GHG emissions. Massachusetts et al. appealed the EPA's decision and two of the three judges on the panel in the United States Court of Appeals for the District of Columbia Circuit agreed, "that the EPA

¹¹ *Control of Emissions from New Highway Vehicles and Engines*, 68 Fed. Reg. 52922, 52925 (2003).

¹² *Id.* at 52925 (asserting that "[t]he international nature of global climate change also has implications for foreign policy, which the President directs. In view of EPA's lack of CAA regulatory authority to address global climate change, DOT's authority to regulate fuel economy, the President's policy, and the potential foreign policy implications, EPA declines the petitioners' request to regulate GHG emissions from motor vehicles.").

¹³ *Id.* at 52931.

¹⁴ *Id.* at 52933 (explaining that the president's policy "supports vital global climate change research and lays the groundwork for future action by investing in science, technology, and institutions" and it "emphasizes international cooperation and promotes working with other nations to develop an efficient and coordinated response to global climate change.").

¹⁵ *Id.* at 52933.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

Administrator properly exercised his discretion under § 202(a)(1) in denying the petition for rule making.”¹⁶ The petitioners then appealed to the United States Supreme Court and the Court granted certiorari.

The United States Supreme Court’s decision in *Massachusetts v. EPA* in April 2007 is one of the most significant developments in the power of states to force the hand of federal government agencies to promulgate and implement environmental regulations. Petitioners in *Massachusetts v. EPA* specifically wanted the EPA to regulate by setting limits on the emission of GHGs, much like the limits found in international treaties such as the Kyoto Protocol. *Massachusetts v. EPA* has been referred to as “a landmark decision in environmental law”¹⁷ because it demonstrates the increasing and still-emerging role that American states play in the creation and implementation of international environmental law. Specifically, *Massachusetts v. EPA* will potentially result in the strengthening of the United States’ environmental regulation position on the international stage because it affirms the rights of states to create regulations based on international environmental standards and goals that the federal government has consistently refused to accept and implement. The newly affirmed power of the states is known as the “special solicitude for states”, which the Court explains in *Massachusetts v. EPA* when addressing the threshold issue of state standing.¹⁸

Massachusetts, along with several other states, brought suit against the EPA to force the agency to regulate GHG emissions from motor vehicles. The Court in *Massachusetts v. EPA* addressed three specific issues: (1) whether the petitioners have standing to bring their claims under Article III of the United States Constitution; (2) “whether the EPA has the statutory authority to regulate greenhouse gas emissions from new motor vehicles”¹⁹; (3) if the EPA has the statutory authority to do so, “whether [the EPA’s] stated reasons for refusing to do so are consistent with the statute.”²⁰ The legislation specifically in question was Section 202(a)(1) of the CAA, which the EPA claimed did not give the agency authority to regulate GHG emissions from motor vehicles because they did not fall under the definition of “pollutants”.²¹

¹⁶ *Massachusetts v. EPA*, 415 F.3d 50, 58 (2005).

¹⁷ Dru Stevenson, *Special Solicitude for State Standing: Massachusetts v. EPA*, 112 PENN ST. L. REV. 1, 4 (2007) (asserting that *Massachusetts v. EPA* “presents a host of implications for the role of the EPA in worldwide protection of the environment, the proper occasions for the federal judiciary to intervene in highly debated public policy matters, and even for divining the current political composition of the Supreme Court” and most importantly “the question of standing for challenging inaction by an administrative agency.”).

¹⁸ *See id.*

¹⁹ *Massachusetts*, 127 S. Ct. 1438 at 1446.

²⁰ *Id.*

²¹ 42 U.S.C. § 7521(a)(1) (provides in part: “The [EPA] Administrator shall by regulation prescribe (and from time to time revise) in accordance with the provisions of this section, standards applicable

MASSACHUSETTS V. EPA: CLIMATE CHANGE REGULATIONS

In *Massachusetts v. EPA*, the EPA relied on two of the same arguments as it did in its 2003 agency decision to defend its refusal to regulate GHG emissions. First, the EPA argued that it did not have the statutory authority to regulate because the emitted gases are not “pollutants” under the CAA.²² In the alternative, the EPA argued that such a decision is a foreign policy matter, which should be handled solely by the President.²³ Finally, the EPA argued that Massachusetts and the other states that brought suit did not have standing because they had not suffered a particularized injury and there is no effective remedy available.²⁴ However, when the Court announced its holding on April 2, 2007 in a 5-4 decision, it refused to accept the EPA’s three arguments. Rather, the Court held that such gases are “pollutants” and that the CAA gives the EPA broad discretion to regulate such gases.²⁵ However, the Court did not mandate any specific type of regulation be employed. It stated simply but bluntly that the EPA could no longer rely on its former arguments for the agency’s failure to regulate these gases.²⁶

The Court’s majority opinion, delivered by Justice Stevens, acknowledges at the outset the link between a rise in global temperatures and “a significant increase in the concentration of carbon dioxide in the atmosphere.”²⁷ In analyzing the CAA, the Court notes that the definition of “air pollutant” is broad and includes “any air pollution agent or combination of such agents, including any physical, chemical, biological, radioactive, . . . substance or matter which is emitted into or otherwise enters the ambient air.”²⁸ The Court summarizes the history of the CAA and emphasizes that Congress’ passage of the CAA came before the global causes and effects of climate change were well understood.²⁹ The Court was willing to interpret the statutory language broadly because the dangers that the Act was designed to protect against were not fully known by Congress at the time. The Court essentially describes why it believes reducing GHGs that contribute to climate change is a compelling cause and what our federal government has and has not done to lessen its effects.

to the emission of any air pollutant from any class or classes of new motor vehicles or new motor vehicle engines, which in his judgment cause, or contribute to, air pollution which may reasonably be anticipated to endanger public health or welfare...”).

²² *Massachusetts*, 127 S. Ct. 1438 at 1450.

²³ *Id.* at 1451.

²⁴ *Id.* at 1453.

²⁵ *Id.* at 1443.

²⁶ *See Massachusetts*, 127 S. Ct. 1438.

²⁷ *Id.* at 1446.

²⁸ 42 U.S.C. § 7602(g).

²⁹ *Massachusetts*, 127 S. Ct. at 1447.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

A. Standing

The Court's rule on standing empowers the states to take independent action to control GHG emissions. One of the EPA's defenses was that Massachusetts, as well as the other plaintiff-states, did not have standing because they had not suffered a concrete, particularized injury and there was no available remedy.³⁰ The Court concluded that the "EPA's steadfast refusal to regulate greenhouse gas emissions presents a risk of harm to Massachusetts that is both 'actual' and 'imminent'" and that there is a remedy available because there is "a 'substantial likelihood that the judicial relief requested' will prompt EPA to take steps to reduce that risk."³¹ The Court notes "that States are not normal litigants for the purposes of invoking federal jurisdiction" and continues to cite a 1907 Supreme Court decision in which Justice Holmes explained that ". . . the State has an interest independent of and behind the titles of its citizens, in all the earth and air within its domain. It has the last word as to whether its mountains shall be stripped of their forests and its inhabitants shall breathe pure air."³²

The Court relies upon an historical analysis to articulate a new rule for state standing. The Court explains that when a state enters the Union, it must give up a certain amount of its sovereignty.³³ As a result of the state giving up some of its sovereignty, the federal government has a duty to protect those rights and act on behalf of the interest of the states.³⁴ Since the states surrender some of their sovereign rights to the federal government, the Court concludes that "Massachusetts' stake in protecting its quasi-sovereign interests" entitles it "to special solicitude in our standing analysis."³⁵

The Court's majority opinion relies on three arguments for supporting the new special solicitude standing rule.³⁶ First, states only have the authority to regulate the events that occur inside their territorial borders.³⁷ As a result, states that receive pollution from other states do not have the power to force the other state to limit its pollution. For instance, "Massachusetts cannot invade Rhode Island to force reductions in greenhouse gas emissions."³⁸ Instead, "[t]he states must appeal to the federal government—either court or agencies—to resolve

³⁰ *Id.* at 1453.

³¹ *Massachusetts*, 127 S. Ct. 1438 at 1455 *citing* *Duke Power Co. v. Carolina Environmental Study Group, Inc.* 438 U.S. 59, 79 (1978).

³² *Id.* at 1454 *citing* *Georgia v. Tennessee Copper Co.*, 206 U.S. 230, 237 (1907).

³³ *Id.* at 1454.

³⁴ *Stevenson*, *supra* note 17, at 8.

³⁵ *Massachusetts*, 127 S. Ct. 1438 at 1454.

³⁶ *See Massachusetts*, 127 S. Ct. 1438; *see also Stevenson*, *supra* note 17, at 6.

³⁷ *Id.*

³⁸ *Massachusetts*, 127 S. Ct. 1438 at 1454.

MASSACHUSETTS V. EPA: CLIMATE CHANGE REGULATIONS

problems of interstate externalities.”³⁹ The Court reasons that states must be given special status, as opposed to individuals, because states have given a portion of their sovereignty to the federal government and must have a mechanism by which to enforce their rights if the federal government refuses to do so. Second, the Court holds that a state has no ability to engage in foreign relations.⁴⁰ Third, the Court finds that a state may face preemption if it attempts to regulate in an area where the federal government has power to regulate.⁴¹ In the Court’s own words, a state “cannot negotiate an emissions treaty with China or India, and in some circumstances the exercise of its police powers to reduce in-state motor-vehicle emissions might well be pre-empted.”⁴² Some scholars have convincingly argued that this is an indirect reference to the Kyoto Protocol.⁴³ It is possible that the majority, led by Justice Stevens, is expressing their disapproval of the U.S. refusal to sign the Kyoto Protocol. Although the special solicitude rule is the current law, it is unclear whether the Court will choose to apply this rule the next time a state attempts to force a federal agency to promulgate rules. The standing rule certainly does not discourage states from exercising power when thought necessary because the federal government refuses to do so.

B. “Pollutants”

The next issue addressed by the majority is whether the EPA has statutory authority under the CAA to regulate emissions from new motor vehicles. The EPA argued that it did not have the authority to regulate emissions from new motor vehicles because such emissions did not constitute an “air pollutant” under the CAA.⁴⁴ The Court rejected this argument, holding that “[o]n its face, the definition embraces all airborne compounds of whatever stripe, and underscores that intent through the repeated use of the word ‘any’ . . . The statute is unambiguous.”⁴⁵ The Court emphasized that the EPA did not rely on the statutory text, but rather legislative intent for its position. The Court dismissed that rationale as well, stating that the “EPA never identifies any action remotely suggesting that Congress meant to curtail its power to treat

³⁹ Stevenson, *supra* note 17, at 6.

⁴⁰ See *Massachusetts*, 127 S. Ct. 1438 at 1454. See also Stevenson, 112 PENN ST. L. REV. at 6.

⁴¹ *Massachusetts*, 127 S. Ct. at 1454. See also Stevenson, 112 Penn St. L. Rev. at 6.

⁴² *Id.*

⁴³ Stevenson, *supra* note 17, at 6. (arguing “[t]his is probably an allusion to the Kyoto Protocol, a treaty the federal government repudiated, which would have been the primary instrument of international law for addressing manmade climate change. The relatively free ride given to China and India under the Protocol was the main justification for its lack of federal endorsement.”).

⁴⁴ *Massachusetts*, 127 S. Ct. at 1460.

⁴⁵ *Id.*

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

greenhouse gases as air pollutants.”⁴⁶

The EPA’s alternative argument was that even if it did have statutory authority to regulate GHG emissions, it determined in its “judgment”, according to the statute, that it should not exercise that authority.⁴⁷ The Court here announced that the EPA’s alternative argument “rests on reasoning divorced from the statutory text” because the “judgment” the EPA is granted by the statute requires the agency to regulate when an air pollutant “ ‘causes, or contribute[s] to, air pollution which may reasonably be anticipated to endanger public health or welfare.’”⁴⁸ Clearly, the Court feels that GHG emissions from motor vehicles contribute to air pollution and therefore must be regulated. The Court criticized the EPA’s argument saying, “the use of the word ‘judgment’ is not a roving license to ignore the statutory text” but is instead “a direction to exercise discretion within defined statutory limits.”⁴⁹ The Court reasons that the EPA’s failure to regulate is not justified and is incompatible with the statute. The Court bluntly says the EPA’s reasons “have nothing to do with whether greenhouse gas emissions contribute to climate change.”⁵⁰ The Court stopped short of requiring the EPA to regulate emissions, but its holding is a clear indication that the EPA must come up with a different justification should it continue to refuse to regulate motor vehicle GHG emissions.

