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BITCOIN AND THE BLOCKCHAIN AS POSSIBLE CORPORATE GOVERNANCE TOOLS: STRENGTHS AND WEAKNESSES

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Bitcoin and similar virtual currencies are rapidly evolving and gaining traction in today's economy. However, legislators in the United States and abroad are still assessing the legal status of cryptocurrencies and often pursuing quite different approaches in their regulation. On the other hand, the blockchain, the technology underlying Bitcoin transactions, offers itself as a great tool that should be implemented in the corporate governance field because of its recording certainty features. The blockchain, through the distributed ledger, allows users within a network to perform peer-to-peer digital transactions while accessing and monitoring changes in the ledger as they occur. The ledger also offers an opportunity to maintain information securely, by encrypting and allowing access only to holders of cryptographic "keys".

Because of its lack of a centralized issuer and absence of securities deriving from a national apparatus and definite legislation, Bitcoin presents a series of uncertainties that prevent implementation as a corporate governance tool. Instead, the blockchain's capacity to maintain confidential information securely, such as corporate strategies to be voted on by a board of directors or shareholders, within a network of allowed users and to record transactions or events with certainty should be explored and implemented in the corporate field. This article analyzes the current legal status of Bitcoin and blockchain technology; the relationship between the two; and advantages and disadvantages of implementing either or both technologies for transparency of ownership, corporate voting, accounting, and self-executing, "smart", contracts purposes. This article suggests that while neither should be implemented for accounting and ownership reporting purposes, blockchain could prove a useful tool for corporate voting.

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* Fiammetta S. Piazza, J.D. Loyola Law School, Los Angeles, Class of 2017; J.D., Bocconi University, Italy, Class of 2012; LL.M., UCLA School of Law, Class of 2013. Starting November 2017, Ms. Piazza will be an associate in the business department of Polsinelli LLP, Los Angeles office. Ms. Piazza started researching Bitcoin and blockchain as part of her law review note research while at Loyola. The peculiar nature of Bitcoin and its sudden raise caught her attention especially because she noticed the lack of legal certainty around cryptocurrencies. The author has recently published an article on the matter: *Bitcoin in the Dark Web: A Shadow over Banking Secrecy and a Call for Global Response*, 26 S. CAL. INTERDISC. L.J. 521 (2017). She has since expanded her research from regulatory issues to exploring block chain's corporate governance potential and Bitcoin use in corporate transactions. Ms. Piazza's work experiences include U.S. and Italian prominent law firms, Federal Trade Commission, California State Court and Federal Bankruptcy Court, Los Angeles City Attorney's Office, and real estate investment management.

I. INTRODUCTION

With the rapid evolution of the Internet and the transition to the Web of a diverse array of infrastructure and systems, virtual currencies have quickly developed. Today, virtual currencies play a key role in the transformational change affecting the world economy, reflecting the expanded venues available to consumers to access goods and services.[1] Indeed, unlike traditional currencies, virtual currencies offer a peer-to-peer exchange mechanism eliminating the need for intermediaries and central clearinghouses.[2]

While virtual currencies are not afforded legal tender, they may still have equivalent traditional currency value.[3] Within this category, Bitcoin has developed and attained primary market status among virtual currencies that can be exchanged for traditional currencies.[4] Bitcoin's main feature is the so-called blockchain: a ledger where the parties to each transaction report their exchange. Accordingly, while the features and characteristics of each Bitcoin exchange may vary tremendously, it is possible, within the exchange and with the necessary access authorization, if any, to monitor transactions. However, this does not translate in complete transparency because some exchanges permit users to create anonymous accounts. While this is no longer possible in the United States following the recent Financial Crimes Enforcement Network ("FinCEN") guideline making it clear the Banking Secrecy Act applies to Bitcoin even though it has not been recognized as currency, anonymous foreign exchanges may still impact American corporate governance because of the global nature of today's economy and the ease of access to those foreign exchanges.[5]

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[1] International Monetary Fund, *Virtual Currencies and Beyond Virtual Currencies and Beyond: Initial Considerations*, 5, available at https://www.imf.org/external/pubs/ft/sdn/2016/sdn1603.pdf.

[2] *Id.*

[3] Sarah J. Hughes & Stephen T. Middlebrook, Feature, *Advancing a Framework for Regulating Cryptocurrency Payments Intermediaries,* 32 YALE J. REG. 495, 504 (2015).

[4] *Id.*

[5] Dep't of the Treasury Fin. Crimes Enforcement Network, Guidance Paper FIN-2013-G001, Application of FinCEN's Regulations to Persons

Section II of this paper discusses, in subsection A, the general realm of virtual currencies and Bitcoin's supremacy. Subsection B distinguishes between Bitcoin, blockchain technology, and distributed ledgers. Subsection C analyzes the mechanics of Bitcoin's transactions on the blockchain. Lastly, subsection D, surveys the current regulatory framework regarding Bitcoin in the United States.

Section III examines the consequences of implementing Bitcoin or the blockchain in the governance of companies. Specifically it examines the potential benefits and disadvantages of both as tools to enhance transparency, conduct corporate voting and accounting, and enter "smart contracts." Ultimately, this paper suggests implementation of blockchain, but not of Bitcoin, may be viable in some of those areas.

II. VIRTUAL CURRENCIES, BITCOIN, AND THE BLOCKCHAIN

A. Virtual Currencies and Bitcoin: Evolution and Problems

Satoshi Nakamoto – an alias[6] – has long been thought to be the creator of Bitcoin when a technical paper was posted on the

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Administering, Exchanging, or Using Virtual Currencies (2013) available at https://www.fincen.gov/statutes_regs/guidance/pdf/FIN-2013-G001.pdf.

[6] While Bitcoin has developed since Nakamoto first published its protocol, the true identity of its designer (or designers) is still unknown. After posting the protocol, Nakamoto, other than for a few messages, has disappeared and, in his words, "[has] moved on to other things." *Who is Satoshi Nakamoto?*, THE ECONOMIST (Nov. 2, 2015 23:27) http://www.economist.com/blogs/economist-explains/2015/11/economist-explains-1 (discussing how, among other things, Nakamoto's own funds have remained untouched). Several individuals and agencies, spanning from John Nash to the NSA, have been thought to be the "face" behind the Nakamoto mask, but no ultimate finding has been made. *See, e.g.* Justin OConnell, *10 People who have been Called the Inventor of Bitcoin, Satoshi Nakamoto*, CRIPTOCOINSNEWS (Aug. 21, 2015), https://www.cryptocoinsnews.com/called-the-inventor-of-bitcoin-satoshi-nakamoto/ (discussing the ten people who have been thought to be the inventor).

Internet describing the protocol in 2008.[7] However, recent developments around the identity of Bitcoin's creator identify in Craig Wright the true "father" of Bitcoin.[8] Regardless of the identity behind Bitcoin, the protocol was first implemented in 2009 and, since then, several versions of the cryptocurrency have been created and are easily available for download.[9]

Before explaining the functioning of Bitcoin and its role in today's economy, it is helpful to remember that traditional currencies are defined as a system of money used and generally accepted in a country (or union of countries as in the European Union's eurozone) as a form of payment.[10] Traditional currencies are also known as fiat currencies from the Latin term *fiat* meaning "let it be done" or "so it shall be" in the sense of a governmental decree or order. This is so because, different from commodity-based money like gold, silver or copper-backed coins, fiat currencies do not have an intrinsic value. Instead, the national government, as issuer, declares its value as legal tender and, in the words of Milton Friedman, "[t]he pieces of green paper have value because everybody thinks they have value. Everybody thinks they have value because in his experience they have had value."[11] Indeed, fiat currencies are part of multi-layer national infrastructure inclusive of a national bank or system of banks (e.g. the United States Federal Reserve) and an agency or department

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[7] P. CARL MULLAN, THE DIGITAL CURRENCY CHALLEGE – SHAPING ONLINE PAYMENT SYSTEMS THROUGH U.S. FINANCIAL REGULATIONS 85 (Palgrave MacMillan eds., 1st ed. 2014).

[8] Following years of speculation, Australian Craig Wright has come forward claiming to be the original creator of Bitcoin. As proof, he "digitally signed messages using cryptographic keys created during the early days of Bitcoin's development. They keys are inextricably linked to blocks of bitcoins known to have been created or 'mined' by Satoshi Nakamoto." *Australian Craig Wright Claims to be Bitcoin Creator*, BBC.COM (May 2, 2016), http://www.bbc.com/news/technology-36168863.

[9] MULLAN, *supra* note 7, at 86.

[10] Article, Ralph E. McKinney Jr. et al., *The Evolution of Financial Instruments and the Legal Protection against Counterfeiting: A Look at Coin, Paper, and Virtual Currencies*, 2015 U. Ill. J. L. TECH. & POL'Y 273, 274.

[11] MILTON FRIEDMAN & ROSE FRIEDMAN, FREE TO CHOOSE: A PERSONAL STATEMENT 249 (1980).

entrusted with the production of currency (e.g., the United States Department of the Treasury Bureau of Engraving and Printing.)[12]

A virtual currency is a "medium of exchange existing entirely in intangible form that is not legal tender but which can substitute for legal tender."[13] Within the broader category of virtual currencies often used for online games and social media are cryptocurrencies, Bitcoin being the most popular example.[14] Cryprotcurrencies are distinguishable from other virtual currencies in that theyare "internet-based virtual currenc[ies] in which the ownership of a particular unit of value is validated using cryptography."[15] Accordingly, Bitcoin is a virtual currency with equivalent value in real currency but no legal tender status, at least in most jurisdictions.[16]

The American Constitution reserves to the Federal Government the power to coin money and regulate its value.[17] However, laws prohibiting the circulation and use of unauthorized instruments meant as currency or generally means of payment, have not been interpreted to prohibit new types of money.[18] Instead, these laws have been applied for prosecuting counterfeited US dollar bills and coins.[19] Nonetheless, many countries have taken a direct stance and have explicitly ruled that Bitcoin cannot be used as legal tender within their borders.[20] Even so, private parties can agree, in contract, to use Bitcoin as method of payment for their transactions. Thus, the

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[12] *Id.* at 277.

[13] Hughes & Middlebrook, *supra* note 3, at 504.

[14] *Id.*

[15] *Id.*

[16] *In Re Coinflip, Inc. et al.*, CFTC Docket No. 15-29 (CFTC Filed Sept. 17, 2015), https://www.irs.gov/pub/irs-drop/n-14-21.pdf.

[17] U.S. Const. art. I, §8(5).

[18] U.S.C. §336.

[19] Julie Andersen Hill, Virtual Currencies & Federal Law, J. CONSUMER & COMM. L., 49 (2015).

[20] European Central Bank, *Virtual Currency Schemes – A Further Analysis*, 24 (2015), available at https://www.ecb.europa.eu/pub/pdf/other/virtualcurrencyschemesen.pdf.

biggest hurdles Bitcoin faces are volatility and absence of a supporting institutional infrastructure.[21]

Between March and April 2013, "Bitcoin's dollar exchange rose from about $50 to $350 and then fell back to near $70. Bitcoin's price rose even more sharply during the fall of 2013, rising from near $50 in September to more than $110 by early December. During 2014, Bitcoin's price showed large day-to-day variations but generally trended down. By mid-January 2015, a Bitcoin was priced near $200"[22] then, as of July 2015, Bitcoin was trading at an exchange rate of $279.32 per Bitcoin.[23] However, it should be noted that Bitcoin's volatility has been declining steadily and Bitcoin has maintained lower levels of volalititly compared to unstable reserve currencies like the Russian Ruble and the Brazilian Real.[24] Specifically, Bitcoin's volatility between March and May 2016 has been about 1.23% and around 1.45% between April and May 2016.[25] For comparison, and to better grasp Bitcoin's level of risk, volatility of gold averages at around 1.2%, while major currencies average between 0.5% and 1.0%.[26] Furthermore, "while gold has decreased by around 11% amid the [F]ederal [R]eserve's announcement of new interest rates implementation, the price of [B]itcoin has increased to around US$430."[27] In 2017, in the midst of uncertainties surrounding what

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[21] Since most countries have abandoned the gold standard – the guarantee that anyone could trade a country's currency in return for equivalent amount of gold – the value of national currencies derives from social acceptance, trust, and confidence in that country's economy. *The Global Monetary System – Not Floating, but Flailing*, THE ECONOMIST (July 5, 2015), http://www.economist.com/news/finance-and-economics/21606322-after-150-years-monetary-experimentation-world-remains-unsure-how.

[22] Craig K. Elwell, M. Maureen Murphy & Michael V. Seitzinger, *Bitcoin: Questions, Answers and Analysis of Legal Issues*, CONGRESSIONAL RESEARCH SERVICE REPORT, 7 (Jan. 28, 2015) (available at http://www.fas.org/sgp/crs/misc/R43339.pdf).

[23] *Id.*

[24] Joseph Young, *Volatility of Bitcoin Price Consistently Declined since 2010*, BITCOIN NEWS SERVICE (Jan. 3, 2016, 4:00 PM), http://www.newsbtc.com/2016/01/03/volatility-of-bitcoin-price-consistently-declined-since-2010/.

[25] *The Bitcoin Volatility Index*, BITCOIN VOLATILITY, https://btcvol.info/.

[26] *Id.*

[27] Young, *supra* note 24.

policies will be implemented regarding Bitcoin by the new administration, "the cryptocurrency rose 3.1% to $1,164.10 . . .topping the all-time closing high of $1,137 set in November 2013."[28] February 2017, as a response to the newly inaugurated presidential administration, has indeed marked the longest Bitcoin has traded at over $1,000.[29] This is because commentators expect "the Trump administration to be at least more accepting of the cryptocurrencies, even if they will not necessarily embrace them."[30] This stems, at least in part, from the fact that Trump's transition team includes "Bitcoin supporters" like Peter Thiel, co-founder of PayPal and investor in several Bitcoin companies, and Mick Mulvaney, an outspoken supporter of Bitcoin and founder of the bipartisan Blockchain caucus.[31] Mulvaney, Director of the Office of Management and Budget, has created the bipartisan caucus aimed at educating Congress about Bitcoin and blockchain technology.[32] This is a significant step, regardless of political views, to foster regulation and thus certainty around cryptocurrencies and blockchain technology. Mulvaney has also stated that "[b]lock chain technology has the potential to revolutionize the financial services industry, the United States economy and the delivery of government services, and I am proud to be involved with this initiative."[33]

Hypothetically, and national debates aside, if Bitcoin's acceptance becomes more widespread, its volatility may decrease and this, in turn, may result in increased global acceptance of Bitcoin as a

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[28] Olga Kharif, *Bitcoin Price Sets Record on Trump Policy Uncertainties*, BLOOMBERG (Feb. 23, 2017 10:35 AM), https://www.bloomberg.com/news/articles/2017-02-23/bitcoin-price-sets-intraday-record-on-trump-policy-uncertainties.

[29] Charles Bovaird, *Bitcoin Price Tops $1,000 for Longest Stretch in History*, COINDESK (Feb. 21, 2017 20:32), http://www.coindesk.com/bitcoin-price-tops-1000-longest-stretch-history/.

[30] Neha Thakur, *Will Trump and Bitcoin be Good Partners*, NEWSBTC (Jan. 23, 2017 9:35 AM), http://www.newsbtc.com/2017/01/23/will-trump-and-bitcoin-be-good-partners/.

[31] *Id.*

[32] *Id.*

[33] Shivdeep Dhaliwal, *Donald Trump Inauguration Special: Make Bitcoin Great Again!*, THE COINTELEGRAPH (Jan. 20, 2017), https://cointelegraph.com/news/donald-trump-inauguration-special-make-bitcoin-great-again.

means of exchange.[34] However, without a national infrastructure backing the virtual currency, Bitcoin's success can merely be temporary as in the case of mortgage-backed securities and other financial instruments in the past.[35] Indeed, it has been argued that Bitcoin may become the subject of a financial bubble as it "seems to fit the basic definition of speculative bubble – that is, a special kind of fad, a mania for holding an asset in expectation of its appreciation."[36] News regarding price increases both publicize and amplify bubbles' effects.[37] They often justify the current bubble phenomenon by attributing it to an inspiring "new era" story aimed at attracting more attention as the prices rise.[38] In Bitcoin's case, the narrative was that "a computer whiz invented a new kind of money in the form of electronic currency units, as part of decentralized computer-driven system for a world economy that extends beyond the reach of any single government."[39] Indeed, commentators have speculated Bitcoin has already been the subject of a bubble in China in 2013.[40] There, the Government has issued laws both banning the use of Bitcoin and prohibiting transfers out of the country of currency in amounts higher than $50,000.[41] Interestingly, on November 3, the price of Bitcoin rose to its 2015 peak of US$377.36, amounting to a 75% increase since August of that same year.[42] Supporting the speculation that Bitcoin was the subject of a Chinese bubble, while the price rose globally, Chinese Bitcoin exchanges were

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[34] Kevin V. Tu & Michael W. Meredith, *Rethinking Virtual Currency Regulation in the Bitcoin Age,* (Aug. 22, 2014) (available at SSRN 2485550).

