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CYBERTERRORISM: ARE WE LEGALLY READY?

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INTRODUCTION

Human beings, by their very nature, have a tendency to find the destructive side of most innovations and advancements. Current technological developments present us with opportunities to enrich our lives by using simple, quick and high-quality devices. At the same time, these technological developments also hold the potential to be used as weapons in the hands of terrorists. When I first became acquainted with the idea of cyberterrorism, I was fascinated by the large amount of ink that had already been spilled on the gloom prospects that cyberterrorism is not a question of “if” but of “when.”

However, there was no reference as to how the international community can react to such an attack after it had happened. This article is an attempt to take that next step, and try to analyze whether the international tool kit is well equipped to handle cyberterrorism. I have focused on the legal aspects, rather than discussing the technological options to combat cyberterrorism. While existing counter-terror conventions could, by way of legal interpretation, apply to cyberterrorism, there could be a better direct way of addressing this threat, via the creation of an explicit regime for the suppression of cyberterrorism consisting of conventional prohibitions, Security Council resolutions and international criminal laws.

The article includes four parts. Part I sets the stage for the arguments presented above, and provides a brief introduction to the concept of terrorism and the international response to these terrorist threats. Part II defines what cyberterrorism is and what distinguishes it from other manifestations of terrorism. Part III examines international conventions that were designed to address certain types of terrorism and whether they would be applicable in cases of cyberterrorism. Finally, Part IV discusses several avenues to address cyberterrorism in the future.

* This Article is based on my LL.M. Thesis. I would like to thank Prof. Moshe Hirsch and Prof. Yuval Shany of the Law Faculty of the Hebrew University of Jerusalem for their insightful and inspiring notes. This article is dedicated to my parents, Netta and Amir Cohen.

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I. INTERNATIONAL LEGAL RESPONSES TO TERRORISM

Almost every country in the world condemns terrorism and assigns itself to fight it, but what exactly are they fighting against?¹ Answering this question and distinguishing terrorist acts from non-terrorist acts forced states to crystallize definitions of terrorism. Defining the term “Terrorism,” however, is not a simple task. Specialists in the area of terrorism studies have devoted hundreds of pages toward trying to develop a widely accepted definition of the term, only to realize that “terrorism is intended to be a matter of perception and is thus seen differently by different observers.”²

The complexity of finding an agreeable definition for “Terrorism” is considered one of the obstacles in creating an international mechanism to combat it.³ Terrorism is a subjective concept, associated with different events in the eyes of different groups of people. One thing remains clear – terrorism is commonly regarded as a destructive force threatening the world as we know it in a way that makes it nearly impossible to prevent.

The widely accepted definition for terrorism at the international level is found in Article 2 Section 1(b) of the United Nation (“UN”) International Convention for the Suppression of the Financing of Terrorism, 1999 (“The Financing Convention”).⁴ This definition has been reaffirmed in other international instruments, such as in the UN Security Council Resolution 1566⁵, and is widely accepted among scholars.⁶ The Article reads as follows:

¹ Daniel Taub, *Terrorism in the International Law*, in INTERNATIONAL LAW 476, 476 (Robbie Sabel ed., 2003).

² Audrey Kurth Cronin, *Behind the Curve: Globalization and International Terrorism*, 27(3) INT’L SEC. 30, 32 (2002).

³ MALCOLM N. SHAW, INTERNATIONAL LAW 1048 (5th ed. 2003).

⁴ International Convention for the Suppression of the Financing of Terrorism, Dec. 9, 1999, 39 I.L.M. 270 (hereinafter “Financing Convention”).

⁵ S.C. Res. 1566, U.N. Doc. S/RES/1566 (Oct. 8, 2004):

...Recalls that criminal acts, including against civilians, committed with the intent to cause death or serious bodily injury, or taking of hostages, with the purpose to provoke a state of terror in the general public or in a group of persons or particular persons, intimidate a population or compel a government or an international organization to do or to abstain from doing any act, which constitute offenses within the scope of and as defined in the international conventions and protocols relating to terrorism, are under no circumstances justifiable by considerations ...

⁶ Tim Stephens, *International Criminal law and the Response to International Terrorism*, 27(2) U. NEW SOUTH WALES L.J. 454, 461-462 (2004). See also: Reuven Young, *Defining Terrorism: The Evolution of Terrorism as Legal Concept in International Law and its Influence on Definitions in Domestic Legislation*, 29 B.C. INT’L & COMP. L. REV. 23, 53 (2006).

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(b) Any other act intended to cause death or serious bodily injury to a civilian, or to any other person not taking an active part in the hostilities in a situation of armed conflict, when the purpose of such act, by its nature or context, is to intimidate a population, or to compel a government or an international organization to do or to abstain from doing any act.

This definition consists of several elements: first and foremost, the causation of physical harm to a victim who is a civilian or other person not taking an active part in the hostilities in a situation of armed conflict. From this stems the conclusion that an act which does not involve physical harm could not be considered an act of terrorism.⁷ The physical harm is usually aimed at targets which possess a symbolic value and/or potential to cause great damage. For instance, suicide bombers on buses probably do not pick their targets because of any symbolic value that is attributed to them, but pick them due to their accessibility and the amount of potential damage they may achieve. Events like 9/11 or the bombing of the Israeli embassy in Buenos-Aires, on the other hand, clearly carry a symbolic statement in addition to its potential to cause massive destruction.⁸

The second element is the attacker's intention. Terrorism does not happen by accident. Terrorists seek to influence three main groups – the immediate victims of the terrorist act, the rest of the public in whom the terrorist act has engendered a sense of fear and the policymakers on a national or international level.

A part of terrorists' success derives from the fact that none of the attackers' potential victims feels protected; nobody knows when terrorism will strike next. This brings about the continuous state of terror (from the Latin word "*terrere*" – to frighten), creating an aftermath of fear long after the event itself took place. By hurting a group of random victims⁹, terrorists hope to create widespread intimidation or fear, with which they wish to change human policy or course of action.¹⁰ Generally speaking, the principal targets of a terrorist episode are not the victims who are killed or maimed in the attack, but rather the governments, publics, or constituents among whom the terrorists hope to produce a reaction.¹¹

Despite its comprehensive quality, the Financing Convention does not

⁷ Daniel M. Schwartz, *Environmental Terrorism: Analyzing the Concept*, 35(4) J. PEACE RES. 483, 485-486 (1998).

⁸ *Id.*

⁹ Gilbert Guillaume, *Terrorism and International Law*, 53 INT'L & COMP. L.Q. 537, 541(2004).

¹⁰ Schwartz, *supra* note 7, at 485-486.

¹¹ Cronin, *supra* note 2, at 32.

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address the identity of the terrorists. It defines only the activity and not the actor. Thus, the definition may include individuals, groups and even state entities. Nonetheless, for the purposes of this essay I will refer to “Terrorism” as it is defined in the Financing Convention. It is worth noting that most scholars have identified acts of terrorism as consisting of the same elements enumerated in the Financing Convention – causing physical harm with the intent to create a sense of fear and influence governmental processes.¹²

The UN approach toward combating Terrorism consisted of two main courses of action – condemning the general phenomena and suppressing specific manifestations of it.¹³ The current international regime against terrorism consists of thirteen international conventions and protocols as well as seven regional conventions.¹⁴ The international conventions deposited with the UN secretary cover issues like civil aviation, maritime, protection of diplomatic agents, hostage situations, and more. Member states are currently negotiating a fourteenth international treaty intended to be a comprehensive convention on

¹² Walter Enders, Adolfo Sachsida & Todd Sandler, *The Impact of Transnational Terrorism on U.S. Foreign Direct Investment*, 59(4) POL. RES. Q. 517, 518 (2006). See also Guilaume, *supra* note 9, at 540.

¹³ Shaw, *supra* note 3, at 1049.

¹⁴ The international conventions are: Convention on Offenses and Certain Other Acts Committed on Board Aircraft, Sep. 14, 1963, 704 U.N.T.S. 219; Convention for the Suppression of Unlawful Seizure of Aircraft, Dec. 16, 1970, 860 U.N.T.S. 105; Convention for the Suppression of Unlawful Acts against the Safety of Civil Aviation, Sep. 23, 1971, 974 U.N.T.S. 178; Convention on the Prevention and Punishment of Crimes against Internationally Protected Persons, including Diplomatic Agents, Dec. 14, 1973, 1035 U.N.T.S. 167; International Convention against the Taking of Hostages, Dec. 17, 1979, 1316 U.N.T.S. 205; Convention on the Physical Protection of Nuclear Material, Mar. 3, 1980, 1456 U.N.T.S. 246; Protocol on the Suppression of Unlawful Acts of Violence at Airports Serving International Civil Aviation, supplementary to the Convention for the Suppression of Unlawful Acts against the Safety of Civil Aviation, Feb. 24, 1988, 1652 U.N.T.S. 499; Convention for the Suppression of Unlawful Acts against the Safety of Maritime Navigation, Mar. 10, 1988, 1678 U.N.T.S. 221; Protocol for the Suppression of Unlawful Acts against the Safety of Fixed Platforms Located on the Continental Shelf, Mar. 10, 1988, 1678 U.N.T.S. 304; Convention on the Marking of Plastic Explosives for the Purpose of Detection, Mar. 1, 1991, 30 I.L.M. 721; International Convention for the Suppression of Terrorist Bombings, Dec. 15, 1997, 2149 U.N.T.S. 256; Financing Convention, *supra* note 4; International Convention for the Suppression of Acts of Nuclear Terrorism, Apr. 13, 2005, UN Doc. A/RES/59/290.

The regional conventions are: Arab Convention on the Suppression of Terrorism, Apr. 22, 1998; Convention of the Organization of the Islamic Conference on Combating International Terrorism, Jul. 1, 1999; European Convention on the Suppression of Terrorism, Jan. 27, 1977; OAS Convention to Prevent and Punish Acts of Terrorism Taking the Form of Crimes against Persons and Related Extortion that are of International Significance, Feb. 2, 1971; OAU Convention on the Prevention and Combating of Terrorism, Jul. 14, 1999; SAARC Regional Convention on Suppression of Terrorism, Nov. 4, 1987; Treaty on Cooperation among States Members of the Commonwealth of Independent States in Combating Terrorism, Jun. 4, 1999.

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international terrorism, as will be elaborated *infra*.¹⁵

UN efforts to fight terrorism are also carried out through the Security Council. Prior to 9/11, the Security Council efforts to combat international terrorism took the form of sanctions against states considered to have links to certain acts of terrorism, such as Libya and Sudan. In 1998, after the terrorist bombings in Kenya and Tanzania the Security Council adopted Resolution 1189.¹⁶ This resolution included a short statement on condemning terrorism and called upon states and international institutions to cooperate on the matter. It did not, however, impose any sanctions. In resolution 1269 of October 1999, the Security Council began advancing towards a more operative course of action, and requested the Secretary-General of the UN “to pay special attention to the need to prevent and fight the threat to international peace and security as a result of terrorist activities.”¹⁷

After 9/11 the Security Council began addressing the issue of international terrorism more vigorously as was expressed in Security Council Resolution 1373.¹⁸ Adopted under Chapter VII of the UN Charter, Resolution 1373 declares international terrorism “a threat to international peace and security.” It imposes binding obligations on all UN member states such as the prevention and the suppression of the financing of terrorist acts, the criminalization of terrorism-related activities and providing assistance to carry out those acts, the denial of funding and safe haven to terrorists and the exchange of information to prevent the commission of terrorist acts. The resolution also establishes a “Counter Terrorism Committee” (CTC) to monitor implementation of the resolution, with all states being required to report back to the CTC regarding steps taken to execute Resolution 1373.¹⁹

In December 2004, the UN High-Level Panel on Threats, Challenges and Change published a report calling for the creation of a comprehensive global counter-terrorism strategy, encompassing the various counter-terrorism activities under the leading role of the UN. Two years later, on September 2006, the General Assembly created the UN Global Counter Terrorism Strategy.²⁰ The Annex to this Resolution established a “Plan of Action”, specifying various measures to be taken by the Member States domestically and

¹⁵ General Assembly, *Report of the Ad Hoc Committee established by General Assembly resolution 51/210 of 17 December 1996, Seventh Session*, U.N. Doc. A/58/37, Supplement no. 37 (31 March – 2 April 2003).

¹⁶ S.C. Res. 1189, U.N. Doc. S/RES/1189 (Aug. 13, 1998).

¹⁷ S.C. Res. 1269, U.N. Doc. S/RES/1269 (Oct. 19, 1999), ¶ 5.

¹⁸ S.C. Res. 1373, U.N. Doc. S/RES/1373 (Sep. 28, 2001).

¹⁹ *Id.*, at ¶ 6. See also Eric Rosand, *Security Council Resolution 1373, the Counter-Terrorism Committee, and the Fight against Terrorism*, 97(2) AM. J. INT’L L. 333-341 (2003).

²⁰ G.A. Res. 60/288 U.N. Doc. A/RES/60/288 (Sep. 8, 2006).

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internationally. These measures were designed to enhance both international cooperation to prevent and combat terrorism and the UN role within this cooperation, as well as strengthening the individual state's commitment and ability to eliminate terrorism in its territory and create "a culture of peace." The effectiveness of this Strategy has yet to be determined.

II. CYBERTERRORISM: THE NEW THREAT

Over a decade ago, in 1998, Ehud Tenenbaum, an 18-year-old Israeli hacker known as the "Analyzer," penetrated the computer systems of the Pentagon, NASA, the Massachusetts Institute of Technology, the Naval Undersea Warfare Center and other highly protected computer systems in the U.S. A U.S. Defense Department official called it "the most organized and systematic attack the Pentagon has seen to date."²¹ Tenenbaum's hacking operation was even given a code name, the "Solar Sunrise," by the F.B.I. In 2001, a 16-year-old from Canada, called "Mafia Boy" also managed to pass the information security systems of some of the most sensitive computer infrastructures in the U.S.

During the past ten years information security systems grew more sophisticated, but so did hackers. This section asks the question – "What if?" What if Ehud Tenebaum and "Mafia Boy" had been members of a terror organization? What if they had been able to penetrate highly sensitive information in the Pentagon? What if they had covered their tracks better?

Terrorist groups have been using the Internet for various purposes, such as communicating, propagandizing, recruiting and collecting intelligence.²² The network of computer-mediated communication is ideal for terrorists as communicators: it is decentralized, it is more difficult to subject it to control or restriction and it allows access to anyone who wishes to use it.²³ However, the cyber-world can also be used in a different way, not only as an indirect tool for executing an attack, but also as a direct weapon.

One way to use the weapon of cyberspace is through cyberattacks on websites. For instance, such attacks have taken place in the India-Pakistan dispute over Kashmir, in the context of the Israeli-Palestinian conflict and

²¹ *Master hacker 'Analyzer' held in Israel*, Mar. 18, 1998, available at <http://www.cnn.com/TECH/computing/9803/18/analyzer/index.html>.

²² Gabriel Weimann, *TERROR ON THE INTERNET: THE NEW ARENA, THE NEW CHALLENGES* (2006). See also: Benjamin R. Davis, *Ending the Cyber Jihad: Combating Terrorist Exploitation of the Internet with the Rule of Law and Improved Tools for Cyber Governance*, 15 *COMMLAW CONSPPECTUS* 119-186 (2006).

²³ *Id.* at 25.

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against NATO websites during the crises in Kosovo in the early 1990's.²⁴ These attacks still do not constitute "terrorism" in the sense that they do not cause physical harm and do not intend to influence the government, as required by the definition of terrorism in the Financing Convention.

The other way of using cyberspace as a weapon is the case of cyberterrorism. Cyberterrorism is the use of computer networks in order to harm human life or to sabotage critical national infrastructure in a way that may cause harm to human life.²⁵ Joel Trachtman distinguishes between different types of networks that may be subjected to cyberterrorist attacks: military and civilian defense networks; other governmental networks (police, fire); privately or publicly owned networks used to control public utilities and other systems for providing infrastructural services (electricity, water); and public networks used by individual consumers and businesses for communication, education etc . . .²⁶

Cyberterrorism may be disrupting bank data, penetrating rail company computers, blocking computer communication at an international airport, deleting the voter register 24 hours before an election, and many more. All these systems are service providers, which means they are linked to the Internet in one way or another and therefore are under the risk of invasion. Today, Western societies are dependent in almost every aspect of life upon computer communication. Computer systems control nearly everything required for our daily routines and our emergency plans.

But is cyberterrorism similar in its characteristics to other forms of terrorism mentioned earlier? Surely there must be some difference between hijacking an airplane with a gun and hijacking it by taking control over the airplane's computer system. Establishing the legal nature of cyberterrorism is crucial in combating it through international legal instruments, which, as was demonstrated above, are central to the international community's fight against terrorism.

As stated above, terrorism exhibits the elements of physical harm and

²⁴ Janet J. Prichard & Laurie E. MacDonald, *Cyber Terrorism: A Study of the Extent of Coverage in Computer Security Textbooks*, 3 J. INFO. TECH. EDU. 279, 281 (2004).

²⁵ This is according to Shlomo Harnoy, Founder, senior VP & Professional manager at SDEMA Group, and Yossi Or, VP Information Security at SDEMA Group. The SDEMA Group is an integrated, homeland security solutions partnership specializing in risk mitigation. SDEMA also offers information security service including market forward protection against cyber terrorism. This definition is also accepted in academic literature, *see* Weimann, *supra* note 22, at 148; Dorothy E. Denning, "Cyberterrorism": Testimony before the Special Oversight Panel on Terrorism Committee on Armed Services, U.S. House of Representatives, May 23, 2000, <http://www.cs.georgetown.edu/~denning/infosec/cyberterror.html>.

²⁶ Joel P. Trachtman, *Global Cyberterrorism, Jurisdiction, and International Organization*, Jul. 20, 2004, available at <http://ssrn.com/abstract=566361>.

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intention to cause a sense of fear and to influence the decision making process. The cause of physical harm can be attained through disruption of computer systems, such as disabling traffic light systems, hospital computers, electric companies' computer etc . . . These acts bring about a sense of fear and uncertainty among the victim population, which in turn leads to pressuring the government to "do something" about it. Thus, you do not need to go through the trouble of getting a gun or a knife onboard an aircraft in order to become a terrorist. You can get the same results sitting in front of a computer screen.

In addition, most of the potential infrastructure targets of cyberterrorism, like those stated above, are protected by some sort of information security and anti-virus programs. Penetrating these programs takes time and knowledge, and it happens solely if the hacker intends for it to happen. Of course not every Ehud Tenenbaum is a terrorist just because he intended to break into classified computer networks. As the abovementioned definition requires, the intention element also means there was intention to influence a government course of action.

Regardless, cyberterrorism has several unique characteristics distinguishing it from other forms of Terrorism.²⁷ We defined Terrorism as being aimed at a certain target that has great potential damage in terms of human life. The identity of the humans itself did not matter. Cyberterrorism, on the other hand, can hurt a very specific group of people – the population of modern western countries.

As stated above, cyberterrorism hurts computerized infrastructure, on which advanced societies have come to depend. Thus, different societies are vulnerable to cyberterrorism in different degrees in accordance with their level of dependence on technology and computer networks. The more dependent a state is on electronic communications and information processing networks, the more vulnerable to cyberterrorism it will be.²⁸ As Richard Clarke put it already in 1999 – "If you are connected you are vulnerable."²⁹

One might say that the level of technology advancement also results in better defense systems, which enable states to protect themselves from these kinds of attacks. This is correct, yet while assessing the volume of the risk, it remains clear that the U.S. is more exposed to cyberterrorism than Rwanda. This, in turn, will force the cyberterrorists trying to attack the U.S. to become more sophisticated themselves. Still, these cat and mouse games between the

²⁷ Susan W. Brenner & Marc D. Goodman, *In defense of Cyberterrorism: An Argument for Anticipating Cyber-Attacks*, J.L. TECH. & POL'Y 1, 12 (2002).

²⁸ Weimann, *supra* note 22, at 148; Trachtman, *supra* note 26, at 5.

²⁹ Richard Clarke, *Threats to U.S. National Security: Proposed Partnership Initiatives Towards Preventing Cyber Terrorist Attacks*, 12 DEPAUL BUS. L.J. 33, 37 (1999-2000).

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cyberterrorists and the information security experts are most likely to occur in the U.S. and not in Rwanda because the U.S. has more at stake – it is more dependent on its information security to hold on against a cyberterrorism attack because it is more dependent on computerized infrastructure.

Another distinctive feature of cyberterrorism is its relatively low costs. A terrorist attack in the physical world requires recruiting an executor, equipping him with weapons or explosives and making sure he will pass all security checks on his way to the designated location. Cyberterrorism on the other hand, will most likely save the terrorist these costs and obstacles. Committing a cyber-attack, assuming you know how, does not involve purchasing weapons or actually being present at the attack's location. All a cyberterrorist needs is a good computer and hacking skills that exceed his opponent's. In today's world, anyone has the potential to acquire the required technical skills, as a crash-course "Hacking 101" can be easily be found on the Internet itself.

Despite all the gloomy predictions of a cyberterrorism doomsday, no single instance of real cyberterrorism has yet been recorded. This fact leads people to think that the prophecies on cyberterrorism are exaggerated.³⁰ However, there are several arguments that need to be considered. Theoretically speaking, just because an event has not yet happened, does not affect the possibility of it happening in the future. Similarly, the superpowers in the international system have been preparing for the scenario of a nuclear war even though it is also based on an event that, fortunately, has not occurred. In addition, like physical terror cells that hold "sleeping agents" at their enemy's territory ready to be active on a phone call, so too can computer viruses be programmed to be active as of a certain date in the future, until which time no one will know of their existence.

Shlomo Harnoy and Yossi Or, both experts in the field of counterterrorism, have pointed out that a possible reason as to why there have been no cyber-attacks could simply be that terrorist organizations have not yet acquired the technological ability, which is the core factor in cyberterrorism.³¹ Other reasons are difficult to discern. At least in theory this is a highly effective weapon for terrorists. Assuming that the reason there has, of yet, been no cyberterrorism event is indeed the technological gap between the potential targets and potential terrorist, this calls for immediate action. Technological gaps can be closed, rapidly. Since the most critical infrastructures in Western societies are networked through computers, the potential threat of

³⁰ Weimann, *supra* note 22, at 149.

³¹ See also Brenner & Goodman, *supra* note 27, at 44-52.

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cyberterrorism is, at least in theory, alarming.³²

Governments in Western countries have been taking cyberterrorism threats very seriously for at least a decade. For instance, the U.S. authorities conducted the first experiment of its kind, designed to check the level of readiness of U.S. computer systems for the next attack. This operation was held in 2002 and was given the symbolic name “Digital Pearl Harbor.” The results were startling. The “Red Team,” which was supposed to try to hack into computer systems and disrupt their functioning, succeeded in nearly all cases.³³ After this experiment the U.S. government began a campaign of improving readiness for cyberterrorism, both on the technical and legislative level.³⁴

In Israel, Government Decision B-84 from 2002 defined critical data systems that will undergo a security upgrade to adjust their information security systems to a scenario of cyberterrorism. In Europe, governments have acted not only on a singular basis, such as the establishing of the National Technical Assistance Center in the United Kingdom,³⁵ but also in the framework of the European Union. In 2005 the European Council adopted the European Program for Critical Infrastructure Protection (EPCIP) as part of its overall fight against terrorism. The EPCIP focuses mainly on strengthening the computer security systems, in order to enhance the preparedness for terrorist attacks involving critical infrastructure.

Currently there is no international legal instrument which deals specifically with cyberterrorism. Since the threat seems not to be far fetched, it is prudent thinking to try and see what the legal international community has in store for the “Day After.” Accordingly, the following chapters will examine the question of whether the existing international regime on terror, as previously described, is adequate for an event of cyberterrorism. If it is – the international community has sufficient legal instruments in case the next Ehud Tenenbaum is a terrorist. If it is not – some alternatives must be considered.

³² Weimann, *supra* note 22, at 148; see Brenner & Goodman, *supra* note 27.

³³ Eric Purchase & Franch Caldwell, *Digital Pearl Harbor: a Case Study in Industry Vulnerability to cyber Attacks*, in: Sumit Ghosh, Manu Malek & Edward A. Stohr (eds.), *GUARDING YOUR BUSINESS – A MANAGEMENT APPROACH TO SECURITY* (2004).

³⁴ Tara Mythri Raghavan, *In fear of Cyberterrorism: An Analysis of the Congressional response*, *J.L. TECH. & POL'Y* 297-312 (2003).

³⁵ Clive Walker, *Cyberterrorism: Legal Principle and Law in the United Kingdom*, 110(3) *PENN ST. L. REV.* 625-665 (2006).

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III. INTERNATIONAL COUNTER TERRORISM CONVENTIONS AND THEIR APPLICABILITY TO CYBERTERRORISM: TWO CASE-STUDIES

The previous section presented cyberterrorism as the next phase in the evolution of terrorism and as one of the significant threats to future international peace and security. While information security experts are assigned with the task of maintaining the technological gap in favor of the governments over the cyberterrorists, it is in the hands of international law experts to make sure that the international community is prepared for the “day after” the first cyberterrorism attack.

The legal analysis of the international response to cyberterrorism begins with an examination of the existing legal framework. In order to determine the applicability of any of those conventions to cyberterrorism, the first step is to make sure that the offenses defined in them are not limited to execution by physical means. As explained earlier, the current conventions were originally designed to respond to specific manifestations of terrorism, and hence they create specific offenses to suit each scenario, such as aircraft hijackings or hostage situations. Since most of these conventions were drafted when cyberterrorism was considered to be, at most, science fiction, it is not at all certain that they apply to a cyber attack.³⁶

The next sections provide the legal background to treaty interpretation and examine three of the thirteen counter-terror conventions to see whether they apply to cyberterrorism or not. The selection of those three particular treaties is by no means exhaustive regarding the question of applicability, and further examination of all counter terror conventions is needed. However, due to the limits of the current research I have chosen to focus on leading conventions from different fields of terror, namely: terrorism aimed at aircrafts and terrorist bombings.

A. Interpretation of International Conventions

International law, much like domestic legal systems, suffers from an inherent deficiency – it creates legal regimes to correspond with a given reality but which might not be suitable to address changes in that reality. The instrument developed to cope with this problem is the notion that treaties, like

³⁶ This can be said with respect to any new method of terrorism that may evolve, for further reading on the criticism of the counter-terrorism conventions and their failure to address new methods of terrorism, see Jennifer Trahan, *Terrorism Conventions: Existing Gaps and Different Approaches*, 8 NEW ENG. INT’L & COMP. L. ANN. 215, 221-222 (2002).

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domestic constitutions, are “living documents.” This allows deviating from the strict literal meaning of the text as long as it fulfills the rationale of the text. Hence, a text that was written five years ago or one-hundred-years ago can maintain its relevance. In contrast, there is a point of view which holds that a legal document should be read in the context in which it was written. As will be seen, the controversy between these two theories of interpretation is reflected in the attempt to adjust existing conventions to a threat that did not concretize at the time of drafting.

The issue of interpretation of international law was codified in 1969 in the Vienna Convention on the Law of Treaties³⁷ (The Vienna Convention), also known as the “Treaty on Treaties.”³⁸ Articles 31-33 set forth the interpretive norms and rules for all treaties concluded between states.³⁹ The Vienna Convention, including Articles 31-32, is widely considered to reflect customary international law by scholars⁴⁰ as well as by the International Court of Justice.⁴¹

Most scholars agree that Article 31 puts a strong emphasis on a textual approach to treaty interpretation.⁴² The preference of the textual approach, however, is not absolute. The recourse to contextual interpretation exists at the end of Article 31(1). In addition, Article 31 allows relying upon sources other than the text of the treaty, but only to the extent that the parties agreed to

³⁷ Vienna Convention on the Law of Treaties, May 23, 1969, 1155 U.N.T.S. 331.

³⁸ Richard D. Kearney & Robert e. Dalton, *The Treaty on Treaties*, 64 AM. J. INT’L L. 495-562 (1970).

³⁹ A separate convention governs the interpretation of agreements between states and international organizations and agreements between international organizations, see: Vienna Convention on the Law of Treaties between States and International Organizations or between International Organizations, Mar. 21, 1986, 25 I.L.M. 543. Since Article 33 deals with preference of translation issues, it does not concern the following treaty analysis and it will not be discussed.

⁴⁰ Shaw, *supra* note 3, at 839; Anthony Clark Arend, *Who’s Afraid of the Geneva Convention? Treaty Interpretation in the Wake of Hamdan v. Rumsfeld*, 22 AM. U. INT’L L. REV. 709, 722 (2007); Jared Wessel, *Relational Contract Theory and Treaty Interpretation: End-Game Treaties v. Dynamic Obligations*, 60 N.Y.U. ANN. SUR. AM. L. 149, 162 (2004); Evan Criddle, *The Vienna Convention on the Law of Treaties in U.S. Treaty Interpretation*, 44 VA. J. INT’L L. 431, 438 (2004); P. Brazil, *Some Reflections on the Vienna Convention on the Law of Treaties*, 6 FED. L. REV. 223, 235 (1974-1975).

⁴¹ See e.g. Territorial Dispute (Libya v. Chad), 199 I.C.J. 16; Legal Consequences for States of the Continued Presence of South Africa in Namibia (S. W. Afr.), 1971 I.C.J. 16; Appeal Relating to the Jurisdiction of the ICAO Council (India v. Pak.), 1972 I.C.J. 46; Nuclear Tests (Austl. v. Fr.), 1974 I.C.J. 253. See also adherence to the Vienna Convention by the Dispute Settlement Body of the World Trade Organization: Panel Report, *Colombia — Indicative Prices and Restrictions on Ports of Entry*, WT/DS366 (Apr. 27, 2009) ¶ 7.81.

⁴² Arend, *supra* note 40, at 723; Michael P. Van Alstine, *Dynamic Treaty Interpretation*, 146(3) U. PA. L. REV. 687, 744 (1998); Wessel, *supra* note 40, at 163; Criddle, *supra* note 40, at 438; Brazil, *supra* note 40, at 236.

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consider those sources as providing authoritative interpretive information.⁴³ Due to rapid technological changes, the text of an agreement might become obsolete. This creates a need to expand the treaty, either implicitly or explicitly, so as to cover new circumstances.⁴⁴ It should be noted that another possible way of addressing changes in circumstances is to conclude a new treaty. While the latter option is examined further ahead in Part III, the following examination centers on the use of interpretation as a means of adjusting legal texts to changes in the legal reality.

Article 32 allows the interpreter to use the negotiating history (*travaux préparatoires*) in order to confirm the analysis reached under Article 31, and seems to give only secondary place to the exploration of the preparatory work.⁴⁵ On the other hand, Article 32 does not specify the extent of ambiguity or obscurity that must persist after completing the Article 31 analysis in order to trigger Article 32(a), thus, it could be argued that even reasonable doubt may justify recourse to Article 32.⁴⁶

B. Case-Study #1: The Convention for the Suppression of Unlawful Acts against the Safety of Civil Aviation, 1971

A State Airline company is a national symbol. Though nowadays the number of privately owned airline companies is larger than in the past, these airline companies, as well as the state owned ones, are still subject to governmental oversight and regulation on the national as well as the international level. Their existence, routes, and most of their commercial activities are a product of governmental cooperation.⁴⁷ Commercial aviation disasters, intentional or accidental, are uniquely treated by the public and news media as singular events⁴⁸ An airplane contains the two features terrorists seek: it has a symbolic nature and an enormous damage potential. Furthermore, aviation disasters affect world order and economic relations between states,⁴⁹ as

⁴³ Arend, *supra* note 40, at 724.

⁴⁴ Wessel, *supra* note 40, at 177.

⁴⁵ Arend, *supra* note 40, at 725. See Eberhard P. Deutsch, *Vienna Convention on the Law of Treaties*, 47 NOTRE DAME LAW. 297, 299 (1971).

⁴⁶ Criddle, *supra* note 40, at 440.

⁴⁷ Humphrey G. Dawson, *Civil Aviation, Hijacking and International Terrorism – An Historical and Legal Review*, 15 INT'L BUS. LAW 53, 57 (1987).

⁴⁸ Amon Haruta & Kirk Hallahan, *Airline Crisis Communication: A Japan-U.S. Comparative Study*, 13(1) ASAIN J. COMM. 122-150 (2004). See also William A. Crenshaw, *Civil Aviation: Target for Terrorism*, 498 ANNALS AM. ACAD. POL. & SOC. SCI. 60-69 (1988).

⁴⁹ Dawson, *supra* note 47, at 57.

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aviation is a key factor in international trade.⁵⁰

For these reasons and others, commercial aircrafts have been prominent targets of terrorist attacks.⁵¹ Aviation terrorism manifests itself by means such as hijacking an aircraft, firing heat-seeking missiles at an aircraft, bombing an aircraft or airport lounges, gunning down passengers at airports, and more recently, turning aircrafts into guided missiles aimed at financial and governmental institutions.⁵²

International law has dealt with aviation safety since the early years of the twentieth century. As soon as an airline route was established between Paris and London it was obvious that basic standards and principles in this new field were needed. In 1919, the Convention for the Regulation of Aerial Navigation⁵³ was signed in Paris, creating for the first time an international aviation organization, known as CINA. In 1944, after World War II presented new frontiers to military as well as civil aviation, fifty-two world nations met in Chicago, U.S., and drafted a new convention, the Convention on International Civil Aviation.⁵⁴ This Convention established the International Civil Aviation Organization (ICAO), a specialized agency that became a part of the United Nations, and replaced CINA.⁵⁵

Though the Paris and Chicago conventions dealt extensively with flight safety regulation, they did not deal with aviation security. The first effort was made in 1963, at the Convention on Offenses and Certain Other Acts Committed on Board Aircraft, signed in Tokyo,⁵⁶ to assert formal international control over criminal acts such as hijackings.⁵⁷ Following the *aut dedere aut judicare* principle, the Tokyo Convention was designed to insure that when an offense⁵⁸ was committed on board an aircraft in flight, at least one state would

⁵⁰ Michael Milde, *The International Civil Aviation Organization: After 30 Years and Beyond*, 1996 AUSTL. INT'L L.J. 61 (1996).

⁵¹ Paul S. Dempsey, *Aviation Security: The Role of Law in the War Against Terrorism*, 41 COLUM. J. TRANSNAT'L L. 649, 651 (2003). See also Gerald F. Fitzgerald, *Aviation Terrorism and the International Civil Aviation Organization*, 25 CAN. Y.B. INT'L L. 219, 221 (1987).

⁵² Dempsey, *supra* note 51, at 651.

⁵³ Convention Relating to the Regulation of Aerial Navigation, Oct. 13, 1919, 11 L.N.T.S. 173.

⁵⁴ Convention on International Civil Aviation, Dec. 7, 1944, 15 U.N.T.S. 295. (hereinafter: "Chicago Convention").

⁵⁵ For further reading on the ICAO see: Milde, *supra* note 50; Eugene Sochor, *ICAO and Armed Attacks against Civil Aviation*, 44 INT'L J. 134-170 (1988-1989); Fitzgerald, *supra* note 51.

⁵⁶ See Conventions, *supra* note 14.

⁵⁷ The first hijack attempt on a commercial aircraft occurred in 1931, but the first real wave of hijackings began around 1958 when individuals hijacked aircraft as a means to divert them from Cuba to the United States. See Dempsey, *supra* note 51, at 664; Dawson, *supra* note 47, at 59.

⁵⁸ Article 1(1)-(2) of the Tokyo Convention defines the offenses as follows:

"Article 1: (1) This Convention shall apply in respect of:

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be able to exercise its jurisdiction over the offense and bring the offenders to justice.

Although the Tokyo Convention included a universal jurisdiction as a principle remedy, it in fact did not prove to be sufficient in confronting the increased number of acts of terrorism against aircrafts in the late 1960's. It was clear that there was a need for a broader definition of unlawful acts against aircrafts and a more definite statement as to the appropriate penalties than those offered by the Tokyo Convention.

The ICAO responded by adopting the Hague Convention of 1970.⁵⁹ The Hague Convention dealt specifically with acts of unlawful seizure of aircrafts,⁶⁰ and was considered a more efficient instrument than the Tokyo Convention. However, aviation terrorists began using methods that were not addressed by the Hague Convention, i.e. performing acts that did not constitute "seizing or exercising control over an aircraft." As quickly as 1971, only one year after the signing of the Hague Convention, there was already a need for further measures and for the creation of further criminal offenses.⁶¹ Thus, in 1971, the ICAO drafted the Montreal Convention for the Suppression of Unlawful Acts against the Safety of Civil Aviation (The Montreal Convention).

The Montreal Convention broadened the legal instruments available to combat aviation terrorism. It expanded the definition of "offense" beyond mere seizure as to include the general category of "interference with aircraft."⁶² Though it was criticized for not addressing situations of state involvement in a

(a) offences against penal law;

(b) acts which, whether or not they are offences, may or do jeopardize the safety of aircraft or of persons or property therein or which jeopardize good order and discipline on board;

(2) Except as provided in Chapter III, this Convention shall apply in respect of offences committed or acts done by a person on board any aircraft registered in a Contracting State, while that aircraft is in flight or on the surface of the high seas or of any other area outside the territory of any State."

⁵⁹ See Conventions, *supra* note 14. See also: Dawson, *supra* note 47, at 60.

⁶⁰ Article 1 of the Hague Convention defines the offences as follows:

"Any person who on board an aircraft in flight:

(a) unlawfully, by force or threat thereof, or by any other form of intimidation, seizes, or exercises control of, that aircraft, or attempts to perform any such act, or

(b) is an accomplice of a person who performs or attempts to perform any such act

Commits and offence (hereinafter referred to as "the offence").

⁶¹ Dawson, *supra* note 47, at 60.

⁶² Dempsey, *supra* note 51, at 659. See also D.J. Musch, INTERNATIONAL TERRORISM AGREEMENTS AND COMMENTARY 41 (2004).

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terrorist act, as was the case in the famous Lockerbie incident,⁶³ the Montreal Convention is still regarded as a primary instrument in dealing with aerial terrorism.

The Applicability of the Montreal Convention to a Cyberterrorism Attack

Article 1 of the Montreal Convention defines the offenses under the scope of the Convention. In the deliberation on the draft convention, some countries preferred the enumerative approach,⁶⁴ listing a limited number of specific offenses, while others supported a general definition.⁶⁵ The latter states argued that adopting a list of offenses would necessarily mean that future acts, unpredictable at the time of drafting, would be left out the scope of the Convention.⁶⁶ After much debate the enumerative approach was adopted, though the definition was drafted quite broadly, raising doubts regarding the actual difference between the two approaches. Article 1(1) states five alternative offenses being executed by the prime offender, and Article 1(2) criminalizes offenses of attempt and accomplice. Article 1(1) reads as follows:

Any person commits an offence if he unlawfully and intentionally:

- (a) Performs an act of violence against a person on board an aircraft in flight if that act is likely to endanger the safety of that aircraft; or
- (b) Destroys an aircraft in service or causes damage to

⁶³ On December 1988, Pan Am flight 103 from London to New York was bombed over the town of Lockerbie, Scotland, killing 270 passengers, crew and local townsman. The U.S. and The U.K. accused Libya of being responsible for the attack, and brought the matter before the International Court of Justice. The ICJ was unable to establish that Libya had violated the Montreal Convention, since it did not address the issue of state-sponsored terrorism. *See* Case concerning questions of interpretation and application of the 1971 Montreal Convention arising from the aerial incident at Lockerbie (Libya v. U.K.) 1998 I.C.J. 9. For further reading see Jonathan A. Frank, *A return to Lockerbie and the Montreal Convention in the Wake of the September 11th Terrorist Attacks: Ramifications of Past Security Council and International Court of Justice Action*, 30(4) DENV. J. INT'L L. & POL'Y 532, 536 (2002).

⁶⁴ ICAO, *International Conference on Air Law: Minutes and Documents*, ICAO Doc. 9801, p. 21, Delegates of France and Japan (hereinafter: "ICAO Documents").

⁶⁵ *Id.*, p.21, 27, Delegates of Canada and the People's Republic of the Congo.

⁶⁶ Abraham Abramovsky, *Multilateral Conventions for the Suppression of Unlawful Seizure and Interference with Aircraft, Part II: the Montreal Convention*, 14(2) COLUM. J. TRANSNAT'L L. 268, 280 (1975).

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such an aircraft which renders it incapable of flight or which is likely to endanger its safety in flight; or

(c) Places or causes to be placed on an aircraft in service, by any means whatsoever, a device or substance which is likely to destroy that aircraft, or to cause damage to it which renders it incapable of flight, or to cause damage to it which is likely to endanger its safety in flight; or

(d) Destroys or damages air navigation facilities or interferes with their operation, if any such act is likely to endanger the safety of aircraft in flight; or

(e) Communicates information which he knows to be false, thereby endangering the safety of an aircraft in flight.

Considering the threat of cyberterrorism, which did not exist during the drafting of the Montreal Convention, it is time to re-evaluate whether the offenses listed in Article 1 are applicable to a cyberterrorism event, or whether the predictions of the states who voted for the general definition turned out to be accurate. Unlike other conventions, the Montreal Convention does not include a definitions clause that would assist in interpreting its provisions. Thus, the legal analysis of the text is based on the rules of interpretation set in the Vienna Convention on the Laws of Treaties,⁶⁷ and other interpretation guidelines, mainly including the protocols of the Montreal Conference in which the draft convention was approved⁶⁸ and additional related literature.

The starting point of the discussion is that all five items listed in Article 1 reflect the notion that the Convention meant to protect the safety of an aircraft in flight, rather than protection of human life.⁶⁹ Therefore, intentionally endangering the life of a passenger without endangering the safety of the aircraft is not an offense covered by the Convention. It can, on the other hand, be argued that the two elements can not in fact be separated, and that one could not endanger the safety of the aircraft without endangering the lives of the crew and passengers in that aircraft and that the lives of the crew and passengers could not be put at risk without jeopardizing the safety of the aircraft.⁷⁰

It should also be noted that according to the text of Article 1, there is no requirement that the perpetrators or their accomplices be on board the

⁶⁷ Vienna Convention, *supra* note 37, § 31, 32.

⁶⁸ ICAO Documents, *supra* note 64.

⁶⁹ Abramovsky, *supra* note 66, at 281.

⁷⁰ ICAO Documents, Delegate of the United Kingdom, *supra* note 64, at 27.

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aircraft. This is another feature of the Montreal Convention which makes it more advanced than the Hague Convention. Unlike the Hague Convention, the provisions of the Montreal Convention may apply whether the alleged offender was on board the aircraft or on the ground. This enhances the likelihood that the Montreal Convention would be suitable for dealing with cyberterrorism against an aircraft, since as noted in the previous chapter, one of the advantages of cyberterrorism is the ability to execute an attack from a distant location.

The Montreal Convention also deals with offenses committed on board an aircraft “in service,” as opposed to an aircraft “in flight.”⁷¹ This extends the period of time to which the provisions of the Convention are applicable. At the deliberation on the adoption of the draft convention, most participating states hesitated to adopt the “in service” period. Those states believed that as long as an offender on board an aircraft is subject to both arrest and prosecution in the state where the aircraft is confined, there is no need for international intervention.⁷² This point illustrates that the focus of the Convention seems to be on *ex post* punishment rather than *ex ante* prevention.

Based on these starting points, the following analysis examines whether the different items listed in Article 1(1) are applicable to cyberterrorism. It is important to note that the primary aspect of my analysis is a legal, rather than a technical one. Thus, I assume that all the activities that will be mentioned below are technologically possible. My main purpose is to examine the language of the text and its possible interpretations.

(a) Act of violence against a person on board an aircraft in flight that is likely to endanger the safety of the aircraft

Article 1(1)(a) is designed to prevent and punish acts of violence committed against persons on board an aircraft in flight. The term “Act of

⁷¹ Article 2 of the Montreal Convention defines the two categories as follows:

(a) An aircraft is considered to be in flight at any time from the moment when all its external doors are closed following embarkation until the moment when any such door is opened for disembarkation; in the case of forced landing, the flight shall be deemed to continue until the competent authorities take over the responsibility for the aircraft and for persons and property on board;

(b) An aircraft is considered to be in service from the beginning of the preflight preparation of the aircraft by ground personnel or by the crew for a specific flight until twenty four hours after any landing; the period of service shall, in any event, extend for the entire period during which the aircraft is in flight as defined in paragraph (a) of this Article.

⁷² Abramovsky, *supra* note 66, at 278.

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Violence” is in fact wider than the phrase of the original draft convention.⁷³ The original draft provided that Article 1(1)(a) would apply in case an offender commits “an armed attack against the life of a person on board.” Adopting the “Act of Violence” term does not restrict the provision’s applicability to the use of certain weapons, nor does it restrict the offense to acts which jeopardize the life of the victim.⁷⁴

With respect to the term “Person,” it is clear that an attack on the pilot or the navigator of an aircraft in flight would endanger the safety of the aircraft. The less obvious cases regard the attack upon a flight attendant or a passenger. As mentioned above, the criteria for applying this provision in a specific case is not the gravity of the violent act, but rather its likelihood to affect the safety of the aircraft in flight. Hence, a murder of a passenger or a crew member other than the pilot or the navigator may not constitute the offense.⁷⁵ On the other hand, since the Article requires only “likelihood” to endanger the safety of the aircraft, it may be argued that an attack on a passenger could create panic and hysteria that are possible to endanger the safety of the aircraft in flight. Similarly, attacking a flight attendant could endanger the safety of an aircraft in flight since the flight attendants possess vital skills in cases of emergency.

Can an “act of violence” against a “person” on board an aircraft in flight be carried out through Cyberterrorism? The answer to this question depends on the meaning given to the term “violence.” While there is extensive literature on the meaning of the term “violence” in general philosophical writings, I chose to adhere to the legal interpretations given to it. Violence is usually associated with a physical element, but the physical element can be established in two ways. In the first, as described in Black’s Law Dictionary, the physical element regards the attacker. Violence, according to this view, is referred to as an unjustified use of force.⁷⁶ If we were to adopt this interpretation, than Cyberterrorism would probably be excluded from the scope of Article 1(1)(a), given that the cyberterrorist is not using any physical force.

According to the second possible interpretation, it can be argued that the physical element is attributed not to the perpetrator, but to the victim. Thus, violence is established whenever physical harm was caused to the victim of a certain act.⁷⁷ This view is reflected in the deliberation held at the ICAO Conference. Since cyberterrorism may result in physical damage to persons, for

⁷³ *Id.*, at 284.

⁷⁴ *Id.* See C. S. Thomas & M. J. Kirby, *The Convention for the Suppression of Unlawful Acts against the Safety of Civil Aviation*, 22(1) INT’L & COMP. L.Q. 163, 165 (1973).

⁷⁵ Abramovsky, *supra* note 66, at 285.

⁷⁶ BLACK’S LAW DICTIONARY 1570 (6th ed. 1990).

⁷⁷ ICAO Documents, *supra* note 64, at 139.

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instance by a plane crash or damage to the aircraft's pressure system, cyberterrorism can very well constitute the offense described in Article 1(1)(a). Thus, it is possible that item (a) will apply to a cyberterrorism attack on an aircraft.

(b) Destroying an aircraft in service or causes damage to such an aircraft which renders it incapable of flight or which is likely to endanger its safety in flight

Article 1(1)(b) penalizes acts of sabotage against the aircraft itself. The destruction or damage must occur while the aircraft is "in service," but the particular act which causes the destruction of the aircraft may be performed before the aircraft is "in service."⁷⁸ This further expands the period to which the Convention can be applied. In addition, since the provision does not require causing harm to a person, the offense may be constituted whether or not the aircraft is occupied.⁷⁹ This is not to be taken lightly, as it establishes the applicability of other provisions of the Convention to a case of mere property damage.

Item (b) contains two key elements. First, the action taken by the offender should be "destroying" or "causing damage" to an aircraft in service. Second, that action must result in disabling the aircraft from flying or enabling it to fly but endangering its safety in flight. Much like the term "violence" in item (a), it is likely that the "destruction" and "damage" referred to in item (b) were also intended to include physical destruction or damage. There have been cases in which simple maintenance errors, such as losing screws or cutting wires, have resulted in devastating crashes. These acts can be performed by a terrorist who has access to the aircraft. In order for cyberterrorists to cause such damage, they must take control over computerized systems in the aircraft and through them achieve the same damage as the cutting of a wire. Since this item focuses on the result of the act, rather than on the means achieving those results, the text of Article 1(1)(b) could encompass damage to an aircraft caused by cyberterrorism.

⁷⁸ Thomas & Kirby, *supra* note 74, at 165.

⁷⁹ Abramovsky, *supra* note 66, at 286.

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(c) Places or causes to be placed on an aircraft in service, by any means whatsoever, a device or substance which is likely to destroy that aircraft, or to cause damage to it which renders it incapable of flight, or to cause damage to it which is likely to endanger its safety in flight

Article 1(1)(c) was originally intended to deal with situations in which explosives or other incendiary devices are placed on board an aircraft.⁸⁰ The phrase “Any Means Whatsoever” was originally put in the Article with the purpose to encompass acts such as the use of mails or the airline food storage to place incendiary devices on board an aircraft.⁸¹ A proposal by the delegate of Egypt to replace the former term with the general term “anything” was rejected, and the protocols of the Montreal Conference reveal that “any means whatsoever” was perceived as covering all possibilities.⁸² With respect to this notion, “any means whatsoever” can be interpreted as cyberterrorism.

Can a cyberterrorist place a device or substance on board an aircraft in service that would destroy it or endanger its safety in flight? The answer is probably yes. The computers on board an aircraft are in charge of almost every function in the aircraft, including the most critical ones like igniting the engines, controlling the landing gear. Hence, it is possible that a cyberterrorist would plant software that would disrupt the aircraft’s computer system in one of the ways enumerated in the provision. Thus, it appears that the language of item (c) is applicable to cyberterrorism.

(d) Destroys or damages air navigation facilities or interferes with their operation, if any such act is likely to endanger the safety of aircraft in flight

Article 1(1)(d) includes situations of intentionally committing an act of interference with the operation of aeronautical communications.⁸³ In compliance with Article 28 of the Chicago Convention, “Navigation Facilities” means airport control towers, and radio and meteorological services used in international flights.⁸⁴

Like in item (b), it appears that “destroying” or “damaging” air navigation facilities could be executed through cyberterrorism. Moreover, “interfering with their operation” may also be carried out through cyberterrorism. According to Michael Oron, aircraft engineer and former El-Al

⁸⁰ Abramovsky, *supra* note 66, at 286; Thomas & Kirby, *supra* note 74, at 166.

⁸¹ ICAO Documents, *supra* note 64, at 38.

⁸² *Id.*, at 108.

⁸³ Thomas & Kirby, *supra* note 74, at 166.

⁸⁴ Chicago Convention, *supra* note 54.

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representative at Boeing, the navigation system on board an aircraft was designed to be a closed circuit and independent system. This means that the sensors on the body of the aircraft which measure temperature and altitude could almost never be exposed to foreign disruption.⁸⁵

While this may be a relief to the worry of cyberterrorists attacking those sensors, there are other navigation facilities that are conditional upon communication between ground control computers and the computers on board the aircraft. It is also important to note that item (d) sets the threshold at only likelihood to endanger the safety of an aircraft in flight. Taking this into consideration, it is possible to think of a computer interference with the line of communication between the ground and the aircraft. This could be carried out in a way that would interfere with the operation of the navigation facilities thus endangering the safety of the flight or through interference with the ground facilities directing the aircraft to landing or take off. This scenario is closely related to the following item (e).

(e) Communicates information which he knows to be false, thereby endangering the safety of an aircraft in flight

Article 1(1)(e) covers situations in which a person who himself is not on board an aircraft exercises control over the craft. According to the observer of the International Federation of Airline Pilots Associations at the Montreal Conference, such acts may be used to divert the aircraft to an aerodrome located in an area in which no maps were on board.⁸⁶ The safety of an aircraft in flight could be seriously endangered by such acts. This item also covers bomb hoax situations. In this sense, the requirement of knowledge eliminates cases where the false information was given in good faith.⁸⁷

Using the phrase “communicate” makes the offense in item (e) applicable to cyberterrorism. When originally drafted, the scenario associated with item (e) was that of a vocal transmission between the ground and the aircraft, but in today’s high-technological world, the transmission could be between the computers on the ground directly to the computers on board the aircraft. According to Amir Cohen,⁸⁸ an expert on communication systems, the communication systems of aircrafts are shifting from voice-based-

⁸⁵ Interview with Michael Oron, aircraft engineer and former El-Al representative at Boeing.

⁸⁶ Chicago Convention, *supra* note 64, at 42.

⁸⁷ Abramovsky, *supra* note 66, at 286.

⁸⁸ Amir Cohen is the C.E.O. of SigNext Wireless Ltd., a leading company in the design and development of innovative wireless communication system based on space diversity multiple access technology.

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communication to data-communication. This shift greatly contributes to flight safety and enables ground control to monitor the aircraft activities more accurately in real-time. Nevertheless, this wireless communication between the aircraft computer systems and the ground control creates vulnerabilities and exposes it to cyberterrorism, just like any other computer communication system.

In 1988 a Supplementary Protocol to the Montreal Convention (the Protocol) was adopted.⁸⁹ The Protocol expands the scope of the Montreal Convention by constituting two additional offenses:

1. Any person commits an offence if he unlawfully and intentionally, using any device, substance or weapon:
 - (a) Performs an act of violence against a person at an airport serving international civil aviation which causes or is likely to cause serious injury or death; or
 - (b) Destroys or seriously damages the facilities of an airport serving international civil aviation or aircraft not in service located thereon or disrupts the services of the airport,

If such an act endangers or is likely to endanger safety at that airport.

With respect to item (a), it seems that it is possible that it will apply to cyberterrorism.⁹⁰ In addition, item (b) could probably also apply to cyberterrorism. The terms “destroy” and “damage” were discussed at length previously, and so I will concentrate on the phrase “disrupting the services of the airport.” It is conceivable that this term could also be executed through cyberterrorism. Any computer activity that interferes with the standard operation of the computer systems in the airport could comply with this requirement of the offense.

In conclusion, the Montreal Convention and the Supplementary Protocol constitute provisions relating to seven international offenses regarding the field of aviation security. If in the future cyberterrorists would attack aircrafts or airports, any of those seven offenses could be applicable.

⁸⁹ See Conventions, *supra* note 14.

⁹⁰ For the discussion on the interpretation of the term “Act of Violence” and its relation to Cyberterrorism *see id.*

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Nevertheless, their application is dependent upon the interpretation of terms such as “violence” and “destroys,” in a way that can be countered by good arguments claiming for the literal meaning of the text. Furthermore, while these offenses seem to cover a wide range of possible cyberterrorist attacks, the lack of a clear and general prohibition on using computerized infrastructures for executing terrorist acts leaves a gap for cyberterrorism attacks that could not be covered by the abovementioned offenses.

C. Case-Study #2: The Convention for the Suppression of Terrorist Bombings, 1997

On June 25, 1996, a terrorist truck bomb exploded outside the northern perimeter of a military compound housing American and Allied forces in Khobar Towers, Dhahran, Saudi Arabia. The attack resulted in nineteen fatalities and hundreds of wounded. The perpetrators escaped, and no group or individual claimed responsibility for the bombing.⁹¹

The method of using bombs in terrorist attacks became frequent long before the Dhahran attack. Some scholars have commented that this form of terrorism proved itself to be quite efficient in comparison to former methods.⁹² All through the 1970's and the 1980's terrorist groups such as the Irish Republican Army and ETA used car-bombs to generate destruction. According to the Terrorism Research Center, since 1960 there have been over 4,000 bombing attacks throughout the world. These include small local bombs with little to no injuries, as well as large bomb attacks such as the one against the Israeli embassy in Buenos Aires in March 1992, or the Oklahoma City bombing against an American federal building office complex in April 1995.⁹³

Nonetheless, unlike prior terrorist bombing attacks, the Dhahran bombing attack had an imperative impact on the international community's response to such terrorist bombings. After the attack, the U.S. military and intelligence community were heavily criticized for a lack of foresight that was considered an intelligence failure that could have been avoided.⁹⁴ Even more profound was the observation by U.S. officials that the attack was not an

⁹¹ "Massive bomb rocks U.S. military complex", report by CNN, Jun. 26, 1996, available at <http://www.cnn.com/WORLD/9606/25/saudi.explosion>.

⁹² Robert A. Pape, *The Strategic Logic of Suicide Terrorism*, 97(3) AM. POL. SCI. REV. 343-361 (2003).

⁹³ See <http://www.terrorism.com>.

⁹⁴ Douglas Jehl, *Fatal Lapses – A Special Report: How U.S. Missteps and Delay Opened Door to Saudi Blast*, N.Y. TIMES, Jul. 7, 1996.

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isolated case, but rather it was a part of an escalating global jihad ideology.⁹⁵

One month after the Dhahran bombing attack, on late July 1996, the Group of Seven Major Industrialized countries (also known as the “G7”) and the Russian Federation, met in Paris. At that conference the ministries of justice accepted an American proposal to develop a new international instrument on terrorist bombings.⁹⁶ It is a common view that the Dhahran bombing was the trigger for this initiative.⁹⁷ Shortly after, the UN established an Ad Hoc working group of the Sixth Committee on the subject. The working group based its work primarily on a draft of the convention submitted by France on behalf of the G7.⁹⁸

The Working Group drafted a Convention for the Suppression of Terrorist Bombings (the Bombing Convention). The draft was criticized by developing countries for lacking a clear definition of what “terrorist bombing” is, and was perceived as a tool of the developed countries to gain jurisdiction over political offenses outside their territories.⁹⁹ In spite of these protests, the Convention was adopted by the UN on 15 December 1997 and entered into force on 23 May 2001.

The Bombing Convention prohibits bombing of targets that are certain to cause a large number of civilian casualties.¹⁰⁰ The Convention broadened and strengthened international enforcement and cooperation in cases of international terrorism.¹⁰¹ By requiring member states to outlaw different types of weapons detonations, such as chemical, biological and radiological, the Convention filled a serious gap in the international law regime.¹⁰² The Convention was based on the structure of prior counter-terrorism conventions¹⁰³ and was used as the core text for drafting the Financing Convention, which was

⁹⁵ Toussef M. Ibrahim, *Saudi Rebel are Main Suspects in June Bombing of a U.S. Base*, N.Y. TIMES, Aug. 15, 1996.

⁹⁶ Declaration of the G7 Ministerial Conference on Terrorism, Paris, France, Jul. 30, 1996, ¶ 17.

⁹⁷ Samuel M. Witten, *Current Developments: The International Convention for the Suppression of Terrorist Bombings*, 92(4) AM. J. INT'L L. 774-781 (1998).

⁹⁸ U.N. Ad Hoc Committee on Terrorist Bombing, *Press Release L/2825 1st Meeting, U.N. Ad Hoc Committee on Terrorist Bombing*, Feb. 24, 1997.

⁹⁹ General Assembly, *Report by the Sixth Committee: Summary record of the 30th meeting*, U.N. Doc. A/C.6/52/SR.30 (Dec. 4, 1977).

¹⁰⁰ Bombing Convention, *supra* note 14, § 1. See also Anne-Marie Slaughter & William Burke-White, *An International Constitutional Moment*, 43 HARV. INT'L L.J. 1, 10 (2002).

¹⁰¹ Witten, *supra* note 97, at 781.

¹⁰² Seth Brugger, *International Law, Terrorism, and Weapons of Mass Destruction: Finding and Filling the Gaps*, 57 RUTGERS L. REV. 803, 819 (2005).

¹⁰³ Christopher C. Joyer, *International Extradition and Global Terrorism: Bringing International Criminals to Justice*, 25 LOY. L.A. INT'L & COMP. L. REV. 493, 527 (2003).

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adopted two years later.¹⁰⁴

**The Applicability of the Bombing Convention to a Cyberterrorism
Attack¹⁰⁵**

Article 2 of the Bombing Convention defines the offenses under the scope of the Convention. The Article contains three categories of offenses – an offense committed by the main perpetrator, an attempt to perform the offense, and various forms of accomplices. The following paragraphs will evaluate whether the Bombing Convention could apply in case of Cyberterrorism.

Article 2(1) of the Bombing Convention reads as follows:

Any person commits an offence within the meaning of this Convention if that person unlawfully and intentionally delivers, places, discharges or detonates an explosive or other lethal device in, into or against a place of public use, a State or government facility, a public transportation system or an infrastructure facility:

- (a) With the intent to cause death or serious bodily injury; or
- (b) With the intent to cause extensive destruction of such a place, facility or system, where such destruction results in or is likely to result in major economic loss.

The offenses in Article 2(1) consist of several elements. Since cyberterrorism differs from “physical” terrorism only in terms of the act being performed, and not in the state of mind of the terrorist performing it, the two alternatives regarding the intention of the offender will not be analyzed. A cyberterrorist has the same intentions as a “normal” terrorist and thus there will be no legal difference in attributing intention to either one of them. The discussion below will examine the applicability of the acts described in the Article in a cyberterrorism scenario.

The offense requires that the perpetrator performs one of four physical

¹⁰⁴ Financing Convention, *supra* note 4; Report of the Ad Hoc Committee, *supra* note 15, ¶ 32.

¹⁰⁵ The following interpretation of the Bombing Convention is based on numerous sources. First and foremost, the definition clause set forth in Article 1 of the Convention. As will be elaborated ahead, Article 1 sheds light on some key expressions in the offenses definition. In addition, the interpretation also relied on reports and protocols of the Working Group which drafted the Convention as well as other relevant literature.

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actions— delivers, places, discharges or detonates an explosive or other lethal device”, against one of four locations – “place of public use, a State or government facility, public transportation system or an infrastructure facility.” The application of Section 2(1) to a cyberterrorism attack depends first and foremost on the meaning given to the phrase “explosive or other lethal device.”

According to the definition set forth in Article 1(3), “an explosive or other lethal device” stands for one of two possible interpretations. First, it could mean “*an explosive or incendiary weapon or device that is designed, or has the capability, to cause death, serious bodily injury or substantial material damage.*” A computerized infrastructure would probably fall short from complying with this interpretation. A computer could be used to trigger a bomb, but a computer in itself can not function as a bomb. The only way to cause an explosion associated with computer based infrastructure is to attach an external bomb to it, or to use the computers as the “red buttons” for triggering the detonators.

The second possible interpretation for the aforementioned definition was a later addition to the negotiation of the Working Group, which specifies various forms of materials that their release could endanger the population.¹⁰⁶ According to Article 1(3)(b), “an explosive or other lethal device” could be “*a weapon or device that is designed, or has the capability, to cause death, serious bodily injury or substantial material damage through the release, dissemination or impact of toxic chemicals, biological agents or toxins or similar substances or radiation or radioactive material.*” As opposed to the former interpretation, this definition may very well fit the profile of cyberterrorism.

Computer infrastructures monitor and control the functioning of highly dangerous and sensitive places, among which are nuclear reactors, biological and medical labs and power plants. Computers are in charge of monitoring levels of temperature, moisture, radiation and other data that is crucial to the safety of these facilities. Hence, these computerized systems, these “devices”, could be subject to cyberterrorism and their disruption could lead to “causing death, serious bodily injury or substantial material damage through the release, dissemination or impact of toxic chemicals, biological agents or toxins or similar substances or radiation or radioactive material.” Though designed for the opposite purpose, such computer systems could be viewed as having the capability of causing a large scale disaster.

Having established that “an explosive or other lethal device” could mean computerized infrastructure, can a cyberterrorist “deliver, place, discharge or detonate” it? On the basis of the guidelines in Article 31 of the Vienna

¹⁰⁶ General Assembly, *Report of the Working Group to the Sixth Committee on: Measures to Eliminate International Terrorism*, U.N. Doc. A/C.6/52/L.3, at 36-37 (10 October 1997).

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Convention for the Law of Treaties, the text should be interpreted in light of its purpose. Therefore, it can be argued that disrupting the operation of a computer system in a way that causes dangerous materials to be released is the equivalent of detonating a bomb, or discharging it. Since the computer system is located at the targeted site prior to the attack, the actions of “delivering” and “placing” appear to be irrelevant. This interpretation is acceptable because the purpose of the text is not compromised by addressing cyberterrorism, although it could be countered by arguments supporting the literal approach to treaty interpretation.

The third and last parameter that is noteworthy is the locations category. These represent places where terrorist attacks had typically occurred and where the public would be put at the greatest risk of harm due to such attacks.¹⁰⁷ According to Article 1 of the Convention, all four items refer to physical locations such as public facilities or governmental buildings—¹⁰⁸all locations in which cyberterrorists can execute attacks through “discharging or detonating” an “explosive or other lethal device.”

In conclusion, the Bombing Convention allows a relatively flexible interpretation of the offense set forth in Article 2. Each element of the offense can embody a wide range of meanings, which gives the Convention a maximum coverage. Due to this fact, an offender in the meaning of the Bombing Convention could also be a cyberterrorist who interferes with computer-based systems in a way that generates a release of dangerous substances in or against a public place.

¹⁰⁷ Witten, *supra* note 97, at 776.

¹⁰⁸ Bombing Convention, *supra* note 14, § 1:

"place of public use" means those parts of any building, land, street, waterway or other location that are accessible or open to members of the public, whether continuously, periodically or occasionally, and encompasses any commercial, business, cultural, historical, educational, religious, governmental, entertainment, recreational or similar place that is so accessible or open to the public.

"state or governmental facility" includes any permanent or temporary facility or conveyance that is used or occupied by representatives of a State, members of Government, the legislature or the judiciary or by officials or employees of a State or any other public authority or entity or by employees or officials of an intergovernmental organization in connection with their official duties.

"Public transportation system" means all facilities, conveyances and instrumentalities, whether publicly or privately owned, transportation of persons or cargo."

"Infrastructure Facility" means any publicly or privately owned facility providing or distributing services for the benefit of the public, such as water, sewage, energy, fuel or communications."

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IV. THE FUTURE REGULATION OF COUNTER CYBERTERRORISM

The previous section analyzed the applicability of the two international counter-terrorism conventions to cyberterrorism. The conclusion of this examination was that the current counter-terror regime might apply to a cyberterror attack, but it is not obvious that it will. There is a fair chance that a legal tribunal will prefer a literal interpretation of the counter-terror conventions and in doing so may exclude cyberterrorism from their scope.

This section offers five additional legal regimes for combating cyberterrorism, outside the current conventional regime. These alternatives are the Draft International Comprehensive Convention on Terrorism; the Council of Europe Convention on Cybercrime; a particular convention for the suppression of cyberterrorism; international criminal law as codified in the statute of the International Criminal Court; and Security Council resolutions. As will be illustrated ahead, each one of the abovementioned instruments has its own advantages and deficiencies.

A. Draft International Comprehensive Convention on Terrorism

In 1996, India transmitted to the Secretary General of the UN for consideration by Member States a Draft International Convention on the Suppression of Terrorism (Draft Convention).¹⁰⁹ The Draft Convention proposed by India was revised several times, until the latest draft was published by the Ad-Hoc Committee in 2002.¹¹⁰ In many respects, the Draft Convention is similar to prior conventions.¹¹¹ The improvements the Draft Convention introduces relate to the coverage of *all* acts of terrorism and to a greater extent of prevention and cooperation obligation.

The literature highlights the role of the Draft Convention in strengthening the international community's condemnation of terrorism.¹¹² It places states which sponsor terrorism on a defensive side and assist in the creation of an international customary denunciation of terrorism.¹¹³ In addition, it would complement and guide the work of the Counter Terrorism Committee

¹⁰⁹ Letter dated 01/11/96 from the permanent representative of India to the United Nations addressed to the Secretary General, UN Doc. A/C.6/51/6 (Nov. 1, 1996).

¹¹⁰ Report of the Ad Hoc Committee, *supra* note 15.

¹¹¹ Trahan, *supra* note 36, at 231; Asli U. Bali, *International Law and the Challenge of Terrorism*, 9 J. ISLAMIC L. & CULT. 1, 19 (2004).

¹¹² Report of the Ad Hoc Committee, *Supra* note 15, Annex I.A, ¶ 8.

¹¹³ Matthew Lippman, *The New Terrorism and International Law*, 10 TULSA J. COMP. & INT'L L. 297, 358 (2003).

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established by the Security Council.¹¹⁴

The Draft Convention's potential contribution to the international struggle against terrorism is hampered by two weaknesses, holding back any progress towards its adoption.¹¹⁵ First and foremost, the Draft Convention includes only a limited definition of terrorism.¹¹⁶ For the Draft Convention to truly provide a comprehensive basis to combat international terrorism, it must be applicable to all acts, methods and practices of terrorism wherever and by whoever committed.¹¹⁷ The definitional problem is expressed in two core issues – the execution of terrorist acts during armed conflicts,¹¹⁸ and state-sponsored harboring of terrorists and colluding in terrorist crimes.¹¹⁹

Despite these weaknesses, the Draft Convention is still considered to be a significant step towards unifying international cooperation against terrorism.¹²⁰ The applicability of the Draft Convention to Cyberterrorism is examined with regard to the offense defined in the Draft Convention. However, it should be noted that the preamble to the Draft Convention defines the scope of the Convention so as to address the general category of “acts, methods and practices of terrorism,”¹²¹ thus providing a relatively low threshold enabling interpretation that includes cyberterrorism under the scope of the Draft Convention.

According to the Draft Convention, each state party undertakes to establish the offenses set forth in Article 2 as criminal offenses under its

¹¹⁴ Report of the Ad Hoc Committee, *Supra* note 15, Annex I.A, ¶ 2.

¹¹⁵ Supplementing to the two main weaknesses, concerns were also raised regarding the compatibility of the Draft Convention to the standards of human rights protection. This point requires a complex and in depth debate on the relationship between terrorism and human rights, and because it does not address directly the applicability of the definition in the Draft Convention to cyberterrorism, it overflows the scope of the current examination. See Bruce Broomhall, *State Actors in an International Definition of Terrorism from a Human Rights Perspective*, 36 CASE W. RES. J. INT'L L. 421, 421 (2004).

¹¹⁶ Lippman, *supra* note 113, at 357; Gerhard Hafner, *Certain Issues of the work of the Sixth Committee at the Fifty-Sixth General Assembly*, 97 AM. J. INT'L L. 147, 156 (2003).

¹¹⁷ Malvina Halberstam, *The Evolution of the United Nations Position on Terrorism: from Exempting National Liberation Movements to Criminalizing Terrorism Wherever and by Whomever Committed*, 41 COLUM. J. TRANSNAT'L L. 573, 584 (2003).

¹¹⁸ Trahan, *supra* note 36, at 231; Broomhall, *supra* note 115, at 428.

¹¹⁹ John P. Grant, *Beyond Montreal Convention*, 37 CASE W. RES. J. INT'L L. 453, 471 (2005); Broomhall, *supra* note 115, at 428.

¹²⁰ Lippman, *supra* note 113, at 357-358.

¹²¹ Draft Convention, Report of the Ad-Hoc Committee established by General Assembly resolution 51/210 of December 1996, General Assembly Official Records, fifty-seven session, Supplement no. 37 UN Doc. A/57/37, preamble.

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domestic law.¹²² The Draft Convention also addresses issues of jurisdiction, cooperation between states, prosecution and enforcement measures and more. Article 2(1)(b) provides that:

Any person commits an offence within the meaning of this Convention if that person, by any means, unlawfully and intentionally causes serious damage to public or private property, including a place of public use, a State or government facility, a public transportation system, an infrastructure facility or the environment, when the purpose of the conduct, by its nature or context, is to intimidate a population, or to compel a Government or an International Organization to do or abstain from doing any act.

Article 1(3) defines “infrastructure facility” as:

Any publicly or privately owned facility providing or distributing services for the benefit of the public, such as water, sewerage, energy, fuel, banking, communications, telecommunications and information networks.

The reference in Article 2(1)(b) to “any means” combined with the definition of “infrastructure facility” as including “communications, telecommunications and information networks,” enables the offense set forth in the Draft Convention to apply to cyberterrorism attacks. Its language is wide enough and clear enough to address cyberterrorism directly. The main advantage of this is that there is no need to rely on interpretation methods which could be argued against by those who represent a different school of legal thought.

Using computer-based communications networks qualifies as “any means,” and harming computer-based infrastructure, or an “infrastructure facility” is written in plain English. This leaves little room to argue that cyberterrorism falls short of the Draft Convention’s definition of the offense. Nonetheless, while the Draft Comprehensive Convention offers a definition which can encompass cyberterrorism directly, there are still major issues withholding any progress towards its adoption.

¹²² *Id.*, Article 4.

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B. Regulation through the Council of Europe Convention on Cybercrime

In 2001, the Council of Europe adopted the Convention on Cybercrime¹²³ (Cybercrime Convention). The Cybercrime Convention is the product of four years of work by experts from the Council of Europe, the United States, Canada, Japan and other countries, and it is open for signature for all countries. The Cybercrime Convention's main objective, as set out in the preamble, is to pursue a common and harmonized criminal policy aimed at the protection of society against cybercrime, especially by adopting appropriate legislation and fostering international co-operation.

Although the term "cybercrime" implies crime occurring on the Internet or via the internet, the scope of the Cybercrime Convention goes beyond such crimes and also includes crimes that occur through the use of a computer and crimes that involve computers in general.¹²⁴ For instance, the Cybercrime Convention has been supplemented by an additional protocol making any publication of racist and xenophobic propaganda via computer networks a criminal offense.¹²⁵ Also in this respect, it is worth mentioning that although the substantive law provisions relate to offenses using information technology, the Cybercrime Convention uses technology-neutral language so that the substantive criminal law offenses may be applied to both current and future technologies involved.¹²⁶ This approach has many advantages, and it may prevent the emergence of legal gaps in the future like the one we are facing now concerning cyberterrorism.

The Cybercrime Convention requires states parties to criminalize offenses included therein in their domestic laws. However, the convention was criticized for not including any guidelines detailing the elements required for those offenses, leaving the matter to the discretion of the states parties, thus leading to the creation of a de facto fragmented legal framework instead of fulfilling the purpose of the Cybercrime Convention which was to unify the legal handling of the issue.¹²⁷ The Cybercrime Convention set forth provisions

¹²³ Council of Europe Convention on Cybercrime, Nov. 8, 2001, E.T.S. 185. (hereinafter "Convention on Cybercrime").