C. The Dissenting Opinions

Not all members of the Court agreed with the majority’s standing holding. Four of the Justices, including Chief Justice Roberts, disagreed with granting petitioners standing in this matter. In Chief Justice Roberts’ dissent, in which Justice Scalia, Justice Thomas, and Justice Alito join, he asserts that “[r]elaxing Article III standing requirements because asserted injuries are pressed by a State, however, has no basis in our jurisprudence, and support for any such “special solicitude” is conspicuously absent from the Court’s opinion.”⁵¹ Focusing on this lack of case law in the majority’s opinion, Chief Justice Roberts continues to explain in his dissent that “the Court has to go back a full century in an attempt to justify its novel standing rule, but even there it comes up short” because *Georgia v. Tennessee Copper Co.* dealt “solely with available remedies” and “had nothing to do with Article III standing.”⁵² Justice Roberts summarizes his dissent by asserting, “[t]his Court’s jurisprudence

⁴⁶ *Id.*

⁴⁷ *Id.* at 1462.

⁴⁸ *Id.*

⁴⁹ *Id.*

⁵⁰ *Id.*

⁵¹ *Id.* at 1464.

⁵² *Id.* at 1465.

MASSACHUSETTS V. EPA: CLIMATE CHANGE REGULATIONS

simply recognizes that redress of grievances of the sort at issue here ‘is the function of Congress and the Chief Executive,’ not the federal courts.”⁵³

To establish standing, according to the Court’s jurisprudence in Chief Justice Roberts’ opinion, the “petitioners bear the burden of alleging an injury that is fairly traceable to the Environmental Protection Agency’s failure to promulgate new motor vehicle greenhouse gas emission standards, and that is likely to be redressed by the prospective issuance of such standards.”⁵⁴ Since the petitioners did not meet this burden, in Chief Justice Roberts’ opinion, he felt compelled to dissent from the majority’s opinion. He did not think that the petitioners were able to prove a particular injury because “[g]lobal warming is a phenomenon ‘harmful to humanity at large’ and the redress petitioners seek is focused no more on them than on the public generally – it is literally to change the atmosphere around the world.”⁵⁵ Chief Justice Roberts also believes that the majority “ignores the complexities of global warming” and disregarded the requirement of particularized injury and used “the dire nature of global warming itself as a bootstrap for finding causation and redressability.”⁵⁶

Justice Scalia also filed his own separate dissent, in which Chief Justice Roberts, Justice Thomas, and Justice Alito joined. Justice Scalia acknowledged that he “would hold that this Court has no jurisdiction to decide this case because petitioners lack standing.”⁵⁷ However, Justice Scalia puts aside that issue because the majority decided otherwise, and he continues to argue his dissent on the merits. He does not agree with the majority’s interpretation of “air pollution” because “regulating the build up of CO₂ and other greenhouse gases in the upper reaches of the atmosphere, which is alleged to be causing global climate change, is not akin to regulating the concentration of some substance that is *polluting the air*.”⁵⁸ The essence of Justice Scalia’s dissent is best summarized in the concluding paragraph of his dissent when he explains:

The Court’s alarm over global warming may or may not be justified, but it ought not distort the outcome of this litigation. This is a straightforward administrative-law case, in which Congress has passed a malleable statute giving broad discretion, not to us but to an executive agency. No matter how important the underlying policy issues at stake, this Court has no business substituting its own desired outcome for the

⁵³ *Id.* at 1464.

⁵⁴ *Id.*

⁵⁵ *Id.* at 1467.

⁵⁶ *Id.* at 1468.

⁵⁷ *Id.* at 1471.

⁵⁸ *Id.* at 1477.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

reasoned judgment of the responsible agency.⁵⁹

As Justice Scalia sees it, the EPA has broad discretion to regulate under the CAA and absent some egregious error, Justice Scalia does not believe the Court should interfere with the EPA's discretion. Scalia explains that the majority, "with no basis in text or precedent, rejects all of EPA's stated 'policy judgments' as not 'amoun[ting] to a reasoned justification,' effectively narrowing the universe of potential reasonable bases to a single one: Judgment can be delayed *only* if the Administrator concludes that 'the scientific uncertainty is [too] profound.'"⁶⁰ However, the Court did not require the EPA to regulate emissions, it simply held that the EPA's stated reasons for doing so were not consistent with the statute. This does not amount to the Court interfering with an executive agency's discretion because the agency can still refuse to regulate GHG emissions, so long as its refusal to do so is consistent with the CAA.

II. STATE RESPONSES TO MASSACHUSETTS V. EPA

Refusing to wait for the federal government to implement regulations limiting GHG emissions, California decided to take action on its own at the state level. In 2002, California was the first state to pass a law that required auto manufacturers to reduce GHG emissions.⁶¹ Two years later, in 2004, California issued specific regulations detailing how the auto manufacturers were supposed to meet the reduction requirements.⁶² Five other states followed California's lead and passed the same or similar laws.⁶³ Initially, it seemed as though California had successfully implemented stricter GHG emission standards than the federal government would ever agree to abide by in international treaties. However, in order for California to implement stricter regulations than the federal government follows under the CAA, California must receive a waiver from the EPA.⁶⁴ California applied for a waiver from the EPA on December 21, 2005, under section 209(b) of the CAA.⁶⁵ California argued a waiver was

⁵⁹ *Id.* at 1477-78.

⁶⁰ *Id.* at 1472.

⁶¹ John M. Broder, *Judge Backs California Rules on Greenhouse Gases*, N.Y. TIMES, Dec. 12, 2007.

⁶² *Id.*

⁶³ *Id.*

⁶⁴ 42 U.S.C.A. § 7543 (issuing a general prohibition against states adopting their own standards for controlling emissions from new motor vehicles, but allowing a waiver "to any State which has adopted standards...for the control of emissions from new motor vehicle engines...if the State determines that the State standards will be, in the aggregate, at least as protective of public health and welfare as applicable Federal standards").

⁶⁵ 72 FR 21260-01, California State Motor Vehicle Pollution Control Standards; Request for

MASSACHUSETTS V. EPA: CLIMATE CHANGE REGULATIONS

necessary because of the “compelling and extraordinary conditions” associated with GHG emissions and the lack of strict federal standards.⁶⁶

In December 2007, the EPA denied California’s waiver application because the Administrator determined that California does not have “compelling and extraordinary conditions” since it is affected by climate change to the same extent as the other states in our country.⁶⁷ California’s governor, Arnold Schwarzenegger, referred to the EPA decision to deny the waiver as “unconscionable” when he announced California’s decision to sue the EPA.⁶⁸ The EPA attempted to justify its denial of California’s waiver by stating that there was no need for it because a federal fuel-economy regulation would be “more efficient” at reducing GHG emissions.⁶⁹ However, the California Air Resources Board has calculated that if the EPA were to grant the waiver and allow California’s regulations to go forward, carbon dioxide would be reduced in 2016 by 17.2 million metric tons, “more than double the 7.7 million metric tons that would be eliminated under the new federal fuel-economy standard.”⁷⁰ In addition, the total reduction from 2009 through 2016 would be triple that of the federal regulation.⁷¹

The implications of the EPA’s refusal to grant a waiver are wide-ranging. In effect, when the EPA denied California’s waiver, it invalidated all other state GHG emission standards that were grounded on California’s regulations.⁷² The EPA’s decision to refuse to grant a waiver is also noteworthy because the decision is a departure from decades of precedent of granting California such waivers.⁷³ After all, a waiver to do more than is allowed under federal regulation does not contravene federal statutes or regulatory goals. Congress had previously recognized that granting California a waiver to implement stricter standards allowed the state to serve “as a proving ground for new technology that would later be introduced nationwide pursuant to federal

Waiver of Federal Preemption; Opportunity for Public Hearing, Apr. 30, 2007.

⁶⁶ *Id.* at § (b)(1)(B) (waiver can be denied if the EPA Administrator determines that “such State does not need such State standards to meet compelling and extraordinary conditions”).

⁶⁷ Felicity Barringer, *California Sues E.P.A. Over Denial of Waiver*, N.Y. TIMES, Jan. 3, 2008, at A14.

⁶⁸ *Id.*

⁶⁹ *Id.*

⁷⁰ *Id.*

⁷¹ *Id.*

⁷² *Green Mountain Chrysler Plymouth Dodge Jeep v. Crombie*, 508 F.Supp.2d 295, 344 (D.Vt. 2007) (stating unequivocally that “[t]here is no dispute that if California fails to receive a waiver from EPA for its standards, then Vermont’s GHG standards are invalid.”).

⁷³ *Id.* at 344-345 (explaining that “Congress has allowed California to avoid preemption” in the past “because it was persuaded that California had uniquely severe air pollution problems and a burgeoning number and concentration of automobiles” and because Congress “determined that there were potential benefits for the nation in allowing California to continue to experiment and innovate in the field of emissions control”).

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

regulations.”⁷⁴ In fact, the EPA has “issued waivers to California in virtually all of California’s applications. . .and has never denied California an emissions waiver in its entirety.”⁷⁵ The court also recognized that “actions by sub-national governments have indeed led to nationally significant emissions reduction for criteria pollutants” and “[t]here is no reason to believe that this approach would not also prove effective for GHG emissions abatement.”⁷⁶

California has separately filed a public nuisance suit under both federal common law and California state law against six major motor vehicle manufacturers in the United States.⁷⁷ California was seeking damages for the harm caused by the motor vehicle manufacturers in the form of GHG emissions from their automobiles.⁷⁸ The automobiles emit approximately 289 million metric tons of GHGs in the United States, which “constitutes approximately nine percent of human-generated carbon dioxide emissions in the United States and over thirty percent in California.”⁷⁹ In the suit, California alleged the harm from climate change has caused “an increase in the winter average temperatures. . .a reduction in the snow pack which serves as thirty-five percent of the State’s water. . .increased risk of flooding within the state. . .increased erosion along California’s 1,075 miles of coastline. . .and increases in the risk and intensity of wildfires, among others.”⁸⁰

Although the case seemed like an opportunity for the courts to step in and solidify California’s role as a pioneer in implementing mandatory climate change regulation at the regional level, the court never reached the merits of the case, holding that the public nuisance claim under federal common law was a non-justiciable political question.⁸¹ The court held it was “precluded from exercising supplemental jurisdiction over Plaintiff’s state law nuisance claim” and therefore that claim was dismissed without prejudice.⁸² Although California’s attempt to recover damages by way of a public nuisance suit was unsuccessful, it is yet another significant step at the regional level in the battle to reduce GHG emissions.

⁷⁴ *Id.* at 345.

⁷⁵ *Id.* at 348-349.

⁷⁶ *Id.* at 394.

⁷⁷ Randall S. Abate, *Automobile Emissions and Climate Change Impacts: Employing Public Nuisance Doctrine as Part of a “Global Warming Solution” in California*, 40 Conn. L. Rev. 591, 595 (2008). See also *California v. Gen. Motors Corp.*, Slip Copy 2007 WL 2726871 (N.D. Cal. 2007).

⁷⁸ *Id.* at 596.

⁷⁹ *Id.*

⁸⁰ *California v. Gen. Motors Corp.*, Slip Copy 2007 WL 2726871 at 1 (N.D. Cal. 2007).

⁸¹ *Id.* at 16.

⁸² *Id.*

MASSACHUSETTS V. EPA: CLIMATE CHANGE REGULATIONS

III. FEDERAL RESPONSES TO MASSACHUSETTS V. EPA

Massachusetts v. EPA is a landmark case because the Court validated the right of a state to challenge a federal agency's judgment. The majority opinion paves the way for states to challenge decisions by other federal agencies and potentially impact numerous areas of law. Specifically, *Massachusetts v. EPA* can be credited with altering the foreign policy of the United States regarding global climate change. The change in policy began with an Executive Order soon after the Court's decision and its most recent manifestation is the United States' participation in an international forum in Bali, Indonesia to discuss a successor treaty to the Kyoto Protocol.

In direct response to *Massachusetts v. EPA*, President George W. Bush issued Executive Order 13432, which states the policy of the United States.⁸³

It is the policy of the United States to ensure the coordinated and effective exercise of the authorities of the President and the heads of the Department of Transportation, the Department of Energy, and the Environmental Protection Agency to protect the environment with respect to greenhouse gas emissions from motor vehicles. . . in a manner consistent with sound science, analysis of benefits and costs, public safety, and economic growth.⁸⁴

Following that executive order, the EPA Administrator, Stephen Johnson acknowledged at a press briefing that "the U.S. Supreme Court decided in *Massachusetts versus EPA* that the Clean Air Act provided the EPA with the statutory authority to regulate greenhouse gas emissions from new vehicles if I determine in my judgment whether such emissions endanger public health and welfare under the Clean Air Act."⁸⁵ The Administrator, in the same set of remarks, acknowledged that the first steps towards EPA regulation had been taken, and he also supported the Bush administration's efforts to date.⁸⁶ Administrator Johnson explained that he believed that the United States is already making significant progress in reducing GHG emissions, arguing "U.S.