[35] David Min, *Understanding the Failure of Market Discipline*, 43 (Mar. 3, 2014), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2403988).

[36] Robert J. Shiller, *In Search of a Stable Electronic Currency*, N.Y. TIMES (Mar. 1, 2014), http://www.nytimes.com/2014/03/02/business/in-search-of-a-stable-electronic-currency.html.

[37] *Id.*

[38] *Id.*

[39] *Id.*

[40] Anthony Cuthbertson, *Bitcoin Price Hits 2015 Peak Amid Speculation of 'Second Bitcoin Bubble'*, INT'L BUS. TIMES (Nov. 2, 2015), http://www.ibtimes.co.uk/bitcoin-price-hits-2015-peak-amid-speculation-second-bitcoin-bubble-1526956.

[41] *Id.*

[42] *Id.*

trading the virtual currency at leading prices, "sometimes trading at $10/bitcoin higher" than other exchanges world wide.[43]

Historically, national central banks have been entrusted with the mandate of protecting their national currency by "seeking to match the supply of money to the needs of the economy and thus maintain[ing] price stability."[44] This result is usually achieved by attempting to make inflation rates as close as possible to set benchmarks. Those benchmarks are usually low, as in the 2% target of the United States, to avoid the uncertainty about the future and the corrosive effects on currency value that would be caused by high inflation.[45] In fact, trust that a national currency is a reliable store of value derives from the confidence that the currency will be honored at a value reflecting public expectations.[46] Accordingly, be it directly by setting interest rates,[47] or indirectly by issuing public communications "prepared for the purpose of shaping economic and monetary conditions prospectively, as instruments of persuasion," central banks play a pivotal role in managing currency stability.[48] Bitcoin's independence from countries' currency systems has been claimed to be its strength, however, while this may be somewhat true for highly unstable economies, it is not an automatic conclusion for more stable and confidence-inspiring ones. Indeed, regardless of the actual level of a country's economic stability, it does provide consumers with an interface to relate to and that is neutral from private interests. Distinguishably, Bitcoin's anonymous creation and the private ownership of all Bitcoin exchanges create a reality where

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[43] *Id.*

[44] Board of Governors of the Federal Reserve System, *Why Does the Federal Reserve Aim for 2 Percent Inflation Over Time?*, available at http://www.federalreserve.gov/faqs/economy_14400.htm. Similarly, in Europe, the ECB has a targeted inflation rate below, but close to 2%. *See* ECB, *Monetary Policy*, available at https://www.ecb.europa.eu/mopo/html/index.en.html.

[45] Sarwat Jahan, *Inflation Targeting: Holding the Line*, IMF, http://www.imf.org/external/pubs/ft/fandd/basics/target.htm.

[46] Hilary J. Allen, *$ = € = Bitcoin?*, (Aug. 13, 2015), Suffolk Law School Research Paper No. 15-33, 15, http://ssrn.com/abstract=2645001.

[47] Morgan Ricks, *Regulating Money Creation After the Crisis*, 1 HARV. BUS. L. REV. 75, 77 (2011).

[48] Douglas R. Holmes, *Communicative Imperatives in Central Banks*, 47 CORNELL INT'L L.J. 15, 17 (2014).

Bitcoin stability depends on the interrelation of conflicting private interests.

Interestingly, according to its own website, Bitcoin's value derives from the fact that it is "useful as a form of money."[49] This circular reason strengthens the fear that while the public is currently interested in purchasing Bitcoin because of trust in its development, if this belief disappears no central bank or government can provide support to users. A sudden end to the acceptance of Bitcoin as a payment method would translate into chaotic erosion of its value and, ultimately, Bitcoin would lose its status as currency.

The lack of a neutral institution devoted to price stability can explain, at least in part, Bitcoin's volatility and riskiness. In contrast to public sovereigns, Bitcoin exchanges have a private corporate nature and relatively easy access to bankruptcy procedures that could leave subscribers, as creditors, unprotected to a higher degree than they would be if a bank were to be insolvent. However, as mentioned above, Bitcoin is an interesting alternative in unstable economies where the national currency is completely distrusted. For example, Argentina is increasingly gaining interest in Bitcoin.[50] Nonetheless, Bitcoin may not be the best option even in those economies. An example of a more structured and more reliable alternative currency is the Unified System for Regional Compensation ("SUCRE").[51] SUCRE started as a virtual currency for transaction between Ecuador and Venezuela. It was intended as a medium to replace the US dollar as means of exchange in order to limit and decrease the US influence

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[49] Bitcoin, *Why Do People Trust Bitcoin?*, https://bitcoin.org/en/faq#why-dopeople-trust-bitcoin.

[50] *See* J.M.P. Montevideo, *Bitcoin in Argentina: If it can't Make it there*, THE ECONOMIST (June 12, 2014, 13:36), http://www.economist.com/blogs/schumpeter/2014/06/bitcoin-argentina; Nathaniel Popper, *Can Bitcoin Conquer Argentina?*, THE NEW YORK TIMES (Apr, 29, 2015), http://www.nytimes.com/2015/05/03/magazine/how-bitcoin-is-disrupting-argentinas-economy.html?_r=0.

[51] Mercedes Alvaro & Jeffrey T. Lewis, *Who Needs Bitcoin? Venezuela has its "Sucre"*, (Jan. 2, 2014 6:51 pm), http://www.wsj.com/articles/SB10001424052702304202204579256062854362716.

and control over Latin American trade and, at the same time, increase stability of those markets.[52]

While theoretically appealing, Bitcoin lacks the full faith and credit that has allowed national currencies to successfully function and resist crises.[53] "No private issuer enjoys the same extent for its markets, the same capacity to coerce demand for its liabilities, or the same psychological association with confidence in society."[54] This is not to say that currencies alternative to national fiat currencies cannot successfully exist. However, it is of extreme importance that virtual currencies, by nature, tend to be unstable and extremely sensitive to new events requiring past commitments to be readjusted.[55]

Consider the fate of bank-issued money in the United States prior to the establishment of the US dollar as the common currency. Many state banks issued their own IOUs with nothing but their own assets to back them. Predictably, they failed whenever too many claimants sought to make good on their claims at the same time. This follows from the hierarchy of finance and the fact that non-state entities, by definition, have limited resources. Critically, their ability to mobilize fresh resources may falter precisely when it is most needed, namely in times of crisis.[56]

Accordingly, Bitcoin and other similar virtual currencies' are too unstable to implement an overreaching corporate governance system like that applicable to companies. Doing so could potentially expose shareholders to greater risks than traditional transaction-recording methods do without a countervailing benefit.

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[52] *Id. See also* generally, Caroline R. Hurtado, Note, *Fiscal Policies as Decisive Solutions for Troubled Economies: Differing Legislative Enactments in Argentina and Ecuador*, 24 LOY. L.A. INT'L & COMP. L. REV. 391 (discussing the dollarization process undergone Latin American countries to obviate to economic instability).

[53] FELIX MARTIN, MONEY: THE UNAUTHORIZED BIOGRAPHY, 75 (2014).

[54] *Id.* at 114.

[55] Katharina Pistor, *A Legal Theory of Finance*, 41 J. COMP. ECO. 315, 322 (2013).

[56] *Id.*

B. Distinguishing Distributed Ledgers, Blockchain, and Bitcoin.

Blockchain and Bitcoin are too often incorrectly used interchangeably because of the strong association between the two. However, the blockchain is merely the technology through which Bitcoin functions and making the distinction between the two is fundamental to understanding the potential independent use in corporate governance of the blockchain, but not of Bitcoin, proposed by this paper.

The blockchain is a particular type of distributed ledger and represents the technological evolution of a tool as old as commerce.[57] Indeed, in ancient times transactions were recorded on papyrus and paper, today, the same recording occurs in computerized form.[58] What distinguishes distributed ledgers from the traditional form of recording is that, through algorithms, the ledgers can be collaboratively created by all of those sharing it in a network consisting of multiple sites, geographies, and institutions.[59] Distributed ledgers allow all users within the network to access and visualize changes to the ledger as they occur while maintain the information safe from unauthorized access via cryptographic "keys" and signatures, controlling users' relative powers.[60] Indeed, underlying the distributed ledger technology lays the blockchain, which accomplishes peer-to-peer digital cash transaction in Bitcoin, or otherwise.[61] This is further analyzed in the next subsection.

Distributed ledgers, as contrasted to Bitcoin, offer an interesting tool to implement in corporate governance because of their potential positive effect in at least some field of governance which is discussed in Section III of this paper. Compared to current data management methods, distributed ledgers offer a more secure alternative given their resistibility to hacks. Unlike centralized

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[57] UNITED KINGDOM GOVERNMENT CHIEF SCIENTIFIC ADVISOR, *Distributed Ledger Technology: Beyond Block Chain*, 5, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/492972/gs-16-1-distributed-ledger-technology.pdf.

[58] *Id.*

[59] *Id.*

[60] *Id.*

[61] *See infra* Subsection Section II-c.

systems, a successful cyber-attack on a distributed ledger would have to contextually target all shared copies.[62] While not completely immune from hacks, this technology is also resistant to unauthorized changes or malicious tampering because users can immediately spot those changes.[63] The technology represents an opportunity for evolution in various fields given its adaptability to various uses: distributed ledgers are capable of applicability to most transactions given their ability of "guaranteeing and tracking assets as they move from one ledger to another."[64] Interestingly, various governments globally, are already moving towards the implementation of distributed ledger technologies paralleling the private corporate world.[65]

C. Mechanics of Bitcoin Transactions on the Blockchain

Given Bitcoin's nature, mathematical formulas and cryptography respectively control its issuance and use.[66] While users' software store a public record of all transactions – the blockchain – the actual identity of the transacting parties remains anonymous, as no personal information is required to create an account on the platform or exchange Bitcoins.[67] Elimination of a third party intermediary, such as a bank, ensures anonymity within Bitcoin transactions.[68] Anonymity is furthered by the absence of reporting

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[62] UNITED KINGDOM GOVERNMENT CHIEF SCIENTIFIC ADVISOR, *supra* note 57, at 6.

[63] *Id.*

[64] *Money with no Middleman*, THE ECONOMIST, http://www.economistinsights.com/technology-innovation/analysis/money-no-middleman/tab/1, (last visited May 10, 2016).

[65] UNITED KINGDOM GOVERNMENT CHIEF SCIENTIFIC ADVISOR, *supra* note 57. Five countries (United Kingdom, Estonia, Israel, New Zealand, and South Korea, have also created a network of digitally advanced government with the goal of strengthening the digital economy. *See* UNITED KINGDOM CABINET OFFICE AND GOVERNMENTAL DIGITAL SERVICE, *D5 London: About D5 Member Countries*, (Dec. 9, 2014), https://www.gov.uk/government/news/d5-london-about-d5-member-countries.

[66] MULLAN, *supra* note 7, at 86-87.

[67] *Id.* (noting that Bitcoin's issuance is capped at 21M units).

[68] Federal Reserve Board, *Bitcoin: Technical Background and Data Analysis*, 5 available at http://www.federalreserve.gov/econresdata/feds/2014/files/2014104pap.pdf.

requirements and regulatory agencies, such as central banks and taxing authorities.

In the absence of a third party clearinghouse, participants are free, but not bound, to voluntarily record each transaction on the blockchain.[69] However, the effectiveness of this recording method is disputable: users who record their transactions are rewarded with newly minted Bitcoins.[70] Conversely, no penalty follows from failure to record.[71] This incentive-based policy explains, at least in part, the steady growth of Bitcoin systems.[72]

The blockchain is comprised of a series of transactions each consisting in a "block".[73] Each block indicates the asset and consideration exchanged, the time of the transfer, and the identity (or at least the pseudonym) of the transacting parties.[74] Each block is "chained" to the preceding and the subsequent one through headers that report information (using codes) regarding the content of the previous transaction block.[75] Thus, through the codes reported in each block's header one can retrieve the preceding transaction block and so on until the original transaction is reached.[76] However, while it is possible to trace Bitcoin transactions back to the original acquisition of assets, depending on the type of exchange used, it is potentially impossible to trace the transaction back to individuals.[77] Furthermore, depending on the visibility options set by the exchange, blockchain records may be publicly visible or restricted to authorized users and subscribers only.[78] In the alternative, an intermediate solution has developed whereby a company uses a private blockchain accessible to authorized users only to record its daily transactions but then periodically updates and reports an aggregate version of those

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[69] *Id.*

[70] *Id.* (explaining that minting refers to the creation of new Bitcoins).

[71] *Id.*

[72] *Id.*

[73] PAOLO TASCA, *Digital Currencies: Principles, Trends, Opportunities and Risks*, Deutche Bundesbank research report (2015), http://papers.ssrn.com/sol3/Papers.cfm?abstract_id=2657598.

[74] *Id.*

[75] *Id.*

[76] *Id.*

[77] *Id.*

[78] *Id.*

transactions on a publicly accessible blockchain.[79] This intermediate solution is called, given its mechanics, a side chain.[80]

Regardless of the accessibility options, to execute a transaction, both a private and a public key are necessary.[81] Each party to the transaction has a private encryption key that provides access to their personal account and that, when paired with the public key, allows transactions to go through.[82] Specifically, a transaction requires a "pair of interlocking encryption keys" acting as peer-to-peer signatures.[83] The use of digitally encrypted signatures to authenticate transactions is threefold in that it ensures the authentication, non-repudiation, and integrity of payment messages.[84]

Moreover, Bitcoin transactions are final and irreversible: voluntary refunds are the only way to revert the effect of the transfer.[85] Because there is no administrator, no transaction can be blocked or penalized.[86] Furthermore, Bitcoin users have the option to either keep a Bitcoin wallet (also called dark wallet when kept on dark web[87] exchanges), on their own or through third parties, or convert the currency back to their local currency.[88] The latter option may, depending on the method used, entail a potential for identity

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[79] *Id.*

[80] *Id.*

[81] MULLAN *supra* note 7, at 86.

[82] *Id.*

[83] *Id.*

[84] Federal Reserve Board, *supra* note 68, at 8.

[85] MULLAN *supra* note 7, at 87.

[86] *Id.*

[87] The dark web is a layer of the web accessible only through specific software and where users can maintain nearly absolute anonymity. Stuart Dredge, *What is Tor? A Beginner's Guide to the Privacy* Tool, THE GUARDIAN, (Nov. 5, 2013 07:47 AM), http://www.theguardian.com/technology/2013/nov/05/tor-beginners-guide-nsa-browser (last visited Nov. 24, 2015).

[88] Steve Kovach, *What It's Like Using an ATM that Automatically Turns Your Cash into Real Bitcoins*, BUSINESSINSIDER (Mar. 10, 2014 5:00 PM), http://www.businessinsider.com/bitcoin-atm-2014-3 (on how to buy and cash Bitcoin).

discovery.[89] Indeed, it should not come as a surprise that a commonly heard phrase in the Bitcoin industry is "buyer beware."[90]

As mentioned, Bitcoin further differs from traditional currencies in that no central bank controls the amount of currency available and no jurisdiction guarantees it.[91] Instead, a mathematical protocol with no central administrating or monitoring authority generates the Bitcoin.[92] Given its math-based issuance and incentive-based transaction recording, while Bitcoin's current cap of $21M should not be reached earlier than 2140, each Bitcoin unit can be divided into fractional units thus enhancing the currency's presence and spread.[93] The cap of Bitcoin availability tends to suggest a commodity-like nature, which will be discussed more in depth in the following section about Bitcoin regulation alternatives. However, unlike traditional natural commodities, Bitcoin's cap is only mathematically enforced and thus easily transformable, which adds a further layer of unique complexity.

Furthermore, software and services like TOR (necessary to access the dark web), the "dark wallet" (Bitcoin wallets stored on the dark web), and Bitcoin-laundering services which are intentionally designed to obscure the source of a Bitcoin transaction, enhance Bitcoin's already anonymous character and further complicate traceability.[94] Indeed, in the case of laundering services, the chain of transactions on the blockchain is obscured by "linking all transactions in the same [B]itcoin address and sending them together in a way that makes them look as if they were sent from another address."[95] Other services pursuing the same goal instead "comingle" different series of

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[89] This paper does not go into detail as to Bitcoin use in the dark web but suffices it to say that there Bitcoin's anonymous features are extremely enhanced by additional layers of encryption. *Id.*

[90] MULLAN *supra* note 7, at 87.