¹²⁴ Sara L. Marler, *The Convention on Cyber-Crime: Should the United States Ratify?* 37 NEW ENG. L. REV. 183, 185 (2002).

¹²⁵ Additional Protocol to the Convention on cybercrime, concerning the criminalization of acts of a racist and xenophobic nature committed through computer systems, Jan. 23, 2003, E.T.S. 189.

¹²⁶ Convention on Cybercrime, Explanatory Report. *available at* <http://conventions.coe.int/Treaty/en/Reports/Html/185.htm>

¹²⁷ For instance, Article 4(2) allows Parties to enter a reservation concerning the offense set forth in paragraph (1), in that they may require that the conduct result in serious harm. The interpretation of what constitutes such serious harm is left to domestic legislation. *See also* Shannon L. Hopkins,

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regarding criminal sanctions, jurisdiction, mutual legal assistance and more. Chapter II of the Convention deals with substantive as well as procedural legal issues. Section 1 of Chapter II defines nine offenses divided into four different categories.

All the offenses contained in the Cybercrime Convention must be committed “intentionally” for criminal liability to apply. Thus, a preliminary question should be raised as to whether the *mens rea* of the “cyber-criminal” is different than that of the “cyber-terrorist.” As noted in Chapter 1,¹²⁸ a mere “intention” to commit an attack does not render that attack a terrorist attack. For a terrorist, as opposed to a criminal, it is required that the intention was to use the attack in order to influence policy makers. Therefore it is unclear whether the term “intentionally” in the sense of the Cybercrime Convention also covers that type of intention.

However, if it is assumed that the special intention associated with terrorists could be proved with regard to the term “intention” in the Cybercrime Convention, then most of the various offenses included in the Convention could apply to cyberterrorism. Cyberterrorism attacks could be carried out through illegal access to a computer system without right,¹²⁹ or through the interception of non-public electronic data transfer.¹³⁰ It is also conceivable that infliction of damage to the integrity and proper functioning or the use of stored computer data or computer programs will be part of a cyberterrorist attack.¹³¹ Similarly, the rest of the offenses described in the Cybercrime Convention could also take place during a cyberterrorist attack, namely, the hindering of the functioning of a computer system,¹³² misuse of devices,¹³³ computer-related forgery, and fraud.¹³⁴ Specific offenses regarding child pornography¹³⁵ and intellectual property rights¹³⁶ are less relevant to cyberterrorism activities.

To summarize, the Council of Europe Convention on Cybercrime contains some offenses which could be carried out through cyberterrorism. Nevertheless, the *mens rea* attributed to the perpetrator is merely “intention,” and not the unique intention characterizing terrorism, aiming for consequences

Cybercrime Convention: A Positive Beginning to a Long Road Ahead, 2 J. HIGH TECH. L. 101, 113 (2003).

¹²⁸ *Id.*

¹²⁹ Convention on Cybercrime, *supra* note 123, E.T.S. 185 at § 2.

¹³⁰ *Id.*, at § 3.

¹³¹ *Id.*, at § 4.

¹³² *Id.*, at § 5.

¹³³ *Id.*, at § 6.

¹³⁴ *Id.*, at § 7, 8.

¹³⁵ *Id.*, at § 9.

¹³⁶ *Id.*, at § 10.

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at a policy level, beyond the immediate damage itself. Moreover, the Cybercrime Convention provides only limited coverage. By June 2009 only forty-six states signed the Convention, out of which only twenty-six ratified it. This fact demonstrates how the political will of countries also plays a vital part in determining the effectiveness of legal instruments. Even if the Cybercrime Convention contained a *mens rea* relevant to terrorism, the adherence or lack thereof by states would be the key factor in assessing its value.

C. Sectoral Convention for the Suppression of Cyberterrorism

Already in August 2000 experts from Stanford University published “A Proposal for an International Convention on Cyber Crime and Terrorism” (The Stanford Draft).¹³⁷ The Draft builds upon the Council of Europe Convention on Cybercrime, which was in its final drafting stages. The Stanford Draft proposes to criminalize several conducts, including, *inter alia*, using cyber-systems to execute offenses specified in certain other treaties¹³⁸ and targeting critical infrastructures.¹³⁹ The Stanford Draft also suggests establishing an international agency for information infrastructure protection, a forum for developing standards and practices concerning cyber security.¹⁴⁰

As opposed to the Council of Europe Cybercrime Convention discussed above, the Stanford Draft specifically addresses the correspondence between terrorism and computer communications based infrastructure. It does not concern aspects of cyber acts which may constitute cyber-crimes but not cyberterror. In contrast to the Draft Comprehensive Convention, the Stanford Draft states clearly that it shall not apply to activities related to an ongoing armed conflict.¹⁴¹

Since the Stanford Draft was drafted no further steps were taken towards presenting it before the UN Sixth Committee, and the project did not develop into a more substantive legal work. Theoretically, the Stanford Draft could become the basis to create an international convention for the suppression of cyberterrorism. However, since it was drafted there have been two important advancements which may render such a cyberterrorism convention obsolete.

¹³⁷ Abraham D. Sofaer, Seymour E. Goodman et al., *A Proposal for an International Convention on Cyber Crime and Terrorism*, Hoover Institution, Stanford University (2000).

¹³⁸ Of the counter-terror conventions, Article 3 refers to the following: Tokyo Convention, *supra* note 14; Hague Convention, *supra* note 14; Montreal Convention, *supra* note 14; Hostage Convention, *supra* note 14; Terrorist Bombings Convention, *supra* note 14.

¹³⁹ Convention on Cybercrime, *supra* note 123, E.T.S. 185 at Art. 3.

¹⁴⁰ *Id.* at Art. 12.

¹⁴¹ *Id.* at Art. 20.

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First, while the Stanford Draft remained an academic project, the Council of Europe's Convention on Cybercrime came into force. The latter created a framework that treats many issues that were also raised in the Stanford Draft. This poses a critical question mark before the proponents of the Stanford Draft, as to whether there is a further need to treat numerous issues parallel in both instruments, or is the Cybercrime Convention enough.

Second, the drafting of the Comprehensive Convention is already underway, and, as seen earlier, its definition of offenses could encompass cyberterrorism. Thus, the resources that would be invested into concluding the cyberterrorism convention could be devoted into concluding the comprehensive convention, a generally more practical goal.

On the other hand, an independent counter-cyberterrorism convention could be a perfect tailor-made instrument to deal with cyberterrorism. A separate convention could furnish specific clauses that are designed to address the special features of cyberterrorism. It can establish designated mechanisms and mutual assistance procedures that are relevant to cyberterrorism, but may be excluded from the Comprehensive Convention due to its more general nature. Still, the core obstacle in the way of such a solution is the current lack of an updated draft to present before the Sixth Committee, or any other forum for that matter.

D. Terrorism as an International Crime

On July 1, 2002, the Rome Statute, establishing the International Criminal Court (ICC), entered into force.¹⁴² Terrorism was excluded from the Rome Statute, presumably due to the following grounds: the offense of terrorism was not well defined; some acts of terrorism were not deemed to be sufficiently serious to warrant prosecution by the ICC,¹⁴³ and there was

¹⁴² Rome Statute of the International Criminal Court, Jul. 17, 1998, 2187 U.N.T.S. 90. (hereinafter "Rome Statute"). For a thorough discussion on the International Criminal Court, see: Antonio Cassese, *INTERNATIONAL CRIMINAL LAW* (2008); William Schabas, *AN INTRODUCTION TO THE INTERNATIONAL CRIMINAL COURT* (2004).

¹⁴³ Article 1 of the Rome Statute set forth that:

"An International Criminal Court ("the Court") is hereby established. It shall be a permanent institution and shall have the power to exercise its jurisdiction over persons for the most serious crimes of international concern, as referred to in this Statute, and shall be complementary to national criminal jurisdictions. The jurisdiction and functioning of the Court shall be governed by the provisions of this Statute" (emphasis added).

In addition, Article 5(1) of the Rome Statute set forth that "*The jurisdiction of the Court shall be limited to the most serious crimes of concern to the international community as a whole.*" See

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considerable concern that the inclusion of terrorist crimes in the Statute would politicize the Court.¹⁴⁴

Some scholars believe that the reason terrorism was not included in the Rome Statute was the fact that it was already proscribed under existing conventional arrangements.¹⁴⁵ In my opinion, this last argument is not as strong as the former ones, since genocide was also addressed as early as 1948¹⁴⁶ and it was still reiterated in the Rome Statute. The inclusion of genocide in the statute of the ICC allowed the ICC to have jurisdiction over it, rather than leave it to application of universal jurisdiction by states. Similarly, entrusting the ICC with jurisdiction over terrorism in general and cyberterrorism in particular, would mean including it in the statute.

Whatever the reasons may be, the idea to address terrorism through the Rome Statute was not entirely rejected. A Review Conference, anticipated to be held in early 2010 in Uganda,¹⁴⁷ should consider the crime of terrorism “with a view to arriving at an acceptable definition and its inclusion in the list of crimes within the jurisdiction of the Court.”¹⁴⁸ There are important benefits to be derived from the inclusion of the crime of terrorism in the Rome Statute.¹⁴⁹ It could, for instance, assist states in bringing terrorists to justice, while overcoming domestic weaknesses which prevent them from doing so in local courts; and send a strong political signal about the seriousness with which the international community views international terrorism.¹⁵⁰

The current mandate of the ICC is to hold jurisdiction with respect to four types of international crimes:¹⁵¹ genocide; crimes against humanity, war crimes; and the crime of aggression. With regard to the latter, Article 5(2) of the Rome Statute provides that the ICC will have jurisdiction over the crime of aggression once an agreed definition of that crime is adopted. Since no such definition has yet been adopted, the following discussion will only address the first three categories of international crimes.

Is it possible to include cyberterrorism under the aforementioned

Grant, *supra* note 119, at 465.

¹⁴⁴ Christian Much, *The International Criminal Court (ICC) and Terrorism as an International crime*, 14 MICH. ST. J. INT'L L. 121, 126 (2006).

¹⁴⁵ Grant, *supra* note 119, at 465.

¹⁴⁶ The Convention on the Prevention and Punishment of the Crime of Genocide, Dec. 9, 1948, 78 U.N.T.S. 277.

¹⁴⁷ ICC, *Resolution ICC-ASP/7/Res.2, Adopted at the 7th plenary meeting*, (Nov. 21, 2008).

¹⁴⁸ United Nations Diplomatic Conference of Plenipotentiaries on the Establishment of an International Criminal Court, 15-17 July 1998, UN Doc. A/CONF.183/13 (Vol. I), p. 72.

¹⁴⁹ Much, *supra* note 143, at 134-136.

¹⁵⁰ *Id.*, at 135.

¹⁵¹ Rome Statute, *supra* note 141, § 5.

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crimes? Where genocide is concerned, the answer will probably be that it does not include terrorism, and therefore could not include cyberterrorism as well. This category represents an international offense that has a long history and clear parameters.¹⁵² As to war crimes, it is possible that a systematic and large scale cyber attack against civilian objects could comply with the definition of war crimes as set forth in the Rome Statute.¹⁵³ Although a degree of overlap does exist between humanitarian law and terrorism, the relation between them is not entirely clear. The discussion above regarding the disagreement about whether to include acts of terrorism committed during an armed conflict under the scope of the Draft Convention demonstrates that controversy. As long as it is not clear if acts of terrorism are treated differently in the context of armed conflicts, there is still a long way to go before there is an acceptance in considering terrorism as a war crime.

The idea that the definition of the term “crimes against humanity” contained in the Rome Statute could include terrorism is not new, though not widely accepted.¹⁵⁴ Article 7 of the Rome Statute sets forth a list of acts which, if committed knowingly as part of a widespread or systematic attack directed against any civilian population, are considered crimes against humanity. Cyberterrorism is not suitable to be included in the first ten out of eleven acts enumerated in the Article. Such acts include, *inter alia*, murder, enslavement, deportation, torture and persecution. Those acts, as well as the rest of the acts listed, cannot be carried out through cyberterrorism. Harming communications infrastructure is not on the list. Even sub-article (k), which leaves room for future developments in the words of “other inhumane act” sets a high threshold for such inhumane acts to constitute crimes against humanity. It clearly states that the inhumane acts should be “of a similar character.” Since cyberterrorism is by its nature different than the aforementioned acts, it will be difficult, if not impossible, to argue that it can be included under sub-Article (k).

To conclude, international criminal law is not helpful as long as there is no clear definition of terrorism as an international crime in the Rome Statute. As seen earlier, terrorism could not be addressed within the current international crimes. It is currently in the hands of the Review Conference to determine whether there will be a change in this respect, or whether terrorism will remain excluded from the Rome Statute.

¹⁵² Grant, *supra* note 119, at 465.

¹⁵³ Rome Statute, *supra* note 141, § 8, in particular section (2)(b)(ii).

¹⁵⁴ Much, *supra* note 143, at 127-129.

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E. Security Council Resolution on the Suppression of Cyberterrorism

The power of the Security Council to adopt legally-binding decisions, vested in it by Article 25 of the UN Charter,¹⁵⁵ is considered a strong and effective implementation tool which has a global application to all members of the UN.¹⁵⁶ In countries where international law is absorbed directly into the domestic legal system (i.e. a monistic system as opposed to a dualistic system), Security Council Resolutions are given the status of binding domestic legislation. A clear example of that is Resolution 1373,¹⁵⁷ which demonstrates the authority of the Security Council to take various obligations from the existing counter-terrorism conventions and apply them to all UN member states, regardless of whether they signed those conventions or not.¹⁵⁸

When considering turning to the Security Council as an avenue to combat cyberterrorism, the issue of legitimacy should also be taken into account. On the one hand, it is an exclusive club of fifteen members that are not accountable to other UN organs.¹⁵⁹ Any one of the permanent five members ("P-5") has the ability to veto any resolution with which it does not agree without needing to provide an explanation, which enhances the political character of the Council.¹⁶⁰ On the other hand, it can react promptly to urgent global threats, especially in cases where international law does not provide an answer.¹⁶¹ It might even be said that in addressing terrorism the traditional law making approach falls short from delivering a genuine counter terrorism regime and that without the interference and pressure by the Security Council the counter terrorism conventions would have been left as dead letters.¹⁶²

Another point that should be raised is the fact that the debate preceding Security Council Resolutions is by and large shorter than the one accompanying

¹⁵⁵ Article 25 sets forth that: "*The Members of the United Nations agree to accept and carry out the decisions of the Security Council in accordance with the present Charter.*"

¹⁵⁶ Trahan, *supra* note 36, at 239. *See also* Payal K. Shah, *Assisting and Empowering Women Facing Natural Disasters: Drawing from Security Council Resolution 1325*, 15(3) COLUM. J. GENDER & L. 711, 716 (2006).

¹⁵⁷ Resolution 1373, *supra* note 18, U.N. Doc. S/RES/1189.

¹⁵⁸ Trahan, *supra* note 36, at 240.

¹⁵⁹ Ian Johnstone, *Legislation and Adjudication in the UN Security Council: Bringing Down the Deliberative Deficit*, 102 AM. J. INT'L L. 275-308 (2008).

¹⁶⁰ Justin S. Gruenberg, *An Analysis of United Nations Security Council Resolution: Are All Countries Treated Equally?*, 41 CASE W. RES. J. INT'L L. 469-511 (2009).

¹⁶¹ Eric Rosand, *The Security Council as "Global Legislator": Ultra Vires or Ultra Innovative?* 28 FORDHAM INT'L L.J. 542, 544 (2005); Shah, *supra* note 156, at 717.

¹⁶² For further elaboration on the role of the Security Council in strengthening the counter terrorism conventions *see* Rosand, *supra* note 160.

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the drafting and adoption of a treaty.¹⁶³ It could take years for states to draft a convention for the suppression of cyberterrorism, and who knows how much time will pass before the Draft Convention will be finalized. A Security Council resolution by itself could be an effective tool in the short run, although it does not have the substance to create a full international counter cyberterrorism instrument. Thus, issues of cardinal importance like those discussed with regard to the Draft Comprehensive Convention could be left unaddressed for the sake of adopting the resolution.

V. CONCLUSION

The international community has a rare and unique opportunity to take a preventive approach and create the legal framework that will make sure the international community is prepared for the “day after” a cyberterror attack. Many leaders of western countries, as well as numerous scholars have already identified cyberterrorism as the next phase in the evolution of terrorism. It is only logical that such a threat should be treated like other manifestations of terrorism have been treated – through a clear and strict prohibition under international law.

Characterized by some distinctive features, cyberterrorism presents international law scholars with the challenge of whether the current counter terrorism regime is sufficient or whether new instruments should be developed. The language of the counter-terrorism conventions which were examined developed along with time. From a relatively narrow terminology in the Montreal Convention the law evolved to include phrases such as “any other device” or “any means” in the Bombing Convention. The latter allows more flexible interpretations of the legal conditions that are to be met in order to establish legal responsibility for cyberterrorists. It is conceivable that these differences stem from the rapid development of modern technologies in the last three decades that led to the understanding among the legal community that terrorism may manifest itself through these technologies. Thus, drafting of conventions became more sensitive to the need to adjust to future developments.

The applicability of these two conventions to cyberterrorism is, as demonstrated, possible. Nevertheless, as long as there is no clear prohibition on any form of use of computer infrastructure for terrorist purposes the analysis suggested above presents just one school of thought. There are other ways interpretations could exclude cyberterrorism from the scope of the abovementioned conventions. Given that my interpretation derives from the text, but is not embedded in the text, it leaves room for opposite claims. For this

¹⁶³ Trahan, *supra* note 36, at 242-243.

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reason it is important to explore the options to explicitly prohibit cyberterrorism. As long as there is no clear cut prohibition on cyberterrorism in all forms and methods, then we are not as prepared to deal with cyberterrorism as we can be.

Creating a direct prohibition on cyberterror can take many forms, as discussed at length in Part IV. There are at least five other possible courses of actions that may be used to target cyberterrorism. Each of these options has advantages, as well as deficiencies, preventing any of them from being an “ultimate” counter cyberterrorism legal instrument. While some of the tools may provide a relatively efficient way, their scope is rather limited. Other tools enjoy a wider coverage but at the same time are not suitable for cyberterrorism.

A combination of the various instruments described may prove to be a better way to address the issue. Such a regime will include a clear prohibition of cyberterrorism via the Draft Comprehensive Convention or through a sectoral convention drafted for this purpose, in addition to an acute Security Council resolution under Chapter VII as well as criminalizing cyberterrorism in the Rome Statute and/or amending the Council of Europe’s Convention on Cybercrime.

This course of action will allow for an expeditious filling of the current gap in international law with respect to cyberterrorism. It would enable the international community to have the direct legal basis to combat it, rather than recourse to treaty interpretation. Moreover, relying on different instruments would contribute to the legitimacy of the regime, as it will aspire to balance the binding Security Council resolution with the ability of states to comply with provisions of other conventions in accordance with the domestic legal system.

While it is left in the hands of computer experts to ensure that data protection programs will combat cyberterrorism on the technological aspect, it is in the hands of international legal experts to make sure that if they fail, and a cyberterror attack is successful, we will have the means to bring the cyberterrorists to justice.

THE GLOBAL FINANCIAL CRISIS AND ITS IMPACT ON INDIA

*K. G. Viswanathan **

I. INTRODUCTION

The world has witnessed several financial crises in the past few decades, such as the OPEC oil crises of the 1970s, the United States Savings and Loan crisis of the 1980s, the prolonged economic downturn in the Japanese economy in the 1990s, the Asian financial crisis in the latter part of the 1990s, and the problems following the crash of the dot com bubble in the early part of the last decade. Each of these events had been accompanied by shocks to the economies of one or more markets or regions and it took several years of concerted economic and regulatory policy adjustments for the affected markets to return to stability. While it is normal for financial crises to occur frequently and the affected economies to recover subsequently, it nevertheless results in economic losses for the countries involved and for the people, businesses and institutions in those countries.

The Global Financial Crisis, which started in 2008, is the latest in the series of economic crises to adversely impact world economies. Unlike the past few crises, the current crisis has not spared any of the countries or market sectors, and has devastated economies that were traditionally strong. While the world is slowly seeing an end to the crisis, it is widely acknowledged that among the financial crisis of the past hundred years, only the Great Depression of the 1930s had a more severe and protracted effect on the world economy compared to the current economic upheaval. What started as an excessively loose monetary policy in the 1990s in major developed economies transformed into global imbalances and a full-blown financial and economic crisis for all the economies of the world.¹ The problems that were first noticed in the US sub-prime mortgage market quickly spilled over into the real estate and banking

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¹ Mohan, Rakesh (2009), "Global Financial Crisis: Causes, Impact, Policy Responses and Lessons", Working Paper 407, Stanford University, Stanford, CA, USA. Taylor, John (2008), "The Financial Crisis and the Policy Responses: An Empirical Analysis of What Went Wrong," Working Paper 14631, *National Bureau of Economic Research*, Washington D.C., USA.

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sectors. From the financial sector, it moved on to the real sector in the US market and then into the international markets. The contagion effect impacted both the advanced economies and the emerging market economies (EME).

II. CAUSES AND MAGNITUDE OF THE CRISIS

Beginning in the 1990s, countries had been following relatively loose monetary policies which continued in the period following the dot com bubble. During this period, the United States faced a growing current account deficit which was financed by capital flows from exporting countries. This global imbalance contributed to the low interest rates in the United States and the resulting real estate asset bubble. In addition, lenders relaxed their standards for mortgage loans and financial innovations allowed them to mask the risk of their portfolios. Beginning in 2004, the United States Federal Reserve Bank started tightening the credit markets by raising interest rates in response to rising inflation, which caused the crisis in the sub-prime mortgage market. This quickly spread to the entire banking sector in the United States and other advanced economies, resulting in the liquidation of several major banks. The banking sector in the advanced economies is estimated to have lost up to \$2.8 trillion between 2007 and 2010. The contagion in the banking sector caused a near shutdown of the credit markets and the United States economy went into a severe recession which was reflected in the securities markets. The crisis was not limited to the United States market – it quickly spread to all other markets, including emerging markets, through both financial channels (i.e., flow of funds) and real channels (i.e., foreign trade).

Table 1 shows the economic indicators for selected markets during 2005-2010. The deterioration in the economic conditions is evident in all the indicators and in all markets. The world economy, represented by the change in Gross Domestic Product (GDP), was growing at a healthy rate of about 5% from 2005 to 2007. In 2008, the year when the financial crisis started, the GDP grew at a rate of only 3%. In 2009, when the crisis was at its peak, the world economy contracted by 0.8%. For 2010, the growth rate is projected to be 3.10%, well below the average growth rate that existed prior to the crisis. Similar trends are evident in all the markets shown in the table. The advanced economies, including United States, United Kingdom and Germany, were growing steadily prior to the crisis, but deteriorated significantly in 2008 and 2009. These economies are projected to grow in 2010, but at a very small rate. The emerging economies as a group and developing Asian countries were growing at impressive rates in the years leading up to the financial crisis, but the growth rates were curtailed in the subsequent periods. Although they are projected to grow faster than the advanced economies in the next few years, it

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will be some time before they can match the growth rates they had prior to the crisis.

Table 1. Economic Indicators for Selected Markets: 2005-2010

	2005	2006	2007	2008	2009 ^s	2010 ^e
GDP (annual % change)						
World	4.48	5.09	5.17	3.00	-0.80	3.10
Advanced economies	2.63	2.99	2.72	0.56	-3.20	1.32
Emerging and developing economies	7.09	7.94	8.31	5.99	2.10	5.08
Developing Asia	9.03	9.83	10.59	7.50	6.50	7.35
Germany	0.73	3.18	2.52	1.25	-4.80	0.34
United Kingdom	2.17	2.85	2.56	0.74	-4.80	0.91
United States	3.05	2.67	2.14	0.44	-2.50	1.52
Current Account Balance (% of GDP)						
Advanced economies	-1.18	-1.26	-0.92	-1.26	-0.66	-0.40
Emerging and developing economies	4.18	5.20	4.30	3.88	2.02	2.84
Developing Asia	4.16	6.09	7.03	5.90	4.99	5.24
Germany	5.15	6.13	7.52	6.41	2.91	3.61
United Kingdom	-2.62	-3.31	-2.70	-1.73	-2.04	-1.95
United States	-5.92	-6.00	-5.16	-4.89	-2.59	-2.21
Unemployment (% of total labor force)						
Advanced economies	6.20	5.79	5.40	5.80	8.20	9.29
Germany	10.62	9.83	8.38	7.40	8.02	10.69
United Kingdom	4.79	5.39	5.40	5.55	7.65	9.33
United States	5.08	4.62	4.63	5.81	9.26	10.15
Trade Volume of Goods and Services (annual % change)						
World	7.80	9.10	7.33	2.95	-12.30	2.47

Source: International Monetary Fund. World – *World Economic Outlook Database*, October 2009, January 2010.

^s GDP and Trade Volume are actual values; Current Account Balance and Unemployment are IMF estimates as of October 2009.

^e IMF estimates.

The volume of trade in goods and services across the world was

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significantly affected by the crisis. It was growing at a rate of 9.1% in 2006. It fell to 2.95% in 2008, and shrank by 12.30% in 2009. Contraction in trade volume across countries can exacerbate global imbalances and cause financial distress in firms that depend on international trade for selling their output and for sourcing their resources. This is also reflected in the unemployment numbers reported for the different markets. The unemployment rate for the advanced economies was projected to rise to 8.20% in 2009, and 9.29% in 2010. Such high unemployment rates for protracted periods in the US and the UK are unprecedented in the post-world war period. The unemployment rates among EMEs (not shown in Table 1) also deteriorated, but to a lesser extent. For example, the unemployment rate for India increased from 10.4% to 10.7% between 2008 and 2009. In China and Russia, the corresponding increases were from 4.2% to 4.3% and 6.5% to 8.9%, respectively.² The current account balance expressed as a percentage of the GDP shows that while EMEs, developing Asian countries and some advanced economies, such as Germany, continue to be positive, it remains negative for United States, United Kingdom and other advanced economies.

III. IMPACT OF THE CRISIS ON EMERGING MARKETS

Several emerging market economies were severely impacted by the financial crisis that originated in the advanced economies. Nanto claims that the impact of the crisis on EMEs was more severe than that of the Asian financial crisis of 1997-98 and the Latin American crisis of 2001-02.³ EMEs had been growing at very high rates prior to the crisis. They were able to finance their growth by borrowing in global capital markets, and by exporting a growing part of their output to the advanced economies. This made them very vulnerable to the availability of credit and the demand for their output. When the crisis started and a severe credit crunch ensued in the advanced economies, it became difficult for the EMEs to continue to finance their foreign debt. Eventually, the liquidity crisis transferred from the advanced economies to the domestic sector of the EMEs and many of them had problems borrowing in the domestic capital markets. In addition to causing a liquidity crisis in the EMEs, the financial crisis had adverse effects in the real sectors in all of them. As the advanced economies contracted, the EMEs experienced a decline in the growth of their exports. Export revenues are a significant component of the GDP of EMEs and

² The computation procedures of unemployment rates differ across countries and levels cannot be meaningfully compared to one another.

³ Nanto, Dick (2009), "The Global Financial Crisis: Analysis and Policy Implications", *Congressional Research Service* 7-5700.

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a slowing down of the exports led to socio-economic problems in the affected countries.⁴

Previously, it was assumed that EMEs had sufficiently decoupled from the rest of the world and that they could withstand downturns in the advanced economies. But the events of the last two years have shown that EMEs and developing countries are still linked to the advanced economies of the world, albeit to a lesser extent compared to the economic interdependence among the more advanced economies. Dooley and Hutchinson find that while the emerging markets were decoupled from the US at the beginning of the crisis and were sufficiently insulated, the economic and financial linkages reappeared subsequently and adversely affected them in both the real and financial sectors.⁵ Following the Asian financial crisis of 1997-98, many EMEs had accumulated foreign reserves to withstand any pressure on their currencies.⁶ In the second half of 2008, many of them drew down their reserves to protect their currencies and to dampen the contagion effects of the crisis.⁷ But, this did not prevent the financial crisis from spreading from the advanced economies to the EMEs.

IV. GLOBAL RESPONSE TO THE CRISIS

In response to the shocks caused by the crisis, world economies have been adopting reforms to their economic policies and have implemented several fiscal and monetary stimulus initiatives to recover from the crisis. Some of these initiatives include tax rebates and tax cuts at both the corporate level to spur investment, and at the personal level to increase consumption and to bail out households with diminished wealth and income. Other initiatives provide incentives to invest in infrastructure and public works projects. Though difficult to measure accurately, Saha and Weizsacker estimate the size of the stimulus package for the European Union for 2009 at 0.9% of the GDP, while the corresponding figures for the United States and China are 2% and 7.1%, respectively.⁸ Nanto estimates the size of the stimulus package in Japan at

⁴ Ghosh, Jayati (2009), "Global Crisis and the Indian Economy", in *Global Financial Crisis: Impact on India's Poor*, United Nations Development Programme (India).

⁵ Dooley, Michael and Michael Hutchinson (2009), "Transmission of the U.S. Subprime Crisis to Emerging Markets: Evidence on the Decoupling-Recoupling Hypothesis", *Journal of International Money and Finance*, Volume 28, pp. 1331-1349.

⁶ For example, the foreign reserves holding of India in June of 2008 was over \$312 billion. The corresponding amount for China in September of 2008 was \$585 billion.

⁷ The *Wall Street Journal* reported that Brazil, Russia, India and Mexico used \$75 billion of their foreign reserves in October of 2008 to support their currencies. *Wall Street Journal* (2008), "Currency-Price Swings Disrupt Global Markets", October 25, 2008.

⁸ Saha, David and Jakob von Weizsacker (2009), "Estimating the Size of the European Stimulus

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about 5% of its GDP in 2009.⁹ In addition to the fiscal stimulus initiatives, many countries adopted a more accommodative monetary policy to ease the liquidity tightening in the credit markets.¹⁰

While most of the economic indicators portended a bleak outlook for the world economy and for individual markets, the severity of the crisis in the affected countries and their responses to tackle the problems were not uniform. While the advanced economies either contracted or had no growth during the crisis, the emerging market economies continued to grow, although at a lower rate. The impacts of the crisis on the financial and real sectors of the economy were also not uniform across the countries. While some economies that were structurally strong were able to better withstand the crisis, others had to be bailed out with extensive and multiple stimulus packages to overcome the adverse effects on the domestic economies. The consensus opinion is that countries that curtailed the use of risky assets and encouraged domestic investment and savings were less affected by the crisis. The countries that did not adequately penalize risky behavior and those that had high rates of consumption were more severely affected.

One of the EMEs that performed relatively well during the financial crisis and recovered quickly from its effects was India. The strength of the economy, the structure of regulation in the financial markets, and the timely and appropriate responses to the financial crisis by the monetary authorities in India allowed the country to contain the adverse effects of the crisis and continue on the expansionary path it was on prior to the crisis. In the following sections, the impact of the financial crisis on the Indian economy and some of the strategies adopted by it to manage the crisis are detailed.

V. IMPACT OF THE CRISIS ON INDIA

A. Indian Economy prior to the Crisis

In 1991, India started implementing a policy of economic liberalization, which has been opening up the Indian market to the outside world in different areas. Over the last nineteen years, the country has witnessed

Packages for 2009: An Update”, *Bruegel Policy Contribution*, Issue 2009/02, April.

⁹ Nanto, Dick (2009), “The Global Financial Crisis: Analysis and Policy Implications”, *Congressional Research Service* 7-5700.

¹⁰ For example, OECD estimates that the net effect of the fiscal and monetary policy initiatives in the US amounts to about 5.6% of the 2008 US GDP, and the corresponding number for OECD countries is 3.3%.

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dramatic changes in economic policy and market regulation which has made it one of the fastest growing economies among emerging markets. The bilateral trade with the rest of the world has grown significantly during this period and is now a significant component of the GDP. A major part of the export revenues is in the Information Technology and Textiles sectors. The liberalization policy has attracted growing foreign direct investments (FDI) in the various industry sectors and portfolio investments in the Indian capital markets.¹¹ Regulatory reforms introduced in the capital markets have increased transparency which helped attract portfolio investments from foreign investors. Meanwhile, in the domestic market, the market reforms allowed the private sector to successfully challenge the dominance of the state-owned and state-sponsored business organizations. In a recent study using various operating and financial performance measures, Viswanathan finds that the private sector firms in India, which include family-owned and non-family-owned firms, have outperformed state-owned firms since the implementation of the economic liberalization policies.¹² Banking reforms have ensured continued access to credit and capital for household consumption and for businesses.

The macroeconomic and financial indicators predominantly pointed to a strong and vibrant Indian economy prior to the financial crisis. Table 2 presents selected macroeconomic and financial indicators for India for 2004 to 2009.¹³ The GDP was growing at the rate of 7.5%, 9.5%, 9.7% and 9%, respectively, for the four years leading up to the crisis. The original consensus estimate for 2008-09 was also around 9%. The impressive growth in the Indian economy is further validated by the growth rates in industrial production which ranged from 8.2% to 11.5% over the four years. The optimism in the economy was reflected in the stock markets. The Bombay Stock Exchange (BSE) Index representing 30 large companies in India increased by 16.1%, 73.7%, 15.9% and 19.7%, respectively, during the same period. The average inflation (computed using the Wholesale Price Index) during this period was a manageable 5.2%.¹⁴

¹¹ Foreign portfolio investment in India is primarily conducted by Foreign Institutional Investors (FII); the foreign individual investor market is practically non-existent.

¹² Viswanathan (2009), "Financial and Operating Performance of State-Owned, Family-Owned and Publicly-Owned Firms in India", Paper presented at Seventh Annual AIMS Conference, Bangalore, India, December 2009.

¹³ The fiscal year for India starts in April and ends in the following March. The first four columns in Table 2 cover the period leading up to the global financial crisis. The last column shows the values for the indicators during the crisis.

¹⁴ Although high by the standards of industrialized countries, this range of inflation is normal for emerging markets.

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Table 2. Selected Macroeconomic and Financial Indicators for India: 2004-2009

Item	2004-05	2005-06	2006-07	2007-08	2008-09
GDP (Annual % change)	7.5	9.5	9.7	9.0	6.7
Industrial Production (Annual % change)	8.4	8.2	11.5	8.5	2.7
BSE Index (Annual % change)	16.1	73.7	15.9	19.7	-37.9
Inflation (% change)	6.4	4.4	5.4	4.7	8.3
Export Growth (Annual % change)	28.5	23.4	22.6	28.9	5.4
Export/GDP (%)	12.1	13.0	14.1	14.2	15.1
Foreign Reserves (US \$ Billions)	141.5	151.6	199.1	309.7	252.0
Current Account (% of GDP)	-0.4	-1.2	-1.1	-1.5	-2.6
External Debt (US \$ Billions)	133.0	138.1	171.3	224.6	229.9
Foreign Debt-GDP Ratio (%)	18.5	17.2	18.1	19.0	22.0

Source: Compiled from various tables in Reserve Bank of India 2009 Annual Report and Central Statistical Organization database

Note: The fiscal calendar year for India starts in April and ends in March of the following year.

A significant component of the growth in the Indian economy was the export sector. In the four years leading up to the crisis, India's exports grew by more than 22% each year, averaging 25.8% during that period. The significance of the external trade to the economy is further evidenced by the increasing contribution of exports to the GDP each year. The exports, as a percentage of GDP, increased each year, from 12.1% in 2004-05 to 14.2% in 2007-08. At the same time, India was building its foreign reserves, which increased from \$141.5 billion in 2004-05 to \$309.7 billion in 2007-08. However, the current account, as a percentage of GDP, was negative and growing in size – from -0.4% in 2004-05 to -1.5% in 2007-08. Finally, Table 2 also shows that India was increasingly financing its growth by borrowing in the external markets. External debt increased from \$133 billion to \$224.6 billion, a 69% change over the four year period. As a percentage of GDP, foreign debt was close to 20%.

B. Indian Economy during the Crisis

Dooley and Hutchinson has identified that prior to May 2008, the EMEs were insulated from the financial crisis that had been severely affecting

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the industrialized countries for more than sixteen months.¹⁵ The decoupling of the EMEs from the advanced economies broke down in May 2008 as the crisis spread to the rest of the global economy. This is apparent in the case of India, as evidenced by the deterioration of all the macroeconomic and financial indicators in 2008-09. Industrial production increased by 2.7%, a significant drop from the 9.2% average growth in the previous four years. This contributed to the economy growing at only 6.7%. The BSE Index, which had been rising over a protracted period, lost 37.9% of its value, adversely affecting household wealth and the ability of businesses raising money in the capital market. At the same time, rising commodity prices in world markets contributed to a sharp increase in inflation rates. As the advanced economies started growing at slower rates and in some cases contracted, India's bilateral trade stagnated in 2008-09, with exports growing at only 5.4% and current account deficit increasing to 2.6%. The tightening in the credit markets in advanced economies made it more difficult for Indian businesses to continue borrowing in external markets. The size of the external debt did not change much from 2007-08 to 2008-09. In fact, the Indian Rupee had depreciated against many of the major foreign currencies and the debt service cost was rising. To rectify the problem, India intervened in the foreign exchange market to support its currency using its foreign reserves, which declined from US\$ 309.7 billion in 2007-08 to US\$ 252 billion in 2008-09.

C. Transmission of the Crisis to the Indian Economy

The global financial crisis which originated in the advanced economies, spread to India and other EMEs through financial and real channels. Given the strength of its economy, India should have been able to withstand the adverse effects of the financial crisis and avoid any serious and long-term consequences to its economic growth. However, its increasing dependence on bilateral trade with other countries and on financing from external markets makes it vulnerable to economic shocks in the global economy. Although India was not immune to the contagion effects of the global financial crisis, it was one of the few countries to recover quickly from the slowdown in the economy and appears to be back on the growth trajectory it was on prior to the crisis. In its latest report, IMF estimates that India's GDP will grow by 7.7% in 2010 and by 7.8% in 2011.¹⁶ This compares very favorably with IMF's estimates for the

¹⁵ Dooley, Michael and Michael Hutchinson (2009), "Transmission of the U.S. Subprime Crisis to Emerging Markets: Evidence on the Decoupling-Recoupling Hypothesis", *Journal of International Money and Finance*, Volume 28, pp. 1331-1349.

¹⁶ International Monetary Fund, World Economic Outlook Update, January 26, 2010.

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world output to grow by 3.9% in 2010 and 4.3% in 2011. To understand India's response to the crisis and the resiliency of the Indian economy, it is helpful to analyze the channels through which the real and financial shocks are transmitted from the advanced economies to India.

The contagion effects of the financial crisis spread from the advanced economies to the Indian market in three distinct channels – the financial channel, the real or trade channel, and the confidence channel.¹⁷

1. Financial Channel

The losses in the subprime mortgage markets in the US and the consequent exposure on the part of the banking sector in the advanced economies resulted in a liquidity crisis. The heightened risk aversion on the part of investors resulted in a credit crunch which directly impacted the financial markets in India in three ways. First, the ability of Indian businesses to use the external markets to finance their operations was severely curtailed by the credit crunch in global markets. As shown in Table 2, the size of the external debt, which had increased by 69% over the previous four years, remained stagnant in 2008-09. Funds raised through American Depositary Receipts and Global Depositary Receipts in 2008-09 had dropped by 63% from the previous year.¹⁸ This was exacerbated by the fact that the cost of borrowing funds in the domestic markets had also spiked. Gupta reports that the call money rates in October of 2008 was above 20%, and that credit default spreads for some Indian banks increased suddenly, indicating a greater degree of risk aversion on the part of the investors.¹⁹ Second, businesses with existing foreign debt started borrowing in the domestic market to meet debt service payments in foreign currencies. This caused a sharp depreciation in the value of the Indian Rupee, which made the debt service burden even larger. To support its currency, India intervened in the foreign exchange markets, which resulted in a decline of foreign reserves from US\$ 309.7 billion in 2007-08 to US\$ 252 billion in 2008-09. The third way in which the financial markets were affected by the global liquidity crisis was through the reduction in capital flows in the equity markets. Table 3 shows the flow of external funds in India for 2000 to

¹⁷ Subbarao, Duvvuri (2009), "Impact of the Global Financial Crisis on India – Collateral Damage and Response," Speech delivered at the Symposium on *'The Global Economic Crisis and Challenges for the Asian Economy in a Changing World'*, Institute for International Monetary Affairs, 18 February 2009.

¹⁸ As reported in the Reserve Bank of India Annual Report, 2009.

¹⁹ Gupta, Abhijit (2009), "India's Tryst with the Global Financial Crisis", *Review of Market Integration*, Volume 1, Number 2, pp. 171-197.

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2010. During this ten year period, the foreign direct investment into India had been increasing and remained strong even during the crisis. The size of the FDI was US\$ 4 billion in 2000-01. By 2008-09, it had grown into US\$35 billion. This segment of the capital flows was not affected by the liquidity crisis. However, the net Foreign Institutional Investment, which had been growing from US\$ 1.847 billion in 2000-01 to US\$ 20.328 billion in 2007-08, suddenly became a deficit in 2008-09. In that year, foreign investors withdrew a net amount of US\$ 15.017 billion from the equity markets in India. This was a reflection of the heightened risk aversion on the part of the investors, and the liquidity crunch in the credit markets. The result was a decline in the equity prices in India – the BSE Index lost 37.94% in 2008-09, after posting gains in each of the previous six years.

Table 3. Flow of External Funds in India: 2000 – 2010

	Fiscal Year									
	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10*
Foreign Direct Investment (US\$ millions)	4029	6130	5035	4322	6051	8961	22826	34835	35180	26506
Growth in FDI (% change from year to year)	+87	+52	-18	-14	+40	+48	+146	+53	+1	0 ^p
Net Foreign Institutional Investment (in US\$ millions)	1847	1505	377	10918	8686	9926	3225	20328	15017	20518

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Change in BSE Sensex Index(% change from year to year)	-27.9	-3.7	-12.1	+83.37	+16.13	+73.73	+15.89	+19.68	37.94	+79.88
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Source: Securities and Exchange Board of India (SEBI) Annual Reports, SEBI Handbook of Statistics, and Reserve Bank of India Annual Report

Note: The fiscal calendar year in India starts in April and ends in March of the following year

* 2009-2010 fiscal year data is for the period ending in December 2009.

^P Computed using prorated FDI based on the first nine months of the fiscal year.

Despite the negative impact of the liquidity crisis on its financial markets, India was able to contain the effects and implement a quick recovery, as shown in the Table 3. The net Foreign Institutional Investment for the first three quarters of 2009-10 has exceeded that of any of the prior fiscal years. As noted previously, IMF estimates the growth rates in GDP and industrial production to rebound in the near future to levels that existed prior to the crisis. The optimism in the Indian economy is also reflected in the BSE Index, which rose by 79.88% in the first three quarters of the last fiscal year.

Several factors contributed to the quick recovery of the financial markets in India. Although the economic liberalization policies were initiated in 1991, the transformations in the markets have been implemented cautiously, and the markets are still highly regulated relative to the standards of advanced economies. Stringent regulation of banks has limited their exposure to complex derivatives and off-balance sheet activities. The exposure of the banks in India to the United States subprime mortgage and credit default swaps markets was negligible and indirect.²⁰ Further, the share of bank assets held by foreign banks in India is only 5%, one of the lowest among all EMEs, which limits the transmission of the crisis through the banking sector. This contrasts with the high foreign ownership of bank assets in East European and Latin American EMEs, which made them more vulnerable to contagion effects. The banks in India were also prudent in their lending practices in the real estate sector.

²⁰ Although Lehman Brothers had 14 offices in India, its operations did not materially affect the banking sector. Only ICICI Bank had some exposure to the US subprime mortgage market, but it was able to absorb the losses due to its strong capitalization.

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Unlike in the United States, subprime mortgages are non-existent in India and the mortgage loans generally have shorter maturities. In response to the crisis, the Reserve Bank of India had raised the capital adequacy ratio from 8% to 9% for existing banks, and to 10% for new private sector banks and banks undertaking insurance business. This exceeds the 8% requirement imposed by Basel II on commercial banks. Table 4 shows selected monetary policy measures in India for 2000-10.

Table 4. Selected Monetary Policy Measures in India: 2000 – 2010
Fiscal Year

	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10*
Gross Domestic Savings (% of GDP)	23.5	23.4	26.1	28.1	31.7	34.2	35.7	37.7	na	na
Capital Adequacy Ratio (% capital to assets)	11.4	12.0	12.7	12.9	12.8	12.3	12.4	13.1	na	na
Net Nonperforming Assets Of Commercial Banks (% of assets)	2.5	2.3	1.8	1.2	0.9	0.7	0.6	0.6	na	na
Net Nonperforming Assets Of Public Sector Banks (% of assets)	2.7	2.4	1.9	1.3	1.0	0.7	0.6	0.6	na	na
Gross Fiscal Deficit (% of GDP)	5.65	6.19	5.91	4.48	3.99	4.08	3.45	2.69	6.14	6.85
Call Money Rate (%)	9.15	7.16	5.89	4.62	4.65	5.60	7.22	6.07	7.06	3.22

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Cash Reserve Ratio (CRR) (%)	8.0	5.5	4.75	4.5	5.0	5.0	6.5	7.5	5.0	5.0
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Source: Securities and Exchange Board of India (SEBI) Annual Reports, SEBI Handbook of Statistics, and Reserve Bank of India Annual Report.

Note: The fiscal calendar year in India starts in April and ends in March of the following year.

* 2009-2010 fiscal year data is for the period ending in December 2009.

The capital adequacy ratio (that is, the capital as a percentage of the risk-weighted assets of the bank) had been rising steadily from 11.4% in 2000-01 to 13.1% in 2007-08. Further, all 79 commercial banks in 2007-08 surpassed the 9% requirement, and 56 of them had capital adequacy ratios that exceeded 12%. The net nonperforming assets as a percentage of all assets, which is an indication of problem loans in the asset portfolio, of both commercial banks and public sector (or government sponsored) banks have been declining in each year from 2000-01 to 2007-08. For both groups of banks, this ratio had dropped to 0.6% in 2007-08, which is less than one-fourth of that in 2000-01. The gross domestic savings rate as a percentage of the GDP has also been rising from 23.5% in 2000-01 to 37.7% in 2007-08, which again, contributed to the investment component of the India's economic output. Lastly, the direct participation of households and retirement portfolios in the equity markets was relatively small. Most of the household wealth and pension funds were invested in fixed income and secured investments. Consequently, the sharp decline in the equity markets in 2008-09 did not result in significant losses in household wealth. Although the real estate market did stagnate for some time, it has since recovered and has been growing.

2. Trade Channel

The effects of the crisis in the real sector of the Indian economy were transmitted through the external trade channels, that is, exports and imports. Although India's exports are a relatively small fraction of the GDP (15.1% in 2008-09), it had been growing steadily since 2004-05 (Table 2). The two-way trade (sum of exports and imports) as a fraction of the GDP was about 34% in 2008-09. As shown in Table 1, in Section II, the global volume of trade in goods and services declined by 12.30% in 2009. The advanced economies' imports did not grow in 2008 and declined sharply in 2009. Gupta reports that India's exports in the second half of 2008-09 shrunk by 15% mainly due to the economic contraction in its trading partners and partly due to the threats of

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protectionism.²¹ Specifically, export oriented sectors, such as textiles, gems and jewelry, leather, chemicals and information technology, experienced declines in export growth. Software and IT enabled services, whose exports to the United States accounted for 60% of its total exports, witnessed revenue declines as United States firms cut back on their purchases from India. At the same time when its exports were declining, India's imports were rising, primarily due to higher prices for oil, fertilizers and other commodities. Inflation (measured by wholesale price index) had been falling from 6.4% in 2004-05 to 4.7% in 2007-08 (Table 2). In 2008-09, due to higher commodity prices, it climbed steeply to 8.3%, affecting sales and profit margins of businesses. The declining exports and rising imports resulted in a larger current account deficit in 2008-09. In the domestic market, the liquidity crisis in the financial sector, along with rising inflation rates, resulted in lowering the demand for goods and services. The rising current account deficit and the declining demand in the domestic market contributed to labor retrenchment in the affected industries.

Another consequence of the declining demand for India's output was a fall in direct and indirect tax revenues for the government. Political exigencies limited the government's ability to completely pass-through the higher commodity import costs to the consumers. Along with the reduced tax revenues, this put pressure on India's fiscal deficit. Table 4 shows the gross fiscal deficit as a percentage of GDP for the last ten years. Prudent policies on the part of the government helped reduce the fiscal deficits from 5.65% in 2000-01 to 3.45% in 2006-07 and 2.69% in 2007-08. As a direct consequence of the global financial crisis, the fiscal deficit more than doubled to 6.14% in 2008-09. It is projected to rise to 6.85% for 2009-10. In view of the problems in the real sector and the high fiscal deficit faced by the government, Standard and Poor's lowered its long-term sovereign credit rating of India from 'stable' to 'negative' in February 2009. The downgrade of the sovereign ratings raises the cost of borrowing for firms in the external markets.

The effects of the global financial crisis transmitted through both the financial and trade channels impacted the real estate market in India in 2008-09, which did not post any growth for the first time in many years. According to Gupta, private investment in India, which accounted for 28.5% of GDP in 2007-08, declined from a growth rate 29.9% in 2004-05 to 5.9% in 2007-08.²²

Although India's export to GDP ratios has been steadily rising in the past five years, it is still lower than that of many of the East Asian countries.

²¹ Gupta, Abhijit (2009), "India's Tryst with the Global Financial Crisis", *Review of Market Integration*, Volume 1, Number 2, pp. 171-197.

²² Gupta, Abhijit (2009), "India's Tryst with the Global Financial Crisis", *Review of Market Integration*, Volume 1, Number 2, pp. 171-197.

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Consequently, the adverse effects of shrinking imports by advanced economies were not as severe on India as that of other EMEs with higher exports to GDP ratios. As soon as the financial markets around the world recovered, India's exports, employment and real estate market rebounded. Service exports are generally more resilient than merchandise exports as they are less reliant on external finance and are necessities for the buyers even during economic downturns.²³ Currently, exports and employment in the software and information technology industries are on the rise again. Several fiscal and monetary policy initiatives (listed in the next section) were successfully implemented by the government to tackle the problems posed by the financial crisis.

3. Confidence Channel

The third channel through which the financial crisis spread from the advanced economies to the Indian economy is through the confidence channel, that is, the impact of the crisis on the sentiment of investors and consumers in India. Regardless of whether the financial crisis in the United States and Europe had any direct or indirect bearing on the Indian market, and the size of the effect, if any, consumers, investors and businesses became more risk averse and cut back on their consumption and investment. Mishra reports that banks became more cautious about lending to borrowers in 2008-09 and credit growth declined to 17.3% from 22.3% in the previous year.²⁴ Similarly, consumers in India cut back on their demand for goods and services after being spooked by the sharp decline in the equity markets. Unsure about the demand for their output in both domestic and external markets, businesses cut back on their investments and labor resources. Gupta documents decline in employment in several industries and in wage earnings of the labor force.²⁵ The pessimistic sentiment of businesses, consumers and investors were reflected by the 41% decline in the National Council of Applied and Economic Research (NCAER) Business Confidence Index in January 2009, compared to the previous year. Several other indicators, such as ABN Amro's Purchasing Managers' Index, Dun and Bradstreet Business Optimism Index and UBS Lead Economic

²³ Ghosh, Jayati (2009), "Global Crisis and the Indian Economy", in *Global Financial Crisis: Impact on India's Poor*, United Nations Development Programme (India).

²⁴ Misra, B. M. (2009), "Global Financial Crisis and Monetary Policy Response: Experience of India", Paper presented at the workshop on *Strengthening the Response to the Global Financial Crisis in Asia-Pacific: The Role of Monetary, Fiscal and External Debt Policies*, United Nations Economic and Social Commission for Asia and the Pacific, Dhaka, Bangladesh, July 2009.

²⁵ Gupta, Abhijit (2009), "India's Tryst with the Global Financial Crisis", *Review of Market Integration*, Volume 1, Number 2, pp. 171-197.

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Indicator exhibited similar declines in sentiment in the manufacturing sector.

Economies can adopt measures to insulate themselves from the contagion effects of financial crises in foreign markets through the financial and trade channels. However, the crisis can still spread through the confidence channel. In the stated opinion of the monetary policy makers (that is, the Reserve Bank of India), financial markets in India continued to function in an orderly manner even when most of the world economies were experiencing a severe liquidity crisis. Although India was well positioned to manage the spread of the global financial crisis from the advanced economies, it could not deflect the effects on the confidence level of the investors, consumers and businesses. In the domestic economy, the primary impact was a sharp reduction in consumption by both households and businesses. As a consequence, business investment slowed down during the crisis, and it was reflected in the domestic component of the growth in GDP. It was also reflected in the higher rates of unemployment in some of the sectors of the market. This translated into an increased aversion and higher premium for risk among private and institutional investors. The lack of confidence in the financial markets was reflected by the 37.9% decline in the BSE Index.

D. India's Policy Response to the Crisis

Subbarao, Misra and Thorat present the various monetary and fiscal policy initiatives implemented by the Indian government and its agencies in response to the global financial crisis and its effects on the domestic economy.²⁶ In its role as the principal regulator of the financial markets in India, the primary responsibility of the Reserve Bank of India (RBI) is to ensure the orderly functioning of the credit and foreign exchange markets in India. The monetary policy response of the RBI was aimed at containing the contagion effects of the financial crisis from the advanced economies by ensuring sufficient liquidity in

²⁶ Dr. Duvvuri Subbarao, Ms. Usha Thorat and Mr. B.M. Misra are, respectively, the Governor, the Deputy Governor and Economic Adviser of the Reserve Bank of India. Subbarao, Duvvuri (2009), "Impact of the Global Financial Crisis on India – Collateral Damage and Response", Speech delivered at the Symposium on *'The Global Economic Crisis and Challenges for the Asian Economy in a Changing World'*, Institute for International Monetary Affairs, 18 February 2009. Misra, B. M. (2009), "Global Financial Crisis and Monetary Policy Response: Experience of India", Paper presented at the workshop on *'Strengthening the Response to the Global Financial Crisis in Asia-Pacific: The Role of Monetary, Fiscal and External Debt Policies'*, United Nations Economic and Social Commission for Asia and the Pacific, Dhaka, Bangladesh, July 2009. Thorat, Usha (2009), "Impact of Global Crisis on Reserve Bank of India (RBI) as a National Regulator", Paper presented at the 56th EXCOM Meeting and FinPower CEO Forum, APRACA, Seoul, Korea, June 2009.

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the credit markets. On the fiscal side, the government's policy responses were aimed at protecting businesses and groups that were directly affected by the crisis. This was accomplished through relaxation of some onerous restrictions, tax subsidies and strengthening of social safety-nets.

1. Monetary Policy Responses

The goals of the monetary policy initiatives were three-fold: to provide sufficient liquidity in the domestic market, to provide dollar liquidity for businesses financing in the external markets, and to ensure flow of credit to those industry sectors that were productive.

Following the rapid expansion in the first half of the decade, the monetary policy was tightened in the second half. This policy had been in place till August 2008 when the initial effects of the crisis started impacting India in the form of reduced credit availability. Banks became cautious and started cutting back on their new loan offerings. To provide more liquidity to the credit markets, the RBI gradually reduced the repo rate from 9% (in August 2008) to 4.75%, and the reverse repo rate from 6% to 3.25%.²⁷ Table 4 shows the call money rates (an indicator of the borrowing rates) in India for the last ten years. From 2000-01 to 2004-05, the rates were declining during the expansionary phase. To moderate the expansion, monetary tightening was put into effect between 2005-06 and August of 2008, when the rates increased. In 2009-10, the call rate was reduced sharply to 3.22%, reflecting the RBI's injection of liquidity into the market. In effect, this expanded the money supply in India by providing incentives to banks to increase their loan portfolios. The cash reserve ratio (or reserve requirement), which had been at 7.5% in 2007-08, was also reduced to 5%, allowing the multiplier effect to expand the money supply. Along with this, the Statutory Liquidity Rate, a liquidity requirement for commercial banks, was also relaxed to allow them to provide more credit.

To facilitate availability of sufficient dollar liquidity, the RBI intervened in the foreign exchange markets to support the Indian Rupee. In the process, the foreign reserves held by India declined from US\$ 309.7 billion in 2007-08 to US\$ 252 billion in 2008-09. The rising dollar had been increasing the debt service costs for businesses that had been using external financing. By stabilizing the value of the Indian Rupee, RBI was attempting to manage the exchange rate risks by the borrowers. Further, it initiated currency swaps with businesses that were exposed to United States dollar payables, and extended

²⁷ The repo rate is the discount rate at which the RBI buys government securities from commercial banks, and the reverse repo rate is the interest rate at which RBI borrows money from commercial banks.

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export credit finance to them. With the limited availability of United States dollar funding in external markets and increased risk aversion on the part of lenders, ceilings on rates at which businesses could borrow in external markets were relaxed. Finally, the rates on Eurodollar deposits in India were raised to attract more funds from foreign individual investors.

The RBI, in conjunction with the government, implemented policies that provided additional credit facilities specifically for Small and Medium Enterprises (SMEs) that were particularly affected by the non-availability of credit. Banks were allowed to reclassify certain nonperforming assets in a way that allowed them to refinance borrowers who were behind in their debt service payments. A bailout package was implemented in the agriculture sector in the form of a farm-loan waiver that allowed farmers to continue operations facing a mounting debt burden.

2. Fiscal Policy Responses

The focus of the fiscal policy responses of the Indian government to the financial crisis was to stimulate demand for the country's output and to bailout those industries and groups that were most vulnerable to the crisis. Starting in December 2008, the government introduced three stimulus packages in the span of four months that lowered tax rates and increased tax subsidies, increased capital expenditures and government spending, and provided incentives that encouraged growth in consumption and demand. Specifically, the government announced plans for additional public spending in capital expenditure projects, provided government guarantees for infrastructure spending, and expanded credit for SMEs and exporters. The agriculture industry, which supports a majority of the population, was particularly affected due to rising oil and fertilizer prices, and due to failed monsoons. The loans that were in default in the farming sector were waived by the government. The stimulus packages also included tax rebates and subsidies for some of the affected sectors of the market. Finally, a revised pay structure for all government employees implemented salary increases that raised the disposable income for a significant part of the labor force. Subbarao estimates the size of the fiscal stimulus amounted to about 3% of the GDP.²⁸

²⁸ Subbarao, Duvvuri (2009), "Impact of the Global Financial Crisis on India – Collateral Damage and Response", Speech delivered at the Symposium on *The Global Economic Crisis and Challenges for the Asian Economy in a Changing World*, Institute for International Monetary Affairs, 18 February 2009.

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E. Evaluation of Policy Responses

Starting in 1991, India had been implementing economic reforms that were aimed at moving from a centrally-planned economy to a market based economy. In the process, it had been cautious in opening up its markets and allowing risky innovations in the financial markets. While encouraging the private sector to play a more dominant role in the economy, it was also in the process of strengthening and streamlining the regulation of markets. The banking sector, which plays a pivotal role in the savings and capital formation functions in India, was heavily regulated to limit overly risky behavior by the participants. Consequently, while the global financial crisis is having a protracted and devastating effect on most of the economies of the world, its impact on the Indian economy is not that severe. The strength of the Indian economy along with the timely and appropriate monetary and fiscal policy responses by the government helped manage the adverse effects of the crisis. Mohan estimates the monetary policy responses to the crisis injected liquidity that amounted to about INR 4,900 billion or 9% of GDP.²⁹ On the fiscal side, the spending initiatives amounted to INR 2,928 billion, and tax subsidies cost INR 1,600 billion. These policy responses stabilized the financial markets and facilitated a quick recovery of the economy. One negative consequence of the various stimulus packages is that the fiscal deficit is at 11 percent of GDP and will continue to be at this level for some time. This limits the policy options available to the RBI to manage future shocks to the economy in the near term.

VI. CONCLUSION

Recent economic history has taught us that financial crises that simultaneously affect several economies occur frequently, and that prudent policies and appropriate responses by monetary authorities help in managing the crises. However, the task of containing the adverse effects becomes more challenging when all the economies of the world are affected by the crisis. The current global financial crisis, which started in 2008, has been adversely affecting all the world economies and the magnitude of its impact is exceeded only by that of the Great Depression of 1930s. In response to the crisis, the various national monetary authorities and international financial organizations have implemented fiscal and monetary policy initiatives to alleviate the problems and soften the impact on the affected sectors. While all economies were adversely affected by the crisis, the impacts were not uniform across

²⁹ Mohan, Rakesh (2009), "Global Financial Crisis: Causes, Impact, Policy Responses and Lessons", Working Paper 407, Stanford University, Stanford, CA, USA.

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countries. Consequently, the responses by the governments in individual countries varied.

The global financial crisis has had a more severe impact on the advanced economies compared to the rest of the world. The economic indicators in the United States and the European Union countries point to a severe contraction in these markets. At the same time, the slowdown in the emerging markets has been smaller. Within the emerging markets, countries such as India, China and Brazil have even managed to expand during the crisis, albeit at a lower rate compared to their growth prior to the crisis. They have also successfully avoided a protracted slowdown and are projected to achieve higher growth rates. This paper detailed the impacts of the global financial crisis on the Indian economy, and the responses of the Indian government in managing the crisis.

The proactive policies of the RBI have ensured the availability of adequate liquidity in the markets. In the credit and consumer markets, interest rates and inflation rates have stabilized. In the foreign exchange market, the Indian Rupee has rebounded against currencies of the major trading partners. The fiscal stimulus provided by the government has helped cushion the decline in private investment and consumption in the real sector. Although preliminary estimates of the nonperforming assets of banks have been rising, they are still at manageable levels. In the meantime, industries that were facing rising unemployment in 2008-09 have been reversing the trend. The stock market, which is an indicator of the strength of the economy, has risen by 80% in the first three quarters of the current fiscal year (2009-10), after falling by 38% in the previous year. The current figures for the Purchasing Managers' Index, the RBI's Business Expectations Index and the Nielsen Global Consumer Confidence Index for India indicate optimism about the economy on the part of businesses and consumers in India. Finally, IMF's consensus estimate for the GDP of 7.7% and 7.8% for 2010 and 2011, respectively, is evidence that India has recovered from the global financial crisis and is back on the growth trajectory.

Although India has been liberalizing its markets since 1991, it has adopted a cautious approach by opening up its markets slowly and implementing reforms after studying their effects on the domestic market. Unlike many other emerging economies, the banking sector in India is still highly regulated and continuously monitored. The Reserve Bank of India has at its disposal a number of tools to control the money supply and to infuse liquidity as needed. The size of its foreign reserves allows India to intervene effectively in the foreign exchange market to support its currency. Consequently, businesses can manage their exchange rate risk when trading with foreign countries and when borrowing in the external markets. Although

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India has expanded its foreign trade sector, which is now a major component of its GDP, the domestic sector is large enough to cushion any shocks in the real sector of the global economy. This contrasts with several EMEs that have implemented strategies to expand their external trade sector at the expense of the domestic markets, making them vulnerable to external shocks. Finally, the government in India has been expanding investments in social safety-nets to soften the impact on the groups most vulnerable to economic shocks and contagion in free markets.

PIRATES, BLACKWATER AND MARITIME SECURITY: THE RISE OF PRIVATE NAVIES IN RESPONSE TO MODERN PIRACY

*Michael L Mineau**

I. INTRODUCTION

This essay examines the controversial rise of private security companies (PSCs) available for hire to maritime shipping companies in response to the troubling increase in piratical attacks over the past 15 years in dangerous shipping routes, such as the Gulf of Aden and the Straits of Malacca. This introduction briefly highlights current trends in modern piracy, the scope of piracy and its impact on the maritime shipping industry, and the consequential growth of the market for maritime private security as a potential solution to the problem. Section II identifies the major maritime PSCs that have begun providing services in the Straights of Malacca and off the Horn of Africa. Section III assesses the legal and practical concerns that critics have with the use of maritime PSCs. The legal issues of liability and jurisdiction are analyzed in Section IV. Finally, Section V concludes with the presentation of several possible solutions to the legal and practical issues that currently surround the use of PSCs to defend against piracy and several potential benefits of using PSCs.

2008 was a shocking year statistically. According to the International Maritime Bureau (IMB) Piracy Reporting Centre (PRC), an independent arm of the International Chamber of Commerce (ICC), there were more hijacked vessels and hostages taken in 2008 than in any other year since the PRC began reporting on worldwide piracy statistics in 1992.¹ In 2008, there were 293 total

* Michael L Mineau. I would like to thank all of the brilliant admiralty professors at the Roger Williams University School of Law, including Jonathan Guttoff, William Coffee, Robert Falvey, and everyone in the Marine Affairs Institute. I would also like to thank professor Cecily Banks, my parents for their tremendous support and the love of my life, Nicole.

¹ ICC Commercial Crime Services, *IMB Reports Unprecedented Rise in Maritime Hijackings* (Jan. 16 2009), available at http://www.icc-ccs.org/index.php?option=com_content&view=article&id=332:imb-reports-unprecedented-rise-in-maritime-hijackings&catid=60:news&Itemid=51 (last visited May 2, 2009).

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attacks against ships - up 11% from the 263 total attacks against ships in 2007.² The categorical breakdown of the 2008 numbers is equally concerning - 49 vessels were hijacked, 889 crew members were taken hostage, 46 vessels were fired upon, 11 crew members were killed, and 21 crew members went missing.³

While many maritime nations have deployed coalition warships as part of a NATO flotilla to parts of the Gulf of Aden to address the problem of piracy there, the Associated Press (AP) reported in October 2008 that “the growing interest among merchant fleets to hire their own firepower is encouraged by the U.S. Navy and represents a new and potentially lucrative market for security firms scaling back operations in Iraq.”⁴ Even with the increased presence of the coalition warships patrolling the waters off the Horn of Africa, the U.S. Navy admits that the limited coalition fleet can only patrol a small percentage of the 2.5 million square miles of waters off the Horn of Africa.⁵ Lt. Nate Christensen of the U.S. 5th Fleet actually expressed to the AP his support of the use of PSCs by shipping companies: “This is a great trend. . . We would encourage shipping companies to take proactive measures to help ensure their own safety.”⁶ Over 20,000 vessels pass through the Gulf of Aden each year.⁷

While there are a host of legitimate legal and policy concerns surrounding the use of maritime PSCs, the commercial shipping industry may soon be relying more on PSCs to ensure safe passage through dangerous waters than on the promise of further international state action.⁸ Because the international liner shipping industry is such a vital part of worldwide transportation, it is not surprising that many shipping and marine insurance

² *Id.*

³ *Id.*

⁴ Katharine Houreld, *After Iraq, Security Firms Join Somalia Piracy Fight: Pirate Coast of Africa Offers New Frontier for Security Firms Looking Beyond Iraq*, The Associated Press via USA TODAY (Oct. 26, 2008), available at http://www.usatoday.com/news/world/2008-10-26-2583935117_x.htm (last visited March 23, 2010).

⁵ *Id.*

⁶ *Id.*

⁷ *International Piracy on the High Seas: Hearing Before the H. Subcomm. on Coast Guard and Maritime Transportation*, 111th Cong. (Feb. 4, 2009) [hereinafter WSC Hearing] (statement of Christopher Koch, President & CEO of the World Shipping Council).

⁸ See James H. Hohenstein, *Private Security Companies at Sea: Unseen and Unregulated*, International Bar Association, Maritime and Aviation Law Section, Maritime and Transportation Law Committee, Session: Piracy and Crimes at Sea including Pollution Liability (Oct. 18, 2007), available at

<http://74.125.95.132/search?q=cache:laOhlUkZ3JQJ:www.ebalawyers.com.au/system/files/download/o81/SIN87.pdf+%22private+security%22+sea+piracy&cd=7&hl=en&ct=clnk&gl=us> (last visited May 3, 2009).

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companies are considering the costs and benefits of the use of PSCs.⁹ As Christopher Koch, President and CEO of the World Shipping Council (WSC), emphasized to the House Subcommittee on Coast Guard and Maritime Transportation in a February 2009 hearing on piracy, “liner shipping is the heart of a global transportation system that connects American companies and consumers with the world.”¹⁰ The liner shipping sector of the maritime shipping industry, which transports more than half of the \$1.8 trillion in U.S. ocean-borne commerce each year, has been identified by the U.S. Department of Homeland Security as part of the nation’s “critical infrastructure.”¹¹ In U.S. ports each day, over 50,000 container loads of imports and exports are handled, involving nearly 175 countries.¹² According to Koch, “liner shipping generates more than one million American jobs and \$38 billion in annual wages.”¹³

The recent explosion of media coverage on piratical attacks in the Gulf of Aden has likely dispelled many public misconceptions about modern piracy. However, the WSC has made a concerted effort to educate its liner shipping company members about the militant weapons and tactics that modern pirates are using to approach targeted commercial vessels, board and hijack those vessels, and take crew members hostage.¹⁴

Piratical attacks usually occur at dusk or dawn, when visibility is low.¹⁵ Vessels operating at lower speeds - at or below 15 knots - are at the highest risk of piratical attacks, because high-speed pirate skiffs deployed from mother ships often can reach speeds of up to 25 knots.¹⁶ “Pirates employ machine guns, rifles and rocket propelled grenades (RPGs) and attempt to slow or stop target ships by firing on them so the pirates can then use grappling hooks and portable ladders to get on board.”¹⁷ Protection and indemnity (P&I) clubs, which are cooperative marine insurance organizations that collectively insure against third party losses, often are left with no choice but to make large ransom payments to pirates in exchange for the safe return of hijacked vessels, crew, and cargoes.¹⁸

The market for maritime PSCs as a potential solution to the problem of

⁹ See *International: Private Firm May Have Anti-piracy Role*, Oxford Analytica (Dec. 4, 2008), available at <http://www.oxan.com/display.aspx?ItemID=DB147444> (last visited May 3, 2009).

¹⁰ WSC Hearing, *supra* note 7.

¹¹ *Id.*

¹² *Id.*

¹³ *Id.*

¹⁴ *See id.*

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ *Id.*

¹⁸ *Id.*

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piracy seems to have grown out of a climate of necessity and desperation. The next section identifies the major private contractors that have responded to this demand for a more cost-effective, comprehensive, and viable solution to the problem of modern piracy that has placed such an enormous strain on the commercial shipping and marine insurance industries.

II. MAJOR MARITIME PSCS

Although any information about specific contracts between shipping companies and maritime PSCs is highly secretive and difficult to obtain, many of the major PSCs have recently been advertising their services to shipping companies and the general public.

XE Corporation (formerly “Blackwater Worldwide”¹⁹), which has endured a considerable amount of public scrutiny after being investigated for its role in a number of civilian shootings in Iraq, is one of the major companies that have entered the maritime private security market to assist vessels in defending against piracy at sea.²⁰ In October 2008, Blackwater unveiled its new 183-foot vessel, the McArthur, announcing to shipping companies that it would be available for hire to provide escort services and defense from piratical attacks.²¹ The McArthur, a former decommissioned National Oceanic and Atmospheric Administration (NOAA) research vessel, was purchased by Blackwater in 2006 and refurbished into the high-tech security vessel it is today.²² Some of the advanced features of the McArthur include:

state-of-the-art navigation systems, full Global Maritime Distress and Safety System communications, SEATEL broadband satellite communications, dedicated command and control battlefield air support, helicopter decks, a hospital, multiple support vessel capabilities, and a crew of 45 highly

¹⁹ Blackwater Worldwide changed its name to XE (pronounced like the letter “Z”) in early 2009. *See US security firm mired in Iraq controversy changes its name: Blackwater Worldwide renamed XE as company tries to salvage its tarnished brand*, The Associated Press via THE GUARDIAN UK (Feb. 13, 2009), available at <http://www.guardian.co.uk/world/2009/feb/13/blackwater-changes-name-xe> (last visited May 3, 2009). Note that throughout this essay, the names “Blackwater Worldwide,” “Blackwater” and “XE” are used interchangeably and should be construed as such.

²⁰ *See* Houreld, *supra* note 4.

²¹ Jerry Seper, *Blackwater Joins Fight Against Sea Piracy*, The WASH. TIMES (Dec. 4, 2008), available at <http://www.washingtontimes.com/news/2008/dec/04/blackwater-joins-fight-against-sea-piracy/> (last visited May 3, 2009).

²² *Id.*

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trained personnel.²³

According to Anne Tyrrell, a Blackwater spokesperson, the company has received over 70 requests from commercial shipping and marine insurance companies for more information about the McArthur and Blackwater's services.²⁴

Blackwater spokespeople directly attribute recent increases in shipping costs to the increase of piratical attacks off the Horn of Africa.²⁵ The severe risk of piracy in that region has also translated into a tenfold increase in marine insurance premiums for ships transiting the Gulf of Aden.²⁶ Some marine insurance firms have offered to reduce premium costs by as much as 40 percent for any vessels hiring private security.²⁷

One of the largest and most established maritime PSCs, Background Asia Risk Solutions, was the first maritime PSC to open for operations in Singapore²⁸ after Lloyd's of London labeled the Straits of Malacca a "war-risk zone" in 2005.²⁹ Background Asia Risk Solutions is one of a number of PSCs that are routinely hired to provide escort services and chartered patrol boats to accompany large cargo vessels and tankers through the dangerous Strait.³⁰ PSCs operating in the region also have advertised the ability to deploy security forces from helicopters to recover hijacked vessels and oil rigs.³¹

Background Asia Risk Solutions charges approximately \$100,000 per escort mission - a figure much lower than the average ransom payment in the area of \$120,000 for the safe return of a kidnapped vessel's master.³² Many of the security personnel that Background Asia Risk Solutions hires are former military and law enforcement personnel from the United States and Britain.³³

HollowPoint Protective Services, which is based out of Mississippi, is

²³ *Id.*

²⁴ *Id.*

²⁵ *Id.*

²⁶ Houreld, *supra* note 4.