⁸³ 72 FR 27717, Exec. Order. No. 13432, *Cooperation Among Agencies in Protecting the Environment with Respect to Greenhouse Gas Emissions From Motor Vehicles, Nonroad Vehicles, and Nonroad Engines*.

⁸⁴ *Id.*

⁸⁵ White House Press Release, *Briefing by Conference Call on the President's Announcement on CAFE and Alternative Fuel Standards*, May 14, 2007.

⁸⁶ *Id.* (stating that "Since 2001, EPA and the entire administration have invested more than \$37 billion to study climate change science, promote energy-efficient and carbon-dioxide-reducing technologies, and fund tax incentive programs..." which amounts to "more money than any other country in the world has spent to address this global climate change").

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

greenhouse gas intensity declined by 1.9 percent in 2003, declined by 2.4 percent in 2004, and 2.4 percent again in 2005. Put another way, from 2004 to 2005, the U.S. economy has increased by 3.2 percent, while greenhouse gas emissions increased by 0.8 percent.⁸⁷ In other words, there has been no reduction in GHG emissions. Rather, there has been an increase, which further demonstrates the need for a federal comprehensive scheme and a coordinated international plan to reduce GHG emissions.

In a potentially productive first step, several members of Congress agreed to address the issue of implementing mandatory caps on carbon emissions.⁸⁸ The three most prominent sponsors of the bill are Senators John McCain, Barack Obama, and Joe Lieberman, a Republican, Democrat, and Independent respectively. The wide political spectrum of support gained by this bill seems to suggest it has a legitimate chance of becoming law. The bill requires “mandatory caps on greenhouse emissions by power plants, industry, and oil refineries” and requires the release of GHGs “to return to 2004 levels by 2012 and to 1990 levels by 2020.”⁸⁹ To accomplish the stated goals of the bill, “businesses could buy emissions ‘credits’ from other companies that have exceeded their reduction targets and could use other methods to avoid the most costly cutbacks, according to a draft of the bill.”⁹⁰ In an effort to compromise, the Chairman of the Energy and Natural Resources Committee is offering a “more modest”⁹¹ bill that allows GHG emissions to increase until 2030.⁹² While it is unclear which bill, if any will pass, the encouraging aspect is that Congress seems to be grasping the urgency and severity of the problem.

IV. THE U.S. APPROACH TO INTERNATIONAL CLIMATE CHANGE REGULATION

The United States first responded to the problem of climate change in 1978 when Congress passed the National Climate Program Act (“NCPA”).⁹³ Prior to this time, climate change was not perceived by scientists as a serious threat, but rather “meteorologists explained that weather patterns always did vary modestly, in cycles lasting a few decades or centuries” and scientists even

⁸⁷ *Id.*

⁸⁸ *Congress to Reconsider Caps on Carbon: McCain, Obama Among Sponsors of Bill to Curb Global Warming*, The Associated Press, Jan. 12, 2007, available at <http://www.msnbc.msn.com/id/16593468>.

⁸⁹ *Id.*

⁹⁰ *Id.*

⁹¹ *Id.*

⁹² *Id.*

⁹³ Matthew Visick, *If Not Now, When? The California Global Warming Solutions Act of 1006: California's Final Steps Toward Comprehensive Mandatory Greenhouse Gas Regulation*, 13 *Hastings W.-N.W. J. ENVTL. L. & POL'Y* 249, 250 (2007).

MASSACHUSETTS V. EPA: CLIMATE CHANGE REGULATIONS

speculated that there could be beneficial effects for the farm industry.⁹⁴ However, as more scientists began to study the possible problems, it became clear that the government should be involved in discovering the specific problems associated with GHG emissions, and more importantly, possible solutions.⁹⁵ As a result, the NCPA created a system “to study the causes and effects of climate change.”⁹⁶ In addition, President Carter directed the National Research Council, a “nonprofit institution that provides science, technology and health policy advice under a congressional charter signed by President Abraham Lincoln”⁹⁷ to study the implications of climate change.⁹⁸ Nine years later, Congress amended the NCPA and implemented the Global Climate Protection Act of 1987, which created the National Climate Program to study the effects of man-made GHG emissions and how to reduce their impact domestically and more importantly, internationally.⁹⁹ Three years later, Congress passed the Global Change Research Act, “which called for an annual report to Congress, research into energy efficiency and the climate change implications of urban and suburban development practices, and discussions with other nations on ways to coordinate climate change research.”¹⁰⁰

In 1990, the IPCC released its first complete report on climate change and concluded that man-made emissions are contributing to a warmer Earth.¹⁰¹ Based on this conclusion, in 1992 the United Nations held the Earth Summit in Rio de Janeiro, at which President George H.W. Bush, along with 154 other nations, decided to support the United Nations Framework Convention on Climate Change (“UNFCCC”).¹⁰² The United States Senate ratified the UNFCCC and it took effect in 1994.¹⁰³ The UNFCCC’s stated objective is the “stabilization of greenhouse gas concentrations in the atmosphere at a level that would prevent dangerous anthropogenic interference with the climate system.”¹⁰⁴ While the UNFCCC “does not set specific targets for each signatory

⁹⁴ Spencer R. Weart, *The Discovery of Global Warming* 1-2 (2003).

⁹⁵ See Visick, *supra* note 93.

⁹⁶ *Id.*

⁹⁷ The National Research Council, <http://sites.nationalacademies.org/nrc/index.htm>.

⁹⁸ See *Massachusetts*, 127 S.Ct. at 1448 (noting that “If carbon dioxide continues to increase, the study group finds no reason to doubt that climate changes will result and no reason to believe that these changes will be negligible...A wait-and-see policy may mean waiting until it is too late.”).

⁹⁹ Visick, *supra* note 93.

¹⁰⁰ *Id.*

¹⁰¹ See *Climate Change: The IPCC Scientific Assessment*, at xi (John Theodore Houghton, G.J. Jenkins, J.J. Ephraums, eds., 1990) (explaining that “emissions resulting from human activities are substantially increasing the atmospheric concentrations of...greenhouse gases [which] will enhance the greenhouse effect, resulting on average in an additional warming of the Earth’s surface.”).

¹⁰² Visick, *supra* note 93.

¹⁰³ *Id.*

¹⁰⁴ United Nations Framework Convention on Climate Change art. 2, May 9, 1992, *available at*

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

to meet. . . it does set the broad goal of returning greenhouse gas emissions to 1990 levels,” and urges developed countries to take the lead in stopping and reversing the effects of climate change.¹⁰⁵ After the UNFCCC, the IPCC released its second complete report in 1995 and concluded that “[t]he balance of evidence suggests there is a discernable human influence on global climate.”¹⁰⁶ Following the IPCC’s second similar conclusion, UNFCCC members met in Japan in 1997 and created the Kyoto Protocol, “which stipulates specific targets for greenhouse gas emissions reductions from signatories to the UNFCCC.”¹⁰⁷ Notably, the Kyoto Protocol requires only developed countries to reduce GHG emissions.¹⁰⁸ This continues the earlier Rio Declaration’s position that the “right to develop” on the part of developing countries outweighs the obligation not to cause environmental harm.¹⁰⁹ Although President Bill Clinton signed the Kyoto Protocol in 1998, he never presented it to the Senate for ratification and therefore the United States is not bound by its terms.¹¹⁰ At the very minimum, by signing the treaty, the United States has agreed not to act inconsistently with the stated aims and objectives of the treaty.

The Senate explained the position of the United States when it passed a unanimous resolution explaining that because developing countries were not subject to Kyoto emission limitations, the United States should not enter it.¹¹¹ In addition, President George W. Bush has not supported the Kyoto Protocol on the grounds that developing countries are not required to reduce GHG emissions, even though they are “major emitters”.¹¹² This is a legitimate concern but ought not to impede climate change efforts by the states or the federal government. In a letter from President George W. Bush to several Senators, Mr. Bush explained that he opposes the Kyoto Protocol because “it exempts 80 percent of the world, including major population centers such as China and India, from compliance, and would cause serious harm to the U.S. economy.”¹¹³ Mr. Bush continues in the letter to explain that the Senate’s 95-0 vote on the Kyoto Protocol demonstrates “that there is a clear consensus that the

<http://unfccc.int/resource/docs/convkp/conveng.pdf>.

¹⁰⁵ Visick, *supra* note 93, at 251.

¹⁰⁶ IPCC, Climate Change 1995, The Science of Climate Change at 4, *available at* <http://www.ipcc.ch/ipccreports/assessments-reports.htm>.

¹⁰⁷ Visick, *supra* note 93.

¹⁰⁸ *Id.*

¹⁰⁹ James E. Hickey, Jr., *Environmental Protection and Energy Development*, in ENERGY LAW AND POLICY FOR THE 21ST CENTURY 5-28 (2000).

¹¹⁰ Visick, *supra* note 93, at 251.

¹¹¹ See S. Res. 98, 105th Cong., 1st Sess. (July 25, 1997).

¹¹² *Connecticut v. Am. Elec. Power Co.*, 406 F. Supp. 2d 265, 270 (S.D.N.Y. 2005).

¹¹³ George W. Bush, *Text of a Letter from the President to Senators Hagel, Helms, Craig, and Roberts* (March 13, 2001) *available at* <http://www.whitehouse.gov/news/releases/2001/03/20010314.html>.

MASSACHUSETTS V. EPA: CLIMATE CHANGE REGULATIONS

Kyoto Protocol is an unfair and ineffective means of addressing global climate change concerns.”¹¹⁴ Instead, the President advocates a “balanced national energy policy” that includes requiring power plants to reduce GHG emissions by “phasing in reductions over a reasonable period of time, providing regulatory certainty, and offering market-based incentives to help industry.”¹¹⁵ President Bush also wrote in the letter that he does “not believe, however, that the government should impose on power plants mandatory emissions reductions for carbon dioxide” because it “is not a ‘pollutant’ under the Clean Air Act.”¹¹⁶ It remains to be seen whether President Bush now believes in imposing mandatory emissions reductions on various industries given the Supreme Court’s holding that carbon dioxide is indeed a pollutant under the CAA. It seems as though this finding could give President Bush the political opportunity to advocate for and ultimately implement some type of coherent and comprehensive federal legislation mandating GHG emissions reductions. While Congress has not yet produced a viable piece of legislation addressing the issue, President Bush has signaled to the international community that the United States is serious about confronting the problems associated with global climate change.

On both the domestic and international fronts, the world has taken steps to mitigate the effects of GHGs and their contribution to climate change. However, the scientists who comprise the United Nations Intergovernmental Panel on Climate Change agree that the efforts to date, both domestically and internationally, have been insufficient.¹¹⁷ The Intergovernmental Panel on Climate Change is composed of over two thousand scientists whose main “role is to assess on a comprehensive, objective, open and transparent basis the latest scientific, technical and socio-economic literature produced worldwide relevant to the understanding of the risk of human-induced climate change, its observed and projected impacts and options for adaptation and mitigation.”¹¹⁸ Indeed, the scientists on this panel were awarded the Nobel Peace Prize in October 2007, and recently agreed that the world must “reverse the growth of greenhouse gas emissions by 2015 to prevent serious climate disruptions.”¹¹⁹ Although the efforts to address the problems associated with rising GHG emissions by various countries and institutions have been mostly unsuccessful and inadequate, all of the parties involved share the common goal of protecting our planet.

¹¹⁴ *Id.*

¹¹⁵ *Id.*

¹¹⁶ *Id.*

¹¹⁷ See Elisabeth Rosenthal, *U.N. Chief Seeks More Climate Change Leadership*, N.Y. TIMES, Nov. 18, 2007, at A3.

¹¹⁸ Intergovernmental Panel on Climate Change Mandate, available at <http://www.ipcc.ch/about/index.htm>.

¹¹⁹ Rosenthal, *supra* note 117.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

Despite a common goal, some scholars argue that commonality is precisely why there has been minimal success with the initiatives to date.¹²⁰ In essence, although there may be a shared common good, “there is seldom a common interest in paying for that good. Each member of the group wants other members to pay the costs of providing it because, by definition, each member will benefit from the good regardless of whether or not he or she pays for it.”¹²¹ The problems associated with acting on behalf of a common good, such as the ever-present threat of free riders, may explain why the efforts to date have been inadequate to address the problem. As a result, any proposed solution in the future must ensure that each nation bears its fair portion of the burden. Much of the debate will focus on what amounts to a fair portion, but there is no reason why an agreement cannot be reached.