[91] FATF Report, *Virtual Currencies Key Definitions and Potential AML/CFT Risks* (June 2014), http://www.fatf-gafi.org/media/fatf/documents/reports/Virtual-currency-key-definitions-and-potential-aml-cft-risks.pdf.

[92] *Id.*

[93] *Id.*

[94] As mentioned above, use of Bitcoin in the dark web offers further opportunities to avoid and evade regulation. *Id.*

[95] *Id.*

transactions, rendering the identification of the user to whom the sender intended to direct the funds impossible.[96]

To further understand Bitcoin's instability, it should be noted that Bitcoin acceptance peaked in 2013 with over 64,000 businesses around the globe accepting it as form of payment.[97] However even lucrative businesses suffer from this instability, for example Mt. Gox, the largest Bitcoin exchange, filed for bankruptcy in 2014, after Bitcoin valued at around US$500 million mysteriously disappeared.[98] This example, considering the anonymous features of the currency, illustrates the great volatility and risks associated with the trading of Bitcoins.

Enforcement agencies picked up on Bitcoin early, and, relatively soon after its creation, the FinCEN intervened issuing an interpretative guidance which is discussed in the next subsection.

D. Current Regulatory Framework for Bitcoin in the United States

Similarly to other virtual currencies, no Bitcoin-specific regulation has been enacted, nor does this paper suggest that it is necessary. However, a definitive categorization of Bitcoin as a specific financial instrument is necessary for market confidence in terms of legal certainty and clarity regarding applicable statutes and regulations. Indeed, while this article focuses on the dichotomy of Bitcoin and blockchain technology as potential corporate governance tools, it is important to understand that depending on the definition of Bitcoin as a certain financial instrument or another, its regulation may change considerably. Specifically, depending on the path followed, Bitcoin may function as a reliable governance tool. While legislatures are globally moving towards regulating Bitcoin use and exchange, regulation is not uniform as countries are following different approaches.

This article suggests that, notwithstanding what the applicable regulation is, Bitcoin is not a suitable corporate governance tool

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[96] *Id.*

[97] Federal Reserve Board, *supra* note 68, at 5.

[98] *Id.* at 2.

because of externalities that render the virtual currency unstable and unreliable. However, to overview the current regulatory framework in the United States is helpful in understanding how unripe the legal system is to accept Bitcoin as corporate governance tool. Instead, this article suggests that, for at least certain aspects of corporate governance, distributed blockchain ledgers may represent a feasible and practical tool as discussed below in Section III.

Given the lack of a universal definition of Bitcoin, its status and consequent regulation greatly differs depending on whether it is categorized as a form of money, a security, or a commodity.[99]

1. *Current Applicable Law*

FinCEN has clarified in its 2013 guideline that, because of their anonymous features, Bitcoin users and exchangers are subject to the Bank Secrecy Act ("BSA").[100] Specifically, the guideline clearly states the BSA applies "to persons creating, obtaining, distributing, exchanging, accepting, or transmitting virtual currencies", but does not go as far as classifying Bitcoin's status. [101] Pursuant to the BSA, a "money transmission service" is a two-step service of "acceptance of currency, funds, or other value that substitutes for currency from one person *and* the transmission of currency, funds, or other value that substitutes currency to another location or person by any means."[102]

Following the FinCEN 2013 guideline, Bitcoin administrators and exchangers, in their capacity as Money Services Businesses ("MSB"), must comply with the appropriate Treasury Department registration process.[103] Conversely, Bitcoin users do not fall within the guideline MSB definition and are outside the Treasury

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[99] For further and deeper analysis of Bitcoin's regulation *see*, Fiammetta S. Piazza, *Bitcoin in the the Dark Web: A Shadow over Banking Secrecy and a Call for Global Response*,

[100] Guidance Paper FIN-2013-G001, *supra* note 5.

[101] *Id.*

[102] *Id.*

[103] *Id.* (emphasis in original); *Money Services Business (MSB) Registration*, FINCEN, https://www.fincen.gov/financial_institutions/msb/msb.registration.html, (last accessed Feb. 5, 2016).

Department scope of authority, at least for registration purposes.[104] The guideline also defines and clarifies that Money Transmitting Services ("MTS") are within the scope of the USA Patriot Act of 2001, which, among other addressed issues, imposes fines for, for example, failure to register and obtain a Money Transmitter license.[105]

FinCEN's conclusion that the BSA applies to Bitcoin represents a major turn towards a thorough regulation of Bitcoin and, by extension, of other similar cryptocrurrencies.

2. *Status as a Form of Money*

"[Bitcoin] can be used to purchase goods or services, and [. . .], to pay for individual living expenses."[106] Based on this reasoning, a Texas District Court ruled on a matter of first instance and held that "[i]t is clear that Bitcoin can be used as money."[107] While relatively limited in terms of market acceptance, Bitcoin "can also be exchanged for conventional currencies, such as the US dollar, Euro, Yen, and Yuan."[108] Accordingly, the Texas court found that "Bitcoin is a currency or form of money."[109] The ruling is dated July 2013, only four months after FinCEN's guideline publication.

While avant-garde and based on a sound reasoning, the Texas court ruling should be carefully approached. Indeed, even though Bitcoin is exchanged and used as money, unlike national currencies, it lacks the support of a central authority like the United States Treasury for the US dollar and it does not have intrinsic value, as do

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[104] *Id.*

[105] Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA Patriot ACT) Act of 2001, Pub. L. No. 107-56.

[106] *Id.*

[107] SEC v. Shavers, 2013 U.S. Dist. LEXIS 110018 (E.D. Tex. Aug. 6, 2013). (Addressing the issue of whether jurisdiction under the Securities Acts of 1933 and 1934 applied to the facts of the case involving a Bitcoin Ponzi scheme).

[108] *Id.*

[109] *Id.* (The court's ultimate finding was that investors wishing to invest in BTCST provided an investment of money).

commodities.[110] Because of the differences between traditional national currencies and Bitcoin, it has been argued that Bitcoin lacks at least one of two required characteristics to be considered a true currency.[111] Specifically, although Bitcoin may be a means of exchange it is not a store of value.[112]

Furthermore, in evaluating whether Bitcoin can be brought within the definition of currency, it is of remarkable importance to remember Bitcoin's lack of national infrastructure, as opposed to fiat currencies. Indeed, other than in exceptional cases, a national currency can always be exchanged for and accepted as form of payment. Instead, Bitcoin could vanish both because of the combination of Bitcoin being the result of an Internet mathematical protocol, the absence of a physical "paper-trail" backing up the blockchain, and the Internet and computers being subject to viruses.[113]

3. *Status as a Security*

The issue of "whether the Bitcoin itself could be a security" has yet to be addressed by a court."[114] Indeed, while *Shavers* acknowledges it as an option, the court there did not delve into an analysis of whether Bitcoin can be considered a security instrument. The issue is even more intricate considering that, while there is agreement regarding the fact that a security is, in economic terms, a

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[110] Paul Krugman, *Op-Ed., Bitcoin Is Evil*, NEW YORK TIMES (Dec. 28, 2013), http://krugman.blogs.nytimes.com/2013/12/28/bitcoin-is-evil/?_r=0.

[111] John Authers, *Time to Take the Bitcoin Bubble Seriously*, FIN. TIMES (Dec. 11, 2013), http://www.ft.com/cms/s/0/4ad1bba0-61fa-11e3-aa02-00144feabdc0.html#axzz3sNu5guRP.

[112] *Id.*

[113] An example of a more structured and more reliable alternative currency is the Unified System for Regional Compensation (SUCRE). SUCRE started as a virtual currency for transaction between Ecuador and Venezuela and was intended as a medium to replace the US dollar as means of exchange to limit and decrease the US influence and control over Latin American trade and, at the same time, increase stability of those markets. Alvaro & Lewis, *supra* note 51. *See also* generally, Hurtado, *supra* note 52. (discussing the dollarization process undergone Latin American countries to obviate to economic instability).

[114] Daniela Sonderegger, Note, *A Regulatory and Economic Perplexity: Bitcoin Needs Just a Bit of Regulation,* 47 WASH. U. J.L. & POL'Y 175, 195.

form of investment, there is not a uniform definition. Instead, different countries' legal definitions vary, sometimes significantly, covering a broad spectrum of alternatives. In the United States, the Securities Act of 1933 comprehensively defines the term and provides, in relevant part, that "security means any note, stock, treasury, stock, security future, security-based swap, bond . . ., investment contract . . . or, in general, any interest or instrument commonly known as a 'security'. . . ."[115]

Over the years, American courts have developed and used the Howey test to determine whether an interest is a security pursuant to the Securities Act of 1933.[116] In *Howey*, the court, beginning with a textual analysis of the law, reasoned that the preliminary issue to solve to understand what is a "security" is determining what is intended by "investment contract."[117] Specifically, the Howey test analyzes whether, at the time the interest is issued, the "investment contract," and consequently the security, is "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party."[118] For purposes of applying the Howey test, whether the shares in the enterprise are evidenced by formal certificates, or by nominal interests in the physical assets employed in the enterprise, is irrelevant.[119] However, Bitcoin's analysis in light of the Howey test is ineffective, at least in part because Bitcoin's features do not suit themselves.[120] Specifically, while Bitcoin users may invest Bitcoin, the cryptocurrency itself does not generally represent a share of a common enterprise the investor believes will prove fruitful through the efforts of a third party. Thus, although Bitcoin may be used as a

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115 15 USCS § 77b.

116 SEC v. Howey Co., 293 U.S. 293.

117 Section 2 (1) of the Act defines the term "security" to include the commonly known documents traded for speculation or investment. This definition also includes "securities" of a more variable character, designated by such descriptive terms as "certificate of interest or participation in any profit-sharing agreement," "investment contract" and "in general, any interest or instrument commonly known as a 'security.'" *Id.* at 297.

118 *Id.* at 298-299.

119 *Id.*

120 Sonderegger, *supra* note 114, at 195.

security if the mentioned conditions are met, it remains unclear whether it does, unequivocally, qualify as such.[121]

4. *Status as a Commodity*

Classical political economy defines a commodity as product or service produced by human labor and available for sale on the market.[122] Regardless of school of thought, it is generally agreed that a commodity is a good, easily interchangeable with other commodities of the same type also used in commerce.[123] Indeed, an essential characteristic of commodities is that their quality is essentially uniform across producers and are uniquely fungible.[124] Specifically, to be commodities, goods must be: (1) standardized; (2) usable upon delivery; (3) and their price must vary enough to justify creating a market for the item.[125] As an illustration, agricultural goods like wheat, corn, oil, and coffee, energy-related goods like coal, oil, and gas as well as precious metals like copper, silver, and gold are typical commodities.[126]

Unlike the unexplored status as a security, the US Commodity and Futures Trading Commission ("CFTC") issuance of its first action against an unregistered Bitcoin option-trading platform in 2015, confirms that Bitcoin, and similar digital currencies, fall within the definition of commodities and are thus subject to the Commodity Exchange Act ("CEA").[127] While the CFTC's action apperars to show a clear intent to regulate Bitcoin as a commodity, it might be an effort to at least pose some restrictions and promote its regulation.

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[121] *Id.* at 196.

[122] KARL MARX, CAPITAL: VOLUME I 38 (Int'l Publishers, 1967).

[123] *Commodity*, INVESTOPEDIA, http://www.investopedia.com/terms/c/commodity.asp (last visited Feb. 6, 2016).

[124] *Id.*

[125] *Commodity*, INVESTING ANSWERS, http://www.investinganswers.com/financial-dictionary/commodities-precious-metals/commodity-1035 (last visited Feb. 6, 2016).

[126] *Commodity*, BUSINESS DICTIONARY, http://www.businessdictionary.com/definition/commodity.html (last visited Feb. 6, 2016).

[127] *In Re Coinflip, Inc. et al.*, *supra* note 16.

It is important to note that, significantly differently from traditional commodities, Bitcoin's availability is potentially limitless. However, taking into account Bitcoin's potential status as a form of money and its lack of an infrastructure typical of national currencies, Bitcoin's availability is limited. This is because of the long-standing belief that currencies, typically currencies of countries possessing significant quantities of commodities or other natural resources, have been endorsed as commodities.[128] Additionally, Bitcoin is notably different from traditional commodities, as it is extremely volatile.[129] For these reasons as well as Bitcoin's virtual nature, leading to its unknown supply because of its algorithmically coded scarcity and future demand, some argue Bitcoin is more dissimilar to traditional commodities than it is similar.[130]

In light of the general uncertainty surrounding Bitcoin, the CFTC has clarified "commodity" as a term to be broadly construed to include "all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in."[131] Regardless, scholars are perplexed about the CFTC's finding and suggest its implications may shake *Shaver*'s holding that Bitcoin can be a security.[132] In the words of New York Law School Professor Houman Shadab,"[t]he [CFTC order] puts to rest any notion that virtual currencies qualify as securities. Otherwise, the Securities and Exchange Commission would be bringing this action, not the CFTC."[133] Unfortunately, no light is shed in the general gray fog surrounding Bitcoin even in this context because neither the SEC nor

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[128] Brian Perry, *Forex Currencies: Commodity Pairs (USD/CAD, USD/AUD, USD/NZD)*, INVESTOPEDIA, http://www.investopedia.com/university/forex-currencies/currencies8.asp (last visited Feb. 6, 2016).

[129] Bitcoin's volatility is further discussed in Section II-A of this article. *See supra* p. 268. *See, also, e.g.,* Young, *supra* note 24.

[130] Danny Bradbury, *Why Bitcoin's Volatility is Unique among Commodities*, COINDESK (Apr. 29, 2014, 11:11 A.M.), http://www.coindesk.com/bitcoins-volatility-no-other/.

[131] 7 U.S.C. 1(a)(9). *See, e.g.,* Board of Trade of City of Chicago v. SEC, 677 F. 2d 1137, 1142 (7th Cir. 1982).

[132] Pete Rizzo, *CFTC Ruling Defines Bitcoin and Digital Currencies as Commodities*, COINDESK (Sept. 17, 2015 22:06), http://www.coindesk.com/cftc-ruling-defines-bitcoin-and-digital-currencies-as-commodities/.

[133] *Id.*

the CFTC have issued any disclosures following issuance of the CFTC order. Consequently, while it is undisputed that Bitcoin falls within the scope of the definition of commodity, no final determination can be made regarding its status as security.

5. *The Federal Reserve, the Internal Revenue Service, and Other State and Federal Regulators*

The Federal Reserve Chairwoman Janet Yellen expressly stated during testimony before the Senate Banking Committee that the agency "doesn't have authority to supervise or regulate Bitcoin in any way."[134] This conclusion was heavily motivated by the absence of a "central issuer or network operator," which makes it "not easy to regulate Bitcoin." [135] The Chairwoman has not offered policy guidance but has made clear that "[t]his is a payment innovation that is taking place entirely outside the banking industry."[136]

Taking a diametrically opposed approach, the Internal Revenue Service ("IRS") has affirmed its authority over Bitcoin. Specifically, the IRS has clarified that it treats Bitcoin like property subject to property tax and that "sale or exchange of convertible virtual currency, or the use of convertible virtual currency to pay for goods or services in a real-world economy transaction, has tax consequences that may result in a tax liability."[137] As a means of comparison, the United Kingdom has moved towards a comprehensive regulation of Bitcoin.[138] The HM Revenue and

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[134] Ryan Tracy, *Yellen: Bitcoin 'Doesn't Touch' Banks the Fed Oversees*, THE WALL STREET J. (Feb. 27, 2014 12:32 P.M.), https://www.wsj.com/amp/articles/no-headline-available-1393521584.

[135] Charles Cooper, *Fed Chief Yellen: No Power to Regulate Bitcoin*, CNET (Feb. 27, 2014 10:37 A.M.), https://www.cnet.com/news/fed-chief-yellen-no-power-to-regulate-bitcoin/.

[136] Shelly Palmer, *Bitcoin: Money, Currency or Something Else?*, THE HUFFINGTONPOST (March 3, 2014 10:10 AM), http://www.huffingtonpost.com/shelly-palmer/bitcoin-money-currency-or_b_4889845.html.

[137] IRS Notice 2014-21: Virtual Currency Notice at 1, March 25, 2014, available at https://www.irs.gov/pub/irs-drop/n-14-21.pdf.

[138] Sarah Saunders, *Cryptic Currency*, TAXATION (March 11, 2015), https://www.taxation.co.uk/Articles/2015/03/10/332784/cryptic-currency.