²⁷ *Id.*

²⁸ *Private Navies Combat Malacca Strait Pirates: Waterway Now So Dangerous For Shipping, Lloyd's Classifies Major Seaway As Warzone*, WorldNetDaily (Jul. 31, 2005), available at http://www.worldnetdaily.com/news/article.asp?ARTICLE_ID=45535 (last visited May 3, 2009).

²⁹ Andrew Marshall, *Waterway To the World: Modern trade, ancient traditions and lawless habits collide in the planet's most crucial choke point: the Malacca Strait*, TIMEasia (Jul. 31, 2006), available at <http://www.time.com/time/asia/2006/journey/strait2.html> (last visited May 3, 2009).

³⁰ *Private Navies Combat Malacca Strait Pirates*, *supra* note 28.

³¹ *Id.*

³² *Id.*

³³ *Id.*

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another maritime PSC that began advertising its services in the Gulf of Aden³⁴ following the shocking September 2008 hijacking of the Ukrainian MV Faina by Somali pirates.³⁵ The MV Faina was carrying 33 tanks, in addition to other highly valuable cargo.³⁶ The CEO of HollowPoint, John Harris, has received several recent requests from shipping companies for more information about the company's security capabilities off the Horn of Africa.³⁷ "We'll get your crew and cargo back to you, whether through negotiations or through sending a team in," Harris told the AP in 2008.³⁸

In January 2009, a sister company of HollowPoint, HP Terra-Marine International, secured a licensing agreement with Yemen to operate out of several of that state's ports.³⁹ As a result, HP Terra-Marine has been able to use Yemen's ports to transport its security forces by boat to safely and efficiently load and off-load its security personnel onboard its client's vessels.⁴⁰ When pressed by *Anderimar Shipping News* on whether HollowPoint has already provided private security operations to shipping company clients in the Gulf of Aden, John Harris would neither confirm nor deny any specifics about HollowPoint's services provided to date.⁴¹ "Due to security demands and operational integrity we are not at liberty to discuss specifics of said attacks," Harris remarked.⁴² However, the HollowPoint CEO stressed the high level of training and experience of its skilled security forces, adding that HollowPoint's "longevity in the protection and security industry is due to our success at what we do."⁴³

Another maritime PSC which has been rapidly expanding operations in the Gulf of Aden is Drum Cussac, which earned its reputation in the maritime community by providing security services to luxury yachts, including the

³⁴ Houreld, *supra* note 4.

³⁵ *International: Private Firm May Have Anti-piracy Role*, *supra* note 9.

³⁶ *Id.*

³⁷ Houreld, *supra* note 4.

³⁸ *Id.*

³⁹ *HollowPoint Protective Services, LLC Secures Agreement to Operate Marine Security From Yemen*, *The MAR. EXEC.* (Feb. 5, 2009), available at <http://www.maritime-executive.com/pressrelease/hollowpoint-protective-services-llc-through-its-sister-company-secures-operational-agreements-operate-marine-security-yemen-2009-02-05/> (last visited May 3, 2009).

⁴⁰ *Id.*

⁴¹ See "*Ships Need Armed Guards*," *Says Security Firm Chief*, *Mar. Global Net* (Oct. 20, 2008), available at <http://www.mgn.com/news/dailystorydetails.cfm?storyid=9283&type=2> (last visited May 3, 2009).

⁴² *Id.*

⁴³ *Id.*

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French yacht *Le Ponant* which was hijacked in April 2008.⁴⁴ Drum Cussac's business doubled over the course of 2008 as bulk carriers and oil tankers began contacting the company to hire armed guards to provide onboard security to merchant vessels transiting the Gulf of Aden.⁴⁵

Olive Group, a PSC based out of London, which has previously been responsible for providing security services to Shell Corporation in Iraq, also entered the maritime PSC market in 2008.⁴⁶ Olive Group is now offering to provide security to vessels transiting the Gulf of Aden region.⁴⁷ Crispian Cuss, the Olive Group security consultant, has suggested that armed security personnel onboard vessels act as a deterrent to potential hijackers.⁴⁸ He said, "No client's ship has been approached by pirates while we've been on them."⁴⁹

Hart Security is another maritime PSC that announced a recent partnership with Swinglehurst Ltd., a marine insurance provider, to provide comprehensive "all round protection on voyages in the Gulf of Aden."⁵⁰ Under this agreement, ship-owners who have contracted with Hart to provide security in the Gulf of Aden are now entitled to War Risk Coverage on any pirate attacks against their vessels.⁵¹ Including piracy within the meaning of War Risk Cover greatly reduces insurance rates.⁵²

The expansion and shift in focus of many security contractors to respond to the global threat of piracy signals an emerging market for these services in the private sector. The next section identifies some of the major legal and practical concerns with employing the use of maritime PSCs.

III. LEGAL AND PRACTICAL CONCERNS WITH EMPLOYING MARITIME PSCS

In the February 2009 piracy hearing before the House Subcommittee on Coast Guard and Maritime Transportation, the WSC report indicates in a footnote that shipping companies typically do not hire private security

⁴⁴ Houreld, *supra* note 4.

⁴⁵ *Id.*

⁴⁶ *Id.*

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ *Id.*

⁵⁰ Press Release, Hart Security, *Protected Gulf of Aden Voyages* (Oct. 6, 2008), available at <http://www.hartsecurity.com/news.asp?rel=1109> (last visited May 3, 2009).

⁵¹ *Id.*

⁵² *Id.*

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contractors to defend against piratical attacks.⁵³ The note then lists a host of reasons why PSCs are not hired to provide maritime security.⁵⁴ The first concern presented is that the use of firearms could escalate situations, resulting in loss of life.⁵⁵ While this proposition might be nothing more than mere speculation at this stage, it gives rise to several other important questions. If ship-owners are looking to increase security onboard their vessels by arming someone, it might be better to rely on highly-trained professional contractors to provide armed security than on arming inexperienced crew members not trained in the array of skills that PSC personnel have. In the event of a piratical attack on an unarmed cargo vessel, the arrival of a coalition warship ordering the pirates to stand down might escalate a situation more than would the presence of a handful of highly-trained and well-equipped private contractors. However, these questions remain unsettled and highly controversial. No clear answer exists to the question of whether the presence of armed security personnel would tend to escalate situations or act as a deterrent. The use of arms and liability are further discussed in Section IV.

Another concern with the use of PSCs is that many flag states discourage the use of armed guards and also restrict commercial vessels from carrying arms aboard.⁵⁶ Members of the U.S. Navy have expressed their support of the use of private security contractors.⁵⁷ Surprisingly, Somali official Abdulkadir Muse Yusuf, the deputy marine minister of Puntland, has stated that PSCs are “welcome” in Somalia’s waters.⁵⁸ Minister Yusuf even asserts that the presence of PSC personnel might not only deter piracy in Somali waters but also other harmful acts being committed off of Somalia’s coast, such as illegal fishing and waste dumping.⁵⁹

The recent exclusive agreement between HollowPoint’s subsidiary HP Terra-Marine and the government of Yemen⁶⁰ might signal a new era of partnerships between coastal states and private security contractors. By closely regulating and monitoring the operations of PSCs, coastal states can ensure that PSCs maintain the highest standards of professionalism and accountability, while at the same time being able to generate tax revenue from these companies’ operations. By arming PSCs instead of crews, vessel owners also

⁵³ WSC Hearing, *supra* note 7, at n.4.

⁵⁴ *See id.*

⁵⁵ *Id.*

⁵⁶ *Id.*

⁵⁷ *See* Houreld, *supra* note 4.

⁵⁸ *Id.*

⁵⁹ *Id.*

⁶⁰ *See HollowPoint Protective Services, supra* note 39.

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avoid the problem of entering port states with differing regulations on carrying onboard weapons, placing this burden on PSCs.⁶¹

Another argument against the use of PSCs is that many P&I insurers discourage the use of armed guards.⁶² This position is not supported by any citing authority in the WSC report.⁶³ Furthermore, several sources seem to directly contradict this claim. The recent partnership between Hart Security, a PSC, and Swinglehurst Ltd., a marine insurer, to provide War Risk Coverage to vessels protected by Hart Security personnel is one example of the marine insurance industry favoring the use of PSCs.⁶⁴ The move by marine insurers to reduce charges for vessels by up to 40 percent if protected by private security is another example of the insurance industry supporting PSCs at sea.⁶⁵

The WSC report also notes that the possibility of fire, explosion, or sinking of vessels under attack is another argument against employing PSCs.⁶⁶ This concern is legitimate, but if insurers and shipping companies are trying to avoid paying enormous ransoms for the safe return of vessels, crew, and cargo by employing the use of PSCs, then any increased risk of fire, explosion, or sinking can simply be calculated and factored into future insurance premiums.

The concern over hazardous cargo is also cited as a potential reason why the use of PSCs should be discouraged.⁶⁷ This argument does not distinguish between PSC personnel actually aboard the vessels they are protecting and PSC personnel aboard separate escort ships. Many of the PSCs discussed in this essay have been advertising armed escort missions instead of actual onboard security services. The liability issues surrounding the distinction between onboard security and separate escort ships are further discussed in Section IV.

Other concerns that the WSC report raises with respect to the use of PSCs are some of the practical operational concerns, including “command and control, rules of engagement, use of deadly force, weapons security, [and] intra port/ship transfer of weapons and guards.”⁶⁸ These issues could all be addressed through further cooperation between PSCs, port states, and the international maritime community to establish uniform and clear protocol for

⁶¹ See David Isenberg, *Yaargh, Here Be Contractors*, CATO Institute (Oct. 24, 2008), available at http://www.cato.org/pub_display.php?pub_id=9748 (last visited May 3, 2009).

⁶² WSC Hearing, *supra* note 7, at n.4.

⁶³ See WSC Hearing, *supra* note 7.

⁶⁴ See Press Release: *Protected Gulf of Aden Voyages*, *supra* note 50.

⁶⁵ See Houreld, *supra* note 4.

⁶⁶ WSC Hearing, *supra* note 7, at n.4.

⁶⁷ *Id.*

⁶⁸ *Id.*

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PSCs to follow.

Finally, numerous unresolved issues of liability and jurisdiction present challenging questions about what legal regimes currently govern maritime PSCs and the use of force by third-party security forces at sea. These issues are discussed in the next section.

IV. LEGAL ISSUES OF JURISDICTION AND LIABILITY GOVERNING PSCS AND PIRACY

One of the first legal issues raised by the unique situation of armed security contractors defending commercial vessels against acts of piracy is over what laws, if any, govern a PSC's right to carry arms and actively defend client vessels. Traditional notions of self-defense do not seem to adequately cover third-party security personnel, especially if a PSC officer exercises lethal force against a pirate.⁶⁹ Additionally, no international agreements comprehensively regulate the carriage of arms aboard vessels.⁷⁰ When operating on the high seas, the flag state of a vessel retains exclusive jurisdiction over whether the carriage and use of weapons is permitted onboard that vessel.⁷¹ Generally, a vessel operating within a coastal state's territorial waters is governed by the laws of the coastal state.⁷²

Article 101 of the UN Convention of the Law of the Sea (UNCLOS) defines "piracy" as:

- (a) any illegal acts of violence or detention, or any act of depredation, committed for private ends by the crew or the passengers of a private ship or a private aircraft, and directed:
 - (i) on the high seas, against another ship or aircraft, or against persons or property on board such ship or aircraft; or
 - (ii) against a ship, aircraft, persons or property in a place outside the jurisdiction of any State;

- (b) any act of voluntary participation in the operation of a ship or of an aircraft with knowledge of facts making it a pirate

⁶⁹ See Hohenstein, *supra* note 8.

⁷⁰ *Id.*

⁷¹ *Id.*

⁷² *Id.*

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ship or aircraft;

(c) any act inciting or of intentionally facilitating an act described in sub-paragraph (a) or (b).⁷³

Under this definition, only acts committed on the high seas are technically considered acts of piracy.⁷⁴ Acts committed within a coastal state's territorial waters or ports are not encompassed by the UNCLOS definition of piracy.⁷⁵ However, the Convention for the Suppression of Unlawful Acts of Violence Against the Safety of Maritime Navigation (SUA Convention) further prohibits acts of violence against vessels in any waters and requires signatories with jurisdiction over pirates, pirate ships, or piratical attacks to immediately take offenders into custody for questioning or to extradite those offenders to their home states.⁷⁶ The SUA Convention also requires cooperation between member states so that acts of violence against ships do not go unpunished.⁷⁷ Nevertheless, UNCLOS and the SUA Convention only authorize states and governmental forces to respond to piratical attacks through force and to arrest pirate vessels; these conventions do not discuss whether PSCs may carry arms aboard client vessels, escort ships, or whether PSCs may engage pirates either before or after an act of piracy has occurred.

The International Ship and Port Facility Security (ISPS) Code also does not discuss the "engagement or use of PSCs or the use of firearms on board vessels, whether by members of the crew or hired guns, although the ISPS Code recognizes that ships will employ outside contractors to provide security services, especially in port."⁷⁸

The International Maritime Organization (IMO) has strongly discouraged aggressive responses to piracy and the use of arms to defend against piratical attacks,⁷⁹ warning that "[t]he use of firearms requires special training and aptitudes and the risk of accidents with firearms carried on board

⁷³ United Nations Convention on the Law of the Sea, art. 101, Dec. 10, 1982, 1833 U.N.T.S. 397 [hereinafter UNCLOS].

⁷⁴ *See id.*

⁷⁵ *See id.*

⁷⁶ *See* Convention for the Suppression of Unlawful Acts of Violence Against the Safety of Maritime Navigation (SUA Convention), available at http://74.125.47.132/search?q=cache:3wMmZ8FPwqYJ:nti.org/e_research/official_docs/inventory/pdfs/maritime.pdf+sua+convention+nti.org&cd=1&hl=en&ct=clnk&gl=us (last visited May 3, 2009).

⁷⁷ *See id.*

⁷⁸ Hohenstein, *supra* note 8.

⁷⁹ *Id.*

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ship is great.”⁸⁰ Although the above quoted IMO Maritime Security Committee circular was published in 2002 and therefore probably does not fully account for the unique piracy concerns that have developed off of the Horn of Africa in more recent years, it correctly asserts that crew on merchant vessels are not properly trained in the use of advanced weaponry. The quote actually supports the argument that skilled private security personnel, many having elite military training and combat experience, might be the best people to arm. The WSC has urged passive defense tactics such as discharging water from fire hoses, zig-zag maneuvering, and maximizing vessel speed,⁸¹ but these methods of evasion are not always an effective defense. When pirates armed with advanced weapons are determined to hijack a vessel at any cost, no amount of passive evasion will adequately repel them.⁸² “When such a scenario develops while the vessel is underway, no matter the resources of nearby governmental authorities, the only practical (and effective) response is the presence of PSC personnel with the ‘special training and aptitude’ to deal with the threat.”⁸³

The liability governing PSCs varies significantly based on the vessel’s location.⁸⁴ A PSC vessel on the high seas is governed exclusively by the laws of the flag state of that vessel, including the regulation of firearms and PSC personnel on board.⁸⁵ Therefore, any criminal acts committed by PSC personnel on the high seas would be subject to prosecution in the flag state of the vessel carrying the personnel.⁸⁶

When a PSC vessel or a merchant vessel carrying PSC personnel is in port, the vessel “is subject to the laws of the port state.”⁸⁷ There are no comprehensive international agreements that currently address the issue of weapons aboard commercial vessels.⁸⁸ “In general terms, maritime nations recognize the general principle of international comity, i.e., matters of a vessel’s internal management and discipline are not subjects of local concern or law.”⁸⁹ A port state’s authorities typically only become involved in the event of some type of disturbance.⁹⁰ The issue of comity was addressed in the famous

⁸⁰ INT’L. MAR. ORG., *Piracy and Armed Robbery Against Ships*, MSC Circular 623/Rev. 3, Annex, ¶¶ 45, 46 (May 29, 2002).

⁸¹ WSC Hearing, *supra* note 7.

⁸² Hohenstein, *supra* note 8.

⁸³ *Id.*

⁸⁴ *Id.*

⁸⁵ *Id.*

⁸⁶ *See id.*

⁸⁷ *Id.*

⁸⁸ *Id.*

⁸⁹ *Id.*

⁹⁰ *Id.*

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Wildenhus' Case, where United States authorities arrested several crewmembers of a Belgian ship after allegedly killing a fellow crew member while the vessel was in a U.S. port.⁹¹ In a writ of habeas corpus, the Belgian government sought release of the crewmembers on grounds that Belgium maintained exclusive jurisdiction over the internal management of the ship under a treaty between the two governments.⁹² The Supreme Court held that, because the "disorder" aboard the Belgian vessel was enough to disturb the "tranquility" and "public repose" of the state of New Jersey, the crew members could only exercise their right of habeas corpus in U.S. courts and could not be released to the Belgian government.⁹³ As the Court stated in its opinion:

Disorders which disturb only the peace of the ship or those on board are to be dealt with exclusively by the sovereignty of the home of the ship, but those which disturb the public peace may be suppressed, and, if need be, the offenders punished by the proper authorities of the local jurisdiction.⁹⁴

Therefore, under the holding of this case and the general principles of comity, any potential violent exchange between PSC personnel in port and pirates would likely result in the intervention by authorities of the port state.⁹⁵ Somalia presents a more difficult set of jurisdictional issues however, since, according to the CIA World Factbook, Somalia has "no permanent national government."⁹⁶ Additionally, with statements such as the one by minister Yusuf of the semiautonomous region of Puntland welcoming PSCs into Somali waters,⁹⁷ it is unclear what authorities, if any, could legitimately exercise jurisdiction over PSC personnel in a Somali port.

Even more complicated jurisdictional issues are raised by a vessel navigating an international strait, like the Straits of Malacca.⁹⁸ Whether arms are prohibited aboard a vessel in an international strait depends on whether the vessel is engaged in "transit passage" as opposed to "innocent passage" under

⁹¹ See *Mali, Consul of His Majesty the King of the Belgians v. Keeper of the Common Jail of Hudson County*, New Jersey, 120 U.S. 1 (1887) [hereinafter Wildenhus' Case].

⁹² See *id.*

⁹³ See *id.*

⁹⁴ *Id.*

⁹⁵ See Hohenstein, *supra* note 8.

⁹⁶ CIA World Factbook, Somalia, available at <https://www.cia.gov/library/publications/the-world-factbook/geos/so.html> (last visited May 3, 2009).

⁹⁷ See Houeild, *supra* note 4.

⁹⁸ Hohenstein, *supra* note 8.

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the relevant provisions of UNCLOS.⁹⁹ Ships passing through international straits are generally governed by the “transit passage” provisions of Part III of UNCLOS, which states that:

Ships and aircraft, while exercising the right of transit passage, shall:

- (a) proceed without delay through or over the strait;
- (b) refrain from any threat or use of force against the sovereignty, territorial integrity or political independence of States bordering the strait, or in any other manner in violation of the principles of international law embodied in the Charter of the United Nations;
- (c) refrain from any activities other than those incident to their normal modes of continuous and expeditious transit unless rendered necessary by force majeure or by distress;
- (d) comply with other relevant provisions of this Part.¹⁰⁰

However, because Indonesia, Singapore, and Malaysia, the coastal states bordering the Malacca Straits, have all claimed to have sovereignty over the Straits, a legitimate question exists over whether these waters might be construed as the territorial waters of those three states instead of simply an international straight.¹⁰¹ Vessels ordinarily passing through a state’s territorial waters are governed by the “innocent passage” provisions of UNCLOS, which are far more restrictive than the “transit passage” provisions, prohibiting, among other things, “any exercise or practice with weapons of any kind.”¹⁰² Therefore, if navigation through the Malacca Strait is construed under the “innocent passage” provisions of UNCLOS instead of the “transit passage” provisions, then the ban on weapons would theoretically prevent PSCs or armed guards from using or potentially even carrying weapons.¹⁰³ Subjecting a vessel passing through the Malacca Straits to the territorial sovereignty of Indonesia, Singapore, and Malaysia would also subject any PSCs onboard to the laws of

⁹⁹ *See id.*

¹⁰⁰ UNCLOS, *supra* note 73, 1833 U.N.T.S. 397 at art. 39.1.

¹⁰¹ *See* Hohenstein, *supra* note 8.

¹⁰² UNCLOS, *supra* note 73, 1833 U.N.T.S. 397 at art. 19.2(c).

¹⁰³ Hohenstein, *supra* note 8.

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those three states, which all have strict laws governing the carriage of weapons.¹⁰⁴

The areas of the world where piracy is most prevalent, such as the Horn of Africa and the Malacca Straits, present some of the most complicated and unresolved jurisdictional issues concerning the use of maritime PSCs. While the international community has not yet resolved some of these tough questions, several possible solutions and some of the potential benefits of using maritime PSCs are discussed in the next section.

V. CONCLUSION

While the idea of vessel owners hiring armed private security forces from a company like Blackwater to defend against piratical attacks remain unpalatable and even unthinkable to many, a market has been created for maritime PSCs due to the inability of the world's coastal states to control the severe problem of piracy. Stabilizing Somalia by establishing a functioning government and empowering its citizens with aid and education is the likely long-term solution to the ultimate problem of piracy currently breeding in Somali coastal towns. However, such an enormous nation-building endeavor will require years of cohesive and cooperative effort by the entire developed world. In the immediate future, shipping companies are faced almost daily with the threat of piratical attacks and the thought of having to negotiate expensive and delicate ransom payments to pirates for the safe return of vessels, crew, and cargo. While employing PSC personnel as armed security onboard liner vessels is not an ideal and permanent solution to the explosion of piratical activity off the coast of Somalia, it is one of many options that vessel owners are currently considering. Maritime PSCs may be able to offer many potential benefits to the shipping and marine insurance industries, as well as to all of the coastal governments of the world. Some potential benefits of using PSCs are: 1) the prevention of loss of life; 2) the prevention of loss of property; 3) that PSC vessels could supplement the limited amount of NATO flotilla warships; 4) a reduction in marine insurance premiums; 5) the possible prevention of future terrorist attacks; 6) added stability to the unstable region of Somalia; 7) that PSCs offer a sophisticated and efficient means of preventing piracy; and 8) the ultimate reduction of the cost of consumer goods that will result with the worldwide reduction of piracy.

Several possible solutions to the legal and practical issues of maritime PSCs might in the future make the use of these companies more viable, legitimate, and even preferred. One option is for flag state to license "sea

¹⁰⁴ *See id.*

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marshals” under some type of uniform international licensing regime, where regulations and standards would govern weapons, engagement, personnel training and qualification, and penalties.¹⁰⁵ Another option is for an international non-government organization or non-profit to closely monitor and regulate PSC activities.¹⁰⁶ A third option, which would probably take at least several years, would be for the United Nations to adopt a comprehensive convention regulating PSCs and defining the areas where they are permitted to operate.¹⁰⁷ As the international community is gradually beginning to consider the potential concerns and benefits with vessel owners using maritime PSCs to provide security in response to piracy, these companies continue to quietly expand their operations, train additional personnel, acquire old ships and refurbish them into high-tech security vessels, and enter into security contracts with many of the world’s largest shipping companies. While legitimate concerns over territorial sovereignty make the use of PSCs problematic, the navies of the world have been ineffective at preventing and combating piracy.¹⁰⁸ Therefore, the use of private security at sea is not only a viable option, but a necessity for many shipping companies routinely facing this threat. Private navies are on the rise, and the international community should respond to this trend by uniting in a cooperative effort to reach some type of acceptable compromise on how PSCs should be regulated.¹⁰⁹

¹⁰⁵ *Id.*

¹⁰⁶ *Id.*

¹⁰⁷ *Id.*

¹⁰⁸ *See id.*

¹⁰⁹ *See id.*

COMMERCIAL BANKS IN UNDERWRITERS AND THE DECLINE OF THE INDEPENDENT INVESTMENT BANK MODEL

*George J. Papaioannou**

I. INTRODUCTION

The period from 1997 to 2008 has witnessed a dramatic transformation of the investment banking sector. While, prior to 1999, securities firms comprised most of the top fifteen placed underwriters in the League Tables, commercial banks had come to dominate the League Tables by 2008. Part of the disappearance of prominent independent investment banks can be traced to heavy losses or declines of reputational capital. For example, First Boston was folded into Credit Suisse in 1989 after suffering enormous losses from merchant banking loans. Salomon Brothers, unable to recover from the hit to its reputation due to trading irregularities in the early 1990's, sold to Travelers in 1998. In 2008, heavy losses in their proprietary portfolio of mortgaged-backed and collateralized debt obligations forced Bear Stearns and Merrill Lynch to sell to JP Morgan Chase and Bank of America, respectively, and Lehman to succumb to bankruptcy. Nonetheless, most securities firms lost independence through takeovers by commercial banks. Thus, contrary to the expectations of those advocating the full deregulation of investment banking in 1999, eleven years later the industry has undergone a consolidation wave that has perpetuated the traditional structure of investment banking as an industry dominated by a limited number of organizations. Moreover, deregulation led to the emergence of the commercial plus investment banking model that gradually has replaced the traditional integrated investment bank model adopted earlier by securities firms. Interestingly, the new model has materialized through the acquisition of securities firms by commercial banks.

This article purports to examine two questions. First, what explains the acquisitive strategy of commercial banks? Second, does the commercial plus investment banking model possess any distinct advantages over the pure investment banking model in the conduct of underwriting business? The answer

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to the second question is relevant to the issue of long-run sustainability of this new model. This article examines a wide body of literature and empirical evidence in relation to these issues.

II. HISTORICAL BACKGROUND

Prior to the repeal of the Glass-Steagall Act by the Financial Services Modernization Act of 1999, commercial banks were barred from being directly involved in the underwriting and trading of corporate securities. However, several steps of deregulation adopted by the Federal Reserve Board had already empowered banks to enter the underwriting and trading business. In 1987 banks were given Tier I powers that allowed them to underwrite municipal revenue bonds, mortgage-and asset-backed debt and commercial paper, as long as these activities were organized under Section-20 affiliates of the commercial banks and the revenues of the traditionally non-permissible activities did not exceed 5% of the total revenues of the affiliate. In 1989, commercial banks were allowed to underwrite and trade corporate debt and equity (Tier II powers) through Section-20 affiliates and the revenue constraint was eased to 10%. This revenue limit was further raised to 25% in 1996 along with the removal of the strict firewalls that had separated the information flow and, hence, the integration of commercial lending and investment banking up to that time.

By the time the Glass-Steagall Act was repealed in 1999, all major United States and foreign commercial banks had established their presence in the securities underwriting market. Most of the commercial banks had expanded into the investment banking business organically by establishing Section 20 securities affiliates or by buying small securities firms. The lifting of the revenue limit to 25% allowed banks to pursue acquisitions of greater scale, as for example the Bankers' Trust acquisition of Alex Brown in 1997. In an even more dramatic fashion, the co-mingling of commercial and investment banking was accomplished through the merger of Travelers and Citicorp in 1998, which became the catalyst for the repeal of the Glass-Steagall Act.

III. THE RISE OF COMMERCIAL BANKS AS UNDERWRITERS

Table 1 shows the major acquisitions and mergers involving commercial banks and securities firms. The table includes only those transactions where both the acquirer and acquiree are underwriters ranked in the League Tables published annually by the Investment Dealers Digest. This data restriction excludes cases where the acquired firm is a very small underwriter with little impact on the market.

It is clear that with the exception of JP Morgan Chase, the other major

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commercial banks built their market share in underwriting by acquiring, directly or indirectly, securities firms with significant presence in the various underwriting markets.

Table 1: Acquisitions by Major Commercial Banks Up to 2007**

**Firms in brackets are those that were part of the acquired firm. Names in italic font are those of securities firms.

Acquiring Bank	Year of Acquisition and Acquired Bank or Securities Firm
Citigroup	1998 - Travelers [Smith Barney; Shearson; Salomon Bros.] 2000 - Schroders (U.K.) 2000 - Lewco Securities 2005 - Legg Mason Wood Walker
JP Morgan Chase	2000 - Chase Bank [Chemical Bank] 2004 - Banc One
Bank of America	2000 - Nations Bank [<i>Montgomery Securities</i>] 2004 - Fleet Bank [Bank of Boston (<i>Robertson Stevens</i>); <i>Quick & Reilly (L.F. Rothchild)</i>]
CSFB	1989 - First Boston 2000 - <i>Donaldson, Lufkin and Janrette</i>
UBS	1998 - SBC (Warburg (U.K.); Dillon Reed) 2000 - Paine Webber 2006 - Piper Jaffray
Deutsche Bank	1989 - Morgan Grenfell 1999 - Bankers Trust [<i>Alex Brown</i>]

Table 2 shows the fraction of total proceeds raised by commercial banks and their affiliates (hereafter, commercial banks) and by independent investment banks that placed in the top fifteen positions of the League Tables in the years 1989, 1999 and 2007.¹ The three underwriting categories are all debt and equity issues, common stock issues and initial primary offerings in the United States. The table also shows the number of commercial banks and

¹ The percentages do not add up to 100% because they are estimated by taking the total market share of the commercial banks and independent investment banks, respectively, that appear in the top 15 spots. The remainder represents the market share of commercial banks and independent investment banks that do not appear in the League Tables.

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independent investment banks, respectively, that placed in the top fifteen positions of the League Tables. The data shows that by 1999, commercial banks on average controlled one third of these underwriting markets. By 2007, their share had grown to about 56% for all debt and equity issues, and 44% and 48%, respectively, for common stock and initial primary offerings. Table 2 also shows that by 1999, commercial banks occupied a greater number of the top fifteen positions. This dominance was stronger in the debt plus equity category in 2007, where ten of the top fifteen underwriters were commercial banks.

TABLE 2: Market Share and Number of Commercial Banks and Securities Firms in the Top 15 Positions of the League Tables**

**Market share is given as percentage. Numbers in parentheses are the count of commercial banks and affiliates or securities firms placed in the top 15 spots of the League Tables.

	1989		1999		2007	
	Commercial Securities	Bank Firms	Commercial Securities	Bank Firms	Commercial Securities	Bank Firms
Debt & Equity	13.1(2)	81.2(13)	38.4(8)	52.3(7)	55.9(10)	33.7(5)
Common Stock	3.9(1)	86.9(14)	33.4(9)	60.5(6)	44.1(8)	50.7(7)
IPOs	4.7(1)	85.7(14)	28.4(8)	66.2(7)	48.1(8)	51.9(7)

IV. THE ARGUMENTS FOR ACQUISITIONS VERSUS ORGANIC GROWTH

Compared to securities firms, commercial banks were endowed by heavy balance sheets and more stable sources of funds. This capital superiority gave banks the flexibility to pursue expansion by acquisitions or through organic growth. The fact that the commercial plus investment banking model was built mostly by acquisitions suggests that capital heft was not sufficient. This article proposes that the acquisitive strategy enabled commercial banks to overcome barriers to entry faster and at a lower start up cost.

Successful conduct of the underwriting business requires support from other securities-related operations: brokerage, trading and market making, asset management, and research and analysis. Therefore, commercial banks willing to enter the underwriting business had to build multi-service infrastructures that would be too costly if done in-house. Second, underwriting requires significant

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relationship and reputational capital to win mandates for new issues. Again it would have been very costly and time-consuming for commercial banks to develop this type of capital. Third, the lending operations of commercial banks, while advantageous in attracting underwriting business from relatively small and lower quality firms, were not necessarily so with respect to larger, better quality firms that have greater access to capital markets and are subject to lower information asymmetry.

The role of the investment banker in underwriting is that of an intermediary that brings together issuers and investors. To act as lead managers in the syndication process, investment banks need to secure issuance deals from potential issuers and then identify investors with whom they place the new securities. Therefore, strong networks of issuers and investors, as well as skills in price discovery, comprise the competitive advantages in the underwriting business. The need to develop and maintain these advantages were the main reason for the emergence of the earlier integrative investment banking model (adopted by securities firms) that combines underwriting with corporate finance advisory services as well as with brokerage, asset management, trading, market making, and analyst research and coverage.² The lynchpin of this integrative model has always been reputation, that is, the expectation for high-quality execution across the spectrum of operations that came to define investment banking.³ Reputation is what gives investment banks certification power, that is, the credibility they are fair arbiters of value in financial transactions. The evidence shows that reputable underwriters are more likely to place bonds (especially those of low quality) at lower yields (i.e., cost of capital) to the issuer and charge higher spreads for their services.⁴ Reputation is established though through repeat execution of deals that allows the market to form an opinion about the quality profile and the skills of an investment bank. Therefore, reputation is developed over a fairly long period of time. This explains why a small group of top investment banks, the so-called bulge bracket banks, came to dominate the top ranks of investment banking markets with remarkable stability.⁵

Once commercial banks were permitted to enter investment banking, it was imperative that they embraced the integrative investment bank model. It

² Morrison, A. and W. Wilhelm, 2008, The demise of investment banking partnerships: Theory and evidence, *Journal of Finance* 63, 311-350.

³ Brau, J. and S. Fawcett, 2006, Initial Public Offerings: An analysis of theory and practice, *Journal of Finance* 61, 399-436.

⁴ Fang, L., 2005, Investment bank reputation and the price and quality of underwriting services, *Journal of Finance* 60, 2729-62.

⁵ Hayes, S., M. Spence and D. Marks, *Competition in the Investment Banking Industry* (Cambridge, Mass.: Harvard University Press, 1983).

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was also important that they developed their reputational and relationship capital quickly. The easiest approach to accomplishing this dual goal was to takeover already established investment banks that operated as securities firms. As the remainder of the article will show, the successful conduct of underwriting is dependent on various other services. The acquisition strategy was, therefore, the most efficient approach for commercial banks to overcome barriers to entry emanating from the particular organizational structure of underwriting firms and the need for reputation.

V. UNDERWRITING AND THE STRUCTURE OF THE INVESTMENT BANK

The innovative advantage that commercial banks brought to the underwriting business was their relationships with corporate clients through loan services and retail customers through deposit and savings products. Whether this advantage is decisive for the success of the commercial plus investment bank model depends, however, on its relative importance compared to other competitive resources available to independent investment banks. The review of the literature reveals that success in underwriting is impacted critically by relationships, analyst quality and coverage, formation of syndicates and pricing and allocation of new issues. This implies that the competencies and capabilities a firm brings to its underwriting business depend on its organizational structure.

A. Relationships in Investment Banking

On the issuer side of relationships, commercial banks came into the underwriting business with a distinct advantage over securities firms, that being their lending relationships with firms that can be potential issuers. On the investor side, however, securities firms had an advantage because of their long standing trading and brokerage relationships, as well as asset management services. So, the question is: what type of relationships affect the flow of underwriting deals?

Lending relationships can be advantageous in two respects. They can help reduce the cost of price discovery and, thus, offer issuance cost savings. They can also increase the likelihood that loan clients will choose their lender to act as underwriter if relationship banking optimizes the overall net benefits to the client. However, the advantage of commercial banks due to lending relationships is not free of possible conflicts of interest. On the one hand, commercial banks can produce more inside information about a firm's quality of business. Thus, they can better certify the value of the firm's securities and

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bridge the information gap between outside investors and firm insiders. Yet, a bank has a self-serving interest in facilitating a new issue by a high-risk loan client if the purpose of the proceeds is to pay the bank's loan. Therefore, acting as underwriters, commercial banks face a value certification advantage over independent investment banks as well as a conflict of interest that makes them less credible price setters.⁶

Early research on the topic of lending relationships and issuance costs revealed mixed evidence. Gande, Puri, Saunders and Walter report that underpricing was lower for bonds of lower quality if underwritten by commercial banks than securities firms, especially when proceeds were not used to repay the bank's debt.⁷ To the contrary, Rotten and Mullineaux do not find any significant difference in the degree of underpricing.⁸ These authors do find, nonetheless, that banks charged lower underwriting fees than those charged by securities firms in the case of low quality bond issues. This would imply that banks have more private information about their issuers and they pass their cost savings to clients through lower fees. The evidence in studies of equity offerings – IPOs in particular – shows that while there was no difference in gross fees⁹ underpricing was lower if the underwriter was a commercial bank.¹⁰ A more recent study that includes issues up to 2004 shows that commercial banks charged significantly lower fees than independent underwriting firms in the case of initial primary offerings (IPOs), seasoned equity offerings (SEOs) and debt offerings.¹¹

What is the relative value of lending relationships versus underwriting relationships? Shenone reports that a lending relationship between the lead underwriter and the issuer helps reduce IPO underpricing more than a prior underwriting relationship.¹² She finds, though, that among issuers with prior loan and underwriting relationships a greater fraction choose the prior

⁶ Puri, M., 1999, Commercial banks as underwriters: Implications for the going public process, *Journal of Financial Economics* 54, 133-163.

⁷ Gande, A., M. Puri, A. Saunders and I. Walter, 1997, Bank underwriting of debt securities: modern evidence, *Review of Financial Studies* 10, 1175-1202.

⁸ Rotten, I. and D. Mullineaux, 2002, Debt underwriting by commercial bank-affiliated firms and investment banks: More evidence, *Journal of Banking and Finance* 26, 689-718.

⁹ Gande, A., M. Puri and A. Saunders, 1999, Bank entry, competition and the market for corporate securities underwriting, *Journal of Financial Economics* 54, 165-195.

¹⁰ Fields, P., D. Fraser and R. Bhargava, 2003, A comparison of underwriting costs of initial public offerings by investment and commercial banks, *Journal of Financial Research* 26, 517-534.

¹¹ Kim, D., D. Palia, and A. Saunders, 2008, The impact of commercial banks on underwriting spreads: Evidence from three decades, *Journal of Quantitative and Financial Analysis* 43, 975-1000.

¹² Schenone, C., 2004, The effect of banking relationships on the firm's IPO underpricing, *Journal of Finance* 59, 2903-58.

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relationship underwriter than the prior relationship bank. Yasuda finds evidence that prior lending relationships have a positive impact on the underwriter choice.¹³ This preference is stronger among first-time and low-quality debt issuers where the bank relationship is more effective in producing credible offer prices. The importance of prior lending relationships is also confirmed in Bharath, Dahiya, Saunders and Srinivasan, who find a higher probability for a debt and IPO underwriting mandate when the underwriter has been a lender to the issuing firm.¹⁴ Prior lending relationships, however, are not more advantageous than prior underwriting relationships in securing SEO mandates.

Another competitive advantage of commercial banks is their capacity to extend loan facilities concurrently with new issue placement services. Whereas in 1994 only 1% of seasoned equity offerings (SEOs) had a concurrent loan deal, this percentage had risen to 20% by 2001.¹⁵ These authors find that in concurrent deals the average underpricing, underwriter spread and loan yield are lower and this is more so for lower-quality issuers. More important is the evidence that concurrent deals increase the probability of securing a SEO mandate over and beyond what would be expected because of any prior lending relationship. Surprisingly, the study also finds that securities firms had underwritten a significant portion of concurrent deals, as they tried to counter the lending advantage of commercial banks.

The above evidence supports the view that lending relationships have a positive impact on underwriting deal flow, but it also shows that they are most critical for the underwriter choice of first-time issuers who are relatively small, less well-known and lower quality firms. We can infer then that lending relationships alone could not have enabled commercial banks to gain underwriting business in the more lucrative market segment occupied by large, well-known issuers. These issuers could continue to deal with their traditional independent investment banks.

Although prior lending relationships gave commercial banks an advantage in price discovery, especially in the case of lower quality issuers, the literature also shows that other benefits to the issuer mattered as well and can influence the underwriter choice.

¹³ Yasuda, A., 2005, Do bank relationships affect the firm's underwriter choice in the corporate-bond underwriting markets?, *Journal of Finance* 60, 1259-1292.

¹⁴ Bharath, S., S. Dahiya, A. Saunders and A. Srinivasan, 2007, So what do I get? The bank's view of lending relationships, *Journal of Financial Economics* 85, 368-419.

¹⁵ Drucker, S. and M. Puri, 2005, On the benefits of concurrent lending and underwriting. *Journal of Finance* 60, 2763-99.

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B. Analyst coverage

One of the major services the lead underwriter offers the issuer is to provide analyst coverage of the new security. Bradley, Jordan, and Ritter find that analyst coverage starts for 76% of IPOs immediately after the end of the quiet period and the market responds positively by bidding up the so covered IPO share.¹⁶ This is particularly important for IPOs since the new issue is relatively unknown to investors. More extensive analyst coverage increases the firm's visibility and investor base and eventually the price of the new security. In the case of IPOs, insiders can benefit from selling at higher prices once the lock up period expires. Consistent with this, Cliff and Denis find that issuers are less likely to switch to another underwriter for future issues as the analyst coverage increases.¹⁷ However, higher analyst quality comes with greater underpricing.¹⁸

Direct evidence on the positive impact of analyst quality on underwriting market share is reported in Dunbar.¹⁹ Star analyst movement across underwriters also affects the underwriter choice and deal flow.²⁰ When All-Star analysts switch to another investment bank, the hiring bank gains in equity market share whereas the previous employer of the leaving analyst loses. The market share gain is not related to more aggressive recommendations at the new investment bank and the gains are due to new issuers attracted to the hiring firm. Underwriter quality in analyst coverage also affects the decision to switch to another investment bank. Thus, Krigman, Shaw and Womack find that securing higher quality in analyst coverage is a more important factor for switching to another underwriter than the degree of underpricing.²¹ Similarly, Burch, Nanda and Warther find that graduating to an underwriter of higher quality for a follow-on issue is motivated by greater analyst coverage.²²

¹⁶ Bradley, D., B. Jordan and J. Ritter, 2003, The quiet period goes out with a bang, *Journal of Finance* 58, 1-36.

¹⁷ Cliff, M. and D. Denis, 2004, Do initial public offering firms purchase analyst coverage with underpricing?, *Journal of Finance* 59, 2871-2901.

¹⁸ Bradley, D., B. Jordan and J. Ritter, 2003, The quiet period goes out with a bang, *Journal of Finance* 58, 1-36.

¹⁹ Dunbar, C., 2000, Factors affecting investment bank initial public offering market share, *Journal of Financial Economics* 55, 3-43.

²⁰ Clarke, J., A. Khorana, A. Patel, and P. Rau, 2007, The impact of all-star analyst job changes on their coverage choices and investment banking deal flow, *Journal of Financial Economics* 84, 713-737.

²¹ Krigman, L., W. Shaw and K. Womack, 2001, Why do firms switch underwriters?, *Journal of Financial Economics* 60, 245-84.

²² Burch, T., V. Nanda and V. Warther, 2005, Does it pay to be loyal? An empirical analysis of

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Moreover, this motive overtakes the benefits of loyalty which result in lower underwriter fees for equity issuers (although not for debt issuers).

The importance of analysts is tempered, however, by the need to protect reputation. Ljungqvist, Marston and Wilhelm report that the flow of underwriting mandates is influenced more by past debt or equity underwriting relationships than aggressive analyst recommendations.²³ Reputable investment banks are less likely to use analyst recommendations to please the issuer because of the high cost they may pay in reputational capital. Thus having worked with a reputable underwriter in the past is more important for future mandates. Fernando, Gatchev and Spindt argue that issuers and underwriters are matched by their relative quality.²⁴ They find that high (low)-quality issuers end up with high (low)-quality underwriters and ongoing underwriting relationships depend on the stability of the issuer-underwriter relative quality.

The above findings imply that underwriting relationships, reputation and quality of analyst coverage are additional important factors in attracting new issue deals besides prior lending relationships and the level of issuance costs.

C. Syndicate structure and competition

Despite their fierce competition for underwriting deals, investment banks are forced by the nature of this activity to form coalitions in the form of syndicates that collectively underwrite and place new securities. The persistence of underwriting syndicates is proof of the importance issuers attach to the various services they expect from underwriters beyond a guaranteed placement of the new issue. Syndication improves price discovery, achieves placement over a wider investor base, increases the issue's visibility and information flow through greater analyst coverage and secures a more liquid aftermarket through more extensive market making.

Although an integrated investment bank can offer all these services, it is unlikely that it can offer them equally well as a group of underwriters. The issuers' demand for more co-managers is also an indication of the enhanced services syndicates can produce. Furthermore, exclusive handling of new issues would prevent the lead underwriter from participating in several deals simultaneously, given capital and other resource constraints. Frequent deals and

underwriting relationships and fees, *Journal of Financial Economics* 77, 673-700.

²³ Ljungqvist, A., F. Marston and W. J. Wilhelm, 2006, Competing for securities underwriting mandates: banking relationships and analysts recommendations, *Journal of Finance* 61, 301-40.

²⁴ Fernando, C., V. Gatchev and P. Spindt, 2005, Wanna dance? How firms and underwriters choose each other, *Journal of Finance* 60, 2437-70.

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repeat business is, however, important for maintaining the requisite skill set within a dynamic market setting. Syndication is also a form of risk-sharing that reduces each underwriter's risk that the new issue will fail to attract investors at the fixed offer price.

Notwithstanding the advantages of collaboration with other underwriters, syndication poses risks for established lead-managing firms. Hayes describes how in the 1970's Merrill Lynch and Salomon Brothers used their respective advantages in retail investor networks and fixed income analysis to join syndicates as co-managers and move closer to issuers.²⁵ This way they increased their chances to be chosen for the lead underwriter's position in future deals. It is interesting, therefore, to examine the factors that drive the formation of syndicates and how investment banks strategize to increase their chances to be included in underwriting syndicates.

In their study of the structure of underwriting syndicates, Corwin and Schultz find that the likelihood an investment bank will be included in the syndicate increases with underwriter reputation, number of star analysts, and prior status as lead underwriter.²⁶ They show that syndicates with more co-managers produce better price discovery, provide greater analyst coverage and more extensive market making in the aftermarket. But syndicates with more co-managers also result in higher underwriting fees. Pichler and Wilhelm propose that syndicates perform a monitoring function to ensure that the lead underwriter delivers the expected quality of service for the fee charged.²⁷ In this monitoring framework, the members of the syndicate not only complement each other across various services. They also monitor the efforts of the lead underwriter and thus the overall quality of the deals handled by the syndicate. Since syndicate memberships are relatively stable,²⁸ each investment bank has a self-serving interest to protect its own reputation which would be tarnished if lead managers pursued their own gain at the expense of the reputation of the syndicate. This is one of the reasons why issuers insist on the presence of more co-managers and they are willing to pay higher fees.

The monitoring theory of syndicates explains why investment banks that receive new issue mandates are forced to invite potential rival banks to participate in the syndicate. Song presents interesting evidence on the reasons

²⁵ Hayes, S., 1979, The transformation of investment banking, *Harvard Business Review* 79, 153-170.

²⁶ Corwin, S. and P. Schultz, 2005, The role of IPO underwriting syndicates: Pricing, information production, and underwriter competition, *Journal of Finance* 60, 443-486.

²⁷ Pichler, P., and W. Wilhelm, 2001, A theory of the syndicate: Form follows function, *Journal of Finance* 56, 2237-2264.

²⁸ Corwin, S. and P. Schultz, 2005, The role of IPO underwriting syndicates: Pricing, information production, and underwriter competition, *Journal of Finance* 60, 443-486.

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for and the performance of hybrid syndicates, i.e., those comprised of an independent investment bank acting as lead underwriter and a commercial bank acting as a co-manager.²⁹ Hybrid syndicates are more likely to be used when there is more informational asymmetry about the issuer and the lending relationship between the issuer and the commercial bank raises the perception of a conflict of interest, which could diminish the certification power of the bank. Song finds that hybrid syndicates are indeed more frequently used when the issuer is a smaller firm, has lower rating, relies more on bank loans and has less prior access to capital markets. Compared to commercial bank-led syndicates, hybrid syndicates underwrite a greater fraction of debt issues when the proceeds are used to repay the bank's loan. The evidence also shows that the incidence of hybrid syndicates increased with the expansion of commercial banks into underwriting. Narayanan, Rangan and Rangan also find that prior relationships and possible conflicts of interest determine whether a commercial bank lead-manages as opposed to co-managing a syndicate.³⁰ They find that a commercial bank is less likely to be chosen to lead-manage the SEO of a loan client. Moreover, when there is a lending relationship, co-management of the syndicate by the relationship commercial bank and the independent underwriter averts any pricing discount due to the perceived conflict of interest and results in lower underwriting fees. These findings imply that the presence of an independent investment bank restores certification power whereas the commercial bank's lending relationship with the client reduces the cost of price discovery.

Demonstrating deal execution skills to the issuer is of particular importance for establishing reputation in the underwriting business. Since the second half of the 1990's, one resource that has acquired particular importance for issuers is top analyst coverage. Ljungqvist, Marston and Wilhelm present evidence that investment banks make strategic use of their strength in top analysts to increase the chances of joining future syndicates.³¹ They find that investment banks issue favorable coverage for potential issuers, especially when the latter prefer to hire multiple co-managers, and this increases the likelihood of being hired subsequently as co-managers. In addition, past relationships with the issuer and the eventual lead underwriter, as well as the capacity to lend increase the chances of an investment bank joining the syndicate.

²⁹ Song, W., 2004, Competition and coalition among underwriters: The decision to join a syndicate, *Journal of Finance* 59, 2421-44.

³⁰ Narayanan, R., K. Rangan and N. Rangan, 2004, The role of syndicate structure in bank underwriting, *Journal of Financial Economics* 84, 87-109.

³¹ Ljungqvist, A., F. Marston and W. J. Wilhelm, 2009, Scaling the hierarchy: How and why investment banks compete for syndicate co-management appointments, *Review of Financial Studies* 22, 3977-4009.

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Overall, the evidence shows that commercial banks and independent investment banks can produce complementary syndicate benefits in the execution of underwriting deals that increase certification power and lower costs. The evidence also reveals that without a fast buildup of analyst power and reputation commercial banks would have had hard time penetrating the market for IPOs and other offerings by higher quality issuers that have greater bargaining power in the negotiations regarding the overall package of services surrounding an underwriting deal.

D. Pricing and allocation of new issues

The value of underwriters as information intermediaries is greater when there is an information gap or asymmetry between issuers and investors. The underwriter's job is to arrive at an offer price for the new issue that is credible to both parties. Therefore, underwriters must engage in the costly process of price discovery. If public information were all that is needed for the valuation of new issues, underwriters would have little need for relationships with issuers and investors. In a world of information asymmetry though, underwriters need to extract private information from both sides of the market. Arriving at a credible offer price has value, however, if it has a singular importance for the placement of the issue. The literature shows that the importance of price discovery for placement is affected by how underwriters manage their relationships with issuers and investors.

As noted earlier, traditional investment banks (i.e., securities firms) had a relationship advantage with respect to investors, especially those considered to be well-informed, i.e., institutional investors. Upon receiving an underwriting mandate the investment bank engages in an underwriting investigation with the purpose to gather information about the issuer that can be communicated credibly to the investors. In this connection, commercial banks enjoy an advantage because of their lending relationships to potential issuers, which allows banks to possess inside information on an ongoing basis. This can lower the price discovery costs significantly and can also increase the bank's credibility as it conveys value-related information to investors. However, this apparent competitive advantage of commercial banks over traditional independent investment banks is subject to two possible limitations. One is the aforementioned potential of a conflict of interest that diminishes the bank's credibility as an objective arbiter of the information exchange. The second limitation is how sensitive new issue mandates and placement are to the offer price.

A review of the pertinent literature on price discovery and allocation of new issues reveals that we can distinguish among three paradigms. The first is

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the reward to private information paradigm; the second is the enhanced benefits paradigm; and the third is the reciprocity of benefits or quid pro quo paradigm.

(i) The reward to information paradigm

The reward to private information or extraction of information paradigm is best exemplified in the Benveniste and Spindt hypothesis that underwriters use underpricing as a reward to private information they receive from informed investors.³² The premise of this hypothesis is the bookbuilding method of arriving at the offer price. Issuers are viewed as passive participants who rely on the underwriter to gather information and then achieve the highest possible offer price. Because underwriters do not know whether investors have the same opinion about the value of the issue, they promise those investors who reveal positive information to reward them with greater allocations of underpriced issues. That is, the underwriter does not expropriate for the benefit of the issuer all the additional value over and above what was set by the underwriter as a result of the underwriting investigation and reflected in the preliminary filing price range. Indeed, there is extensive empirical evidence that when the final offer price is set above the preliminary price range (apparently because of positive information from investors), the resulting underpricing is greater than when the offer price is set below the mid-point of the price range. This pattern, called partial price adjustment, was first documented in Hanley³³ and subsequently in other studies, including Cornelli and Goldreich³⁴ and Lowry and Schwert.³⁵ The extraction of information hypothesis requires that underwriters form stable long-term relationships with investors in order to establish mutual trust and a reputation for fair dealing. In a recent study, Hoberg finds that underpricing of IPOs persists for a group of underwriters that have sustained relationships with institutional investors.³⁶ These contacts enable underwriters to be better informed and, hence, identify and pursue new issues that will perform well in the post-issue period. These high-underpricing underwriters can then use the underpricing to reward their institutional clients as well as seek rents from the parties involved in the

³² Benveniste, L. and P. Spindt, 1989, How investment bankers determine the offer price and allocation of new issues, *Journal of Financial Economics* 24, 213-232.

³³ Hanley, K. W., 1993, The underpricing of initial public offerings and the partial adjustment phenomenon, *Journal of Financial Economics* 34, 231-50.

³⁴ Cornelli, F. and D. Goldreich, 2003, How informative is the order book? *Journal of Finance* 58, 1415-1443.

³⁵ Lowry, M. and G. Schwert, 2004, Is the IPO pricing process efficient? *Journal of Financial Economics* 71, 3-26.

³⁶ Hoberg, G., 2007, The underwriter persistence phenomenon, *Journal of Finance* 62, 1169-1206.

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placement of new issues.

(ii) The enhanced benefits paradigm

The enhanced benefits paradigm focuses on the objective function of the issuer and questions whether issuers act with the sole purpose to maximize the proceeds from the issue. Several papers present evidence to the contrary. These papers argue that the firm insiders who have decision-making authority over new issues attempt to maximize a combination of firm-specific objectives, such as issue proceeds and analyst coverage, as well as self-specific objectives, such as proceeds from future sales of shares and side payments from underwriters in the form of spinning.

Aggarwal, Krigman and Womack propose that insiders of IPO firms care more about the market price of the stock at the time they can sell their holdings than at the time of the offer, thus paying less attention to underpricing.³⁷ Since the time insiders can unload shares is when the lockup expiration arrives, about 180 days after the IPO, the selling shareholders have an incentive to see that share price is relatively high at that time. These authors find that insiders retain more shares (presumably for later sale) in IPOs with greater degree of underpricing. Heavily underpriced offers also receive more analyst coverage and stronger recommendations, which are found to have an influence on the level of prices observed around the lockup expiration date. Loughran and Ritter offer further evidence that other side benefits distort the issuers' objective to maximize proceeds from a new issue.³⁸ One possible distortion comes from insiders' self-dealing as when they are promised allocations of hot IPOs.³⁹ The other distortion is related to what the authors call the "analyst lust" hypothesis, that is, the issuers' demand that their IPO is backed up by extensive analyst coverage. Analyst coverage is desirable because it creates and sustains "buzz" about the new issue and helps prop up its market price. Although providing extensive analyst coverage and other kickbacks increases the expected cost of the underwriting services, investment banks effectively offset this increase through excessive underpricing which lowers the underwriting risk and the costs of the placement effort. Interestingly, Loughran and Ritter find that the degree of underpricing increased dramatically in the late

³⁷ Aggarwal, R., L. Krigman and K. Womack, 2002, Strategic IPO underpricing, information momentum, and lockup expiration selling, *Journal of Financial Economics* 66, 105-137.

³⁸ Loughran, T. and J. Ritter, 2004, Why has the IPO underpricing changed over time?, *Financial Management* 33, 5-37.

³⁹ Loughran and Ritter (2004) cite the case of Frank Quatrone of CSFB who was accused of spinning by the SEC.

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1990's and most of the rise was due to heavily underpriced IPOs underwritten by prestigious investment banks, since they were the ones that could satisfy the issuers' demand for extensive coverage by top quality analysts. Evidence in James and Karceski is also supportive of the view that underwriters try to garner new issue business through aggressive analyst coverage, especially of poorly received IPOs.⁴⁰

The issuer's objective to maximize the issue proceeds can be also distorted because of cognitive biases. Loughran and Ritter invoke the "prospect theory" to argue that inside shareholders of IPO firms are more concerned about maximizing their wealth change than the level of their wealth.⁴¹ If insiders anchor the preliminary estimate of their wealth at the midpoint of the price range, the wealth gain is then determined by the spread between the final offer price and the midpoint price. When the offer price is sufficiently higher than the midpoint price, insiders feel satisfied from the issue regardless of the money left on the table, for example, the difference between the opening market price and the offer price. On their part, underwriters have an incentive to inflate underpricing rather than charge a greater gross spread because insiders pay less attention to the underpricing. This is so because underpricing is after all contingent on market conditions, whereas the gross spread is fixed in advance. Furthermore, underwriters can use the excess underpricing to engage in quid pro quo deals with issuers, such as allocating hot IPO shares to the brokerage accounts of insiders (a practice called spinning), or with investors, such as demanding more brokerage business or aftermarket purchases to support the prices of new issues. Ljungqvist and Wilhelm provide evidence supporting the behavioral bias of issuers concerned with wealth change rather than level of wealth.⁴² They find that IPO issuers are more likely to switch to another underwriter for a follow on SEO if they are not satisfied in terms of wealth gains resulting from the IPO deal.

(iii) The reciprocity of benefits paradigm

The quid pro quo paradigm refers mostly to rewards underwriters grant to investors to facilitate the placement of the new issues. These benefits go beyond what the Benveniste and Spindt model of information extraction would

⁴⁰ James, C. and J. Karceski, 2006, Strength of analyst coverage following IPOs, *Journal of Financial Economics* 82, 1-34.

⁴¹ Loughran, T. and J. Ritter, 2002, Why don't issuers get upset about leaving money on the table in IPOs?, *Review of Financial Studies* 15, 413-43.

⁴² Ljungqvist, A. and W. Wilhelm, 2005, Does prospect theory explain IPO market behavior?, *Journal of Finance* 60, 1759-1790.

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suggest as necessary to coax informed investors to disclose any private information they may have about the issue. Hanley and Wilhelm,⁴³ as well as Sherman,⁴⁴ extend the Benveniste and Spindt model to suggest how and why underwriters and institutional investors form durable and stable relationships. To ensure loyalty and the truthful revelation of their private information, underwriters require that these investors purchase new securities in both hot and cold markets. In return, underwriters promise preferred allocations of underpriced issues so that investors realize net profits over the long-run. Consistent with this proposition, Aggarwal, Prabhala and Puri find that institutional investors receive underpriced IPO shares in excess of the amount justified by the extraction of information hypothesis.⁴⁵ Conversely, institutional investors are allocated proportionately less of cold IPOs. The implication is that either underwriters transfer excess profits to informed investors in anticipation of side payments or informed investors do not fully reveal their positive private information and oversubscribe for the hot new issues on account of their positive but undisclosed valuations. In related research, Aggarwal reports that institutional investors are treated preferentially with respect to flipping, i.e., selling back their allotted shares in the aftermarket.⁴⁶ By flipping a greater percentage of hot IPOs than cold IPOs, institutional investors realize net profits while at the same time help support weak demand for cold IPOs in the aftermarket. In a study of European IPOs, Jenkinson and Jones find little evidence that allocations favor investors who submit informative bids, that is, bids that can help the underwriter to produce a higher offer price.⁴⁷ Instead their evidence suggests that preferred allocations go to investors deemed to hold new shares for a longer-term period and, thus, help minimize flipping and sale pressure in the aftermarket. Boehmer, Boehmer and Fische find that underwriters favor institutional investors with IPO stocks that realize positive one-year returns after the offer and allow flipping for IPO shares that realize low returns.⁴⁸

⁴³ Hanley, K. W. and W. Wilhelm, 1995, Evidence on the strategic allocation of initial public offerings, *Journal of Financial Economics* 37, 239-57.

⁴⁴ Sherman, A., 2000, IPOs and long-term relationships: An advantage of bookbuilding, *Review of Financial Studies* 13, 687-714.

⁴⁵ Aggarwal, R., N. Prabhala and M. Puri, 2002, Institutional allocation in IPOs: Empirical evidence, *Journal of Finance* 57, 1421-1442.

⁴⁶ Aggarwal, R., 2003, Allocation of IPOs and flipping activity, *Journal of Financial Economics* 68, 111-135.

⁴⁷ Jenkinson, T. and H. Jones, 2009, IPO pricing and allocations: A survey of the views of institutional investors, *The Review of Financial Studies* 22, 1477-1504.

⁴⁸ Boehmer, B., E. Boehmer and R. Fische, 2006, Do institutions receive favorable allocations of IPOs with better long-run returns?, *Journal of Financial and Quantitative Analysis* 41, 809-828.

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Another way underwriters can trade underpriced new issues for a reciprocal favor from institutional investors is to ask that the latter buy additional IPO shares in the aftermarket. This post-issue buying activity, called laddering, increases demand and hence sustains share price at a higher than otherwise level.⁴⁹ It also generates greater degree of underpricing which underwriters can use to trade it for favors from issuers and investors. Griffin, Harris and Topaloglu report that IPO investors return to the market to buy additional shares from the lead manager.⁵⁰ Their evidence shows that buys are not motivated by genuine demand because the shares are resold in later periods, nor are they due to superior execution of buy orders by the lead managers. Furthermore, laddering appears to be more extensive when the lead underwriter is relatively active in the IPO market and thus can assure investors of future allocations of IPO shares. Besides helping to support price at a higher level, such aftermarket buys can be used to generate trading income for the lead underwriter. More on laddering is provided by Hao, who refers to evidence in the order book, run by the lead manager, indicating expression of interest to buy 2x or 3x the number of subscribed shares in the aftermarket.⁵¹ Her evidence also shows that laddering coincides with higher offer prices but also with more money left on the table by the issuing firm.

Recent studies find evidence that allocation of new securities is not strictly tied to the effort of price discovery. Underwriting firms have extensive trading and brokerage business with institutional investors. Nimalendran, Ritter and Zhang find a positive relationship between the degree of underpricing and the volume of trading conducted by institutional investors around the IPO date.⁵² This implies that trading business is exchanged for greater allocations of underpriced shares. Reuter finds evidence that mutual funds that have brokerage business with the lead underwriter hold more shares of IPO stocks in the aftermarket and this relationship is stronger for issues with greater underpricing.⁵³ Both studies find, however, that the gains from trading and brokerage do not exhaust the investor gains from underpricing. Therefore, the

⁴⁹ In 2003 the Securities and Exchange Commission (SEC) settled laddering charges with JP Morgan, Morgan Stanley and Goldman Sachs in relation to Rule 101 of Reg-M of the Securities and Exchange Act of 1934 that prohibits this type of price manipulation (Hao, 2007).

⁵⁰ Griffin, J., J. Harris and S. Topaloglu, 2007, Why are IPO investors net buyers through lead managers?, *Journal of Financial Economics* 85, 518-551.

⁵¹ Hao, G., 2007, Laddering in initial public offerings, *Journal of Financial Economics* 85, 102-122.

⁵² Nimalendran, M., J. Ritter and D. Zhang, 2007, Do today's trades affect tomorrow's IPO allocations? *Journal of Financial Economics* 72, 555-580.

⁵³ Reuter, J., 2006, Are IPO allocations for sale? Evidence from mutual funds, *Journal of Finance* 6, 2289-2324.

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remainder could be a reward for other benefits received by the lead underwriter, including private information. Ritter and Zhang also find that lead underwriters allocate more shares to their own family of mutual funds when underpricing is higher.⁵⁴ This evidence for nepotism suggests that underwriters use preferential allocations to juice up the performance of their mutual funds and thus attract more asset management business.

Using responses to surveys of institutional investors allocated shares in European IPOs, Jenkinson and Jones find that the volume of brokerage business is the most influential factor in the awarding of IPO allocations.⁵⁵ Most interesting is the finding that the contribution institutional investors make to the valuation of IPOs is limited and does not emerge as the main factor in influencing the allocation of shares. Although institutional investors exchange information with lead underwriters on new issues, not all such investors produce their own valuation and those who do are not eager to share it fully with the underwriters. Thus, for example, 71% of those investors who submitted a limit bid⁵⁶ responded that they set the bid price below their own valuation. These findings are not consistent with the view of the reward for information paradigm that is supposed to characterize the underwriter-investor relationship.

Quid pro quo deals can be also struck with retail investors. Although these investors are less important in improving the underwriter's valuation opinion, they can contribute to the demand for the new issue. Recent evidence suggests that attracting the interest of retail investors can impact the pricing outcome in new issues. Cook, Kieschnick and Ness find that when the underwriter promotes the issue among retail investors, the resulting "buzz" and anticipation produce higher final offer prices and enable underwriters to reap higher gross spreads.⁵⁷ The strong aftermarket demand by retail investors generates greater underpricing, but issuers do not seem to mind it since evidence shows they are more likely to keep the same underwriter for future new issues. Thus, pre-offering publicity is appreciated and rewarded by issuers. Cornelli, Goldreich, and Ljungqvist also report that retail investor over-optimism

⁵⁴ Ritter, J. and D. Zhang, 2007, Affiliated mutual funds and the allocation of initial public offerings, *Journal of Financial Economics* 86, 337-68.

⁵⁵ Jenkinson, T. and H. Jones, 2004, Bids and allocations in European IPO bookbuilding, *Journal of Finance* 59, 2309-38.

⁵⁶ A limit bid sets the highest (reservation) price at which an investor is willing to buy a fixed number of, say IPO shares. Another type of less informative bid is the strike bid which simply indicates that the investor is willing to buy new securities worth a fixed monetary amount at the consensus offer price.

⁵⁷ Cook, D., R. Kieschnick and R. Van Ness, 2006, On the marketing of IPOs, *Journal of Financial Economics* 82, 35-62.

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produces higher prices in the pre-offer grey market for European IPOs.⁵⁸ This helps underwriters to set a higher than otherwise offer price. Moreover, underwriters seem to weigh less the information received from informed investors if the grey market price signifies retail investor over-optimism. The findings in these two studies suggest that relationships and interaction with retail investors is also important for investment banks in the execution of new issue deals. Aggarwal shows evidence that investment banks with stronger emphasis in retail investor clienteles award retail investors a greater portion of IPO shares than wholesale investment banks.⁵⁹ If retail investors are perceived to possess less valuable information for the pricing of a new issue, then what motivates the underwriters' preference in the allocation of new issue shares? Puri and Rocholl utilize allocation data from a sample of German banks serving as underwriters and find that retail investors subscribe to and buy proportionally more underpriced than overpriced shares.⁶⁰ This pattern implies that the banks share information with retail customers that enables the latter to discriminate between hot and cold IPOs. Moreover, the benefits banks expect as a *qui pro quo* include increased cross-selling of underwriting services with brokerage and consumer loans.

The review of the evidence in relation to the pricing and allocation paradigms reveals that the procurement of underwriting services takes place within a complex web of underwriter, issuer and investor interests that make the pricing and allocation of new issues also dependent on factors beyond those suggested by the pure price discovery paradigm. The most direct implication is that winning mandates and successfully placing new issues are not necessarily or strictly related to the quality of price discovery through the exchange of private information. Instead, both depend to a considerable extent on the structure of the underwriting firms as organizations of multi-faceted operations that enable the underwriting division to satisfy the evolving interests of issuers and investors through a variety of reciprocal and mutually beneficial exchanges.

VI. IMPLICATIONS AND PROSPECTS

With all major underwriting firms, including Goldman Sachs and Morgan Stanley, operating under the commercial plus investment banking

⁵⁸ Cornelli, F., D. Goldreich and A. Ljungqvist, 2006, Investor sentiment and pre-IPO markets, *Journal of Finance* 61, 1187-1216.

⁵⁹ Aggarwal, R., 2003, Allocation of IPOs and flipping activity, *Journal of Financial Economics* 68, 111-135.

⁶⁰ Puri, M. and J. Rocholl, 2008, On the importance of retail banking relationships, *Journal of Financial Economics* 89, 253-267.

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model, what implications can we draw about the future conduct of underwriting business? The previous review of the literature has shown that integration of services is a potent condition for success in underwriting. But integrating multifaceted operations under one corporate roof generates the possibility of serious conflicts of interest that can undo the benefits of synergy. Even before the ascendancy of the commercial plus investment bank model, securities firms operating as integrated investment banks were faced with conflicts of interest between their role as underwriters and their role as providers of services in research and analysis, brokerage, trading and asset management. The new conflict, therefore, stems from the role of the underwriter as a lender. Eventually, the case for joint versus separate production of financial services is a matter of whether the economies of scope more than offset the costs of managing and overcoming conflicts of interest.

It was explained above how the lender as underwriter is confronted with a conflict of interest that complicates its role as a credible and truthful discloser of the true state of the firm. Combining lending and underwriting can create additional unintended complications that a commercial plus investment bank has to manage. If a firm believes that its lender will eventually help it raise capital to repay the debt, the firm has less incentive to carefully screen and develop the investments it undertakes. Thus, the task of separating good from poor quality firms falls on the underwriting bank.⁶¹ In this case, underwriting reputation is important in restoring the certification credentials of the underwriter. As a result the gains from economies of scope (extending both lending and underwriting services) may be offset by the costs of building and maintaining reputation. We saw that the hybrid syndicate is an efficient solution to this problem. Banks with lending ties to the issuer are willing to have an underwriter without such ties act as the lead manager of the syndicate. Surrendering the role of lead manager to another firm, however, reduces the overall direct and indirect gains the lender would earn as a lead manager. Kanatas and Qi also identify another complication in the issuer-lender relationship.⁶² A firm that retains its lender as underwriter has greater assurance that the lender will provide a new loan if the new issue is withdrawn. Moreover, this refinancing does not necessitate any additional information production costs. This financial flexibility comes though at the cost associated with the ongoing monitoring of the firm by its bank. Underwriters without lending ties to the issuing firm can pry it away from its lending bank by

⁶¹ Kanatas, G. and J. Qi, 1998, Underwriting by commercial banks: Incentive conflicts, scope economies, and project quality, *Journal of Money, Credit, and Banking* 30, 119-33.

⁶² Kanatas, G. and J. Qi, 2003, Integration of lending and underwriting: Implications of scope economies, *Journal of Finance* 58, 1167-1192.

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promising a greater probability of success for the new issue that eliminates the need to have a lender at the ready. This again introduces a trade-off between the gains from economies of scope and the attendant costs. It is not surprising, therefore, that smaller and riskier firms with less access to capital markets and greater likelihood of withdrawal are more likely to choose their lender as underwriter as the previous literature review has shown.

Another related theory on the value-added benefits of the multi-service versus the specialized financial institution is advanced by Bolton, Freixas and Shapiro.⁶³ Their model proposes that under certain conditions, multi-service organizations can provide credible disclosure of product information to their customers just like specialized firms. They argue that both organizational types have an incentive not to reveal the true quality of their products for fear of losing customers to rivals. The authors show that strong competition in the financial services market compels specialized firms to truthful disclosure even when reputation costs are low. On the other hand, one-stop firms with high market share can structure their prices across products so that they have less incentive to withhold information from customers. In the absence of strong competition, the cost from loss of reputation must be sufficiently high for both types of firms to conduct themselves truthfully, but in this case, one-stop firms lose their advantage. Given the importance of reputation in underwriting this theory suggests that both specialized and one-stop firms can co-exist.

Nonetheless, the structure of the underwriting markets is characterized by significant concentration. Utilizing data from the League Tables, it can be shown that the four-firm concentration ratio was, respectively, 36.4%, 48.7%, and 46.2% in the markets for debt and equity offerings, common stock offerings and IPOs in 2007. The high market share commanded by top underwriters affords them greater flexibility in structuring the prices of their services in yet another way than the one proposed in the above study. Benveniste, Ljungqvist, Wilhelm and Yu show that when an underwriter is successful in aggregating many contemporaneous flotations,⁶⁴ they can lower the average degree of underpricing for all issuers. This is possible because the bundling of new issues, especially of similar business lines, generates information spillovers that help reduce the cost of valuation and at the same time produce credible higher offer prices.

The above analysis suggests that the success of the underwriting business rests on a set of distinct organizational features that include multi-

⁶³ Bolton, P., X. Freixas and J. Shapiro, 2007, Conflicts of interest, information provision and competition in the financial services industry, *Journal of Financial Economics* 85, 297-331.

⁶⁴ Benveniste, L., A. Ljungqvist, W. Wilhelm and X. Yu, 2003, Evidence of information spillovers in the production of investment banking services, *Journal of Finance* 58, 577-608.

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faceted services, reputation, and appreciable market share. The multi-faceted services are necessary in order to facilitate the management of relationships which can be used for information production, valuation, and placement of new issues. Reputation is needed to ensure ongoing quality and commitment to the tacit agreements underlying the relationships with issuers and investors. Finally, controlling considerable market share is both a consequence of reputation as well as the source of economies of scale, valuation skills, and the driver of sustained relationships.

Although there is much talk about the virtues of the “boutique” specialized firm as an investment banker, this is more relevant to the corporate finance (like M&A and restructuring advice) side of the investment banking business than the underwriting side. The offering of securities by large, well-known firms with presence in the capital markets produces valuations that depend much less on the information intermediation efforts of the underwriter. In this segment of the market, the conflict-free valuation advantage of specialized firms over the integrated investment bank is a lot less critical. The supposed advantage of a specialized firm to produce more objective valuations is more critical when there is high uncertainty and severe asymmetry of information, as in the case of IPOs, low-grade bonds, and SEOs of low quality and visibility firms. The above review of the literature has revealed, however, that these are the types of offerings which require that the underwriter provide the issuer with other benefits (like, analyst coverage and market making) which minimize the importance of a high valuation. In the case of such offerings, the underwriter also needs to use offer price discounts and discretionary allocation to ensure placement of the issue with investors. The end goal of the efforts of the underwriter is to equate the expected cost of the underwriting service to its net payoffs. The integrated investment bank appears to be more efficient than the specialized firm in executing this model of production of underwriting services

VII. CONCLUSIONS

This paper has pursued answers to two questions: (a) what explains the acquisitive strategy of commercial banks? and (b) does the commercial plus investment banking model possess any distinct advantages over the pure investment banking model in the conduct of underwriting business? Based on the review and analysis of the extant evidence, we can draw the following conclusions.