V. INTERNATIONAL CLIMATE CHANGE REGULATION INITIATIVES

Massachusetts v. EPA led to a direct change in the United States’ approach to global climate change. The change in policy began with an Executive Order soon after the Supreme Court’s decision and its most recent manifestation is the United States’ participation in an international forum in Bali, Indonesia to discuss a successor treaty to the Kyoto Protocol. In December 2007, the signatory countries of the Kyoto Protocol, including the United States, came together again in an attempt to reach a more meaningful and effective solution to the problems associated with the emission of GHGs that directly result in global climate change.¹²² Representatives from 187 countries met in Bali, Indonesia and agreed to participate in discussions over the next two years in an attempt to form a new treaty aimed at reducing GHG emissions.¹²³

The resulting agreement, the Bali Action Plan, has as its stated objective, “[r]esponding to the finding of the Fourth Assessment Report of the Intergovernmental Panel on Climate Change that warming of the climate system is unequivocal, and that delay in reducing emissions significantly constrains opportunities to achieve lower stabilization levels and increases the risk of more severe climate change impacts.”¹²⁴ The discussions surrounding the Bali Action Plan focused in large part on the most recent report from the IPCC, released in

¹²⁰ Paul G. Harris, *Collective Action on Climate Change: The Logic of Regime Failure*, 47 NAT. RESOURCES J. 195, 201 (2007).

¹²¹ *Id.*

¹²² Thomas Fuller, *Climate Plan Looks Beyond Bush’s Tenure*, N.Y. TIMES, Dec. 16, 2007, §1, at 11.

¹²³ Fuller, *supra* note 122.

¹²⁴ Bali Action Plan, *available at* http://unfccc.int/files/meetings/cop_13/application/pdf/cp_bali_action.pdf.

MASSACHUSETTS V. EPA: CLIMATE CHANGE REGULATIONS

November 2007, just weeks before the meeting in Bali.¹²⁵ The report states that climate change is “unequivocal” and the United Nations Secretary General urged the two biggest polluters in the world, the United States and China, to play a central role in reducing the effects of GHG emissions.¹²⁶ China’s contribution to GHG emissions is mostly attributable to exports, which account for twenty three percent of all Chinese GHG emissions, six percent of which is directly attributable to exports going to the United States.¹²⁷ The IPCC’s most recent report is actually based on three earlier reports, which when analyzed simultaneously, paint an outlook so grim that “[o]nly urgent, global action will do.”¹²⁸ According to the report, the dangers are widespread and potentially affect the entire planet ranging from water shortages in Africa, increased risk of coastal flooding for cities around the world, species loss, hotter summers, and colder winters.¹²⁹

The Bali Action Plan, does not have any binding effect, but does state that “deep cuts in global emissions will be required”¹³⁰ and offers a schedule to negotiate a modified treaty based on the Kyoto Protocol.¹³¹ Although the United States has agreed to participate in the discussions over the next two years, the same concerns that have kept the United States from signing the Kyoto Protocol, specifically the concern that China and India must agree to limit their emissions, remain at the forefront of concern by United States officials. One United States official stated, “[t]he negotiations must proceed on the view that the problem of climate change cannot be adequately addressed through commitments for emissions cuts by developed countries alone. Major developing economies must likewise act.”¹³² Rapidly industrializing countries such as India and China have insisted that their priority must be to remove their country from poverty before agreeing to any mandatory reductions in GHG emissions.¹³³ These countries often assert that the United States was not subject to such regulations while it was going through its industrial revolution and therefore countries like China and India should not be forced to reduce GHG emissions at the risk of further increasing poverty. However, the problem with this argument is that the current condition of our planet is much different than it was when the United States was undergoing its industrialization. It is an

¹²⁵ See Fuller, *supra* note 122.

¹²⁶ Associated Press, *U.N. Panel Issues Warnings on Climate Change*, WALL ST. J., November 17, 2007, available at http://online.wsj.com/article_print/SB119527692839496890.html.

¹²⁷ Judith Chevalier, *A Carbon Cap That Starts in Washington*, N.Y. TIMES, December 16, 2007, §3, at 35.

¹²⁸ Associated Press, *supra* note 126.

¹²⁹ *Id.*

¹³⁰ Fuller, *supra* note 122.

¹³¹ *Id.*

¹³² *Id.*

¹³³ *Id.*

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

undeniable fact that to solve the problems associated with climate change, the major emitters of GHGs must play an active and central role in reductions. Without their efforts, any initiative is doomed to produce the same inadequate solutions that are found in the Kyoto Protocol. The conference in Bali concluded on an emotional note “after a last-minute standoff in the public plenary at the end of a day of high emotions, with the co-organizer of the conference, Yvo de Boer, fleeing the podium at one point as he held back tears.”¹³⁴ Clearly the parties involved in these negotiations recognize the importance of arriving at a new pact that will pick up where the Kyoto Protocol leaves off when it expires in 2012. One of the main reasons necessitating a new treaty that easily picks up where Kyoto left off is to maintain the stability and promote the growth of carbon markets.¹³⁵

A. Carbon Markets

An integral part of the Kyoto Protocol was the provision that set up a “complex market for companies to trade permits to pollute.”¹³⁶ The idea was to “harness market forces to solve global warming.”¹³⁷ Since the Kyoto Protocol sets GHG emission level restrictions for each signatory country, each country must then decide which companies within its borders to restrict in order to meet its emission caps.¹³⁸ “After a government sets an emissions limit for a company, it gives that company just enough permits to cover it.”¹³⁹ Companies that reduce emissions below their caps can sell excess credits to companies that don’t have enough.”¹⁴⁰ The trading in these permits has been in effect since 2005 and was a thirty billion dollar industry in 2007.¹⁴¹ This “cap-and-trade” system has promise. The main challenge is that the world’s two largest polluters, the United States and China, are not bound by caps and therefore two major players are left out of the “cap-and-trade” system.¹⁴² Future agreements must develop a cap-and-trade system that includes the United States and China simply because of their immense contributions to GHG emissions.¹⁴³ The current system has

¹³⁴ *Id.*

¹³⁵ Jeffrey Ball, *Gas Leak: Kyoto’s Caps on Emissions Hit Snag in Marketplace*, WALL ST. J., Dec. 3, 2007, at A1.

¹³⁶ *Id.*

¹³⁷ *Id.*

¹³⁸ *Id.*

¹³⁹ *Id.*

¹⁴⁰ *Id.*

¹⁴¹ *Id.*

¹⁴² *Id.*

¹⁴³ *Id.* (stating that “The U.S. and China together account for about 40% of emissions of carbon dioxide from fossil-fuel combustion, which scientists say is the most common source of man-made greenhouse-gas emissions...” and that amount “...dwarfs the 28% share from the countries that did

MASSACHUSETTS V. EPA: CLIMATE CHANGE REGULATIONS

produced some positive environmental effects. However, the progress has been much slower than originally envisioned by Kyoto's creators.¹⁴⁴ In fact, "Japan's emissions are rising, Canada has backed away from its target, and the EU says it will meet its goal only if member nations get tougher. Scientists say far bigger cuts than those called for in the treaty are needed. But global energy use is expected to rise by 50% by 2030."¹⁴⁵

Part of the problem is that industries and companies located in countries that are bound by caps have found ways to meet cap requirements without actually reducing the consumption of fossil fuels.¹⁴⁶ A United Nations official, who helped create the carbon market, acknowledged that "markets work as markets will do, to find the lowest-cost alternative" meaning that if it is cheaper for a company to meet its cap requirements using technology, but not by reducing the consumption of fossil fuels, it will do so.¹⁴⁷ Frequently technology allows a company to reduce emissions and meet its cap requirements in a more economically efficient way than by switching to alternative fuels.¹⁴⁸ One such way is by purchasing emissions permits from developing countries engaged in projects that reduce carbon, which actually generates permits under the terms of the Kyoto treaty.¹⁴⁹ Permit-generating projects have sprung up throughout the world and importantly, "projects targeting more potent gases generate more credits than projects targeting carbon dioxide" which "accounts for 77% of all man-made greenhouse gas-emissions. . .but. . .is also the weakest" GHG.¹⁵⁰ By doing this, companies can avoid reducing their own emissions and simply pay a fee for their GHG emissions in the form of purchasing permits.¹⁵¹ Advocates of the permit trading system argue that because companies have to purchase permits to maintain their current emissions levels, the price of consumer goods will ultimately reflect the harm caused to the planet by their production.¹⁵² If companies are forced to buy permits, they will ultimately pass that expense on to the consumer in the form of higher prices.¹⁵³ Consumers, in turn, would eventually choose to purchase

sign up for Kyoto caps").

¹⁴⁴ *Id.*

¹⁴⁵ *Id.*

¹⁴⁶ *Id.*

¹⁴⁷ *Id.*

¹⁴⁸ *Id.* (noting that "Installing machinery on a refrigerant plant to incinerate HFC-23 is cheap...generating one carbon credit through an HFC-23 project typically costs less than \$1. Generating a credit from a renewable-energy project – erecting a wind turbine or solar panel – can cost \$5 to \$10" according to the World Bank).

¹⁴⁹ *Id.* (in fact.).

¹⁵⁰ *Id.*

¹⁵¹ *Id.*

¹⁵² Chevalier, *supra* note 127.

¹⁵³ *Id.*

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

goods manufactured by companies that do not have to purchase carbon credits, thus providing an incentive for all companies to lower GHG emissions.¹⁵⁴

CONCLUSION

As a direct result of the United States Supreme Court's decision in *Massachusetts v. EPA*, the federal Executive Branch has taken a new and different policy stance on reducing the emission of GHGs. Directly after *Massachusetts v. EPA*, President Bush signed an Executive Order officially altering his administration's policy regarding GHG emissions. In addition, with a new pact, the United States agreed, during the Bali conference, to try to accomplish what the Kyoto Protocol was not able to do.¹⁵⁵ The Bali agreement marks a change in position from the Bush administration's prior position that the 1992 UNFCCC was adequate to address all the problems associated with climate change. Domestically, Congress is debating several bills that would impose mandatory caps on carbon emissions. However, there are still no binding agreements on the United States or economically developing countries such as India and China, and therefore only time will tell whether these countries will be able to reach an agreement over the next two years to solve the deficiencies of the Kyoto Protocol. What is certain is that the countries need somehow to reach a universally accepted international agreement that provides for meaningful mandatory caps on emissions. The science is no longer debatable that man's energy activities contribute to global climate change. The IPCC has published its warnings. It is now up to the rest of the world to listen and take action. The United States is in a unique position to lead the march toward a practical and effective solution.

¹⁵⁴ *Id.*

¹⁵⁵ Fuller, *supra* note 122.

**TO LEGISLATE OR TO ARBITRATE: AN ANALYSIS OF
U.S. FOREIGN INVESTMENT POLICY AFTER FINSA
AND THE BENEFITS OF INTERNATIONAL
ARBITRATION**

*Brian J. Farrar**

Rarely in U.S. history has a single business transaction caused as much of an uproar as the sale of the British company, Peninsular and Oriental Steam Navigation Company (“P&O”), to Dubai Ports World (“DPW”), “a state-owned company located in the United Arab Emirates.”¹ The proposed sale would have theoretically placed several U.S. seaports under the direct control of the government of Dubai. When word of this transaction spread from the media airwaves to the halls of Congress, it is perhaps not surprising that the reaction from the American public was almost universal outrage.²

Senator Charles Schumer argued, “[The Committee on Foreign Investment in the U.S.] has proven itself unreliable and in matters of national security, the buck stops at the President who should step in now to protect our ports.”³

Senator Frank Lautenberg warned, “Dubai has allowed terrorists to pass freely through their own country. Why in the world should we let this rogue government control ports in the United States?”⁴

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¹ Press Release, Dept. of the Treasury, CFIUS and the Protection of the National Security in Dubai Ports World Bid for Port Operations (Feb. 24, 2006), <http://www.treas.gov/press/releases/js4071.htm>.

² David D. Kirkpatrick & Patrick McGeehan, *Pataki Joins Opposition to Takeover of Ports*, N.Y. TIMES, Feb. 21, 2006.

³ Press Release, Sen. Charles Schumer, Lawmakers Begin Push For New Thorough Federal Review Of United Arab Emirates-Owned Company Taking Control Of Major U.S. Ports In NY, NJ And East Coast, (Feb. 16, 2006), <http://www.senate.gov/~schumer/SchumerWebsite/pressroom/record.cfm?id=259436&>.