Customs ("HMRC") has issued a policy brief on the treatment of income received from, and charges made in connection with, activities involving Bitcoin and other similar cryptocurrencies, for: Value Added Tax ("VAT"); corporation and income tax; and capital gains purposes.[139] While the country's recent vote towards leaving the European Union will have consequences over this issue, currently, the tax treatment in the United Kingdom is as follows: acquisitions by mining are considered outside the scope of VAT; Bitcoin is considered a foreign currency for corporation and income tax purposes; and gains or losses on Bitcoin are chargeable or allowable for capital gains tax if they accrue to an individual and are not covered by trading profit rules.[140]

Domestically, states have moved in the direction of regulating Bitcoin and cryptocurrencies through license systems. For example, New York has proposed a "BitLicense" regulation plan aimed at "help[ing] protect consumers and root[ing] out illicit activity."[141] So far, five more states – California, Colorado, New Hampshire, New Mexico, and Texas – have also moved toward a similar and favorable regulation of the Bitcoin.[142] Implementation of these systems of regulation, offer the benefit of ease of enforcement and monitoring because they offer the opportunity to conduct upfront investigation of Bitcoin issuers and exchanges.[143]

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[139] *Id.*

[140] HM Revenue & Customs, Revenue and Customs Brief 9 (2014): Bitcoin and other Cryptocurrencies (March 3, 2014), https://www.gov.uk/government/publications/revenue-and-customs-brief-9-2014-bitcoin-and-other-cryptocurrencies/revenue-and-customs-brief-9-2014-bitcoin-and-other-cryptocurrencies.

[141] Benjiamin M. Lawsky, Superintendent of Fin. Serv., Speech: NYFDS Announces Final Bitlicense Framework for Regulating Digital Currency Firms (June 3, 2015), available at http://www.dfs.ny.gov/about/speeches/sp1506031.htm (discussing 23 NYCRR §200.1 et seq. available at http://www.dfs.ny.gov/legal/regulations/revised_vc_regulation.pdf).

[142] For more detail as to the specific actions of those states, *see* Daniel Cawrey, *5 US States Poised to Promote Bitcoin Friendly Regulation*, COINDESK (Aug. 31, 2014 11:00), http://www.coindesk.com/5-us-states-poised-promote-bitcoin-friendly-regulation/.

[143] *Id.*

III. BLOCKCHAIN AND BITCOIN: POTENTIAL IMPLEMENTATION AS NEW CORPORATE GOVERNANCE TOOLS

This section analyzes the potential benefits and detriments deriving from implementing Bitcoin together with or independently from the blockchain technology in corporate governance. This paper suggests that the present features of Bitcoin and its current under-regulation do not necessitate its implementation because of the extreme exposure to volatility risks and hacks. However, the paper suggests the blockchain technology, as distinguished from Bitcoin, may instead offer a viable tool in areas of corporate governance like voting.

The following subsections explore the relative benefits and disadvantages deriving from implementing Bitcoin or the blockchain in the corporate governance of companies as tools for enhanced transparency, voting, accounting, and self-executing contracts (smart contracts).

A. Transparency of Ownership and Trading Value

Transparency and disclosure are at the base of good corporate governance models in that they enable shareholders and stockholders to make informed decisions and hold corporate executives accountable, thus limiting the agency costs associated with asymmetry of information.[144] In line with this perspective, countries globally have moved towards implementation of legislation aimed at enhancing corporate disclosures in a broad attempt at curtailing a greater role for shareholders in corporate governance.[145]

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[144] *See, e.g.,* Benjiamin Fung, *The Demand and Need for Transparency and Disclosure in Corporate Governance*, 2 UNIVERSAL J. MGMT 2, 72-80 (2014), http://www.hrpub.org/download/20140105/UJM3-12101630.pdf.

[145] For example, in the United States, the Sarbanes-Oxley Act of 2002 requires publicity of information including roles of and responsibilities of board and management executives and the Williams Act of 1968 requires disclosures regarding tender offers. Sarbanes-Oaxley Act of 2002, 107 P.L 204 (2002); Williams Act, Securities Exchange Act of 1934, 90 P.L. 439 (1968).

Transparency can be considered to be based on five pillars: (1) truthfulness, (2) completeness, (3) materiality of information, (4) timeliness, and (5) accessibility.[146] Implementing distributed ledgers as a corporate governance tool could, at a minimum, result in enhanced timeliness and accessibility of corporate information. Indeed, as discussed in the previous section, users given access to the ledger would be able to track changes in the ledger as they occur thus allowing for timely transmission of information to shareholders. Shared ledgers would also address the accessibility pillar of transparency in that information stored on the ledgers would be readily accessible to all authorized users. The use of shared ledgers does not directly affect truthfulness and completeness of shared information, however they would allow users to easily monitor transactions as well as recognize possible breaches to the system.[147] Conversely, the same result may not flow from using Bitcoin because of its anonymous features as further discussed hereunder. Accordingly, this paper suggests use of blockchain, but not Bitcoin, in corporate transaction recording to foster enhanced transparency.

In the United States, Bitcoin is undergoing regulation and exchangers are thus implementing amendments to their systems to comply with the BSA and, consequently, certain minimum identity requirements are now necessary for subscription as an exchange user.[148] However, it is not mandatory for companies wishing to use Bitcoin in their governance to use local exchanges only. Indeed, just like a company may have international shareholders, it may decide to use an international Bitcoin exchange that allows reduced identity checks. Accordingly, because local regulation of Bitcoin exchanges are highly diverse in type and thoroughness, if any, using a foreign blockchain may result in non-transparent ownership. This would be so because of lack of disclosure requirements as well potential anonymous accounts.

Use of local exchanges respecting the BSA could still not be sufficient to ensure complete transparency of ownership. Possible implementation of closed blockchains, accessible to authorized users

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146 Fung, *supra* note 144, at 75-76.

147 *See, supra,* Section II-B, at 274.

148 *See supra*, Section II.

only, or of side chains, would *de facto* frustrate the goal of inspiring shareholders and investors' trust in the company by way of allowing transparent and easy access to ownership arrangements and instantaneous changes thereof.

Assuming full transparency is implementable, it would have remarkable effects on the behavior of players such as managers, investors, and shareholder activists. Using executive compensation as an illustration, this paper discusses the consequences of complete transparency. Specifically, regardless of the driving forces producing the final arrangement, managers' compensation is often a combination of salary and equity.[149] Currently, public companies are required to file with the SEC disclosures including executive compensation, however those filings do not necessarily come in a format easily comprehensible to non-sophisticated investors.[150] Implementation of blockchain technology could render executive compensation more easily traceable and quantifiable for lay investors because of its user-friendly interface. Indeed, while theoretical problems regarding whether executive compensation is optimal or whether the specific boards are beholden to the executives in their choices, complete transparency coupled with easier understanding would at least allow shareholders real time monitoring. This would enhance the shareholders' role of serving as a check on both board decisions, generally, and executive compensation, specifically.

Depending on the percentage distribution of each component, managers' incentives tend to flow towards, more or less, shareholder-centered strategies. Indeed, acquisition and liquidation of managers' equity in the company have become of central importance, especially after the enactment of the Sarbanes-Oxley Act in 2002.[151] Among other things, the act has reduced filing periods for managers to disclose their acquisition and disposition of company shares.[152] Indeed, while originally managers had to make such disclosures

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[149] Lucian A. Bebchuk & Jesse M. Fried, *Pay without Performance: Overview of the Issues*, 30 J. CORP. L. 647, 443 (2005).

[150] *See generally*, Press Release, U.S. Securities and Exchange Commission, SEC Adopts Rule for Pay Ration Disclosure (Aug. 5, 2015), available at https://www.sec.gov/news/pressrelease/2015-160.html.

[151] Sarbanes-Oaxley Act.

[152] *Id.*

within ten days from the acquisition of disposition, the Sarbanes-Oxley Act has reduced this disclosure window to two business days.[153]

While enhancing shareholders awareness, registration of company shares on a public ledger could undercut the effectiveness of equity-based compensation because trades observable in real time would have a lower value to executives as they could lose trade leverage or edge as a consequence.[154] This might result in increased salary-based compensation of executives given the loss of value of their equity compensation.[155] Furthermore, registration of shares on the blockchain would also result in higher consciousness by shareholders of when company shares are pledged as collateral for loans or in connection with derivative hedging product.[156] These typical managerial moves may seem alarming to an inexperienced and uninformed market observer even when fully sound according to business judgment and could thus result in unwarranted market drops. Accordingly, while registration on the blockchain and the heightened transparency flowing from it can increase the role of shareholders in the governance of companies, it may also result in inefficiencies and obstacles in a board's execution of its strategic and managerial role within the company.[157]

On the other hand, assuming full transparency is achieved by implementing direct public blockchain systems, as opposed to side chain, the positive effects of transparency could still be undermined if Bitcoin is used. In fact, using Bitcoin to assess the value of transactions, here of compensation, and given the volatile value of Bitcoin, it would be quite possible to circumvent true reporting simply by assessing the transaction during low Bitcoin value trading. This would effectively enhance likelihood of circumvention of accounting fraud and misreporting frustrating the purpose of

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153 *Id.*

154 David Yermack, *Corporate Governance and Blockchains*, (NYU Stern Sch. of Bus. & Nat'l Bureau of Econ. Research, Working Paper No. w21802, 2015), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2703207.

155 *Id.*

156 *Id.*

157 *See, id.*; Jill E. Fish, *Taking Boards Seriously*, 19 CARDOZO L. R. 265, 272-275 (1997).

legislation such as the Sarbanes-Oaxley Act. Accordingly, while intermediary fees usually associated with banking transactions may be avoided, this would be at the cost of providing executives with an additional method to circumvent honest accounting.

Lastly, regardless of the blockchain used (Bitcoin-based or simple shared ledger) registering a company's shares on the blockchain, would possibly also translate into added management costs, especially up front in the form of accountants and executive training, and system transitioning. Implementation of the blockchain could, at least initially translate in an additional layer of diversification of the board. Indeed, while accountants may be tasked with the mechanical registration on the ledger, the board should be aware of the consequences of certain timing of transactions. However, these costs do not seem justified given the high level of doubt surrounding the effectiveness of blockchain for corporate governance purposes.

Accordingly, Bitcoin should not be used to record transactions, specifically executive compensation, because of its still unclear status and unstable nature. The blockchain technology behind it instead may promote enhanced transparency. But this heightened transparency may actually come at the detriment of shareholders, especially in the case of inexperienced investors that may not be familiar with typical corporate strategies and might misinterpret perfectly innocent board decisions. Accordingly, given the limited additional benefits of registration on public blockchain as compared to the current disclosures required by the SEC, it is advisable the blockchain too not be used, at least in this field.

B. Voting

Corporate elections, given diverse and spread ownership structures, are commonly held through corporate proxy systems. Currently, vote tabulation are subject to a considerable degree of inaccuracy resulting in certain cases in the inability to verify the question "who won?"[158]

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[158] Marcel Kahan & Edward B. Rock, *The Hanging Chads of Corporate Voting*, GEORGETOWN L. J. 96, 1227, 1279 (2008). *See also*, *A Call for Change in*

Studies have found that proxy voting, while solving the issue of reaching quorums even though shareholders may be absent from the voting meeting, has flaws such as inexact voter lists, incomplete distribution of ballots, and problematic vote tabulation.[159] Implementation of blockchain could solve these issues given its accuracy and reliability levels deriving from availability of copies of ledgers to all users. In practice, voting via blockchain would be achieved by allocating eligible voters tokens (also called "vote coins") in a number that represents their voting power.[160] Voters would then transmit to addresses on the blockchain their vote, which would then be registered on the ledger.[161]

Additionally, implementation of blockchain voting may defeat empty voting practices. Empty voting occurs when "an investor uses borrowed shares or certain combinations of derivative securities to acquire voting rights temporarily, without economic exposure to the cash flow rights connected to a share."[162] These voting strategies mostly rely on secrecy and, while legally doubtful, the difficulty connected to their monitoring and enforcement continues to enable them. Accordingly, a transparent system like shared ledger would effectively render empty voting impossible.

However, empty voting is not necessarily a negative tool. Supporters highlight the efficient effects of the strategy in that it effectively permits pricing of voting rights according to the marginal benefit attributed to the highest-valued voter.[163] Empty voting is also a great tool for minority shareholders in that it provides them with an opportunity to maximize their profit by selling or temporarily renting their voting rights.[164] This view assumes that shareholders' interests

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the Proxy Advisory Industry Status Quo 50-61 (Ctr. on Exec. Compensation (White Paper c11-07b, Jan. 2011), http://online.wsj.com/public/resources/documents/ProxyAdvisoryWhitePaper02072011.pdf.

159 A Delaware attorney "estimates that, in a contest that is closer than 55 to 45%, there is no verifiab[ility]" of the election results. Kahan & Rock, *supra* note 158, at 1277-1281.

160 *Id.*

161 *Id.*

162 Yermack, *supra* note 154.

163 *Id.*

164 *Id.*

are more focused on their profits per se than on actual active participation in the decision making process of the company. Indeed, whether empty voting is considered an acceptable practice also depends on what level of shareholder participation in corporate governance one believes appropriate.[165]

Opponents of empty voting, instead, point out the potential undemocratic effect of disjoining ownership and voting rights, which could, especially where it is the minority that rents or sells its voting rights, turn against the very shareholders that are attempting to benefit from the practice.[166] Indeed, where minority shareholders have, as it is common, opposite interests to the majority and control shareholders, selling or renting their voting rights to those parties may result in the support and passage of a resolution not in their best interests.[167] Accordingly, the benefit of empty voting is strongly based on whether one considers shareholders' interests to be those of immediate profit making, or long term and active participation in company governance.

Independently from how one views empty voting, given the relatively straightforward use of the blockchain in the context of voting, this could be an area in which the blockchain could be tested for potential further implementation in governance. The removal and independence of voting from share value avoids the evaluation issue discussed above in the context of Bitcoin blockchains and could render implementation of such model feasible too. In fact, the tokens would be automatically assigned and would not be representative of value. Thus, the analysis above regarding Bitcoin's volatility would not apply, rendering this specific use quite implementable even in the regulatory status quo.[168]

Accordingly, voting via blockchain would effectively solve ambiguities about election outcomes and thus reduce opportunities to manipulate such results and would therefore be an advisable corporate governance tool.

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[165] Onnig H. Bombalagian, *Can Borrowing Shares Vindicate Shareholders Primacy?*, 42 U.C. DAVIS L. REV. 1231, 1238-1257 (2009).

[166] Yermack, *supra* note 137.

[167] *Id.*

[168] *See supra* Section II.

C. Accounting

Commentators have suggested companies may successfully transition to blockchain accounting and voluntarily post all their ordinary business transactions on distributed ledgers.[169] This result may be achieved both through use of Bitcoin as a means of exchange for transactions or by reflecting the value of transactions via token amounts using blockchain technology. However, neither method implements a truly transparent system. Instead, both would allow for managerial manipulation because of the value assessment issues posed by Bitcoin and mentioned in Section III-A.

Implementation of blockchain accounting could reduce accounting and auditing costs in that various units of a company would be able to directly and centrally record transactions into the ledger and thus there would be no need for an auditor to examine the books of every unit to then assemble them ex post.[170] Furthermore, blockchain accounting would also lower the cost of auditing in that auditors and governmental agencies would have direct access to the ledger and be able to examine the regularity of transactions as they occur. This system would thus require extended access to the ledger by certain institutional players, such as taxing agencies, raising the issue of who is entitled to access those records. Accordingly, the the question of whose interests companies must pursue and what the objectives of corporate governance are affect the resolution of this issue. A possible solution to avoid overbroad access to confidential records could be to grant access to only those market player that would have access to SEC disclosures. However this could frustrate

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[169] Ryan Lazanis, *How Technology Behind Bitcoin Could Transform Accounting as We Know it*, (Jan. 22, 2015), TECHVIBES, http://www.techvibes.com/blog/how-technology-behind-bitcoin-could-transform-accounting-as- we-know-it-2015-01-22.

[170] Oliver Staley, *The Unsexy Future of Blockchain is* Accounting, QUARTZ (Mar. 3, 2016), http://qz.com/629662/the-unsexy-future-of-blockchain-is-accounting/; *see, also, Blockchain Technology: A Game-changer in Accounting?*, DELOITTE, https://www2.deloitte.com/content/dam/Deloitte/de/Documents/Innovation/Blockchain_A%20game-changer%20in%20accounting.pdf (last accessed May 10, 2016); Matthew Spoke, *How Blockchain Tech will Change Auditing for Good*, COINDESK (July 11, 2015, 15:00), http://www.coindesk.com/blockchains-and-the-future-of-audit/.

the very purpose of blockchain accounting by denying access to more confidential information needed by taxing agencies.