First, the strategy of commercial banks to expand into underwriting through acquisitions is explained by the need to overcome barriers to entry in a more time-efficient and less costly way. For commercial banks to expand their

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network of potential issuers beyond the domain of small and lower quality firms with which they had lending relationships, they had to establish their credentials as underwriters and develop relationships with investors. To do so it was necessary for banks to develop multiple operations in the securities business.

Second, the lending relationships of banks were not enough to secure mandates, especially from larger and more established firms. Thus, they could not easily displace the established securities firms in these client segments. Independent investment banks could utilize their resources in analyst research and coverage and prior underwriting relationships, as well reputation to continue to have a significant presence in the underwriting markets.

Third, lending relationships contribute positively to the chances of a bank to become a member of the syndicate, but they are not the only factor. Reputation, analyst coverage and market making services (i.e., the traditional operating features of securities firms) count even more than lending relationships. Besides, a lending relationship is more likely to relegate a commercial bank to the role of co-manager than lead manager, thus depriving it of the lion's share of the underwriting fees and influence.

Fourth, the price discovery process, best exemplified by the reward for information model, is only one of the several factors that impact the pricing and allocation of new issues. Therefore, the inside information commercial banks have due to lending relationships is not as important in light of the factors suggested, respectively, by the enhanced benefits and the reciprocal benefits paradigms.

Fifth, multi-service operations are prerequisites for satisfying the interests of issuers and investors in the execution of underwriting deals. Hence, the integrated investment banking model is more efficient than the specialized firm model.

Finally, the review of the evidence showed that independent investment banks have advantages that enable them to compete effectively with commercial banks in the underwriting business. Indeed, at the time of deregulation securities firms possessed more resources conducive to successful underwriting than the commercial banks. Therefore, it is not surprising that the consolidation wave toward the commercial plus investment banking model was driven by acquisitions undertaken by commercial banks. The more recent demise of independent investment banks has not been the superiority of the commercial plus investment banking model over the independent banking model in the underwriting side of the business. Rather, it has been the excessive risk taking of independent investment banks in trading and proprietary investments without the support of a heavy balance sheet.

An interesting question for future research is whether the economies of scope from adding lending relationships and other advantages of commercial

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banking have generated more value than the costs associated with the integration of investment banks under the organizational umbrella of commercial banks.

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PREEMPTION V. PUNISHMENT: A COMPARATIVE STUDY OF WHITE COLLAR CRIME PROSECUTION IN THE UNITED STATES AND THE UNITED KINGDOM

*Daniel Huynh **

I. INTRODUCTION

Compared to most types of crime, white collar crime is a relatively new phenomenon. After several high profile cases in the mid-1900's in the United States, white collar crime emerged into the national spotlight. The idea materialized that there should be a separate and distinct category of crime aside from the everyday common crimes, like murder or burglary. More recently, large-scale scandals and frauds have been uncovered worldwide with public losses on the scale of billions of dollars. In the United States, white collar crimes have cost losses of more than \$200 billion annually.¹ In 2004, the United States Corporate Fraud Task Force recorded over five hundred corporate fraud convictions, which was twice many than was recorded in 2003.² In the United Kingdom, in 2002, the estimated cost of fraud in the United Kingdom was approximately £14 billion.³

The term white collar crime was first coined by Edwin Sutherland,⁴ who stressed the need to expand the study of criminology to include crimes committed by “respectable individuals in the course of their occupation.”⁵ Since then, many definitions have arisen, describing white collar crime as separate and distinct from “common crimes and street crime,”⁶ which led to the mistaken belief that white collar criminals were all from the upper class.

* Special thanks to Professor Lucia Zedner at Corpus Christi College, Oxford for her insight and advice.

¹ Michael Goldsmith, *Judicial Immunity for White-Collar Crime: The Ironic Demise of Civil RICO*, 30 HARV. J. ON LEGIS. 2 (1993).

² Zachary Bookman, *Convergences and Omissions in Reporting Corporate and White Collar Crime*, 6 DEPAUL BUS. & COM. L.J. 349 (2008).

³ LAWRENCE SALINGER, 2 *Encyclopedia of White-collar & Corporate Crime* 361 (Sage 2004).

⁴ Sutherland defined the term using words such as “respectability” and “high social status.”

⁵ *Id.* at 355.

⁶ ELLEN CHAYET, ET AL., *WHITE-COLLAR CRIME AND CRIMINAL CAREERS 2* (Cambridge Press 2001).

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Today, white collar criminals run the spectrum from executives, upper and middle management to general accountants.⁷ Sociologists in the past, like Sutherland, defined offenses only by the type of a violator, meaning white collar crimes were defined as any crime committed by wealthy, high standing individuals in the course of their occupation.⁸ In the alternative, today white collar crime is defined by the offenses committed, such as fraud or embezzlement. In an international context, the United Nations uses the term “abuse of power” when discussing white collar crimes.⁹

The United States Federal Bureau of Investigation defines white collar crime as:

those illegal acts which are characterized by deceit, concealment, or violation of trust and which are not dependent upon the application or threat of physical force or violence. Individuals and organizations commit these acts to obtain money, property, or services; to avoid the payment or loss of money or services; or to secure personal or business advantage.¹⁰

Within the past several decades, losses stemming from white collar crime have increased tenfold. In the United States, the “junk-bond king,” Michael Milken was responsible for over \$650 million in losses and ordered to pay the same amount as restitution before he was sentenced.¹¹ Bernard Madoff is responsible for over \$50 billion in losses. With the economic structure and the fast pace markets in place today, losses from white collar crimes are on a Herculean scale. To compound the problem, the public is hard pressed to grasp the magnitude of loss from white collar crime because the actual cost and damage to people’s lives and the national economy are extensive and often impossible to calculate.¹²

Because most white collar crimes are largely based on deception or fraud, it hard to detect. White collar crime might pose such a problem since

⁷ *Id.* at 10.

⁸ INTERNATIONAL HANDBOOK OF WHITE-COLLAR AND CORPORATE CRIME 31 (Gilbert Geis and Henry Pontell eds., Spring 2006).

⁹ *Id.* at 36.

¹⁰ FBI Los Angeles, *Investigative Programs: Counterterrorism*, available at <http://losangeles.fbi.gov/investprior.htm>

¹¹ David Nelken, *White Collar and Corporate Crime*, in OXFORD HANDBOOK OF CRIMINOLOGY, WHITE-COLLAR AND CORPORATE CRIME 733, 735 (Mike Maguire et al. eds., Oxford University Press 4th ed. 2007).

¹² *Id.*

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many times there are no readily identifiable victims and often times the perpetrators are only discovered after extensive investigation. Even when there are cognizable injured parties, the injured parties are unaware of even being victimized until it is too late. As a consequence, said individuals are not good witnesses nor reliable source of information.¹³ Furthermore, victims and, more importantly, prosecutors often lack the financial acumen necessary to understand and properly prosecute cases involving complex and sophisticated schemes. The nature of white collar crimes enables no detection long after its commission.¹⁴ Thus, the increase in commercial crime can be linked to “[t]he idea that white-collar offenders commit their crimes because they are unlikely to be punished.”¹⁵

In response to national scandals and fraud often linked to white collar crime, both the United States and the United Kingdom have enacted statutes and other procedures aimed at curbing the occurrence of major commercial crimes. Today, both countries have weapons to combat would-be white collar offenders in various stages to prevent a second-round of national scandal.

The article examines two of the world’s leading economic and legal systems, the United States and the United Kingdom, and analyzes how each country deals with white collar crime and its prosecution.¹⁶ The white collar justice systems are compared in both countries for key differences in their systems by evaluating: (1) the current system in each country, (2) their respective effectiveness and weaknesses; and (3) what ramifications are derived from each country’s approach.

Part II, analyzes the United States regulatory system that oversees economic crime, specifically dealing with two statutory schemes, the Racketeer Influenced Corrupt Organization Act (RICO) and the Sarbanes-Oxley Act of 2002. Along with its regulatory agencies, there will be an examination of how the United States relies on its enhanced punishment scheme to deter white collar crime.

Part III scrutinizes the United Kingdom’s legal system and its

¹³ *Id.* at 749.

¹⁴ White collar crimes like fraud and money laundering have an air of secrecy and concealment that make it difficult for victims or the authorities to detect them. With these crimes, the victim could be completely unaware and could even unknowingly help the criminal with their crime.

¹⁵ Michael Bensen et al., *Community Context and the Prosecution of Corporate Crime*, in *WHITE-COLLAR CRIME RECONSIDERED* 62 (Kip Schlegel and David Weisburd eds., University Press of New England 1994).

¹⁶ Because of this disparity and potential differences in detection and enforcement, the paper will only concentrate on large-scale corporate crimes. However, by looking at how each legal system deals with large-scale commercial crimes can also determine how effective the system is at catching smaller occurrences.

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regulatory agencies. In 2007, Parliament passed the Serious Crimes Act (SCA), which established Serious Crimes Prevention Orders (SCPO). As will be discussed, the prevention orders have the potential to deter white collar crime.

Part IV compares and contrasts the legal systems in the United States and United Kingdom by applying a hypothetical situation to each country's white collar prosecution system. Finally, Part V concludes with final comments on white collar crime prosecution and a recommendation for preventing white collar crime in both countries.

II. UNITED STATES SYSTEM

American outrage over white collar crimes is not new, rather it is a reaction stemming from a series of corporate misdeeds going back sixty years. Due to the misconduct of American companies like Wright-Mills in the 1940's and 1960's, public distrust of big business grew.¹⁷ Lawmakers began to realize the social and economic impact of white collar crimes. In response, legislators have tried to encourage a "court-organized social engineering of company compliance"¹⁸ movement. In 1934, Congress established the Securities and Exchange Commission (SEC) to be an economic watchdog. Later, other methods of compliance were established and have been somewhat effective. RICO is used currently to prosecute white collar crimes and after the Enron scandal the United States Congress passed the Sarbanes-Oxley Act of 2002, establishing a higher standard of accountability within corporations.

A. SEC

The SEC is responsible for the enforcement and regulation of the United States stock and securities market. The Commission is charged with regulating all companies that hold and trade public stock. Formed as an independent agency by the Securities Exchange Act of 1934, the SEC's duties include enforcing various United States securities laws, including the Sarbanes-Oxley Act.¹⁹ In addition to its traditional executive functions, the SEC also serves to collect monies from securities violations and disburse those remedies to compensate fraud victims.²⁰

¹⁷ Nelken, *supra* note 11, at 736.

¹⁸ *Id.* at 764.

¹⁹ U.S. SECURITIES AND EXCHANGE COMMISSION, *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity and Facilitates Capital Formation*, available at: <http://www.sec.gov/about/whatwedo.shtml>.

²⁰ U.S. SECURITIES AND EXCHANGE COMMISSION, *How Can Investors Get Money Back in Fraud*

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Historically, the SEC has been criticized as being “unnecessary” or only “sufficiently effective.”²¹ In the 1970s, the SEC took a more active role and expanded their enforcement of securities law. Later in the 1980s, the SEC gained recognition by focusing on the prosecution of insider trading. By the 2000s, the SEC has grown into a full enforcement agency with the help of Congress.

(i) Procedure

The SEC’s main tasks are to investigate potential violations, enforce statutes and its own guidelines and regulate companies that are connected to the United States stock and securities market. Congress granted the SEC the power to bring civil actions against persons who have violated any securities laws. In its regulatory function, all public companies are required to submit to the SEC quarterly and annual financial reports and company executives are required to submit an affidavit of management plans for the upcoming year.

When the SEC starts its initial investigation on a potential violation, the agency will send out either comment or “no action” letters. Comment letters are sent directly to the companies identifying possible violations, requesting a response from the company. In the alternative, “no action” letters demand the company engage in a particular action, if they fail to comply, then the SEC will pursue further action, such as initiating a civil suit or arbitration.

As stated earlier, Congress granted the SEC the power only to bring civil actions for securities violations. However, if the SEC staff determines a criminal prosecution is a viable option, they will recommend that the Justice Department pursue criminal proceedings.²² It is in the Department of Justice’s discretion to pursue such criminals and if they do, the SEC works closely with them to prosecute those individuals and corporations who violate criminal laws.²³

(ii) SEC Collection Procedures

Section 308 of the Sarbanes-Oxley Act of 2002 grants the SEC the

Cases Involving a Violation of the Federal Securities Law?, available at <http://www.sec.gov/answers/recoverfunds.htm>.

²¹ SALINGER, *supra* note 3, at 725.

²² *Id.* at 725.

²³ See Barbara Black, *Should the SEC be a Collection Agency for Defrauded Investors?* 63 BUS. LAW. 317 (2008).

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power to compensate victims of corporate fraud.²⁴ The SEC can disburse collected civil penalties and illegally obtained corporate profits. Originally, this section was added to the Act in order to create a fund for Enron employees to recover some of their losses as a result of the actions of Enron and Arthur Andersen.²⁵

In the first five years after Sarbanes-Oxley, the SEC obtained orders to disgorge \$1.6 billion per year worth of profits and assessed \$1.1 billion a year in penalties.²⁶ The SEC's collection power also extends to third parties. Profits received from investment bank or accounting fees can be designated as profits that may be disgorged.²⁷ Furthermore, the SEC's power under Section 308 allows the agency to seize corporate executive's compensation specifically "performance-based bonuses as well as any profits derived from trading in the company's securities while the fraud was ongoing."²⁸

(iii) Limitations

Research has shown that one out of every ten SEC cases that are initially investigated are recommended to the Justice Department for further processing.²⁹ A study completed in 1984 found that United States attorneys only prosecuted 26% of all cases referred to them for prosecution by the SEC. In all, almost 48% of cases that were recommended for prosecution by the SEC were not prosecuted and never went to trial.³⁰

The low rate of prosecution can be attributed to lack of resources and the inherent difficulty in investigating a white collar crime. The nature of white collar crimes and fraud cases may require expertise or special skill in a certain area outside the experience of some district attorneys. Their inexperience can put them and their prosecution of the case at a serious disadvantage.³¹ On the other hand, defense attorneys representing their clients charged with securities violations start their investigation and preparation as soon as the SEC investigation begins. Many times defendants hire a litany of professionals to provide expert counseling and to assist in the case.

The SEC's low prosecution rate can also be attributed to other

²⁴ *Id.* at 317

²⁵ *Id.* at 326.

²⁶ *Id.* at 328.

²⁷ *Id.* at 329.

²⁸ *Id.*

²⁹ *Id.*

³⁰ CYNDI BANKS, PUNISHMENT IN AMERICA 156 (ABC-CLIO 2005).

³¹ *Id.*

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variables. The agency is notoriously understaffed and commands limited resources. Furthermore, the SEC is criticized for being too lenient against securities violations.³² Most recently criticisms of SEC's regulations emerged after the Bernard Madoff ponzi-scheme. Former SEC chairman, Christopher Cox, acknowledged the SEC's failure to fully investigate Madoff's company.³³ An initial investigation of Madoff occurred in 1992, but the SEC neglected red flags indicating possible wrongful activity and even ignored numerous complaints of alleged fraud.³⁴

(iv) Overall Assessment of the SEC

The SEC is the United State's main regulatory agency that monitors an ever growing securities and stock market. White collar crimes are becoming more sophisticated and subsequently harder to detect and investigate. Because of the increased difficulties faced, Congress should recognize the demand placed on the agency and increase the federal budget allowance for the Commission. Without help of additional resources and staff, the SEC will continue to lag far behind and, as seen with the more recent scandals, white collar crimes left undetected and unhindered can cause astronomical losses.

B. RICO

The RICO statute was established by Title IX of the Organized Crime Control Act in 1970 to provide enhanced criminal penalties and establish a new civil cause of action for acts performed as a part of an ongoing criminal organization.³⁵ The statute has a broad scope: it makes it illegal "to acquire, operate, or receive income from an enterprise through a pattern of racketeering activity."³⁶

³² SALINGER, *supra* note 3, at 725.

³³ Joanna Chung, *SEC Chief Admits to Failures in Madoff Case*, FINANCIAL TIMES, Dec.17, 2008, available at

<http://www.ft.com/cms/s/92bd4c68-cbd7-11dd-ba02-000077b07658,Authorised=false.html>

³⁴ *Id.* Bernard Madoff established a ponzi-scheme promising steady returns on his clients' investments. However, no money was ever invested and instead returns were paid out of money that was newly invested from other clients. The fraud, spanning decades, grew to over \$50 billion in losses.

³⁵ Julie Lewis, *An Offer He Couldn't Refuse: Firestone v. Galbreath Finds that the Racketeer Influenced and Corrupt Organizations Act is Unconstitutionally Vague*, 23 U. TOL. L. REV 619 (1992).

³⁶ SALINGER, *supra* note 3, at 660. The term "enterprise" is defined in the statute as "any individual, partnership, corporation, association, or other legal entity, and any union or group of individuals

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Congress originally drafted the Act to trigger and facilitate mafia criminal prosecution. In practice, however, RICO has been applied to a wide variety of cases. The purpose stated in the beginning of the Act was to

seek the eradication of organized crimes in the United States by strengthening the legal tools in the evidence gathering process, by establishing new penal prohibitions, and by providing enhanced sanctions and new remedies to deal with the unlawful activities of those engaged in organized crime.³⁷

In 1985, the Supreme Court of the United States held in *Sedima S.P.L.R. v. Imrex Co., Inc.* that RICO can apply to legitimate commercial enterprises where the business was forging purchase orders and credit memos in order to increase their purchase price.³⁸ Civil RICO's were "rare" for the first ten years after RICO was enacted.³⁹ Subsequently, Robert Blakely, who was one of the initial drafters of the Organized Crime Control Act, wrote an article popularizing civil RICO suits.⁴⁰ After *Sedima*, RICO was used for white collar crimes and corporate offenses. Thus, commercial businesses have been prosecuted under the RICO statute.⁴¹

The New York Times published an opinion in 1989, stating that RICO

is among the few effective tools against economic crime. Law enforcers have used its enhanced criminal penalties against insider trading and government corruption . . . Civil RICO has been a powerful tool against white-collar crime.⁴²

Civil RICO actions have been used by relatively unsophisticated parties like middle income families victimized by home fraud to recover damages when there were no other alternatives.⁴³ Unlike criminal prosecution, most civil actions for white collar offenses are brought by private plaintiffs.⁴⁴

Because of the complex, systematic and continuous nature of many

associated in fact, although not a legal entity."

³⁷ Lewis, *supra* note 35, at 621.

³⁸ *Id.* at 662.

³⁹ *Id.* at 624.

⁴⁰ *Id.*

⁴¹ *Sedima, S.P.R.L. v. Imrex Co., Inc.*, 473 U.S. 479 (1985).

⁴² Waldman and Gilbert, *RICO Goes to Congress: Keep the Teeth in White Collar Law*, N.Y. TIMES, March 12, 1989 at 2F.

⁴³ SALINGER, *supra* note 3, at 662.

⁴⁴ *Id.*

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white collar crimes, prosecutors have found RICO to be an effective statutory tool in white collar prosecution.⁴⁵ When comparing the two types of criminals,

both white-collar and organized criminals use similar techniques, share the same illegal know-how, and share the same values-even if perpetrators come from different backgrounds. Their crimes are performed in or by organized structures, thrive on collusion, and normally enjoy the connivance of administrators and legislators.⁴⁶

RICO defendants have included Major League Baseball, anti-abortion activists, the Key West police department, inside traders, street gangs and crime families across the country.

The most notable white collar prosecution under RICO involves Michael Milken, an inside trader. Milken, who had no ties to organized crime, was accused of manipulating stock and bond prices and as a result was indicted on ninety-eight counts of racketeering and fraud. Milken pled guilty to six lesser offenses. Milken's employer, Drexel Burnham Lambert, could have faced RICO charges under the doctrine of respondeat superior, but claims against them were never pursued. If they had been convicted under RICO, Drexel would have been required to post a \$1 billion bond to avoid their assets from being frozen and the charge would have likely put the firm out of business, as banks' prohibit extending credit to indicted businesses.⁴⁷

(i) Statutory Effect

RICO's statutory language allows for a broad application of the Act. Under the statute, one can be criminally liable if he is part of an enterprise that has committed a pattern of racketeering, even though such activity was done by others in the enterprise.⁴⁸ Racketeering is defined under the statute as "any act or threat involving murder, kidnapping, gambling, arson, robbery, bribery, extortion or dealing in narcotic or other dangerous drugs, which is chargeable under state law and punishable by imprisonment for more than one year."⁴⁹

⁴⁵ Goldsmith, *supra* note 1, at 7.

⁴⁶ Nelken, *supra* note 11, at 739.

⁴⁷ See DAN STONE, APRIL FOOLS: AN INSIDE'S ACCOUNT OF THE RISE AND COLLAPSE OF DREXEL BURNHAM (D.I. Fine 1990).

⁴⁸ SALINGER, *supra* note 3, at 660. The RICO statute makes the maximum fine for offenses under the statute \$25,000 and 20 years in prison.

⁴⁹ *Id.*

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Additionally, the statute lists other federal offenses such as bribery, sports bribery, counterfeiting, embezzlement, loan sharking, mail fraud, wire fraud, obstruction of justice, contraband of cigarettes, prostitution, trafficking of people, bankruptcy fraud, drug violations and obscenity.”⁵⁰ The central element of a RICO crime is proof of a pattern of illegal offenses.⁵¹ In order to be indicted of racketeering, a person must be a member of an enterprise that has committed two or more crimes listed in the Act within the span of ten years.

(ii) Penalties

The consequences of racketeering charges are two-fold. First, racketeering gives prosecutors a platform to show that the defendant is involved in a pattern of illegal activities that might otherwise be inadmissible in court. In general, a court may not allow past convictions into evidence in a proceeding, as it might be considered inadmissible propensity evidence. However, with the RICO statute, the prosecutor may produce evidence of past convictions to show participation in a racketeering enterprise.

Second, racketeering charges increase the penalty for criminal offenses since the crime is committed by an enterprise engaged in racketeering.⁵² The penalties are more than the standard punishment for the criminal offense. A racketeering charge brings a maximum fine of \$25,000 and a twenty year prison sentence per charge. RICO also allows the government to seize any property that it believes was acquired from or purchased by illegal racketeering activities.⁵³

Additionally, the statute provides causes of action for private plaintiffs and the government.⁵⁴ Private plaintiffs can request courts to seize assets, order sanctions, or provide injunctive relief against enterprises or individuals involved in RICO crimes.⁵⁵ The RICO civil action procedure allows courts to force defendants to “forfeit any interest in property, restrict a defendant from

⁵⁰ *Id.*

⁵¹ *Id.* A “pattern” is defined under the RICO statute as “the commission of at least two identified offenses with a 10-year period.”

⁵² *Id.*

⁵³ *Id.* In situations where asset forfeiture is appropriate, the government can seize the property without issuing notice to the defendant. Furthermore, the court proceedings that issue the grant of forfeiture may be ex parte. For the civil provisions under RICO, the burden of proof is by the preponderance of the evidence and not the traditional criminal standard. The burden then shifts to the defendant to prove that the assets in question were acquired through legitimate and legal channels.

⁵⁴ *Id.*

⁵⁵ *Id.* at 660-661.

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engaging in certain future activities or investments, or dissolve or reorganize an enterprise.”⁵⁶ RICO prevents a person from using finances that were generated from illegal racketeering activities that affect interstate commerce.⁵⁷ Finally, private plaintiffs who are successful can collect treble damages.

(iii) In Practice

RICO has been quite an effective statute and is used frequently by federal prosecutors. As previously noted, the prosecution of white collar crimes is an arduous task. In the criminal context, prosecutors must prove their case beyond a reasonable doubt. Especially for cases dealing with sophisticated enterprises with a number of actors, the prosecutors must sift through a mountain of evidence to find what is relevant and admissible. However, there are potential problems of collecting evidence from criminal organizations.⁵⁸

When the government decides to pursue a RICO charge, the United States attorney obtains a pre-trial restraining order or preliminary injunction seizing the defendant’s assets and restricting the defendant’s access to certain property. A RICO defendant is sometimes required to post a performance bond to ensure that if found guilty that there will be collateral. These pre-trial seizures of company assets can have devastating effects on everyday business activity. Because of the commercially crippling effects of RICO, many defendants are forced into a decision of defending their case, and potentially having their business grind to a halt or pleading guilty to lesser charges, even if innocent, simply to avoid pre-trial seizures.

In the twenty-year span between 1970-1990, over one thousand criminals were convicted and sentenced under the RICO standards.⁵⁹ Rudy Giuliani, then the U.S. Attorney for the Southern District of New York, praised the RICO statute as being the only criminal statute that gave juries in criminal trials a whole picture of how an organized criminal network operates.⁶⁰

(iv) Criticism

For all its benefits, prosecutor’s unfettered application of RICO has

⁵⁶ *Id.*

⁵⁷ *Id.*

⁵⁸ Nelken, *supra* note 11, at 753.

⁵⁹ *Id.*

⁶⁰ *Id.* Here, Giuliani discussed the benefits of the RICO statute as it applies to organized crime families. If RICO did not exist, Giuliani posited that it would have been nearly impossible for all the criminal actors to be included in a single prosecution.

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been denounced. RICO has been criticized for infringing one's constitutional right to due process.⁶¹ Some have argued that RICO is far reaching and risks over-criminalization, as the statute can lead to prosecution of individuals involved in criminal behavior but not involved in the actual criminal organization.⁶² For example, an enterprise conducting a series of criminal activities over the years may involve the help of third party. This person is not truly involved in the main criminal venture such as planning or sharing the main proceeds of the crime. However, even though he has no major role in the racketeering enterprise, prosecutors can file RICO charges against this third party. Because RICO provides for enhanced damages, these individuals will be punished more severely as a result of this association. Over-penalizing individuals is unjust and is against societal goals in a punishment scheme.

There have been several challenges to the statutory construction of the RICO statute. In *United States v. Angiulo*, the defendants argued that the "pattern requirement" was unconstitutionally vague.⁶³ Yet none of these challenges have been successful and the Supreme Court continues to allow wide use of civil RICO claims.⁶⁴

Moreover, RICO pre-trial seizures have the potential to be intrusive and erroneous. Assets are seized before the defendant company has his day in court. The drawn out process of litigation can last months, even years, and pre-trial seizures can hinder a company's ability to operate successfully. Since a court grants pre-trial seizures of company assets, there is a chance that the defendant company is found not guilty. The fear of having the assets frozen may induce defendant companies to plead guilty to lesser charges even if they believe they have done nothing wrong.

As stated earlier, the traditional goal of RICO was to curb organized criminal activities associated with the mafia organizations.⁶⁵ Thus, RICO prosecution of the defendant attaches the social stigma that a person or company is involved with organized crime, specifically the mafia. This stigma can be harmful to the defendant's reputation and community goodwill. Because of RICO's broad scope, potential defendants may unknowingly be associated with these criminal organizations or the defendants could be purely white collar criminals, with no mafia connection.

Finally because of its expanded application in commercial contexts, RICO's enhanced punishment scheme as applied to white collar criminals

⁶¹ *Id.*

⁶² *Id.* at 662.

⁶³ Lewis, *supra* note 35, at 633-34.

⁶⁴ *Id.* at 622.

⁶⁵ *Id.*

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derogates from original Congressional intent in punishing individuals involved in the mafia. Because RICO can be used in prosecution of white collar crimes, the treble damages feature is misplaced and punishes a defendant too severely. Arguably, pursuing treble damages may violate the 8th Amendment of the United States Constitution.⁶⁶

C. Sarbanes-Oxley

In 2002, Congress passed the Sarbanes-Oxley Act of 2002 in response to the large corporate scandals involving Enron, Tyco International, Adelphia and Worldcom.⁶⁷ The Act requires additional obligations for publicly held companies to ensure compliance with securities laws and encourage transparency and accuracy in their public financial disclosures. Along with heightened disclosure requirements, the Act also codified enhanced penalties for securities violations.

(i) Independent Accounting Board

To prevent a fraud on the scale of Enron from ever occurring again, Sarbanes-Oxley established the Public Company Accounting Oversight Board (PCAOB), which is responsible for oversight, regulation, and discipline of accounting firms when auditing public companies. The PCAOB is an independent board that issues guidelines to define the procedures auditing firms should follow and enforces those measures within the reaches of Sarbanes-Oxley. Holding auditing firms accountable for their actions and monitoring for conflicts of interest help ensure that the audits conducted are trustworthy.

(ii) Corporate Responsibility

The statute compels new responsibilities on public corporations and their executives, auditors, securities analysts and attorneys. The Act does not apply to private companies. One major consequence after Sarbanes-Oxley is that corporate CEOs are personally responsible for the veracity of the company's financial documents and any misrepresentation on those statements could result in criminal liability. Before a company's financial report is sent to the SEC, the CEO is required to sign off on the disclosure validating that the

⁶⁶ U.S. CONST. amend. VIII. ("Excessive bail shall not be required, nor excessive fines imposed, nor cruel and unusual punishment inflicted").

⁶⁷ *INT'L HANDBOOK*, *supra* note 8, at 519. See also Earl Powers, *The History of Sarbanes-Oxley*, Feb. 16, 2006, available at <http://ezinearticles.com/?The-History-of-Sarbanes-Oxley&id=143573>.

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information contained within is correct. Establishing personal accountability on financial reports would deter CEOs from committing securities violations since any irregularities in the numbers would be directly linked to the CEO.

(iii) White Collar Crime Enhancement

One of the primary objectives in passing Sarbanes-Oxley was to strengthen criminal fraud accountability and create individual liability for deception on financial statements. Not only did Sarbanes-Oxley broaden the scope of liability, but it also enhanced the penalty for white collar crimes. The section, appropriately named the White Collar Crime Penalty Enhancement Act, increases the punishment for attempt and conspiracy to commit fraud, heightens the maximum penalty for certain white collar offenses, creates statutory liability for mail and wire fraud, and establishes individual corporate responsibility for financial statements.⁶⁸ The Act codified specific penalties for corporate fraud and tampering. The sentencing guidelines were amended to increase penalties for other crimes and allow the SEC to temporarily seize large payments identified as criminal.⁶⁹ More importantly, the penalty enhancement portion of the Act allows courts to increase the sentence based on the damages on a case by case basis.

(iv) Costs and Benefits

Many argue that complying with the Sarbanes-Oxley Act is costly and has adverse effects on companies operating in the United States. Studies were performed to estimate the actual cost of compliance with the Act. However, the actual monetary cost of complying with the Sarbanes-Oxley Act is difficult to calculate due to external variables that affect public companies and the stock market. Financial Executives International estimated the costs of internal controls required by the Act. In their 2007 survey of one hundred sixty eight companies averaging revenues of \$4.7 billion, the average cost of compliance was \$1.7 million.⁷⁰

Critics argue that Sarbanes-Oxley has a negative impact on businesses and the United States economy. After the enactment of the Act, the rate of United States companies deregistering from the American stock exchange tripled. There has been a call to repeal the Act in fear of rising costs of

⁶⁸ SALINGER, *supra* note 3, at 841.

⁶⁹ Sarbanes-Oxley Act of 2002, H.R. 3763, 107th Cong. § 2 (2002).

⁷⁰ *FEI Survey: Average 2007 SOX Compliance Cost \$1.7 million*, April 30, 2008, available at <http://fei.mediaroom.com/index.php?s=43&item=204>.

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compliance, resulting in companies heading overseas to avoid these additional costs.⁷¹

With all the criticism concerning additional expenses, public companies are responding to the more strict disclosure requirements. A year after Sarbanes-Oxley was introduced over three hundred companies revised their earnings report. The Act has been credited as restoring investor confidence by forcing more accurate and reliable financial disclosure by companies. The Act creates additional incentives for corporate executives to take ownership of their company's representations to the public. Finally, the Act addressed and prohibits any potential conflict of interests an auditor may face when he is given a consulting contract by the firm he is to audit.⁷²

D. Punishment in the United States

In three years between 2002 and 2005, there were over seven hundred corporate crime convictions in the United States.⁷³ As compared to prior times, the punishments for the same crimes are harsher and white collar criminals are serving longer sentences.⁷⁴ The recent trend in ratcheting up the punishment for crimes is intended to serve as an example to deter future criminals.⁷⁵ The United States government has set a clear precedent that "financial malpractice" on corporate sales can constitute serious crimes and will be prosecuted.⁷⁶

Before the Federal Sentencing Guidelines were passed, white collar criminals were penalized under the same schemes as non-white collar criminals.⁷⁷ One study, completed by John Hagan, Ilene Nagel and Celesta Albonetti, looked at the difference in sentencing for white collar criminals. The group factored into their assessment defendants who had a college education and income as a substitute for white collar status. The comparison showed that indeed white collar criminals were given lighter sentences than criminals committing non-white collar offenses.⁷⁸ In 1991, the Federal Sentencing

⁷¹ Hon. Ron Paul, Congressman, U.S. H.R., Remarks before the US House of Representatives: Repeal Sarbane-Oxley! (April 14, 2005), available at <http://www.house.gov/paul/congrec/congrec2005/cr041405.htm>.

⁷² See Guy Farrell, *Sarbanes-Oxley law has been a pretty clean sweep*, USA TODAY, July 30, 2007, available at http://www.usatoday.com/money/companies/regulation/2007-07-29-sarbanes-oxley_N.htm.

⁷³ Nelken, *supra* note 11, at 764.

⁷⁴ *Id.*

⁷⁵ *Id.*

⁷⁶ *Id.*

⁷⁷ Bookman, *supra* note 2, at 361.

⁷⁸ INT'L HANDBOOK, *supra* note 8, at 41-42.

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Guidelines were put into law and set out clear sentencing rules for white collar crimes. Critics argue that these guidelines are too severe, as twenty year sentences unnecessarily punish the defendants and do little to deter future crimes.⁷⁹

Coupled with the enhanced penalties codified by RICO and Sarbanes-Oxley, the Federal Guidelines provide a regime of increased penalties for white collar criminals, in order to deter potential white collar criminals.

III. UNITED KINGDOM SYSTEM

In 2002, the estimated cost of fraud in the United Kingdom was approximately £14 billion.⁸⁰ Although the damages due to fraud are astronomic, the punishment of white collar criminals was lax. The Attorney General speaking in front of an audience at the 21st International Symposium on Economic Crime in 2003 said,

It is notable how often white-collar defendants receive non-custodial and suspended sentences despite committing serious economic crime . . . Social equality requires that we bear down on white collar crime as effectively as on blue collar crime, such as fraud in obtaining social security.⁸¹

After a series of high profile scandals much like the events in the United States, white collar crime became the focus of public attention.⁸² In 2006, the United Kingdom established the Serious Organised Crime Agency (SOCA), which focused on reducing the harm caused by criminals rather than act as a law enforcing body.⁸³ With the increased recognition that white collar crime was a problem in the United Kingdom, several solutions arose. As a result, a number of agencies were established that are responsible for the detection, investigation and prosecution of white collar and corporate crimes.⁸⁴ Two of these agencies, the Serious Fraud Office (SFO) and the Financial

⁷⁹ Joshua Block and Andrew Weissmann, *White-Collar Defendants and White Collar Crimes*, 116 YALE L.J. POCKET PART 286 (2007).

⁸⁰ SALINGER, *supra* note 3, at 836.

⁸¹ *Is White Collar Crime Taken Seriously?* UK LEGAL NEWS ANALYSIS, September 24, 2003.

⁸² See SALINGER, *supra* note 3, at 836. Cases involving Lonhro, Guinness takeover of Distillers (1986), Blue Arrow share dealings (1987), Harrods takeover, the Bank of Credit and Commerce International Collapse (1991), Polly Peck (1993), the hostile takeover bid for the Co-op, and the Barings Bank Collapse (1995).

⁸³ Nelken, *supra* note 11, at 772.

⁸⁴ *Id.*

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Services Authority (FSA), are charged with monitoring and investigating commercial crimes in the United Kingdom.

In addition to establishing agencies to monitor financial crimes, Parliament created Serious Crime Prevention Orders as a preemptive step in white collar crime enforcement. The orders allow Courts to preemptively act upon suspicious activities, which led or potentially could lead to white collar crimes. The new prevention orders are in contrast with the traditional mode of agency regulation and prosecution of securities laws.

A. SCPO

The Preamble of the SCA defines the purpose of the statute to

make provisions about serious crime prevention orders; to create offences in respect of the encouragement or assistance of crime; to enable information to be shared or processed to prevent fraud or for purposes relating to proceeds of crime . . . to transfer to the functions of the Director of the Assets Recovery Agency to the Serious Organised Crime Agency.⁸⁵

These “orders” are court imposed to restrict the actions of persons, corporate bodies, partnerships, and unincorporated associations who are “involved in serious crimes.”⁸⁶ SCPOs cover persons who are criminally “involved in a serious crime,” who may have “facilitated the commission of a serious offence,” or even who are “likely to facilitate the commission of an offence (intentional or otherwise).”⁸⁷

(i) History

Before SCPOs, the prosecutor in the United Kingdom was left with a tough decision when determining whether to proceed with or drop a case. Parliament recognized that this “all or nothing” approach, which left the prosecutor with many quasi-actionable situations, meant cases were inefficiently prosecuted or wrongfully dropped. In response, Parliament introduced the SCPO as early as July 2006.⁸⁸ These orders give the prosecutor the option of

⁸⁵ Serious Crime Act, 2007, c.27 Preamble (Eng.).

⁸⁶ *Id.* at § 3-4.

⁸⁷ *Id.* at § 2(1).

⁸⁸ RUDI FORTSON, BLACKSTONE’S GUIDE TO THE SERIOUS CRIME ACT 2007 14 (Oxford University Press 2008).

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proceeding with a case where there is insufficient evidence to meet the criminal standard of proof,⁸⁹ but where the civil standard could be satisfied.⁹⁰

The government believed that a SCPO “fills a gap in the law to deal with persons who are involved in serious crime and who, for one reason or another, cannot be satisfactorily controlled by way of other judicial or administrative processes.”⁹¹ Newspapers have coined SCPO as “Super ASBO’s.”⁹² Anti-social Behaviour Orders are civil orders like SCPO, but are used to prevent persons from “carrying out antisocial acts that are likely to cause harassment, alarm, or distress to another person.”⁹³

An SCPO request can be made to the High or Crown Court in England if two requirements are met. First, the Court must be “satisfied that a person has been involved in serious crime; and secondly it [the High or Crown Court] has reasonable grounds to believe that the order would protect the public by preventing, restricting, or disrupting, involvement by the person in serious crime.”⁹⁴ The request hearing for an SCPO does not have the strict evidentiary standards of a criminal proceeding and can consider information that would not be admissible otherwise.⁹⁵ The grant of an SCPO has to meet the objective criteria of the commission of a serious crime, while the second requirement is up to the discretion of the High Court.

(ii) Against Whom

High Courts are given substantial leeway to issue a SCPO, subject to two exceptions: a minor under the age of 18 and any person that falls under written exception by the Secretary of State are immune from a SCPO.⁹⁶ Besides these exceptions, there are three main categories of SCPO defendants: a person

⁸⁹ The criminal standard of proof entails that the state prove its case beyond a reasonable doubt. Serious Crime Act 2007, § 35 (“Proceedings before the High Court in relation to serious crime prevention orders are civil proceedings. One consequence of this is that the standard of proof to be applied by the court in such proceedings is the civil standard of proof”).

⁹⁰ FORTSON, *supra* note 88, at 14 (stating that “other examples, set out in the Green Paper, include cases where: (a) evidence that would be admissible in civil proceedings is not admissible in criminal proceedings, (b) crimes have been committed overseas that cannot be prosecuted in the UK; or (c) a person has been released after conviction overseas ‘in circumstances where we would expect them in the UK to be subject to strict license conditions’”).

⁹¹ *Id.* at 4.

⁹² *Id.* at 3.

⁹³ *Id.*

⁹⁴ Serious Crime Act 2007, § 1(1).

⁹⁵ *Id.* at § 36(3).

⁹⁶ *Id.* at § § 6-7.

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who “has committed a serious crime in England”; a person who “has facilitated the commission by another person of a serious offence in England”; or a person who has “conducted himself in a way that was likely to facilitate the commission by himself or another person of a serious offence in England.”⁹⁷

(iii) What is a Serious Crime?

A serious crime is defined as the commission of any offense in England that, at the time when the case is before the Court, it was specified as a serious crime under the Act⁹⁸ or “is one which, in the particular circumstances of the case, the court considers to be sufficiently serious to be treated for the purposes of the application or matter as if it were so specified.”⁹⁹ In drafting the wording of the Act, Parliament gave courts the opportunity to grant a SCPO to “sufficiently serious” circumstances. Thus, the Court has discretion to grant an SCPO even if the action is not a serious crime defined within the Act.

When the Court analyzes whether a person has facilitated the commission of a crime, the Act directs Courts to disregard “any act that the respondent can show to be reasonable in the circumstances; and subject to this, his intention, or any other aspect of his mental state, at the time.”¹⁰⁰ As such, a person can be subject to a SCPO if he encourages or assists the commission of an offense. A person is liable if he commits “an act capable of encouraging or assisting the commission of an offence; and . . . he intends to encourage or assists its commission” or “he believes (i) the offence will be committed; and (ii) that the act will encourage or assist its commission.”¹⁰¹

Practically speaking, the SCA creates three offenses. First, the Act makes a person liable if he “intends to encourage or to assist another person to commit an offense.”¹⁰² However, the person must have the requisite intent for the crime to be committed. For example, the Act would hold A criminally liable for leaving a door unlocked if it was intent to have B come in at night and steal televisions from the store. Even if B did not commit the crime, A would be liable for burglary. The second offense covers the situation where “a person

⁹⁷ *Id.* at § 2(1).

⁹⁸ *Id.* at Schedule 1, § 1-16 lists all the offences that are serious. They include: drug trafficking, people trafficking, arms trafficking, prostitution and child sex, armed robbery, money laundering, fraud, offences in relation to public revenue, corruption and bribery, counterfeiting, blackmail, intellectual property (acts that infringe intellectual property rights), environment (violating various wildlife and environmental regulations), inchoate crimes (any incomplete crime in this Schedule).

⁹⁹ *Id.* at § 2(2).

¹⁰⁰ *Id.* at § 4(2).

¹⁰¹ *Id.* at § 44-45.

¹⁰² FORTSON, *supra* note 88, at 5.

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believes that the anticipated offence will be committed . . . and he believes that his act will encourage or assist its commission”¹⁰³ Finally, the last situation covers cases where

[a person] does an act that is capable of encouraging or assisting the commission of one or more of a number of offences; and he believes - (i) that one or more of those offences will be committed . . . ; and (ii) that his act will encourage or assist the commission of one or more of them.¹⁰⁴

(iv) Scope

The scope of an SCPO is largely up to the discretion of the Court and gives little guidance to what actions a SCPO prohibits. The Act allows the Court to issue obligations to the defendant, but gives little guidance to what is or is not allowed. The Court can also rationalize its grant of an SCPO under broad and sweeping justifications of “protection of the public.” Clearly, Parliament granted the Courts tremendous autonomy in issuing a large variety of SCPO’s.

(v) Process

A request for a SCPO can be made in the High Court or in the Crown Court.¹⁰⁵ The requisite standard of proof is a civil standard. However, in practice, the courts will apply the criminal standard of proof.¹⁰⁶ The person subject to an SCPO, or the relevant authority against a decision made, can appeal to the High or Crown Court.¹⁰⁷

(vi) Control of SCPO

As noted before, the Court has discretion over SCPO to that which is “necessary and proportionate to prevent, restrict, or disrupt, that subject’s ‘involvement in serious crime.’”¹⁰⁸ For example, Section 5 discusses the scope of SCPO. It can range from

¹⁰³ Serious Crime Act, § 44.

¹⁰⁴ *Id.* at § 46.

¹⁰⁵ FORTSON, *supra* note 88, at 4.

¹⁰⁶ *Id.*

¹⁰⁷ Serious Crime Act, § § 23-24.

¹⁰⁸ FORTSON, *supra* note 88, at 4.

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prohibitions, restrictions, or requirements, in connection with: (a) an individual's financial, property or business dealings or holdings; and/or (b) an individual's working arrangements; and/or (c) the means by which an individual communicates or associates with others, or the persons with whom he communicates or associates; and/or (d) the premises to which an individual has access; and/or (e) the use of any premises or item by an individual; and/or (f) an individual's travel (whether within the United Kingdom, between the United Kingdom and other places or otherwise).¹⁰⁹

A SCPO can require a subject to answer questions, provide information or produce requested documents.¹¹⁰

(vii) Type of SCPOs that can be Issued

The Act provides examples of SCPOs that may be issued to corporations and individuals. Parliament envisioned that SCPOs would have the power over an individual's financial, property, or business dealings, work arrangements, the means and whom an individual communicates, access of premises, the use of premises or items by an individual and the individual's travel.¹¹¹ An SCPO can require an individual to answer questions, provide information, or produce documents specified in the order.¹¹² However, the Act prohibits SCPOs from requiring disclosure of privilege information and any of the information requested be provided orally.¹¹³

For corporations and other business entities, SCPOs have the power over a business' financial, property, or business dealings, the types of agreements they can enter, access of premises, the use of any premises or items, and the employment of staff by that person.¹¹⁴

(viii) Violation

An SCPO can be in effect for a maximum of five years.¹¹⁵ The length

¹⁰⁹ *Id.*

¹¹⁰ *Id.*

¹¹¹ *Id.* at § 5(3).

¹¹² *Id.* at § 5(5).

¹¹³ *Id.* at § § 11- 12.

¹¹⁴ *Id.* at § 5(4).

¹¹⁵ *Id.* at § 16(2).

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of a SCPO is decided by the Court granting the order. If a person fails to comply with the terms of the SCPO they are in violation of Section 25 of the 2007 Act. Under Section 26 of the Act, the Court requires the person to “forfeit anything in the offender’s possession at the time of the offence, which the Court considers to have been involved in the offense.”¹¹⁶ An individual who violates the terms of an SCPO faces “imprisonment for a term not exceeding 12 months or to a fine not exceeding the statutory maximum or both.”¹¹⁷ If the conviction is on indictment, the prison sentence for a violation is a maximum of five years. In certain circumstances, the Court even has the power to “wind up companies, partnerships, or a relevant body” under section 27 of the Act.

(ix) Criticism

The SCPO has been criticized as a broad and far-reaching statute. The statutory provision allows for a Court to issue a SCPO to a person who “facilitated the commission of a serious offence” without defining the scope of such a crime. Thus the Court has wide discretion to determine who is the subject of a SCPO and what the SCPO entails.

Furthermore, there is no requirement that a crime be committed, only that it is “likely to facilitate the commission of an offense.” A person potentially could be subject of a SCPO even if he committed no affirmative act, but was likely to facilitate a crime. This situation is completely independent of whether the crime actually occurred. The statute does not require that the subject of the SCPO intend to facilitate the commission of the crime or was reckless about his acts and inadvertently facilitated in the crime. Because of the broad definitions of the statute, the court arguably could issue a SCPO based merely on speculation. Coupled with the fact the prosecution only has to prove their case by the preponderance of the evidence, the potential for an erroneously granted SCPO is high. SCA allows for considerable flexibility in drafting the conditions of a SCPO. The Court drafts requirements, restrictions and prohibitions that are “necessary and proportionate.”

Finally, another source of criticism is the duration of a SCPO. The statutory provisions allow for a SCPO to last for up to five years. With an order lasting up to five years, the effects to one’s professional and personal life can be drastic.

¹¹⁶ FORTSON, *supra* note 88, at 4-5.

¹¹⁷ Serious Crime Act, § 25 (2).

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(x) In Practice

The first SCPO orders were issued by the Isleworth Crown Court on June 27, 2008 in response to an investigation conducted by SOCA. Since the SCPO's aim is to prevent activities related to possessing or transferring money, the defendants were convicted of laundering cash for organized crime networks. The defendants were told that the SCPO would last for five years and any violation would result in five additional years in prison.¹¹⁸

To date, the only SCPO's that have been issued are related to drug and organized crime related activities. However, SCPOs may prove to be an effective tool in preventing and combating white collar crime. Because of the broad scope given by Parliament to apply and draft different kinds of SCPO's, Courts have the ability to tailor a SCPO to prevent a specific or potential criminal act.

B. The Serious Fraud Office

The SFO was established in 1988 by the Criminal Justice Act (CJA) and is responsible for investigating and prosecuting fraud in Britain.¹¹⁹ In 2007, the SFO employed fifty-six full time lawyers and in addition spent £4.2 million on external legal counsel.¹²⁰

(i) Investigation of a Fraud Case

The SFO does not investigate every reported case of suspected fraud. Instead, the agency considers each case individually based on a number of factors: if the value of the alleged fraud exceeds over £1 million, if it involves an international element, if the case affects the public or if the investigation and eventual prosecution require specialized skill and knowledge.¹²¹ Weighing these factors, the SFO tries to investigate and prosecute cases that are of public importance.

¹¹⁸ Press Release, Revenue and Customs Prosecution Office, RCPO Landmark Case- The First Ever Use of SCPO Powers Under the Serious Crime Act (June 27, 2008), available at <http://nds.coi.gov.uk/content/detail.aspx?NewsAreaId=2&ReleaseID=372198&SubjectId=16&AdvancedSearch=true>.

¹¹⁹ See SERIOUS FRAUD OFFICE, *About the SFO*, available at <http://www.sfo.gov.uk/about-us/history--legislation.aspx>.

¹²⁰ Jessica de Grazia, *Review of the Serious Fraud Office, Final Report 3* (June 2008), available at <http://www.sfo.gov.uk/media/34318/de%20grazia%20review%20of%20sfo.pdf>.

¹²¹ See SERIOUS FRAUD OFFICE, *supra* note 119.

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(ii) Section 2 Special Powers of Criminal Justice Act

Under Section 2 of the CJA, the SFO staff can require a person “to answer questions, provide information or produce documents for the purpose of an investigation.”¹²² These powers are to be used only to investigate, with good reason, a suspected offense which appears to involve a serious or complex fraud.¹²³ When being questioned by the SFO staff, a person can refuse to answer any question so long as he has a reasonable excuse.¹²⁴ Section 2 bars the use of a person’s answer to questions for evidentiary purposes in trial unless the person provided misleading answers in the interview.¹²⁵

A review was completed comparing the SFO with the prosecutorial office in the United States Southern District of New York (SDNY). Both the SFO and the SDNY serve an important function in the prosecution of white collar crime. SDNY is the district where the New York Stock Exchange is located, so the prosecutor’s office deals with white collar crime that affects the United States on a regular basis. The study focused on a joint prosecution completed between both the SFO and SDNY. In the course the prosecution, the study reported that the SFO used a total of thirty-one staff members to prosecute four defendants, while the SDNY used a team of eight people to prosecute fourteen defendants.¹²⁶

C. Financial Services Authority

The FSA, an independent non-governmental agency, was established by the Financial Services and Markets Act in 2000.¹²⁷ The FSA is one the world’s first “unified financial services regulators” and operates on a budget of £270 million with a staff of over twenty-eight hundred.¹²⁸ The FSA’s main goals are to bolster public confidence, increase public awareness in the financial system, maintain consumer protection and reduce financial crime.¹²⁹ To meet these objectives, FSA has rule-making powers, an investigatory function, and

¹²² *Id.*

¹²³ *Id.*

¹²⁴ *Id.*

¹²⁵ *Id.*

¹²⁶ de Grazia, *supra* note 120, at 2.

¹²⁷ See FSA: FINANCIAL SERVICES AUTHORITY, *Who We Are*, available at <http://www.fsa.gov.uk/Pages/About/Who/index.shtml>.

¹²⁸ NATIONAL AUDIT OFFICE THE FINANCIAL SERVICES AUTHORITY, A REVIEW UNDER SECTION 12 OF THE FINANCIAL SERVICES AND MARKETS ACT 2000, 6 (April 2007).

¹²⁹ FSA: FINANCIAL SERVICES AUTHORITY, *supra* note 127.

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enforcement powers.¹³⁰ Currently, the FSA regulates over twenty-nine thousand companies in the United Kingdom and publishes an eight thousand page rule handbook for all authorized business operating in the United Kingdom.¹³¹

With the large amount of companies operating in the United Kingdom, FSA has the important function of assessing a firm's potential risk to consumers and the market. The FSA prioritizes their limited regulatory powers on medium or high impact firms. For these firms, the FSA conducts a regular risk assessment once every one to four years.¹³² In regulating and investigating financial crime, the FSA works along side the police and the SOCA.¹³³

IV. COMPARATIVE ANALYSIS IN THE UNITED STATES AND UNITED KINGDOM

A. Scenario

Apple Company has around three hundred employees. At Apple, the chief accountant Barry suffered major losses through bad investments in the market several years ago. Too embarrassed to tell his wife about his losses, Barry decides to manufacture a "loan" using Apple's funds to cover up for his losses. Barry had full intentions of paying back the Apple quasi-loan. However, after some time, Barry did not save enough money to pay back the loan and replenish the amount he had lost in the market. Digging his hole deeper and deeper, Barry starts to skim several thousands of dollars from various accounts to pay off other accounts, some of which are pension funds for several of the employees at Apple. He continued to take the money for the past two years. To date, Barry has skimmed \$1.8 million out of Apple's accounts.

Running out of accounts to input forged charges, Barry resorts to siphoning funds from Apple's fun account that are specifically reserved for their annual company outing. Barry knows that Apple is known for their extravagant outings, so he felt he could take as much money as he wanted without anyone noticing. However, all moneys from this account go through Apple's events coordinator, Carol. Barry knows that he cannot commit the crime alone so he decides to recruit Carol and also recruits his own secretary, Diane, on a limited basis.

¹³⁰ *Id.*

¹³¹ *Id.*

¹³² *Id.*

¹³³ NATIONAL AUDIT OFFICE, *supra* note 128, at 45.

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Barry contacts Eric, the mailroom clerk, and asks if he can help him with a project that needed to be done before the end of the year. Eric agrees to help with the project, unknowingly agreeing to be part of a scheme that would allow Barry to access millions of dollars.

Carol, on the side, owns a catering business, Carol Caters. On the weekends she goes to exotic places to oversee big events that her clients plan on the weekends. She also keeps a business account of \$100,000 for costs such as airfare, down payments for venues, costs of foods, and payment of her employees. Some of the money Carol received from Barry is invested into the company. Carol hired Eric as an employee on the weekends doing odds and ends.

Barry's secretary, Diane, was told that she could not tell anyone what she was doing. She was given \$500 to go to the store to buy envelopes. She asks Eric to drive her and she buys the necessary item. She also buys a typewriter because she thought it might be useful.

Since Barry thinks this scheme is going well, he contacts his chief accountant friend, Fred, at Orange Company. He emails Fred the methods that he used to steal money from Apple.

B. In the United States

(i) SEC

The SEC is allowed to bring a civil cause of action against Barry on its own behalf for violating any securities laws. Here, Barry violated the truthful financial statement disclosure required by Sarbanes-Oxley. Being the chief accountant for Apple, Barry would be required to send quarterly and yearly financial reports. If the SEC discovered discrepancies in Apple's disclosure during the investigation, they could send Apple a comment letter allowing the Apple to respond to any existing problem.

As a result of their investigation, the SEC would determine if criminal prosecution is necessary in this case. Here, after finding out the Barry was skimming an exorbitant amount of money from Apple and its employees, the SEC would likely refer the case to the Department of Justice for further criminal prosecution under Sarbanes-Oxley, the RICO Act, and relevant state laws. The SEC, under their collective power, could seek a civil penalty against Barry to disburse among the victims and get restitution damages for the borrowed funds.

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(ii) Sarbanes-Oxley

The Sarbanes-Oxley Act requires that executives like Barry vouch for the accuracy of their financial statements. For at least two years, Barry made misstatements on financial disclosures to the SEC. As a result, he would face criminal liability for his misrepresentations to the SEC. Title III of the Sarbanes-Oxley Act requires that companies install internal controls to ensure accurate financial reports. Under this theory, Apple may be liable for not implementing an internal system that would alert others of Barry's actions.

(iii) RICO

Since RICO allows the government or a private plaintiff to bring a cause of action, Apple could make a pre-trial request to freeze Barry's personal assets and Carol Caters' business account. These precautions ensure there would be available funds if their cause of action is successful. However, Barry and Carol would have an opportunity to respond and prove that those funds were acquired through legal means. If unsuccessful, the Carol Caters' business account would be frozen, which would force the business to close or at the least be unable to pay for additional employees like Eric. Apple could require that Barry and Carol be suspended from their positions until after the trial.

To be convicted under RICO, the plaintiff would have to prove that the group comprised an enterprise and committed two or more crimes within the past ten years. Here, Apple could easily prove that Barry, who has committed countless acts of bribery and embezzlement, and Carol, who assisted him, were an enterprise. Because Barry committed multiple crimes covered under RICO within ten years, RICO could be applicable and Apple could collect treble damages from the defendants. Since both would be guilty of racketeering, Barry and Carol face an additional \$25,000 fine and, in the case of government prosecution, twenty extra years in prison in addition to punishment for the base crime.

Diane would also be prosecuted under the RICO statute even though she arguably is not part of the criminal enterprise. The only knowledge she has was buying supplies for Barry, who she knew was doing something illegal. Eric may as well be prosecuted since he drove Diane to the store and agreed to help Barry on a project. Based on the RICO statute, although it might seem unfair, Eric and Diane could face the additional racketeering penalty.

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C. In the United Kingdom**(i) SCPO**

Based on the statutory language of the SCA, the High and Crown Courts both have wide latitude on to whom to issue a SCPO and what the SCPO requires. The SCPO can be tailored to the specific situation. Here, each of the players in the scenario would receive a different SCPO based on the specific circumstances.

In regards to Barry, the prosecutor could show that he was involved in a serious crime. Fraud is a crime within the Act. The Court has the discretion to issue a SCPO, if in a particular circumstance there is a sufficiently serious situation that necessitates a grant of an order. In the current case, the prosecutor could argue that Barry has systematically taken money from Apple's employees and the company and an SCPO would be appropriate. Under the SCA, the Court could proscribe an SCPO seizing Barry's personal finances, inhibiting his ability to transfer any private property, and limiting his access to Apple's accounts.

The High Court can also issue an SCPO on Carol. The prosecutor can argue that Carol "facilitated the commission by another person [Barry] of a serious offence." Carol agreed to help Barry and received proceeds from their scheme. As a result, the SCPO covering Carol may include seizure of her personal property and her business account at Carols Catering. Carol may be prohibited from speaking to the other defendants or employees at Apple. Finally, SCPO is able to prohibit Carol from traveling even if it is for her business.

The prosecutor would likely not request for a SCPO for Diane. By simply going to the store and purchasing envelopes, she might appear to have encouraged or assisted the commission of the crime, but it is unlikely she will be subjected to a SCPO because of her extenuated relationship with Barry.

Fortunately for Eric, he too will not likely be the subject of an SCPO. Eric agreed to help with the commission of the fraud and drove Diane to the store, but he agreed to help and did not intend to further the commission of fraud.

Moreover, Fred arguably will be the subject of an SCPO. According to the prosecutor, Fred is "likely to facilitate the commission" of the crime, since there was email correspondence between Fred and Barry specifically regarding the fraud. The SCPO under the discretion of the court can limit Fred's access to his Orange Company's files, require that Fred's work be overviewed by another, or any other remedy that the court deems necessary.

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(ii) The Serious Fraud Office

Based on the factors that the SFO considers before investigating a case, it is most likely that the SFO would not investigate Barry's case. Although Barry skimmed over \$1.8 million, his crime has no international element and did not affect the public. Barry's crime is seemingly too small and unsophisticated to draw the attention of the SFO.

(iii) Financial Services Authority

The FSA monitors over 29,000 companies in the United Kingdom and requires a risk assessment to be completed every one to four years. Given the size of Apple, the amount of money Barry has borrowed and the extent of time of the scheme, the FSA would categorize Apple as a high impact firm and begin an investigation. The reason for the high impact categorization is due to the amount of money that was loaned, the size of Apple's company, employing three hundred people and the length of the scheme.

V. CONCLUSION

The systems of the United States and the United Kingdom for handling white collar crime are quite similar, but do differ in certain respects. Both have broad, far reaching statutes, RICO and the SCA respectively, are used by prosecutors to convict white collar criminals. Both statutes allow for seizure of property and funds to provide victims the ability to recoup some losses. Both countries established regulatory agencies to oversee the securities markets and investigate potential violations. The effectiveness of either country's regulatory agencies has been put into question.

What differs between these two countries is the way each approaches deterring white collar crime. It may be readily apparent that the United States legal system has a harsher punishment system. RICO allows for treble damages and enhanced penalties for racketeering charges. Sarbanes-Oxley codifies enhanced penalties for securities violations. These tools are used as deterrents for future white collar criminals. Based on RICO and Sarbanes-Oxley, the United States relies on regulatory oversight by the SEC requiring companies to submit annual reports. The United States is not preventative in nature, but relies more heavily on harsher punishments and larger fines to deter corporate persons from committing crimes than the United Kingdom.

In the United States, the system is set up to catch criminals as they are about to commit the crime or after the crime is committed. The touchstone of the American white collar prosecution system is the heightened punishment

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schemes and the availability of private causes of action. It seems apparent that the United States chose deterrence instead of early action in their battle against commercial crimes.

On the other hand, the United Kingdom does not grant harsher penalties for white collar crimes or those involved in organized crime. Like the SEC, the FSA and SFO are charged with monitoring public companies. What they lack in harsher punishment, the United Kingdom makes up in, arguably, a better preventative system. The United Kingdom places their emphasis proactively and tailors white collar prosecution focusing on early action against corporate criminals. The United Kingdom's focus is *ex ante*, before the crime is committed. Given the overbroad statutory wording the SCA, prosecutors are able to strike would-be criminals early at the first sign of wrongdoing or even arguable at the first intention of wrongdoing. The SCPO allows for restrictions to put on those who are likely to facilitate in a crime, giving the Crown prosecutors a preemptive tool to tackle would-be white collar criminals. The SCPO can be tailored by the courts in a various ways. A court can restrict a person's activities or prohibit travel for up to five years. Courts have a robust means to combat white collar crime in its initial stages.

The better choice between preemption versus a heightened punishment based system is unclear. Based on the recent news of financial scandal neither scheme is one hundred percent effective although neither has had time to be completely implemented. However, both systems could improve in increasing public knowledge, awareness, and involvement. If the public is made fully aware of corporate misdeeds at an early stage, then losses from financial crimes would not be able to grow in excess of a billion dollars.

In fact, the media may be an effective source in monitoring corporate and white collar crimes. By utilizing the media, each government can make corporate actions more visible to the public. One function of the press should be keenly aware of corporate transactions that are neither transparent nor understandable. What the mass media brings to the war against white collar crime is transparency, the dissemination of knowledge to the public. In doing so, the media plays a part in prevention, where news articles and opinion pieces can shed light on potential corruption in corporate settings.

The media has the power to draw national significance to any situation. Their traditional role as public watchdog needs to broaden into a more assertive public spotlight drawing the crowd's attention to potentially damaging corporate scandals and calling for action. By reporting in detail and frequently about certain corporation actions, the public will scrutinize the corporation's actions and perhaps prevent catastrophic damages by stopping corporate crime at its early stages. The media also can influence what is relevant in public opinion.

The introduction of the SCPO in the United Kingdom and the passing

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of tough statutes like RICO and Sarbanes-Oxley in the United States is a step in the right direction. Utilizing the media could be another step to influence policymaking by creating public opinion about certain issues. Both countries have seen the importance of monitoring and stopping white collar crime no matter what method is used.

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BETTER WAYS OF RESOLVING DISPUTES IN HONG KONG—SOME INSIGHTS FROM THE LEHMAN-BROTHERS RELATED INVESTMENT PRODUCT DISPUTE MEDIATION AND ARBITRATION SCHEME

*Gary Soo, Yun Zhao & Dennis Cai **

I. INTRODUCTION

Following the collapse of Lehman Brothers in September, 2008 until December 23, 2009, the Hong Kong Monetary Authority (the “HKMA”) received 21,770 complaints from investors regarding the ways in which some banks were misselling Lehman Brothers-related investment products.¹ On October 31, 2008, the HKMA announced the Lehman Brothers-related Investment Products Dispute Mediation and Arbitration Scheme (the “Scheme”), and appointed the Hong Kong International Arbitration Centre (the “HKIAC”) as its service provider.² The purpose of the Scheme was to provide a dispute resolution platform for disputes between aggrieved investors that purchased Lehman Brothers-related investment products and the banks which sold it to them. The HKIAC provided such mediation and arbitration services to resolve those disputes. The introduction of the Scheme can be seen as a step taken by the Government of Hong Kong to promote the development of mediation as an alternative means of dispute resolution. This paper reviews the effectiveness of the Scheme since its implementation more than a year ago, in

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¹ H.K. MONETARY AUTH. (“HKMA”), COMPLAINTS STATISTICS CONCERNING LEHMAN-RELATED INVESTMENT PRODUCTS (2009), available at

<http://www.info.gov.hk/hkma/eng/new/lehman/lehman.htm> (last visited on Feb. 23, 2010). HKMA regularly updates the progress and statistics concerning Lehman-related investment products.

² Press Release, Hong Kong International Arbitration Centre (“HKIAC”), HKIAC to Provide Mediation and Arbitration Services for Lehman-Brothers Related Inv. Prods. Dispute (Oct. 31, 2008), available at http://www.hkiac.org/documents/Mediation/News/081031_Lehman_E.pdf.

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light of recent developments. Before introducing the Scheme, this paper first considers the use of mediation as an alternative dispute resolution compared to the traditional means of litigation. Following that, there is a brief outline of mediation in Hong Kong along with an introduction to the Scheme. Finally, this paper considers the latest empirical data published on the Scheme, before concluding with an evaluation of the Scheme.

II. ALTERNATIVE DISPUTE RESOLUTION LANDSCAPE IN HONG KONG

A. Litigation or Mediation?

Mediation is not a new phenomenon in Hong Kong. Prior to the enactment of the Scheme, mediation has been successfully used to resolve disputes relating to construction and building management. Despite the increase in popularity and usefulness of mediation, litigation is still likely to be the first choice of dispute resolution mechanism on which most people or commercial enterprises locked in disputes would rely on.

Litigation has not lost all of its attractiveness, and is likely preferable in the following circumstances.³ First, litigation is most desired where courts are better equipped to understand the legal dispute at hand. For example, commercial courts have the specialization necessary to deal with financial products and will likely better understand the technical aspects of a transaction. Second, litigation is preferred where there is a desire for an authoritative and legal precedent, so that the judgment would be legally binding on similar cases.⁴ Third, litigation can utilize the developed set of court procedures that allow quick judgments to be obtained and cut down legal costs, such as summary judgment. This is seen in some common law jurisdictions such as England & Wales, Singapore and Hong Kong.

Thus, despite its rise as an alternative means of dispute resolution, mediation will not replace litigation. Therefore, the types of cases suitable for mediation need to be identified prior to promoting its use.

³ James Kwan, *A New Solution*, ASIALAW, Dec. 2008, available at <http://www.asialaw.com/Article/2068790/Search/Results/A-new-solution.html?Keywords=%22a+new+solution%22>.

⁴ Joseph Wong, *Repairing the Damage: The Government Can Do More for Lehman Minibond Investors, Including Helping to Expedite Legal Cases*, S. CHINA MORNING POST, Nov. 5, 2008, at 21.

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B. Mediation as an ADR Process in General

Briefly, mediation is a form of voluntary dispute resolution for parties who are unable to reach a settlement on their own. Both sides of the dispute agree to appoint a neutral mediator, who will bring the two sides together to try to settle a claim in a speedy, confidential and amicable way.⁵

Generally, mediation has the following advantages over other forms of dispute resolution.⁶ First, its costs are considerably lower. Second, it is quicker than litigation, which can drag on for many years. Third, the process is less adversarial than other methods of dispute resolution. Unlike litigation, mediation encourages the parties to negotiate and reach a settlement. This, in turn, creates a less pressurized setting as parties are not encouraged or 'forced' to compete by presenting their case or arguments according to the common law adversarial style of advocacy. Fourth, mediation is easy to follow and understand because it avoids or limits the use of legal jargon. Fifth, the mediation process is free from the restrictions of pre-trial procedures such as requests for particulars, specific discovery, security for costs and other interlocutory applications that can be quite onerous and not necessarily beneficial to the parties. Finally, the mediation process is private and confidential.

⁵ H.K.M.A., LEHMAN-BROTHERS-RELATED PRODUCTS DISPUTE MEDIATION AND ARBITRATION SCHEME: FREQUENTLY ASKED QUESTIONS (2008), *available at* http://www.info.gov.hk/hkma/eng/new/lehman/lehman_dispute.htm (follow "Frequently asked questions" hyperlink).

⁶ For more discussion on the process of mediation and its benefits, *see* Julian Cohen, *Making Mediation Work for your Commercial Clients*, H.K. LAWYER, May 5, 2009, at 32-38, *available at* <http://law.lexisnexis.com/webcenters/hk/Hong-Kong-Lawyer-/Making-Mediation-Work-for-your-Commercial-Clients>; Louise Barrington, *Slowly but Surely... Mediation goes mainstream in Hong Kong*, H.K. LAWYER, March 2007, *available at* http://www.hk-lawyer.com/InnerPages_features/0/2307/2007/3; Wong Yan Lung, H.K. Sec'y for Justice, Address at the EMBA Forum 2007-08: Mediation Helps Preserve Relationships (Feb. 25, 2008), *available at* <http://www3.news.gov.hk/isd/ebulletin/en/category/ontherecord/080226/html/080226en11001.htm>; CHAN BING WOON AND TAN KHAIN SEIN OSCAR, HOW MEDIATION CAN HELP CORPORATIONS SURVIVE THE RECESSION (Asian Mediation Conference, 2009), *available at* <http://www.asianmediationassociation.org/conference/pdf/AMA%20Conference%202009%20-%20How%20Mediation%20Can%20Help%20Corporations%20Survive%20Recession%20by%20Chan%20Bing%20Woon.pdf>; Bernard Chan, A Shifting Role from Facilitator to Mediator, S. CHINA MORNING POST, Dec. 5, 2008, at 18; Kwan *supra* note 3.

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C. Mediation as an ADR Process in Hong Kong

In Hong Kong, mediation is not a new vehicle for dispute resolution. In the 1980s, mediation was initially used in sectors like the construction industry as a standard dispute resolution clause within the multi-tiers dispute resolution process.⁷ Mediation has also been used in the Hong Kong Family Court, and more recently, in the Lands Tribunal and the Companies Court in the format of pilot schemes.⁸

Since 1994, the Hong Kong Mediation Council (the “HKMC”), a division of the HKIAC, has been operating to promote and develop the use and education of mediation. At present, there are approximately three hundred “Accredited Mediators” on the list of general category kept and maintained by the HKIAC. Mediation schemes performed by the HKMC in sectors such as commercial, employees’ compensation and construction, have all been operating in full gears.

On April 2, 2009, the Civil Justice Reform (the “CJR”)⁹ came into effect. Modeled on the approach taken in England and Wales, the CJR represents the most important change in the practice of civil litigation since the current rules were introduced.¹⁰ A key feature of the CJR is the encouraged use of mediation, which is the main theme that permeates its underlying objectives. The CJR emphasizes cost effectiveness, the avoidance of delays, fairness, the facilitation of settlements and fair employment of the courts’ resources. Order 1A, rule 2(2) provides that in exercising its powers, the court shall recognize that the primary aim is to secure ‘the just resolution of disputes in accordance with the substantive rights of the parties.’¹¹

⁷ The standard clause in construction contracts in Hong Kong commonly provide for the use of mediation and arbitration for the resolution of disputes, if they remain not settled after the decision by the Engineer/Architect. The contractual uses of adjudication or a dispute resolution adviser system have also been respectively seen in some standard contracts, such as the Airport Core projects in the 1990s and the refurbishment of hospitals.

⁸ For more discussion on the use of mediation schemes in Hong Kong, *see* Barrington, *supra* note 6; Lung, *supra* note 6; Andrew Kwok Nang Li, Honorable Chief Justice, and Wong Yan Lung, Sec’y for Justice, Address at the Conference on Mediation in Hong Kong: Mediation in Hong Kong: The Way Forward, *available at* <http://law.lexisnexis.com/webcenters/hk/Mediation-in-Hong-Kong-The-Way-Forward>.

⁹ Civil Justice Reform Homepage, <http://www.civiljustice.gov.hk>.

¹⁰ David Ravenscroft, MEDIATION AND CIVIL JUSTICE REFORM, H.K. LAWYER, Oct. 2008, at 47-51, *available at* <http://law.lexisnexis.com/webcenters/hk/Hong-Kong-Lawyer-/Mediation-and-Civil-Justice-Reform>.

¹¹ Rules of the High Court, (2008) Cap. 4A, 1A, § 2(2). (H.K.), *available at* <http://www.legislation.gov.hk/eng/home.htm>. Rules of the District Court, (2008) Cap. 336H, 1A, § 2(2). (H.K.), *available at* <http://www.legislation.gov.hk/eng/home.htm>.

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Under the new CJR, courts are expected to take a more proactive approach in the management of their cases. Rule 4(2)(e) states that active case management includes “encouraging the parties to use an alternative dispute resolution procedure if the court considers that appropriate, and facilitating the use of such a procedure.”¹² Before the litigation commences, parties are expected to be ready, and come with their cases properly documented and prepared. The intention is to provide more initiatives for the parties and their legal representatives to know the facts, and realistically assess the merits of their cases at an earlier stage, with a view towards entering into direct negotiation for settlement.

In addition, the CJR obligates legal representatives to advise parties on mediation, and obligates parties to consider using it.¹³ Courts are permitted to adversely take into account a party’s refusal to mediate without a reasonable explanation.¹⁴ Likewise, a legal representative who fails to properly advise his or her client on the use of mediation can face a court order against himself or herself. Thus, in Hong Kong, litigants and their legal representatives need to seriously think before saying ‘no’ to mediation because of the risk of penalization by the Courts for legal costs. In addition, on January 1, 2010, a comprehensive set of Practice Directions¹⁵ for the use of mediation following the CJR will take effect.