⁴ *Id.*

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

House Representative Chris Shays opined,

Our ports are a welcome mat for terrorists trying to bring weapons of mass destruction into the United States...I am eager to understand why the Committee on Foreign Investment in the United States approved the sale, handing over several key ports to a company based in the United Arab Emirates, and ensure it is thoroughly inspected and investigated.⁵

While this controversy provided great fodder for talk radio and internet bloggers, politicians jockeyed to see who could appear the strongest on national security issues. Suddenly, the once unknown Committee on Foreign Investment in the United States (“CFIUS”) and the entire process by which foreign investment in the U.S. is vetted and approved became a topic of conversation. Everyone wanted to weigh in on this debate, particularly Congress. To address the apparent shortcomings of CFIUS and the official U.S. policy towards foreign investment, Congress passed the Foreign Investment and National Security Act of 2007 (“FINSA”).⁶

This comment examines the recent changes to U.S. foreign investment policy and the practicality of an international arbitral system to better balance the commercial needs of investors with the security needs of the host nation. Part I of this note describes a history of CFIUS and previous amendments that have reshaped the foreign investment landscape in the U.S. Part II discusses the changes implemented in FINSA and their application to future investment transactions. Part III examines the rise of International Commercial Arbitration and the institutions that currently practice it. Part IV analyzes the viability of an international body to arbitrate and decide investment disputes, particularly those relating to sensitive national security issues.

PART I. A HISTORY OF FOREIGN INVESTMENT REGULATION IN THE U.S.

The United States receives the most foreign investment of any country in the world and is also the world’s largest foreign investor.⁷ American presidents, over the years, have taken various positions on the issue of foreign direct investment and how the government should control it. Nevertheless, the U.S. is generally viewed as among the world’s most welcoming nations to

⁵ See Press Release, Sen. Charles Schumer, *supra* note 3.

⁶ 50 app. U.S.C.A. §2170 (2007).

⁷ James K. Jackson, Foreign Direct Investment: Current Issues, Congressional Research Service, Order Code RL33984, Apr. 27, 2007, available at http://openocrs.com/rpts/RL33984_20070427.pdf.

TO LEGISLATE OR TO ARBITRATE

foreign investors.⁸ The position of the Carter Administration in 1977 was that the U.S. “will neither encourage nor discourage the inflow or outflow of international investment,” because such government interference could lead to retaliatory measures from other nations.⁹ A decade and a half later, President George H.W. Bush reaffirmed the United States policy of free and open foreign investment and assured all that his administration is, “aggressively seeking to open markets abroad.”¹⁰

A. The Creation of CFIUS

In May 1975, President Gerald Ford established CFIUS under executive order.¹¹ The committee initially consisted of representatives from the State, Treasury, Defense and Commerce Departments, as well as a member appointed by the President’s Assistant for Economic Affairs.¹² CFIUS was charged with gathering and reviewing information on proposed transactions in confidence and reporting to the President those investments which, “might have major implications for United States national interests.”¹³ The Secretary of Treasury was designated chair of the committee and was granted the power to solicit assistance from other departments and agencies, as needed, during the course of an investigation.¹⁴ In 2003, Executive Order 13286 added the Department of Homeland Security to the list of departments comprising CFIUS.¹⁵

Although CFIUS was given the task of monitoring foreign investment, the committee in its early stages lacked the necessary power to effectively intervene and prohibit a potentially troublesome investment from taking place.¹⁶ This changed with the passage of the Exon-Florio Amendment to the Omnibus Trade and Competitiveness Act of 1988, which provided some much-needed guidelines for CFIUS.¹⁷ Such guidelines included a mandated heightened scrutiny for foreign investments in U.S. defense companies and by nations who

⁸ *Id.*

⁹ *Id.* at CRS3.

¹⁰ George H.W. Bush, Statement Released by the White House, Office of the Press Secretary, U.S. Dep’t of State Dispatch (Jan. 6, 1992), available at http://findarticles.com/p/articles/mi_m1584/is_n1_v3/ai_11826670.

¹¹ Executive Order No. 11858, 40 Fed. Reg. 20263 (May 7, 1975).

¹² *Id.*

¹³ Executive Order No. 11858, 40 Fed. Reg. 20263.

¹⁴ *Id.*

¹⁵ Executive Order No. 13286, 68 Fed. Reg. 10619 (Feb. 28, 2003).

¹⁶ Deborah M. Mostaghel, *Dubai Ports World Under Exon-Florio: A Threat To National Security or a Tempest in a Seaport?*, 70 ALB. L. REV. 583, 589 (2007).

¹⁷ 50 U.S.C.S. app. §2170 (1988).

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

are on a State Department list for supporting terrorism.¹⁸ Exon-Florio established a formal process for foreign investors by which one of the parties to the transaction voluntarily notifies CFIUS of the terms and conditions, followed by a 30-day review by CFIUS to determine whether any security risks are involved.¹⁹ If, after this initial review, CFIUS determines that there could be security concerns, an additional 45-day investigation ensues ending with a Presidential decision on the matter.²⁰ It is worth pointing out that under Exon-Florio, notifying CFIUS was entirely voluntary.²¹ However, failure to notify CFIUS before a transaction occurs gives the President and CFIUS the ability to still intervene after the fact, and any decision made will be enforced retroactively.²²

Four years after Exon-Florio, the Byrd Amendment gave CFIUS even more enforcement power and continued to affect the process by which foreign investment is vetted in the U.S. The Byrd Amendment required a formal CFIUS investigation, “in any instance in which an entity controlled by or acting on behalf of a foreign government seeks to engage in any merger, acquisition, or takeover which could result in control of a person engaged in interstate commerce in the United States that could affect the national security of the United States.”²³ This replaced the voluntary notification by the parties only in these specific instances of foreign government control.²⁴ Additionally, the Byrd Amendment threw Congress into the mix by requiring the President to issue a report to Congress whenever a decision is made regarding a foreign investment.²⁵

After Congress passed the Byrd Amendment, President Bill Clinton signed an Executive Order expanding CFIUS membership by adding the Director of the Office of Science and Technology Policy, the Assistant to the President for National Security Affairs, and the Assistant to the President for Economic Policy.²⁶ The addition of these members to CFIUS reflects the increase in the level of sophistication and specialization required to accurately assess foreign investment transactions.

Despite the evolution of power given to CFIUS, prior to 2005 only one

¹⁸ *Id.*

¹⁹ Gaurav Sud, *From Fretting Takeovers To Vetting CFIUS: Finding a Balance in U.S. Policy Regarding Foreign Acquisitions of Domestic Assets*, 39 VAND. J. TRANSNAT'L L. 1303, 1316 (2006).

²⁰ *Id.*

²¹ *Id.*

²² See Sud, *supra* note 19, at 1316.

²³ Pub. L. No. 102-484, 106 Stat. 2315, 2464 (1992).

²⁴ *Id.*

²⁵ *Id.*

²⁶ Executive Order 12,860, 58 Fed. Reg. 47,201 (Sept. 8, 1993).

TO LEGISLATE OR TO ARBITRATE

transaction had been blocked by the committee from going forward.²⁷ In reality, “this provision for Presidential review has been, like much of CFIUS, more of a formality than an actual bar to cross-border transactions.”²⁸ However, critics argue that CFIUS, in fact, plays a much more important role. As explained by Joseph D. West, Chair of the Government and Commercial Contracts Practice for the law firm Gibson, Dunn & Crutcher., “[a]lthough the CFIUS process has only once resulted in the President prohibiting a transaction, this statistic is quite deceptive. A number of proposed transactions have been abandoned or significantly restructured after initial CFIUS scrutiny signaled that approval was unlikely.”²⁹ Therefore, the fact that foreign corporations and governments are withdrawing their bids before CFIUS can make its recommendation indicates a strong unwillingness on the part of many foreign investors to subject themselves to this intense review process. As a result, the U.S. could very well be missing out on lucrative contract deals with foreign investors.

Although rarely invoked in economic situations, the President has another mechanism to prevent foreign direct investment other than through CFIUS. The International Emergency Economic Powers Act, enacted under President Carter, gives the President the authority to block an economic transaction by declaring a national emergency.³⁰ The act gives the President the right to prevent, “any unusual and extraordinary threat, which has its source in whole or substantial part outside the United States, to the national security, foreign policy, or economy of the United States, if the President declares a national emergency with respect to such threat.”³¹ Declaring a national emergency in response to a proposed economic transaction is clearly a dramatic move and to date presidents have been hesitant to go to that extreme in these instances. By contrast, presidential intervention through CFIUS is more discrete and therefore less likely to be scrutinized by Congress or the media.

B. Recent Investor Controversies and Their Impact on the Political Environment

Prior to 2006, when the DPW deal sprung into the public sphere, few Americans outside of Washington knew what CFIUS was or what role it played. However, DPW was not the first time in recent history that a controversy has brewed regarding a foreign takeover. In 2005, China National Offshore

²⁷ See Sud, *supra* note 19, at 1317.

²⁸ See Sud, *supra* note 19, at 1317.

²⁹ Joseph D. West, *National Security Implications of Foreign Investment in U.S. Government Contractors*, 07-11 Briefing Papers 1, (Oct. 2007).

³⁰ International Emergency Economic Powers Act, 50 U.S.C. §1701 (a) (2000).

³¹ *Id.*

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

Petroleum Company, Ltd. (“CNOOC”), a state-owned oil company, withdrew its \$18.5 billion all cash bid for American Unocal in response to strong political pressure from Washington.³² As CFIUS’ investigation was proceeding, members of Congress wasted no time in proposing legislation that would undermine the transaction in the event CFIUS approved the sale.³³ CNOOC even cites this political pressure as a significant reason for withdrawing its bid, stating that, “[t]he unprecedented political opposition that followed the announcement of our proposed transaction, attempting to replace or amend the CFIUS process that has been successfully in operation for decades, was regrettable and unjustified.”³⁴

Supporters of the review process in place at the time of the DPW and CNOOC controversies often cite CFIUS’ insulation from the political process as one of its key strengths “because it intentionally lies out of the reach of Congress.”³⁵ Unlike legislators who depend on votes from their constituents to stay in power, members of CFIUS are Presidential appointees from various departments and are arguably less susceptible to influence by the politics *du jour*. Free from such political constraints, CFIUS is more likely to base its decisions on sober analysis rather than political hype. However, as seen in these recent controversies, even CFIUS is not entirely free from legislative influence and the process of foreign investment as a whole continues to be dominated by political interests in Congress. Additionally troubling is the fact that Congressional disapproval over DPW and CNOOC was not entirely based on national security concerns. There is evidence to suggest that the controversies sparked a return to the Cold War standard of “national and economic security.”³⁶

A year after the DPW controversy, another Dubai company, Dubai Aerospace Enterprise (“DAE”), raised eyebrows when it acquired two American companies, Standard Aero and Landmark Aviation from The Carlyle Group.³⁷ After witnessing what happened with DPW, DAE took no chances and immediately hired a lobbyist and PR consultants in anticipation of strong skepticism coming from Congress and the public at large.³⁸ DAE’s actions

³² Press Release, CNOOC Ltd.; Unocal, CNOOC Limited To Withdraw Unocal Bid, (Aug. 2, 2005) http://www.cnocold.com/en/news_info.aspx?newsid=20070620163702296.

³³ Matthew R. Byrne, *Protecting National Security and Promoting Foreign Investment: Maintaining The Exon-Florio Balance*, 67 Ohio St. L. J. 849, 876 (2006).

³⁴ See Press Release, CNOOC Ltd., *supra* note 32.

³⁵ See Sud, *supra* note 19 at 1320.

³⁶ See Mostaghel, *supra* note 16, at 608.

³⁷ Press Release, Landmark Aviation, Dubai Aerospace Enterprise completes acquisition of Standard Aero and Landmark Aviation, (Aug. 1, 2007). http://64.226.226.52/news_events/press_releases/2007/2007_0801_DAE.shtm.

³⁸ Kevin Bogardus, *Lobbyists helping Dubai company to seal \$1.8 billion deal*, THE HILL, June 7, 2007.

TO LEGISLATE OR TO ARBITRATE

were significant because they reflected a change in how foreign investors deal with the U.S. regulatory process. Particularly, these changes were indicative of Congress' increasing role in reviewing these investment matters which have traditionally been under the sole jurisdiction of the President and the agencies comprising CFIUS. Recent acts of Congress have made this trend more likely to continue as the process by which foreign investors are vetted becomes increasingly carried out in the public sphere.