Furthermore, commentators pushing for adoption of blockchain accounting stress that this method would ensure complete transparency as the entire ledger would be immediately visible, assuming no restrictions to access are set by management, to all stakeholders, from shareholders to creditors, and from lenders to interested parties.[171] While back-dating of transactions or amortizing operation expenses over long periods is not feasible given the time-stamped nature of the transaction blocks, forward dating can be achieved by simply keeping a parallel undisclosed accounting system.[172] Indeed, parallel accounting, be it on a side ledger or in paper form, would still offer companies an "under the table" opportunity to circumvent reporting duties. Accordingly, this system does not accomplish the result it purports to achieve: spotting and impeding self-interested and fraudulent transactions.[173] Indeed, proponents of this type of accounting forget to take into account human nature. They assume a perfect reality where voluntariness to report all transactions at the moment they occur is the rule and self-interests are nonexistent or not pursued. But how can a voluntary reporting system ensure transparency in a system, especially in big corporations, where ownership and management are quite separate? Considering transition costs as well as the above-described pitfalls, feasibility of blockchain accounting seems utopic and impracticable.

D. Smart Contracts

A smart contract is a "computerized protocol that executes the terms of a contract."[174] Smart contracts are not a wholly new concept, however, the advent of virtual currencies and Bitcoin have offered a way to reinvent this transactional product. Given Bitcoin's rapid success among consumers, smart contract providers have

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171 Yermack, *supra* note 154. *See also,* DELOITTE, *supra* note 170.

172 *Id.* at 17.

173 *Id.*

174 Nick Szabo, *Smart Contracts*, (1994) unpublished manuscript, available at http://szabo.best.vwh.net/smart.contracts.html.

quickly developed and offer user-friendly interfaces.[175] Accordingly, consumers may engage in smart contracts that vary from easy daily sales to substantive investments without going through traditional intermediaries.

Technically speaking, the same concept at the basis of smart contracts applies from daily tasks like operating a mechanical soda machine to more sophisticated exchange market operations. The premise on which a smart contract is based is assuring performance.[176] Applicability of this mechanism to blockchain technology translates in execution of contracts based upon the occurrence or non-occurrence of specific verifiable events varying from the passage of time to sophisticated contingencies such as financial outcomes.[177]

While smart contracts may succeed and prove valuable to private individuals' where timing and certainty of execution are key,[178] they may not prove successful as corporate governance tools. While smart contracts may reduce agency costs associated with debt, they would impose on corporations, and thus on boards, tight boundaries for strategic actions. As one commentator noted, the willingness of a company to enter into a smart contract in regard to a loan may be limited as it "represents a pre-commitment not to behave opportunistically in the future and it would protect a lender against fraud strategies by a debtor such as pledging the same collateral to two borrowers."[179] This effect may also prove legally unfeasible considering directors' fiduciary duties to shareholders as in the context of hostile takeovers and relative Revlon duties.[180]

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[175] *See, e.g.,* SMARTCONTRACT, http://about.smartcontract.com/#1-naming-and-description.

[176] *Id.*

[177] *Id.*

[178] Sue McLean & Simon Deane-John, *Demystifying Blockchain and Distributed Ledger Technology – Hype or Hero?*, MORRISON FOSTER (Apr. 5, 2016), http://www.mofo.com/~/media/Files/ClientAlert/2016/04/160405Blockchain.pdf.

[179] Allen, *supra* note 46.

[180] Revlon, Inc. v. Mecandrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).

Furthermore, the private nature of smart contract providers and consequent access to bankruptcy mechanisms for those providers, in addition to Bitcoin's volatility, increases the risks of market bubbles and chaos were some of the providers to fail suddenly. Accordingly, however efficient, smart contract use does not necessarily translate into corporate governance benefits warranting the risks associated with committing to a set and irreversible course of action (once a smart contract is active and the set occurrences happen, execution is automatic). Accordingly, without prior regulation of the status of smart contracts within the realm of investment instruments, companies should not engage in such transactions so as to better safeguard shareholders' interests as well as the overall company's stability. Lastly, the complete automation of execution overburdens companies' boards, thus, without a possibility to provide for "fiduciary out" mechanisms, smart contracts are not an appropriate corporate governance tool and should be left to the realm of private transactions.

IV. CONCLUSION

Bitcoin's current under-regulated status and the lack of confidence deriving from the absence of assurances derived from a centralized bank and government backing, renders use of Bitcoin as a corporate governance tool unjustifiably risky. However, the distributed ledger technology of blockchains, as distinguished from Bitcoin, can, in some fields, represent an efficient solution. During a question-and-answer session with the Commonwealth Club Chair George Scalise, Federal Reserve Chairwoman Yellen herself recognized that, while Bitcoin is not within the scope the Federal Reserve's authority,

> "[Blockchain] is a very important, new technology that could have implications for the way in which transactions are handled throughout the financial system. We're looking at it in terms of its promise in some of the technologies we use ourselves and many financial institutions are looking at it. It could make a

> big difference to the way in which transactions are cleared and settled in the global economy."[181]

Chairwoman Yellen has consistently pointed out that "[blockchain] could have very significant implications for the payment system and the conduct of business."[182] Although the Federal Reserve is not currently exploring regulation, Yellen has explained that the Federal Reserve is, importantly, "trying to understand the nature" of fintech" and that she believes "innovation using these technologies could be extremely helpful and bring benefits to society."[183] Accordingly, regardless of political views and affiliations, the blockchain represents an opportunity to be pursued.[184] Indeed, this article argues that blockchain technology is more suited than Bitcoin to be implemented in the realm of corporate governance because of its more reliable nature.

In regard to the registration of shares to enhance transparency of ownership and shareholders' confidence, neither Bitcoin nor the blockchain would better the current situation. Indeed, companies may implement closed side chains to hide, at least temporarily, some transactions and thus defeat the goal of enhancing the respective managing and monitoring roles of boards and shareholders.[185] Furthermore, in the case of Bitcoin, its volatile value does not create trust in that transactions may be conveniently recorded during low trading value so as to allow executives to pursue self-interests and gain on the edge.[186] Moreover, while the blockchain may avoid this edging issue, potential shareholders' panic may still be a problematic consequence of complete transparency.[187] Thus, while companies could create diversified access levels by creating different

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[181] Stan Higgins, *Fed Chair Yellen: Blockchain is an 'Important Technology'*, COINDESK (Jan. 18, 2017 22:00), http://www.coindesk.com/fed-yellen-blockchain-important-tech/.; For the full speech, *see*, Commonwealth Club, *Federal Reserve Chair Janet Yellen*, YouTube (Jan. 18, 2017), https://www.youtube.com/watch?v=ktBgb4xHKGY.

[182] *Id.*

[183] *Id.*

[184] *See, above*, part II(a) for Trump's administration embracing attitude towards Bitcoin and blockchain.

[185] TASCA, *supra* note 73.

[186] Yermack, *supra* note 154; *see supra* pp. 293-296.

[187] Yermack, *supra* note 154; *see supra* p. 289.

keys, transparency, the very benefit that the technology purports to achieve would be capped at the outset similar to the status quo. Accordingly, implementation of either Bitcoin or the blockchain in this area is not warranted, as it does not enhance the current status of the SEC, and other similar, disclosures.

The arena of corporate voting is, instead, one where implementation of distributed ledgers, and possibly Bitcoin, may bring about a better corporate governance model. Indeed, in this area, the actual market value of shares is unnecessary in the computation of shareholders' voting rights.[188] Accordingly, the time stamping and accuracy level guaranteed by block chain technology would probably bring about a better voting system. While use of Bitcoin in this area does not pose the risks and issues it poses in areas such as transaction reporting and accounting where value is key, Bitcoin's use should, at least until further regulation is enacted, be paused in favor of block chain technology not using virtual currencies.

Accounting represents the most problematic area in which block chain or Bitcoin could be implemented within corporate governance. Bitcoin's volatile value is detrimental to implementation in at least two ways. First, fluctuations in Bitcoin's value may actually further illegal and evasive acts of boards attempting to circumvent accounting laws instead of encouraging transparent and truthful accounting.[189] Indeed, registering transactions at a later date would permit, through exchange rates, modification of the actual value of a company's assets and liabilities.[190] Second, and this applies to blockchain generally as well, this system of accounting is based on the false premise that boards are made of individuals perfectly able to withhold self-interests.[191] Instead, managerial evasion of shareholder monitoring would still be possible, especially given the voluntary blockchain reporting mechanisms. Also, implementation of such a radically different method of accounting would result in great costs,

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188 Kahan & Rock, *supra* note 158.

189 *Supra* pp. 293-296.

190 Yermack, *supra* note 154; *see also supra* p. 294.

191 *Supra* p. 296.

thus, its relative benefits are not warranted, regardless of whether Bitcoin of mere distributed ledgers are used.[192]

Lastly, while blockchain-based smart contracts represent an interesting evolution in the area of self-executing contracts, implementation in the corporate governance arena is not warranted because of board's fiduciary duties issues. This is so regardless of whether the smart contract is based on Bitcoin currency, though in that case, implementation would pose the added dangers deriving from value volatility and lack of supporting infrastructure discussed with regards to accounting.

Accordingly, because of its private and unpredictable nature as well as its current under-regulation, Bitcoin does not present great enough benefits to offset the risks deriving from its implementation. This is so especially in the American market and economy, which do not suffer from lack of consumer confidence in the national currency like other currencies. Instead, the block chain can achieve a progressively relevant status as a corporate governance tool. Accordingly, this paper discourages, at least in the current regulatory atmosphere, implementation of blockchain accounting and ownership reporting but does support blockchain as a corporate voting instrument aimed at ending empty voting and enhancing accuracy.

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[192] *Supra* p. 291.

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EXPLAINING THE FINANCIAL STABILITY BOARD: PATH DEPENDENCY AND ZEALOUS REGULATORY APPREHENSION

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The present paper tries to explain why the current international financial legal regime has taken the shape it has, particularly as it regards to the use of soft-law norms and institutional-making in the apex of the regime: the coordination level of the relevant actors by the Group of Twenty's Financial Stability Board (FSB). Accordingly, it will be argued that path-dependency and the national financial regulators' zealously held powers are two main factors that explain the current informal, "softness" of the FSB—its lack of international legal personality and legally binding instruments.

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I. INTRODUCTION

A key characteristic of international financial law is the lack of binding rules: Almost every aspect of the field has been created through "non-binding" standards that states, banks and financial institutions can implement on a voluntary basis through so-called "soft-law".

This regime was put to the test in the recent 2007-2008 financial crisis, and was found to be wanting, particularly in its ability to coordinate all relevant actors. While there were many causes for the crisis, it is clear that the financial institutions and their national regulators played a key role in triggering it.[1] Therefore, there appears to be a post-crisis consensus that financial institutions cannot only be regulated through market forces,[2] but rather that governmental oversight is needed—as the failures and successes of countries in

[1] *See* Joseph Stiglitz, *The Anatomy of a Murder: Who Killed the American Economy?*, *in* WHAT CAUSED THE FINANCIAL CRISIS 139, 141–42 (Jeffrey Friedman ed., 2011) (recognizing that although there are many actors and institutions responsible for the crisis, "blame should be centrally placed on the Banks (and the financial sector more broadly) and the investors," because the former created the risk they were supposed to manage by "engag[ing] in excessive leverage" and the latter didn't understand the risk involved); *but cf.* Richard Posner, *Afterword: The Causes of the Financial Crisis*, *in* WHAT CAUSED THE FINANCIAL CRISIS, *Id.* at 279 ("there were two main causes [for the crisis]: unsound monetary financial intermediation [and inadequate banking regulation]").

[2] *See* José Fernández, *Global Politics*, 5 MEXICAN LAW REVIEW 333, 363–64 (2013) (arguing that the 2008 financial crisis ended the neoliberal free-market model, thereby posing a global economic challenge difficult to overcome: "finding an economic model to go beyond statism (*Welfare state*), and mercantilism (*liberalism*)") (emphasis in the original).

weathering past crises attest[3]—and more coordination between parties through regulation at the international level.[4]

In the aftermath of the crisis, a new entity was created to address the lack of coordination: the Financial Stability Board (FSB). Established in April of 2009 by the Group of Twenty (G-20)—an informal forum for central banks' governors and financial ministers of nineteen economies and the European Union to discuss global economic issues—the FSB has assumed the function of coordinating all the regulatory and supervisory actions done at the international level.[5] As a successor of the Financial Stability Forum (FSF), which in turn was created by the Group of Seven (G-7)—akin to the G-20, the G–7 is a political forum for the most industrialized economies—the FSB "has assumed a key role in promoting the reform of international financial regulation."[6] However, unlike other creations in the international financial legal regime, the FSB was not endowed with any

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[3] *See, e.g.,* Karen Sigmond, *Banking Regulation in Mexico: Lessons from Financial Crisis*, 4 MEXICAN LAW REVIEW 3, 31 (2011) (praising the creation of the CNBV in Mexico during its 1995 crisis—the governmental entity entrusted with supervising the whole financial system—and asking whether this could be made at the international level); *see also* Geoffrey Miller, *Is Deposit Insurance Inevitable? — Lessons from Argentina*, *in* ECONOMIC DIMENSIONS IN INTERNATIONAL LAW: COMPARATIVE AND EMPIRICAL PERSPECTIVES 392, 398–401 (Jagdeep S. Bhandari & Alan O. Sykes eds., 1997) (arguing that one effect of the Mexican 1995 crisis was the bank runs and burgeoning crisis that arose in Argentina during that year, which in turn led Argentina to the creation of both a deposit insurance system and an entity that oversees its functioning to counteract the crisis effectively; thus, despite the opposition of high-ranking officials in Argentina's government to deposit insurance, that country departed from its policy of controlling bank risk through only market discipline because the political pressure of reinstating the deposit insurance system became irresistible).

[4] *See* Rosa Lastra, *Do We Need a World Financial Organization?*, 17 J. INT'L ECON. L. 787, 805 (2014).

[5] G20 2016 CHINA, *About*, (last visited May 1, 2016), http://g20.org/English/aboutg20/AboutG20/201511/t20151127_1609.html; Charter of the Financial Stability Board (June 19, 2012), art. 1, (last visited May 1, 2016), http://www.financialstabilityboard.org/wp-content/uploads/FSB-Charter-with-revised-Annex-FINAL.pdf.

[6] FINANCIAL STABILITY BOARD, *About: Our History*, (last visited May 1, 2016), http://www.fsb.org/about/history/.

real international legal personality,[7] and therefore, its decisions are not legally binding.[8]

In light of this "softness", different proposals have emerged that try to give more "teeth" to the international financial architecture, particularly through "hardening" the existing norms into internationally, legally binding ones, enforced through an international organization.[9] On the other side of the debate, there are calls to keep soft-legal instruments and forums with greater flexibility, but enhancing their effectiveness to accomplish what the pre-crisis regime did not: more coordination of supervisory, standard-setting, and enforcement authorities.[10]

Considering that debate helps establish a backdrop for the present paper which will try to explain why the current international financial legal regime has taken the shape it has, particularly as it regards to the use of soft-law norms and institutional-creation in the apex of the regime: the coordination level of the relevant actors in the regime. Furthermore, it will be argued that path-dependency and the powers zealously held by national financial regulators are two

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[7] Articles of Association of the Financial Stability Board (January 28, 2013), art. 1, (last visited May 1, 2016) http://www.financialstabilityboard.org/wp-content/uploads/r_130128aoa.pdf ("An association by the name of "Financial Stability Board" . . . is hereby established pursuant to Article 60 of the Swiss Civil Code.").

[8] Charter of the Financial Stability Board, *supra* note 5, art. 24 ("This Charter is not intended to create any legal rights or obligations"); *but cf.* Suyash Paliwal, *The Binding Force of G-20 commitments*, 40 YALE J. INT'L L. ONLINE 1 (2014) (analyzing the bindingness of the commitments undertaken within the FSB as unilateral declarations, custom, estoppel and reciprocity).

[9] *See* Lastra, *supra* note 4, at 793 ("The IMF is the only institution (other than the Bank for International Settlements and the World Trade Organization) that has international legitimacy, an array of tools (surveillance, conditional financial assistance, and technical assistance), appropriate financial resources, and staffing to assume a formal role as global financial authority . . . . [O]nly the Fund can effectively contribute to the enforcement of those standards through its surveillance function."); *see also* John Jackson, *Global Economics and International Economic Law*, 1 J. INT'L ECON. L. 1, 22-23 (1998) (providing a laundry list of topics to address whenever designing international institutions for the banking and financial sectors).