D. Arbitration in Hong Kong

In addition to mediation, arbitration is another alternative to litigation. Although arbitration and mediation share many of the same advantages, arbitration may not necessarily be cheaper than litigation or quicker than mediation. In addition, arbitral awards are final and binding on both sides.

Because Hong Kong is now a common-law jurisdiction and part of the People’s Republic of China (“PRC”), it has a unique position on arbitration. As an arbitration venue, Hong Kong has benefited from the increasing number of Chinese-related disputes arising from the escalation of foreign investment and economic activities in Asia, particularly in China. It is believed that, because it

¹² Cap. 4A, 1A, § (2)(e); Cap. 336H, 1A, 4(2)(e).

¹³ This applies to the High Court and the District Court of Hong Kong. Other courts already have mediation schemes that encourage the use of mediation in similar settings, such as the Lands Tribunal for building management disputes, the Construction and Arbitration Court at the Court of First Instance, the Companies Court for shareholders disputes, and of course the Family Court.

¹⁴ Cap. 4A, Order 62, § 5; Cap. 336H, Order 62, § 5

¹⁵ Mediation Practice Direction, *Mediation* (2010) 31 (H.K.), available at http://legalref.judiciary.gov.hk/doc/prac_dir/html/PD31.htm.

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retained its English common law-based legal system, foreign parties regard Hong Kong as a fair, familiar and neutral forum for resolving commercial disputes. In addition, because of its proximity in location, Chinese parties regard Hong Kong as a culture-friendly venue.¹⁶

According to HKIAC's statistics, 602 arbitration cases have been recorded in 2008. Among them, the number of cases between two parties from Mainland China is increasing. For reference, the caseload figures for the last thirteen years are listed in the table below.¹⁷

<i>Year</i>	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
<i>Cases</i>	197	218	240	257	298	307	320	289	280	281	394	448	602

The existing Arbitration Ordinance (Cap. 341)¹⁸ applies the UNCITRAL Model Law on International Commercial Arbitration ("UNCITRAL Model Law") as the statutory regime for international commercial arbitration. Hong Kong judges adhere not only to common law, but also to the New York Convention for enforcement of arbitral awards made overseas and in various arbitration commissions in Mainland China. In the High Court of Hong Kong, the Construction and Arbitration List operates to hear arbitration-related cases.

Currently, Hong Kong is in the process of reforming the existing Arbitration Ordinance in order to extend the UNCITRAL Model Law to its domestic regime and incorporate its framework, structure, and wordings to make it user-friendly for international users. Another one of its key features, apart from harmonizing the good aspects of laws and practices from the international arbitration world, is to give legal effect to the main amendments to the UNCITRAL Model Law in 2006 that deal with the definition of 'in writing' and the procedures for ordering and enforcing interim measures by the arbitral tribunal.¹⁹

With all these new and interesting developments in mind, it is now

¹⁶ Lung, *supra* note 6.

¹⁷ H.K.I.A.C. – About the HKIAC, *available at* http://www.hkiac.org/show_content.php?article_id=9.

¹⁸ 'Cap.' is the standard abbreviation for 'Chapter.'

¹⁹ UNCITRAL, MODEL LAW ON INT'L COMMERCIAL ARBITRATION (2006), *available at* http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/1985Model_arbitration.html.

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time for a closer examination of the use of mediation, particularly in conjunction with arbitration. To this end, an introduction of the Scheme may help cast some light on this specific issue.

III. LEHMAN-BROTHERS RELATED INVESTMENT PRODUCT DISPUTE MEDIATION AND ARBITRATION SCHEME

A. Background of the Scheme

Founded in 1850, Lehman Brothers was the fourth largest investment bank in Wall Street and a leader in sales of various assets and equities. During the economic downturn in 2008, Lehman reported a loss of \$39 billion in the third quarter of 2008. On September 15, 2008, Lehman Brothers Holdings Inc., filed for bankruptcy protection under Chapter 11 of the US Bankruptcy Code. The collapse of Lehman Brothers caused serious repercussions on financial markets, and Hong Kong, an international financial center, was no exception. More than 48,000 Hong Kong investors invested in structured products, otherwise known as “minibonds,” that were related to Lehman Brothers. These investments derived part of its value from the performance of an underlying asset. The total invested in minibonds amounted to HK\$20 billion.²⁰ As a result of Lehman’s bankruptcy, these investments either lost the majority of its value or became entirely worthless.²¹

The HKMA is responsible for promoting the safety and soundness of Hong Kong’s banking system. The organization received 21,770 complaints regarding the sale of Lehman Brothers-related investment products, alleging fraud, misrepresentation and/or misconduct in the form of bad advice or the failure to disclose material information. As of December 23, 2009, only 246 of the 21,770 complaints filed with the HKMA have been referred to the Securities and Futures Commission (“SFC”) for further investigation.²²

The complainants came from all walks of life. Some were still able to manage their lives despite dealing with the loss of value of their Lehman Brothers-related minibonds. Others, including many who were senior in age, invested all of their life-long savings in these products, and are thus, in very difficult situations. Not surprisingly, political parties got involved by assisting with the resolution of these disputes. There are also ongoing demonstrations by

²⁰ See H. K.M.A., *supra* note 1.

²¹ See Woon and Oscar, *supra* note 6.

²² See H.K.M.A., *supra* note 1.

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investors in the Central Business District of Hong Kong.

Aiming to recover their investments, complainants were very proactive. Some commenced litigation against the banks in the High Court or the District Court, while others started legal proceedings in the Small Claims Tribunal. In addition, a number of complainants are in the process of pursuing a class action in the Courts of the United States.

Therefore, several measures were implemented to deal with the public outcry. On October 31, 2008, the HKMA introduced the Scheme to provide operative and administrative support to the mediation and arbitration services. In discussing the Scheme, Dr. Michael Moser, Chairman of the HKIAC commented:

[The Scheme] provides a mechanism for the resolution of the Lehman Brothers-related Investment Products disputes in a speedy, cost effective and efficient manner. The Scheme allows the Hong Kong Government, Hong Kong businesses and the entire community to address one of the consequences of the current financial crisis in a way which benefits all parties.²³

Under the Scheme, the HKMA will pay half of the total costs to two groups of investors. The first group consists of the investors whose complaints to the HKMA resulted in a referral for investigation to the SFC (the “With-Referral Claims”).²⁴ The second group of investors consists of the investors whose complaints resulted in a finding against a relevant individual²⁵ or an executive officer, by either the HKMA or SFC (the Without-Referral Claims”). The Scheme is also available to claims other than the With-Referral Claims and Without-Referral Claims if the bank is willing to take part. As part of its commitment to assist the HKMA to launch the Scheme, the HKIAC has agreed to handle these claims according to the same procedures as under the Scheme. However in these circumstances, the costs of mediation are to be borne by the respective investors and the banks equally, unless otherwise agreed.²⁶

²³ See H.K.I.A.C., *supra* note 2.

²⁴ See H.K.M.A., *supra* note 5.

²⁵ The HKMA does not expressly define the term “a relevant individual,” but it should mean an individual relevant to the complaint in issue.

²⁶ See H.K.M.A., *supra* note 5.

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B. Characteristics of the Scheme

Mediation is a voluntary, non-binding dispute resolution process in which a neutral mediator helps bring the parties together with the aim of settling the dispute in a speedy, confidential and amicable way. The mediator does not adjudicate on the dispute. Rather, the mediator either helps the parties narrow the issues in dispute or reach a negotiated settlement. In the former, an “Agreed Matters Form” is provided for the purpose of encouraging the parties to agree on certain issues, such as liabilities, facts, documents or method of calculating quantum, to name a few.²⁷ It should be noted that either party may terminate the process at any time.

As defined in the Rules, mediation proceedings are conducted in a private, confidential setting. Under the Scheme, parties may not appoint the mediator as an arbitrator, representative, counsel or expert witness of either party in any subsequent arbitration or judicial proceeding arising out of the mediation or connected to the dispute in question.²⁸ In addition, parties under the Scheme may not disclose, transmit, introduce or otherwise use any opinions, suggestions, proposals, offers or admissions obtained or disclosed during the mediation as evidence in any judicial proceedings, arbitration or other proceedings, unless the parties agree in writing or are compelled by law.²⁹

Under the Scheme, the HKMA and the bank pay in equal shares the appointment fees³⁰ and mediator/arbitrator fees,³¹ which are fixed amounts. As the Scheme is a means to resolve disputes by agreement, it expressly provides that parties may not be legally represented. If both parties agree to settle their dispute, a settlement agreement is negotiated, which is binding on both parties.³²

C. Operations of the Scheme

The Rules of the Scheme are quite simple: its four sections³³ and

²⁷ *Id.*

²⁸ *Id.*

²⁹ H.K.I.A.C., *Lehman-Brothers-Related Investment Products Dispute Mediation and Arbitration Rules*, § 7 (Effective May 5, 2009) (H.K.), available at

http://www.hkiac.org/documents/RICS/RICS_Procedure.pdf [hereinafter Scheme Rules].

³⁰ *See id.* at art. 4.; As per the Rules, the appointment fees for the appointment of a mediator and an arbitrator are the same, which is fixed at HK\$ 2,000 per case.

³¹ *See id.* As per the Rules, the fees for the mediator and for the arbitrator are respectively fixed at HK \$15,000 and HK \$22,500 per case.

³² *See* H.K.M.A., *supra* note 5.

³³ Namely, ‘Definitions,’ ‘Mediation,’ ‘Arbitration’ and ‘Fees and Costs.’

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twelve articles³⁴ aim to simplify the proceedings and languages to be as practicable as possible, while balancing the need for proper procedures. This is divided into three processes:

i. Information gathering, pre-mediation briefings and preparatory meetings

The HKMA supplies the Scheme with an office, staff and a venue (the “Scheme Office”), which is administratively supported by the HKIAC. The Scheme Office operates a special hotline that handles all inquiries relating to the Scheme,³⁵ and assists those who wish to initiate mediation. Furthermore, its staff, having been taught basic mediation knowledge, is able to answer and explain queries from investors regarding the Scheme, and help parties, including investors and banks, with the documentation required by the Scheme during the case intake process.

User-friendly forms and rules, including guidance notes and flowcharts, are tailor-made and prepared so that investors and bank personnel can easily understand the Scheme. Suitably qualified mediators and arbitrators draw up special lists that are used to provide services under the Scheme.

The Scheme Office is also used to hold mediation meetings. Parties interested in mediation are invited to attend pre-mediation briefing sessions at the Scheme Office. During these briefings, mediators discuss with banks and investors the suitability of mediating specific cases.³⁶ From these sessions, investors gain a basic understanding of mediation to make an informed decision as to whether or not to resolve their claims using mediation.

Investors having a complaint that was referred to the SFC or had resulted in a finding against a relevant individual or executive officer, receive information from the Scheme Office about the mediation service and the procedures for initiating it. Before mediation takes place, the parties attend preparatory meetings, which serve several purposes. Some investors come from low educational backgrounds. Most are unfamiliar with mediation. Thus, a mediator, other than the one in the actual mediation, acts as a mediation advocate by preparing the investor for negotiations, including familiarizing the

³⁴ See Scheme Rules, *supra* note 29. Section 2 ‘Mediation’ contains articles titled ‘Appointment of Mediator,’ ‘Roles of Mediator and the Parties,’ ‘The Mediation Process,’ ‘Termination of the Mediation,’ ‘Confidentiality,’ ‘Language of the Mediation,’ ‘Mediator’s Role in Subsequent Proceedings’ and ‘Exclusion of Liability’. Section 3 ‘Arbitration’ contains articles titled ‘General,’ ‘Appointment of Arbitrator’ and ‘Procedures in General.’

³⁵ The hotline number is +852 8100 6448.

³⁶ All mediators are Accredited Mediators of the HKIAC, engaged or volunteering to provide assistance in the operation of the Scheme.

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investor with the mediation process. The mediation advocate also helps the investor explore settlement options using interest-based negotiation, in order to prevent the mediation from being dragged into hostile arguments that run counter to the amicable nature of mediation.

Additionally, the Scheme Office facilitates the exchange of information and documents between the parties. The mediator's task is to understand the interests and needs of the parties, to avoid legal arguments and to help explore settlement options, all while taking into account the parties' interests and needs. At this stage, parties are required to complete the consent to mediation form, the claim form and the response form. A 'Without Prejudice' offer may be made at this stage by the banks to settle a matter once and for all. Direct negotiations for an amicable settlement may happen before the completion of the forms, or shortly thereafter.

By the parties' choice, the substantive dispute resolution process under the Scheme can adopt a two-stage approach (mediation and arbitration), where a settlement does not need to be reached during the information gathering stage.

ii. Mediation

Under the Scheme, mediation is designed to help the investor and the bank either settle the claim on terms agreed to by both parties or to narrow the issues in dispute. Where there is no direct negotiation, a mediator is appointed by agreement of the parties from a list of mediators provided by the HKIAC. The mediator must commence and finish the mediation within twenty-one days of the appointment, and unless otherwise agreed to by all involved, the mediation meetings should last no more than five hours. The mediator's task is to bring the two sides together to settle the case in an amicable, speedy and confidential way. Hence, a successful mediation concludes with a settlement agreement. In the event that no overall settlement agreement is reached, the process still encourages the parties and the mediator to endeavor to agree on the common facts, whether full or partial, that can be used in subsequent arbitration or litigation.³⁷

iii. Arbitration

The arbitration limb is not intended to be used in all types of disputes. In particular, under the Scheme, "documents-only" arbitration is not suitable for

³⁷ Scheme Rules § 2.3.

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disputes involving complex issues or substantial examination of witnesses.³⁸ Parties electing to arbitrate under the Scheme are expressly required to thoroughly consider the circumstances before doing so. Relevant factors include the need for seeking, at the party's own cost, separate legal advice on whether to arbitrate on a "documents-only" basis, litigate or take other appropriate actions to resolve the dispute. The underlying rationale is to ensure that each party understands that he or she is at full liberty to decide whether to only use mediation or to use mediation in combination with "documents-only" arbitration, and to decide whether or not to agree to a settlement agreement in mediation.

When a dispute does not end in a settlement, the parties may agree to proceed with a "documents-only" arbitration. This commenced by a notice of arbitration. The arbitrator then has twenty-one days from its appointment to publish an award.³⁹

Under "documents-only" arbitration, there should not be any in-person hearings (including hearings by teleconference, videoconference, and web conference), unless, under exceptional circumstances, the arbitrator determines, in his or her sole discretion, that such a hearing is necessary for deciding the claim and both parties have agreed to pay the related expenses and fees incurred. If needed, the arbitrator may conduct an informal hearing with the parties for the purpose of seeking any clarification. Awards under this kind of arbitration will be binding on the parties, and will not be subject to appeal.

IV. EMPIRICAL STUDY OF THE SCHEME

A. Summary

The HKMA has received 21,770 complaints concerning Lehman Brothers-related investment products as of December 23, 2009. Of these complaints, the HKMA has completed the investigation process for 3,266 cases and is currently investigating an additional 5,108 cases. Among those investigated, 2,846 complaints have been closed, because of insufficient *prima facie* evidence. So far, disciplinary action has only been taken in one case, while 419 complaints cases are currently under disciplinary consideration or notice. The HKMA has also referred 246 cases, involving 16 banks, to the SFC for further action.⁴⁰

³⁸ See Woon and Oscar, *supra* note 6.

³⁹ *Id.*

⁴⁰ See H.K.M.A., *supra* note 1.

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As of November 2009, the HKIAC has recorded 334 requests for mediation. About thirty cases have been settled through direct negotiations between the banks and the investors. Of the investors who sought assistance from the Scheme Office, 78% of them have chosen mediation as the first method for resolving their disputes.⁴¹ The first mediation was successfully concluded on December 10, 2008 and lasted for five hours. Mediation sessions were conducted in eighty-six other cases, all of which resulted in the conclusion of a settlement agreement. Thus, the Scheme has experienced an 88% success rate.

All of those mediation sessions took place within a week of having the mediators appointed and were concluded within five hours. In addition, some cases outside of the Scheme were mediated, of which the investors and the banks jointly agreed to use the Scheme to settle their disputes and pay the fees among themselves. In those cases, the amount in dispute ranged from approximately HK \$100,000 to approximately HK \$500,000. Post-mediation surveys revealed that parties were satisfied with the mediation process and the performance of their mediator.⁴² So far, no case has reached the stage of 'documents-only' arbitration. As the matter presently stands, in view of the large number of pending cases, it is expected that the Scheme remain in operation for quite a while.

B. Analysis of the Scheme

By obtaining full and final settlements, the Scheme helps to prevent disputes from escalating into full-blown litigation. For banks, mediation is attractive because settlement agreements do not have the binding effect of law. Thus, a bank can resume its normal operations and maintain amicable relationships with its customers. In addition, by avoiding long disputes, a bank can maintain long-term relationships the investors, which is in the best interest of its shareholders.⁴³

The private and confidential nature of the Scheme also prevents the disclosure of private and sensitive information. This is an added incentive for banks because court hearings and decisions are assessable by the public and reported by the media. Thus, documents disclosed during the discovery process

41 Press Release, H.K. Int'l Arbitration Ctr., Mediation 100% Success for Lehman Brothers-Related Investment Product Cases, (Feb. 19, 2009), *available at*

http://www.hkiac.org/documents/Mediation/News/090219_LehmanUpdate_E.pdf.

⁴² *Id.*; Press Release, H.K. Int'l Arbitration Ctr., HKIAC Successfully Mediates First Lehman Brothers-Related Investment Products Case, (Dec. 22, 2008).

⁴³ See Woon and Oscar, *supra* note 6.

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would no longer remain confidential. As the Scheme is not subjected to the usual pre-trial discovery procedures, banks do not have to disclose confidential documents or information, including documents relating to internal operations and customers.⁴⁴

Furthermore, mediation costs are low compared to other alternative means of dispute resolution. This is beneficial to investors who are unable to withstand a costly and time consuming litigation against financial institutions that are likely to have greater bargaining power due to advice from a team of legal counsel.⁴⁵

As previously stated, the mediation process generally does not last longer than five hours. This benefits both parties since litigation is costly and can last for many years. For banks, on-going litigation is likely to affect its daily operations and damage its relationships with customers.⁴⁶

Mediation can also be used under the Scheme as an attempt to narrow the issues in a dispute. In the event that no overall settlement agreement is reached, Article 2(3) of the Rules provides that the parties can agree on some, if not all, of the common facts. This will be helpful if the mediation fails to conclude in a settlement and the parties proceed to 'documents only' arbitration.

In general, the Scheme generated a lot of publicity among the various sectors of the communities. The intake of cases under the Scheme has been slower than expected, partly due to the limited understanding of mediation by its users and the limited number of complaints referred by the HKMA to the SFC. However, the HKIAC expects more cases to go through mediation as more inquiries regarding mediation are made, and investors and banks show eagerness to partake in a suitable, efficient and effective dispute resolution method for their disputes.⁴⁷ In any case, with its high rate of settling disputes, the Scheme has successfully delivered the message that "mediation is a flexible dispute resolution process and is more and more widely accepted as a practical and effective tool to settle disputes of various types and nature."⁴⁸

C. Challenges to the Scheme

Essentially, there are three key insights that can be drawn from the Scheme, in relation to the use of mediation as a dispute resolution process. First, the whole dispute resolution process should be and can be tailor-made to

⁴⁴ *Id.*

⁴⁵ *Id.*

⁴⁶ *Id.*

⁴⁷ See H.K.I.A.C., *supra* note 42.

⁴⁸ See H.K.I.A.C., *supra* note 2.

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suit the users and the nature of their cases. One of the challenges under the Scheme is to control costs. Hence, the Scheme provides mediation and arbitration services at fixed fees.

Furthermore, the Scheme, in absence of an agreement otherwise, provides for “documents-only” arbitration. Since the allegations of disputes concern misselling of minibonds, there are different views on how “documents-only” arbitration might be helpful. It is believed that “documents-only” arbitration may still be used in suitable cases as an alternative to litigation where the issues involved are limited or have been narrowed down by mediation. The risks of a case not suitable for resolution by “documents-only” arbitration entering into the arbitration limb of the Scheme are safeguarded by the emphasis that the Scheme Office places on the types of cases that the process is designed for during the case intake process. The arbitration limb also helps parties stay more focused during the process of the mediation. Thus, instead of merely providing a one-size fits-all mediation or arbitration service to all users, consideration is given to the individual category of a case, to allow users to gain the most benefits of combining mediation and arbitration.

Second, to the users of mediation, the efficiency of the process is a significant indicator of whether mediation is helpful as a dispute resolution process. As such, it is important that the mediation process not be abused and seen as just another hurdle that the parties have to go through before beginning litigation or arbitration. Proper control of the timeline of the mediation needs to be maintained in order to build up public confidence in mediation. Speed is also an important matter that the parties appreciate. In some instances, investors held demonstrations in front of the banks on one day, and on the next day, their disputes were settled by mediation in hours.

Third, the Scheme Office and its special hotline have played a great role in contributing towards the success of the Scheme, from information gathering to the conduct of the mediation and arbitration. A team of HKIAC-led mediators and arbitrators perform the preliminary contacts and the arrangement of the logistics. Although mediation information and preliminary preparation are provided and done by the mediators under the Scheme, it is worthwhile to consider setting up a mediation helpline office.⁴⁹ Although many litigants are legally represented, the number of litigants appearing in person is increasing. The mediation helpline office, similar to the Scheme Office, would function as the one-stop contact point for the parties before entering into mediation. For other arbitration schemes that incorporate mediation, it may also be worthwhile to use a helpline in suitable cases and circumstances, which is essential to the success of the mediation.

⁴⁹ See *supra* note 35.

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D. The Future of Mediation

With the CJR coming into force in Hong Kong, it is anticipated that the use and development of mediation as an amicable settlement process will be taken to new heights. The 100% success rate of the Scheme has not only increased the public's confidence in the use of mediation, but has also placed HKIAC in a positive light, as an institution to administer proceedings in an impartial and transparent manner. This opportunity encourages the HKIAC to promote its services in the financial sector and establish a panel of mediators and arbitrators with an expertise in financial transactions. As much as the Scheme is an indicator of the Hong Kong Government's efforts to promote mediation, the Scheme is now also an example of both the government's policy of promoting mediation and its goal of developing the city as an international mediation and arbitration center.⁵⁰

V. CONCLUSION

Following the publicity and success of the Scheme, interest among the wider communities in the use of mediation in Hong Kong is growing. Experience garnered from the Scheme's operation has contributed new insights on how to better provide mediation services and how to integrate mediation with other dispute resolution processes, such as arbitration. The challenges of creating a tailored-made process, keeping the process of mediation efficient and establishing a helpline office for users should be considered, along with an aim to successfully use mediation, with or without arbitration, in the dispute settlement process for users. All in all, it is believed that the HKIAC's experience and observations over the Scheme's operation is valuable, in the sense that it helps identify ingredients for the successful use of mediation in the vast amount of cases to come under the CJR in Hong Kong.

⁵⁰ For more discussion on the future of mediation, see Kwan *supra* note 3; Lung, *supra* note 6; Woon and Oscar, *supra* note 6; Li and Lung, *supra* note 8.

ABORTION IN KOREA: A HUMAN RIGHTS PERSPECTIVE ON THE CURRENT DEBATE OVER ENFORCEMENT OF THE LAWS PROHIBITING ABORTION

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I. INTRODUCTION

For decades, the Republic of Korea¹ has seen hardly any debate about abortion rights.² Although abortion is illegal based on Korea's criminal code drafted in 1953, it is actually very common. Since 1973, the law has provided broad exceptions to this ban on abortion, allowing abortions for victims of rape or incest, women whose health is at risk, cases where the fetus is suspected of having a genetic disorder, and cases where the pregnant woman or her spouse suffers from a list of communicable or hereditary disease.³ In practice, these exceptions have been used to justify abortion on demand, and the law prohibiting abortion in normal circumstances has gone largely unenforced. Although there has been some opposition to this non-enforcement from Korean religious leaders, it has been relatively subdued. Unlike the United States and many other countries, abortion has not been a political lightning rode in Korea.⁴

As of January 2010, however, it can no longer be said that there is a lack of discussion on abortion within Korean society. On the contrary, debate on the future of abortion regulation is raging in newspapers, Internet chat rooms

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¹ This article will use the term 'Korea' to refer to the Republic of Korea.

² See So-yun Kim, *A Secret Scourge*, JOONGANG DAILY, Dec. 5, 2007, available at <http://joongangdaily.joins.com/article/view.asp?aid=2883512> ("It is not an exaggeration to say there has never been any serious discussions about abortion").

³ Mother-Child Health Act, art. 14 (Limited Permission of Induced Abortion Operations) in 6 CURRENT LAWS OF THE REPUBLIC OF KOREA 3456-4 (Korea Leg. Research Institute ed. 1992).

⁴ See, e.g., Press Release, National Human Rights Commission of Korea, Chairperson Ahn Kyong-Whan Meets with Cardinal Nicolas Cheong Jin-Suk (Nov. 15, 2007) (on file with author); Casimiro Song, *Korean Church: "Unite the World Against Abortion"*, ASIANEWS, Jan. 8, 2008, available at <http://www.asianews.it/index.php?l=en&art=11191&dos=117&size=A>.

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and the halls of government.⁵ Specifically, the debate centers on whether the government should crack down on illegal abortions and enforce the existing law (or some revised version of it). Proponents of a crackdown come from two camps. First, there are governmental officials who advocate cracking down on abortions in order to increase the fertility rate, which as of 2009 was the second lowest in the world at 1.22%.⁶ Second, there is a group of obstetricians who have emerged to argue for government enforcement of abortion laws. While some of these obstetricians oppose abortion for religious reasons, others are non-religious and oppose abortion because it violates their ethical precepts.

In response to governmental calls for a crackdown, some Korean women's rights groups have vocally opposed the idea of punishing women for having abortions. For example, a coalition of women's groups stated that "this plan illustrates the anti-human rights stance of the government which portrays women as an instrument for child birth rather than human beings with reproductive rights."⁷ Meanwhile, mainstream human rights groups, including the National Human Rights Commission, have yet to comment on this issue.

This article will closely examine the current debate regarding the enforcement of the criminal laws on abortion in Korea from the perspective of international human rights law, focusing primarily on the international human rights treaties that have been ratified by Korea.⁸ Section II will provide background on abortion regulation in Korea and the current debate, and Section

⁵ See, e.g., Bae Ji-Sook, *Campaign Underway Against Abortion*, KOREA TIMES, Nov. 22, 2009, available at http://www.koreatimes.co.kr/www/news/nation/2009/11/113_55937.html; Si-Soo Park, *Anti-Abortion Campaign Ignores Doctors' Plight*, KOREA TIMES, Dec. 2, 2009, available at http://www.koreatimes.co.kr/www/news/nation/2009/12/117_56560.html; Hai-ri Ahn, *Birthrate Crisis Forces Tougher Stand on Abortion*, JOONGANG DAILY, Nov. 16, 2009, available at <http://joongangdaily.joins.com/article/view.asp?aid=2912604>.

⁶ UNITED NATIONS POPULATION FUND, STATE OF WORLD POPULATION 2009 88 (2009) (this figure refers to the total fertility rate, or the "number of children a woman would have during her reproductive years if she bore children at the rate estimated for different age groups in the specified time period." *Id.* at 93-94).

⁷ Ji Young LeeAn, *Low Birth Rate Blamed on Women*, IPS NEWS, Dec. 19, 2009, available at <http://www.ipsnews.net/news.asp?idnews=49752> (citation omitted).

⁸ This article will not examine Korean statutes or constitutional rights, nor will it look closely at the extensive abortion jurisprudence in other nations, which has traditionally centered on domestic civil rights arguments rather than international human rights jurisprudence. However, an increasing number of domestic courts are in fact basing abortion decisions on an analysis of international human rights law. See WOMEN'S LINK WORLDWIDE, HIGH IMPACT LITIGATION IN COLUMBIA: THE UNCONSTITUTIONALITY IN ABORTION LAW 28-29, 45 (Women's Link Worldwide 2007), available at http://www.womenslinkworldwide.org/pdf_pubs/pub_c3552006.pdf (citing *In re Abortion Law Challenge in Colombia*, Corte Constitucional, Sentencia C-355/06 (2006) (overturning Colombia's law criminalizing therapeutic abortion in part because of recommendations of the CEDAW Committee)).

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III will attempt to clarify the human rights implications of a crackdown. Finally, Section IV will draw conclusions from the analysis, namely that criminally punishing women who undergo abortions and their abortion providers would run counter to a number of Korea's international human rights commitments, and thus the government should instead use alternative human rights-beneficial methods in its attempts to raise the birth rate.

II. ABORTION IN KOREA

A. Historical Background

Articles 269 and 270 of the 1953 Korean Criminal Code prohibit abortions, providing penalties for both the pregnant woman and the doctor involved.⁹ In 1973, Article 14 of the Maternal and Child Health Act set up a system of exceptions to this general prohibition.¹⁰ Specifically, doctors were permitted to perform abortions within the first twenty-four weeks of pregnancy on women who were victims of rape or incest. Abortions could be performed if a fetus was suspected of having a genetic disorder or if continuation of the pregnancy was likely to damage the woman's health. Additionally, if the pregnant woman or her spouse suffered from a communicable disease or from a "eugenic or hereditary mental or physical disease" specified by a Presidential Decree, an abortion could be performed.¹¹ After the twenty-four week period, abortions were prohibited under all circumstances.¹²

If a woman did not qualify for one of the listed exceptions, the punishment for undergoing an abortion was up to a year in prison and 2 million Won (\$1,740) fine.¹³ A doctor who performed an abortion in the absence of an exception could be punished up to two years in prison if there was no injury to the woman operated on.¹⁴ If the woman was injured during the abortion, the

⁹ See Korean Criminal Code, art. 269(1), 270(1) in CURRENT LAWS OF THE REPUBLIC OF KOREA 797-8 (Korea Legislation Research Institute 1992).

¹⁰ Mother-Child Health Act, *supra* note 3.

¹¹ *Id.* (In 2009, the list of diseases justifying a legal abortion was considerably narrowed by the government, eliminating several diseases, including schizophrenia, chicken pox, hepatitis, hemophilia, bipolar disorder and hereditary epilepsy and HIV). See Bae Ji-Sook, *Rules on Abortion Toughened: Contraction of HIV, Hepatitis Won't Justify Abortion*, KOREA TIMES, June 30, 2009, available at http://www.koreatimes.co.kr/www/news/nation/2009/06/117_47720.html.

¹² Mother-Child Health Act, *supra* note 3, art. 270. The deadline for abortions was previously set at 28 weeks, prior to the 2009 revision.

¹³ *Id.*

¹⁴ *Id.*

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punishment for the doctor is raised to three years. If the woman died the doctor could be jailed for up to five years.¹⁵ Furthermore, the doctor can lose his or her medical license for up to seven years for performing an abortion.¹⁶

Nevertheless, these punishments are seldom administered due to widespread non-enforcement of the law. In fact, from the early 1960s to the late 1990s, the Korean government actively encouraged women to get abortions as a means of heading off the perceived dangers of overpopulation.¹⁷ Currently, the government no longer encourages abortions nor does it enforce the abortion laws, as the country is faced with a low birth rate. According to one report, there were a total of seventeen abortion-related indictments between 2005 and September 2009.¹⁸

However, the number of abortions has skyrocketed. According to Korea's Ministry of Health, there are 350,000 abortions each year, as compared to 450,000 live births.¹⁹ The real number is assumed to be even higher: according to Rep. Chang Yoon-seok, of the ruling Grand National Party, the number of illegal abortions exceeds 1.5 million a year.²⁰ Others have estimated the figure as high as 2 million a year.²¹ Since abortions often go unreported, nobody really knows the true number of abortions that take place in Korea each year.

Until recently, there was little discussion regarding abortion in Korea, especially not as a human rights issue. The National Human Rights Commission, the most prominent national advocacy institution for human rights since its founding in 2002, has not addressed the issue of abortion, only noting that it was a controversial issue in the 'Right to Life' section of its 2007 National Action Plan.²² Major non-governmental human rights advocacy groups, such as Minbyun – Lawyers for a Democratic Society and People's Society for Participatory Democracy, have not developed a stance on the issue of abortion.²³

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ Tom Welsh, *Why Feminists Object to Korea's High Abortion Rate*, KOREA HERALD, Dec. 18, 1998.

¹⁸ Hai-ri Ahn, *supra* note 5.

¹⁹ *Id.*

²⁰ Bae Ji-Sook, *supra* note 5. It is unclear if there is any hard evidence behind this figure, but it has often been cited in the current debate.

²¹ Park Soo-Mee, *After 30 Years of Abortion, Protesters Urge Change*, JOONGANG DAILY, Feb. 10, 2003, available at <http://joongangdaily.joins.com/article/view.asp?aid=1932288>.

²² National Human Rights Commission of Korea, National Action Plan for the Promotion and Protection of Human Rights 2007-2011 at 121-22 (2006) (in Korean).

²³ This can be contrasted to the major Western international human rights organizations, which

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While reproductive rights were not widely discussed in Korea, for many years there has been debate at both the international and domestic level regarding the human rights implications of sex-selective abortions in Korea and the human rights implications of an over-reliance on abortion.²⁴ The selective abortion of female fetuses became a serious problem in Korea, as well as in some other Asian countries, with the advent of affordable ultrasound facilities in the early 1980s. This preference for male children was due to the strength of the traditional patriarchal family system typical of Confucian societies. The International Covenant on Economic, Social and Cultural Rights (“ICESCR”) and Convention on the Elimination of all Forms of Discrimination Against Women (“CEDAW”) Committees have repeatedly expressed their concern with the practice of sex-selective abortion in Asian countries, and have called upon States to implement a comprehensive strategy to overcome the traditional gender stereotypes that underlie the practice.²⁵

In 1987, the newly democratic Korean government attempted to curb the practice of sex-selective abortion by passing a law that prohibited doctors from revealing to the pregnant women the gender of their fetuses.²⁶ The penalty for doctors violating the law was up to three years of incarceration and a fine of up to 10 million won (\$8,700). Yet, this law did not succeed in preventing sex-selective abortions and the ratio of boys to girls at birth rose steadily until the mid-1990s, after which it started to decline.²⁷ In 2008, the Constitutional Court declared the law unconstitutional, noting that it violated women’s right to know

generally have clear-cut positions in favor of reproductive rights and decriminalizing abortion. See Human Rights Watch, *Abortion* (Mar. 31, 2009), available at <http://www.hrw.org/en/news/2009/03/31/abortion> (“equitable access to safe abortion services is first and foremost a human right”); Amnesty International, *Sexual and Reproductive Rights*, available at <http://www.amnesty.org/en/campaigns/stop-violence-against-women/issues/implementation-existing-laws/srr> (“Imprisonment or other criminal sanctions for seeking or having an abortion is a violation of women’s reproductive rights”).

²⁴ See, Naryung Kim, *Breaking Free From Patriarchy: A Comparative Study of Sex-Selective Abortions in Korea and the United States*, 17 UCLA PAC. BASIN L.J. 301 (1999).

²⁵ See, e.g., International Committee on Economic, Social and Cultural Rights (ICESCR), *Concluding Observations: Republic of Korea*, ¶ 81, Nov. 5, 2001, E/C 12/1/Add.59; Convention of Elimination of All Forms of Discrimination Against Women (CEDAW), *Concluding Comments: China*, ¶¶ 17- 21, Aug. 25, 2006, U.N. Doc. CEDAW/C/CHN/CO/6 (2006); CEDAW, *Concluding Observations: India*, ¶¶ 38-39, Feb. 2, 2007, U.N. Doc. CEDAW/C/IND/CO/3 (2007).

²⁶ Medical Practices Act, art. 19.2 (Prohibition of Divulgence of Secrets) in 6 CURRENT LAWS OF THE REPUBLIC OF KOREA 3457-5 (Korea Leg. Research Institute ed. 1992).

²⁷ Woojin Chung and Monica Das Gupta, *Why is Son Preference Declining in South Korea? The Role of Development and Public Policy and the Implications for China and India* 8 (Policy Research Working Paper No. 4373, 2007).

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and restricted the freedom of medical professionals.²⁸ Since the Constitutional Court allowed the law to continue in effect until December 31, 2009, it is too soon to tell if its repeal will affect the number of sex-selective abortions. It is suspected to have little effect, since the law was not widely enforced, with only two doctors being convicted of illegally revealing a fetus' gender between 2004 and 2008.²⁹

There is evidence that the traditional preference for sons and practice of sex-selective abortion may be far less widespread than it used to be. In 2008, the gender ratio at birth, 106.4 boys for every 100 girls, fell within the normal range of 1.03 to 1.07 for countries that do not engage in sex-selective abortions.³⁰ The Constitutional Court, in its decision allowing doctors to reveal the gender of fetuses, concluded that the age-old preference for boys had lessened and the skewed gender ratio due to sex-selection abortion had dropped to an acceptable level.³¹ In fact, one recent survey revealed that both mothers and fathers in Korea are more likely to prefer daughters than they are to prefer sons.³²

In addition to sex-selection, the other human rights issue regarding the peculiarly high rate of abortion in Korea has seen some public debate. As mentioned previously, the exact number of abortions performed annually in Korea is unknown, but very high. According to the 2005 official figures of the Ministry of Health, Welfare and Family Affairs, 30 out of 1,000 Korean women between the ages of 15 and 44 had abortions in 2005.³³ This would make Korea one of the top three countries (along with Russia and Vietnam) in number of abortions per capita.³⁴ The CEDAW Committee has repeatedly expressed its concerns over the high number of abortions in general in Korea, and in 2007 over the particularly "high rate of abortion among women between the ages of 20 and 24."³⁵

The reasons for the large quantity of abortions in Korea are complex,

²⁸ Judgment of Constitutional Court, July 31, 2008, 2004 Hunma 1010, 2005 Hunba 90 (S. Korea).

²⁹ Park Si-Soo, *Ban on Telling Fetus Sex Unconstitutional*, KOREA TIMES, July 11, 2008, available at http://www.koreatimes.co.kr/www/news/nation/2008/07/117_28574.html.

³⁰ Editorial, *Daughter Preference: Changing Trend Reflects Crumbling Confucian Values*, KOREA TIMES, Jan. 13, 2010, available at http://www.koreatimes.co.kr/www/news/opinion/2010/01/202_58940.html.

³¹ Judgment of Constitutional Court, July 31, 2008, *supra* note 29.

³² Editorial, *supra* note 30.

³³ Kang Hyun-kyung, *'Anonymous Birth' to Slow Down Falling Birth Rates*, KOREA TIMES, Mar. 18, 2009, available at http://www.koreatimes.co.kr/www/news/nation/2009/03/116_41513.html.

³⁴ *Id.*

³⁵ See CEDAW, Concluding Comments: Republic of Korea, ¶ 29, Aug. 10, 2007, CEDAW/C/KOR/CO/6 (2007).

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but clearly center on a lack of societal acceptance of effective means of contraception. According to one study, 20.5% of Korean women use either the coitus interruptus or the rhythm methods of birth control, both of which are generally less effective than condoms or hormonal treatment.³⁶ Birth control pills have yet to achieve significant market exposure and are widely mistrusted by Korean women.³⁷ This has led some to view abortion as simply another form of contraception.³⁸ Clearly, there is an ongoing human rights imperative for the Korean government to engage in more effective sex education programs in order to ensure that women and men are aware of and willing to use more efficient means of contraception.

B. Recent Developments

Since his election in 2007, President Lee Myung Bak has hinted that he might favor a harder line on the enforcement of abortion laws.³⁹ In mid-2009, legislators took a small step in this direction by tightening the restrictions on performing abortions in the current law, removing certain diseases off the list justified for the use of legal abortion and revising the deadline for legal abortion to twenty-four weeks from conception instead of twenty-eight weeks.⁴⁰ However, the issue of criminalization did not truly come to a head until a few months later, with the November 2009 issuance of a report on declining birth rates by the Presidential Council for Future & Vision. The Council's report proposed a slew of measures aimed at increasing the birth rate, including: giving a family's third-born child financial support for high school, university fees and advantages in university entrance and employment; encouraging the use of paternity leave; giving special mortgage rates to families with three or more

³⁶ Bae Ji-sook, *Tips on Contraception for Women*, KOREA TIMES, Dec. 9, 2007, available at http://www.koreatimes.co.kr/www/news/art/2009/11/147_15248.html.

³⁷ Naryung, *supra* note 24 at 319. See also, Ellen R. Wiebe, et al., *Ethnic Korean Women's Perceptions about Birth Control*, 71 *CONTRACEPTION*, 623, 625 (2006) (noting deep distrust for hormonal methods of contraception among women of Korean ethnicity in Vancouver).

³⁸ *Id.* at 315 n.71. Human rights treaty bodies have attempted to counter such views, which are detrimental to women's health. See, CESCR, *Concluding Observations: Lithuania*, ¶ 50, June 7, 2004, U.N. Doc. E/C.12/1/Add.96 (calling upon Lithuania to "strengthen its efforts to promote awareness of sexual and reproductive health, safe contraceptive methods and the health risk of using abortion as a method of birth control").

³⁹ See, e.g., Editorial, *Enhancing Abortion Rights: Fetus-termination Is Not Something Seoul Should Encourage*, KOREA TIMES, Feb. 15, 2008, available at http://www.koreatimes.co.kr/www/news/opinion/2008/02/202_19018.html (reporting Lee Myung Bak's statement that strict control would automatically solve the low birthrate issue).

⁴⁰ Bae, *supra* note 11.

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children; extending retirement age for parents with multiple children; lowering of the elementary school entrance age one year, to age five, in order to reduce private education costs; and providing financial support for artificial insemination treatments.⁴¹ The council also called on the government to relax immigration rules and allow dual citizenships, in order to increase the number of immigrants to Korea.⁴² Most controversially, however, these plans also called for an extensive anti-abortion campaign.⁴³

While the report did not directly advocate criminal prosecutions for illegal abortions, the implication was certainly there, and other legislators and governmental officials began to broach the issue. For example, the Minister of Health, Welfare and Family Affairs, Jeon Jae-hee, commented that “even if we don’t intend to hold anyone accountable for all those illegal abortions in the past, we must crack down on them from now on.”⁴⁴ Rep. Chang Yoon-seok, of the ruling Grand National Party, stated that “[t]he most important thing will be for the doctors to understand that abortion is a serious crime.”⁴⁵ Eventually, President Lee Myung Bak announced that it was “time to start the debate” of revising the Mother and Child Health Law⁴⁶ and scheduled public hearings on a revised law for January 2010. In addition, the government commenced a public relations campaign to discourage abortions, including subway posters stating: “With abortion, you are aborting the future.”⁴⁷

Although it has proved tempting to blame the low birth rate on the lack of enforcement of anti-abortion laws, this is not necessarily a convincing explanation. Many commentators assert that there are other causes of Korea’s low birth rate. For example, one recent study pointed to the high differentials in salaries between Korean men and women as a possible reason for the country’s low birth rate.⁴⁸ Another study highlighted labor market insecurity, marriage trends (i.e., a delay in marriage, decrease in marriage and increase in incidence

⁴¹ Presidential Council for Future & Vision, *Comprehensive Plans for New Birth Rate*, Nov. 25, 2009, available at

http://www.future.go.kr/01.activity/02_Activity_broadcast.php?mode=view&tID=41 (in Korean).

⁴² *Id.*

⁴³ *Id.*

⁴⁴ Choe Sang-Hun, *South Korea Confronts Open Secret of Abortion*, N.Y. TIMES, Jan. 5, 2010, available at <http://www.nytimes.com/2010/01/06/world/asia/06korea.html>.

⁴⁵ Bae Ji-sook, *OB/GYNs to Refrain From Illegal Abortions*, KOREA TIMES, Oct. 19, 2009, available at http://koreatimes.co.kr/www/news/nation/2009/10/113_53809.html.

⁴⁶ Choe, *supra* note 44.

⁴⁷ *Id.* (citation omitted).

⁴⁸ Kim Tae-Gyu, *Gender Equality in Salary to Boost Low Birth Rates*, KOREA TIMES, Dec. 22, 2009, available at http://www.koreatimes.co.kr/www/news/nation/2009/12/123_57775.html (citing study by the LG Economic Research Institute).

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of divorce), increased female participation in higher education and the employment market, and greater female control over child-bearing decisions.⁴⁹ Others have blamed Korea's dearth of public welfare programs and unequal distribution of income.⁵⁰ Regardless of its effectiveness in raising birth rates, the policy of prohibiting abortions in order to increase a state's population actually has a long and peculiarly undistinguished history as a policy tool, having been used by some of the twentieth century's most coercive and authoritarian regimes.⁵¹

At the same time the governmental report was issued, there was a parallel movement underway among Korean doctors to call for enforcement of abortion laws. Starting in October 2009, a group of obstetricians and gynecologists, calling itself GYNOB in English, began quite vocally campaigning for enforcement of the anti-abortion laws. While the motivations of GYNOB's members vary, the group's public statements tend to emphasize the ethical problems with abortion and have largely avoided the religious rhetoric of existing (Christian) anti-abortion groups and the population growth rhetoric of government policy-makers. As of January 2010, around 680 obstetricians had joined GYNOB.⁵²

GYNOB has three stated objectives: to end all abortions in Korea; as a short-term measure, to reduce the number of abortions in Korea to 100,000 within ten years; and to eliminate all forms of abortion except when necessary to save the life of an expectant mother.⁵³ The group has already set up a hotline

⁴⁹ See Doo-Sub Kim, *Theoretical Explanations of Rapid Fertility Decline in Korea*, 3(1) THE JAPANESE JOURNAL OF POPULATION 2 (2005).

⁵⁰ Joung-Woo Lee, Op-Ed, *On the Relationship Between South Korea's Income Distribution and Birth Rate*, THE HANKYOREH, Nov. 21, 2009, available at http://english.hani.co.kr/arti/english_edition/e_opinion/389003.html.

⁵¹ For example, in 1936, Joseph Stalin outlawed abortions in the Soviet Union (reversing Lenin's policy of legalization) in order to increase population growth. See Libor Stloukal, *The Politics of Population Policy: Abortion in the Soviet Union*, 12 (Australian National University Working Papers in Demography No. 43 1993). The Nazi regime in Germany also cracked down on abortions (by 'Aryans'), which had been classified as misdemeanors and widely tolerated by the Weimar regime, in order to increase 'desirable' population growth. Tessa Chelouche, *Doctors, Pregnancy, Childbirth and Abortion During the Third Reich*, 9 ISR. MED. ASSOC. J. 202 (2007). More recently, Nicolae Ceaucescu's regime in Romania prohibited abortions (which had previously been available on demand) from 1966 to 1990, in order to increase Romania's population. Ceaucescu asserted that "the fetus is the socialist property of the whole society . . . giving birth is a patriotic duty." Charlotte Hord et al., *Reproductive Health in Romania: Reversing the Ceaucescu Legacy*, 22(4) STUD. FAM. PLAN., 231, 232 (1991).

⁵² E-mail Interview by Steve Weatherbe with Dr. Anna Choi, GYNOB Spokesperson (Jan. 20, 2010), available at http://www.prolife-dr.org/eng_free/13165.

⁵³ E-mail Interview by Michael Cook with Dr. San-Duk Shim, GYNOB Spokesperson (Dec. 13, 2009), available at <http://www.prolife-dr.org/12576>.

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to report clinics that perform illegal abortions and plans to report practitioners of illegal abortions to the police.⁵⁴

As of January, 2010, around 680 obstetricians had joined GYNOB.⁵⁵ Another anti-abortion group, called the Korean Pro-life Doctors Association, was formed in December 2009 that includes both medical and non-medical professionals. As of January 2010 it had 120 members. The Korean Association of Obstetrics and Gynecologists has opposed GYNOB's call for a crackdown because it believes that a crackdown on abortions will lead to an increase in health problems from unsafe abortions as the operations are forced deeper underground, as well as an increase in abandoned children.⁵⁶ While it is too early to conclude whether Korean doctors' growing reluctance to provide abortions is affecting the availability of the operation within Korea, the Director of the Korea Sexual Violence Relief Center reports there has been an increase in the number of women denied abortions (even in one case of rape) who have approached the Center for counseling.⁵⁷

III. CRACKING DOWN ON ABORTIONS AND HUMAN RIGHTS

Given the renewed discussion of *de facto* criminalization, as opposed to the *de jure* criminalization that exists today, it is worth examining what would be the human rights consequences of such a policy. To date, human rights treaties have, with one exception, not directly mentioned abortion, a fact that should not be particularly surprising given the wide diversity of views on the subject around the world.⁵⁸ Various "soft law" documents, such as declarations from international conferences, have come closer to explicitly embracing reproductive rights and decriminalization of abortion *per se*, but these pronouncements do not reach the level of binding international law.⁵⁹

⁵⁴ Kim, *supra* note 48.

⁵⁵ *Id.*

⁵⁶ *Id.*

⁵⁷ E-mail Interview by Sungmin Koh with Eun Sang Lee, Director, Korea Sexual Violence Relief Center (Jan. 26, 2010).

⁵⁸ The exception is the Protocol to the African Charter on Human and People's Rights on the Rights of Women in Africa (Maputo Protocol), which states that:

Parties shall take all appropriate measures to... protect the reproductive rights of women by authorising medical abortion in cases of sexual assault, rape, incest, and where the continued pregnancy endangers the mental and physical health of the mother or the life of the mother or the foetus.

Maputo Protocol, art. 14(2)(c), July 11, 2003.

⁵⁹ For example, the 1995 Fourth World Conference on Women addressed abortion criminalization by urging governments to "consider reviewing laws containing punitive measures against women

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Nevertheless, while human rights treaties do not directly address the issue of whether criminalizing abortion violates a party's treaty obligations, one can make strong arguments from the texts that criminalization of abortion would be a human rights violation. The United Nations (U.N.) treaty bodies have issued comments highlighting the negative human rights implications of such laws. Policy pronouncements of U.N. treaty bodies, in the form of General Comments or Recommendations, are not considered binding international law, but are helpful interpretations of the treaty at issue from recognized authorities, which can guide national policies in a rights-affirming direction.⁶⁰

There are five types of rights most commonly invoked in the debate over abortion prohibitions: right to life; right to be free from cruel, inhuman and degrading treatment; right to privacy; right to health; and right to equal treatment for women and men.⁶¹ This section will examine each of these rights in turn, looking in particular at international treaties to which Korea is a party.⁶² These treaties include, most notably, the International Covenant on Civil and Political Rights ("ICCPR"),⁶³ the International Covenant on Economic, Social, and Cultural Rights ("ICESCR")⁶⁴ and the Convention on the Elimination of all Forms of Discrimination Against Women ("CEDAW").⁶⁵ It will also review the application of the non-retrogression principle to Korean abortion laws.

A. Right to Life

The Right to Life is protected in Article 6 of the ICCPR,⁶⁶ as well as in

who have undergone illegal abortions." Fourth World Conference on Women, *Beijing Declaration and Platform for Action*, ¶ 106(k), Oct. 17, 1995, UN Doc. A/CONF.177/20.

⁶⁰ See Kerstin Mechlem, *Treaty Bodies and the Interpretation of Human Rights*, 42 VAND. J. TRANSNAT'L L. 905, 924 (2009).

⁶¹ A number of other human rights have been implicated to a greater or lesser extent in relation to abortion jurisprudence; these will not be reviewed in this article, but for good overview see Center for Reproductive Rights, *Twelve Human Rights Key to Reproductive Rights* (2009), available at <http://reproductiverights.org/en/document/twelve-human-rights-key-to-reproductive-rights>.

⁶² It should be noted, however, that the human rights discussed in this article are generally protected by customary international law, in addition to existing treaties. See, Hurst Hannum, *The Status of the Universal Declaration of Human Rights in National and International Law*, 25 GA. J. INT'L & COMP. L. 287 (1995-96).

⁶³ CEDAW, G.A.res 34/180, 34 U.N. GAOR (No.46) at 193, U.N. DOC. A/34/46, entered into force Sept. 2, 1981.

⁶⁴ ICCPR, G.A.res 2200A (XXI), 21 U.N. GAOR Supp. (No. 16) at 49, U.N. Doc. A/6316 (1966), 993 U.N.T.S. 3, entered into force Jan. 3, 1976 (accession by Korea on Apr. 10, 1990).

⁶⁵ CEDAW, G.A. res. 34/180, 34 UN G.A.O.R. Supp. (No. 46) at 193, UN Doc. A/34/46; 1249 U.N.T.S. 13, entered into force Sept. 3, 1981 (ratification by Korea on Dec. 27, 1984).

⁶⁶ ICCPR, *supra* note 64, U.N. Doc. A/6316 at art. 6.1 ("Every human being has the inherent right

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the Universal Declaration of Human Rights (“UDHR”)⁶⁷ and many regional human rights treaties.⁶⁸ According to the Committee (of the ICCPR), the right to life is “the supreme right” and should “not be interpreted narrowly.”⁶⁹ As Hipólito Solari Yrigoyen, of the Human Rights Committee stated, “it is not only taking a person’s life that violates article 6 of the Covenant but also placing a person’s life in grave danger.”⁷⁰

The evidence that criminalizing abortion negatively affects women’s right to life is fairly convincing. Essentially, the argument is that if abortions are illegal, they will be less safe and lead to more women’s deaths.⁷¹ This causal connection has been shown in scientific studies⁷² and is perhaps illustrated most vividly by the data from Romania, where abortion was criminalized between 1966 and 1990 as a method of increasing population growth.⁷³ There, the rate of abortion-related maternal deaths per 100,000 live births rose from under 20 in 1965 to over 120 in 1989, more than ten times that of any other European country. The year after abortion was legalized, the abortion-related maternal mortality rate dropped in half.⁷⁴

The U.N. treaty bodies have repeatedly recognized the negative effect of criminalizing abortion on the right to life. For example, the Human Rights Committee has expressed deep concern about abortion laws in Poland (which contain exceptions where the mother’s health is in danger among other circumstances) because they “incite women to seek unsafe, illegal abortions, with attendant risks to their life and health.”⁷⁵ In many other instances, the

to life. This right shall be protected by law. No one shall be arbitrarily deprived of his life”).

⁶⁷ Universal Declaration of Human Rights (UDHR), G.A. Res. 217A, art. 3, U.N. GAOR, 3d Sess., 1st plen. mtg., U.N. Doc. A/810 (Dec. 12, 1948) (“Everyone has the right to life, liberty and security of person.”)

⁶⁸ See, e.g., Convention for the Protection of Human Rights and Fundamental Freedoms [European Convention], art. 2, 213 U.N.T.S. 221, entered into force Sept. 3, 1953.

⁶⁹ Human Rights Committee, General Comment 6, art.6 (16th session, 1982), Compilation of General Comments and General Recommendations Adopted by Human Rights Treaty Bodies, U.N. Doc. HRI/GEN/1/Rev.1, 6 (1994).

⁷⁰ Karen Noelia Llantoy Huamán v. Peru, Communication No. 1153/2003, appendix, U.N. Doc. CCPR/C/85/D/1153/2003 (2005) (separate dissenting opinion of Mr. Solari Yrigoyen).

⁷¹ According to the World Health Organization, there are 67,000 deaths annually due to unsafe abortions. See World Health Organization, *Preventing Unsafe Abortion*, available at http://www.who.int/reproductivehealth/topics/unsafe_abortion/hrpwork/en/index.html.

⁷² See Alan Guttmacher Institute, *Abortion in Context: United States and Worldwide*, (May 1999), available at http://www.guttmacher.org/pubs/ib_0599.html.

⁷³ Rebecca J. Cook & Bernard M. Dickens, *Human Rights Dynamics of Abortion Law Reform*, 25 HUM. RTS. Q. 1, 20 (2003).

⁷⁴ *Id.*

⁷⁵ Covenant on Civil and Political Rights (CCPR), *Concluding Observations: Poland*, ¶ 8, Dec. 2,

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Human Rights Committee has emphasized the fact that clandestine or illegal abortions put women's lives at risk and instructed countries to liberalize their abortion laws.⁷⁶ The Committee also stated in General Comment No. 28 that State Parties, when reporting on the right to life, should "give information on any measures taken by the State to help women prevent unwanted pregnancies, and to ensure that they do not have to undertake life-threatening clandestine abortions."⁷⁷ However, the Human Rights Committee has not directly stated that general criminalization of abortion violates the right to life if exceptions exist that would allow abortions when the mother's life is in danger.

The CEDAW and ICESCR do not explicitly protect the right to life, but both the CEDAW and ICESCR Committees have also highlighted the fact that criminalizing abortion can lead to large numbers of women's deaths. For example, in its 2006 concluding report on Mexico, the CEDAW Committee noted that unsafe abortions were a leading cause of maternal deaths, despite the existence of exceptions for therapeutic abortions.⁷⁸ In 2001, the ICESCR Committee criticized Nepal's total abortion ban, in part for leading to a high maternal mortality rate due to unsafe illegal abortions.⁷⁹ In 2008, the CEDAW Committee concluded that Nigeria should "assess the impact of its abortion law on the maternal mortality rate and to give consideration to its reform or modification" because of the high mortality rate from unsafe abortions, which are illegal with certain exceptions for therapeutic abortions.⁸⁰

The right to life has also been used by some to justify the criminalization of abortion because as the argument goes, allowing abortions violates the unborn child's right to life. This argument is dependent on the assumption that criminalizing abortion will reduce the actual abortion rate, instead of simply pushing abortion providers underground. In the Korean context, representatives of the Catholic Church have made this claim most prominently, with Cardinal Nicolas Cheong Jin-Suk stating in 2007 that

2004, U.N. Doc. CCPR/CO/82/POL.

⁷⁶ See, e.g., CCPR, *Concluding Observations: Chile*, at ¶ 8, May 18, 2007, U.N. Doc. CCPR/C/CHL/CO/5; CCPR, *Concluding Observations: El Salvador*, ¶ 14, Aug. 22, 2003, U.N. Doc. CCPR/CO/78/SLV.

⁷⁷ Human Rights Committee, General Comment No. 28: art. 3 (The Equality of Rights Between Men and Women), ¶ 10, Mar. 29, 2000, U.N. Doc. CCPR/C/21/Rev.1/Add.10.

⁷⁸ CEDAW, *Concluding Observations: Mexico*, ¶ 32, Aug. 25, 2006, U.N. Doc. CEDAW/C/MEX/6. Therapeutic abortion is defined as an abortion "induced because of the mother's physical or mental health, or to prevent birth of a deformed child or a child resulting from rape." PDR MEDICAL DICTIONARY 4 (Marjory Spraycar ed., 1995).

⁷⁹ CESCR, *Concluding Observations: Nepal*, ¶ ¶ 548, 549, 571, Sep. 24, 2001, U.N. Doc. E/2002/22 (2001).

⁸⁰ CEDAW, *Concluding Observations: Nigeria*, ¶ 34, July 8, 2008, CEDAW/C/NGA/CO/6.

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abortion is the most serious human rights violation issue in Korea.⁸¹ Without wading into discussions on the question of “when life starts,” the fact remains that international human rights law, as currently constituted, does not grant the fetus’ right to life.⁸² In the preparatory discussions to the ICCPR, an amendment was proposed to extend the scope of the ICCPR to include unborn children, but this suggestion was rejected.⁸³ More recently, the Human Rights Committee has repeatedly urged the liberalization of abortion laws.⁸⁴ National courts in France and Austria have concluded that liberal abortion laws do not violate the right to life provisions of the European Convention on Human Rights.⁸⁵

The only exception to the rule that human rights protections do not extend to the unborn child is found in the American Convention for Human Rights, which was influenced by the prominence of the Catholic Church in Latin America. It states that the right to have one’s life respected “shall be protected by law and, in general, from the moment of conception.”⁸⁶ However, this provision has been quite controversial and has not been cited by the Inter-American Commission or Court to mandate states prohibit abortions. Rather, it directs that the rights of the fetus be measured against the rights of the pregnant woman.

B. Right to Health

The negative health consequences of unsafe abortions have long been evident. According to a 1997 World Health Organization report, 5.3 million women are temporarily or permanently disabled each year from unsafe abortions.⁸⁷ The most common adverse health consequences of unsafe abortions include severe bleeding, tearing of the uterus, internal infection and blood poisoning conditions, which can often lead to an impairment of future child-bearing capacity. These adverse health consequences have long been

⁸¹ Press Release, *supra* note 4.

⁸² See Cristina Zampas & Jaime Gher, *Abortion as a Human Right: International and Regional Standards*, 8 HUM. RTS. L. REV. 249, 262-68 (2008).

⁸³ See Rebecca J. Cook, *International Protection of Women’s Productive Rights*, 24 N.Y.U. J. INT’L L. & POL. 645, 690-1 (1992).

⁸⁴ Zampas & Gher, *supra* note 82, at 256-58.

⁸⁵ See Berta E. Hernandez, *To Bear or not to Bear: Reproductive Freedom as a Human Right*, 17 BROOK. J. INT’L L. 309, 332-33 (1991).

⁸⁶ American Convention on Human Rights, O.A.S. Treaty Series No. 36, art. 4, Nov. 22, 1969, 1144 U.N.T.S. 123, *entered into force* July 18, 1978.

⁸⁷ Jocelyn E. Getgen, *Reproductive Injustice: An Analysis of Nicaragua’s Complete Abortion Ban*, 41 CORNELL INT’L L.J. 143, 147 (2008).

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recognized by the world community. For example, at the 1994 International Conference on Population and Development (ICPD), governments agreed to “deal with the health impact of unsafe abortion as a major public health concern.”⁸⁸

As discussed in the previous section, it is generally recognized that the adverse health consequences of abortion stem in large part from its clandestine nature in countries where abortion is illegal. While abortion laws are generally not currently enforced in Korea, there are reports of adverse health consequences for women because the illegal nature of the procedure forces them to visit unlicensed or “underground” doctors, putting them at risk of post-operative infections and other negative health outcomes.⁸⁹ There can be little doubt that unsafe abortions will increase if the abortion laws are actively enforced and the operations are pushed further underground.

From a human rights standpoint, the right to health is one of the most important rights protected by Article 25 of the UDHR⁹⁰ and Article 12 of the ICESCR, which recognizes “the right of everyone to the enjoyment of the highest attainable standard of physical and mental health.”⁹¹ According to the ICESCR Committee, in General Comment 14, this includes the “right to control one’s health and body, including sexual and reproductive freedoms.”⁹² General Comment 14 also asserts that “[t]he realization of women’s right to health requires the removal of all barriers interfering with access to health services.”⁹³

The CEDAW and ICCPR treaty bodies have also commented on the adverse health consequences of restrictive abortion laws. For example, the

⁸⁸ *Programme of Action of the International Conference on Population and Development*, Cairo, Egypt, Sept. 5-13, 1994, ¶ 8.25, U.N. Doc. A/CONF.171/13/Rev.1 (1995).

⁸⁹ See John Glionna, *In South Korea, Abortion Foes Gain Ground*, LA TIMES, Nov. 29, 2009, available at

[http://www.latimes.com/news/nation-and-world/la-fg-korea-abortion29-](http://www.latimes.com/news/nation-and-world/la-fg-korea-abortion29-2009nov29,0,5103901,full.story)

2009nov29,0,5103901,full.story; Bae Ji-Sook, *Move Underway to Legalize Abortion*, KOREA TIMES, Dec. 4, 2007, available at

http://www.koreatimes.co.kr/www/news/nation/2007/12/113_14935.html;

Equality Now, *Cameroon. Submission to the United Nations Human Rights Committee*, 67th session, Oct. 1999, 3 (“Equality Now also submits that the relatively high level of maternal mortality is attributable to unsafe, illegal abortions which threaten a women’s right to life guaranteed by Article 6 of the Covenant”).

⁹⁰ UDHR, *supra* note 67, U.N. Doc. A/810 (“Everyone has the right to a standard of living adequate for the health and well-being of himself and of his family, including . . . medical care and necessary social services . . . Motherhood [is] entitled to special care and assistance”).

⁹¹ ICCPR, *supra* note 64, U.N. Doc. A/6316 at art. 12.

⁹² ICESCR, *General Comment No. 14 on ICESCR Article 12 (The Right to the Highest Attainable Standard of Health)*, 22d Sess., ¶ 8, April 25- May 12, 2000, U.N. Doc. E/C.12/2000/4.

⁹³ *Id.* at ¶ 21.

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CEDAW Committee noted that particularly restrictive abortion laws can violate the right to health⁹⁴ and the Human Rights Committee has observed that illegal abortions have harmful consequences for women's health, even in the context of States that have exceptions allowing therapeutic abortions.⁹⁵

C. Discrimination

One of the basic principles of international human rights law is that women have the right to be free of discrimination against them by the State. This is reflected in the UDHR,⁹⁶ the ICCPR,⁹⁷ the ICESCR,⁹⁸ the CEDAW⁹⁹ and other treaties. Gender discrimination is a particularly sensitive issue in Korea, which has generally passed advanced laws against discrimination. These laws are widely seen as ineffective in practice due to long-held patriarchal traditions.¹⁰⁰

It is now well-accepted in international human rights instruments that a law can be discriminatory in effect, even if it appears gender-neutral on its face. Thus, even if the criminalization of abortion might not seem to apply solely to women, it is self-evident that in the real world women bear the brunt of such

⁹⁴ See, e.g., CEDAW, *Concluding Observations; Belize*, ¶ 56, June 7-25, 1999, U.N. Doc. A/54/38; CEDAW, *Concluding Observations; Chile*, ¶ 228, July 9, 1999, U.N. Doc. A/54/38; CEDAW, *Concluding Observations; Dominican Republic*, ¶ 337, May 14, 1998, U.N. Doc. A/53/38; CEDAW, *Concluding Observations; Paraguay*, ¶ 131, May 9, 1996, U.N. Doc. A/51/38.

⁹⁵ See CCPR, *Concluding Observations: Mali*, ¶ 14, April 16, 2003, CCPR/CO/77/MLI; and CCPR, *supra* note 76 at ¶ 8. .

⁹⁶ See UDHR, *supra* note 67, U.N. Doc. A/810 at art. 7 ("All are equal before the law and are entitled without any discrimination to equal protection of the law. All are entitled to equal protection against any discrimination in violation of this Declaration and against any incitement to such discrimination").

⁹⁷ See ICCPR, *supra* note 64, U.N. Doc. A/34/46 at art. 26 ("...the law shall prohibit any discrimination and guarantee to all persons equal and effective protection against discrimination on any ground such as race, colour, sex, language, religion, political or other opinion, national or social origin, property, birth or other status").

⁹⁸ See *id.* at art. 2.2 ("The States Parties to the present Covenant undertake to guarantee that the rights enunciated in the present Covenant will be exercised without discrimination of any kind as to race, colour, sex, language, religion, political or other opinion, national or social origin, property, birth or other status".)

⁹⁹ CEDAW, *supra* note 65, U.N. Doc. A/34/46 at art. 2(f) ("States Parties condemn discrimination against women in all its forms, agree to pursue by all appropriate means and without delay a policy of eliminating discrimination against women and, to this end, undertake ... To take all appropriate measures, including legislation, to modify or abolish existing laws, regulations, customs and practices which constitute discrimination against women").

¹⁰⁰ See Gina Kong, *Are Women-Only Trade Unions Necessary in South Korea? A Study of Women Workers' Struggles in Korea's Labor Market*, 29 NW. J. INT'L L. & BUS. 217, 235-36 (2009).

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laws. It can also be argued that denying women the ability to have abortions leads to discriminatory outcomes in many other areas of life, by “reinforcing women’s traditional roles in childbearing and childbearing, continuing their dependency on men or on the state, and effectively foreclosing their economic development.”¹⁰¹

The anti-discrimination principle has been applied specifically to reproductive health by Article 12 of CEDAW, which holds that state parties must “take all appropriate measures to eliminate discrimination against women in the field of health care in order to ensure, on a basis of equality of men and women, access to health care services, including those related to family planning.”¹⁰² Article 12 was expanded to include abortion and other procedures in General Recommendation 24 of the CEDAW Committee, which states that

[t]he obligation to respect rights requires States parties to refrain from obstructing action taken by women in pursuit of their health care goals . . . Other barriers to women’s access to . . . care, including laws that criminalize medical procedures only needed by women and that punish women who undergo these procedures.¹⁰³

The Recommendation also affirms that states must “put in place a system that ensures effective judicial action. Failure to do so will constitute a violation of article 12.” The Human Rights Committee has made similar statements. For example, General Comment 28 on the Equality of Rights between Men and Women asserts that States “should ensure that women do not have to undertake life-threatening clandestine abortions.”¹⁰⁴ This implies the necessity of decriminalization in order to avoid clandestine abortions from becoming common.

D. Right to be Free from Cruel and Inhuman Treatment

It is possible to assert that forcing a woman to bear a child against her will constitutes torture or cruel and inhuman treatment, as prohibited by the Convention Against Torture¹⁰⁵ and Article 7 of the ICCPR, which states that no

¹⁰¹ Hernandez, *supra* note 85, at 343.

¹⁰² CEDAW, *supra* note 65, U.N. Doc. A/34/46 at art. 12.

¹⁰³ CEDAW, *General Recommendation 24: Women and Health*, ¶ 14, Jan. 19- Feb. 5, 1999, U.N. Doc. A/54/38/Rev.1.

¹⁰⁴ The Equality of Rights Between Men and Women, *supra* note 77, at ¶ 10.

¹⁰⁵ Convention Against Torture and Other Cruel, Inhuman or Degrading Treatment, G.A. Res. 46,

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one “shall be subjected to torture or to cruel, inhuman or degrading treatment.”¹⁰⁶ The Torture Committee recently condemned Nicaragua’s draconian anti-abortion laws, which do not allow for therapeutic abortion, for violating the right to be free from cruel and inhuman treatment.¹⁰⁷

This argument has also been used to condemn Peru’s anti-abortion laws. The Human Rights Committee has cited Article 7, both in its concluding observations¹⁰⁸ and in response to an individual complaint in *Llantoy Huaman v. Peru*.¹⁰⁹ The Committee, using this article, along with Article 17, discussed below, found that the failure of the Peruvian government to ensure the complainant’s access to an abortion amounted to a breach of her civil and political rights. The complainant was a pregnant woman who was not permitted to abort an anencephalic fetus.¹¹⁰ She claimed that she experienced mental suffering from the stress of knowing she would give birth to an anencephalic baby, saw its deformities, and breast-fed the baby for four days. The Human Rights Committee accepted her argument and found the State’s failure to allow a therapeutic abortion caused the suffering, in violation of Article 7 of the ICCPR.

This represents the first time a treaty body addressed a complaint against a government for failing to allow an abortion and held the State responsible for violating the woman’s human rights.¹¹¹ However, it should be noted that the Peruvian and Nicaraguan situations involved the denial of therapeutic abortions. It is unclear whether, in the future, the Human Rights Committee will take a broad reading of *Llantoy Huaman* and extend abortion rights to women who experience mental suffering from unplanned pregnancies, absent fetal deformity.

E. Right to Privacy

For many years, there has been a growing realization that abortion and reproductive choices belong to the sphere of personal decisions best left to

annex, U.N. GAOR, 39th Sess., 93d plen. mtg., Supp. No. 51, at 197; U.N. Doc. A/39/51 (1984); 1465 U.N.T.S. 85 (1987), *entered into force* June 26, 1987 (accession by Korea on Jan. 9, 1995).

¹⁰⁶ ICCPR, *supra* note 64, U.N. Doc. A/6316 at art. 7.

¹⁰⁷ See Convention Against Torture and Other Cruel, Inhuman or Degrading Treatment or Punishment, *Concluding Observations: Nicaragua*, ¶ 16, June 10, 2009, U.N. Doc. CAT/C/NIC/CO/1.

¹⁰⁸ See CCPR, *Concluding Observations: Peru*, ¶ 20, Nov. 15, 2000, U.N. Doc. CCPR/CO/70/PER.

¹⁰⁹ *Karen Noelia Llantoy Huamán v. Peru*, U.N. Doc. CCPR/C/85/D/1153/2003.

¹¹⁰ Anencephalic babies are born without much of their brains, and invariably die soon after birth.

¹¹¹ Individual complaints can be submitted to the Human Rights Committee pursuant to the First Optional Protocol to the ICCPR, to which Korea is a Party.

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women without the interference of governmental authorities. This principle was recognized as early as the 1968 International Conference on Human Rights in Tehran, where the Final Act stated that “parents have a basic human right to determine freely and responsibly the number and spacing of their children.”¹¹² The right to privacy is protected in general terms by the Universal Declaration of Human Rights¹¹³ and various human rights treaties. Most notably, Article 17 of the ICCPR states

[n]o one shall be subjected to arbitrary or unlawful interference with his privacy, family, home or correspondence, nor to unlawful attacks on his honour and reputation. Everyone has the right to the protection of the law against such interference or attacks.¹¹⁴

While the jurisprudence surrounding abortion rights in the United States has focused on the right to privacy¹¹⁵ at the international level, human rights bodies have been somewhat more likely to condemn anti-abortion laws on right to life and health or anti-discrimination grounds than on privacy grounds. One exception was the aforementioned *Llantoy Huaman* complaint, where the Human Rights Committee stated that Peru had violated the complainant’s Article 17 privacy rights by refusing to allow her to get an abortion.¹¹⁶ The Committee agreed with the complainant’s claim that Peru had interfered arbitrarily in her private life by “taking on her behalf a decision relating to her life and reproductive health which obliged her to carry a pregnancy to term.”¹¹⁷

F. Principle of Non-Retrogression

Non-retrogression is an important principle of human rights law, which proposes that countries should progressively develop towards a state of greater human rights observance and avoid “backsliding” or withdrawing previously assured human rights.¹¹⁸ This principle is often derived from Article 2.1 of the ICESCR, which requires States to “take steps” to achieve “progressively the full

¹¹² *Final Act of the International Conference on Human Rights*, ¶ 16, U.N. Doc. A/CONF.32/41 (1968). Proclamation of Teheran, *Final Act of the International Conference on Human Rights*, Teheran, ¶ 16, April 22 to May 13 1968, U.N. Doc. A/CONF. 32/41 at 3.