PART II. FOREIGN INVESTMENT AND NATIONAL SECURITY ACT OF 2007

The rising tensions in the aftermath of the DPW and CNOOC controversies sent ripples through Washington. Congressional members of both parties saw this as an opportunity to flex their power on issues involving foreign investment and national security. Almost immediately, Congress proposed legislation aimed at formalizing and streamlining the process by which foreign direct investment comes into the United States.³⁹ Congress was eager to point out the failures of DPW and CNOOC and blamed those scandals on the lack of active involvement by the legislative branch.⁴⁰ In her testimony before the House Subcommittee on Transportation Security and Infrastructure Protection, Rep. Sheila Jackson Lee described the proposed legislation as increasing "the role of congressional oversight by requiring greater reporting by CFIUS on its actions and allowing for a greater amount of detailed information about CFIUS' operations."⁴¹

Congressional oversight of foreign investment is hardly a new concept or idea. The authority to regulate trade with foreign countries is one of Congress' plenary powers.⁴² The Commerce Clause in the U.S. Constitution gives Congress the broad authority to regulate commerce and trade between the states and foreign governments.⁴³ Courts have long recognized Congress' power to legislate on these issues. In *Tyson Foods, Inc. v. McReynolds*, the Sixth Circuit Court of Appeals held that, "[t]he control of takeovers of and foreign investments in broadly based national corporations of the United States is clearly a duty of Congress and not the individual states."⁴⁴ Since foreign direct investment is a function of trade, Congress has a legitimate argument that it should have a say on issues such as these. However, the appropriate method

³⁹ *Impact of Foreign Ownership on Data Controls and Infrastructure: Hearing on H.R. 556 Before the H. Subcomm. On Transportation Security and Infrastructure Protection (2007)* (statement of Subcommittee Chair Rep. Sheila Jackson Lee).

⁴⁰ *Id.*

⁴¹ *Id.*

⁴² U.S. Const. Art. I, §8 ("Commerce Clause").

⁴³ *Id.*

⁴⁴ *Tyson Foods, Inc. v. McReynolds*, 865 F.2d 99, 102, (6th Cir. 1989).

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

of Congressional involvement remains the subject of much debate.

Scholars are quick to point out, however, that increased Congressional regulations and oversight on this issue comes with the potential and likely risk of deterring foreign direct investment.⁴⁵ The problem, therefore, is not that the current CFIUS system is broken, but rather that the process lacks the necessary confidence from Congress and the American public. Some have asserted that “the existing regime has been successful in maintaining the primacy of traditional U.S. open investment policy without compromising national security. The DPW and Smartmatic⁴⁶ deals nonetheless reveal a central problem with the existing paradigm: the lack of public and congressional confidence that CFIUS has conducted an effective review.”⁴⁷

As Congress debated statutory changes to the foreign investment review process, their actions were making a direct impact on CFIUS. Analysts note that in the aftermath of DPW, CFIUS has taken a markedly more cautious role in their investigations.⁴⁸ This, in turn, caused more investors to preemptively file for CFIUS review in the anticipation of heightened analysis.⁴⁹ CFIUS filings in 2006 were up 73 percent over 2005 and withdrawals were up 150 percent for the same time period.⁵⁰ It is worth noting, however, that along with these increases in CFIUS filings, there is no evidence to suggest that any more risky investments from a national security standpoint are taking place.⁵¹ Therefore, it stands to reason that the real effect of DPW is that CFIUS must now waste its time and resources on investigating more transactions when there appears to be no increase in the number of potential risks.⁵² As a result, “this forces CFIUS and the intelligence agencies to conduct a full analysis of inconsequential transactions, taking their focus off the transactions that really matter to national security.”⁵³

Perhaps more importantly, this new environment has a chilling effect

⁴⁵ Shannon M. Haley, *A Shot Across the Bow: Changing the Paradigm of Foreign Direct Investment Review in the United States*, 32 BROOK. J. INT'L L. 1157, 1159 (2007).

⁴⁶ *Smartmatic*, a voting machine company with ties to the Venezuelan government made headlines in 2006 when it invested in American-owned Sequoia Voting Systems. *Smartmatic* initially refused to undergo CFIUS review but later withdrew and divested its interest in Sequoia. The deal caused suspicion among Congress due to America's strong concern over voter irregularity in elections.

⁴⁷ See Haley, *supra* note 45, at 1158.

⁴⁸ *Foreign Ownership of Infrastructure: Hearing on H.R. 556 Before the H. Subcomm. On Transportation Security and Infrastructure Protection* (2007) (statement of David Marchick, Covington & Burling LLP).

⁴⁹ *Id.*

⁵⁰ See *Foreign Ownership of Infrastructure: Hearing on H.R. 556 Before the H. Subcomm. On Transportation Security and Infrastructure Protection*, *supra* note 48.

⁵¹ *Id.*

⁵² *Id.*

⁵³ *Id.*

TO LEGISLATE OR TO ARBITRATE

on foreign direct investment by creating uncertainty in the eyes of investors.⁵⁴ A large part of this uncertainty was caused by the inability of government to define what “critical infrastructure” means so that foreign investors may be able to accurately predict what kind of scrutiny they are subjecting themselves to by investing in the U.S.⁵⁵ Without such guidelines, investment advisors will recommend that their clients proceed cautiously when investing in the U.S., causing many unnecessary filings with CFIUS.⁵⁶ Skeptics of the new legislation argue that, “[t]he Administration and Congress should work together to determine how best to protect critical infrastructure, regardless of who owns a particular company or asset. Security policies and guidance could be developed on a sector-by-sector basis.”⁵⁷ Once clear definitions of what constitutes “critical infrastructure” are in place, foreign investors will be better able to assess the costs and benefits of investing in the U.S., even if it means undergoing a complete review by CFIUS.

In addition to causing uncertainty among foreign investors, the lack of a coherent foreign investment procedure can have far-reaching effects on the U.S. economy as a whole. Statistics provided by the U.S. Treasury Department indicate that in 2005, foreign companies employed at least 5 million American workers, accounting for 4.5% of the private sector employment.⁵⁸ Clearly, foreign direct investment has a very real impact on the U.S. economy.

After months of debate in Congress and the American media, The Foreign Investment and National Security Act of 2007 (“FINSAs”), was passed and signed into law by President George W. Bush.⁵⁹ Effective October 24, 2007, the act makes significant changes to CFIUS and the process by which foreign companies may invest domestically. The new law adds statutory authority to many of the procedures previously followed by CFIUS.⁶⁰ For instance, FINSAs formally recognizes CFIUS’ membership to include representatives from the Treasury, Homeland Security, Defense, and Commerce Departments as well as the Attorney General.⁶¹ The Director of National Security is also added in a non-voting role.⁶² FINSAs authorizes the Secretary of Treasury to designate a lead agency during the review process in which the agency will be directly responsible for enforcing and mitigating security

⁵⁴ *Id.*

⁵⁵ *Id.*

⁵⁶ *Id.*

⁵⁷ *Id.*

⁵⁸ See *Foreign Ownership of Infrastructure: Hearing on H.R. 556 Before the H. Subcomm. On Transportation Security and Infrastructure Protection*, *supra* note 48.

⁵⁹ 50 app U.S.C.A. §2170, *supra* note 6.

⁶⁰ *Id.*

⁶¹ *Id.*

⁶² *Id.*

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

issues.⁶³ This flexibility allows CFIUS to adapt to various security situations and to appoint the most appropriate agency to review these issues as they arise. In theory, this lead agency will be most capable of analyzing any potential security risks and conveying the risk to the other members.

In addition to providing more flexibility for the way in which CFIUS designates roles internally, FINSAs provides some clear procedural standards for the entire review process. For instance, CFIUS is now required to investigate any proposed investment by a foreign government (or an entity controlled by a foreign government) unless the initial review from the committee or the designated lead agency determines that no national security risks will arise.⁶⁴

FINSAs attempts to correct some of the uncertainties for foreign direct investors following the DPW controversy. The law makes it clear that tougher review standards are in place and that even previously approved transactions are subject to further review by CFIUS.⁶⁵ If any foreign investor is suspected of breaching a national security agreement or has failed to timely notify CFIUS of any changes in status, CFIUS now has the authority to re-evaluate the transaction and take appropriate action.⁶⁶ Furthermore, CFIUS and its agencies have the statutory authority to enforce national security agreements against violators.⁶⁷

Another significant provision of FINSAs is the power it vests in either CFIUS or the President to consider other factors in its review process including a foreign government's adherence to nuclear nonproliferation and cooperation with U.S. anti-terrorism measures.⁶⁸ These additional factors are not meant to be exclusive and CFIUS or the President maintains the authority to consider additional factors as well.⁶⁹ An obvious side-effect of this statutory requirement is that foreign governments may not want to draw attention to their anti-terrorism efforts and subject themselves to comparison to the U.S. on these sensitive issues.

FINSAs attempts to alleviate some of the uncertainty regarding which industries will be subject to the highest level of scrutiny by CFIUS. FINSAs defines "critical infrastructure" as those "systems and assets . . . so vital to the United States that the incapacity or destruction of such systems or assets would

⁶³ *Id.*

⁶⁴ 50 app U.S.C.A. §2170, *supra* note 6, at §(b)2(D)(i) "an investigation of a foreign government-controlled transaction . . . or a transaction involving critical infrastructure . . . shall not be required under this paragraph, if the Secretary of the Treasury and the head of the lead agency jointly determine, on the basis of the review of the . . . that the transaction will not impair the national security of the United States."

⁶⁵ *Id.*

⁶⁶ *Id.*

⁶⁷ *Id.*

⁶⁸ *Id.*

⁶⁹ *Id.*

TO LEGISLATE OR TO ARBITRATE

have a debilitating impact on national security.”⁷⁰ Critical technologies are defined as, “items essential to national defense.”⁷¹ While these definitions may provide some minor clarity for foreign investors, it is unlikely that they will significantly lessen the ambiguity that still exists. For instance, investors must still predict which infrastructure and technologies are “essential” to security or national defense. This leaves many foreign investors having to roll the dice to see whether their proposed transaction will raise any red flags. As previously discussed, this in turn leads to unnecessary filings with the CFIUS and raises the costs associated with it.⁷²

When determining which industries are critical, FINSA authorizes the President to take into account the levels of domestic production that are necessary for defense purposes, the domestic capability to meet those levels of production, and whether foreign control could negatively impact U.S. capability of reaching those levels.⁷³ While these guidelines are helpful to the President, they do little to ease the burden on foreign investors. Despite intense market research, foreign investors may not be capable of determining U.S. production capacity and FINSA leaves them guessing whether their transaction will really effect domestic production in the U.S.

Unlike Exxon-Florio and previous litigation, FINSA specifically provides for the continued monitoring of risks by CFIUS and its lead agency.⁷⁴ Under the statute,

[t]he lead agency shall negotiate, modify, monitor, and enforce, on behalf of the Committee, any agreement entered into or condition imposed under paragraph (1) with respect to a covered transaction, based on the expertise with and knowledge of the issues related to such transaction on the part of the designated department or agency.⁷⁵

This provision bolsters CFIUS’ enforcement capabilities by allowing the committee to ensure compliance even after it approves a transaction. Therefore, FINSA puts investors on notice that they can be monitored indefinitely by CFIUS as the committee’s lead agency sees fit.

A particularly important feature of FINSA is its ability to mitigate potential security risks without having to block the entire transaction.⁷⁶

⁷⁰ 50 app U.S.C.A. §2170 (a) (6).

⁷¹ 50 app U.S.C.A. §2170 (a) (7).

⁷² See *supra* notes 52 – 57.

⁷³ 50 app U.S.C.A. §2170.

⁷⁴ 50 app U.S.C.A. §2170 (1)(3)(A).

⁷⁵ *Id.* §(1)(3)(A).

⁷⁶ Jonathan C. Stagg, *Scrutinizing Foreign Investment: How Much Congressional Involvement is*

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

Supporters argue that this flexibility helps investors by fostering a more open investment policy.⁷⁷ In other words, “[t]his change assures foreign investors that any potential security concerns can be dealt with through agreements or conditions, and it will not necessarily lead to CFIUS blocking the deal.”⁷⁸ However, certain transactions will never even reach the mitigation stage because many investors will withdraw their bid once it appears that conditions will be placed on the transaction. Furthermore, the take-it-or-leave-it approach to mitigation does nothing to ensure that the restrictions or conditions placed on investors are reasonable. While the ability to mitigate can be helpful to some investors, it leaves others burdened with arbitrary restrictions and little or no avenue for redress.

Perhaps the most significant provision of FINSA is its requirement that CFIUS report its findings directly to Congress.⁷⁹ As we witnessed in the DPW and CNOOC controversies, Congressional involvement can undermine CFIUS’ investigation by politicizing the entire process. Members of Congress may exploit potential foreign transactions for political gain in an attempt to appear strong on issues of national security.⁸⁰ As a result, Congressional involvement and its inevitable politicking can have serious consequences for investors and the public at large. For instance, there is a high potential for “political mischief” since members of Congress must answer to their U.S. constituents who may object to a proposed transaction for reasons other than national security.⁸¹ This pressure from constituents might compel members of Congress to reject a proposed transaction for these illegitimate reasons. For example, a Senator from a heavily agricultural state may object to a foreign competitor relocating in the U.S. because of the negative economic impact it would have on the Senator’s constituents. Furthermore, the recent corruption scandals plaguing Congress, particularly those involving gifts from lobbyists, highlights this potential risk.⁸²

Another negative consequence of FINSA’s Congressional involvement stems from the risks associated with the disclosure of sensitive information. Under FINSA, CFIUS briefings can be provided not only to members of Congress, but also to their Congressional staff who possess the appropriate

Too Much?, 93 IOWA L. REV. 325, 349 (2007).