[10] *See* Jan Wouters & Jed Odermatt, *Comparing the 'Four Pillars' of Global Economic Governance: A Critical Analysis of the Institutional Design of the FSB, IMF, World Bank, and WTO*, 17 J. INT'L ECON. L. 49 (2014).

important factors that explain the current informal, "softness" of the FSB.[11] Through arguments that explore the unique and rapid technological changes of the regime, the use of soft-law in international financial law has been said to be preferred because of its flexibility and expediency. However, on one hand, through these soft-law and informal forums national regulators have been able to retain the power they hold pursuant to their domestic legislative instruments, while on the other, have found success in projecting these enhanced power and enforcement capabilities on the international level. Contrary to what would occur by ceding rule-making power to an international organization—which allegedly would complicate the decision-making process and diminish direct communication among national regulators—the national regulators retain the ability to wield the rules of the international financial game through soft-law standards that conform to their points of view, and which countervail the need for achieving consensus with more stakeholders[12] that formal venues and treaty-making would require.

Although not every national financial regulator is invited to the game, this result is not necessarily negative, as the main priority and value of the regime (financial stability) does not rely on the democratic character of the rule-making process and institutions, but rather, on the technocratic knowledge of its experts. But even when taking that factor into account, the move from the "elite" membership of the FSF to the FSB's more democratic structure signals a positive step taken by the controllers of the regime: the national financial regulators.

II. SOFTNESS IN INTERNATIONAL FINANCIAL LAW

Many of the legal institutions and instruments underpinning the international financial legal regime are neither treaty-based, nor considered to be part of general international law. Conversely, they are part of another subset of norms referred to as "soft–law" that are used in the international financial legal world; particularly because of soft

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[11] *See* Pierre-Hugues Verdier, *The Political Economy of International Financial Regulation*, 88 IND. L.J. 1405 (2013).

[12] Like their national diplomatic representatives or other foreign regulators.

law's tendency for flexibility and effectiveness *vis-à-vis* their "harder" siblings.

A. Distinction Between "Soft" and "Hard" International Law

Under a rule-based approach to public international law,[13] legally binding norms are only those reflected in Article 38 of the Statute of the International Court of Justice: international treaties, custom, and general principles of international law;[14] everything else is legally irrelevant.[15] Under this positivistic view, only rules created by states are legally binding, and thus enforceable.[16]

In contrast, different ways of regulating areas of international relations have emerged on a transnational and global basis, thus leading to the emergence of the so-called "soft-law" norms.[17] The main characteristic of these soft law norms is that they do not comply with either of the requirements for "harder" norms: those being created by states and conforming to one of the three primary sources of international law. Therefore, they are not "legally" binding, but rather, implemented on a voluntary basis without the ability to be legally enforced or sanctioned at the international level.

Because soft-law does not require creation by states, it has largely been international organizations, private entities, other non-state actors, and even subsets of states' governments creating them.[18]

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[13] The main feature of this approach is the emphasis on the normative aspect of public international law, conceptualizing the law as a system of rules binding upon its subjects, which can be appreciated through an examination of the three recognized normative sources of international law. MARTTI KOSKENNIEMI, THE POLITICS OF INTERNATIONAL LAW 39–41 (2011).

[14] Statute of the International Court of Justice (entered into force 24 October 1945) 1 UNTS 993, art. 38 (1).

[15] JOSÉ ÁLVAREZ, INTERNATIONAL ORGANIZATIONS AS LAW-MAKERS 48 (2005).

[16] *Id.*

[17] Nico Krisch & Benedict Kingsbury, *Introduction: Global Governance and Global Administrative Law in the International Legal Order*, 17 EJIL 1 (2006).

[18] *See* Mauricio Del Toro, *El Fenómeno del Soft Law y las Nuevas Perspectivas del Derecho Internacional*, 6 ANUARIO MEXICANO DE DERECHO INTERNACIONAL [Mexican Yearbook of International Law] 513 (2006) (advocating for the conceptualization of soft law as a continuum of normative force to analyze practically

Thus, this flexibility makes these alternative bodies suitable for whenever there is deadlock or lack of consensus for a multilateral treaty, or a need to harmonize the rules at the international level.[19]

When technocratic experts create soft law, the legitimacy of these rules rely on their consensual basis to attain the common goal of their creators, as well as the technocratic expertise involved.[20]

The use of soft-law has mainly been attributed to two of its main virtues: flexibility and effectiveness, both of which have been praised for their help in achieving greater rates of compliance in certain areas, such as capital adequacy.[21] Whereas soft-law can be rapidly created without the need to seek state consensus or state participation

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how the international legal system works and norms are created by actors other than states).

[19] *See e.g.*, Andrea Bjorklund, *Assessing the effectiveness of soft law instruments in international investment law*, *in* INTERNATIONAL INVESTMENT AND SOFT LAW 51, 81 (Andrea Bjorklund & August Reinisch eds., 2012) (analyzing the forms of soft law instruments and their usage for investment law, concluding that because of the criticism to the regime and failed, past attempts to negotiate a multilateral instrument without states' participation—like the Organization for Economic Co-operation and Development's failed Multilateral Agreement on Investment—the "negotiation of a multilateral instrument might be facilitated and influenced by a soft law instrument that brings together investment law practice in an objective manner, that sets forth areas of convergence and divergence and the choices that need to be made by drafters, and that clearly sets out the policy implications of each of those choices". In other words, not a codification attempt, but rather "the distillation would more likely take the form of a commentary, annotation or treatise, and would be directed towards a wider audience than just States, though it could help to guide treaty negotiators and decision-makers, including States and arbitrators").

[20] *See* Alejandro Rodiles, *Coalitions of the Willing: Coyuntura, Contexto y Propiedades. Un Primer Esbozo*, 7 ANUARIO MEXICANO DE DERECHO INTERNACIONAL [Mexican Yearbook of International Law] 675, 701-02 (explaining that soft law norms compete with formal public international legal rules, as the former do not claim legitimacy from their legal status, but rather from the political consensus achieved by its participants—engaging in a normative process to regulate a common right cause—and the technocratic nature of both the decision-process and the standard created).

[21] Bas Arts & Dieter Kerwer, *Beyond legalization? How global standards work*, *in* LAW AND LEGALIZATON IN TRANSNATIONAL RELATIONS 144, 160–62 (Christian Brütsch & Dirk Lehmkuhl eds., 2007).

at all, custom and principles require long periods of time and universal consensus to emerge.

Likewise, whereas soft-law can be created by entities other than states and does not require consensus by its creators or the ratification of national legislatures to exist and be modified, treaties do require the consensus of state entities or international organizations for their creation, usually after a national legislature ratification process has occurred, and can only be modified with the consensus of the involved parties;[22] all of which lengthens the creation and adaptation processes and may hinder its effectiveness as a rule–making tool.[23] When informal forums, or what Vabulas and Snidal call "informal international intergovernmental organizations," (IIGOs) are preferred over international organizations it is due to the following reasons:

> States opt for less formality by using IIGOs when the advantages of lower sovereignty and negotiation costs, flexibility and speed outweigh the need for enforcement commitment, consensus, and the bureaucratic centralization.[24]

Accordingly, although soft-law lacks the status of harder law, *per se*, "[it] is not necessarily inferior to legally binding obligations as a

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[22] *See* UNGA Vienna Convention on the Law of Treaties (adopted 22 May 1969, entered into force 27 January 1980) 1155 UNTS 331, arts. (2)(1)(a), 11, 39; *see also* Vienna Convention on the Law of Treaties between States and International Organizations or between International Organzations, arts. 2 (1)(a)(b), 11, 39.

[23] Hanspeter Neuhold, *Variations on the Theme of 'Soft International Law'*, *in* INTERNATIONAL LAW BETWEEN UNIVERSALISM AND FRAGMENTATION. FESTSCHRIFT IN HONOUR OF GERHARD HAFNER 343, 344 (Isabelle Buffard et al. eds., 2008); *but cf.* Nico Krisch, *More equal than the rest? Hierarchy, equality and US predominance in international law*, *in* UNITED STATES HEGEMONY AND THE FOUNDATIONS OF INTERNATIONAL LAW 135, 156–59 (Michael Byers & George Nolte eds., 2003) (depicting the use of informal standard-setting—such as the Basel Committee on Banking Supervision—as a departure of the sovereign equality of states, and thus as an opportunity for the United States to place itself above the law: "the United States relies heavily on informal means of lawmaking and enforcement, as this very informality allows it to disregard many of the constraints otherwise imposed by sovereign equality.").

[24] Felicity Vabulas & Duncan Snidal, *Organization without delegation: Informal intergovernmental organizations (IIGOs) and the spectrum of intergovernmental arrangements*, 8 REV. INT. ORG. 193, 219 (2013).

means for solving problems in international relations [because, as discussed previously] . . . it offers advantages, which in some cases may outweigh its shortcomings [i.e., their lack of enforceability]."[25] As espoused by Chris Brummer, the use of soft law in international financial regulation is bolstered by disciplining mechanisms that make soft law more coercive: "reputational constraints inform the decision making of regulators in the same way that reputation disciplines heads of state who commit to international agreements".[26]

B. International Financial Architecture

The use of soft-law mechanisms can be seen throughout the whole international financial regime. To illustrate this, the following sections will analyze the three different levels or stages that comprise the regime: standard-setting; supervision and coordination; and enforcement and sanctioning.

1. *Standard-setting*

International financial law has been regulated mainly through soft-law norms, such as standards, which are implemented on a voluntary basis by national financial regulators or financial institutions and banks. Almost invariably, all members of the FSB[27] have engaged in international standard setting: states' financial regulators; international financial organizations;[28] and other standard-setting bodies that were conceived to standardize international finance and that we could call standard-setting bodies *strictu sensu*.[29]

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[25] Neuhold, *supra* note 23, at 351.

[26] Chris Brummer, *How International Financial Law Works*, 99 GEO. L.J. 257, 263 (2011).

[27] *See* Charter of the Financial Stability Board, *supra* note 5, art. 5(1).

[28] International Monetary Fund (IMF), World Bank, Organization for Economic Co-operation and Development, and the Bank for International Settlements (BIS).

[29] Such as the Basel Committee on Banking Supervision (BCBS), the Committee on the Global Financial System, the Committee on Payments and Market Infrastructures, the International Association of Insurance Supervisors, the International Accounting Standards Board, and the International Organization of Securities Commissions.

Perhaps the most effective production of soft-law, in terms of compliance, has been BCBS's work on standardizing the capital adequacy of banks, which has been praised for the high number of states that have implemented it (90 percent of all countries adhere to Basel I's capital requirement), and that effect has been attributed to the BCBS's departure from the rigidness of classic international law making,[30] in addition to its undisputed expertise in that area.[31] An additional example of highly valued soft-law is the Equator Principles of the International Financial Corporation, a member of the World Bank Group, which sets *de facto* standards for parties dealing with project finance on a global scale by inciting financial institutions to voluntarily adopt standards in order to implement normative and business related rationales for the conduction of environmental and social risk management.[32] Likewise, this includes the

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[30] *See* Arts & Kerwer, *supra* note 21; *see also* Rodiles, *supra* note 20, at 693–95 (defining the Basle Committee of 1975 as a "coalition of the willing": defined as a transnational network of actors that do not rely on the procedural or substantive rules of public international law rule-making, but conversely engage into normative creation processes through standards that depart from it and which are implemented effectively because of the political consensus of its participants and the convenience to accomplish a common goal).

[31] *See* Arts & Kerwer, *supra* note 21 ("the Committee has a high reputation of experts, no competition from other bodies that engage into standard-setting in that area, and has effective third party enforcement mechanisms—national authorities implement the law voluntarily or are obligated through loans from IMF or other international lenders that require compliance with the standard"); *but see* the critiques on Basel Rules' role in the 2007–2008 financial crisis in Juliusz Jablecki & Mateusz Machaj, *A Regulated Meltdown: The Basel Rules and Banks' Leverage*", *in* WHAT CAUSED THE FINANCIAL CRISIS, *supra* note 1, at 200, 226 (analyzing the negative role that Basel's rules had by diminishing the financial entities incentive to regulate themselves: "Capital-adequacy rules based on fixed risk measurements—and designed (paradoxically) to protect the economy from excessive credit expansion—were used in unanticipated ways, hiding the risks from the sight of supervisors and investors alike and giving everyone an utterly false sense of security, confidence, and stability."); *see also* Posner, *supra* note 1, at 288 ("the American amendment to Basel I adopted in 2001, and Basel II, adopted in 2004, underestimated the riskiness of mortgage-backed securities by assigning them a minimal risk weight, and so gave banks a green light to buy more of these assets than turned out to be safe for the economy as a whole.").

[32] *See* Christopher Wright, *Setting standards for responsible banking: examining the role of the International Finance Corporation in the Emergence of the Equator Principles*, *in* INTERNATIONAL ORGANIZATIONS IN GLOBAL ENVIRONMENTAL GOVERNANCE 51 (Frank Biermann et al. eds., 2009); *see also* Susan Park, *Socialization, the World Bank*

Recommendations on anti-money laundering by the Financial Action Task Force.[33]

Although there are a lot of ways in which members of the FSB engage in standard-setting, for purposes of the present paper, it suffices to show that none of the standard-setting bodies *strictu sensu* possess international legal personality.[34] This explains why those bodies are depicted as a different class of members than states' national regulatory agencies and international financial organizations, which do possess an international legal personality within the FSB Charter.[35] Likewise, it explains why they all work with the BIS's assistance in

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Group and global environmental governance, *in* INTERNATIONAL ORGANIZATIONS IN GLOBAL ENVIRONMENTAL GOVERNANCE 91 (Frank Biermann et al. eds., 2009) (appraising the International Financial Corporation's proneness to incorporate environmental norms into its work and contrasting it with the Multilateral Investment Guarantee Agency's reticence, also part of the World Bank; particularly because the former has been opened to environmental networks that have socialized the institution, thereby diffusing environmental norms through the International Financial Corporation's work, whilst the Multilateral Investment Guarantee Agency has resisted this effect).

[33] *See, e.g.*, Nicholas Turner, *The Financial Action Task Force: International Regulatory Convergence Through Soft Law*, 59 N.Y.L. SCH. L. REV. 547, 559 (2014) ("The FATF demonstrates that under the right conditions, it is possible to achieve substantial, albeit imperfect, legal and regulatory coordination across the globe.").

[34] *See* BANK FOR INTERNATIONAL SETTLEMENTS, *Monetary & financial stability - Overview*, (last visited Mar. 1, 2016), http://www.bis.org/stability.htm (Basel Committee on Banking Supervision Charter, §3 ("The BCBS does not possess any formal supranational authority. Its decisions do not have legal force. Rather, the BCBS relies on its members' commitments . . . to achieve its mandate.")); BANK FOR INTERNATIONAL SETTLEMENTS, *Committee on the Global Financial System: mandate*, *id.* ("The Committee … is a central bank forum"); BANK FOR INTERNATIONAL SETTLEMENTS, Charter of the Committee on Payments and Market Infrastructures, *id.* at §3 ("CPMI does not possess any formal supranational authority"); INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS, (last visited May 1, 2016), http://iaisweb.org/index.cfm?event=showHomePage&persistId=2F9C2180155D89A4065E749C0A3A37F0; INTERNATIONAL ACCOUNTING STANDARDS BOARD, (last visited May 1, 2016), http://www.ifrs.org/About-us/Pages/IFRS-Foundation-and-IASB.aspx; INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS, *About Iosco*, (last visited May 1, 2016), https://www.iosco.org/about/?subsection=about_iosco.

[35] *See* Charter of the Financial Stability Board, *supra* note 5, art. 5(1).

terms of venue, infrastructure, and resources.[36] Finally, this premise also illustrates why states use this approach: because they are a form of IIGO, lacking a binding effect in their decisions.[37]

2. *Supervision and Coordination*

This level of the international financial legal regime is shared mainly between the FSB and the IMF.[38] Whereas the former is concerned with macro-stability, the latter has been said to be concerned with the micro-stability of avoiding risky behavior by banks and other financial institutions.[39] However, considering that the IMF participates within the FSB and the latter's mandate in coordinating all financial entities, it can be said that the FSB holds the coordination

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[36] *See* BANK FOR INTERNATIONAL SETTLEMENTS, *Monetary & financial stability – Overview*, *supra* note 34 (describing the kind of assistance rendered by the BIS); *see also* C.F. AMERASINGHE, PRINCIPLES OF THE INSTITUTIONAL LAW OF INTERNATIONAL ORGANIZATIONS 13, 75 (2d ed., 2005) (analyzing how the dual personality of the BIS as a legal person in both international and Swiss law does not affect its character as an international organization); *see also* ROLAND PORTMANN, LEGAL PERSONALITY IN INTERNATIONAL LAW 228–32 (2010) (analyzing the BIS litigation of *Reineccius et al. v. Bank for International Settlement* as a form of "actor conception"—attaching legal consequences to an international actor without justifying them—whereby a panel of arbitrators recognized the international legal personality of the Bank and analyzed certain legal consequences deriving therefrom, such as the applicability of the expropriation and compensation rules of international law towards its actions *vis-à-vis* private investors).