¹¹³ See UDHR, *supra* note 67, U.N. Doc. A/810 at art. 12.

¹¹⁴ ICCPR, *supra* note 64, U.N. A/6316 at art. 17.1-2.

¹¹⁵ See *Roe v. Wade*, 410 US 113 (1973).

¹¹⁶ *Karen Noelia Llantoy Huamán v. Peru*, U.N. Doc. CCPR/C/85/D/1153/2003 at ¶ 6.4.

¹¹⁷ *Id.* at ¶ 3.6.

¹¹⁸ Cook, *supra* note 83, at 668.

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realization of the rights recognized in the present Covenant,” thus implying that retrogression to a less rights-protective society would not be consistent with a country’s treaty obligations. Specifically, General Comment No. 3 of the ICESCR Committee notes that any deliberate retrogressive measures would require the most careful consideration by the Committee. As such, a government trying to justify retrogressive measures must be mindful of all the rights in the Covenant and of its obligation to fully use the maximum available resources to achieve social, economic and cultural rights.¹¹⁹ While the principle of non-retrogression is most commonly cited with reference to the ICESCR, it has been applied more generally by the U.N. and commentators to condemn backsliding in other contexts, including women’s rights and the right to development.¹²⁰

The significance of the non-retrogression principle in the context of the Korean abortion debate is clear. Enforcing the abortion laws would reduce the rights of women to privacy, health, life and freedom from discrimination and cruel or inhuman treatment. Thus, while other States may or may not be required to liberalize abortion laws, the question of whether Korea can legitimately crack down on abortion is conceptually different. If one takes the non-retrogression principle seriously, backsliding would be prohibited.

IV. CONCLUSION

As discussed in this article, abortion in Korea has not – until very recently – been a topic of robust public debate. Human rights perspectives were seldom applied to issues of reproductive freedom, with the partial exception of ongoing debates on sex-selection in abortion and the over-use of abortion in Korea. When debate recently erupted over enforcement of the existing anti-

¹¹⁹ See CESCR, *General Comment No. 3* (The Nature of States Parties Obligations), U.N. Doc. E/1991/23, Annex III (1991).

¹²⁰ See Cook, *supra* note 83, at 668-69 (“the principle of non-retrogression precludes states which are parties to human rights treaties, such as the Women’s Convention, from enacting laws, health regulations or policies more restrictive of reproductive rights than had previously existed”); HERSCH LAUTERPACHT, *INTERNATIONAL LAW AND HUMAN RIGHTS* 153 (1968); Office of the High Commission of Human Rights, *Human Rights and Poverty Reduction: A Conceptual Framework* at 25 (2004), available at <http://www2.ohchr.org/english/issues/poverty/docs/povertyE.pdf> (“no right can be deliberately allowed to suffer an absolute decline in its level of realization”); DIANE ELSON, *BUDGETING FOR WOMEN’S RIGHTS: MONITORING GOVERNMENT BUDGETS FOR COMPLIANCE WITH CEDAW* 111 (2006) (“principle of non-retrogression means that dutybearers should at least protect the human rights gains already made, when factors beyond their control prevent these gains to grow further”).

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abortion laws, there were relatively few objections from the human rights community.

This relative silence, however, should not be taken to imply that there are no human rights implications to punishing women who undergo abortions. In reality, such a course of action would be detrimental from the perspective of a number of internationally protected human rights, including the right to life, right to health, right to privacy, right to be free from discrimination and right to be free from cruel and inhumane treatment. These rights are protected by binding international treaties, such as the ICCPR, ICESCR and CEDAW, all of which have been ratified by the Korean government. While the treaties themselves are silent about reproductive rights, U.N. treaty bodies have not hesitated to stress the negative human rights implications of criminalizing abortion, and have generally emphasized the principle of non-retrogression from existing rights protections. Of course, regardless of the actual treaty terms and holdings of the treaty bodies, if one takes a step back from the positivist conception of human rights law and defines human rights norms as the rights that all human beings have just because they are human, even if those rights are not yet protected in domestic or international legal systems, then it is even easier to develop a convincing argument for the existence of a woman's human right to choose whether or not to end a pregnancy.¹²¹

Thus, the human rights implications of abortion should not be ignored by the Korean government nor by those Korean institutions charged with protecting and promoting human rights. One would hope to see mainstream human rights non-government organizations play a more active role in protecting a woman's right to choose. Likewise, the National Human Rights Commission, whose mandate requires it to "[a]nalyz[e] laws, policies, and practices from a human rights perspective,"¹²² should speak out in order to ensure that whatever policies are put in place to raise the birth rate in Korea are not harmful to the human rights of women. There are many policies being considered by the government that would both promote human rights and encourage larger families: these include providing subsidies to low-income mothers, mandating that employers provide all parents with generous parental leave benefits, and reducing spiraling education costs. The Korean government should expedite the consideration and adoption of these and other similarly human rights-beneficial policies, rather than opening up a potentially divisive

¹²¹ For ethical arguments for reproductive rights, see, HADLEY ARKES, *NATURAL RIGHTS & THE RIGHT TO CHOOSE* (2002); Elisabeth Porter, *Abortion Ethics: Rights & Responsibilities*, 9(3) *HYPATIA* 66 (1994).

¹²² National Human Rights Commission of Korea, *Mandate & Function*, available at http://www.humanrights.go.kr/english/about_nhrck/mandate_01.jsp.

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and distractive debate on whether to criminally punish women receiving and doctors performing abortions.

THE PUBLIC POLICY EXCEPTION: HAS § 1506 BEEN A SIGNIFICANT OBSTACLE IN AIDING FOREIGN BANKRUPTCY PROCEEDINGS?

*Omer Shahid**

INTRODUCTION

As the economy has become more globalized, there has been an apparent need to address instances of cross-border insolvency. Recognizing the problems associated with such a rapid globalization in the areas of international trade and investment, the United Nations Commission on International Trade Law (“UNCITRAL”) adopted the Model Law on Cross-Border Insolvency (“Model Law”) on May 30, 1997 in order to provide a guideline for national insolvency laws that may be incapable of dealing effectively with financially distressed businesses operating on the international level.¹ Among the issues the Model Law is aimed at addressing are “cases where the insolvent debtor has assets in more than one State or where some of the creditors of the debtor are not from the State where the insolvency proceeding is taking place.”² By providing a framework that will better equip national insolvency laws to confront and resolve insolvency cases of a cross-border nature, the Model Law’s goal is to provide a predictable, smooth, and easy way for courts of

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¹ See generally UNITED NATIONS COMMISSION ON INTERNATIONAL TRADE LAW ON UNCITRAL MODEL LAW ON CROSS-BRODER INSOLVENCY WITH GUIDE TO ENACTMENT 9-13 (1997), available at <http://www.uncitral.org/pdf/english/texts/insolven/insolvency-e.pdf> [hereinafter “Model Law and Guide”].

² *Id.* at ¶ 1.

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foreign nations (1) to communicate with one another, (2) to enable them to recognize foreign insolvency proceedings, and (3) to open their doors to foreign representatives (i.e., administrators of foreign insolvency proceedings).³ Allowing the lack of coordination among foreign courts and administrators to persist would not only increase the likelihood that insolvent debtors would fraudulently hide their assets, but would also gravely diminish “the possibility of rescuing financially viable businesses and saving jobs.”⁴ Therefore, by laying down such a harmonized framework, the UNCITRAL hopes that the Model Law, when adopted by various States (i.e., incorporated into their national laws), will allow foreign courts and administrators to avoid these dangers by facilitating the process of arriving at solutions that would promote international trade and investment, while at the same time keeping the best interests of both the creditors and the debtor in mind.⁵ Despite providing a framework that would ensure predictability, the Model Law “respects the differences among national procedural laws and does not attempt a substantive unification of insolvency law.”⁶ A nation that adopts the Model Law would maintain its substantive insolvency law while giving aid to other nations procedurally so that the insolvency laws of other nations could be carried out without any international barriers. However, public policy considerations might arise when the non-uniform insolvency laws of other nations are allowed to be enforced procedurally around the globe. Article 6 of the Model Law confronted this concern.

Article 6 of the Model Law, known as the “public policy exception,” provides: “Nothing in this Law prevents the court from refusing to take an action governed by this Law if the action would be manifestly contrary to the public policy of this State.”⁷ So in spite of the fact that the Model Law is supposed to make the recognition of foreign proceedings much easier, there is an appreciation that a nation would be unwilling to recognize a foreign proceeding if it patently violates that nation’s public policy. If various nations do have different public policies, would it not then make the goal of providing and carrying out a harmonized and predictable framework impracticable? What would happen if an insolvency proceeding taking place in State A is brought by a foreign representative to State B to be recognized, and the latter State believes it to violate an aspect of its domestic public policy? Would this not hinder the cooperation and coordination among foreign courts and administrators? Would

³ See *id.* at ¶ 3.

⁴ *Id.* at ¶ 17.

⁵ *Id.*

⁶ *Id.* at ¶ 3.

⁷ *Id.* at art. 6.

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the effects of the Model Law's implementation not be astonishingly unpredictable if a court can refuse the recognition of a foreign proceeding on the grounds that it contravenes some part of its public policy while that same proceeding does not violate the public policy of the nation where the proceeding is taking place? Would this not then foster the environment of irregularity that the Model Law was supposed to overcome? How should the courts interpret the "public policy exception" that would carry out the goals of predictability, harmony, and fairness in the recognition of foreign proceedings?

Recognizing the issues just raised, it is without any doubt that the UNCITRAL chose to use the word "manifestly" in the text of Article 6 purposely. The word "manifestly" is used deliberately in order "to emphasize that public policy exceptions should be interpreted restrictively and that article 6 is only intended to be invoked under exceptional circumstances concerning matters of fundamental importance for the enacting State."⁸ Therefore, the UNCITRAL expects that the refusal of recognizing a foreign insolvency proceeding would be rarely used.⁹ UNCITRAL recommends, then, that among considering other competing interests, the court should interpret Article 6 in such a way as to strike a balance between "general public policy goals" and "the goals of insolvency and predictability in commercial relations."¹⁰ An issue arises here because there are nations that interpret their public policy broadly, while there are others that limit it only to situations where an action would contravene fundamental principles. Although the Model Law does not provide an authoritative definition of "public policy" in Article 6, it does favor the narrow approach of the nations that would limit it only to fundamental principles.¹¹ The Model Law recommends that the adopting nations should give a narrow interpretation to Article 6 by "recogniz[ing] a dichotomy between the notion of public policy as it applies to domestic affairs, as well as the notion of public policy as it is used in matters of international cooperation and the question of recognition of effects of foreign laws."¹² If this dichotomy is not made and public policy is thus interpreted as broadly in the international realm as it is at the domestic level, then international cooperation among foreign courts and administrators will surely suffer.¹³ Therefore, in order to encourage

⁸ *Id.* at ¶ 89.

⁹ *Id.* at ¶ 20.

¹⁰ UNITED NATIONS COMMISSION ON INTERNATIONAL TRADE LAW ON LEGISLATIVE GUIDE ON INSOLVENCY LAW 120 (2005), available at http://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf [hereinafter "Legislative Guide"].

¹¹ Model Law and Guide, *supra* note 1, at ¶ 87.

¹² *Id.* at ¶ 88.

¹³ *Id.*

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international coordination, the Model Law posits that public policy should be narrowly limited to interpret a nation's fundamental principles such as constitutional guarantees and protections.¹⁴ Other instances of exclusion would be in areas such as "foreign tax claims, fines and penalties, claims relating to personal injury, [and] claims relating to negligence and gambling debts."¹⁵ Moreover, overriding the recognition of foreign insolvency proceedings for the protection of public policy interests would be understandable to safeguard the environment, public health and safety, and to prevent abuse against the debtor.¹⁶ For the reasons of cultivating a cross-border environment of predictability, harmony, fairness, cooperation, and coordination, the courts should keep in mind the principles of comity and reciprocity when it comes to interpreting Article 6 and other provisions of the Model Law.

As of February 2010, only a handful of nations have adopted the Model Law and have incorporated it into their respective national insolvency laws: Eritrea (1998), Mexico (2000), South Africa (2000), Japan (2000), Montenegro (2002), Northern Ireland and the British Virgin Islands (2003), Poland (2003), Romania (2003), Serbia (2004), the United States (2005), Great Britain (2006), New Zealand (2006), Colombia (2006), South Korea (2006), Slovenia (2007), Australia (2008), and Mauritius (2009).¹⁷

It is the purpose of this note to provide a case study of how the courts in the United States have interpreted the "public policy exception" in their respective legislations. There will be an analysis of cases where the courts have either denied or granted recognition of foreign insolvency proceedings when the claimants have objected to procedures they believe are "manifestly contrary" to the public policy of the United States. By conducting such an analysis of how these courts have dealt with the "public policy exception," the ultimate goal is to see whether the courts of the United States have been consistent in their interpretation and application of the "the public policy exception." This way, we will see whether the courts, in practice, have actualized the Model Law's goal of providing a harmonized and predictable pathway towards dealing with cross-border insolvencies. By conducting such a survey, we will see how the courts of the United States have contributed to the analysis of the public policy considerations in international insolvency law in their own unique and rich ways. Thus, this case study is relevant due to the fact that if courts interpret and

¹⁴ *Id.* at ¶ 87.

¹⁵ Legislative Guide, *supra* note 10, at 251.

¹⁶ *Id.* at 86-87.

¹⁷ Status of the UNCITRAL Model Law,

http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/1997Model_status.html (last visited Feb. 15, 2010).

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apply the public policy exception broadly and loosely, the provision will indubitably become a significant obstacle to granting recognition or relief to representatives of foreign proceedings who seek aid from U.S. courts. Under this type of approach, Congress' major intent in adopting the Model Law (i.e., to facilitate communication and aid between U.S. courts and foreign courts in international bankruptcy proceedings) would no doubt be completely frustrated.

Part I of the Note will provide a discussion of Chapter 15. This section will detail how Chapter 15 was created to adopt the provisions of the Model Law. The discussion will use the legislative history of the new chapter of the U.S. Bankruptcy Code to show Congress' intent to incorporate the spirit of the Model Law in order to remedy the procedural limitations that were in place before the adoption. Part I will also show how the legislature wanted the federal courts to interpret the public policy exception, which is situated in § 1506 of the U.S. Bankruptcy Code, narrowly and only to the most fundamental public policies of the United States. But this inevitably leads to an important question: What is considered to be a fundamental American public policy that would be violated when a foreign proceeding is recognized? In other words, what are the conditions and circumstances in which a bankruptcy court or another federal court would declare a foreign proceeding as being manifestly contrary to the public policy of the United States?

Parts II and III attempt to answer this question. Part II focuses on four cases where the courts have recognized foreign proceedings over objections made under § 1506. The courts in each case held the recognition of foreign proceedings over various objections under § 1506 – even those that may seem, at first, to be a fundamental American public policy. The courts in these cases show how narrowly the courts have applied the public policy exception when it comes to recognizing a foreign proceeding.

Part III focuses on a single case that was decided by the bankruptcy court of the Eastern District of New York in August of 2009. The case is crucial as it is the first case that has been found to violate a fundamental American public policy under the meaning of § 1506. This section will provide a detailed analysis of the case to show what the bankruptcy court found to be a fundamental American public policy that will be violated if relief was granted. It is hoped that by providing this analysis, the reader will see how the bankruptcy court distinguished some of the cases mentioned in Part II while still applying the public policy exception narrowly.

Finally, Part IV will conclude that the United States courts have narrowly interpreted § 1506 and, therefore, have stayed true not only to Congress' legislative intent, but also to the spirit of the UNCITRAL Model Law.

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I. CHAPTER 15 OF THE U.S. BANKRUPTCY CODE

Chapter 15, which incorporated most of the provisions of the Model Law, was added to the U.S. Bankruptcy Code on October 17, 2005.¹⁸ It was part of a set of reforms known as the Bankruptcy Abuse Prevention and Consumer Act of 2005 (BAPCA). Chapter 15 replaced 11 U.S.C. § 304.¹⁹ While § 304 was “enacted in 1978 to provide specific procedures by which a representative in a foreign bankruptcy proceeding could obtain relief in U.S. courts to facilitate the foreign proceeding,”²⁰ there is a reason why Chapter 15 superseded it:

While § 304 afforded bankruptcy courts substantial flexibility to fashion remedies in order to foster principles of international comity and respect for the judgments of other countries, it nevertheless was limited in scope. Filing of a § 304 petition “did not initiate a normal bankruptcy case,” nor was it the exclusive remedy for a foreign representative seeking the assistance of U.S. courts. Thus, there was no centralized forum for addressing requests for U.S. judicial relief in connection with foreign proceedings, and jurisprudence developed on a case-by-case basis. Chapter 15 changes that, centralizing initial requests for comity and cooperation in the U.S. bankruptcy courts and setting forth simple . . . procedures for foreign representatives seeking comity or cooperation from U.S. courts.²¹

Therefore, Chapter 15 replaced § 304 and was enacted into the Bankruptcy Code to provide easier and more predictable procedures for U.S. courts. Chapter 15 also aids the courts in recognizing foreign proceedings, all in

¹⁸ Alesia Ranney-Marinelli, *Overview of Chapter 15 Ancillary and Other Cross-Border Cases*, 82 AM. BANK. L.J. 269, 270 (Spring 2008).

¹⁹ See SALLY McDONALD HENRY, *THE NEW BANKRUPTCY CODE: CASES, DEVELOPMENTS, AND PRACTICE INSIGHTS SINCE BAPCA* 357 (2007).

²⁰ Ranney-Marinelli, *supra* note 18, at 269.

²¹ *Id.* at 269-70. See also Aaron L. Hammer & Matthew E. McClintock, *Understanding Chapter 15 of the United States Bankruptcy Code: Everything You Need to Know About Cross-Border Insolvency Legislation in the United States*, 14 L. & BUS. REV. AM. 257, 262-3 (Spring 2008) (stating that unlike § 304, “Chapter 15 sets forth a comprehensive framework for addressing cross-border insolvency cases, including providing for the recognition of a wider variety of foreign proceedings, allowing representatives of foreign insolvency proceedings to have direct access to the U.S. court system, and allowing for the commencement of full-blown bankruptcy cases under chapters of the Bankruptcy Code”).

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the hopes of promoting comity and cooperation, which the Model Law thought to be extremely important in solving cases of cross-border insolvency.

Under Chapter 15, a foreign representative can file a petition to obtain recognition of a foreign proceeding in order to obtain aid from the courts of the United States.²² Once the petition is filed,²³ the case begins. However, at this point, before recognition is granted, the foreign representative does not enjoy “the vast majority of rights. . .and benefits under Chapter 15.”²⁴ The court, in which the foreign representative has brought its petition for recognition, must grant recognition of a foreign proceeding when three criteria have been met: (1) there is, in fact, a foreign proceeding (whether a main proceeding or non-main proceeding); (2) the foreign representative applying for recognition is a person or body; and (3) the petition fulfills the requirements listed in § 1515.²⁵ Once there is recognition, “the foreign representative earns the power to bring a number of actions, including actions to avoid preferences, fraudulent transfers, wrongful setoffs and improper post-petition transfers.”²⁶ If the foreign proceeding is a non-main proceeding, however, “the court must be satisfied that such an action relates to assets that should be administered in the foreign nonmain proceeding.”²⁷ There is, however, one caveat to granting recognition of a foreign proceeding and providing relief: it must be subject to § 1506, better known as “the public policy exception.”²⁸

Section 1506 provides: “Nothing in this chapter prevents the court from refusing to take an action governed by this chapter if the action would be manifestly contrary to the public policy of the United States.”²⁹ It is important to note that the wording of this provision is remarkably similar to that of Article 6 of the Model Law. The reason why this is so is due to the fact that the U.S. Congress intended for § 1506 to mirror Article 6 of the Model Law:

This provision follows the Model Law article [6] exactly, is standard in UNCITRAL texts, and has been narrowly interpreted on a consistent basis in courts around the world. The word ‘manifestly’ in international usage restricts the

²² Ranney-Marinelli, *supra* note 18, at 280.

²³ Filing a petition for recognition is subject to the requirements enlisted in 11 U.S.C. § 1515.

²⁴ Ranney-Marinelli, *supra* note 18, at 280-1. *See also* Henry, *supra* note 19, at 357 (stating that a foreign representative receives “much broader powers” once a foreign proceeding is recognized).

²⁵ *See* 11 U.S.C. § 1517(a).

²⁶ Henry, *supra* note 19, at 357. *See also* 11 U.S.C. § 1521.

²⁷ Henry, *supra* note 19, at 357. *See also* 11 U.S.C. § 1523(b).

²⁸ *See* 11 U.S.C. § 1517(a).

²⁹ 11 U.S.C. § 1506.

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public policy exception to the most fundamental policies of the United States.³⁰

Here, Congress makes it clear that the public policy exception should be interpreted narrowly and that a court can deny recognition of a foreign proceeding or withhold relief on public policy grounds only if granting such recognition or relief would violate a fundamental U.S. public policy. Besides interpreting the public policy exception narrowly, the courts must also interpret the provision in an international context rather than a national one.³¹

A foreign representative is not required to show that a U.S. public policy will not be violated when filing a petition for recognition or relief in a U.S. court; it is up to either an interested party or the court to raise such an issue.³² “Thus, bankruptcy judges are at the front line of protecting public policy interests, and may be the first line of defense for creditors who are too small or disorganized to raise public policy objections on their own.”³³ Although courts have the power to protect public policy interests, they have, to date, been hesitant to refuse recognition of foreign proceedings on public policy basis.³⁴ “At least one court, however, has explicitly noted that recognition of a foreign proceeding is subject to § 1506’s public policy considerations.”³⁵ To date, there have been a handful of cases where the courts have dealt with § 1506 – each in its own way contributing to the development of the role of public policy in international insolvency law in the United States.

II. CASES THAT HAVE GRANTED RECOGNITION OVER PUBLIC POLICY OBJECTIONS

A. *In re Ephedra Products Liability Litigation*³⁶

In re Ephedra Products Liability Litigation was one of the first cases

³⁰ H.R. REP. NO. 109-31, pt. 1, at 109 (2005).

³¹ See 11 U.S.C. § 1508 (providing that “[i]n interpreting this chapter, the court shall consider its international origin, and the need to promote an application of this chapter that is consistent with the application of similar statutes adopted by foreign jurisdictions”).

³² See John J. Chung, *The Retrogressive Flaw of Chapter 15 of the Bankruptcy Code: A Lesson From Maritime Law*, 17 DUKE J. COMP. & INT’L 253, 259 (Spring 2007).

³³ *Id.*

³⁴ 8 NORTON BANKRUPTCY LAW AND PRACTICE § 154:9 (3d ed. 2009).

³⁵ *Id.* (citing *In re Oversight and Control Com’n of Avanzit, S.A.*, 385 B.R. 525, 532 (Bankr. S.D.N.Y. 2008)).

³⁶ *In re Ephedra Products Liability Litigation*, 349 B.R. 333 (S.D.N.Y. 2006).

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that interpreted and applied § 1506 of the Bankruptcy Code. Prior to the ban of ephedra, a stimulant derived from mostly shrubby plants of the genus *Ephedra*, by the U.S. Food and Drug Administration in 2004, a Canadian company by the name of Muscletech marketed products in the United States that contained ephedra.³⁷ “Some of the consumers suffered severe injuries, such as heart attacks and strokes, and eventually more than thirty civil actions for personal injuries and wrongful deaths allegedly caused by ephedra were filed against Muscletech in state and federal courts in the United States.”³⁸ Muscletech, in early 2006, brought an insolvency proceeding in the Ontario Supreme Court. That court appointed a Monitor that appeared in the court at the Southern District of New York (“S.D.N.Y.”) to serve as the foreign representative of the Ontario Supreme Court. The S.D.N.Y. court granted the Monitor’s motion to have the court recognize the insolvency proceeding in Canada as a “foreign main proceeding.”³⁹ Back in Canada, the Monitor and other interested parties negotiated a claims resolution procedure in order to quickly evaluate all credit claims, including the plaintiffs in the Muscletech actions in the United States, who had filed claims and appeared in the insolvency proceeding in Canada.⁴⁰ Although the Ontario court approved of the claims resolution procedure with the consent of the majority of claimants, four claimants filed oppositions against such an order. The S.D.N.Y. court granted the Monitor’s motion to recognize the Ontario court’s approval of the claims resolution procedure. However, it was subject to the Ontario court approving some amendments to the claims resolution procedure “designed to assure greater clarity and procedural fairness.”⁴¹ The Ontario court then approved these amendments to the claims resolution procedure. The S.D.N.Y. court then finally granted the Monitor’s motion to recognize and enforce the Ontario court’s order approving the amended claims resolution procedure and, thus, granting recognition of the foreign main proceeding in Canada.

The S.D.N.Y. court addressed the four objections arguing that granting recognition of the foreign proceeding in Canada would violate U.S. public

³⁷ *Id.* at 334.

³⁸ *Id.* The federal cases were first consolidated and transferred to the court at the Southern District of New York. The state cases were later transferred to the same court and consolidated with the federal courts pursuant to 28 U.S.C. § 157(b)(5).

³⁹ *Id.* See also 11 U.S.C. § 1502(4) (providing that a foreign main proceeding “means a foreign proceeding pending in the country where the debtor has the center of its main interests). Center of main interests (COMI) analysis is a hot issue in international insolvency law. Compare *In Re SPhinX, Ltd.*, 351 B.R. 103 (Bankr. S.D.N.Y. 2006), with *In re Stearns High-Grade Structured Credit Strategies Master Fund, Ltd.*, 374 B.R. 122 (Bankr. S.D.N.Y. 2007).

⁴⁰ *In re Ephedra*, 349 B.R. at 334.

⁴¹ *Id.*

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policy. The four objectors stated that the claims resolution procedure would deny them due process and trial by jury. The amended claims resolution procedure “provide[s] for mandatory mediation and, if the mediation results in a plan approved by specified majorities of creditors, for the estimation and liquidation of the remaining claims by a Claims Officer appointed by the Ontario Court.”⁴² The S.D.N.Y. court found the objectors’ argument concerning due process frivolous since the amendments “entirely cured” the problems that were raised by the pre-amended claims resolution procedure.⁴³

The S.D.N.Y. court similarly denied the objectors’ argument concerning trial by jury. The court held that “neither § 1506 nor any other law prevents a United States court from giving recognition and enforcement to a foreign insolvency procedure for liquidating claims simply because the procedure alone does not include a right to jury.”⁴⁴ The court looked at the legislative history of the public policy exception in the Bankruptcy Code and stated that since it was based on the Model Law, the provision should be interpreted restrictively. In determining whether the denial of a trial by jury in a foreign proceeding would be “manifestly contrary” to a fundamental public policy of the United States, the court turned to how other federal courts have dealt with the issue. The court found that prior decisions by other federal courts did not invalidate foreign judgments against U.S. citizens in foreign places where the concept of a trial by jury is unknown.⁴⁵ While the court acknowledged that the trial by jury is an important constitutional right, it stated that “the notion that a fair and impartial verdict cannot be rendered in the absence of a jury trial defies the experience of most of the civilized world.”⁴⁶ Therefore, according to the court, recognition of a foreign proceeding would not be denied when the foreign court provides a “fair and impartial proceeding.”⁴⁷ Since the Ontario court approved the amended claims resolution procedure and it, thus, “plainly affords claimants a fair and impartial proceeding[,] [n]othing

⁴² *Id.* at 335.

⁴³ *Id.* Some of the key problems of the Ontario court’s order approving the pre-amended claims resolution procedure were that a Claims Officer could refuse evidence and that he could liquidate claims without giving interested parties the opportunity to be heard.

⁴⁴ *Id.* at 335-6.

⁴⁵ *See, e.g., In re Union Carbide Corp. Gas Plant Disaster at Bhopal*, 809 F.2d 195, 202-3 (2d Cir. 1987) (affirming district court’s finding that Indian courts were adequate forums despite the fact that there was an absence of juries).

⁴⁶ *In re Ephedra Products Liability Litigation*, 349 B.R. at 337. The reader must keep in mind that although the result might be different in a purely domestic case, this is a case concerning the recognition of a foreign proceeding, so the principle of comity is prevalent behind the court’s reasoning.

⁴⁷ *Id.*

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more is required by § 1506 or any other law.”⁴⁸ Also, the court determined that the objectors’ arguments were grounded in the concern of having their bargaining position lessen in negotiating their claims in front of a claims officer instead of a jury. The court determined that the “[d]eprivation of such bargaining advantage hardly rises to the level of imposing on plaintiffs some fundamental unfairness.”⁴⁹ For these reasons, the S.D.N.Y. court granted the recognition of the amended claims resolution procedure and the foreign proceeding in Canada.

B. In re Iida⁵⁰

In this case, a debtor, an individual who happens to be a Japanese citizen, was declared bankrupt under the Japanese bankruptcy law. Another Japanese citizen was appointed as a trustee of the debtor’s estate in the Japanese bankruptcy proceeding. This proceeding is similar, albeit with some procedural differences, to a Chapter 7 case in the United States in that it applies to both individual and corporate insolvencies seeking liquidation.⁵¹ At the time of the commencement of the Japanese bankruptcy proceeding, the debtor had assets in Hawaii. He owned all of the stocks of three Hawaiian corporations. “The Hawaii Corporations held several valuable property interests, including substantial ownership interests in two limited partnerships that owned and operated the Kahala Mandarin Oriental Resort and the Kona Village Resort, two luxury hotels in Hawaii.”⁵² Before the commencement of the Japanese bankruptcy proceeding, the debtor was an officer and director of the Hawaiian corporations. However, there were other officers and directors as well, including Henry Fong.⁵³ Despite having assets in Hawaii, the debtor and his corporations did not have any creditors in the United States.⁵⁴ As part of his duty to liquidate and administer the debtor’s estate assets in the Japanese bankruptcy proceeding, the trustee became the sole shareholder. Pursuant to being the sole shareholder, the trustee took steps to gain control of the Hawaiian corporations. The trustee went to Fong to show proof of the former’s appointment as trustee. Fong consulted the legal advice of both the counsel of the Hawaiian corporations and the debtor’s personal lawyers. Fong was advised

⁴⁸ *Id.*

⁴⁹ *Id.*

⁵⁰ *In re Iida*, 377 B.R. 243 (9th Cir. B.A.P. 2007).

⁵¹ *See id.* at 247 n.2.

⁵² *Id.*

⁵³ *Id.* at 248. Fong was a treasurer and a vice-president of at least two of the corporations.

⁵⁴ *Id.* at 247.

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to accept the trustee's authority as the single shareholder, which he eventually did.⁵⁵ After this development, the trustee continued to take steps in restructuring the management of the Hawaiian corporations. The articles of incorporation for these corporations provided that they could have one officer and one director if there was only one shareholder. Furthermore, "[t]he by-laws of the Hawaii Corporations permitted the shareholders to remove any and all of the directors by a vote of a majority of the shares then entitled to vote. The by-laws also allowed the directors to remove and replace any officer at any time."⁵⁶ The by-laws also provided that shareholders should remove and replace any officers at an annual or special shareholder meeting. However, the shareholders were allowed to replace and remove an officer without holding an annual or special meeting "so long as all the shareholders consented in writing, and such written consent was filed with or made part of the minutes of the board of directors or the corporate records."⁵⁷

In January and March of 2005, the trustee, in a series of written consents, appointed Fong as the sole director of the corporations. Fong then removed all the rest of the officers of the corporations as the sole director and his actions were approved by the trustee in the shareholder consents.⁵⁸ The Japanese bankruptcy court entered an order in September 2005 which authorized the trustee to sell one of the resorts and also to "exercise all powers of decision with respect to the stock of all companies whose stock the debtor owned."⁵⁹

After seven months, since the sale of the last of the two resorts and after one year, the trustee exercised his right as the single shareholder to remove the debtor and other officers from the board of the corporations, the debtor brought a complaint against the trustee in a Hawaiian state court in April 2006.⁶⁰ The complaint sought a declaratory judgment that would declare the debtor as the sole shareholder of the Hawaiian corporations and would reinstate the debtor as the director of these corporations.⁶¹ The complaint also sought an injunction against the trustee that would forbid the trustee from removing the debtor as the director of the corporations and also to enjoin the trustee from distributing the proceeds from the sales of the Hawaiian corporations' assets.⁶²

⁵⁵ *Id.* at 248.

⁵⁶ *Id.*

⁵⁷ *Id.* at 248-49.

⁵⁸ *Id.* at 249.

⁵⁹ *Id.* at 249-50.

⁶⁰ *Id.* at 250.

⁶¹ *Id.*

⁶² *Id.*

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A few months later, in September 2006, the Japanese bankruptcy court issued an order authorizing the trustee to “(1) exercise the shareholders’ rights to remove and replace directors and officers; (2) distribute any proceeds from the liquidation of assets or any remaining assets without notifying the debtor or obtaining his consent; and (3) take such action as was necessary to ensure that the” order is recognized and given full legal effect in both the state and federal courts of the United States.⁶³

Pursuant to the order of the Japanese bankruptcy court, the trustee filed a Chapter 15 petition in June 2006 in order to get the Japanese bankruptcy proceeding to be recognized as a foreign main proceeding. The debtor filed an opposition to the petition for recognition on the grounds that even though the Japanese bankruptcy proceeding is a foreign main proceeding; recognition of that proceeding would be manifestly contrary to the public policy of the United States.⁶⁴ “Specifically, the debtor contended that the Foreign Representative [the trustee] was required to obtain permission from the United States Bankruptcy Court under chapter 15 or its predecessor § 304 before acting in the January and March 2005 to remove the [debtor] as director[] and officer[] of the Hawaii Corporations.”⁶⁵ In July 2006, the U.S. bankruptcy court issued an order that allowed the trustee, as the foreign representative, to commence an ancillary proceeding that would allow it to seek relief under §§ 1519⁶⁶, 1520⁶⁷, and 1521⁶⁸ of the U.S. Bankruptcy Code.⁶⁹ The trustee then soon removed the declaratory judgment action from the Hawaiian state court to the federal bankruptcy court. Thereafter, the trustee filed a motion to dismiss the complaint, alleging that the debtor filed the complaint in order “to circumvent Japanese bankruptcy law and the orders of the Japanese bankruptcy court and to challenge the authority of and actions taken by the Foreign Representative as shareholder of the Hawaii Corporations in his efforts to administer and liquidate the Japanese bankruptcy estate.”⁷⁰ The debtor opposed the motion to dismiss, reiterating his public policy argument by stating that the trustee had no right to remove the debtor as a director of the Hawaiian corporations since both federal

⁶³ *Id.*

⁶⁴ *Id.* at 251.

⁶⁵ *Id.*

⁶⁶ See 11 U.S.C. § 1519 (listing types of relief that may be granted upon the filing of the petition for recognition).

⁶⁷ See 11 U.S.C. § 1520 (providing a list of what happens once the bankruptcy court recognizes a foreign proceeding as a foreign main proceeding).

⁶⁸ See 11 U.S.C. § 1521 (listing types of relief that may be granted once the bankruptcy court recognizes a foreign proceeding, whether it is main or not).

⁶⁹ *In re Iida*, 377 at 251.

⁷⁰ *Id.* at 252.

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bankruptcy and state laws required the trustee to obtain an order from a court within the United States officially recognizing his status as a trustee in the Japanese bankruptcy proceeding.⁷¹ In November 2006, the bankruptcy court, treating the motion to dismiss as a motion for summary judgment, determined that the trustee had the authority to remove and replace the debtor, that he had a right to do so as the sole shareholder; that he complied with the Hawaiian state courts and the by-laws of the corporations when removing and replacing the debtor; that the court was compelled by the principle of comity to recognize the Japanese bankruptcy proceeding; and, finally, that nothing in the Hawaiian state law and the U.S. Bankruptcy Code “required the Foreign Representative to obtain a federal or Hawaii state court order recognizing his authority to act in his capacity as trustee in the Japanese bankruptcy proceeding.”⁷² Therefore, the bankruptcy court granted the trustee’s motion for summary judgment and dismissed the debtor’s complaint with prejudice.⁷³ The debtor then appealed to the Bankruptcy Appellate Panel (B.A.P.) of the Ninth Circuit.

On appeal, the B.A.P. affirmed the bankruptcy court’s opinion. The B.A.P. provided analysis under both § 304 and Chapter 15 because when the trustee exercised his authority in removing and replacing the debtor, § 304 was in effect; but when the trustee received recognition, Chapter 15⁷⁴ was in effect. Although the B.A.P. determined that Chapter 15 should apply in the case and that the case law under § 304 would not serve as precedent for Chapter 15 cases, § 304 case law should nevertheless be informative in Chapter 15 analysis, especially when it comes to comity.⁷⁵ In addressing the debtor’s public policy argument, the B.A.P. stated that § 1506 of the U.S. Bankruptcy Code was to be interpreted narrowly and should only be invoked when “the most fundamental policies of the United States” were violated.⁷⁶ The B.A.P. rejected the debtor’s argument that the trustee needed to obtain an order from either the bankruptcy court or the state law recognizing his status, rights, and privileges as trustee in the Japanese bankruptcy proceeding before removing and replacing any officer. The B.A.P. held that a foreign representative need not obtain a prior order from either a bankruptcy court or state court recognizing his status as a trustee of a

⁷¹ *Id.*

⁷² *Id.*

⁷³ *Id.*

⁷⁴ Chapter 15 applies to all cases from October 17, 2005 and onwards, as stated above.

⁷⁵ *In re Iida*, 377 B.R. at 256. *See* 11 U.S.C. § 304(c)(5). That section provided:

(c) In determining whether to grant relief under subsection (b) of this section, the court shall be guided by what will best assure an economical and expeditious administration of such estate, consistent with - ...

(5) comity

⁷⁶ *In re Iida*, 377 B.R. at 259.

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foreign bankruptcy proceeding before exercising control over assets in the United States.⁷⁷ As a result, the trustee here can avail himself of the reliefs listed in § 1521 of the Bankruptcy Code.

In other words, the bankruptcy court, deciding to grant relief under §§ 1521(a) and (b), simply gives the foreign representative the green light to proceed with his or her duties as trustee, provided that the United States creditors' interests are sufficiently protected. In this case, there are no United States creditors with interests to protect.⁷⁸

Hence, there are not any fundamental public policy considerations to be worried about in granting recognition to the Japanese bankruptcy proceeding as a foreign main proceeding.

C. In re Ernst & Young, Inc.⁷⁹

In *In re Ernst & Young, Inc.*, the Friedmans, Israeli citizens living in Canada, moved to California. The Friedmans formed the Klytie's Developments, Inc. (KDI) in March 2005 under the laws of Canada. The registered office for KDI was in Alberta, Canada. The Friedmans owned a substantial amount of stock in KDI with the remainder left in the ownership of Sharkey, a resident of Denver, Colorado. "In July, 2005, KDI formed and registered Klytie's Developments, LLC (KD/CO) in Colorado" for which Sharkey was responsible for operating under the Friedmans' supervision and direction.⁸⁰ Through both KDI and KD/CO, the Friedmans and Sharkey sought investments in a fund in order to finance and purchase real estate developments around the world. Almost \$8 million were raised by investors located in Canada, the United States, and Israel. Money that was raised by KD/CO was stored in U.S. banks and a considerable amount of the funds were transferred to the Friedmans and KDI. However, in early 2006, the Securities Commissioner of Colorado commenced an investigation of KDI and KD/CO, after which the Coloradan commissioner forwarded his findings to the Securities Commission in Alberta, which started its own investigation. In October 2006, the Coloradan commissioner filed a complaint against the two entities, the Friedmans and Sharkey in Denver, Colorado. The court there ordered the defendants to refrain

⁷⁷ *Id.* at 263.

⁷⁸ *Id.* at 259.

⁷⁹ *In re Ernst & Young, Inc.*, 383 B.R. 773 (Bankr. D. Colo. 2008).

⁸⁰ *Id.* at 774.

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“from selling interests in the fund, and from brokering, dealing, or selling securities in Colorado. The defendants were also prohibited from dissipating assets or destroying records of KDI or KD/CO.”⁸¹ Subsequently, the Alberta Securities Commission commenced its own action against the KDI and the Friedmans in Canada and obtained an order that froze all money in their accounts in two Canadian banks. The Friedmans then entered into a settlement agreement with the Albertan commission “under which KDI and the Friedmans admitted to committing fraud, agreed to pay [the Alberta Securities Commission] \$220,000 (Can.), and agreed to refrain from work in the securities field for 25 years.”⁸² However, that was not an end to the Friedmans’ and Sharkey’s legal troubles. In June 2007, some plaintiffs filed a complaint in the federal district court in Colorado. The defendants moved to stay that action pending the outcome of the legal proceedings in Canada and also the outcome of the criminal indictments against one of the Friedmans and Sharkey that was entered by the grand jury of Jefferson County, Colorado in October 2007.

In August 2007, the Court of Queen’s Bench in Alberta, District of Calgary issued an order which appointed Ernst & Young as Receiver for KDI, KD/CO, and the Friedmans. Among other orders, the Court of Queen’s Bench “authorized the Receiver to seek recognition of its orders and to seek ‘aid and recognition’ of courts in the United States.”⁸³ The Receiver then filed a petition for recognition of the Canadian foreign proceeding as a “foreign main proceeding” due to the fact that KDI was incorporated in Alberta, Canada, the location of the entities’ operations and principal assets. Furthermore, “the [p]etition states recognition as a foreign main proceeding is necessary to assist the Receiver in investigating and pursuing assets of KDI and its related entities located in Colorado and elsewhere in the United States.”⁸⁴ Alternatively, the Receiver argued for the Canadian proceeding to be recognized as a “foreign nonmain proceeding.”⁸⁵ The Coloradan commissioner and the plaintiffs, however, objected to the Receiver’s request for the Canadian proceeding to be recognized as a foreign main proceeding. The commissioner and the plaintiffs contended that the defendants’/debtors’ center of main interests (COMI) were not in Alberta but instead in Colorado since KD/CO had the primary responsibility for the fraud. The plaintiffs also alleged that the money

⁸¹ *Id.* at 775.

⁸² *Id.*

⁸³ *Id.* at 776.

⁸⁴ *Id.*

⁸⁵ See 11 U.S.C. § 1502(5) (providing that a foreign non-main proceeding “means a foreign proceeding, other than a foreign main proceeding, pending in a country where the debtor has an establishment”).

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channeled through that KD/CO went through U.S. banks. Furthermore, they argued that granting recognition of the Canadian proceeding as the foreign main proceeding would run contrary to the U.S. public policy since (1) it will harm the recovery efforts already under way in Colorado; (2) it will not provide relief against all parties since Sharkey is not a party in that proceeding; (3) the plaintiffs' rights will be undermined because the proceeding will allow the Receiver to take funds held by the Colorado court in order to distribute it under Canadian law; and (4) the cost of pursuing assets sustained by the Receiver will go beyond the claims of creditors in the United States.⁸⁶

The bankruptcy court of the federal district court in Colorado had to determine whether the Canadian proceeding was a foreign main proceeding under a COMI analysis and if it was, whether such a proceeding would be "manifestly contrary" to a fundamental public policy of the United States.

The court first conducted a COMI analysis to determine whether the Canadian proceeding was a foreign main proceeding. The court employed the COMI analysis used by Judge Lifland in the *In re Bear Sterns* case. In that case, since the Bankruptcy Code did not provide any help in determining what type of evidence is required to rebut the presumption that the debtor's COMI is its place of registration or incorporation, Judge Lifland provided various factors that could be relevant to such a determination. These factors include:

[T]he location of the debtor's headquarters; the location of those who actually manage the debtor (which conceivably could be headquarters of a holding company); the location of the debtor's primary assets; the location of the majority of the debtor's creditors or of a majority of the creditors who would be affected by the case; and/or the jurisdiction whose law would apply to most disputes.⁸⁷

After conducting a COMI analysis under these factors, the court determined that the Canadian foreign proceeding was a foreign main proceeding.

Since the court determined that the Canadian proceeding was a foreign main proceeding, the court had to determine whether recognizing it as such would make § 1506 applicable. The court stated that § 1506 should be interpreted narrowly and restricted only to "the most fundamental policies of the United States [that] are at risk."⁸⁸ The court rejected the parties' argument that

⁸⁶ *In re Ernst & Young, Inc.*, 383 B.R. at 778.

⁸⁷ *In re Bear Sterns High-Grade Structured Credit Strategies Master Fund, Ltd.*, 374 B.R. at 128.

⁸⁸ *In re Ernst & Young, Inc.*, 383 B.R. at 781.

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allowing the Canadian proceeding to be recognized as the main proceeding would make the investors in the United States receive less (since investors from Canada and Israel will also be included here) than they would if these local investors received from the Colorado courts. The court found this argument to be unpersuasive since “[a]ll wronged investors should share in the assets accumulated in the Receivership Proceeding, regardless of nationality or locale.”⁸⁹ The court also rejected the objecting parties’ argument that allowing the Canadian proceeding to be recognized as the foreign main proceeding would make the Coloradan investors receive less during distribution since the costs sustained by the Receiver in such a proceeding would deplete the debtors’ assets significantly. In rejecting this argument, the court stated that the “[c]osts of liquidation are a reality, whether through a foreign proceeding, or through a United States bankruptcy case.”⁹⁰ For these reasons, the court held that granting recognition of the Canadian proceeding as the foreign main proceeding would not be “manifestly contrary” to the public policy of the United States. Hence, just because the local investors would receive less in an international proceeding than they would in a domestic proceeding and because the costs of liquidation will deplete the debtors’ assets, the public policy considerations of § 1506 will not necessarily be invoked.

D. In re Metcalfe & Mansfield Alternative Investments⁹¹

This is an interesting January 2010 case that arose out of the recent global financial crisis. Specifically, the case arose out of the crisis in Canada’s non-bank sponsored Asset-Backed Commercial Paper (ABCP) market.⁹² The Canadian ABCP market froze in August 2007. Investors in the Canadian ABCP market lost confidence in the transparency of the market which was brought on by news of the widespread defaults on the sub-prime mortgages in the United States. These investors were afraid that the some of the assets that backed the ABCP market had substantial exposure to sub-prime mortgages. “With no new investment, no reinvestment, and no liquidity funding available, coupled with the timing mismatch between the short-term ABCP and the longer-term

⁸⁹ *Id.*

⁹⁰ *Id.*

⁹¹ --- B.R. ---, 2010 WL 20603 (Bankr. S.D.N.Y. 2010).

⁹² For a background on the Canadian ABCP market crisis, *see generally* Lou Brzezinski, *Canada’s ABCP Crisis – The Aftermath*, Blaney McMurty LLP, *available at* http://www.blaney.com/resources/contentfiles/blaney/Resources/article/canadas-abcp-crisis-the-aftermath/pdf/canadas-abcp-crisis_2009_LB.pdf.

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underlying assets, payments due on the ABCP could not be made.”⁹³ Soon, a restructuring plan was devised by stakeholders.⁹⁴ Besides providing for market-wide transparency, restructuring of the transactions of “leveraged super senior” swaps, the plan provided for a non-debtor, third-party release and injunction. This release and injunction would protect asset providers⁹⁵ from “liability and actions on account of any and all past, present and future claims, rights, interests, actions, rights of indemnity, liabilities, demands, duties, injuries, damages, expenses, fees or causes of action of whatsoever kind or nature in any way related to the third-party ABCP market in Canada.”⁹⁶ The release was included into the plan because the asset providers were seen as being crucial in the restructuring of the market. It would also protect them from the claims of investors for indemnity or contribution claims after the implementation of the plan.⁹⁷ In the Canadian proceedings, the issue of the non-debtor, third party debtor release and injunction were the issue before the Canadian courts. Both the Ontario Court and the Ontario Court of Appeals in June and August 2008, respectively, held that the release and injunction were properly included in the plan and that the plan was “fair and reasonable.”⁹⁸

Ernst & Young, Inc., the court-appointed monitor and financial advisor to the plan, filed a Chapter 15 petition in order to have the Canadian proceedings recognized as the foreign main proceeding. The monitor acted so due to the express provisions in the plan that “request[ed] aid, recognition and assistance by U.S. courts in carrying out the terms of the orders.”⁹⁹ Although there was no party claiming that the enforcement of the non-debtor, third-party release and injunction would violate a fundamental public policy of the United States, pursuant to § 1506, the bankruptcy court of the S.D.N.Y. took into consideration that particular analysis.

The monitor argued “that the third-party non-debtor release and injunction provisions included in the Plan and Sanction Order should be enforced in the United States because, if this were a plenary case under chapter

⁹³ *In re Metcalfe*, 2010 WL 20603, at *3.

⁹⁴ The restructuring of the Canadian ABCP market would become the largest restructuring program in Canada’s history.

⁹⁵ Among the asset providers that the release applied to were: “Bank of America, N.A., Canadian Imperial Bank of Commerce, Citbank, N.A., Deutsche Bank AG, HSBC Bank USA, N.A., Merrill Lynch International, Royal Bank of Canada, Royal Bank of Scotland, Swiss Re Financial Products Corporation, UBS AG and Wachovia Bank N.A. and their respective affiliates.” *In re Metcalfe*, 2010 WL 20603, at *2.

⁹⁶ *In re Metcalfe*, 2010 WL 20603, at *5.

⁹⁷ *Id.* at *6.

⁹⁸ *Id.* at *7.

⁹⁹ *Id.*

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11, such provisions would pass the muster under the rigorous standards for release and injunction provisions established by the Second Circuit.”¹⁰⁰ The Second Circuit, through its case law, has imposed strict limitations upon the bankruptcy courts to enforce non-debtor, third-party release and injunction provisions.¹⁰¹ For example, in *In re Metromedia Fiber Network, Inc.*,¹⁰² the Second Circuit held that since non-debtor, third-party release provisions in plans of reorganization increase the likelihood of abuse, they should only be enforced in the rarest of cases.¹⁰³ Furthermore, in *In re Johns-Manville Corp.*,¹⁰⁴ the Second Circuit severely limited the enforcement of the non-debtor, third party releases by the bankruptcy courts only when the released claims have a direct impact on the *res* of the bankruptcy estate.¹⁰⁵ In *Travelers Indemnity Co. v. Bailey*,¹⁰⁶ the Supreme Court of the United States reversed *Manville* on other grounds.¹⁰⁷ Although the *Manville* case was overruled on other grounds, the S.D.N.Y. bankruptcy court stated in the case at bar that “[i]t is unclear whether the circuit panel’s decision remains binding law in this Circuit on other issues decided by the panel – specifically on the jurisdictional limits on a bankruptcy court’s power to approve a third-party non-debtor release and injunction.”¹⁰⁸ The bankruptcy court further provided that “[e]ven if the circuit panel decision is not binding, it may nevertheless be persuasive with respect to the jurisdictional issue.”¹⁰⁹ The monitor argued that the standard in *Metromedia* was met here because the Canadian courts also applied a rigorous standard in determining the validity of the non-debtor, third-party release and injunction.¹¹⁰ Although the bankruptcy court said that it might be so, the standard in *Manville* seems to go the other way when applied in a plenary Chapter 11 case. The bankruptcy court, however, stated that the principles behind the “enforcement of foreign judgments and comity in chapter 15 cases strongly counsel approval of enforcement in the United States of the third-party non-debtor release and injunction provisions included in the Canadian Orders, even if those provisions could not be entered in a plenary chapter 11 case.”¹¹¹

¹⁰⁰ *Id.* at *8.

¹⁰¹ *See id.*

¹⁰² *In re Metromedia Fiber Network, Inc.*, 416 F.3d 136 (2d Cir. 2005).

¹⁰³ *Id.* at 141-42.

¹⁰⁴ *In re Johns-Manville Corp.*, 517 F.3d 52 (2d Cir. 2008).

¹⁰⁵ *Id.* at 66.

¹⁰⁶ *Travelers Indemnity Co. v. Bailey*, 129 S. Ct. 2195 (2009).

¹⁰⁷ *See id.* at 2206.

¹⁰⁸ *In re Metcalfe*, 2010 WL 20603, at *9.

¹⁰⁹ *Id.*

¹¹⁰ *Id.* at *8.

¹¹¹ *Id.* at *9.

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The bankruptcy court stated that under Chapter 15 analysis, recognition is limited by the public policy considerations of § 1506. The bankruptcy court said that the public policy exception of Chapter 15 should be “narrowly construed.”¹¹² The bankruptcy court declared that even though the Second Circuit severely restricts a bankruptcy court to enforce non-debtor, third party releases and injunctions, they are not entirely precluded.¹¹³ The bankruptcy court noted that the Canadian courts that dealt with the issue in this case had expressed similar concerns before holding the release and injunction to be valid.¹¹⁴

The bankruptcy court further stated that comity should be extended to a foreign common law jurisdiction that has similar procedures to that of the United States.¹¹⁵ “The U.S. and Canada share the same common law traditions and fundamental principles of law. Canadian courts afford creditors a full and fair opportunity to be heard in a manner consistent with standards of U.S. due process.”¹¹⁶ Since the issue over the non-debtor, third-party release and injunction had been litigated and the Canadian courts took into consideration the concerns that accompany the enforcement of those provisions, the principle of comity suggests that the bankruptcy court should not question the Canadian courts who believed that such a provision is necessary in the face of the Canadian ABCP market crisis. Therefore, § 1506 should “not preclude giving comity to the Canadian Orders in this case.”¹¹⁷

III. NOT SO SWEET: *IN RE GOLD & HONEY, LTD.*, THE CASE THAT FOUND PUBLIC POLICY VIOLATION

In *In re Gold & Honey*¹¹⁸, the bankruptcy court of the Eastern District of New York (“E.D.N.Y.”) refused to recognize an Israeli bankruptcy proceeding due to the public policy consideration of § 1506. Decided in August 2009, this case is an important breakthrough since it is the first case, and only case thus far, where a bankruptcy court has refused to recognize a foreign proceeding due to it being “manifestly contrary to the public policy of the

¹¹² *Id.* at *11.

¹¹³ *Id.*

¹¹⁴ *Id.*

¹¹⁵ See, e.g., *In re Bd. of Dirs. of Hopewell Intl. Ins. Ltd., Inc.*, 238 B.R. 25, 66 (Bankr. S.D.N.Y. 1999). See also *United Feature Syndicate, Inc. v. Miller Features Syndicate, Inc.*, 216 F. Supp. 2d 198, 212 (S.D.N.Y. 2002).

¹¹⁶ *In re Metcalfe*, 2010 WL 20603, at *12.

¹¹⁷ *Id.* at *11.

¹¹⁸ 410 B.R. 357 (Bankr. E.D.N.Y. 2009).

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United States.”

The debtors in the case are Gold & Honey LP and Gold & Honey, Ltd. The former is a New York limited partnership that has an office in Port Washington, New York. Gold & Honey, Ltd., on the other hand, is a corporation that was organized under the laws of Israel, is a general partner of Gold & Honey LP and is a 49.5% equity holder of that partnership. The First International Bank of Israel (FIBI) is a foreign banking corporation that was organized under the laws of Israel and was a pre-petition lender to Gold & Honey LP. In return for the loans, Gold & Honey LP and Gold & Honey, Ltd. pledged some equipments, machinery, and accounts receivable as collateral security for repayment of the loans.¹¹⁹

Around March 2008, FIBI started litigation in Israel and in July 2008, it seized a large amount of assets of both Gold & Honey LP and Gold & Honey, Ltd. and started an Israeli receivership proceeding. In September 2008, the debtors filed a Chapter 11 petition, thereby prompting the automatic stay. In October 2008, FIBI continued to have a receiver appointed before the Israeli court for the proceeding. At an October 2008 hearing before the Israeli court, FIBI stated that the automatic stay did not apply to FIBI as it attempts to gain control of the property of the bankruptcy estate of the debtors.¹²⁰ At the exact same time, the debtors asked the bankruptcy court in the Eastern District of New York to issue an order that would determine that the automatic stay applied to their “property wherever located and by whomever held, and, in particular, to the Israeli Receivership Proceeding.”¹²¹ FIBI made a special appearance in which it asserted that it was not within the bankruptcy court’s jurisdiction and that the Israeli proceeding was also not within its jurisdiction. The bankruptcy court determined that the automatic stay did apply to debtors’ property everywhere and regardless of who held it.¹²² The bankruptcy court further warned FIBI that if it continued to pursue the Israeli proceeding before the Israeli court, “it did so at its own peril.”¹²³ FIBI, however, disregarded the bankruptcy court’s advice and continued to prosecute the Israeli proceeding. FIBI presented the Israeli court with the stay order of the bankruptcy court, which prompted the Israeli court to issue an order at the end of October 2008 that refused to give effect to the stay order.¹²⁴ In November 2008, the Israeli court appointed an attorney for FIBI and an accountant as permanent receivers

¹¹⁹ *Id.* at 362.

¹²⁰ *Id.* at 363.

¹²¹ *Id.*

¹²² *Id.*

¹²³ *Id.*

¹²⁴ *Id.* at 364.

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of the Israeli proceeding.¹²⁵

In January 2009, FIBI filed a motion for relief pursuant to §§ 362(d)(1) and (d)(2) to lift the automatic stay.¹²⁶ By the end of the month, FIBI filed petitions for recognition under Chapter 15. FIBI filed the petitions in order to have the Israeli receivership proceeding recognized as a foreign main proceeding of the debtors. The bankruptcy court refused to recognize the Israeli receivership proceeding as a foreign proceeding – whether main or non-main – because according to the Bankruptcy Code, the Israeli proceeding is not collective in nature.¹²⁷ Furthermore, the bankruptcy court doubted that one of the receivers of the Israeli proceeding would work in the full interests of the other creditors since he is employed as an attorney for FIBI at the same time.¹²⁸ The bankruptcy court also refused to recognize the Israeli proceeding for two other reasons: “the Receivers were appointed in violation of the automatic stay; and recognition of the petitions would have an adverse effect on public policy, pursuant to section 1506.”¹²⁹

The bankruptcy court found that the receivers were appointed in violation of the automatic stay since the automatic stay applied as soon as the debtors filed petitions under Chapter 11. The stay enjoined FIBI from pursuing the receivership proceeding in Israel, however, FIBI refused to comply with the stay even when the bankruptcy court strongly advised it to do so. FIBI knew that the automatic stay applied to the debtors’ property everywhere and in the

¹²⁵ *Id.*

¹²⁶ Sections 362(d)(1) and (2) of the Bankruptcy Code provide basis for relief from the automatic stay. They state:

(d) On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay—

(1) for cause, including the lack of adequate protection of an interest in property of such party in interest;

(2) with respect to a stay of an act against property under subsection (a) of this section, if—

(A) the debtor does not have an equity in such property; and

(B) such property is not necessary to an effective reorganization.

11 U.S.C. §§ 362(d)(1) and (2).

¹²⁷ 11 U.S.C. § 101(23) defines “foreign proceeding” as:

The term “foreign proceeding” means a collective judicial or administrative proceeding in a foreign country, including an interim proceeding, under a law relating to insolvency or adjustment of debt in which proceeding the assets and affairs of the debtor are subject to control or supervision by a foreign court, for the purpose of reorganization or liquidation.

¹²⁸ *In re Gold & Honey*, 410 B.R. at 371 n.17.

¹²⁹ *Id.* at 368.

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hands of whomever and “[i]t would fly in the face of the Bankruptcy Code for this Court to recognize the petitions here and authorize the post-petition appointed Receivers to proceed in the United States when they were appointed as the result of a knowing and willful violation of the stay by FIBI.”¹³⁰ The case law of the Second Circuit further entails that a violation of the automatic stay would make an action void.¹³¹ Furthermore, the bankruptcy court provided that although the Israeli court lifted the stay for FIBI, the bankruptcy court, and not the Israeli court, had the power to lift the stay and not the Israeli court.¹³²

The bankruptcy court then analyzed whether the recognition of the Israeli proceeding would violate a fundamental public policy of the United States pursuant to § 1506. The court provided that in determining whether recognition of a petition would violate § 1506, the court must apply the provision narrowly and only to the most fundamental of American public policies that are at risk.¹³³ The receivers relied on the *In re Ernst & Young* case in arguing that the public policy exception should not apply to their case. The bankruptcy court, however, distinguished that case from the case at bar by stating that the former case did not involve a fundamental American public policy.¹³⁴ The receivers also relied upon the *In re Ephedra Products Liability* case. The bankruptcy court also distinguished that case from the case at bar and stated that although the former case involved a fundamental American right (i.e., trial by jury), bankruptcy cases usually do not have jury trials.¹³⁵ Violation of the automatic stay, however, would make the stay absolutely meaningless.

Recognizing a foreign seizure of a debtor’s assets postpetition would severely hinder United States bankruptcy courts’ abilities to carry out two of the most fundamental policies and purposes of the automatic stay – namely, preventing one creditor from obtaining an advantage over other creditors, and providing for the efficient and orderly distribution of a debtor’s assets to all creditors in accordance with their relative priorities.¹³⁶

Furthermore, the bankruptcy court stated that recognizing the Israeli

¹³⁰ *Id.*

¹³¹ *See, e.g., In re 48th St. Steakhouse, Inc.*, 61 B.R. 182 (Bankr. S.D.N.Y. 1986).

¹³² *In re Gold & Honey*, 410 B.R. at 369.

¹³³ *See id.* at 372.

¹³⁴ *Id.*

¹³⁵ *Id.*

¹³⁶ *Id.*

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proceeding would only legitimize FIBI's actions and would invite a future creditor to violate the stay in order to obtain a debtor's assets located outside of the United States, while at the same time allowing it to receive benefits within American jurisdiction.¹³⁷ For this reason, the bankruptcy court held that the recognition of the Israeli receivership proceeding and its providing of relief would violate a fundamental American public policy under the meaning of § 1506.

IV. CONCLUSION

The five cases mentioned above illustrate how the courts in the United States have applied the § 1506 public policy exception when it came to both recognizing foreign bankruptcy proceedings and providing relief in those cases. Since Chapter 15 was added to the U.S. Bankruptcy Code less than five years ago, there was virtually no case law¹³⁸ on point that would guide the courts when it came to applying § 1506 to the cases at hand. These courts had to turn to the legislative intent in Congress' adoption of the Model Law. Both the legislative intent and Article 6 of the UNCITRAL Model Law provide that when it comes to applying the public policy exception, the courts should construe that provision narrowly. So the question inevitably arises: Did the courts in these five cases apply § 1506 narrowly?

Four of the five cases, faced with public policy concerns when determining whether to grant recognition of a foreign bankruptcy proceeding and/or when providing relief, concluded that § 1506 should not bar the recognition of the foreign bankruptcy proceeding or in granting relief in their respective cases. Although, in these cases, there were legitimate public policy issues raised, such as the place of the foreign main proceeding not recognizing a trial by jury, the courts still determined that the *fundamental* public policies of the United States were not under threat if the foreign proceeding was recognized or a petition of relief was granted. Therefore, it is clear that the courts in these cases interpreted and applied § 1506 narrowly.

The only case where a court found that a fundamental public policy of the United States was violated under § 1506 was the *Gold & Honey* case. In that case, the E.D.N.Y. bankruptcy court held that the Israeli receivership should not receive any relief since it violated the automatic stay. We are led to ask whether this case interpreted and applied § 1506 broadly and whether this may threaten the system of making it easier to grant recognition or relief to

¹³⁷ See *id.*

¹³⁸ It should be noted, however, that the courts did consult older cases that dealt with the issue of comity.

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cross-border insolvency proceedings. The interesting thing about this case is that unlike the other cases mentioned above, the *Gold & Honey* case focused on the action of the foreign party seeking assistance. The cases where the courts found no public policy violations under § 1506 focused upon the procedures and laws of a foreign jurisdiction (such as the lack of trials by jury in Canada) while the *Gold & Honey* case focused upon the behavior of the foreign party seeking relief.¹³⁹ Nevertheless, we can conclude that the court did not interpret and apply § 1506 broadly since it explicitly recognized that the section should be applied narrowly and that the automatic stay is of such fundamental importance in U.S. bankruptcy law that in assisting the Israeli receivership, the automatic stay would be rendered meaningless. Furthermore, finding a public policy violation under § 1506 would not place similar hurdles to granting recognition to international insolvency proceeding and relief as was the case when § 304 was the law.

Thus, although courts consult § 1506 when it comes to assisting international insolvency proceedings in the form of granting recognition and relief, the five cases above have demonstrated that § 1506 has not been interpreted nor applied broadly. Based on the cases thus far, § 1506 would not pose much of a threat in granting recognition or relief when it comes to international insolvency proceedings. In other words, § 1506 has been construed so narrowly by at least four of the five cases that it is safe to assume that it will not play much of a significant role in granting recognition and relief to representatives of foreign proceedings. Therefore, these cases demonstrate how the courts of the United States, when faced with public policy concerns under § 1506, have stayed true to not only the congressional intent, but also to the spirit of the UNCITRAL Model Law.

¹³⁹ It may be argued that in the *Iida* case, the debtor claimed that the Japanese trustee did not officially obtain recognition of his status from state law or a bankruptcy court. Hence, it may be argued, that the court focused upon the trustee's behavior. This is not the case, however. The issue in the case was whether the Hawaiian state law and the Bankruptcy Code required such an action from the trustee. The focus was not so much on the behavior of the trustee, but what the Hawaiian state law and the Bankruptcy Code entailed. Ultimately, the argument can be made that the court accepted the trustee's argument that the debtor was seeking to avoid Japanese bankruptcy law, which the court found to be similar to U.S. bankruptcy law, despite some procedural differences. In the *Gold & Honey* case, the court was focused wholly upon the Israeli receivership violating the automatic stay.

THE PUNISHMENT OF ALL ATHLETES: THE NEED FOR A NEW WORLD ANTI-DOPING CODE IN SPORTS

*Zachary Blumenthal**

I. INTRODUCTION

Imagine you are a world-class sprinter. Nike, the king of sports sponsorships wants you to wear their label. The only condition to this dream contract is you must be trained by the best coach in the world. It is a no brainer so you satisfy that condition. Now you have the best sponsor and coach in the world. All that is required of you now is to train hard and listen to your coach. So when your coach tells you to take a simple dietary supplement to assist you in your training, you listen. It seems harmless and can be purchased by anyone at popular stores such as GNC and Vitamin World. Your dreams are becoming a reality.

Little do you know, your dream is actually an illusion. The supposedly simple dietary supplement was contaminated with a substance that has been banned internationally in sports. Once a world class Olympic sprinter, you are now a helpless and innocent victim fighting to clear your name. There is almost no chance of winning and you are now just a byproduct of the battle against the use of any performance-enhancing drug (“PED”) in sports. You are part of a world that punishes Athletes using PED’s and other Prohibited Substances for any reason, due to a principle of strict liability.¹ A world in which Athletes are

*J.D. Candidate, 2011, Hofstra University School of Law. I would first like to thank my parents for all of the guidance and support they have always given me. Without them, my past, present, and future successes would not be possible. I would like to thank my advisor, Professor J.S. Colesanti, for his invaluable assistance throughout the writing process. I would also like to thank the entire senior staff of the Journal of International Business & Law; particularly Jennifer Riley and Graham Ogilvy, who helped edit this note. Finally, I would like to dedicate this note to my parents, my brother Ben, my sister Dolly, and the rest of my family.

¹ See World Anti-Doping Association, World Anti-Doping Code 126-127 app. 1 (2009) (defining an Athlete as a person who participates in sport at the international or national level and who is subject to the jurisdiction of a Signatory or other sports organization accepting the World Anti-Doping Code), http://www.wada-ama.org/Documents/World_Anti-Doping_Program/WADP-The-Code/WADA_Anti-Doping_CODE_2009_EN.pdf; *id.* at 133 (defining a Prohibited Substance as “Any substance so described on the Prohibited List.” The Prohibited List is an annually publicized

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punished almost equally for reasons such as trying to gain a competitive advantage, ingesting contaminated foods, ingesting contaminated substances and medical needs. Even in the highly unlikely and miraculous event you are deemed innocent years later, your career has been halted or possibly finished.

This was the story of LaTasha Jenkins.² Jenkins was a world-class sprinter in her mid-twenties, with the best coach in the world, and a Nike contract. But when her coach made her take over-the-counter supplements her dream came to an end. She did not know what she was ingesting, but trusted her coach when he told her to take supplements that could be purchased legally by anyone. As soon as she had to submit a urine sample, the internationally Prohibited Substance was found. That was the last of her sprinting days.

Unfortunately similar stories have been heard before. The current fight against the use of PED's and other Prohibited Substances in sports throughout the world has led to the persecution of countless innocent Athletes.³ The leader of this battle against doping is the World Anti-Doping Agency ("WADA").⁴ WADA recently released its revised World Anti-Doping Code ("Code") in January 2009, which explicitly states, "It is each Athlete's personal duty to ensure that no Prohibited Substance enters his or her body."⁵ The comment to that phrase states that the Code "[a]dopts the rule of strict liability."⁶ This rule has led to the persecution of Athletes who are found to have a Prohibited Substance in their system, even if the Athlete did not ingest the substance intentionally. Consequently, innocent athletes like Jenkins suffer every year. Recently at the Vancouver 2010 Winter Olympics, thirty athletes were disqualified from participating in events without even a clue as to why they tested positive or if a mistake had been made.⁷

Aside from the problems that the strict liability principle creates, the

document, which identifies substances that may not be found in an Athletes body unless for certain exceptions.)

² See Michael S. Straubel, *Lessons from USADA v. Jenkins: You Can't Win When You Beat a Monopoly*, 10 PEPP. DISP. RESOL. L.J. 119, 119-121, 135 (2009).

³ World Anti-Doping Association, World Anti-Doping Code 135 app. 1 (2009) (defining Use as, "The utilization, application, ingestion, injection or consumption by any means whatsoever of any Prohibited Substance or Prohibited Method"); *id.* at 133 app. 1 (2009) (defining a Prohibited Method as, "Any method so described on the Prohibited List").

⁴ WADA, World Anti-Doping Code 18 (2009). Article 1 of the World Anti-Doping Code states, "Doping is defined as the occurrence of one or more of the anti-doping rule violations set forth in Articles 2.1 through 2.8 of the Code." That is, any Athlete who is has been found to have a Prohibited Substance in their body is doping.

⁵ See *id.* at 19 Art. 2.1.1.

⁶ WADA, Code 19 cmt. to Art. 2.1.1 (2009).

⁷ See Bonnie D. Ford, *WADA: More Than 30 Will Not Compete* (Feb. 11, 2010), available at <http://sports.espn.go.com/olympics/winter/2010/news/story?id=4905798>.

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Code has created another major problem. The Code deters Athletes from the Use of modern medicine. Specifically, the Use of the two most notorious Prohibited Substances, anabolic steroids (“steroids”) and human growth hormone (“HGH”) have been subject to worldwide regulation. In WADA’s mission to completely eliminate the use of these two PED’s, the medical community has been shielded as well as the therapeutic benefits of steroids and HGH.⁸ Although Athletes under the Code may be granted a Therapeutic Use Exemption (“TUE”) to Use a Prohibited Substance, they are allowed to only in the most dire circumstances when there is “[n]o reasonable Therapeutic alternative.”⁹

There are numerous other problems in conjunction with the Code such as: the Prohibited List is written in strict medical terminology, testing, and the imbalance of power between WADA and the Athletes.

The Code purports to allow for “[o]ptimal harmonization and best practice in international and national anti-doping programs’ by producing the Code, International Standards, and Models of Best Practice and Guidelines.”¹⁰ However, WADA’s effort to harmonize anti-doping in the world of sports is continuously thwarted by the inconsistencies the Code creates as well as the medical needs of many athletes. If the trend continues where WADA annually adds substances to the Prohibited List, Athletes sanctioned for taking Prohibited Substances will increase exponentially.

This note will argue that the Code must be reformed and revised again in order for the inconsistencies in the legal prohibition of Prohibited Substances to be eradicated and to allow Athletes the Use of modern medicine. Section II will discuss WADA’s influence, as well as the Code and its supplements. Section III will argue there needs to be a difference in the Code between innocent and guilty users of Prohibited Substances, and Athletes must be able to benefit from the therapeutic Uses of steroids and HGH. Section IV will argue the various reforms that could and should be made to the Code in order to eradicate the strict prohibition against the Use of Prohibited Substances.

⁸ See John Burge, *Legalize and Regulate: A Prescription for Reforming Anabolic Steroid Legislation*, 15 LOY. L.A. ENT. L.J. 33, 38-39 (1994).

⁹ See WADA, International Standard for Therapeutic Use Exemptions (“ISTUE”) 12 Art. 4.1(c) (2010), available at http://www.wada-ama.org/Documents/World_Anti-Doping_Program/WADP-IS-TUE/WADA_ISTUE_2010_EN.pdf; see also WADA, Code 34-36 Art. 4.4 (2009).

¹⁰ George T. Stiefel III, Comment, *Hard Ball, Soft Law in MLB: Who Died and Made WADA the Boss?*, 56 BUFF. L. REV. 1225, 1236-1237 (2008) (citing WADA, Code (2009)).

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II. BACKGROUND

A. The International Olympic Committee

On June 23, 1984, the International Olympic Committee (“IOC”) was created as a result of the initiative of the International Athletic Congress of Paris.¹¹ The congress laid the foundations for the creation of the Olympic Charter (the “Charter”) and the IOC to become a legal entity as a Swiss association.¹² The IOC is a self-governing legal body, which creates its own rules and regulations as it deems necessary.¹³

Working under the IOC, an International Federation (“IF”) is the central authority within its designated sport (i.e. soccer, boxing, tennis) outside the Olympic Games (the “Games”).¹⁴ The Charter states that one of the primary purposes of each IF is “[t]o establish and enforce, in accordance with the Olympic spirit, the rules concerning the practice of their respective sports and to ensure their application. . .”¹⁵ As of 2004, each IF must have incorporated the Code into their constitution or by-laws.¹⁶ An example of one of the most well-known IF’s is The Fédération Internationale de Football Association (“FIFA”).¹⁷

Although an IF can exist without the IOC, a National Olympic Committee (“NOC”) is a byproduct of the IOC. There are currently two-hundred five NOC’s, each of which belongs to a country.¹⁸ The primary roles of a NOC are “[t]o develop, promote and protect the Olympic Movement in their respective countries, in accordance with the Olympic Charter.”¹⁹ Each NOC must adopt the Code.²⁰

The IOC has supreme authority over all of these non-governmental

¹¹ Int’l Olympic Comm., Olympic Charter (the “Charter”) 10 (2007), available at http://multimedia.olympic.org/pdf/en_report_122.pdf.