⁷⁷ *Id.* at 349.

⁷⁸ *Id.*

⁷⁹ 50 app U.S.C.A. §2170 (a)(g)(1) “The Committee shall, upon request from any Member of Congress ... promptly provide briefings on a covered transaction ... or on compliance with a mitigation agreement or condition imposed with respect to such transaction”

⁸⁰ See Stagg, *supra* note 76, at 354.

⁸¹ Christopher F. Corr, *U.S. Tightens the Screws on Foreign Investors*, White & Case LLP Client Advisory (July 26, 2007) available at http://www.whitecase.com/alert_internationaltrade_0707/.

⁸² See Stagg, *supra* note 76, at 354.

TO LEGISLATE OR TO ARBITRATE

security clearance.⁸³ This obviously opens the door to a huge array of people who could potentially have access to highly sensitive information. The thought of such a large number of people obtaining confidential information on a proposed financial transaction is enough to prevent many foreign investors from agreeing to go through with the process.⁸⁴ Accordingly, “[t]his realization will cause many investors to opt out of investing in the United States when comparable investments present themselves in countries without such risky disclosure requirements.”⁸⁵

Perhaps the most troubling aspect of Congressional involvement is the potential for compromising U.S. intelligence and national security efforts. For instance, in its Congressional briefing, CFIUS may be forced to disclose the fact that a transaction was blocked because of top secret information gained from U.S. intelligence services. This disclosure could potentially involve methods and capabilities of U.S. intelligence, causing disastrous consequences for that agency. Furthermore, information that an investor’s country is engaging in behavior to which the U.S. objects can cause tension between the countries if that information is ever leaked.⁸⁶

PART III. THE RISE OF INTERNATIONAL ARBITRATION

As foreign investment increases around the globe, investors and host nations have witnessed a rise in the use of international arbitration to settle investment disputes. Arbitration is a method of dispute resolution by which a neutral third party renders a binding decision on the disputing parties.⁸⁷ Using arbitration to settle commercial disputes is anything but a recent phenomenon. In fact, “[c]ommercial arbitration has been practiced in the United States for several hundred years.”⁸⁸ Traditionally, this arbitration was based on common law principles.⁸⁹

In 1947, Congress officially recognized arbitration as being an enforceable mechanism to settling international disputes by passing the Federal Arbitration Act (“FAA”).⁹⁰ The U.S. Supreme Court in *Moses H. Cone Memorial Hosp. v. Mercury Const. Corp.*, recognized the contractual right to

⁸³ 50 app U.S.C.A. §2170 (a)(g)(1).

⁸⁴ See Stagg, *supra* note 76, at 352.

⁸⁵ *Id.* at 357.

⁸⁶ See Stagg, *supra* note 76, at 354.

⁸⁷ Black’s Law Dictionary at 112 (8th Ed. 1999).

⁸⁸ Stephen Hayford & Ralph Peeples, *Commercial Arbitration in Evolution: An Assessment and Call For Dialogue*, 10 OHIO ST. J. ON DISP. RESOL. 343, 351 (1995).

⁸⁹ *Id.*

⁹⁰ 9 U.S.C.A. §1 (1947) (previously the United States Arbitration Act).

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

arbitrate under the FAA.⁹¹ The court held that under FAA, Congress had intended “to move the parties to an arbitrable dispute out of court and into arbitration as quickly and easily as possible.”⁹² The Supreme Court began to recognize that in addition to being enforceable, arbitration should be carried out efficiently.

The first big shift towards an international arbitral system came with the Convention on the Settlement of Investment Disputes between States and Nationals of Other States, commonly referred to as the “Washington Convention”⁹³ The Washington Convention, which was later ratified by the Senate and signed into law by the President, created the International Centre for Settlement of Investment Disputes (“ICSID”) headed by the World Bank.⁹⁴ The main function of ICSID is to facilitate arbitration proceedings between member states and investors from other members states.⁹⁵ ICSID provides the facilities and procedural framework for international arbitration but ICSID itself does not arbitrate disputes. Rather, ICSID provides specific guidelines for selecting arbitrators and conducting proceedings. Such guidelines require that the majority of the arbitrators be nationals of states other than those of which the parties belong.⁹⁶

ICSID is governed by the Administrative Council which contains a representative from each member state.⁹⁷ The President of the World Bank serves as the ex officio Chairman of the council but has no vote.⁹⁸ The Secretariat makes up the other body of ICSID.⁹⁹ The Secretariat is headed by the Secretary-General, the legal representative of ICSID and is elected by the Administrative Council.¹⁰⁰

In addition to international conventions such as the Washington Convention, countries, including the United States, are signing Bilateral Investment Treaties (“BIT”) to promote trade and investment between two sovereigns.¹⁰¹ These treaties provide substantive and procedural rights for the investor that will be respected by both host states.¹⁰² Included in these BITs is

⁹¹ See *Moses H. Cone Memorial Hosp. v. Mercury Const. Corp.*, 460 U.S. 1 (1983).

⁹² *Id.* at 22.

⁹³ Convention on the Settlement of Investment Disputes between States and Nationals of Other States, Mar. 18, 1965, 17 U.S.T. 1270 [hereinafter Washington Convention].

⁹⁴ *Id.* Ch. I, art 1.

⁹⁵ *Id.*

⁹⁶ See Washington Convention, *supra* note 93, Ch. IV, §2, art. 37.

⁹⁷ *Id.* at Ch. I, §2, art. 4.

⁹⁸ *Id.* at Ch. I, §2, art. 5.

⁹⁹ *Id.* at Ch. I, §3, art. 9-11.

¹⁰⁰ *Id.* at Ch. I, §3, art. 11.

¹⁰¹ See http://tcc.export.gov/Trade_Agreements/Bilateral_Investment_Treaties/index.asp for a list of U.S. BIT's currently in force.

¹⁰² Summary of U.S. Bilateral Investment Treaty (BIT) Program, Office of the U.S. Trade

TO LEGISLATE OR TO ARBITRATE

the right to international arbitration, should an investment dispute arise with the host nation.¹⁰³

BITs have important benefits for all parties involved. For instance, from the perspective of the host country, BITs can lend credibility and strengthen the government's reputation as an "international actor"¹⁰⁴ From the perspective of the investor, BITs mean that they have a forum to challenge the actions of the host country and are "no longer at the mercy of international politics and governmental bureaucracy"¹⁰⁵ Many BITs give investors a choice of where they can bring their claim, either in the host country's domestic courts or in international arbitration.¹⁰⁶

When investors do decide to arbitrate, they can do so in a private and confidential environment.¹⁰⁷ Unlike litigation, the arbitration process is highly secretive and amici curie participation from outside interests is restricted.¹⁰⁸ In fact, even the decisions themselves are often confidential.¹⁰⁹ Businesses are likely to take advantage of this secrecy to protect potentially sensitive information involving their investments from becoming public.

When sovereigns sign these BITs with explicit arbitration clauses, they do so with some degree of risk.¹¹⁰ By agreeing to arbitrate disputes, sovereigns have waived their immunity and subjected themselves to the possibility of being found liable.¹¹¹ Host nations may be forced to spend millions of dollars defending their actions in international arbitration.¹¹² Questions arise as to whether international arbitration is worth the risk for sovereign nations.¹¹³ Some analysts argue that investment treaties rarely promote new investment, thereby giving the sovereign almost no benefit at all. According to Susan D. Franck, Assistant Professor of Law at University of Nebraska at Lincoln, "[w]hile investors may be aware of the investment treaties, their existence may

Representative, (Feb. 24, 2006)

[http://www.ustr.gov/Trade_Agreements/BIT/Summary_of_US_Bilateral_Investment_Treaty_\(BIT\)_Program.html](http://www.ustr.gov/Trade_Agreements/BIT/Summary_of_US_Bilateral_Investment_Treaty_(BIT)_Program.html).

¹⁰³ *Id.*

¹⁰⁴ Susan D. Franck, *Foreign Direct Investment, Investment Treaty Arbitration, and the Rule Of Law*, 19 PAC. MCGEORGE GLOBAL BUS. & DEV. L.J. 337, 341 (2007).

¹⁰⁵ Susan D. Franck, *The Legitimacy Crisis In Investment Treaty Arbitration: Privatizing Public International Law Through Inconsistent Decisions*, 73 FORDHAM L. REV. 1521, 1537-1538 (2005).

¹⁰⁶ *Id.* at 1541.

¹⁰⁷ *Id.* at 1544.

¹⁰⁸ *Id.* at 1544-1545.

¹⁰⁹ *Id.* at 1545.

¹¹⁰ See Franck, *supra* note 104, at 346.

¹¹¹ *Id.*

¹¹² *Id.*

¹¹³ *Id.* at 347.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

only have a marginal impact on the decision to invest.”¹¹⁴ Studies have indicated that investment treaties are only one of several factors that investors consider in foreign direct investment.¹¹⁵ The other factors are purely economic, including market size, gross domestic product (“GDP”) and current levels of investment in the host country.¹¹⁶ Developed countries may be even less likely to reap the benefit of investment treaties than developing countries.¹¹⁷

With respect to international arbitration clauses in investment treaties, some analysts believe that they negatively impact developing countries by diverting cases away from their national courts.¹¹⁸ They argue that international arbitration “inhibits the development of the rule of law in national courts by creating a regime that provides a privilege to foreign investors”¹¹⁹ By contrast, international arbitration may serve as a catalyst for developing nations to reform their national courts and reach international standards of justice.¹²⁰ Additionally, international arbitration may give local courts an incentive to compete for the right to settle investment disputes in treaties that provide for choice of venue.¹²¹

As more and more investors turn to arbitration to settle their disputes, questions arise as to which form of arbitration should be followed. Many U.S. law firms are now offering arbitration services to their clients.¹²² In fact, several large firms have even developed separate international arbitration departments.¹²³ Scholars are debating whether international arbitration should follow the American model of litigation or another form altogether.¹²⁴ Some go as far as suggesting that the influence of American law firms has caused international arbitration to become an extension of the American court system; much to the dismay of the rest of the world.¹²⁵ While this may be good for the U.S., it has caused some concern among our foreign counterparts. At the very least, it is evidence that international arbitration is no longer foreign to America.

Despite the tremendous growth in the levels of international arbitration, several important reforms have been suggested to make it run more efficiently. Some reformers argue that the variable language often found in

¹¹⁴ *Id.* at 348.

¹¹⁵ See Franck, *supra* note 104 at 349.

¹¹⁶ *Id.*

¹¹⁷ *Id.* at 352-353.

¹¹⁸ *Id.* at 365.

¹¹⁹ *Id.* at 365.

¹²⁰ *Id.* at 367.

¹²¹ *Id.* at 368.

¹²² Elena V. Helmer, *International Commercial Arbitration: Americanized, “Civilized,” or Harmonized?*, 19 OHIO ST. J. ON DISP. RESOL. 35, 40 (2003).

¹²³ *Id.* at 41.

¹²⁴ *Id.* at 35.

¹²⁵ See Helmer *supra* note 122 at 46.

TO LEGISLATE OR TO ARBITRATE

investment treaties should be replaced with strict definitions and terms for arbitration.¹²⁶ They argue this would provide “textual certainty” to protect against the rendering of inconsistent arbitral decisions.¹²⁷ However, too much rigidity will backfire and turn investors off to arbitration. One of the most important aspects of international arbitration is its ability to adapt to different situations and circumstances and render the most appropriate decision in light of this. Erasing this flexibility will destroy a major incentive to arbitrate investment disputes.

Other reformers, referred to as “barrier builders” support tougher preconditions on the right to arbitrate international disputes.¹²⁸ They would require investors to receive permission from the foreign government before they can pursue their claim in arbitration.¹²⁹ This is based on the fear that investors unduly burden host nations by bringing “unmeritorious claims, which arguably have a detrimental impact on sovereignty and the Sovereign’s ability to pass legislation effecting their citizen’s health, safety, and public morals.”¹³⁰ This approach makes international arbitration practically obsolete. In addition to rejecting an investor’s frivolous claims, the foreign government has no incentive to agree to arbitrate even the meritorious claims. There is nothing stopping the government from forcing an investor to bring suit in the domestic courts, an environment likely to be more favorable to the host government. This exact practice is what international arbitration was designed to avoid.