[37] *But see* Gregory Shaffer & Mark Pollack, *Hard vs. Soft Law: Alternatives, Complements, and Antagonists in International Governance*, 94 MINN. LAW REV. 706, 765–67 (2010) (arguing that many of the standards produced by standard-setting organizations within the international financial legal world have been hailed for being effective because the existing treaties and soft law instruments created acted complimentarily, on account of the consensus generated by the powerful states that participated actively in all of the standard-setting forums explained above: the European Union and the United States).

[38] *But see* Gary Hufbauer, *Rules of the International Trade, Investment, and Financial Systems: What they Deliver, how they Differ, the way Forward*, 17 J. INT'L ECON. L. 833, 839 (2014) (citing Rosa M Lastra, 'Do we need a World Financial Organization', Special Conference in Honor of Professor John Jackson and the Institute of International Economic Law, Georgetown Law Center, 16 November 2012) (arguing that the World Trade Organization also performs this role in the liberalization of financial trade, and that the BIS and other standard-setting bodies share the FSB's role at the micro-stability level).

[39] *Id.*

role of all standard-setting and supervisory functions within the international financial architecture:

> The [FSB] is established to coordinate at the international level the work of national financial authorities and international standard setting bodies (SSBs) in order to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies. In collaboration with the international financial institutions, the FSB . . . address[es] vulnerabilities affecting financial systems in the interest of global financial stability.[40]

Regarding the IMF's supervisory functions, it is important to note that its supervisory function was triggered by the abandonment of the par-value regime in the 1970s.[41] Consequently, the IMF went from being an international monetary institution with a limited mandate on exchange rate stability and convertibility to a financial one with a much narrower mandate, redefining its three main functions: surveillance, conditional financial support, and technical assistance.[42] This has led the IMF to address issues ranging from payment systems, to financial reform, banking and other capital markets.[43] Contrary to the FSB and other actors, the IMF has been heavily criticized for its stance on development, particularly through its function as the lender of last resort for states in addition to the conditions typically imposed,[44] which allegedly straightjackets developing countries to follow a set of economic policies that may not be the best for their development. It also has been denounced for neglecting environmental and

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[40] Charter of the Financial Stability Board, *supra* note 5, art. 1; *see also* Wouters & Odermatt, *supra* note 10, at 75 ("the FSB was not established to harmonize rules or to impose international regulation, but rather to coordinate other important actors involved in maintaining financial stability.").

[41] Rosa Lastra, *The International Monetary Fund in Historical Perspective*, 3 J. INT'L ECON. L. 507, 514 (2000).

[42] *Id.*

[43] *Id.*

[44] *Id.* at 521–23 ("[Since the Mexican and Asian crisis in the mid-1990s,] the IMF appear[ed] to . . . emerg[e] as a de facto international lender of last resort" through its financial support to developing economies in stress.").

stakeholders' interests, such as human rights,[45] that seem to constrain basic sovereign regulatory spaces.[46] Even compared to other international financial institutions, the IMF has not been viewed as receptive towards civil society and developing countries interests and demands,[47] contrary to the World Bank that created the Inspection Panel for that purpose,[48] for example. Be that as it may, today, the IMF

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[45] *See, e.g.*, David Enríquez, *El Derecho Internacional Económico. Apuntes para una Crítica Contemporánea*, 6 ANUARIO MEXICANO DE DERECHO INTERNACIONAL [Mexican Yearbook of International Law] 251 (2006) (advocating for an interdisciplinary approach towards international economic legal issues that considers stakeholders' interests, including human rights and environmental concerns); *see also* David Enríquez, *Batallas en el Sistema Financiero Internacional. Críticas y Réplicas Contemporáneas en torno al Fondo Monetario Internacional y al Banco Mundial*, 11 BOLETÍN MEXICANO DE DERECHO COMPARADO [BMDC] 467, 499–502 (2007) (arguing that states parties to loan agreements with the IMF and the World Bank, as well as those institutions, have an obligation to respect human rights).

[46] *See, e.g.,* ANTHONY ANGHIE, IMPERIALISM, SOVEREIGNTY AND THE MAKING OF INTERNATIONAL LAW 258–69 (2004) (arguing that the World Bank and the IMF, through the promotion of "good governance" in their conditional loans—a recipe for making governments accountable, transparent and democratic, which in turn links human rights and development—reproduce colonial aspects of international law by imposing upon Third World countries structural adjustment programs that reshape their economic, political and financial systems, and that are driven by the economic considerations of richer states, wherein the countries regulated cannot participate in their elaboration).

[47] *See* Enríquez, *Batallas en el Sistema Financiero Internacional. Críticas y Réplicas Contemporáneas en torno al Fondo Monetario Internacional y al Banco Mundial*, *supra* note 45, at 523–25 (contrasting the IMF's and the World Bank's receptiveness to civil society's criticisms and democratic deficits: whereas the IMF's openness has been limited to its co-partnership role in combating poverty and debt relief with the World Bank because economic concerns—and the need to tighten orthodox economic policies—have prevailed over other interests in order to secure the repayment of its loans, the latter has been more receptive due to more criticism by civil society and because its infrastructure financing projects directly concern social and environmental problems; for instance, the World Bank has permitted civil society participation and has changed its policies through the creation of the Inspection Panel).

[48] Alix Gowlland-Gualtieri, *The Environmental Accountability of the World Bank to Non-State Actors: Insights from the Inspection Panel*, *in* NON-STATE ACTORS AND INTERNATIONAL LAW 333 (Andrea Bianchi ed., 2009) (a positive outcome of the World Bank's Inspection Panel is its inclusion of environmental norms into its procedures, thereby making states and the World Bank itself accountable through a soft-law and flexible procedure for their loan activities *vis-à-vis* certain non-state actors); *see also* Ellen Hey, *The World Bank Inspection Panel and the Development of International Law*, *in* INTERNATIONAL COURTS AND THE DEVELOPMENT OF INTERNATIONAL LAW: ESSAYS IN HONOUR OF TULLIO TREVES 727 (Nerina

is one of the oldest actors in the field and the fact is that the IMF has acquired a key place in the new financial architecture through its surveillance powers, mainly.

Given the participation of the IMF in the FSB, and the coordination of the latter in the international legal arena, both institutions have cooperated very strongly to conduct Early Warning Exercises for the analysis of systemic risk at the international level.[49]

3. *Enforcement and Sanctioning*

The picture would not be complete without the governmental actors that behold the monopoly of the enforcement and sanctioning of financial institutions' and banks' deviations from the standards created and consented to by the FSB and member institutions: the national financial regulators. According to Gary Hufbauer, their power, and thus the absence of an international or external examining and disciplining scheme, can be attributed to two main reasons: First, prescriptive rules in international finance are much more probabilistic than trade or investment—in both of which regimes, dispute adjudication has been delegated to international bodies—and thus national regulators prefer to do so themselves because they have more information about their national financial markets; and second, because national financial regulators are not willing to cede their power to an international body—contrary to what trade and investment bureaucrats did—and their regulated financial entities prefer these domestic, national bodies over foreign international regulators.[50]

This second reason could explain, in turn, the use of soft law norms for the other two levels: since the standard-setting agencies' regulations are not legally binding, and therefore cannot be imposed upon states or financial institutions and banks, it seems reasonable that

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Boschiero et al. eds., 2013) (appraising the World Bank Inspection Panel's role in promoting an administrative form of accountability wherein private parties' access is provided without the need of their home state, thereby departing from the classic rules of international law).

[49] *See* Charter of the Financial Stability Board, *supra* note 5, art. 2(h); *see also* Wouters & Odermatt, *supra* note 10, at 70-74 (arguing that since the IMF and World Bank are members of the FSB, they cooperate with it more than with the World Trade Organization, who is not a FSB member).

[50] Hufbauer, *supra* note 38, at 842.

the supervisory and coordinating entities would also apply soft-law. By doing so, they would have coordinating and supervisory functions through a more-narrow mandate, leaving the sanctioning of deviations to states once they voluntarily decide to implement the standards consented to. This analysis is well-explained in the words of Rosa Lastra:

> The development of international financial law has been a slow and patchy phenomenon because of three reasons: (i) the lack of a clear legal mandate; (ii) a reactive rather than a proactive character;[51] and (iii) the vested interests national governments have in the supervision and regulation of their financial sectors.[52]

Accordingly, (i) the absence of legally binding norms is explained by the use of soft-law standards, which in turn helps fathom the (ii) reactive character of the norms and the limited supervisory and coordinating role that the IMF and the FSB have. Since they cannot impose rules on states, reactive standards seem more suitable to be implemented *ex post* financial crises; at a time in which consensus on how to regulate the flaws for counteracting a crisis has emerged—as well as the (iii) lack of delegation of adjudicative and sanctioning functions for an international body.

III. THE FSB EXPLAINED

A. Path Dependency

Why would states seek recourse to an international organization? Traditionally, through institutionalization, not only can

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[51] This aspect has been considered fundamental in explaining the reason why the trade regime has scored better in its objective of liberalizing trade than the financial regime has done to stabilize markets—although international financial institutions have also promoted liberalization, whenever it enters into conflict with stabilization, the latter will always prevail—particularly because GATT/WTO has worked prospectively, whereas the IMF does so at the moment the crash occurs and with "little power to compel appropriate macroeconomic policies and financial practices". Gary Hufbauer & Erika Wada, *Can Financiers Learn from Traders?*, 2 J. INT'L ECON. L. 567, 569-73 (1999).

[52] Lastra, *supra* note 4, at 796.

states act collectively and overcome their coordination problems,[53] but they could also accomplish legally binding decisions derived from the treaty that created the organization.[54] Furthermore, through an international organization they can also legitimize the whole rule-making process, as they would have to be constrained by the rules of international law that protect non-powerful states through the sovereign equality principle.

However, the need for consensus, and even the ability to afford the same voting rights to all states has changed, depending on the international organization concerned.[55] And even in the aegis of the United Nations, the Bretton Woods institutions did not foresee equality of voting rights. Nevertheless, the legitimacy that being an international organization accrues might differentiate them with other informal venues, such as IIGOs. Dani Rodrik depicts this idea by contrasting the contemporary globalization world with the "multilateralism" that existed during the Bretton Woods system:

> Multilateralism meant that rule enforcement and belief systems would work henceforth through international institutions—the International Monetary Fund, the World Bank, and the General Agreement on Tariffs and Trade (GATT)—rather than through naked power politics or imperial rule. Even though the influence of the United States was undeniable, multilateralism endowed these institutions with a certain degree of legitimacy independent of the American power that backed them up.[56]

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[53] Wouters & Odermatt, *supra* note 10, at 52 ("While the whole international community has an interest in a 'stable' global financial system, individual states will continue to take steps that are in their own (short-term) interests, even if they remain precarious for the system as a whole. It is for this reason that states have looked to international institutions to help overcome this collective action problem and promote greater global cooperation.").

[54] ÁLVAREZ, *supra* note 15, at 395.

[55] *Id.*

[56] DANI RODRIK, THE GLOBALIZATION PARADOX: DEMOCRACY AND THE FUTURE OF THE WORLD ECONOMY 70 (2011); *see also* Robert Howse, *From Politics to Technocracy—and Back Again: The Fate of the Multilateral Trading Regime*, 96 AM. J. INT'L L. 94, 94–95 (2002) (arguing that Bretton Woods was "concerned with the

Chris Brummer explains how the current globalization system not only meant an erosion of the dominance of the United States in the world arena—and thus of a more diffused world in terms of power, where "[e]merging markets have generally been the big winners"—but also that the current multi-polarity has made multilateralism more difficult and costly, thereby "giving way to new, innovative modes of cooperation" called minilateralism: strategic alliances with smaller groups; states turning away from treaties towards more soft law; and financial engineering in states' dealings.[57] Although effective, this new economic statecraft raises issues of fairness and democratic legitimacy, given its exclusive character and "sidestep[ping] [of] some of the multilateral values of universality and due process".[58]

Accordingly, Georges Baur argues that whereas international organizations respected the equality of states and other rules of international law through inclusiveness and consent, informal international task groups do not, such as the FSF, because they impose standards and sanctions that are created by the task group's member-states against other non-member states, with the purpose of advancing the former group's economic and political interests at the cost of the latters'.[59]

Nevertheless, this is the current paradigm of global finance today, and we cannot simply return to the Bretton Woods system.[60] On the contrary, the financial globalization created by deregulation,

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interdependency of different states' trade and other economic policies—i.e., managing or constraining the external costs that states impose on other states by virtue of their policies.") (emphasis in original).

[57] CHRIS BRUMMER, MINILATERALISM: HOW TRADE ALLIANCES, SOFT LAW, AND FINANCIAL ENGINEERING ARE REDEFINING ECONOMIC STATECRAFT 16–19 (2014).

[58] *Id.* at 20.

[59] Georges Baur, *Will New Developments in Global Economic and Financial Policy Erode International Law and the Sovereignty of States? – The Example of Liechtenstein*, *in* PROMOTING JUSTICE, HUMAN RIGHTS AND CONFLICT RESOLUTION THROUGH INTERNATIONAL LAW: LIBER AMICORUM LUCIUS CAFLISCH 1017 (Marcelo G. Kohen ed., 2007).

[60] *See* Rolf Weber & Douglas Arner, *Toward a New Design for International Financial Regulation*, 29 J. INT'L L. 391, 438 ("The Bretton Woods system was designed to support global trade but not global finance. As a result, we cannot simply return to the old system but must look towards the requirements of today's reality.").

technology and financial innovation has changed the regulatory space of the field.[61] The reality is that states have decided to use the minilateralism strategy of soft law in international finance, at least since the Group of Ten (G-10)—composed of the most industrialized nations of that time[62]—established the BCBS in the aftermath of the failure of the German Herstatt Bank and the American Franklin National Bank of New York in 1974.[63] In the words of Pierre-Hugues Verdier:

> When the fixed rate system collapsed in the 1970s, national regulators faced numerous new cross-border challenges. With no international framework to address them and no authority to create formal institutions or binding agreements, they instead created informal networks and non-binding standards.[64]

Thereafter, cooperative informal initiatives in other financial sectors were created and their roles exacerbated in the demise of Bretton Woods system, which had a very limited role for international private finance where international capital mobility was not the norm,[65] and thus, "no provision was made for regulating private finance."[66] Contrary to arguments that espouse the rationality of using soft law in international financial law as the ones depicted in the section above, the use of IIGOs and soft law norms in the international financial legal arena can be explained through what Verdier calls a historical path dependency:[67]

> In the absence of an international institution, national regulators took the initiative, but they faced several constraints. Their options were limited by their

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[61] CHRIS BRUMMER, SOFT LAW AND THE GLOBAL FINANCIAL SYSTEM: RULE MAKING IN THE 21ST CENTURY 10 (2015).

[62] *See* BANK FOR INTERNATIONAL SETTLEMENTS, *G10*, (last visited Mar. 1, 2016), https://www.bis.org/list/g10publications/index.htm.

[63] BRUMMER, *supra* note 57, at 99–100.

[64] Verdier, *supra* note 11, at 1408.

[65] *Id.* at 1411–12.

[66] *Id.* at 1416.

[67] *Id.* at 1427; *but cf.* BRUMMER, *supra* note 61, at 108–09 (analyzing an "institutional path dependency" in the structure and composition of the organizations).

> domestic statutory authority, which they could not easily change. They did not have a clear mandate to act internationally, much less bind their state to legal obligations. They did not have a forum in which to meet; often they did not even know each other. In that context, regulators proceeded incrementally by creating informal networks to exchange ideas, coordinate their actions, and agree on nonbinding standards.

B. Regulatory Zealousness

Verdier's explanation of a historical path dependency constraining national financial regulators' options is persuasive on the central role that they have had in the field ever since the 1970s. Under this account, national financial regulators have had a zealous attitude towards "preserv[ing] their domestic autonomy, flexibility and discretion" *vis-à-vis* the national legislatures that create them and other international actors, including their own peers from other countries.[68] Accordingly, national financial regulators have tried to look for legal tools that neither diminish their power nor grant additional ones to other bodies that could supervise or check their work. "[F]rom the regulators' private perspective, soft law and TRNs [transnational regulatory networks or IIGOs] reconcile their wish to achieve short-term regulatory objectives with their desire to preserve their domestic authority and flexibility."[69]

This zealousness can be also seen in bilateral investment treaties and free trade agreements, where although historically both instruments "have covered financial services for decades, . . . they all tread gingerly on national regulators' turf, separating financial liberalization from other investment and service commitments".[70] For

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[68] Verdier, *supra* note 11, at 1430. Verdier also contends that powerful states—such as the United States and the European Union—and private firms are the other two veto players that shape the agenda and outcome, along with national financial regulators, of the international financial legal regime.