¹² Anita L. DeFrantz, *Which Rules? International Sport and Doping in the 21st Century*, 31 HOUS. J. INT’L L. 1, 3 (2008).

¹³ *See id.* (citing http://multimedia.olympic.org/pdf/en_report_122.pdf).

¹⁴ *See* DeFrantz, *supra* note 12, at 4 (citing http://multimedia.olympic.org/pdf/en_report_122.pdf).

¹⁵ Charter 57, available at http://multimedia.olympic.org/pdf/en_report_122.pdf.

¹⁶ *See id.*

¹⁷ Description of Ifs,

<http://www.olympic.org/en/content/The-IOC/Governance/International-Federations/> (last visited Apr. 11, 2010).

¹⁸ DeFrantz, *supra* note 12, at 5.

¹⁹ Charter 61, available at http://multimedia.olympic.org/pdf/en_report_122.pdf.

²⁰ *See id.* at 62.

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entities, but only during the Games does it have authority over the Athletes.²¹ At all times WADA watches over these non-governmental entities and the Athletes have the final say in almost every matter. WADA is truly at the top of the pyramid.

B. WADA

WADA was created in 1999 by the IOC as a response to the continued problems of doping in sports.²² More specifically, WADA was a direct result of the doping that occurred in 1998.²³ During the 1998 Tour de France cycling competition, French police raided several cycling teams' hotels and found an enormous amount of banned substances.²⁴ As a result, the IOC and its president at the time, Juan Antonio Samaranch, were harshly criticized.²⁵ This led to a conference in Lausanne, Switzerland in February 1999; where numerous sport and government leaders came together to create WADA.²⁶

In 2004 WADA implemented the 2003 Code ("Original Code"), which was revised and became effective on January 1, 2009.²⁷ The Code allows for the annual publication of the Prohibited List that includes a wide range of Prohibited Substances such as: steroids, HGH, masking agents, and certain medicines.²⁸

WADA is the leader in the fight against doping in sports and seeks to "harmonize" those efforts within national governing bodies.²⁹ WADA uses the sub-organizations of the IOC to carry out its regulations.³⁰ Specifically, IF's

²¹ See DeFrantz, *supra* note 12, at 7 (citing the Charter).

²² Stiefel III, *supra* note 10, at 1236.

²³ *Id.*

²⁴ See DeFrantz, *supra* note 12, at 16 (citing Samuel Abt, *The Tour de France Faces Its Worst Crisis*, N.Y. TIMES, July 30, 1998, at C1).

²⁵ See DeFrantz, *supra* note 12, at 16.

²⁶ See DeFrantz, *supra* note 12, at 17 (citing George J. Mitchell, *Office of Comm'r of Baseball, Report to the Commissioner of Baseball of an Independent Investigation into the Illegal Use of Steroids and Other Performance Enhancing Substances by Players in Major League Baseball 5-6* (2007), available at <http://files.mlb.com/mitchrpt.pdf> [hereinafter Mitchell Report]).

²⁷ WADA, Code (2009),

http://www.aiba.org/documents/site1/Anti-Doping/2009/2_world_antidoping_code_v2009_En.pdf.

²⁸ WADA, Code 29 Art. 4.1 (2009); see also WADA, The 2010 Prohibited List (2010), http://www.wada-ama.org/Documents/World_Anti-Doping_Program/WADP-Prohibited-list/WADA_Prohibited_List_2010_EN.pdf.

²⁹ Stiefel III, *supra* note 10, at 1226-1227.

³⁰ See WADA, *Q & A on WADA Monitoring* (2009), <http://www.wada-ama.org/en/World-Anti-Doping-Program/Sports-and-Anti-Doping-Organizations/The-Code/Code-Compliance-Reporting/QA-on-WADA-Monitoring/>.

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and NOC's are expected to make sure their organizational regulations stay in compliance with the Code (i.e. testing Athletes for doping, monitoring Athletes whereabouts for testing, granting TUE's, etc.).³¹ WADA oversees these sub-organizations and makes sure the Code is enforced.³² WADA also monitors cases involving doping violations, which are brought against Athletes by an IF or other sub-organization of the IOC.³³ WADA also has the right to appeal a decision as well as interfere and monitor the actions of any Signatory to the Code.³⁴

C. WADA's Influence

Many sports organizations and countries are starting to comply with the Code.³⁵ In 2007, WADA through the United Nations Educational, Scientific and Cultural Organization ("UNESCO"), which is an agency of the United Nations, asked nations to sign a treaty to incorporate doping laws nationally.³⁶ The hope was that ratification would ensure "[t]he World Anti-Doping Code becomes national law and commits a member nation to prevent cross-border trafficking of sporting drugs, support a national drug-testing program and withhold funding from athletes caught cheating."³⁷ The treaty has been signed by over one hundred nations, including the United States.³⁸

Various provisions of the Code highlight the goals of the UNESCO Convention. Article 23.2.1 states, "The Signatories shall implement applicable

³¹ *See id.*

³² *See id.*

³³ *See id.*

³⁴ *See id.*; *see also* WADA, Code 134 app. 1 (2009) (defining a Signatory as an entity "[s]igning the Code and agreeing to comply with the Code, including the International Olympic Committee, International Federations, International Paralympic Committee, National Olympic Committees, National Paralympic Committees, Major Event Organizations, National Anti-Doping Organizations, and WADA").

³⁵ Darryl C. Wilson, "Let Them Do Drugs"—A Commentary on Random Efforts at Shot Blocking in the Sports Drug Game, 8 FLA. COSTAL L. REV. 53, 77 (2006).

³⁶ UNESCO Website,

http://portal.unesco.org/en/ev.php-URL_ID=3328&URL_DO=DO_TOPIC&URL_SECTION=201.html (last visited Apr. 11, 2010);

Graham Dunbar, *WADA President Challenges More Than 100 Nations to Join Anti-Doping Fight*, Assoc. Press, Feb. 27, 2008, available at <http://www.theglobeandmail.com/sports/wada-president-challenges-more-than-100-nations-to-join-fight/article670757/>.

³⁷ *See* Dunbar, *supra* note 36, at ¶8.

³⁸ *See* DeFrantz, *supra* note 12, at 26 (citing *More Than 100 Countries Sign Anti-doping Treaty at U.N.*, ASSOC. PRESS, Nov. 12, 2008, available at

<http://sportsillustrated.cnn.com/2008/more/11/12/wada-praises-government.ap/index.html>).

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Code provisions through policies, statutes, rules or regulations according to their authority and within their relevant spheres of responsibility.”³⁹ Article 22.4 of the Code asks each Signatory’s government to bring domestic regulations of anti-doping “[i]nto harmony with the Code.”⁴⁰ Pursuant to Article 22.5 of the Code, governments of each Signatory should meet the expectations of Article 22 by January 1, 2010.⁴¹ Article 22.6 states that the failure of a government to “[r]atify, accept, approve or accede to the UNESCO Convention thereafter” may result in sanctions which could include: the inability to hold international events, removal of their officers in WADA, and others not mentioned.⁴² Article 23.4.1 states that WADA shall monitor each Signatory’s compliance with the Code in accordance with the agreement created at the UNESCO Convention.⁴³

Even previous to this treaty, there was a noticeable European trend that NOC’s were conforming to the rules and regulations of the Code at all times, notwithstanding the Games.⁴⁴ For example, Norway’s goal was to conform all of their sports organizations and teams within each organization to the rules and regulations of the Code.⁴⁵ Norway’s federal government granted its NOC the power to create statutes, giving them authority over all of their national sports organizations and teams.⁴⁶ More specifically, Chapter 12 (effective June 1, 2004) of those statutes makes each organization responsible for adopting the Code.⁴⁷

Even in countries where the Code was not adopted, regulation of PED’s and other Prohibited Substances became ever-more popular. For example, on October 22, 2004, George Bush signed the Anabolic Steroid Control Act which added more drugs to a banned substance list in the U.S.⁴⁸ This act added to the previous anti-steroid statute eighteen drugs to be banned and also included “[s]everal steroid ‘precursors,’ or derivatives of testosterone that metabolize into anabolic steroids once ingested.”⁴⁹ Approximately sixty of

³⁹ WADA, Code 116 (2009).

⁴⁰ *See id.* at 113.

⁴¹ *Id.*

⁴² *Id.*

⁴³ *See id.* at 118.

⁴⁴ *See* DeFrantz, *supra* note 12, at 26 (2008) (citing The Norwegian Olympic and Paralympic Committee and Confederation of Sports (“NIF”), English, <http://www.idrett.no/t2.aspx?p=26797>).

⁴⁵ *See* DeFrantz, *supra* note 12, at 6 (citing NIF, English, <http://www.idrett.no/t2.aspx?p=26797>).

⁴⁶ *See* NIF, English, <http://www.idrett.no/t2.aspx?p=26797>.

⁴⁷ *See* NIF’s Statutes, *available at* <http://www.nif.idrett.no/files/%7B715A2D90-286C-4D74-9EC8-A5B1F6663B4A%7D.pdf>.

⁴⁸ Adrian Wilairat, *Faster, Higher Stronger? Federal Efforts to Criminalize Anabolic Steroids and Steroid Precursors*, 8 J. HEALTH CARE L. & POL’Y 377, 377 (2005).

⁴⁹ *Id.* at 377-378.

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these “precursors” were added.⁵⁰ This act criminalized the distribution and possession of these substances, and took a significant step towards conforming to WADA’s goal of eliminating the use of all Prohibited Substances.⁵¹

These two examples are a microcosm of WADA’s influence over nations’ domestic regulations. Further, the UNESCO Convention represents a giant leap toward the Code becoming the sole legal document regulating doping in the future of sports.

D. The Code and its Supplements

WADA’s main instrument to regulate doping is the Code. There are two other components that work hand-in-hand with the Code and are referred to in specific articles of the Code: (1) the International Standards and (2) Model Rules and Guidelines. The International Standards includes five separate documents: the Prohibited List, Laboratories, Testing, Therapeutic Use Exemptions, and Protection of Privacy and Personal Information.⁵² The Model Rules and Guidelines are provided to assist stakeholders (i.e. an IF, a NOC), in implementing the Code to their system and rules.⁵³ When implementing the Code the organization may make “[n]on-substantive changes” and it must be consistent with the Code.⁵⁴

Article 2 of the Code is entitled “Anti-Doping Violations.” This article details what constitutes an anti-doping violation. Specifically, Article 2.1 lays out what amounts to an anti-doping violation. Article 2.1.1 states:

It is each Athlete’s personal duty to ensure that no Prohibited Substance enters his or her body. Athletes are responsible for any Prohibited Substance or its Metabolites or Markers found to be present in their Samples. Accordingly, it is not necessary that intent, fault, negligence, or knowing Use on the Athletes part be demonstrated in order to establish an anti-

⁵⁰ *Id.* at 391.

⁵¹ *See id.* at 405.

⁵² *See* WADA International Standards,

<http://www.wada-ama.org/en/World-Anti-Doping-Program/Sports-and-Anti-Doping-Organizations/International-Standards/> (last visited Apr.11, 2010).

⁵³ *See* WADA Model Rules and Guidelines, <http://www.wada-ama.org/en/World-Anti-Doping-Program/Sports-and-Anti-Doping-Organizations/Model-Rules--Guidelines/> (last visited Apr. 11, 2010).

⁵⁴ WADA, Code 117 Art. 23.2.2 (2009). This section states in pertinent part, “[A]llowing for any non-substantive changes to the language in order to refer to the organization’s name, sport, section numbers, etc...”

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doping violation under Article 2.1.⁵⁵

The comment to Article 2.1.1 states that a strict liability principle is applied. Thus, for determining whether a violation occurred it does not matter how the substance entered the Athlete's body. The degree of intent, fault, negligence, and knowing Use is only relevant for reduction of a sanction, which is governed by Article 10. Article 2.2.2 builds on Article 2.1 stating in pertinent part, "[i]t is sufficient that the Prohibited Substance or Prohibited Method was Used or Attempted to be Used for an anti-doping rule violation to be committed."⁵⁶

Article 3 is entitled "Burdens and Standards of Proof." Article 3.1 states that the relevant Anti-Doping Association that is conducting the Testing for Prohibited Substances has the initial burden of proof to establish the Athlete committed an anti-doping violation.⁵⁷ The standard can be satisfied quite easily because a positive result for a Prohibited Substance satisfies that burden.⁵⁸ Under Article 3.2.1, any WADA-accredited laboratory is presumed to follow the proper procedures for conducting Sample collection and analysis as set forth by the International Standards supplement to the Code.⁵⁹ The standard for an Athlete to rebut any presumptions or establish any fact or circumstance is, "[b]y a balance of probability, except as provided under Articles 10.4 and 10.6 where

⁵⁵ WADA, Code 19 Art. 2.1.1 (2009); *id.* at 130 (defining a Metabolite as, "Any substance produced by a biotransformation process"); *id.* (defining a Marker as, "A compound, group of compounds or biological parameter[s] that indicates the Use of a Prohibited Substance or Prohibited Method"); *id.* at 13 (defining a Sample as, "Any biological material collected for the purposes of Doping Control." Doping Control are all "[s]teps and processes," from the beginning of a doping test through any appeals process).

⁵⁶ WADA, Code 128 app. 1 (2009). Attempt is, "Purposely engaging in conduct that constitutes a substantial step in a course of conduct planned to culminate in the commission of an anti-doping rule violation. Provided, however, there shall be no anti-doping rule violation based solely on an Attempt to commit a violation if the Person renounces the Attempt prior to it being discovered by a third party not involved in the Attempt."

⁵⁷ WADA, Code 26 Art. 3.1 (2009); WADA, Code 126 app. 1 (2009) (defining an Anti-Doping Organization as, "A Signatory that is responsible for adopting rules for initiating, implementing or enforcing any part of the Doping Control Process. This includes, for example, the International Olympic Committee, the International Paralympic Committee, other Major Event Organizations that conduct Testing at their Events, WADA, International Federations, and National Anti-Doping Organizations"); *id.* at 134 (defining Testing as, "The parts of the Doping Control involving test distribution planning, Sample collection, Sample handling, and Sample transport to the laboratory"); *id.* at 129 (defining an Event as, "A series of individual Competitions conducted together under one ruling body...").

⁵⁸ See WADA, Code 26 cmt. Art. 3.2 (2009).

⁵⁹ WADA, Code 27 Art. 3.2.1 (2009).

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the Athlete must satisfy a higher burden of proof.”⁶⁰

Article 4 is entitled “The Prohibited List.” Article 4 states that there is a Prohibited List that shall be updated annually and must be followed at all times.⁶¹ The Prohibited List divides Prohibited Substances into separate classes, and each substance is listed by their medical names which are extremely difficult to understand.⁶² The 2010 Prohibited List states that all classes are considered Specified Substances unless indicated otherwise.⁶³ This is important because Article 4.2.2 of the Code states in pertinent part, “[f]or purposes of the application of Article 10 [Sanctions on Individuals], all Prohibited Substances shall be ‘Specified Substances’ except substances in the classes of anabolic agents and hormones and those stimulants and hormone antagonists and modulators so indentified on the Prohibited List.”⁶⁴ Consequently, during a hearing for an anti-doping violation, panels are given more flexibility for punishing someone testing positive for a Specified Substance than a substance that cannot be considered as such (i.e. steroids).⁶⁵ This does not mean that Specified Substances are not serious and do not have the ability to enhance performance, but it is accepted that many of these substances are used in medications and supplements. Further, the ingestions of these substances can be more readily explained.⁶⁶

Article 4.4 describes the basic guidelines for TUE’s.⁶⁷ The ISTUE covers the specifics of when and how such an exemption can be granted.⁶⁸ The Athlete must apply for a TUE through their relevant Anti-Doping Organization.⁶⁹ The application is then reviewed by a Therapeutic Use Exemption Committee (“TUEC”) which is appointed by the Anti-Doping Organization.⁷⁰ A summary of the criteria that a TUEC must follow to grant an exemption are as follows: (1) the Athlete would experience significant impairment to his or her health without the substance, (2) Use of the substance would produce no additional enhancement other than that which is expected,

⁶⁰ WADA, Code 26 Art. 3.1 (2009).

⁶¹ See WADA, Code 30 Art. 4 (2009).

⁶² See WADA, The 2010 Prohibited List (2010).

⁶³ *Id.* at 1.

⁶⁴ WADA, Code 31 Art. 4.2.2 (2009).

⁶⁵ See WADA, *Questions and Answers on the 2009 World Anti-Doping Code*, 3-4, <http://www.wada-ama.org/en/Resources1/Q-and-A/Why-is-it-important-to-combat-doping-in-sport/>.

⁶⁶ See *id.*

⁶⁷ WADA, Code 34-36 Art. 4.4 (2009).

⁶⁸ WADA, ISTUE (2010).

⁶⁹ *Id.* at 12 Art. 4.0.

⁷⁰ *Id.*

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and (3) there is no reasonable alternative.⁷¹

If a TUE is granted, the TUEC must specify the period of time the TUE will last and notify the Anti-Doping Administration and Management System (“ADAMS”).⁷² ADAMS is a “[w]eb-Based database management tool for data entry, storage, sharing and reporting designed to assist stakeholders and WADA in their anti-doping operations in conjunction with data protection legislation.”⁷³ That is, ADAMS allows stakeholders and WADA to obtain and view all relevant information on Athletes and other stakeholders.⁷⁴ WADA may review the decision of a TUEC to grant a TUE at any time.⁷⁵

Article 10 of the Code is entitled “Sanctions on Individuals.” Article 10.2 states that if a violation occurs as per Article 2.1, the period of ineligibility is two years, unless a reduction is warranted under Articles 10.4 or 10.5.⁷⁶

Article 10.4 allows for the reduction of an anti-doping violation for a Specified Substance under special circumstances.⁷⁷ This section presents a two-prong test in order to receive a reduced sanction: (1) the Athlete can establish how the substance entered his or her body, and (2) the substance was not Used for the intended purpose of enhancing his or her performance or mask the Use of another substance.⁷⁸ If the Athlete produces evidence to satisfy the panel that these two-prongs are met sufficiently, the panel will analyze the degree of fault on the part of the Athlete to determine the reduction.⁷⁹ In that case, the penalty may range from the maximum two years to a reprimand.⁸⁰ The comments to 10.4 describe that the following are not reasons for a reduced sanction: the possibility the Athlete will lose large sums of money, the potential to miss important Events, or the length of career left for the Athlete.⁸¹ Further the comment states that only in the most exceptional circumstances may a period of ineligibly be eliminated.⁸²

Article 10.5 deals with the reduction of substances that are not considered Specified Substances (i.e. steroids). Article 10.5.1 describes that if

⁷¹ *See id.* at 12 Art. 4.1.

⁷² *See id.* at 6 Art. 2.0.

⁷³ *Id.* at 8 Art. 3.1.

⁷⁴ *See* WADA, *Questions and Answers on ADAMS*, <http://www.wada-ama.org/en/ADAMS/QA-on-ADAMS/>.

⁷⁵ WADA, ISTUE 17 Art. 10.0 (2010).

⁷⁶ WADA, Code 52 Art. 10.2 (2009).

⁷⁷ WADA, Code 54 Art. 10.4 (2009).

⁷⁸ *See id.*

⁷⁹ *See id.*

⁸⁰ *Id.*

⁸¹ *See* WADA, Code 55 cmt. to Art. 10.4 (2009).

⁸² *Id.*

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an Athlete establishes No Fault or Negligence, the period of ineligibility may be eliminated if the Athlete can establish how the substances entered his or her body.⁸³ However, the comment to this section states that it should only be used in exceptional circumstances (i.e., even when the Athlete exercised all possible due care, he or she was sabotaged by a competitor), and not in the vast majority of cases.⁸⁴

Article 10.5.2 allows the period of ineligibility to be reduced by at most one-half of the period of ineligibility otherwise required if the Athlete can prove he or she was at No Significant Fault or Negligence.⁸⁵ Here the Athlete must also establish how the substance entered his or her body.⁸⁶ The comment to this section also states that it may only be used in exceptional circumstances and not in the vast majority of cases.⁸⁷

The remaining sections of Article 10 deals with multiple violations, admittance of a substance before a positive test Sample, aggravating circumstances (i.e. trafficking, administration of a Prohibited Substance), all of which are not pertinent to this note.

Article 15.4 is important for the purposes of sanctions (or hearings), Testing, and TUE's as well. Article 15.4.1 states, that any decisions for sanctioning, Testing, and granting of TUE's by a Signatory must be recognized and respected by other Signatories as long as the processes are consistent with the Code.⁸⁸ Article 15.4.2 states Signatories should respect the processes of non-Signatories as well, as long as they are consistent with the Code.⁸⁹

The aforementioned Articles of the Code and its supplements are the primary sources of the conflicts that ensue in the battle against Prohibited Substances. Typical issues include: the strict liability principle leads to the punishment of Athletes of varying degrees of fault, Athletes who could vastly benefit medically from a Prohibited Substance are persecuted and not granted TUE's, contamination of common supplements taken by Athletes leads to

⁸³ WADA, Code 56 Art. 10.5.1 (2009); *id.* at 131 app. 1 (defining No Fault or Negligence as, "The Athlete's establishing that he or she did not know or suspect, and could not reasonably have known or suspected even with the exercise of utmost caution, that he or she had Used or been administered the Prohibited Substance or Prohibited Method").

⁸⁴ WADA, Code 56 cmt. to Art. 10.5.1 (2009).

⁸⁵ WADA, Code 57 Art. 10.5.2 (2009); *id.* at 131 app. 1 (defining No Significant Fault or Negligence as, "The Athlete's establishing that his or her fault or negligence, when viewed in the totality of the circumstances and taking into account the criteria for No Fault or Negligence, was not significant in relationship to the anti-doping violation").

⁸⁶ WADA, Code 57 Art. 10.5.2 (2009).

⁸⁷ WADA, Code 56 cmt. to Art. 10.5.2 (2009).

⁸⁸ WADA, Code 94 Art. 15.4.1 (2009).

⁸⁹ WADA, Code 64 Art. 15.4.2 (2009).

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doping violations, a lack of understanding of the 2010 Prohibited List due to its complexity, and the ability of Athletes to defend themselves.

III. CONFLICT

A. Blurred Lines Between the Innocent and the Guilty

In 2009, two cases heard by the International Tennis Federation (“ITF”) depict the need for a new Code.⁹⁰ The first is the case of Courtney Nagle, a twenty-six year-old professional tennis player from the United States. On July 29th, 2008, Nagle provided a urine sample in Sweden before the Nordic Light Event in Stockholm.⁹¹ The sample revealed the presence of canrenone.⁹² Canrenone was listed as a Prohibited Substance under the 2008 Prohibited List and is on the 2010 Prohibited List.⁹³ Canrenone is a diuretic, not even a performance-enhancer.⁹⁴

The standard sanction for the finding of such Prohibited Substance is two-years of ineligibility. Because the ITF believed *lex mitior* applied as per Article 25 of the Code, the sanction could be reduced if she could describe how the substance entered her body and that she did not take the substance to enhance her performance.⁹⁵ Nagle explained that prior to 2008 she was taking spironolactone, which contained canrenone, to treat a medical condition.⁹⁶ Nagle was able to present to the ITF medical records showing her need for the drug from 2005 to 2006, and again in 2008 for a flare up of her condition.⁹⁷ She stated that she did not take the medication to enhance her performance and even declared use of the medication when she provided her sample.⁹⁸ Further, Nagle

⁹⁰ See ITF Press Release, <http://www.itftennis.com/antidoping/news/pressrelease.asp?articleid=19847> (last visited Apr. 11, 2010). Note that the ITF adopted the Code.

⁹¹ *Id.* at ¶2.

⁹² *Id.*

⁹³ *Id.*; WADA, The 2010 Prohibited List 5 S5 (2010).

⁹⁴ WADA, The 2010 Prohibited List 5 S5 (2010).

⁹⁵ WADA, Code 123 Art. 25.2 (2009) (stating if a panel decides *lex mitior* applies to the circumstances of a given case, the panel will apply the Code even if the violation occurred during the time period the Original Code was in effect); ITF, *Decision in the Case of Courtney Nagle*, 1, available at http://www.itftennis.com/shared/medialibrary/pdf/original/IO_40207_original.PDF.

⁹⁶ ITF, *Decision in the Case of Courtney Nagle*, 1, available at http://www.itftennis.com/shared/medialibrary/pdf/original/IO_40207_original.PDF.

⁹⁷ *Id.*

⁹⁸ *Id.*

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stated that she informed her doctor she was an Athlete and inquired as to whether the substance was legal.⁹⁹

However, the ITF stated that Nagle should have taken more steps to ensure the medication did not contain any substance that was on the Prohibited List.¹⁰⁰ The ITF concluded that Nagle should have taken various measures such as: calling the ITF telephone advice line, calling her national association, and showing the doctor the Prohibited List.¹⁰¹ As a result, the ITF held Nagle must suffer the consequences.¹⁰² The ITF reduced the two-year ban to sixteen months.¹⁰³ Her results from the Nordic Light tournament were erased and her prize money was taken away.¹⁰⁴

The second case is of Ivo Minar, a twenty-five year-old professional tennis player from the Czech Republic.¹⁰⁵ On July 11, 2009, during the Davis Cup Quarter Final between the Czech Republic and Argentina, Minar provided a urine sample to the ITF.¹⁰⁶ The sample was sent to a WADA-accredited laboratory in Montreal, Canada.¹⁰⁷ The lab found methlyhexanamine, which is a stimulant that was banned under the 2009 Prohibited List as well as the 2010 Prohibited List.¹⁰⁸

Minar presented evidence that he was taking a nutritional supplement due to professional advice.¹⁰⁹ Minar provided proof that he did not know the Prohibited Substance was in the supplement nor take the supplement to cheat.¹¹⁰ The ITF accepted these statements as true, but still suspended him due to the strict liability principle.¹¹¹ He was suspended for eight months, his accomplishments from two tournaments in 2009 were disqualified, and the prize money from those events were taken away.¹¹²

Other cases decided under the Original Code depict similar harsh

⁹⁹ *Id.* at 2.

¹⁰⁰ *Id.*

¹⁰¹ *Id.* at 2-3.

¹⁰² *Id.* at 4.

¹⁰³ *Id.*

¹⁰⁴ *Id.*

¹⁰⁵ ITF, *Decision in the Case of Ivo Minor*, available at <http://www.itftennis.com/antidoping/news/pressrelease.asp?articleid=20548>.

¹⁰⁶ *Id.* at ¶ 2.

¹⁰⁷ *Id.*

¹⁰⁸ *Id.*; WADA, *The 2010 Prohibited List* (2010).

¹⁰⁹ ITF, *Decision in the Case of Ivo Minor*, ¶3, available at <http://www.itftennis.com/antidoping/news/pressrelease.asp?articleid=20548>.

¹¹⁰ *Id.*

¹¹¹ *See id.* at ¶ 5.

¹¹² *Id.*

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results.¹¹³ On August 9, 2007, the Canadian Center for Ethics in Sport (“CCES”) analyzed urine samples of several Athletes in Canada, one of them being Serge Despres who was a professional bobsledder.¹¹⁴ The laboratory found the presence of nandrolone, which was a Prohibited Substance and is under the 2010 Prohibited List.¹¹⁵ During a hearing by the Bobsleigh Canada Skeleton (“BCS”) (the national organization for bobsledding in Canada), the panel accepted the following facts as true: Despres had hip surgery in 2007, in order to heal faster he was recommended a supplement by a sports nutritionist contracted by the BCS, he did not take the supplement to enhance his performance and only did so for medical reasons, he researched the product and other supplements, and nandrolone was not on the label of the supplement.¹¹⁶ The BCS still suspended Despres.¹¹⁷

Subsequently, Despres submitted his case to the Sport Dispute Resolution Centre of Canada (“SDRCC”).¹¹⁸ The tribunal found that the circumstances complied with the provisions of the Original Code for reduction of a sanction, thus giving him a twenty-month suspension instead of the standard two-years.¹¹⁹

Following that ruling, Despres filed an appeal with Court of Arbitration for Sport (“CAS”). WADA intervened because it believed that the standard sanction of two-years should be given because the circumstances depicted that this was not a case of No Significant Fault or Negligence.¹²⁰ WADA argued that Despres should have done more to prevent the anti-doping violation.¹²¹ The CAS panel agreed and stated he should have done any of the following: contacted the manufacturer, conducted more research, or followed-

¹¹³ It must be noted that the two cases of *Despres* and *Hardy* to follow, were decided under the Original Code (or organizations that adopted the Original Code). However, both the Code and the Original Code adopted the principle of strict liability, while the only difference the Code presents is slightly more flexibility in reduction of sanctions. In the comments to both the Code and the Original Code, complete elimination of a period of ineligibility occurs only in the greatest of circumstances. Therefore, it is reasonable to believe that the Athletes in the following examples still would have suffered a sanction under the Code, and the period of ineligibility would not have been eliminated since they were found to have had some degree of fault or negligence; *see also* WADA, Original Code (2003), http://www.wada-ama.org/rtecontent/document/code_v3.pdf.

¹¹⁴ *Despres v. CCES*, CAS 2008/A/1489 (2008) & *WADA v. Despres*, CCES, BCS, CAS 2008/A/1510 (2008).

¹¹⁵ *Id.* at 5.

¹¹⁶ *Id.* at 9.

¹¹⁷ *Id.* at 5.

¹¹⁸ *Id.*

¹¹⁹ *Id.*

¹²⁰ *Id.* at 8.

¹²¹ *Id.*

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up with the Canadian nutritionist.¹²² As a result, the panel found the circumstances were not exceptional and his culpability was beyond No Significant Fault or Negligence.¹²³ Consequently, Despres received a two-year period of ineligibility.¹²⁴ Further, the panel stated that the possibility of the suspension affecting Despres' ability to qualify for future Events was not a factor in determining the punishment.¹²⁵

At a hearing in the American Arbitration Association ("AAA"), American Olympic swimmer Jessica Hardy was suspended for one-year.¹²⁶ In 2007, Hardy started taking supplements by AdvoCare as per the advice of her coach and teammates.¹²⁷

Hardy was very diligent in her research throughout the process of selecting a supplement.¹²⁸ She contacted AdvoCare through her agent to attain assurances the supplements were "[s]afe, pure, and uncontaminated."¹²⁹ She then agreed to endorse the product, but was not willing to use it quite yet.¹³⁰ Hardy contacted Rob Webb of AdvoCare about the product.¹³¹ Subsequently, she obtained an indemnity provision in her endorsement agreement.¹³² Hardy also spoke to other representatives of AdvoCare to be guaranteed the product was tested and the labels were correct, and that the various products were "[c]ertifiably clean."¹³³ Hardy conducted further research of the company online.¹³⁴

Hardy discussed the product with a U.S.A. swim team nutritionist who said that AdvoCare was the best supplement company.¹³⁵ She then spoke to a sport psychologist from the United States Olympic Committee who told her that there were enough benefits from supplements that she should take them if a reputable company made the supplement.¹³⁶ After all the initiative on the part of Hardy, she began taking a supplement by AdvoCare and tested negative for

¹²² *Id.*

¹²³ *Id.* at 15.

¹²⁴ *Id.*

¹²⁵ *Id.* at 16.

¹²⁶ *United States Doping Agency v. Hardy*, AAA No. 77 190 00288 08 (2009).

¹²⁷ *Id.* at 6.

¹²⁸ *Id.* at 6-7.

¹²⁹ *Id.*

¹³⁰ *Id.* at 7.

¹³¹ *Id.*

¹³² *Id.*

¹³³ *Id.*

¹³⁴ *Id.*

¹³⁵ *Id.*

¹³⁶ *Id.*

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doping eleven to thirteen times.¹³⁷ The majority of those tests took place in July of 2008, during the Olympic team trials.¹³⁸ However, on July 21, 2008, she tested positive for clenbuterol (an anabolic agent like steroids), which was on the Prohibited List and still is under the 2010 Prohibited List.¹³⁹

Consequently, she did not travel with the team to the next stage of trials and withdrew from the Games in preparation for her upcoming hearings.¹⁴⁰ During the AAA arbitration, the panel found based on the evidence, that the last sample tested positive due to contamination of the product.¹⁴¹ The panel then analyzed the degree of her negligence and found the circumstances to be “truly exceptional” due to her diligence and research before taking the supplement.¹⁴² Nevertheless, the panel concluded she could have done more, hence, the period of ineligibility was not eliminated.¹⁴³ They found her to be at No Significant Fault or Negligence and reduced her sentence from two years to one.¹⁴⁴ Hardy was not able to participate in the Games.¹⁴⁵

The aforementioned cases and the Jenkins’ case represent just a fraction of Athletes that have suffered from the past abuses of Prohibited Substances by Athletes. Although WADA believes that the greater flexibility in sanctioning is a great feature of the Code, it is not good enough.¹⁴⁶ The difference between the innocent and guilty users is still too miniscule. Hardy made tremendous efforts to ensure she was not taking a Prohibited Substance and still suffered a harsh penalty. It deprived her of the chance to compete in the Games. It seems the only way to avoid any period of ineligibility is for a medical emergency, otherwise panels will always find a way to blame Athletes due to the strict liability principle.¹⁴⁷

Although Athletes who participate in private U.S. professional leagues (i.e. the National Football League (“NFL”), Major League Baseball (“MLB”)) are not subject to the Code except during international Events, there are numerous stories that depict a blurring of lines between the innocent and the

¹³⁷ *Id.*

¹³⁸ *See id.* 1-2.

¹³⁹ *Id.* at 2; *see* The 2010 Prohibited List S1(2) (2010).

¹⁴⁰ *See Hardy*, AAA No. 77 190 00288 08, at 2.

¹⁴¹ *See id.* at 11.

¹⁴² *See id.* at 13.

¹⁴³ *See id.*

¹⁴⁴ *See id.* at 14.

¹⁴⁵ *See id.* at 14-15.

¹⁴⁶ *See* WADA, *Questions and Answers on the 2009 World-Anti Doping Code*, 3-4,

<http://www.wada-ama.org/en/Resources1/Q-and-A/Why-is-it-important-to-combat-doping-in-sport/>.

¹⁴⁷ *See e.g.*, Socccernet Staff, *Angry Cannavaro Cleared of Doping Offense* (Oct. 2009), <http://socccernet.espn.go.com/news/story?id=684814&cc=5901>.

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guilty. Two of the more recent stories are those of Andy Pettitte and Doug Barron.

Pettitte, an extremely popular MLB pitcher admitted to Use of HGH after the release of the infamous “Mitchell Report.”¹⁴⁸ This report was an investigation of the abuse of PED’s in the MLB conducted by U.S. Senator George Mitchell.¹⁴⁹ However, Pettitte continually stated that he used HGH during a stint on the disabled list in 2002 to help his injured elbow heal faster.¹⁵⁰

A more recent story is that of Barron, a professional golfer who was suspended for testing positive for a PED in 2009.¹⁵¹ It was well-known that Barron had a medical exemption throughout the year and the reasoning for his positive test was unknown.¹⁵² It is well-documented the severity of his injuries and that he took PED’s not to enhance his performance, but to heal faster.¹⁵³ Many golfers corroborated that he was taking PED’s to improve his health and stated that just by looking at him, you could tell he was not doing it to enhance his performance.¹⁵⁴

The stories of Pettitte and Barron do not depict whether they are innocent or guilty, but do demonstrate the struggle to decide whether someone should be punished and for how long. Assuming *arguendo*, that the Code was adopted by private U.S. sports leagues, use of the strict liability principle would most likely have led to the punishment of them both.

B. The Blurred Lines Do Not Allow for the Use of Modern Medicine

The above examples of various Athletes raise a further issue: can PED’s be used for therapeutic purposes? The answer is yes, since the Code provides for TUE’s. Nonetheless, the Code’s language for permitting a TUE portrays they can only be granted in the most exceptional circumstances, and definitely not in the case of steroids and HGH. Steroids and HGH do not pass for TUE’s because the relevant TUEC would unquestionably state there is an alternative to steroids and HGH.

¹⁴⁸ Kat O’Brien, *Pettitte Admits Using HGH, Not Steroids*, NEWSDAY, Dec. 15, 2007, available at <http://www.newsday.com/news/pettitte-admits-using-hgh-not-steroids-1.877443>.

¹⁴⁹ *Id.*

¹⁵⁰ *Id.*

¹⁵¹ See Jason Sobel, *Barron’s Violation a Solitary Issue* (Nov.2009), http://sports.espn.go.com/espn/blog/index?entryID=4617694&name=sobel_jason.

¹⁵² *Id.*

¹⁵³ *Id.*

¹⁵⁴ See Bob Harig, *Barron First Player to Violate Policy* (Nov. 2009), <http://sports.espn.go.com/golf/news/story?id=4617600>.

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This draconian approach does not allow for Athletes to benefit from modern medicine. WADA does not care about the laudatory uses of PED's. All that is relevant to WADA is the legal side of the equation; to rid the world of sports completely from the Use of PED's. However, Athletes can medically benefit greatly from their Use. The following discusses the difference between using steroids and HGH medically, and abusing them to gain performance-enhancement (the overwhelming concern in the Code).

(i) The Medical Values of Steroids

Steroids are man-made drugs “[t]hat are chemically related to the male testosterone.”¹⁵⁵ Steroids have been used for many medicinal purposes. During the second-half of the twentieth century, steroids were used frequently for bone marrow stimulation and growth stimulation (especially in children).¹⁵⁶ More recently, steroids have been used in patients with AIDS, cancer, and other diseases to treat chronic wasting syndrome.¹⁵⁷ Steroids help induce appetite and preserve muscle mass for people who suffer from chronic wasting syndrome.¹⁵⁸ They are also used to help decrease the development of breast cancer in women.¹⁵⁹ They have been used in adolescent boys whose bodies have not yet hit puberty or are slow to reach puberty, as well as in men whose bodies do not produce enough testosterone.¹⁶⁰ Steroids have been used to treat other forms of malnourishment and certain forms of anemia.¹⁶¹ Further, they have even been used as a form of male contraceptive.¹⁶² Finally, patients that needed surgery have been given steroids to improve their overall condition prior to the procedure.¹⁶³

Although steroids have been classified as an “evil” drug in athletics,

¹⁵⁵ 5 KEN R. WELLS, TISH DAVIDSON & A.M. JACQUELINE LONGE, *Anabolic Steroid Use* (2007), available at

http://galenet.galegroup.com/servlet/HWRC/hits?r=d&origSearch=true&bucket=ref&rlt=1&o=&n=10&searchTerm=2NTA&l=d&index=BA&basicSearchOption=KE&tcit=1_1_1_1_1&c=2&docNum=DU2601001750&locID=nysl_li_hofs&secondary=false&t=RK&s=1&SU=steroids.

¹⁵⁶ *Id.* at 155.

¹⁵⁷ *Id.*

¹⁵⁸ *Id.*

¹⁵⁹ *Id.*

¹⁶⁰ *See id.*

¹⁶¹ Burge, *supra* note 8, at 36 (citing JAMES E. WRIGHT & VIRGINIA S. COWART, 35 ANABOLIC STEROIDS: ALTERED STATES (1990)).

¹⁶² Burge, *supra* note 8, at 36 (citing Charles Yesalis et al., *Anabolic-Androgenic Steroid Use in the United States*, 270 JAMA 1217, 1219 (1993)).

¹⁶³ Burge, *supra* note 8, at 36 (citing WRIGHT & COWART, *supra* note 161).

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they have been subject to tests where the conclusions show they have legitimate healing effects for injuries (especially muscle injuries); and can help Athletes heal faster.¹⁶⁴

In one mainstream study, scientists studied rats that had muscle contusion injuries (injuries which are very common in athletic competition).¹⁶⁵ Three groups were studied: rats given steroids, rats given corticosteroids, and a control group given nothing.¹⁶⁶ Corticosteroids are anti-inflammatory medications commonly used for allergic conditions.¹⁶⁷ At day two of the study, the group of rats given the corticosteroids showed significant improvement.¹⁶⁸ At day seven, the muscles of the rats given corticosteroids had actually grown weaker than the control group.¹⁶⁹ By day fourteen, the rats given the corticosteroids had total muscle degeneration.¹⁷⁰

The rats given steroids showed no significant effects until day seven, but thereafter, it was observed their muscles were much stronger.¹⁷¹ The scientists concluded that the steroids had a better long-term affect on muscle contusion injuries than the group given corticosteroids and the control group.¹⁷²

In a more recent study, mice with muscle injuries were given steroids.¹⁷³ They were given steroids to see whether it would aid in muscle regeneration.¹⁷⁴ The study showed that steroids could aid in the later stages of

¹⁶⁴ See Shayna M. Sigman, *Are We All Dopes? A Behavioral Law & Economics Approach to Legal Regulation of Doping in Sports*, 19 MARQ. SPORTS. L. REV. 125, 147 (2008) (citing John M. Beiner et al., *The Effect of Anabolic Steroids and Corticosteroids on Healing Muscle Contusion Injury*, 27 AM. J. SPORTS MED. 2, 8 (1999)).

¹⁶⁵ Beiner, *supra* note 164, at 8.

¹⁶⁶ *Id.*

¹⁶⁷ Mariana C. Castells, *What to do About Allergies*, 2007 HARV. HEALTH SPECIAL REPORT, at 17(4), available at

http://galenet.galegroup.com/servlet/HWRC/hits;jsessionid=AA77D1AFDF4450B78963D37F591DC2F0?r=d&origSearch=true&bucket=ref&rlt=1&o=&n=10&searchTerm=2NTA&l=d&index=BA&basicSearchOption=KE&tcit=1_1_1_1_1&c=6&docNum=A160713865&locID=nysl_li_hofs&secondary=false&t=RK&s=1&SU=steroids.

¹⁶⁸ Beiner, *supra* note 164, at 8.

¹⁶⁹ *Id.*

¹⁷⁰ *Id.*

¹⁷¹ *Id.*

¹⁷² *See id.*

¹⁷³ Gordon S. Lynch, Jonathan D. Schertzer & James G. Ryall, *Anabolic Agents for Improving Muscle Regeneration and Function After Injury*, 35 CLINICAL AND EXPERIMENTAL PHARMACOLOGY AND PHYSIOLOGY 852, 853 (2008) (citing JA Carson et. al., *Nandrolone Decanoate Administration and Skeletal Muscle Regeneration*, 27 FASEB J. 2007, 769.26 (2007)).

¹⁷⁴ Lynch et al., *supra* note 173, at 853.

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muscle regeneration.¹⁷⁵

These tests prove that steroids may be a very beneficial muscle healer for Athletes. The fact that steroids have potential performance-enhancement capabilities for Athletes should not deter organizations, researchers, and others from exploring the Use of steroids. When used properly it seems they can benefit large and small injuries. Further research is needed and ignoring their positive effects is detrimental to the health of Athletes.

(ii) The Abuse of Steroids

The medical and therapeutic values of steroids are apparent when taken in small doses.¹⁷⁶ The negative side-effects of steroids are more commonly found when used in high doses.¹⁷⁷ These high doses are the ones that have given athletes a competitive edge. Athletes have used steroids in a “markedly” different way than the therapeutic procedures, by using very high doses.¹⁷⁸

Since steroids have been outlawed in many nations over the last decade via the Code and national statutes, “designer steroids” have been abused by Athletes all over the world.¹⁷⁹ These steroids are not like the ones used for therapeutic reasons, and are made improperly.¹⁸⁰ These are typically the steroids that Athletes use to attain increased skeletal mass, and take them in extremely high and unsafe doses.¹⁸¹

More research is needed, but is not conducted by “[l]egitimate medical publishers” because of the illegality, general abhorrence, and abuse of the drug.¹⁸² Instead, underground manuals are published. One in particular entitled the “Anabolic Reference Guide” has been used by reportedly thousands of Athletes in many nations.¹⁸³ It has even been reported that steroid medical experts praise the book for its knowledge and its use.¹⁸⁴

¹⁷⁵ *See id.*

¹⁷⁶ *See id.* at 856.

¹⁷⁷ *Id.*

¹⁷⁸ *See e.g.*, Council on Scientific Affairs, *Drug Abuse in Athletes*, 259 JAMA 1703, 1704 (1988); Burge, *supra* note 8, at 38 (citing 13 ROBERT VOY, *Drugs, Sport, Politics* (1991)).

¹⁷⁹ *See* Wells et al., *supra* note 155.

¹⁸⁰ *See id.*

¹⁸¹ *See id.*

¹⁸² Lynch et al., *supra* note 173, at 853; *See* Burge, *supra* note 8, at 39.

¹⁸³ *See* Burge, *supra* note 8, at 39.

¹⁸⁴ *Id.*

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(iii) The Medical Values of HGH

HGH is a naturally produced hormone in the human body.¹⁸⁵ The primary purpose of the hormone is to provide for “[t]he maintenance of normal bone development from birth to adulthood.”¹⁸⁶ HGH was first attained from cadavers, but companies started to make HGH through developments in the 1980’s.¹⁸⁷ This form of HGH is commonly referred to as “recombinant human growth hormone,” and has the same effect of HGH secreted from the body.¹⁸⁸

HGH now has “[s]everal legitimate medical uses.”¹⁸⁹ HGH is used frequently for children that suffer from dwarfism, growing problems, and hormone deficiencies.¹⁹⁰ HGH is used to treat “[p]eople with short bowel syndrome, a group of digestive and related problems that afflict people who have had most of their small intestines removed.”¹⁹¹ HGH has been found beneficial to patients after bariatric surgery (surgery performed on people who are morbidly obese) to prevent loss of lean muscle mass after the surgery.¹⁹² In a recent study of patients who underwent bariatric surgery, patients given HGH lost less lean muscle mass while losing more fat mass after three months than patients treated with exercise and diet only.¹⁹³

Like steroids, HGH has medical and therapeutic benefits for Athletes. Studies have shown the Use of HGH can help with injuries and healing after surgery.¹⁹⁴ The healing abilities of HGH has medical values to Athletes who suffer from injuries during training as well as the larger injuries suffered during competition.¹⁹⁵

There have been numerous Athletes caught using HGH, whether prescribed by a doctor illegally or obtained through other means. But many of these Athletes swear they took it for injuries and not for performance-

¹⁸⁵ Harvard Health Letter, *Human Growth Hormone*, HARV. HEALTH PUBLICATIONS, at 3 (January 2008).

¹⁸⁶ 108 DAVID EPSTEIN, *The ABC's of HGH*, SPORTS ILLUSTRATED, March 17, 2008, at 32.

¹⁸⁷ See Harvard Health Letter, *supra* note 185.

¹⁸⁸ See *id.*

¹⁸⁹ See *id.*

¹⁹⁰ See *id.*

¹⁹¹ Richard Hodin, *HGH After Surgery*, HARV. HEALTH PUBLICATIONS (May 2008).

¹⁹² 20 EATING DISORDERS REVIEW, *Growth Hormone Helps Prevent Lean Mass Loss After Bariatric Surgery*, EATING DISORDERS REV., July-August 2009, at 6.

¹⁹³ *Id.*

¹⁹⁴ 32 MITCHEL L. ZOLER, *Growth Drug Looks Useful for Healing*, MEDICAL WORLD NEWS, July 1991, at 54(1).

¹⁹⁵ See Sigman, *supra* note 164, at 153 (citing S. Doessing & M. Kjaer, *Growth Hormone and Connective Tissue in Exercise*, 15 SCANDINAVIAN J. MED. & SCI. IN SPORTS 202, 207 (2005)).

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enhancement. Dr. Rick Delamarter is a Los Angeles spine surgeon who treats many elite Athletes in professional sports.¹⁹⁶ He declared in a report that he has “[s]een the benefits of growth hormone post-operatively in recovering from surgery.”¹⁹⁷ Dr. Delamarter also stated that he has seen recovery times cut in half.¹⁹⁸ He further stated, “[i]f the science proves that it’s efficacious and safe in the post-operative recovery period. . . then I think it becomes a standard of care for sports medicine and surgeons.”¹⁹⁹

In the same article, an example was given of the extraordinary healing capabilities of HGH and its ability to possibly save careers. This story was about Abdul-Karim al-Jabbar.²⁰⁰ Al-Jabbar was a professional football player in the NFL for five years.²⁰¹ After five years, all of the cartilage in one of his knees was destroyed, as well as half his meniscus.²⁰² He underwent surgery a few times during his football career (in college and in the NFL) but with no positive results.²⁰³ Al-Jabbar then turned to Dr. Allen R. Dunn, a Miami surgeon, who completed a procedure on al-Jabbar’s knee.²⁰⁴ At the conclusion of the procedure, Dr. Dunn injected HGH into that knee.²⁰⁵ Although al-Jabbar was not able to return to the NFL, he regained the ability to function with his crippled knee.²⁰⁶ He was able to run and jump again where previous to the injection, he could not.²⁰⁷

Dr. Dunn stated that he has used HGH in a similar manner with over 800 patients, attaining approximately a seventy-percent success rate.²⁰⁸ Moreover, he stated that he has seen no negative side effects when used in a moderate manner and considered this procedure an amazing alternative to knee and hip replacement.²⁰⁹

Similar to steroids, further research is needed to observe the long-term medical effects of HGH, but clearly there are beneficial therapeutic purposes for

¹⁹⁶ Tom Farrey, *HGH, Performance Enhancer or Healer?* ESPN THE MAGAZINE ¶11 (2006), available at <http://sports.espn.go.com/espn/news/story?id=2574291>.

¹⁹⁷ *Id.*

¹⁹⁸ *Id.* at ¶ 12.

¹⁹⁹ *Id.* at ¶ 13.

²⁰⁰ *Id.* at ¶ 21.

²⁰¹ *Id.* at ¶ 3.

²⁰² *Id.*

²⁰³ *See id.* at ¶¶ 3-4.

²⁰⁴ *Id.* at ¶ 21.

²⁰⁵ *Id.*

²⁰⁶ *Id.*

²⁰⁷ *See id.*

²⁰⁸ *Id.* at ¶ 22.

²⁰⁹ *See id.*

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Athletes.²¹⁰

(iv) **The Abuse of HGH**

Like steroids, Athletes have abused HGH to a point where it is strictly considered a performance-enhancer rather than a medical tool. Dr. Lynne Pirie who runs an institute in Phoenix specializing in HGH stated, “[t]he dark side of HGH comes from people playing doctor and taking more than they should and pushing the envelope past the physiological limit.”²¹¹

Maybe the most significant reason the drug is abused is because there is no reliable detection test, unlike steroids.²¹² WADA first started to use blood samples to detect HGH in 2004, but it was only used on a limited basis.²¹³ In fact, during the past three Games (not including the Games in Vancouver) not one Athlete tested positive for Use of HGH.²¹⁴ However, the blood test has not been deemed reliable and is quite expensive.²¹⁵

Hence, Athletes have abused HGH to a point where the medical values are not researched or published because, WADA and other entities seek the absolute removal of HGH from athletic competition.

C. A Need for Change

The strict liability principle has unjustifiably destroyed the careers of Athletes while the therapeutic uses for steroids and HGH have been discounted and outlawed. Change is needed. But with WADA in charge that does not seem likely. There is a definite “[i]mbalance of power” between WADA and Athletes.²¹⁶ It is clear that the Code and its components were created unilaterally by WADA.²¹⁷

Athlete concerns and suggestions were hardly represented while

²¹⁰ See e.g. Harvard Health Letter, *supra* note 185, at 3.

²¹¹ Evan Wright, *HGH: Like Steroids on Steroids*, ROLLING STONE, August 22, 2002.

²¹² See e.g. Sigman, *supra* note 164, at 154.

²¹³ See *id.* (citing Christian Strasburger, *The Researcher's Perspective*, 2 PLAY TRUE 15 (2007), available at

http://www.wada-ama.org/rtecontent/document/PlayTrue2007_SummerResearch_En_15-18.pdf.)

²¹⁴ See A.J. Perez, *USADA Will Help Fund Further Study of Urine Test for HGH*, USA TODAY (Feb. 26, 2009), available at http://www.usatoday.com/sports/olympics/2009-02-26-usada-hgh_N.htm.

²¹⁵ *Id.*

²¹⁶ See Straubel, *supra* note 2, at 142.

²¹⁷ *Id.* at 143.

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drafting the revised Code.²¹⁸ For example, WADA includes in the Code the criterion of how a substance ends up on the Prohibited List, but does not publicly release the reasoning behind inclusion of a substance.²¹⁹ Further, Athletes may not challenge inclusion of a substance on the Prohibited List, which demonstrates WADA's monopoly over scientific research in the field of PED's.²²⁰ There is a clear bias against the more powerful Prohibited Substances such as steroids and HGH, and further, WADA's domination does not allow for further research to observe their full potential.²²¹

Resolution is needed and a reform to WADA's concepts would allow for a "top-down" change throughout the world of sports. It is clear that change must start with WADA and the Code.

IV. RESOLUTION

A. Suggestions for Change

There are numerous problems that have been mentioned: strict liability, the criteria for granting a TUE, the Prohibited List, imbalance of power, etc. The Code is simply not different enough from the Original Code. Even upon visiting the WADA website, the list of significant changes to the Code is only slightly more than five pages long.²²² Most of the inherent problems from the Original Code still surface. Technology and science will always be able to stay ahead of regulations and testing, thus, a new approach is needed.²²³

The suggestions for change range from simple revisions to various articles of the Code to complete overhauls and everything in between. A popular suggestion is to rid the Code of the strict liability principle.²²⁴ In order to make this change, an Anti-Doping Organization would have to take into consideration the facts of each case without such a negative presumption against

²¹⁸ *Id.*

²¹⁹ See Srikumaran Melethil, *Making the WADA Prohibited List: Show Me the Data*, 50 ST. LOUIS U. L.J. 75, 76 (2005).

²²⁰ See *id.* at 77.

²²¹ See *id.* at 80-81.

²²² See WADA, *Question & Answers on the 2009 World Anti-Doping Code*, <http://www.wada-ama.org/en/Resources1/Q-and-A/Why-is-it-important-to-combat-doping-in-sport/>.

²²³ See e.g., Christopher Geoffrey Rapp, *Blue Sky Steroids*, 99 J. CRIM. L. CRIMINOLOGY 599, 604 (2009).

²²⁴ See e.g., Melethil, *supra* note 219, at 87; Wilson, *supra* note 35, at 107.

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the Athlete.²²⁵ Instead, pharmaceutical experts would testify in each case to help clarify the probability that a doping violation was committed with the intent to enhance.²²⁶

Another revision-based suggestion to the Code would be to make the Prohibited List simpler and more “Athlete-friendly.”²²⁷ This would allow for Athletes to understand the list with much more ease. Working in tandem with this suggestion is leagues and Anti-Doping Organizations should sponsor and promote the use of certain brands of substances.²²⁸ This would allow Athletes to Use substances without fear of contamination. And even if contamination became an issue, Athletes would have a defense because the league or organization was the one who sponsored that substance. This may also put more pressure on supplement companies to be more careful in the production of their supplements. However, most organizations have been reluctant to sponsor such products and continually want to place blame on the Athletes for taking supplements.²²⁹

A new innovative response to the continued problems of doping is called the “biological passport program,” which could work in conjunction with the present Code. This system spurred from the 2006 Winter Olympics due to high levels of hemoglobin in the blood of numerous competitors.²³⁰ The high levels of hemoglobin may have been a result of the Athletes natural make-up or from a Prohibited Substance.²³¹ As a result, the Union Cycliste Internationale (“UCI”) and WADA started the biological passport program which involved the testing of a cyclist-Athlete’s blood to create a baseline blood sample.²³² This would allow a laboratory and the relevant Anti-Doping Organization to quickly analyze whether a Prohibited Substance was the reason for a change in the Athlete’s blood, rather than basing the Athlete’s blood and hormone levels on generic standards set by WADA.²³³ This information would be provided to

²²⁵ *See id.*

²²⁶ *See id.*

²²⁷ *See id.* at 86.

²²⁸ *See* Wilson, *supra* note 35, at 108.

²²⁹ *See* Howard L. Jacobs et al., American Law Institute-American Bar Association Continuing Legal Education ALI-ABA Course of Study January 15-17,2009, *Athlete Lawsuits Against Supplement Companies Following Positive Drug Tests*, SP016 ALI-ABA 1403, 1409 (2009).

²³⁰ *See* Bradley J. Schmalzer, *A Vicious Cycle: The Biological Passport Dilemma*, 70 U. PITT. L. REV. 677, 690 (2009) (citing Juliet Macur, *Cycling Union Takes Leap of Faith in Against Doping*, N.Y. TIMES, Oct. 24, 2007, available at

<http://www.nytimes.com/2007/10/24/sports/othersports/24cycling.html?>).

²³¹ *See* Schmalzer, *supra* note 230, at 690.

²³² *See id.*

²³³ *See id.* at 691 (citing Macur, *supra* note 230).

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ADAMS for laboratories to have access, in order to make the relevant observations.²³⁴

This program focuses on the continued faults and mistakes in laboratory testing and the deference given to labs during Athlete hearings for a finding of a Prohibited Substance.²³⁵ It would also allow for greater accuracy in detecting the manipulation of an Athlete's blood through Prohibited Methods.²³⁶

Dr. Mark Gordon, a prominent member of the American Academy of Anti-Aging Medicine, had a similar idea.²³⁷ He suggested that TUE's should be allowed more frequently and before they are granted, baseline blood or hormone levels should be taken in order to monitor the Athlete's Use of the Prohibited Substance.²³⁸

Others have suggested that steroids and HGH should be more readily allowed for therapeutic purposes. For example, Dallas Mavericks (a professional basketball team) owner Marc Cuban stated, "[s]teroids could have a legal and useful place in sports—as long as they are administered under a doctor's supervision to help athletes recover from injuries. . . . To me, it's just common sense."²³⁹ Similarly, a former Athlete stated, "I think anything that's useful should be legal. . . . Because when you're done, they fold you up and say goodbye."²⁴⁰

The aforementioned suggestions would allow for more conservative changes and could allow for many of the Code's articles to stay intact. There are also proponents of a complete overhaul. One such concept is called full-disclosure. As one professor put it:

Rather than ban certain substances and test for them (or their masking agents), sports leagues should simply call for all players to disclose all "non-food" substances they put into their bodies. Penalties would exist not for using drugs per se, but only for failing to disclose accurately those substances used.²⁴¹

²³⁴ See Schmalzer, *supra* note 230, at 691.

²³⁵ See *id.* at 689.

²³⁶ See *id.* at 690 (citing Information on the Biological Passport, Union Cycliste Internationale (Dec. 2007), <http://www.uci.ch/Modules/ENews/ENewsDetails.asp?id=NTQzOA>).

²³⁷ See Farrey, *supra* note 196, at ¶ 27.

²³⁸ See *id.*

²³⁹ ESPN, *Cuban Sees 'Common Sense' Steroid Use*, ¶¶ 1 & 7 (Oct. 22, 2009), <http://sports.espn.go.com/dallas/nba/news/story?id=4581839>.

²⁴⁰ See Farrey, *supra* note 196, at ¶ 32.

²⁴¹ See Rapp, *supra* note 223, at 602.

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Full-disclosure would make Athletes fill out disclosure statements as to all non-food products they ingest (or inject) on a regular basis.²⁴² Sanctions would then only be given out when Athletes have committed fraud as to what they ingest or inject and as to how much was used.²⁴³ Therefore, if an Athlete ingested a substance that was contaminated with a Prohibited Substance, there would be an explanation.²⁴⁴

Finally, there are those who would rather see zero regulation of Prohibited Substances. This is of course a very extreme view and in all likelihood the least popular suggestion. As one professor suggested, “[l]et them do drugs.”²⁴⁵ The professor’s reasoning was that Athletes have always sought a competitive edge and with constantly evolving advances, it would be almost impossible to stop doping completely.²⁴⁶ The professor added it would be entertaining to see the “naturals” versus the “juicers.”²⁴⁷

B. Reforms that Should be Made

Most of the aforementioned suggestions could and should be used in another revised Code. First, the strict liability principle set out in Article 2 must be eliminated. The principle has completely outweighed the benefits of deterrence and making sports clean from the use of PED’s and other Prohibited Substances. The biological passport system could remedy the strict liability principle. This may cost a lot of money but certainly would be beneficial in the long-run.

Second, the concept of the Prohibited List must be changed in either one of two ways. One way is the list must be made much more simplistic and include explanations of the substances. This would allow for Athletes to truly understand what they cannot take and common non-food items that may contain Prohibited Substances. The second way is the list remains as is, but it must be mandatory for Athletes to attend an annual educational seminar to learn about changes to the Prohibited List, to educate them on substances to be more careful with, and in general to make them more aware of the items they ingest. The general idea behind either reform is simplicity. It must be WADA’s burden to educate Athletes of the list, not the other way around.

Third, full-disclosure should be used due to the past abuses of

²⁴² *See id.*, at 615.

²⁴³ *See id.*

²⁴⁴ *See id.* at 616.

²⁴⁵ *See Wilson, supra* note 35, at 109.

²⁴⁶ *See id.* at 107.

²⁴⁷ *See id.* at 56.

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Prohibited Substances. Athletes should have to make mandatory disclosure statements of all non-food products they ingest or inject at the minimum, monthly. All data from the full-disclosure and the biological passport program should be submitted to ADAMS in order to analyze all data in conjunction with Testing. This may explain the reason for a positive test outside of the Athlete's control (i.e. contamination), without the need for a long hearing.

Fourth, the language for granting a TUE must be changed. The two phrases that need to be removed are “[s]ignificant impairment to health. . .” and “[n]o reasonable Therapeutic alternative . . .” The concept of what is “significant” is too vague and subjective. Additionally, “significant” is too high of a standard. A “reasonable Therapeutic alternative” is also too subjective and makes it too easy for the denial of a TUE, especially in the case of steroids and HGH.

Further, there should be WADA-accredited doctors and physicians throughout the world who may grant TUE's on a case-by-case basis instead of a TUEC. All Athletes who are given TUE's must be monitored by the WADA-accredited doctors or physicians. Athletes would have to visit a WADA-accredited doctor or physician a certain number of times, depending on the performance-enhancement capabilities of the substance and the length of the TUE.

Professional Athlete's endure physical punishment that most people cannot understand. Competition is their source of income and livelihood, they should benefit from whatever they can. Granting of a TUE must expand so that Athletes can benefit from Prohibited Substances taken in very minimal doses. The benefit would not be to make an Athlete stronger, faster, or better. It would be for faster recovery time from injuries and overall recovery from training. In the case of steroids and HGH, they should only be granted as a TUE for serious injuries and surgeries. The biological passport program and full-disclosure would assist in the regulation of TUE's so that Athletes would not abuse the system.

Finally, all Athletes should attend a seminar to be educated on the Code. This would be a one-time occurrence unless significant subsequent changes were made, in which case, Athletes would have to attend another seminar.

Some of these changes would obviously take longer than others. But if for the first time a balance could be struck between the burdens and expectations of WADA and Athletes, positive results could be seen in the foreseeable future.

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V. CONCLUSION

The primary theme throughout this note has been to create a new Code to eradicate the injustices created by it; more specifically the strict liability principle in the Code must be stricken and Athletes must be allowed to take steroids and HGH for therapeutic purposes. There must be a Code that punishes the abusers, instead of those who for example are prone to injury or those who could not understand a Prohibited List requiring a PhD to comprehend.

Reform must occur immediately. The philosophy of WADA and its followers is completely wrong. WADA has become a drug enforcement agency and wants sports to be “squeaky clean” of drugs.²⁴⁸ Athletes have become unrealistically liable for certain supplements they take and are being withheld from modern therapeutics. The battle is not against all Athletes, but against those who have abused PED's and the system. The difference must be known and revealed through a new Code. If WADA and the Code can be changed in a practical way, the rest of the world will follow suit, and the sports world will finally have its harmony.

²⁴⁸ See Melethil, *supra* note 219, at 87.

LIABILITY REGULATIONS IN EUROPEAN SUBCONTRACTING: WILL JOINT LIABILITY BE THE 21ST CENTURY EUROPEAN APPROACH?

*Matthew R. Amon**

The proliferation of Multinational Enterprises (“MNE”) in the European marketplace has been a mixed blessing. On the one hand, the decentralization and transnationalisation of European business enterprises has ushered in an impressive era of economic growth and stability in the European Union (“E.U.”).¹ MNEs can deliver substantial benefits to European Union Member States (“Member States”) by efficiently allocating labour, capital, and technology² and fostering intense competition between enterprises previously protected by national boundaries. The actual result of this brave new world of economic activity has been an “unprecedented rate of economic activity over the last quarter of a century [that] has placed a major role in raising employment levels across most economies of the European Union.”³ On the other hand, the decentralization and transnationalisation of European business enterprises has generated new regulatory, economic, and social challenges. Today’s European MNEs lack the traditional vertical integration of yesteryear, and instead take a more horizontal organizational approach, creating complex production and labor networks.⁴ Particularly, the practice of subcontracting has experienced a boom in the European Union over the past few decades.⁵ Many MNEs do not just

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¹ Motion for a European Parliament Resolution on the Social Responsibility of Subcontracting Undertakings in Production Chains, at 4, EUR. PARL. RES. 2008/2249(INI)(2008), *available at* <http://www.europarl.europa.eu/sides/getDoc.do?type=COMPARTL&mode=XML&language=EN&reference=PE415.234> [hereinafter *Motion*].

² INT’L LABOUR ORG. [ILO], TRIPARTITE DECLARATION OF PRINCIPLES CONCERNING MULTINATIONAL ENTERPRISES AND SOCIAL POLICY 2 (3d ed. 2001), *available at* <http://www.ilo.org/wcmsp5/groups/public/---dgreports/--dcomm/documents/normativeinstrument/kd00121.pdf>.

³ *Id.*

⁴ *Id.*

⁵ *Id.* at 9.

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utilize complex subcontracting chains primarily in the construction sector, “but also in other economic sectors such as the cleaning industry, transport, tourism and the shipyard industry, to name only a few.”⁶ The widespread use of subcontracting chains has raised important legal questions regarding the “legal implications of subcontracting for employers and workers, its impact on employee rights, the increased potential for social dumping and a potential avoidance of fiscal and social security responsibilities.”⁷ This note examines the recent proposal by the European Parliament’s Committee on Employment and Social Affairs (“Committee”) for new regulations imposing enterprise liability for European MNEs. The note is divided into four sections. The First Section will examine the Committee’s *Motion for a European Parliament Resolution on the Social Responsibility of Subcontracting Undertakings in Production Chains* (“Motion”) by examining its broad concepts, defining key concepts, and exploring the Motion’s recitals individually. The Second Section will examine enterprise liability laws already in place in eight Member States. The Second Section will examine each Member States’ laws and evaluate their effect and effectiveness. The Third Section will examine reactions of European social and business actors to the principal of joint liability. The Fourth Section is dedicated to conclusions.

I. THE MOTION, KEY CONCEPTS DEFINED, AND THE MOTION’S RECITALS

A. The Motion’s broad principles.

The Committee’s Motion is an eleven-page document with sweeping possibilities for the European business community. Though it mostly reiterates social and labour policies of previous E.U. resolutions and mandates, including those calling for penalties against companies that illegally employ third-country nationals⁸ and those calling for increased labour rights awareness among posted workers,⁹ the truly ground breaking recommendation is for the “[European] Commission to establish a clear-cut Community legal instrument introducing joint and several liability at the European level.” The Motion’s authors call their proposed liability regime, “[a] European ‘joint liability’ or ‘client liability’

⁶ *Id.*

⁷ *Motion, supra* note 1, at 9.

⁸ *Id.* at 6.

⁹ *Id.* at 5.

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system” that is a European solution to European problems.¹⁰ At a minimum, the Motion calls for enterprise liability for European companies, with regards to “wages, social security contributions, taxes, and damages in relation to work-related accidents.”¹¹ The Motion lacks a scienter requirement, that is, “[a] degree of knowledge that makes a person legally responsible for the consequences of his or her act or omission.”¹² Consequently, the proposed liability would not require any degree of complicity or knowledge on the part of the superior contracting party. The superior contracting party could be held jointly liable simply through association with the malfeasant subcontracting party.

According to the Motion’s authors, such a liability scheme would be a great benefit to posted workers across the European Community, would ensure that all workers, foreign or domestic, receive the agreed industry minimum, and would provide a further ‘debtor’ for aggrieved workers and governments alike that is likely more solvent.¹³ The joint liability proposal seeks to “ensure that the main contractors give greater consideration to whether the [subcontractor] is reliable and whether it intends to act in compliance with” the host nation’s wages, social security, tax, and tort laws.¹⁴ The theory underpinning the Committee’s call for joint and several liability laws is that if the upper tier company (principal contractor) can be held liable for the malfeasance of its subcontractors at any tier, the upper tier companies will have a great incentive to personally “guarantee that all subcontractors assume their corporate responsibility in respect of employee’s rights.”¹⁵

The Motion seeks to regulate the increasingly complex business links between parent companies and their web of suppliers and contractors.¹⁶ The following scenario is what the Motion might seek to address: Parent Company is a construction firm that is incorporated in and has its principal place of business in Germany. It receives a lucrative contract to construct an apartment complex in the Netherlands. Parent Company manages the project but subcontracts the work to three principal subcontractors: Finnish Electrical Subcontractor, Dutch Masonry Subcontractor, and Italian Architectural Subcontractor. The Finnish Electrical Subcontractor in turn subcontracts work to a Portuguese second tier subcontractor to install fiber optic cable. The

¹⁰ *Id.* at 9.

¹¹ *Id.* at 7.

¹² BLACK’S LAW DICTIONARY 1373 (8th ed. 2004).

¹³ *Motion, supra* note 1, at 9.

¹⁴ *Id.*

¹⁵ *Id.* at 6.

¹⁶ *Id.* at 4.

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Portuguese second tier subcontractor then hires a British company, incorporated in Seychelles, to supply laborers from Poland, Lithuania and Russia. If the British company fails to pay either the agreed minimum wage to its Lithuanian workers or the appropriate tax payments, and there was a system of enterprise liability as per the Motion's recommendation, then the Dutch government and the Lithuanian employee could hold each and every party in this subcontracting chain liable for the unpaid taxes and wages, respectively.

B. Defining Key Concepts

A contractor is generally any company that "contracts to do work or provide supplies for another [company]." ¹⁷ A general, prime or principal contractor is "[o]ne who contracts for the completion of an entire project, including purchasing all materials, hiring and paying subcontractors, and coordinating all the work." ¹⁸ A subcontractor is, generally: "[o]ne who is awarded a portion of an existing contract by a contractor." ¹⁹ The practice of subcontracting is sometimes referred to as outsourcing. The process creates a triangular employment relationship with three principal partners: 1. The client who orders the work; 2. The principal contractor who in part performs some work and in part outsources part or all of the work from the client; and 3. The subcontractor who receives the work from the contractor, and then either performs that work or in part outsources it to another lower tier of subcontractor.

Triangular employment relationships are becoming increasingly vital to today's economy. Outsourcing is now widely recognized for the competitive advantages it provides, as reflected in the rapidly growing rates of outsourcing around the world. Many business functions are outsourced for various reasons: to streamline processes, remove burdens, cut costs, etc. There are numerous identifiable forms of outsourcing, such as sub-contracting, employee leasing, and the use of temp agencies and service agencies, as well as various integrated corporate networks and franchising agreements. ²⁰

¹⁷ BLACKS LAW DICTIONARY 350 (8th ed. 2004).

¹⁸ *Id.* at 351.

¹⁹ *Id.* at 1464.

²⁰ Yuval Feldman, *Ex-Ante vs. Ex-Post: Optimizing State Intervention in Exploitive Triangular*

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According to empirical studies, outsourcing can be divided into two types:

The first type tends to build up a network of contractual arrangements, namely service contracts, that concern specific phases or pieces of production to be done outside the firm's premises; by contract the second type of outsourcing involves enterprise contracts with an intermediary agency for the supply of a certain number of workers to work within that undertaking.²¹

Joint and several liability is:

liability that may be apportioned either among two or more parties or to only one or a few select members of the group, at the adversary's discretion. Thus, each liable party is individually responsible for the entire obligation, but a paying party may have a right of contribution and indemnity from nonpaying parties.²²

Joint and several liability is a concept often used interchangeably with *enterprise liability* and *chain liability*, albeit incorrectly. Joint and several liability generally references liability between immediately contracting parties in one segment of the contracting chain. Whereas chain liability "applies not only in relation to the contracting party, but also to the *whole chain*. In this case, the Inland Revenue may address all parties in the chain for the *entire debt* of a subcontractor (emphasis added)."²³

It is helpful to think of subcontracting as links in a chain. The client resides at the top of the chain. The client, either an individual or a business entity, is the ultimate recipient and beneficiary of a contracted-for work. Typically, the client contracts with a principal contractor, the next link in the subcontracting chain, for work to be done. Any further links are merely sub or

Employment Relationships, 30 COMP. LAB. L. & POL'Y J. 751, 752 (2009).

²¹ Luca Ratti, *Agency Work and the Idea of Dual Employment: A Comparative Perspective*, 30 COMP. LAB. L. & POL'Y J. 839 (2009).

²² BLACKS LAW DICTIONARY 933 (8th ed. 2004).

²³ MIJKE HOUWERZIJL & SASKIA PETERS, LIABILITY IN SUBCONTRACTING PROCESSES IN THE EUROPEAN CONSTRUCTION SECTOR, EUROPEAN FOUND. FOR THE IMPROVEMENT OF LIVING AND WORKING CONDITIONS 2 (2008), available at <http://www.eurofound.europa.eu/pubdocs/2008/94/en/1/EF0894EN.pdf> [hereinafter *Eurofound*].

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intermediary contractors or temporary work agencies. The various “links” are bound together in a subcontracting chain. When liability is joint and several, it is generally limited to two immediately bound links. Where liability is chain, the aggrieved party can seek redress from any link in the entire chain. This note will generally use the term *joint liability* to refer to laws that hold the superior contracting party at least partially liable for the malfeasance of another party in the contracting chain, unless the cited legislation specifically calls for chain or joint and several liability.