Reformers often cite the lack of an appellate body as a significant drawback to international arbitration. Supporters argue that an appellate body would create a “determinate and coherent jurisprudence” that reviews arbitral decisions.¹³¹ In addition to restoring faith in the system, they argue it would promote consistency, predictability and prevent the occurrence of conflicting decisions.¹³²

The appropriate body to handle appeals is the subject of much discussion. The United Nations International Court of Justice (“ICJ”) has been suggested, among others.¹³³ However, the ICJ’s jurisdiction only applies to UN member states; therefore it could not handle an appeal involving a private investor.¹³⁴ Supporters argue that the ICJ statute should be amended to include

¹²⁶ See Franck, *supra* note 105, at 1587-1588.

¹²⁷ *Id.* at 1588-1589.

¹²⁸ *Id.* at 1589-1590.

¹²⁹ *Id.*

¹³⁰ *Id.* at 1591.

¹³¹ See Franck, *supra* note 105 at 1607.

¹³² *Id.*

¹³³ *Id.* at 1609.

¹³⁴ *Id.*

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

jurisdiction over non-governmental investors.¹³⁵ Even if that is possible, the ICJ's limited experience with appeals makes it difficult to predict whether the process would be effective.¹³⁶

Given its affiliation with the World Bank, ICSID is viewed as the leading authority on international arbitration and any reforms to the process would likely begin with ICSID. In 2004, the idea of creating an appellate body as part of ICSID was proposed by the Secretariat, but the plan was later withdrawn after facing criticism.¹³⁷ The criticism came largely from investors who "valued the high degree of finality the current ICSID arbitration process provides parties in resolving disputes more than the benefit of substantive consistency."¹³⁸ Despite this criticism, the creation of an appellate division of ICSID some time in the future remains a possibility.¹³⁹

The development of an appellate process would necessarily require a significant restructuring of the entire body as it exists now. ICSID remains a relatively small operation. Although its caseload has grown considerably in recent years, its personnel and resources have remained constant.¹⁴⁰ In 2006, a number of procedural reforms to ICSID were passed for the purpose of making ICSID proceedings, "more streamlined and transparent, while instilling greater confidence in the arbitral process."¹⁴¹ As ICSID continues to reevaluate itself and improve transparency, it is likely that more countries will make use of its arbitration process. As confidence in its ability grows, it is possible that countries will eventually agree to ICSID arbitration for their national security and investment related disputes.

PART IV. APPLYING THE INTERNATIONAL ARBITRATION MODEL TO
INVESTMENT DISPUTES INVOLVING NATIONAL SECURITY

It is one thing for a state to agree to arbitrate a foreign investor's breach of contract action for the sale of goods, it's another thing to ask the state to arbitrate investor disputes that may impact its national security interests. For obvious reasons, governments like the United States are particularly sensitive when it comes to ceding sovereignty on these extremely important issues that

¹³⁵ *Id.*

¹³⁶ *Id.*

¹³⁷ Andrew P. Tuck, *Investor-State Arbitration Revised: A Critical Analysis of the Revisions and Proposed Reforms to the ICSID and UNCITRAL Arbitration Rules*, 13 L. & BUS. REV. AM. 885, 887-888 (2007).

¹³⁸ See Tuck, *supra* note 137 at 902.

¹³⁹ *Id.* at 888.

¹⁴⁰ *Id.* at 886.

¹⁴¹ *Id.* at 892, quoting Steven P. Finizio et al., *Recent Developments in Investor-State Arbitration: Effective Use of Provisional Measures*, in *European Arbitration Review 2007*, (Global Arbitration Review, 2007) available at http://www.globalarbitrationreview.com/ear04_icsid.cfm.

TO LEGISLATE OR TO ARBITRATE

may effect that safety of their citizens. Despite the tremendous rise in investment treaties and international arbitration, sovereigns remain committed to resolving any national security related disputes on their own terms. In the U.S., CFIUS is tasked with handling these issues.¹⁴² Other nations undoubtedly have their own versions of CFIUS to deal with these matters when they arise in the context of foreign investments. As countries nationalize their risk management procedures for dealing with security-related investment issues, they overlook the important role that international arbitration can play in mitigating these risks.

A. International Arbitration Can Assess National Security Risks Without Politicizing the Process

Despite attempts to insulate members from outside pressure, CFIUS is, and remains, a committee comprised mainly of political appointees.¹⁴³ In passing FINSA, Congress stated that its objective is, “[t]o ensure national security while promoting foreign investment and the creation and maintenance of jobs”¹⁴⁴ While this is clearly a universal goal, the Secretaries of Treasury, Defense, Homeland Security, Commerce, Labor, and the Director of National Intelligence all must answer eventually to the President. As a result, their judgment on investment issues may be subject to political influence. FINSA’s involvement of Congress in this process only adds to the risk of “political mischief”¹⁴⁵ A neutral, international arbitration panel would be able to identify those transactions that will effect security interests without being tainted by the political process. International arbitration can provide “a reliable, neutral forum for investors to enforce the rules of law articulated in a specific treaty.”¹⁴⁶

Furthermore, the Congressional briefings that are required by FINSA, run the risk of exposing sensitive information to a wide spectrum of individuals, particularly members of Congress and their aides.¹⁴⁷ By contrast, arbitration can better guarantee privacy and confidentiality by controlling who hears the information in question.¹⁴⁸

¹⁴² See discussion *supra* notes 11 – 15 on the creation of CFIUS.

¹⁴³ 50 app. U.S.C.A. §2170 (2007).

¹⁴⁴ See Foreign Investment and National Security Act of 2007, H.R. 556, 110th Cong. (2007) quoting the stated purpose of FINSA. “An Act To ensure national security while promoting foreign investment and the creation and maintenance of jobs, to reform the process by which such investments are examined for any effect they may have on national security, to establish the Committee on Foreign Investment in the United States, and for other purposes.”

¹⁴⁵ See Corr, *supra* note 81.

¹⁴⁶ See Franck, *supra* note 104, at 344.

¹⁴⁷ See Stagg, *supra* note 76.

¹⁴⁸ Edwin J. Nazario, *The Potential Role of Arbitration in the Nuclear Non-Proliferation Treaty Regime*, 10 AM. REV. INT’L ARB. 139, 148 (1999).

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

B. International Arbitrators Can Be Uniquely Skilled In Evaluating Complex Business Transactions and the Risks They Might Pose

Those who argue international arbitration is not the appropriate forum for handling controversial investment disputes like DPW should bear in mind that international arbitration has been suggested as a means for resolving nuclear non-proliferation. Scholars point out that “arbitration may be more compelling than the ICJ as a method of resolving hard-core disputes over the obligations of the [Non-Proliferation Treaty] Regime.”¹⁴⁹ If countries are willing to trust international arbitration to handle issues as important as nuclear non-proliferation, they should be willing to accept this forum to resolve their international investment disputes.

As is the case with enforcing nuclear non-proliferation, assessing foreign business transactions requires specialized knowledge and expertise. For instance, before one can accurately predict whether a proposed merger would have a detrimental effect on U.S. national security, one must fully understand the inner and outer workings of that industry as well as the meaning and significance of the investors stake in the company. Allowing nation states to select arbitrators with significant experience in that specific industry would result in a fairer outcome.¹⁵⁰ Ideally, international arbitrators will take host state’s national interest into account as one of the factors when rendering its decision.¹⁵¹

C. International Arbitration Can Provide Investors and Host States With More Flexibility To Better Serve Their Interest

Arbitration provides flexibility by considering a number of factors when rendering an opinion. By rejecting strict adherence to any one particular rule of law, arbitrators can focus on general legal principles.¹⁵² Therefore, arbitration could adapt to the needs of investors while at the same time protecting the security concerns of the host state.

Critics argue, however, that international arbitration is weakened by the fact that its decisions have no precedential value and cannot influence future decisions.¹⁵³ However, there are real benefits of this for both investors and states. By not contributing to customary international law, arbitration can better

¹⁴⁹ *Id.* at 149.

¹⁵⁰ See Nazario, *supra* note 148, at 148.

¹⁵¹ *Id.*

¹⁵² Joanne K. Lelewer, *International Commercial Arbitration as a Model For Resolving Treaty Disputes*, 21 N.Y.U. J. INT’L L. & POL. 379, 383 (1989).

¹⁵³ *Id.* at 388.

TO LEGISLATE OR TO ARBITRATE

protect the privacy interests of both parties.¹⁵⁴ This is significant for investors because, “the privacy of arbitration allows parties to protect business and other confidences, regardless of whether the confidences would qualify for special protection under judicial procedures.”¹⁵⁵ Often, investors are not looking to set precedent; they simply want their dispute resolved quickly and efficiently without the possibility of their sensitive financial information being revealed to the public.¹⁵⁶ States also want issues resolved without announcing to the world their own intelligence or security procedures. International arbitration is the ideal forum for achieving both of these goals.

The DPW and CNOOC scandals undoubtedly were cause for embarrassment for all parties involved. Arbitration is beneficial because it allows the losing party to “save face” and avoid public humiliation.¹⁵⁷ By deciding issues in private, without any precedential value, arbitration is best suited to provide both parties the flexibility they desire.

D . International Arbitration Can Protect National Security Interests By Allowing Sovereigns to Avoid Arbitration In Extreme Cases

Investment treaties between states have often included provisions known as non-precluded measures (“NPM”) which allow states to “take actions otherwise inconsistent with the treaty when, for example, the actions are necessary for the protection of essential security, the maintenance of public order, or to respond to a public health emergency.”¹⁵⁸ The United States has been including NPM clauses in its investment treaties since the early 1980’s.¹⁵⁹ Therefore, the concept is not at all foreign to our government.

International arbitral tribunals have analyzed these clauses in the past but have never given them the “rigorous treaty interpretation mandated by the Vienna Convention”¹⁶⁰ Some scholars argue for a “nexus requirement” when

¹⁵⁴ Amy J. Schmitz, *Ending A Mud Bowl: Defining Arbitration’s Finality Through Functional Analysis*, 37 GA. L. REV. 123, 158.

¹⁵⁵ See Schmitz, *supra* note 154, at 158.

¹⁵⁶ While arbitration proceedings are conducted in private, they are not all confidential. In certain cases, the public has the opportunity to access the record. For a more in-depth analysis of confidentiality issues in arbitration, see Laurie Kratky Doré, *Public Courts Versus Private Justice: It’s Time To Let Some Sun Shine In On Alternative Dispute Resolution*, 81 CHI.-KENT L. REV. 463 (2006). Professor Doré’s Article is part of a symposium titled, “Secrecy In Litigation” that appeared in Volume 81 of the 81 CHICAGO KENT LAW REVIEW.

¹⁵⁷ See Schmitz, *supra* note 154, at 158.

¹⁵⁸ William W. Burke-White; Andreas von Staden, *Investment Protection in Extraordinary Times: The Interpretation and Application of Non-Precluded Measures Provisions in Bilateral Investment Treaties*, 48 VA. J. INT’L L. 307, 311 (2008).

¹⁵⁹ See Burke-White, *supra* note 158, at 327.

¹⁶⁰ *Id.* at 316.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

analyzing NPMs that insists on their being, “a link between the actions taken by a state that would otherwise violate the treaty and the permissible objectives provided for in the NPM clause.”¹⁶¹ Assuming this nexus test is met, NPMs could serve as happy medium for some states that are reluctant to give up their sovereignty entirely in this area by allowing them an alternative outlet in extreme cases.

PART V. CONCLUSION

The recent foreign investment scandals such as DPW garnered national attention like never before seen in these types of investment transactions. A once little known governmental agency, CFIUS, suddenly graced the headlines of mainstream newspapers around the country as the controversy unfolded live in front of a watchful and eager audience. In the aftermath of these controversies, Congress responded quickly to the public outrage and decided to act in its legislative authority. In 2007 it passed FINSA in an attempt to prevent future perceived investment risks from slipping under the radar without Congressional approval. Congress wanted to give itself a say on these matters and used FINSA to achieve this. While FINSA means well, it falls far short of its ultimate goal to encourage foreign investment. The additional regulations on foreign investment and involvement of Congress will likely only lead to more confusion for investors. As the U.S. sets up more barriers to its markets, foreign investors are likely to look elsewhere.¹⁶² With the U.S. looking to solve its disputes internally, there is nothing to stop other governments from doing the same and placing more restriction on their markets. This will in turn lead to inconsistent policies and even more confusion and uncertainty for all investors, including Americans.

International arbitration can address these concerns in a neutral, non-biased forum that involves the international community. This will prevent other nations from creating trade and investment barriers all in the name of their own national security. The tremendous rise in the number of businesses and governments turning to arbitration indicates its growing importance and acceptance as a viable means of dispute resolution. Arbitration can better serve the needs of investors and host states by protecting their privacy and avoiding the public humiliation suffered as a result of failed transactions like DPW.¹⁶³ In attempting to prevent future investment scandals, the U.S. government and others around the world should not overlook this important resource.

¹⁶¹ *Id.* at 342.

¹⁶² See Haley, *supra* note 45.

¹⁶³ See Schmitz, *supra* note 154.

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