C. Examination of the Motion’s Recitals

Prior to an in-depth discussion of joint and several liability, a thorough analysis of the Motion’s recitals is in order. The recitals begin with citations to eighteen articles, resolutions, motions, and court cases that purportedly justify the call for a motion on the social responsibility of subcontracting undertakings in production chains. The eighteen citations appear immediately prior to fifteen paragraphs that provide concise justifications for the twenty seven-point motion. The following paragraphs analyze those recitals that address the issue of joint liability in subcontracting chains.

The Motion’s recitals cite both the International Labour Office’s *Tripartite Declaration of Principles Concerning Multinational Enterprises and Social Policy* (“Tripartite Declaration”) and the Organization for Economic Cooperation and Development’s (“OECD”) *Guidelines for Multinational Enterprises* (“Guidelines”).²⁴ Together, these two documents constitute what the European Parliament labeled, “the two most authoritative internationally agreed sets of standards for corporate conduct.”²⁵ Both the Tripartite Declaration and the OECD’s Guidelines address concerns posed by the flourishing of MNEs, and through logical extension, the practice of subcontracting. Both documents stress that MNEs play an important role in modern business. “Through international direct investment and other means . . . [MNEs] can bring substantial benefits to home and host countries by contributing to the more efficient utilization of capital, technology, and labour.”²⁶ The Guidelines note however “[t]oday’s competitive forces are intense and multinational enterprises face a variety of legal, social, and regulatory settings. In this context, some enterprises may be tempted to gain an

²⁴ *Motion*, *supra* note 1, at 3.

²⁵ European Parliament Resolution of 13 March 2007 on Corporate Social Responsibility: A New Partnership, 2007 O.J. (C 301E) 45, 46, *available at* <http://eur-lex.europa.eu/JOHtml.do?uri=OJ:C:2007:301E:SOM:EN:HTML> [hereinafter *C301E*].

²⁶ *ILO*, *supra* note 2, at 2.

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unfair competitive advantage.”²⁷ The Tripartite Agreement states that the challenges posed by MNEs to workers’ rights and host governments are best addressed through laws and policies adopted through cooperation between governments.²⁸ The Guidelines similarly call for international cooperation.²⁹ Though neither document proposes joint liability regulations for MNEs, the principles espoused in the documents emphasize the need for international cooperation and regulation of MNEs to better balance the needs of governments, the rights of workers, and the dynamic nature of MNEs.

Similarly, the Motion’s recitals recall Article 39 of the European Community Treaty, which concerns the movement of workers across the European Community.³⁰ It prohibits discrimination against workers based on nationality, and secures their right to seek and accept employment offers in the various E.C. states.³¹ The immediately preceding recital references Article 31(1) of the Charter of Fundamental Rights of the European Union (“Charter”).³² The Charter’s preamble emphasizes a balance between freedom of enterprise, the rights of individuals, and the stability of public authorities.³³ Article 31, *Fair and Just Working Conditions*, particularly emphasizes the right of European workers to “working conditions, which respect his or her health, safety, and dignity.”³⁴ Taken together with the Guidelines and the Tripartite Agreement, by citing Article 39 of the E.C. Treaty and Article 31(1) of the Charter, the Committee has not only emphasized the benefits offered by MNEs, particularly the free flow of labour between the E.C. states, but also cautioned that the rights of workers and needs of states must be balanced against those benefits.

The recital referencing the proposal for a directive of the European Parliament and the Council providing for sanctions against employers of illegally staying third-country nationals is particularly applicable to the Motion. Like the Motion, COM(2007) 249 (“COM 2007”) addresses a community-wide concern by holding principal employers responsible even where the infringing

²⁷ ORG. FOR ECON. CO-OPERATION & DEV [OECD], OECD GUIDELINES FOR MULTINATIONAL ENTERPRISES 10 (2008), available at <http://www.oecd.org/dataoecd/56/36/1922428.pdf>.

²⁸ ILO, *supra* note 2, at 2.

²⁹ OECD, *supra* note 27, at 5.

³⁰ Consolidated Versions of the Treaty on European Union and of the Treaty Establishing the European Community, 2006 O.J. (C 321) 57 [hereinafter *C321*].

³¹ *Id.* at 57, 58.

³² *Motion, supra* note 1, at 3.

³³ Charter of Fundamental Rights of the European Union, 364/01, 2000 O.J. (C 364) 1, 8 [hereinafter *C364*].

³⁴ *Id.* at 15.

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party is a subcontractor.³⁵ COM 2007 addresses the problem of illegal immigration by punishing business enterprises that employ and take advantage of the illegal immigrants.³⁶ This concern for illegally employed third-country nationals and the business environment in the applicable member state is as also found in the Motion: “Illegal employment . . . leads to losses in public finances, can depress wages and working conditions, may distort competition between businesses and means that undeclared workers will not benefit from health insurance and pension rights that depend on contributions.”³⁷ The proposal calls for a directive that sanctions employers, not the illegally employed workers. Furthermore, under Article 9 of the proposal: “To the extent that a financial penalty cannot be recovered from a subcontractor it should be recoverable from other contractors in the chain of subcontracting, up to and including the main contractor.”³⁸ Sanctions include fines and exclusions from public subsidies or contracts.³⁹ The proposal advances the principle of subsidiarity; that for the directive to be effective, it must be community wide and uniform.⁴⁰

In 2007, the European Parliament and the Council of the European Union published its own proposal providing for sanctions against employers of illegally staying third-country nationals. The proposal’s new Article 9 concerning subcontracting goes further than the previous proposal and requires that “Member States shall ensure that the main contractor and any immediate subcontractor” be liable for sanctions and back payments to workers.⁴¹ Furthermore, “[t]he main contractor and any intermediate subcontractor shall under paragraph 1 be liable jointly and severally, without prejudice to the provisions of national law concerning the rights of contribution or recourse.”⁴² Taken together with the Motion, it becomes clear that the European Union is increasingly considering legislation that uniformly binds the entire Community in sanctioning principal contractors for the malfeasance of their subcontractors. It is important to note that there is no scienter requirement in either L80/29 or the Motion. Consequently, the Principal could be held liable, regardless of

³⁵ *Proposal for a Directive of the European Parliament and of the Council Providing for Sanctions Against Employers of Illegally Staying Third-Country Nationals*, at 10, COM (2007) 249 final (May 16, 2007), available at http://ec.europa.eu/prelex/detail_dossier_real.cfm?CL=en&DosId=195730 [hereinafter *COM249*].

³⁶ *Id.* at 2.

³⁷ *Id.* at 2.

³⁸ *Id.* at 10.

³⁹ Council Directive 2002/14, 2002 O.J. (L 80) 6 (EC) [hereinafter *Directive 2002*].

⁴⁰ *Id.* at 6.

⁴¹ *Id.* at 18.

⁴² *Id.* at 18.

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whether the corporate veil is pierced or whether the principal contractor is at fault.

The Motion also cites the European Parliament's resolution of 13 March 2007 on corporate social responsibility ("2006/2133"),⁴³ which states that "increasing social responsibility by business, linked to the principle of corporate accountability, represents an essential element of the European social model, Europe's strategy for sustainable development, and for the purposes of meeting the social challenges of economic globalization."⁴⁴ Furthermore, 2006/2133 provides that "companies should not be considered a substitute for public authorities when these fail to exercise control over compliance with social . . . standards."⁴⁵ The motion goes on to state that in the transnational context, European companies should be held responsible for the activities of their subcontractors.⁴⁶

In addition, the Motion cites the European Community's Green Paper, *Modernising labor law to meet the challenges of the 21st century* ("Green Paper"), which purports to launch a debate concerning how E.U. labour law can balance modern business trends and organization with the Lisbon Strategy's objective of achieving sustainable growth.⁴⁷ According to the Green Paper, European labour markets are challenged to combine "greater flexibility with the need to maximize [job] security for all. The drive for flexibility in the labour market has given rise to increasingly diverse contractual forms of employment, which can differ significantly from the standard contractual model in terms of the degree of employment."⁴⁸ Like the OECD's Guidelines, the Green Paper attributes technological progress, globalization and a changing economy as factors driving the changes to the traditional employment model.⁴⁹ These factors push European businesses to develop a wide variety of employment contracts.⁵⁰ "Non-standard as well as flexible standard contractual arrangements have enabled businesses to respond swiftly to changing consumer trends, evolving technologies and new opportunities for attracting and retaining a more diverse workforce through better job matching between supply and demand."⁵¹ However, the Green Paper notes that the new contractual

⁴³ *Motion, supra* note 1, at 3.

⁴⁴ *C301E, supra* note 25, at 48.

⁴⁵ *Id.* at 48.

⁴⁶ *Id.* at 51.

⁴⁷ *Commission Green Paper on Modernising Labour Law to Meet the Challenges of the 21st Century*, at 3, COM (2006) final 708 (Nov. 11, 2006) [hereinafter *Green Paper*].

⁴⁸ *Id.*

⁴⁹ *Id.*

⁵⁰ *Id.*

⁵¹ *Id.* at 7.

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arrangements also push European businesses to avoid employment protection rules, social security contributions, industry specific wage minimums, etc.⁵² This is particularly true in extended chains of subcontracting.⁵³ In response, “[s]everal Member States have sought to address such problems by making principal contractors responsible for the obligations of their subcontractors under a system of joint and several liability. Such a system encourages principal contractors to monitor compliance with employment legislation on the part of their commercial partners.”⁵⁴ In response to Question 9 concerning three-way employment relationships and the question of joint and several liability, the Communication *Outcome of the public consultation on the Commission’s Green Paper “Modernising labour law to meet the challenges of the 21st century,”* the European Parliament

highlighted the need to regulate joint and several liability for principal undertakings to deal with abuses in subcontracting and outsourcing in the interests of ensuring a level playing field for companies in a transparent and competitive market.⁵⁵

The response notes that Member States were split on the question of subsidiary liability; some supporting new liability rules and other expressing satisfaction with existing laws.⁵⁶

Finally, the Motion cites the case of *Wolff & Muller GmbH & Co. KG v. Jose Filipe Pereira Felix*, referred by the German courts to the European Court of Justice (“ECJ”), which decided the case in October 2004.⁵⁷ The Court held, in part, that national laws providing that a subcontractor is a guarantor for the minimum remuneration of their subcontractors’ employees is not, *per se*, violative of Directive 96/71 (concerning the posting of workers in the framework of the provision of services).⁵⁸ According to the Court:

Article 5 of Directive 96/71 ‘does not preclude a national system whereby, when subcontracting the conduct of building work to an undertaking established in another Member State, a building contractor in another Member State concerned

⁵² *Id.*

⁵³ *Id.* at 13.

⁵⁴ *Id.*

⁵⁵ *Id.* at 8.

⁵⁶ *Id.* at 8.

⁵⁷ Case C-60/03, *Wolff & Muller GmbH v. Felix*, 2004 E.C.R. I-9553 [hereinafter *Wolff*].

⁵⁸ *Id.*

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becomes liable, in the same way as a guarantor who has waived the defence of prior recourse, for the obligation on that undertaking or that undertaking's subcontractors to pay the minimum wage to a worker employed by the latter or to pay contributions to a joint scheme for parties to a collective agreement where the minimum wage means the sum payable to the worker after deduction of tax, social security contributions, payments towards the promotion of employment or other such social insurance payments (net pay), even if the safeguarding of workers' pay is not the primary objective of the national legislation concerned or is merely a subsidiary objective.⁵⁹

Mr. Pereira Felix was a citizen of Portugal who worked for a Portuguese subcontractor as a bricklayer at a building site in Berlin, Germany.⁶⁰ The Portuguese subcontractor worked for Wolff & Muller GmbH ("Wolff & Muller"), a German company.⁶¹ Mr. Felix brought suit against both his Portuguese employer and Wolff & Muller to recover disputed wages from them jointly and severally.⁶² Mr. Felix claimed that Wolff & Muller was jointly and severally liable for the DEM 4,019.23 in unpaid remuneration because Wolff & Muller was a guarantor of his wages under Paragraph 1(a) of the *Arbeitnehmer-Entsendegesetz* (law on the posting of workers or "AEntG"). Under the AEntG:

[a]n undertaking which appoints another undertaking to provide building services within the meaning of Paragraph 211(1) of the third book of the *Sozialgesetzbuch* ["SGB III"] is liable, in the same way as a guarantor who has waived the defense of prior recourse, for the obligations of that undertaking, of any subcontractor. . . concerning payment of the minimum wage.⁶³

Wolff & Muller countered that it was not liable under the AEntG in part because Paragraph 1(a) violates Article 49 of the E.C. Treaty on the freedom of movement of services.⁶⁴ The ECJ agreed with the petitions filed by the German, Austrian, and French governments and the European Commission that

⁵⁹ *Id.*

⁶⁰ *Id.*

⁶¹ *Id.*

⁶² *Id.*

⁶³ *Id.*

⁶⁴ *Id.*

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“liability as a guarantor certainly provides workers with a genuine benefit that contributes to their protection. Workers are given another party, in addition to their employer, against whom they can pursue their claims for net wages under national legislation.”⁶⁵

The legal underpinning of the decision is as follows: Under Article 5 of Directive 96/71, the E.U. required that Germany adopt national legislation ensuring that there were adequate protections for posted workers to seek redress, as in the case of unremunerated pay.⁶⁶ Article 5 grants Germany a wide berth in fashioning its own national legislation for an aggrieved posted worker to seek redress.⁶⁷ Paragraph 1(a) AEntG does not fall outside that wide scope.⁶⁸

Noticeably absent from the *Wolff & Muller* decision on the chain liability of national legislation in the E.U. Member States is a scienter requirement. That is, neither the courts nor the legislatures place a high importance on the concept of complicity on the part of the client or principal contractor as an element of the offense. Thus, the principal contractors are held to a strict liability. They are responsible to the some degree for the malfeasant acts of the subcontractors regardless of whether the corporate veil was pierced. The situation is reminiscent of the holding in *Union Carbide v. Union of India*,⁶⁹ often referred to as the Bhopal Case. In the Bhopal Case, the government of India, representing thousands of Indian national plaintiffs, brought suit against Union Carbide Corporation (“UCC”), an American corporation, in Bhopal District Court in India under a theory of multinational enterprise liability.⁷⁰ The Indian courts found against UCC, despite a dearth of evidence that either UCC exercised any considerable control over the pesticide factory at dispute or that UCC had pierced the corporate veil.⁷¹ Despite evidence to the contrary, the courts found that UCC had in fact kept itself at arms length from its subsidiary Union Carbide India, Ltd. However, that did not protect UCC from liability.⁷² The Bhopal Case is worth consideration in the context of the Motion, because in the Bhopal Case, liability was assigned without a strong scienter requirement. In both situations, liability for the malfeasance of one company is imposed on an otherwise distinct legal entity,

⁶⁵ *Id.*

⁶⁶ *Id.*

⁶⁷ *Id.*

⁶⁸ *Id.*

⁶⁹ *Union Carbide Corp. v. Union of India*, A.I.R. 1990 S.C. 273 [hereinafter *Union Carbide*].

⁷⁰ DETLEV F. VOGTS ET AL., *TRANSNATIONAL BUSINESS PROBLEMS* 194-95 (Foundation Press 4th ed. 2008).

⁷¹ *Id.* at 196.

⁷² *Id.*

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through no fault of its own.

In the Motion's recitals, the Committee makes a strong argument for joint liability regulations as a European response to abuses in subcontracting. Taken together, the recitals demonstrate that precedent exists for joint liability regulations and that some E.U. Member States already have such regulations, a lack of uniformity across the E.U. impedes their ability to function succinctly. It now becomes appropriate to isolate the studies conducted by the European Foundation for the Improvement of Living and Working Conditions, cited prominently in the Motion's recitals.

II. JOINT LIABILITY LAWS IN EIGHT MEMBER STATES

A. The Eurofound Report

The Motion prominently cites a series of reports by the European Foundation for the Improvement of Living and Working Conditions ("Eurofound").⁷³ Eurofound's main report, *Liability in subcontracting processes in the European construction sector* addresses the legal implications of subcontracting in Europe, and surveys various Member States' liability laws.⁷⁴ Specifically, Eurofound focuses on eight Member States' laws: Austria, Belgium, Finland, France, Germany, Italy, the Netherlands and Spain.⁷⁵ The Eurofound reports offer the most comprehensive and recent survey of E.U. Member State liability laws, and its findings will constitute the bulk of section two of this note.

According to the Eurofound report, there has been a boom in subcontracting practices in Europe over the past twenty-five years.⁷⁶ Though the report cites three different subcontracting trends, at the core of each is a principal organization utilizing smaller businesses to perform the actual contracted for work.⁷⁷ Over time, the chains linking subcontractors and other workers to their principal employers have become increasingly long and complicated.⁷⁸ "The growing use of subcontracting for labour intensive segments of the execution of construction projects does not necessarily lead to a deterioration of the working conditions, *but it certainly has created a decrease*

⁷³ *Motion, supra* note 1, at 4.

⁷⁴ *EUROFOUND, supra* note 23, at 1.

⁷⁵ *Id.*

⁷⁶ *Id.* at 4.

⁷⁷ *Id.*

⁷⁸ *Id.*

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of the direct social responsibility of the principal contractor (emphasis added).⁷⁹ Abuses naturally sprung from this decreased direct responsibility. The Eurofound report cites an example from the Union of Construction, Allied Trades and Technicians (“UCATT”) in the United Kingdom (“UK”), where a principal contractor paid a dozen Lithuanian subcontractors below minimum wages, failed to pay overtime and charged the workers for their rent, tools and utilities.⁸⁰ “The steadily evolving integration of the Member States’ economies in the internal market of capital, goods, services, and persons – together with the recent EU enlargements – have also led to the greater movement of workers across countries.”⁸¹ The lower end of subcontracting chains tends to be filled with foreign companies posting foreign workers who may be particularly vulnerable to abuse.⁸² The Eurofound report cites for example, the case of ZRE Katowicz Ireland Construction Ltd., which had been contracted by a German:

enterprise to carry out scaffolding work on a large contract, which the German company had with the Irish power plant operator, the Electricity Supply Board . . . for the €380 million refurbishment of its plant. When the German company discovered that ZRE had not been complying with the Irish employment law, it terminated its contract, forcing ZRE to dismiss 200 of it[s] Polish employees.⁸³

It is in this context that the European Union and particularly the European Parliament took up the question of joint and several liability for principal contractors, as an effective compliance tool to protect Member State and Community law.⁸⁴

Joint liability laws in subcontracting chains date back to the 1960s and 1970s for Italy, the Netherlands, Belgium, Finland and France.⁸⁵ Spain, Austria and Germany followed suit in the 1980s and 1990s.⁸⁶ “The regulations were introduced in order to prevent the abuse of employee’s rights and the evasion of rules, as well as to combat undeclared work and illegal unfair business competition.”⁸⁷ Some Member States (Austria, France and Italy) developed

⁷⁹ *Id.*

⁸⁰ *Id.*

⁸¹ *Id.*

⁸² *Id.*

⁸³ *Id.* at 5.

⁸⁴ *Id.*

⁸⁵ *Id.* at 1.

⁸⁶ *Id.*

⁸⁷ *Id.*

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legislation to prevent cross-border dumping in the construction sector, while the other Member States developed laws to protect at least two of the following: social security contributions, taxes on wages, and minimum wages.⁸⁸ “Sanctions for parties who do not abide the liability rules fall under three main categories across the eight Member States: back-payment obligations, fines, and/or alternative additional penalties.”⁸⁹ Additionally, Eurofound cites various preventative measures that are in place in all Member States except Belgium. These measures include requirements for the principal company to check the reliability of subcontractors and various measures to “guarantee the payment of wages, social security contributions, and wage tax.”⁹⁰ The following sections will examine the existing laws in eight E.U. Member States, including the laws’ historical context, their breadth and scope, and their effectiveness.

B. AUSTRIA

Generally, under Austrian law, “the principal contractor to a job maintains an element of responsibility for the wages of employees in a subcontracting chain.”⁹¹ Austria first introduced legislation concerning the liability of principal contractors for the malfeasance of subcontractors in the 1990s.⁹² The Austrian parliament considered the legislation in light of problems suffered by their northern neighbor, Germany.⁹³ In post-unification Germany, “social dumping in the construction sector was becoming a major problem with regard to foreign companies and workers.”⁹⁴ Like Germany, Austria is a high wage country surrounded by low wage countries like the Czech Republic, Hungary, Slovenia and Slovakia.⁹⁵ Consequently, “it is very attractive for [non Austrian] companies to operate in Austria using their own workers who receive wages at the level of their country of origin.”⁹⁶ The Austrian government and various Austrian labor groups argued that this would depress wages and

⁸⁸ *Id.* at 2.

⁸⁹ *Id.*

⁹⁰ *Id.*

⁹¹ Walter Gagawczuk, *Liability in Subcontracting Processes in the European Construction Sector: Austria*, in EUROPEAN FOUNDATION FOR THE IMPROVEMENT OF LIVING AND WORKING CONDITIONS 1 (2008), available at <http://www.eurofound.europa.eu/pubdocs/2008/871/en/1/ef08871en.pdf> [hereinafter *Eurofound Austria*].

⁹² *Id.*

⁹³ *Id.*

⁹⁴ *Id.* at 2.

⁹⁵ *Id.*

⁹⁶ *Id.*

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generally disrupt the labor market in Austria.⁹⁷ Prior to the introduction of legislation in 1995, various Austrian ministries and their various labor and business social partners discussed two key issues:

1. Whether Austrian Associations (*Verbandsklage*) could seek judicial remedies in collective suits; and
2. Whether any legislation should sanction employers that pay less than the industry minimum wage.⁹⁸

In 1995, the Austrian parliament introduced the *Antimissbrauchgesetz* (“Anti-Abuse Act”), which contained §7(2)(2) – *Arbeitsvertragsrecht-Anpassungsgesetz* (Employment Contract Law Amendment Act or “AVRAG”).⁹⁹ The provision was later amended with §§7a(2) and 7c, and came into force in 1999.¹⁰⁰ According to Eurofound, “[t]he main objective of the liability provisions – the old Article 7 AVRAG and the new articles 7a(2) and 7c AVRAG is to combat non-payment and abuse of employees in the context of cross-border subcontracting practices and thus avoiding potential cases of social dumping and illegal business competition.”¹⁰¹ Section 7a(2) applies exclusively to cross-border posted workers where the principal contractor’s corporate seat is outside the European Union.¹⁰² Section 7c AVRAG applies to principal contractors whose principal corporate seats are located within the E.U.¹⁰³ Thus every business is within the AVRAG’s reach. Section 7c(2) is similarly applicable in public procurement contracts where the principal contractor subcontracts at least part of the work to a subcontractor.¹⁰⁴ Under the *Bundesvergabegesetz* (Federal Public Procurement law or “BVergG”), the principal contractor can subcontract the work where the subcontractors are capable, competent and have a: “certain reliability.”¹⁰⁵ Thus, the principal contractor is responsible for ascertaining the subcontractor’s credentials, which can be readily accomplished by referencing a register of subcontractors called

⁹⁷ *Id.*

⁹⁸ *Id.*

⁹⁹ *Id.* at 1.

¹⁰⁰ *Id.* at 4.

¹⁰¹ *Id.*

¹⁰² *Id.*

¹⁰³ *Id.* at 2.

¹⁰⁴ *Id.* at 6.

¹⁰⁵ *Id.*

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the *Auftragnehmerkataster Oesterreich* (“ANKO”).¹⁰⁶

Overall, most interested parties consider Austria’s liability legislation for subcontractors to be ineffective.¹⁰⁷ The Eurofound report cites three principal reasons for this opinion:

Enforcement of the few known rules is left solely to the employee and their legal representative;

The provisions do not apply in the case of bankruptcy of the subcontractor;

As liability is restricted to the highest level of the chain, the employee has to prove that the principal contractor was aware of an unreliable subcontractor some levels further down the chain, which is almost an impossible task. At best, the rules have a rather modest preventive impact on the behavior of the principal contractor when choosing subcontractor(s).¹⁰⁸

First, the provisions are private law, so no public ministries like the *Arbeitsinspektorat* (“Labour Inspectorate”) are charged with enforcing the legislation.¹⁰⁹ Consequently, private parties, such as an aggrieved employee or posted worker (and perhaps his advocate from a group like the *Oesterreichischer Gewerkschaftsbund* “Austrian Trade Union Federation”), the employer(s), (sometimes through their representatives like the *Wirtschaftskammer Oesterreich* “Austrian Federal Economic Chamber”), and the courts are involved.¹¹⁰

Furthermore, the AVRAG contains several loopholes through which principal contractors can avoid liability. “[§7c AVRAG] states in its fifth paragraph that the liability is not applicable if the subcontractor is insolvent . . . Furthermore, according to the dominant interpretation, the liability arrangement is restricted to the highest level of the [subcontracting] chain.”¹¹¹ Lastly, even where an employee can legitimately bring suit for lost wages, overtime, etc., he would not seek it from the subcontracting chain, but rather from the Austrian

¹⁰⁶ *Id.* at 7.

¹⁰⁷ *Id.* at 14.

¹⁰⁸ *Id.*

¹⁰⁹ *Id.* at 8.

¹¹⁰ *Id.*

¹¹¹ *Id.* at 9.

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Insolvenzausfallgeldfonds – a fund for the protection of employees should their employer go bankrupt.¹¹² Arguably, the most effective Austrian legislation is §7a(2) AVRAG, which commands joint and several liability without reservation.¹¹³ However, §7a(2) AVRAG applies only to principal contractors having a principal place of business outside of the E.U.¹¹⁴ Despite the strict joint and several liability restrictions, there are many practical barriers for a foreign worker to actually bring suit against the subcontracting chain, including the lack of legal representation, language barriers, and a general fear of losing future employment.

C. BELGIUM

“Belgium does not have a framework on liability in subcontracting processes. Liability is established mainly in the constructor sector. . . pursuant to Article I of the Royal Decree of 27 December 2007. . . The liability covers taxes on wages, social security contributions and social fund payments.”¹¹⁵ Belgium’s liability laws on subcontracting practices date back to the 1970s. They were largely in reaction to the public alarm over the so-called gangmasters, and the aberrant contractors who employed, sometimes, thousands of workers but failed to pay social security contributions or taxes on wages.¹¹⁶ The legislation, then as now, principally targeted the construction sector, where most of the infractions took place.¹¹⁷ In response to these labor abuses, the *Federale Overheidsdienst Financien* (“Federal Public Service Finance”) proposed banning the practice of subcontracting entirely.¹¹⁸

The liability on foreign and domestic contractors and subcontractors alike was joint and several.¹¹⁹ Furthermore, Belgian law required the principal contractor to notify the relevant ministries that it was using subcontractors.¹²⁰ All contractors were strongly urged to register with the appropriate provincial

¹¹² *Id.*

¹¹³ *Id.*

¹¹⁴ *Id.*

¹¹⁵ Jan Buelens, *Liability in Subcontracting Processes in the European Construction Sector: Belgium*, in EUROPEAN FOUNDATION FOR THE IMPROVEMENT OF LIVING AND WORKING CONDITIONS 1 (2008), available at <http://www.eurofound.europa.eu/pubdocs/2008/872/en/1/ef08872en.pdf>.

¹¹⁶ *Id.* at 1-2.

¹¹⁷ *Id.* at 1.

¹¹⁸ *Id.*

¹¹⁹ *Id.* at 12.

¹²⁰ *Id.* at 3.

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registration concern.¹²¹ Under the Royal Decree of 27 December 2007, contractors could register if they met defined registration requirements, such as a lack of bankruptcies, a demonstration of a strong financial situation, and the absence of previous violations of social, tax and wage obligations.¹²² Contractors that successfully registered enjoyed certain tax and subsidy benefits. Furthermore,

the client and principal contractor were jointly liable for the debts of the contracting part. . . if the contracting party was not registered. In case of non-registration, the contracting party had to make certain deductions and pay them into the social and tax administration. After these deductions had been made, the client and principal contractor remained liable only for the outstanding sum of money.¹²³

The European Court of Justice ushered in the current liability laws when it rendered its decision on November 9, 2006 in the matter of *Commission v. Belgium*.¹²⁴ “The ECJ ruled that the Belgian system regarding tax on wages violated the freedom to provide cross-border services within the European Union . . . as stipulated in articles 49 and 50 of the EC Treaty, because the obligatory nature of the registration system could have a deterrent effect on foreign companies.”¹²⁵ Consequently, Belgium passed new legislation (“Article 30bis Law 27 June 1969, as amended by the Law of 27 April 2007; Article 400 and those that followed of the Direct Income Code”)¹²⁶ that went into effect in 2008, that severed the link between registration and liability. Furthermore, the liability is no longer chain, but rather contractual.¹²⁷ “If a contracting party fails to meet their [social security, tax, and social fund] obligations, the administration first has to invoke the liability on the other party. The administration can address the next level in the chain only if this party also fails to meet its obligations.”¹²⁸ The principal contractor must only withhold a percentage of payments to the subcontractors if the latter has outstanding social or tax debts.¹²⁹ Principal contractors may be subject to a small fine if they fail

¹²¹ *Id.*

¹²² *Id.*

¹²³ *Id.*

¹²⁴ *Id.* at 3; *Commission v. Belgium*, 2006 O.J. (C 433) 4.

¹²⁵ *Id.*

¹²⁶ *Id.* at 3.

¹²⁷ *Id.*

¹²⁸ *Id.* at 12.

¹²⁹ *Id.*

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to make these withholdings where appropriate, and may also be liable to a surcharge equal to the withholding amount.¹³⁰

According to Eurofound, Belgians are conflicted on the effectiveness of their pre and post 2006 EJC ruling liability legislation.¹³¹ The social actors interviewed in the report generally agreed that the pre-EJC ruling legislation effectively reduced fraud by giving all contracting parties a strong incentive to register, and thus met good business practice standards.¹³² However, the social actors also expressed frustration with the complicated nature of the old (and new) regulations.¹³³ Eurofound states that though the new liability regulations are too recent to adequately evaluate, many social actors have expressed doubts on feasible enforcement because there is no longer an incentivizing link between registration and liability. Furthermore, “the ministry has experienced problems acting against foreign companies, which are often used as buffers between the Belgian client or principal contractor and the Belgian subcontractor.”¹³⁴ Though time will tell the effectiveness of the new liability rules, the early results indicate that Belgium considered its older liability regime to be more effective.

D. FINLAND

Finnish liability laws are primarily applicable to its construction industry.¹³⁵ The rules are found in both Finland’s Penal Code and Collective Labour Agreements (“CLA”).¹³⁶ The rules cover wage tax and social security contributions, “but are essentially informative and meant to promote a sound economy but do not include a real monetary liability of the principal contractor for the obligations of the subcontractors.”¹³⁷ Finnish liability laws are relatively recent. The latest and most applicable legislation came into force in 2007 (Law 2006/1233 or “Liability Act”).

The Liability Act principally applies to building services across the

¹³⁰ *Id.* at 6.

¹³¹ *Id.* at 8.

¹³² *Id.* at 8-9.

¹³³ *Id.* at 9.

¹³⁴ *Id.*

¹³⁵ Jari Hellsten, *Liability in Subcontracting Processes in the European Construction Sector: Finland*, in EUROPEAN FOUNDATION FOR THE IMPROVEMENT OF LIVING AND WORKING CONDITIONS 1 (2008), available at

<http://www.eurofound.europa.eu/pubdocs/2008/873/en/1/ef08873en.pdf>.

¹³⁶ *Id.*

¹³⁷ *Id.*

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contractual chain, from builders to repairmen to developers.¹³⁸ However, liability is not chain. Instead, the Liability Act imposes “liability throughout the chain but only in relation to the contracting partner.”¹³⁹ Thus, a contractor would only be liable for the most immediate subcontractor’s party. In Finland:

A building project is legally seen as simply a pyramid of independent commercial service contractors, in which each contracting party has its own responsibilities. It is not considered an interrelated chain in which all parties have a share in the same project and which therefore justifies more responsibilities such as chain liability for the client and/or principal contractor.¹⁴⁰

This liability is nationwide and applicable to foreign subcontractors.¹⁴¹ The principal requirement of the Liability Act is that the main contractor investigates and assesses the reliability of their subcontractor.¹⁴² Furthermore, the Liability Act imposes a negligence fee on the principal contractor when it fails to perform the necessary background checks on the subcontractor pursuant to Section 5 of the Liability Act.¹⁴³ The Liability Act does not impose back-payment obligations on the principal contractor.¹⁴⁴

The CLEs date back to the 1970s, much further than the Liability Act.¹⁴⁵ The CLEs are private agreements between contracting parties. They are essentially moral obligations that the principal contractor will be a guarantor of the subcontractor’s employees’ wages.¹⁴⁶ Consequently, the obligation is not sanctioned, and depends entirely on internal discipline and self-regulation.¹⁴⁷ “The liability is not applicable to non-organised principal contractors . . . [and] actions against non-organised principal contractors seldom occur.”¹⁴⁸

Finally, a provision in the Finnish Penal Code can be interpreted as imposing chain liability in subcontracting operations. Under Chapter 10 §2(1) of the Penal Code, “anyone benefitting from a criminal offense, such as work

¹³⁸ *Id.* at 5.

¹³⁹ *Id.*

¹⁴⁰ *Id.*

¹⁴¹ *Id.* at 7.

¹⁴² *Id.*

¹⁴³ *Id.*

¹⁴⁴ *Id.* at 12.

¹⁴⁵ *Id.* at 7.

¹⁴⁶ *Id.* at 8.

¹⁴⁷ *Id.*

¹⁴⁸ *Id.* at 3.

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discrimination or discrimination on the grounds of national origin for profiteering purposes, both due to illegally low wages, may become subject to forfeiture.”¹⁴⁹ A general amendment was added to the penal code in 2001, “making it now possible to direct the confiscation against a principal contractor or client benefitting from the payment of illegally low wages.”¹⁵⁰

Eurofound concluded that the liability provisions currently in place in Finland are generally accepted by the relevant social actors and play a limited preventative role in combating fraud in subcontracting.¹⁵¹ Though various labour and trade union organizations would prefer more stringent chain liability provisions,¹⁵² Eurofound notes that profound opposition to such measures from the Finnish business community is likely to prevent its implementation in the near future.¹⁵³ Furthermore, since the Liability Act is very recent, a full evaluation of its effectiveness is not currently possible.¹⁵⁴ Thus, the Finnish position is likely to be a wait and see one with regards to E.U. legislation.

E. FRANCE

French liability in subcontracting chain laws date back to the 1970s and are some of the most stringent in Europe.¹⁵⁵ In France, several kinds of liability arrangements exist for principal contractors and clients in the subcontracting chain for wages, social security contributions and taxes on wages.¹⁵⁶ The first French law regarding joint liability is still in force today, through amended.¹⁵⁷ Law No. 75-1334 of 31 December 1975 (“1975 Law”) on joint liability primarily protects subcontractors from defaulting general contractors.¹⁵⁸ Law No. 90-613 of 12 July 1990, JORF No. 16 of 14 July 1990 (“1990 Law”) - “on joint liability between an entrepreneur and their subcontractor for the payment of salaries, holidays, and social security contributions for the benefit of the subcontractors” - workers must be seen in the

¹⁴⁹ *Id.*

¹⁵⁰ *Id.* at 4.

¹⁵¹ *Id.* at 12.

¹⁵² *Id.* at 10-11.

¹⁵³ *Id.* at 12.

¹⁵⁴ *Id.*

¹⁵⁵ Barbara Palli, *Liability in Subcontracting Processes in the European Construction Sector: France*, in EUROPEAN FOUNDATION FOR THE IMPROVEMENT OF LIVING AND WORKING CONDITIONS 1 (2008), available at <http://www.eurofound.europa.eu/pubdocs/2008/874/en/1/ef08874en.pdf>.

¹⁵⁶ *Id.* at 3.

¹⁵⁷ *Id.*

¹⁵⁸ *Id.*

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context of bogus subcontracting.”¹⁵⁹ Law No. 91-1383 of 31 December 1991, JO No. 1 of 1 January 1992 (“1992 Law”) mandates joint liability where the business fails to make payments to workers or social security bodies.¹⁶⁰ The rationale of these joint liability provisions is that the ultimate beneficiary of an illegal work/service should bear the financial consequences of the illegality.”¹⁶¹ The 1992 law is supposed to encourage clients and contractors to choose law-abiding subcontractors, and then act as guarantors to the state and other parties in the subcontracting chain if the subcontractors are, in fact, illegal.¹⁶² Finally, Law No. 2005-882 of 2 August 2005 incorporated in Article L 1262-4 and Article 1262-5 of the Labour Code is implementing legislation for E.U. Directive 96/71, previously discussed in this Note’s Belgium section.¹⁶³ Together, these are the principal provisions that delegate chain liability on subcontracting.

The 1975 Law provides “national and/or foreign subcontractors with a direct action against the order provider for the payment of work and services provided where the main contractor proves to be insolvent.”¹⁶⁴ Under the 1975 Law, subcontractors are protected by either of two means: first, through a private agreement where the principal contractor secures an arrangement with the subcontractors for guaranteeing payment, which can take several forms under the French Civil Code¹⁶⁵ Second, under Article 12 of the 1975 Law, the subcontractor can initiate a direct action against the client where the client accepted the subcontractor’s contract to work, the client accepted the private contractual arrangement between the principal and the subcontractor, and the principal contractor failed to honor that arrangement.¹⁶⁶ Clients then have a direct incentive to have direct knowledge of the subcontractors on the project and the agreements arranged between the contracting parties. Likewise, the principal contractors “must secure acceptance of each subcontractor by the client – either when the subcontracting agreement is signed or later on during the whole duration of the contract. The principal contractor must also secure an agreement regarding the conditions of payment. At the same time, principal contractors are legally bound to pass on to the client all subcontracting

¹⁵⁹ *Id.*

¹⁶⁰ *Id.*

¹⁶¹ *Id.*

¹⁶² *Id.*

¹⁶³ *Id.* at 4.

¹⁶⁴ *Id.* at 5.

¹⁶⁵ *Id.*

¹⁶⁶ *Id.*

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agreements whenever they are so required.”¹⁶⁷ Under French law, the aggrieved subcontractor can bring suit to recover the unpaid cost of services.¹⁶⁸ The principal contractor must inform and obtain the same consent from the client in public procurement as well.¹⁶⁹ Non-compliance could cost the contractor a two-year prison sentence or an €18,000 fine.¹⁷⁰ Thus, under the 1975 Law, both the client and the principal contractor are jointly liable when either fails to meet their obligations to the subcontractor. The client and the principal contractor both act as guarantors of compliance.

The 1990 Act similarly applies to every French principal contractor that utilizes foreign or domestic subcontractors.¹⁷¹ The 1990 Act purports to protect the subcontractor’s employees in the event that the employing subcontractor fails to remunerate the worker or otherwise violates legal or collective agreement provisions.¹⁷² The theory behind the 1990 Act is that the contractor, being the beneficiary of the subcontractor’s efforts, must then subsequently act as guarantor of the defunct subcontractor’s social security and worker’s salaries obligations.¹⁷³ The 1990 Law lacks a specific scienter requirement, and is so applicable regardless of any fault or contractual obligations to the contrary.¹⁷⁴ Violations by the subcontractor are subject to a fine of €30,000 and/or two years’ imprisonment, and the principal contractor may also be subjected to a €12,000 fine or a one-year prison sentence.¹⁷⁵ Furthermore, where the subcontractor defaults on any of its obligations to its workers, regardless of whether any party in the contracting chain is at fault, the aggrieved workers, either individually or collectively through a representative trade union, can bring a direct legal action against the principal contractor.¹⁷⁶

France’s liability laws extend further than just the traditional client-contractor-subcontractor model to include the utilization of temporary work agencies. Under the French Labour Code, the user company, whether it is the client, contractor, or subcontractor, is ultimately responsible for the agency worker’s salaries and social security contributions.¹⁷⁷ Though the user company may demand a certificate of good standing from the temporary work agency,

¹⁶⁷ *Id.*

¹⁶⁸ *Id.* at 6.

¹⁶⁹ *Id.* at 5.

¹⁷⁰ *Id.*

¹⁷¹ *Id.* at 7.

¹⁷² *Id.*

¹⁷³ *Id.*

¹⁷⁴ *Id.*

¹⁷⁵ *Id.*

¹⁷⁶ *Id.*

¹⁷⁷ *Id.*

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“the law does not provide for a specific sanction should the agency fail to comply with the requirement.”¹⁷⁸

In addition, in 1992, joint liability in the context of illegal or undeclared work was introduced in French law by an Act of Parliament entitled ‘*Legislation for the reinforcement of the battle against undeclared work.*’ This Act was adopted on the basis of a report highlighting the inadequacy of previous provisions in combating undeclared work in the context of subcontracting chains.¹⁷⁹

In the context of illegal work, the client can be held jointly and severally liable with either the principal contractor or the subcontractor for failure to fully remunerate workers or pay the appropriate taxes or social security obligations.¹⁸⁰ Thus, the client or the principal contractor acts as a guarantor of the malfeasant contractor’s wage and social obligations.

Article L.8222-1 of the Labour Code . . . now provides that every client . . . is under a legal obligation to: verify that the other party has accomplished all declaration formalities required in order to provide services as an independent contractor or to employ others on the conclusion of a contract for services or a subcontracting agreement worth a minimum of €3,000 and then periodically, every six months, until the end of the contract.¹⁸¹

Furthermore, under Article 8.222-2, clients and principal contractors found guilty of benefitting from illegal work face penalties of three years imprisonment, a fine of €45,000, bans of public procurement, public humiliation, etc.¹⁸²

The Eurofound study concluded that there were too few adjudicated cases in French jurisprudence to adequately examine the effectiveness of France’s liability laws.¹⁸³ Eurofound cites widespread social acceptance of black market economic activity as a strong reason why relatively few aggrieved

¹⁷⁸ *Id.* at 8.

¹⁷⁹ *Id.* at 2.

¹⁸⁰ *Id.* at 9.

¹⁸¹ *Id.*

¹⁸² *Id.* at 11.

¹⁸³ *Id.* at 17.

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parties took advantage of the strong provisions.¹⁸⁴ Furthermore, as in all the other national studies, practical considerations such as the language barrier and their limited stay prevent abused foreign workers from exercising their rights under French law.¹⁸⁵ Some business groups decry the regulations as overly burdensome for employers while ignoring the real offenders.¹⁸⁶ Trade union groups have typically come out in favor of the rules, and have even advocated for outright bans on subcontracting.¹⁸⁷ The overall legislative trend in France is towards more liability regulations and strict reporting requirements from posted workers.¹⁸⁸ Consequently, it seems likely that France will be supportive of an E.U. initiative for making joint and several liability in subcontracting.

F. GERMANY

Germany's liability laws date back to the early 2000s, and principally apply to the German construction sector.¹⁸⁹

Articles 48 et seq. [*Einkommensteuergesetz*, Income Tax Act or "EtsG"] were introduced in 2001 against the background of illegal activity in the construction industry. Due to removal of the internal frontiers of the European Union . . . and the increasing permeability of its external frontiers, the opportunity for illegal activity had grown.¹⁹⁰

Article 48 EStG established joint liability for building services recipients for taxes owed to the Inland Revenue office.¹⁹¹ These taxes include workers' wages, income tax and corporation income tax.¹⁹² The liability is not true chain liability. Rather, it is narrower, and binds only two vertically tied parties to each other.¹⁹³ Furthermore, the higher-ranking contracting party

¹⁸⁴ *Id.*

¹⁸⁵ *Id.*

¹⁸⁶ *Id.* at 18

¹⁸⁷ *Id.* at 19.

¹⁸⁸ *Id.*

¹⁸⁹ Gregor Asshoff, *Liability in Subcontracting processes in the European Construction Sector: Germany*, in EUROPEAN FOUNDATION FOR THE IMPROVEMENT OF LIVING AND WORKING CONDITIONS 2 (2008), available at <http://www.eurofound.europa.eu/pubdocs/2008/875/en/1/ef08875en.pdf>.

¹⁹⁰ *Id.*

¹⁹¹ *Id.* at 1.

¹⁹² *Id.*

¹⁹³ *Id.*

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indemnifies itself through obtaining exemption certificates stating that the company is in compliance with the law.¹⁹⁴ The withholding amount is relatively small, at just 15% of the total monetary consideration between the contracting parties.¹⁹⁵ “If an exemption certificate has been submitted, the principal contractor is only liable if it could not trust in the legitimacy of the exemption certificate . . . If the principal contractor withholds tax and transfers it to the Inland Revenue office, preventative measures are not necessary.”¹⁹⁶

Germany adopted Article 28 of the *Viertes Buch des Sozialgesetzbuches* (Fourth Book of the Social Security Code or “Article 28”) in 2002 “to combat illegal employment and illicit work. By establishing a liability of the principal contractor for the obligations of subcontractors concerning the payment of contributions, [Article 28] ensures that the principal contractor takes care that subcontractors fulfil their obligations regarding payments.”¹⁹⁷ Article 28 applies to the provision of building services worth €500,000 or more.¹⁹⁸ Either the principal contractor or another company along the subcontracting chain that hired out another company acts like a directly enforceable guarantor under Article 28.¹⁹⁹ That is, the relevant government body health insurer acts like a creditor with the right to collect from any party in the subcontracting chain, including the principal contractor, the client or any intermediary subcontractors.²⁰⁰ However, before the liability can be invoked, the collecting government agency must first remind the party that its payment is due. The warning period must first expire before further action can be taken.²⁰¹ Even then, the principal contractor has a chance to exonerate itself.²⁰²

Article 1a of the *Arbeitnehmer-Entsendegesetz* (Posted Workers Act or “AentG”) “establishes a liability of the principal contractor of works and services for the obligations of the client, intermediary contractor and temporary work agency (hirer) concerning payment of minimum wages to workers and leave fund contributions to the Leave and Wage Equalisation Fund of the Building Industry (*Urlaubs- und Lohnausgleichskasse der Bauwirtschaft*, ULAK).”²⁰³ Germany introduced Article 1a in 1999, and has substantially

¹⁹⁴ *Id.*

¹⁹⁵ *Id.* at 6.

¹⁹⁶ *Id.* at 7.

¹⁹⁷ *Id.* at 4.

¹⁹⁸ *Id.* at 8.

¹⁹⁹ *Id.*

²⁰⁰ *Id.*

²⁰¹ *Id.*

²⁰² *Id.*

²⁰³ *Id.* at 2.

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amended it over the past 10 years. The article was introduced in response to the pervading corruption existing in the German construction sector in the aftermath of German reunification and E.U. integration.²⁰⁴ Germany correctly concluded, “principal contractors might have a tendency to opt for subcontractors who keep their costs down by not paying minimum wages and leave fund contributions under the AentG.”²⁰⁵ Earlier forms of the AentG merely imposed a fine, which the German government found inadequate to enforce the law in light of numerous complaints from foreign governments and their embassies that had to repatriate posted workers in Germany, who were presumably abandoned in Germany by their malfasant subcontracting employer.²⁰⁶ Under Article 1a, the principal contractor or the intermediate subcontractor that hired the services of another contracting company is liable as a guarantor for the unpaid wages of the subcontracting company’s employees.²⁰⁷ The employing company may also be liable for unpaid contributions to the ULAK.²⁰⁸ Article 1a gives unremunerated employees the right to seek redress in Germany labour courts from the principal contractor or any other contracting party above its employer in the vertical contracting chain.²⁰⁹ Article 1a is the subject of the controversial *Wolff & Mueller* case discussed above. The law was substantially amended in 2007, and its scope was expanded to cover ‘work and services’ instead of building services exclusively.²¹⁰ From the legislative record, it appears that the Germany *Bundestag* will consider expansions to postal services and other economic sectors in the years to come.²¹¹

According to the Eurofound report on Germany, German business, social and governmental actors have mixed views on the existing liability laws.²¹² The report cites widespread criticism of Article 28, which was both overly bureaucratic and expensive and questionably effective.²¹³ Between 2002 and 2004, the German government imposed only eight fines under the law; one of which was enforced, totaling €2,000.²¹⁴ At the same time, it is estimated that Article 28 costs Germany construction companies more than €1 million a year in compliance costs. Likewise, Article 48’s withholding tax procedure has an

²⁰⁴ *Id.* at 3.

²⁰⁵ *Id.*

²⁰⁶ *Id.*

²⁰⁷ *Id.* at 12.

²⁰⁸ *Id.*

²⁰⁹ *Id.*

²¹⁰ *Id.* at 3.

²¹¹ *Id.*

²¹² *Id.* at 16-19.

²¹³ *Id.* at 17.

²¹⁴ *Id.* at 15.

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uncertain claim to success. About 95% of construction business endeavors apply for an exemption to the 15% consideration withholding for the Inland Revenue Office.²¹⁵ However, Article 1a AentG is considered an effective law in Germany, which many credit to its simple liability rules and lack of scienter requirement.²¹⁶

If an element of negligence or fault was included in Article 1a AentG, the mostly justifiable claims of workers and of the joint institution of the social partners could not succeed. Since the liability of the principal contractor regardless of fault has been implemented, large companies and their organizations are much more interested in information regarding the provisions of the AentG and the possibilities of urging their subcontractors to observe this law.²¹⁷

G. ITALY

The breadth and depth of liability laws in Italy is considerable. Italian laws impose chain liability on the client, principal contractor and intermediary subcontractors for wage tax, social security contributions, social fund payments, wage and holiday payments, and even health and safety obligations.²¹⁸ The Italian justification for these extensive liability regulations is the same as in the other eight Member States: to hold the most solvent parties as guarantors of workers' rights and pay,²¹⁹ to protect revenue streams to the relevant government authorities²²⁰ and to ensure a high level of transparency in Italian markets.²²¹ The most sweeping and relevant Italian legislation is also recent, having been implemented in the past ten years.²²²

In 2003, the Italian parliament passed Section 29 Subsection 2 of Legislative Decree No. 276/2003 ("LD 276"), concerning the passive joint and

²¹⁵ *Id.*

²¹⁶ *Id.* at 17.

²¹⁷ *Id.*

²¹⁸ Rosario Salonia & Mario Emanuele, *Liability in Subcontracting Processes in the European Construction Sector: Italy*, in EUROPEAN FOUNDATION FOR THE IMPROVEMENT OF LIVING AND WORKING CONDITIONS 1 (2008), available at <http://www.eurofound.europa.eu/pubdocs/2008/876/en/1/ef08876en.pdf>.

²¹⁹ *Id.* at 14.

²²⁰ *Id.* at 15.

²²¹ *Id.*

²²² *Id.* at 1.

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several liability of both the client and the principal contractor.²²³ Section 29 contains this sweeping legislation:

[I]n the case of the contracting of works or services, the client or employer is jointly and severally obliged, together with the (principal) contractor and with each and every subcontractor, to pay the wages and social security contributions of the workers within two years of the date of termination of the contract.²²⁴

LD 276 also incorporates other workers' rights, like paid holidays, have an international element to it.

In case of cross-border contracting, foreign inland revenue and social security authorities will be able to demand payment by an Italian client or contractor, bound by the constraint of joint and several liability, of contributions and taxes owed in relation to work or services supplied pursuant to contracting . . . arrangements in Italy.²²⁵

The second primary piece of legislation imposing joint liability on Italian contracting chains is Law No. 248/2006 ("Law 248").²²⁶ Law 248 extended Law 276's joint and several liability to the fulfillment of withholding tax obligations.²²⁷

Finally, Law No. 296/2006 ("Law 296") imposed liability on contracting chains unique in Europe. "[T]he client or contractor is also considered jointly and severally liable for injuries to the employees of a contractor or any subcontractor(s) not compensated by the National Insurance Institute for Industrial Accidents."²²⁸

The efficacy of Italy's liability laws is about the same as in France. The Italian business community views these laws as unduly burdensome.²²⁹ Furthermore, the business community balks at the almost unlimited liability that the laws place upon clients and principal contractors.²³⁰ On the other hand,

²²³ *Id.*

²²⁴ *Id.*

²²⁵ *Id.* at 5.

²²⁶ *Id.* at 2.

²²⁷ *Id.*

²²⁸ *Id.*

²²⁹ *Id.* at 14.

²³⁰ *Id.*

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trade unions strongly approve of the regulations, but also note that the laws fail to address the core problems in Italy's markets.²³¹ The regulations impose such liability on Italian clients and principal contractors that almost all pay and social security contribution disputes are settled out of court.²³² Furthermore, the most vulnerable workers are self-employed workers, which constitute 47% of Italy's construction labour force.²³³ Unfortunately, Italy's strict regulations are of little avail to this work force. Overall, according to the trade unions, "no significant improvement has been made over the last few years in the protection of workers involved in contracting and subcontracting chains."²³⁴

H. THE NETHERLANDS

Joint liability laws in the Netherlands date back to the 1960s, and were a response to numerous instances of principal contractors in the construction sector that were deliberately avoiding their social security obligations.²³⁵ The *Coördinatiewet Sociale Verzekeringen* (Social Security Coordination Act or "CSV") made user companies of temporary laborers jointly and severally liable for unpaid social security taxes.²³⁶ However, since the CSV proved easy to evade, the Dutch parliament passed the *Wet Ketenaansprakelijkheid* (Liability of Subcontractors Act or "WKA") as part of the Wages and Salaries Tax and Social Contributions Act of 1982.²³⁷ The WKA applies joint and several liability for social security contributions and wage taxes to user companies or principal contractors.²³⁸ "[S]pecifically, the liability relates to wage tax, national insurance contributions, the income-related contribution towards the healthcare insurance scheme and employee insurance contributions from the wages of the employees concerned."²³⁹ The liability is joint and several, and applicable to the whole chain of subcontractors or temporary work agencies, at the same project or building site, for the social security and wages taxes due.²⁴⁰

²³¹ *Id.* at 16.

²³² *Id.*

²³³ *Id.*

²³⁴ *Id.* at 17.

²³⁵ Mijke Houwerzijl & Saskia Peters, *Liability in Subcontracting Processes in the European Construction Sector: Netherlands*, in EUROPEAN FOUNDATION FOR THE IMPROVEMENT OF LIVING AND WORKING CONDITIONS, 2, (2008), available at <http://www.eurofound.europa.eu/pubdocs/2008/94/en/1/EF0894EN.pdf>.

²³⁶ *Id.*

²³⁷ *Id.* at 1.

²³⁸ *Id.*

²³⁹ *Id.*

²⁴⁰ *Id.* at 4.

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In theory, the liability could apply to every contractor in the chain, but only if the subcontractor that failed to meet its obligations is insolvent.²⁴¹ The principal justifications for the WKA were not only to better ensure that social security contributions were paid, but also to defeat the unfair competitive advantage that non-paying companies enjoyed over the compliant companies.²⁴²

The chain liability rules may partly apply to (sub)contractors and temporary work agencies established in another Member State providing services in the Netherlands. However, the rules will only apply when Dutch tax law or social security law applies to the Dutch employees involved . . . Furthermore, the Dutch chain liability rules may be applicable when the work is carried out abroad by Dutch subcontractors.²⁴³

If they so choose, clients or principal contractors that want to indemnify themselves against liability under the WKA can establish a so-called “G-account.”²⁴⁴ “[A G-account] is a blocked bank account in the agency’s or subcontractor’s name . . . This account may only be used for paying social security contributions and wage taxes to the Inland Revenue.”²⁴⁵ Principal contractors deposit amounts owed by their subcontractors for applicable taxes directly into the G-account, with the remainder going to the subcontractor(s).²⁴⁶ By utilizing G-accounts, the potentially liable principal contractor can take positive actions to ensure that their subcontractor(s) has actually withheld the appropriate sums of money to be paid to their Inland Revenue, and thus, avoid liability.

Like in the other Member States, the Netherlands has a collective *Arbeidsovereenkomst de Bouwnejuverheid* (Collective Labour Agreement or “CLA”) that provides some measure of oversight by the principal contractor.²⁴⁷ The CLA states, “[t]he employer is obliged to monitor the compliance of this collective bargaining agreement in all individual employment contracts covered by the agreement. When dealing with independent entrepreneurs, the employer should agree on this in the subcontracting arrangement.”²⁴⁸ The CLA is generally applicable in the Netherlands, and requires principal contractors to

²⁴¹ *Id.*

²⁴² *Id.* at 3.

²⁴³ *Id.* at 6.

²⁴⁴ *Id.* at 10.

²⁴⁵ *Id.*

²⁴⁶ *Id.*

²⁴⁷ *Id.* at 1.

²⁴⁸ *Id.*

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employ subcontractors or temporary work agencies on the condition that they comply with applicable Dutch wage tax and social security laws.²⁴⁹ However, CLA enforcement mechanisms are somewhat nebulous.²⁵⁰ Furthermore, the CLA is not applicable to every trade, even within the Dutch construction industry.²⁵¹ Though recent Dutch case law suggests that employees may be able to bring suit against their employers for unpaid wages under the CLA, widespread enforcement of CLA provisions remains unclear.²⁵²

Other laws on joint liability in the Netherlands are found in the *Burgerlijk Wetboek* (Civil Code or “BW”) and in the *Wet Arbeid Vreemdelingen* (Foreign Nationals Employment Act or “WAV”).²⁵³ Articles 6 and 7 of the BW provide for joint liability “in the event of industrial accidents or work-related illnesses.”²⁵⁴ The aggrieved employee might be able to bring suit directly against either his or her employer or the principal contractor, provided that he or she can prove that either company failed to meet its duty of care.²⁵⁵ Furthermore, under the WAV, joint liability exists between clients, principal contractors and subcontractors, where the subcontractor employs a foreign national without a work permit.²⁵⁶

According to the Eurofound report on the Netherlands, most of the business, social and governmental actors “are satisfied with the current liability arrangement for social security contributions and wage tax at the national level.”²⁵⁷ In particular, the Dutch government hailed the G-accounts’ success as a preventative measure and for virtually eliminating illegal sewing workshops in the Netherlands.²⁵⁸ The liability laws, including the G-accounts, remain considerably less effective at regulating temporary work agencies.²⁵⁹ Most business, social and governmental actors consider the CLA to be feckless and ineffective.²⁶⁰ Consequently, the most popular and effective measures in the Netherlands are those applying joint liability, while allowing companies to avoid it through the application of basic preventative measures like G-accounts.

²⁴⁹ *Id.* at 2.

²⁵⁰ *Id.*

²⁵¹ *Id.* at 6.

²⁵² *Id.*

²⁵³ *Id.* at 1.

²⁵⁴ *Id.*

²⁵⁵ *Id.*

²⁵⁶ *Id.*

²⁵⁷ *Id.* at 17.

²⁵⁸ *Id.* at 13.

²⁵⁹ *Id.*

²⁶⁰ *Id.* at 17.

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I. SPAIN

Although Spain's joint liability laws in its modern democratic era date back to the 1980s, the first meaningful legislation was passed in the 1990s with Law 31/1995 *on the Prevention of Occupational Hazards* ("Law 31/1995").²⁶¹ Law 31/1995 aimed to improve work place health and safety by requiring the principal contractor to monitor the subcontractor's compliance with health and safety standards.²⁶² Where the subcontractor fails to comply and the work is within the principal contractor's own workplace and sphere of activities, the principal contractor will be held jointly liable.²⁶³

Spain also implemented Law 45/1996, *on posting of workers in the context of cross-border provision of services* ("Law 45/1995") in 1995.²⁶⁴ Law 45/1995 states that Spanish labour laws regarding working hours, wages and the prevention of occupational hazards apply to domestic Spanish companies in the same way that it applies to foreign companies operating in Spain.²⁶⁵ "Therefore, principal contractors and user companies established in Spain have the same obligations toward posted workers as they do in relation to domestic workers."²⁶⁶

Article 42 of the Workers' Statute ("Article 42") provides for joint liability of the principal contractor for social wages and security contributions. As in Law 31/1995, liability attaches where the subcontracted work is within the principal contractor's so-called *own activity*.²⁶⁷ The liability extends throughout the contract life, and ends a full year after the contract expires.²⁶⁸

However, no legally established mechanism exists to enforce the [social security and wage] obligations. The common practice is for the principal contractor to carry out regular and effective checks to ensure compliance with legal obligations on the part of the subcontractors; for example, it may request

²⁶¹ Oscar Vargas Llave, *Liability in Subcontracting Processes in the European Construction Sector: Spain*, in EUROPEAN FOUNDATION FOR THE IMPROVEMENT OF LIVING AND WORKING CONDITIONS 2 (2008), available at <http://www.eurofound.europa.eu/pubdocs/2008/878/en/1/ef08878en.pdf>.

²⁶² *Id.*

²⁶³ *Id.*

²⁶⁴ *Id.* at 7.

²⁶⁵ *Id.*

²⁶⁶ *Id.*

²⁶⁷ *Id.* at 8.

²⁶⁸ *Id.*

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copies of the relevant pay slips or bank transfer documents.²⁶⁹

Principal contractors can also request proof of met obligations directly and monthly from their subcontractors.²⁷⁰

In 2006, Spain passed Law 32/2006, *on subcontracting in the construction sector* (“Law 32/2006”), which as the name implies, applies exclusively to the Spanish construction sector.²⁷¹ “Article 4(2) of [Law 32/2006] refers to the obligation [of principal contractors] to ensure that workers are adequately trained in the prevention of occupational hazards, as well as the duty to have a preventative organization in place and to register with the Register of Accredited Companies.”²⁷² Noncompliance with these requirements results in joint liability between the malfeasant subcontractor and its principal contractor.²⁷³ Interestingly, Article 5 of Law 32/2006 limits the number of vertical links in the subcontracting chain to three, absent a special showing that more subcontractors are objectively required to complete the work.²⁷⁴ Article 5 evidences Spain’s efforts to simplify the contracting process by constricting the length of the vertical contracting chain.

In 2003, Spain passed Law 58/2003, a general tax law that holds principal contractors liable for the tax debt of their subcontractors.²⁷⁵ This includes tax debt for “workers, professionals, or other entrepreneurs – for the part corresponding to the subcontracted works or services; [including] any amounts payable or to be withheld.”²⁷⁶ The principal contractor can avoid this liability if it obtains from the subcontractor clearance certificates declaring that the subcontractor is compliant.²⁷⁷

According to the Eurofound report on Spain, the Spanish labour and business community is generally satisfied with the existing liability laws.²⁷⁸ “In general, the existing laws provide an effective and adequate regulatory framework – although in practices disputes may arise about the interpretation of concepts such as ‘own activity’ and the ‘workplace of the entrepreneur,’ or about the scope of various obligations subsumed under joint liability.”²⁷⁹ The

²⁶⁹ *Id.*

²⁷⁰ *Id.*

²⁷¹ *Id.* at 9.

²⁷² *Id.*

²⁷³ *Id.*

²⁷⁴ *Id.*

²⁷⁵ *Id.* at 10.

²⁷⁶ *Id.*

²⁷⁷ *Id.*

²⁷⁸ *Id.* at 13.

²⁷⁹ *Id.*

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vagueness of key terms in the various liability laws has obstructed enforcement efforts by the Spanish government.²⁸⁰ However, nothing in the report indicates that Spain would oppose stricter liability regulations, so long as they are more clearly worded.

III. REACTIONS OF EUROPEAN SOCIAL AND BUSINESS ACTORS TO JOINT LIABILITY PROPOSALS

The reactions to proposals for joint liability in European subcontracting fall along predictable lines among the various social actors generally favoring more stringent regulations and the business actors generally not favoring them. Social actors include labour organizations, non-governmental organizations and governments. Business actors include MNEs, national businesses, trade groups and non-governmental organizations. Unfortunately, the E.U. neither solicited nor published opinions on the Motion. Consequently, a dearth of information about this Motion exists from social and business actors since its adoption as a non-legislative resolution in March of 2009. Consequently, the most comprehensive materials available concerning European attitudes toward joint liability laws date back to the 2007, *Outcome of the Public Consultation on the Commission's Green Paper "Modernising labour law to meet the challenges of the 21st century* ("Green Paper"), mentioned above in the discussion on the Motion's recitals. Fortunately, the questions posed in the Green Paper concerning joint liability regulations are sufficiently similar to the proposals in the Motion so that an adequate comparison can be made. Question number 9 in the Green Paper asks, in part: "Would subsidiary liability be an effective and feasible way to establish that responsibility in the case of sub-contractors? If not, do you see other ways to ensure adequate protection of workers in 'three-way relationships'?"²⁸¹ The responsive communication from the European Commission to the Council and Parliament generally stated that Member States were split about the need for subsidiarity (joint) liability "to ensure compliance with employment rights through the EU."²⁸² Social actors like the European Trade Union Confederation ("ETUC") "considered that a Community initiative is required in the form of an instrument to regulate the 'chain responsibility' of user enterprises and intermediaries in the case of agency work and sub-

²⁸⁰ *Id.*

²⁸¹ *Green Paper, supra* note 48, at 13.

²⁸² *Communication from the Commission to the Council, the European Parliament, the European Economic and Social Committee and the Committee of the Regions: Outcome of the Public Consultation on the Commission's Green Paper "Modernising Labour Law to Meet the Challenges of the 21st Century,"* at 8, COM (2007) 627 final (Oct. 24, 2007) [hereinafter *Com 2007*].

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contracting.”²⁸³ Business actors generally argued that joint liability laws were ineffective, and that subcontractors were already sufficiently regulated by national legislation.²⁸⁴

Social actors, like the ETUC, argued very strongly for a Community-wide instrument adopting joint liability as a European response to subcontracting abuses.

[I]n recent times we have argued in favour of a European instrument regulating joint and several liability (or ‘chain-responsibility’) of user enterprise and intermediary in case of agency work and subcontracting, not only for the payment of taxes and social security contributions, but also for wages. . . The European Commission should encourage Member States that have not yet done so to take initiatives to introduce so called systems of ‘client liability,’ ‘chain responsibility’ or ‘joint and several liability,’ bring together the various practices in member States, and consider the proposal of a Community initiative on this matter.²⁸⁵

Other social actors like the European Federation of Building and Woodworkers (“EFBWW”) argued that principal contractors have superior financial resources and bargaining power, which they often use to negotiate less-than-fair deals with questionable subcontracting companies.²⁸⁶ Furthermore, a lack of clear and consistent rules exists across the European Community, holding subcontracting chains responsible for failure to pay taxes and wages.²⁸⁷ Consequently:

The EFBWW considers that the adoption of a European directive on ultimate liability of general contractors and/clients is indispensable with a view to ensuring compliance with and application of provisions governing pay and working conditions, social security and tax liabilities in a

²⁸³ *Id.*

²⁸⁴ *Id.*

²⁸⁵ EUROPEAN TRADE UNION CONFEDERATION [ETUC] , ETUC POSITION AS ADOPTED BY THE ETUC EXECUTIVE COMMITTEE OF 20-21 MARCH 2007 IN ROME 28 (2007), available at http://ec.europa.edu/employment_social/labour_law/green_paper_responses_en.htm.

²⁸⁶ WERNER BUELEN, RESPONSE FOR EUROPEAN FEDERATION OF BUILDING AND WOODWORKERS 8 (2007), available at http://ec.europa.edu/employment_social/labour_law/green_paper_responses_en.htm.

²⁸⁷ *Id.*

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subcontracting chain. Such a directive would close the legal loophole whereby subcontracting is used to get around tax, social, statutory and contractual obligations, thereby distorting the market and removing protection for workers.²⁸⁸

Alternately, European business actors generally argued that European-wide joint liability regulations would prove ineffective, or that national legislation was already regulating subcontracting sufficiently.²⁸⁹ EuroCommerce noted in its position paper that principal contractors or companies that utilize temporary work agencies cannot effectively monitor their subcontractors' or temporary workers' hours, and that such legislation should be left to the Member States.²⁹⁰ Likewise, the Confederation of British Industry noted: "UK employers are clear that the agency worker's primary relationship is with the agency. User companies do not get involved in the details of an agency worker's terms and conditions and it would not be acceptable for employment responsibilities to be passed to the user company."²⁹¹ Furthermore, "[c]ompanies using sub-contractors should be able to rely on the fact that those sub-contractors have to fulfill their labour law responsibilities – ensuring their subcontractors comply with the law *is not their responsibility* (emphasis added)."²⁹² The Council of European Employers of the Metal, Engineering and Technology-Based Industries bluntly stated:

It is simply not realistic to make main contractors responsible for the activities of their sub-contractors in the production chain. It would furthermore be neither efficient nor desirable to set up this subsidiary liability for sub-contractors. *It would paralyze the economy and have a negative impact because of the incalculable risks for which companies could be liable* (emphasis added).²⁹³

²⁸⁸ *Id.* at 8-9.

²⁸⁹ *Com 2007, supra* note 284, at 8.

²⁹⁰ POSITION PAPER: EUROCOMMERCE'S CONTRIBUTION TO THE GREEN PAPER, 13 (2007), available at http://ec.europa.eu/employment_social/labour_law/green_paper_responses_en.htm.

²⁹¹ CBI RESPONSE TO THE EUROPEAN COMMISSION GREEN PAPER "MODERNISING LABOUR LAW TO MEET THE CHALLENGES OF THE 21ST CENTURY, CONFEDERATION OF BRITISH INDUSTRY, 4 (2007), available at http://ec.europa.eu/employment_social/labour_law/green_paper_responses_en.htm.

²⁹² *Id.*

²⁹³ COUNCIL OF EUROPEAN EMPLOYERS OF THE METAL, ENG'G AND TECH. - BASED INDUS. [CEEMET]: GREEN PAPER "MODERNISING LABOUR LAW TO MEET THE CHALLENGES OF THE 21ST CENTURY": CEEMET ANSWERS TO THE QUESTIONNAIRE, 30 Mar. 2007, at 7 (2007), available at http://ec.europa.eu/employment_social/labour_law/answers/documents/3_76_en.pdf.

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Even the European Commission, in its June 2009 response to the Motion, urged caution with regards to a Community-wide legal instrument for joint liability. “The Commission believes that a cautious approach is required. Account needs to be taken of the variety of legal systems in place in the Member States as well as the contrasting views among stakeholders as to the feasibility and/or desirability of a Community legal instrument.”²⁹⁴ In its response, the Commission cited the public consultation to the Green Paper as evidence that the E.U. needs more time to analyze the principal of joint liability as an effective means of protecting workers’ rights in subcontracting chains.²⁹⁵

IV. CONCLUSION

It seems unlikely that the Motion will make much headway in the European Union. That is, the principal of joint liability as a European principal is unlikely to become a binding Directive on the Member States. The Motion’s implications are too broad, and the potential opposition to the concept of joint and several liability without a scienter requirement is too strong. The principal reasons why the Motion’s principles will not likely become a Directive are:

1. The Motion is overly broad.
2. The Motion has adamant detractors.
3. Joint Liability Legislation has not proven itself effective at fighting fraud.
4. Joint liability legislation has not proven itself effective at protecting vulnerable workers.

The Motion is overly broad. Though one could interpret the legislation as being applicable solely to the European construction sector, that is not explicitly stated in the Motion. Consequently, it is unclear whether the Committee intended for joint liability to be a European rule in *all* sectors of the

²⁹⁴ Follow-up to the European Parliament Resolution on the Social Responsibility of Subcontracting Undertakings in Production Chains, Adopted by the Commission on 17 June 2009, EUR. PARL. DOC. A6-0065/2009, at 2 (2009).

²⁹⁵ *Id.*

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economy or just in the constructions sectors, where the eight Member States that currently have joint liability legislation have limited its scope. Given that only eight out of the total membership of twenty-seven states have liability rules that are not uniform, and are applicable mostly to the construction sector, it seems unlikely that the European Union would readily accept a sweeping endorsement of joint liability regulations for all sectors of the economy. However, if the legislation would be tailored to the construction or building sector exclusively, the situation may be different.

Furthermore, the Motion has adamant detractors. Consistently, in each of the eight Member State reports, fierce opposition from the business community has prevented the enactment of more stringent liability regulations. The reasons for opposing this legislation are simple: the existing regulations are complicated, expensive to implement, lack a scienter requirement, and expose the client and principal contractor to potentially unlimited liability. Until these concerns are addressed through dialogue between the European Union and the European business community, with the goal of finding the best business practices that address both parties' concerns, the European business community will not likely be persuaded by the Motion's principles.

Joint liability legislation itself has not been proven effective at fighting fraud. The Eurofound reports consistently reported relatively few cases where the liability legislation actually combated fraudulent contracting practices. The reports cites various reasons for this lack of efficacy, including a general cultural acceptance of black market labour, lack of practical access to the host country's legal system, a general unwillingness on the part of worker's to bring suit to recover wages, and a lack of government involvement in the supervision and enforcement of the liability provisions. Given the relatively weak track record of even the strongest liability laws, it seems unlikely that the European Union would adopt a far-reaching liability regime.

Furthermore, joint and several liability legislation itself has not been proven effective at protecting vulnerable workers. Strong practical barriers exist between aggrieved workers and judicial redress. For example, host country's labour unions often do not represent posted workers. Posted workers often work illegally and thus have no legal remedy, posted workers often do not speak the host country's language, posted workers are often ignorant of the judicial remedies available to them, posted workers often fear losing their job or obtaining future employment, posted workers often accept lower-than-minimum wages because they are still higher than their home country's wages, posted workers are often pushed into settling out of court by their employer, and posted workers are reluctant to take advantage of the liability legislation because judicial remedies can take too long.

Moreover, in the construction industry alone, a large percentage of

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workers are self-employed and are not working for a subcontractor in the traditional sense. Though the Motion addresses some of these concerns, the Eurofound reports demonstrate that liability legislation has thus far failed to address the specific needs of these aggrieved workers.

Although it seems unlikely that the Motion will ever be adopted as a Directive as it is currently drafted, the record shows that many E.U. Member States are at least open to the imposition of joint liability restrictions on businesses as a solution to the increasingly complex web of multinational business activities. Given this openness to at least the principle, it seems likely that the E.U. could pass legislation pushing for joint liability laws in a specific industrial sector, such as construction. Thus, by focusing on a specific industrial sector and adopting the best practices that were outlined in the Motion's recitals and the Eurofound reports, the principal of joint liability may indeed become *the* European means of regulating MNEs in the 21st Century.

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