[69] *Id.* at 1457.

[70] Anna Gelpern, *Financial Services, in* ASSESSING THE TRANS-PACIFIC PARTNERSHIP: VOLUME 1: MARKET ACCESS AND SECTORAL ISSUES 91 (Peterson

instance, "[n]either NAFTA nor other US bilateral trade and investment agreements curbed the unlimited discretion of financial regulators, so in this respect the TPP[71] continues a well-established tradition."[72]

Likewise, it can even be fathomed in certain domestic contexts. For example, the use of informal venues that coordinate already existing institutions was pursued by the United States with the creation of the Financial Stability Oversight Council through the Dodd-Frank Wall Street Reform and Consumer Protection Act[73] as an umbrella body that tightened cooperation among the existing federal banking and financial regulatory agencies.[74] Therefore, there seems to be

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Institute for International Economics, 2016) (last visited May 10, 2016), https://piie.com/system/files/documents/piieb16-1.pdf.

[71] Trans-Pacific Partnership.

[72] Jennifer Hillman, *Dispute Settlement Mechanism, in* ASSESSING THE TRANS-PACIFIC PARTNERSHIP, VOLUME 2: INNOVATIONS IN TRADING RULES 101, 110 (Jeffrey Schott & Catleen Cimino-Isaacs eds., 2016), (last visited May 10, 2016), https://piie.com/system/files/documents/piieb16-4.pdf; *see also* Gelpern, *supra* note 70, at 96 ("The TPP's novel treatment of exceptions in dispute resolution evokes a broader pattern of deference to financial regulatory authorities and financial experts. . . . The TPP's innovation is in the dispute settlement procedure that would apply to determine whether a measure is, in fact, there "for prudential reasons" or otherwise exempt. . . . In all, financial firms under the TPP are more limited than firms in other sectors in the relief they can get from taking their grievances to ISDS [investment system of dispute settlement].").

[73] DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT; FINANCIAL STABILITY ACT OF 2010; ENHANCING FINANCIAL INSTITUTION SAFETY AND SOUNDNESS ACT OF 2010; PRIVATE FUND INVESTMENT ADVISERS REGISTRATION ACT OF 2010; FEDERAL INSURANCE OFFICE ACT OF 2010; NONADMITTED AND REINSURANCE REFORM ACT OF 2010; BANK AND SAVINGS ASSOCIATION HOLDING COMPANY AND DEPOSITORY INSTITUTION REGULATORY IMPROVEMENTS ACT OF 2010; WALL STREET TRANSPARENCY AND ACCOUNTABILITY ACT OF 2010; PAYMENT, CLEARING, AND SETTLEMENT SUPERVISION ACT OF 2010; INVESTOR PROTECTION AND SECURITIES REFORM ACT OF 2010.; CONSUMER FINANCIAL PROTECTION ACT OF 2010; IMPROVING ACCESS TO MAINSTREAM FINANCIAL INSTITUTIONS ACT OF 2010; MORTGAGE REFORM AND ANTI-PREDATORY LENDING ACT; EXPAND AND PRESERVE HOME OWNERSHIP THROUGH COUNSELING ACT, 111 P.L. 203, Part 1 of 3, 124 Stat. 1377.

[74] Robert Thompson, *Financial Regulation's Architecture within International Economic Law*, 17 J. INT'L ECON. L. 807, 811 (2014).

continuity from the domestic unto the international level of creating umbrella-coordinating forums for existing agencies, instead of creating new institutions.[75] Seen in another light: the zealousness of financial national regulators to retain their power in the financial arena also affects the institutional building of domestic institutions.

National regulators are the most important actors in the financial legal arena: not only do they behold the gates to the implementation of the rules, but they also participate in their creation and supervision. In other words, this is a "departure from traditional public international models of diplomacy, where political elites and heads of state participate. It injects technocratic skill at the highest level of the rulemaking process."[76] Even though they are ultimately constrained by national regulators from other countries, on the one hand, and their own domestic political organs, on the other,[77] it is clear that they inform the shape of the whole process, and that without some external supervision, the regulators will not "internalize the costs of their regulatory decision making", thereby reducing the compliance pull of international financial law.[78] Accordingly, instead of retaining the current voluntary monitoring and surveillance programs, calls for third party enforcement of prudential standards have been raised.[79]

C. Diversity

As explained above, globalization and the subsequent liberalization of finance saw drawbacks in capital movement controls and financial crises, which for the most part occurred in the developing

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[75] *See Id.* at 808 (implying a continuity by arguing that the response to the 2007–2008 crisis began with national responses, such as Dodd-Frank in 2010, but then saw the creation of the FSB "to play a coordinating role that seeks to meld the technocratic expertise in various international standard setting and supervision bodies and the political legitimacy from heads of government"); *see also* Robert Howse, *The end of the globalization debate: continued*, *in* INTERNATIONAL ECONOMIC LAW AND NATIONAL AUTONOMY 7, 18 (Meredith Kolsky & Susy Frankel eds., 2010) (arguing that state responses to the financial crisis have not been devised to stop the liberalization of capital movements, but rather to strengthen its regulation at the global level through the FSB).

[76] Brummer, *supra* note 26, at 274.

[77] *Id.* at 274–75.

[78] *Id.* at 326–27.

[79] Arts & Kerwer, *supra* note 21, at 162.

world.[80] A tipping point occurred in the 1997 Asian financial crisis, which led to the creation of the first overarching forum for financial stability: the FSF.[81]

However, it was not until the 2008 financial crisis that a coordinated architecture for the whole international financial regime was created. The crisis highlighted the need to integrate the international financial legal regime, on one hand, and that developed nations could also be prone to catastrophic financial failures, on the other; all of which led to the displacement of the G-7 by the G-20 and the creation of the FSB.[82]

Through its more inclusive nature and stronger powers, the G-20 and FSB's combined efforts' have enhanced each other's legitimacy: by "teaming technocratic pragmatism with democratic norms".[83] Although there is a long way to go and the G-20 is still not universal, the transition from only like-minded countries in the G-7 to a more diverse membership in the G-20—in both the geographical and development level in terms of economic importance—is to be hailed.[84]

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[80] *See, e.g.,* Stephen Zamora, *Exchange Control in Mexico: Case Study in the Application of IMF Rules*, 7 HOUS. J. INT'L. L. 103 (1984-1985) (analyzing the compatibility of Mexican exchange control measures after the 1982-83 crisis with Article VIII of the IMF Agreement); *see also* Stephen Zamora, *Recognition of Foreign Exchange Controls in International Creditors' Rights Cases: The State of the Art*, 21 INT'L L. 1055 (1987) (analyzing different legal doctrines by which an American court could give effect or recognition to the exchange controls of foreign governments in the United States, and concluding that the cases demonstrate some limited recognition of foreign governments' acts on that regard, but noting that none of those cases used article VIII of the IMF Agreement).

[81] BRUMMER, *supra* note 57, at 102.

[82] *Id.* at 107.

[83] *Id.* at 193–98.

[84] *But cf.* Weber & Arner, *supra* note 60, at 453 ("a goal of the international financial architecture should focus on the increased integration of developing, emerging, and transition economies into the international financial system. However, this integration is not without its dangers and must be based on coherent sequencing of liberalization preceded as a necessary first stage by the development of an effectively functioning financial system in each country.").

IV. CONCLUSION

In regards to the recent international financial architecture created after the financial crisis, Robert Thompson summarizes its characteristics in the following manner: Focus on macro-prudential regulation through FSB's coordination; prudential regulatory competition between states that puts them in a parallel position, as they all want to regulate banks and financial institutions, thereby suggesting that harmonization of national laws through soft law is a better strategy than an inter-state dispute settlement approach; need for technocratic experts at the national regulatory agencies; lack of enforcement, accountability and transparency; and a possible de-legitimization because of exclusivity in membership to the G-20.[85] This sums up many of the challenges that the system must address.

Although certain reforms have been advanced to harden the regime, path dependency leads to the belief that states will only regulate this area of the international legal system through soft law. Flexibility is preferred over strict long-term rules that could forestall the need to apply effective action in response to a crisis, as has occurred in the past. Likewise, apprehension by national financial regulators of the adjudicative, enforcement, and sanctioning procedures seems to suggest an aversion by states of delegating those functions to an international body, and thus losing their power. Probably for this reason the FSB will remain an IIGO and not become an international organization: the objective underlying its creation was to become an umbrella-coordinating venue for all existing standard-setting bodies, national regulators, and international financial institutions; not to encroach the existing institutions' mandate by imposing another layer of institutionalization. G-20 member states explicitly denied granting an international legal personality to the FSB;[86] they only wanted coordination.[87]

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[85] Thompson, *supra* note 74, at 818–22.

[86] *See* Charter of the Financial Stability Board, *supra* note 5, art. 24.

[87] *See* Wouters & Odermatt, *supra* note 10, at 55-56 (highlighting the fact that G-20 members have adapted and modified continuously the mandate of the FSB, which would be difficult to accomplish had it been created through a treaty charter).

As of late, powerful countries have regulated this area of the law and probably won't cede that law-making power, particularly the states integrating the G-20. Further, it is not necessarily certain that rule-making in the international financial legal regime should be "democratized" and subjected to other state participants outside of the current G-20 members, as the safety and soundness of the international financial system relies purely upon technocratic expertise and legitimacy, not its democratic aspect. Hence, current G-20 member states may be more effective in addressing these issues than other developing nations who struggle with structural problems, such as lack of accountability and transparency in resolving crises.[88]

Nonetheless, the transition from the primordial role in the international financial space that the G-7 had to the current one held by the G-20 can be viewed as a positive step towards a more inclusive regime that, eventually, could lead to even more diversity, and perhaps even universality.

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[88] *See, e.g.,* Sigmond, *supra* note 3 (contrasting the transparency and accountability in the American bailout of banks and financial institutions in the Obama administration with the opacity and corruption in the secretive bailout process of the 1995 Mexican crisis by then President Zedillo's administration; at a time when Mexico was not considered that relevant, and thus was not part of the G-20's predecessor—the Group of Seven); *but cf.* Stephen Haber & Aldo Musacchio *These Are the Good Old Days: Foreign Entry and the Mexican Banking System*, NATIONAL BUREAU OF ECONOMIC RESEARCH 3 (2013), (last visited May 10, 2016), http://www.nber.org/papers/w18713.pdf (contending that Mexico's 1997 liberalization of financial ownership to foreigners, which led to the ownership of more than half of the financial and banking industries to foreign capital very rapidly, actually helped increased the supply of credit, further the stability of the system, and not raise the credit cost).

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RED RIDING HOOD - IS INVESTOR-STATE ARBITRATION THE BIG BAD WOLF?

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I. INTRODUCTION

When Benjamin Franklin pondered[1] "*When will mankind be convinced and agree to settle their difficulties by arbitration?"* he probably did not expect that after over 300 years of successful arbitration history[2] the world is still not convinced. The storm of protest from all quarters of society and all corners of the world in regard to the new investment arbitration chapters in the Trans Pacific Partnership Agreement[3] and the Transatlantic Trade and Investment Partnership[4] suggest the opposite - a deep mistrust in at least one field of arbitration: international investment arbitration.[5] An illustrative example is the editorial of Wellington's Dominion Post[6]:

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[1] DAVE FARNHAM, SNIPPETS OF BENJAMIN FRANKLIN (2014).

[2] For an overview of arbitration history (even predating 300 years), *see* GARY BORN, INTERNATIONAL COMMERCIAL ARBITRATION §1.01 (Kluwer, Alphen aan den Rijn, 2nd ed., 2014).

[3] *Text of the Trans-Pacific Partnership*, NEW ZEALAND FOREIGN AFFAIRS & TRADE, https://www.mfat.govt.nz/en/about-us/who-we-are/treaty-making-process/trans-pacific-partnership-tpp/text-of-the-trans-pacific-partnership (last visited Apr. 2, 2016).

[4] *Documents and events*, EUROPEAN COMMISSION, http://ec.europa.eu/trade/policy/in-focus/ttip/documents-and-events/index_en.htm#_documents (last visited Apr. 2 2016).

[5] Leon E. Trakman, *Investment Dispute Resolution under the Transpacific Partnership Agreement: Prelude to a Slippery Slope?* (2013); Leon E. Trakman *Investor-State Arbitration: Evaluating Australia's Evolving Position* (2011); Jess Hill, *TPP clauses that let Australia be sued are weapons of legal destruction, says lawyers*, THEGUARDIAN (Nov. 9, 2015), http://www.theguardian.com/business/2015/nov/10/tpps-clauses-that-let-australia-be-sued-are-weapons-of-legal-destruction-says-lawyer (last accessed 4 May 2016); George Monbiot, *This transatlantic trade deal is a full-frontal assault on democracy*, THE GUARDIAN (Nov. 4, 2013), http://www.theguardian.com/commentisfree/2013/nov/04/us-trade-deal-full-frontal-assault-on-democracy; *The arbitration game; Investor-state dispute settlement*, THE ECONOMIST, Oct. 11, 2014; Martin Khor, *The Trans-Pacific Partnership Agreement (TPPA): When Foreign Investors Sue the State*, GLOBAL RESEARCH (Sept. 1, 2013), http://www.globalresearch.ca/the-trans-pacific-partnership-agreement-tppa-when-foreign-investors-sue-the-state/5357500; Daniel Kalderimis, *Investor/state arbitration, the TPP and New Zealand*, CHAPMAN TRIPP (July 28, 2015), http://leanz.org.nz/uploads/presentations/Kalderimis_LEANZ%20Presentation_280715.pdf; Bianca Mueller, *The Devil in the TPPA – Investor State Dispute Settlement*, SCOOP (Mar. 22, 2015), http://www.scoop.co.nz/stories/HL1503/S00196/the-devil-in-the-tppa-investor-state-dispute-settlement.htm (last accessed 4 May 2016);

> But the non-trade aspects of the deal are the most worrying. The worst is the mechanism allowing foreign companies to sue New Zealand in controversial offshore tribunals. This raises serious problems of sovereignty and fairness.
>
> These tribunals are not courts as we understand them. They are courts dedicated to the interests of investors, rather than countries. Appeals are very limited. Conflicts of interest among those on the tribunals are not rigorously controlled. Judgments are not required to be consistent.

Responsibility for the public's mistrust in investor-state arbitration lies partly with human rights lawyers' and activists' ["human rights lobby"] claims of lack of transparency, investor bias and the disregard of citizens' human rights.[7] The human rights lobby has painted the investors as the big bad wolves. The state and its citizens are red riding hood and the arbitral tribunals, as the Brothers Grimm, are re-writing the happy end. The international arbitration profession, on the other hand, has shied away from a thorough engagement with human rights and seems to have a severe case of "Berührungsangst".[8]

Julien Chaisse, *The shifting tectonics of international investment law - structure and dynamics of rules and arbitration on foreign investment in the Asia-Pacific region*, 47 GEO. WASH. INT'L L. REV. 563 (2015).

[6] *EDITORIAL: It's too soon to celebrate the singing of this "free trade" deal*, DOMINION POST, ed., Jan. 15, 2016.

[7] *UN experts voice concern over adverse impact of free trade and investment agreements on human rights*, UNITED NATIONS HOMAN RIGHTS OFFICE OF THE HIGH COMMISSIONER (June 2, 2015), http://www.ohchr.org/EN/NewsEvents/Pages/DisplayNews.aspx?NewsID=16031; Andrew Geddis, *Of TPP's, ISDS's and the Constitution*, PUNDIT (Oct. 5, 2015), http://pundit.co.nz/content/of-tpps-isdss-and-the-constitution; *Open Letter*, TPP LEGAL, https://tpplegal.wordpress.com/open-letter/ (last accessed 4 May 2016).

[8] Bruno Simma, *Foreign Investment Arbitration: A Place for Human Rights?*, 60 INT'L & COMP. L.Q. 573, 576 (2011); *see also* Ciaran Cross & Christian Schliemann-Radbruch, *When Investment Arbitration curbs Domestic Regulatory Space: Consistent Solutions through Amicus Curiae Submissions by Regional Organisations*, 6 L. & DEV. REV. 67, 87 (2013) (et seq. which show that arbitral tribunals have not taken the opportunity to clarify the role of human rights in investment arbitration); *see also*

The widespread absence of a discussion of investors' rights by the human rights lobby and the general lack of willingness by the international arbitration community to engage with human rights issues is concerning. It is concerning because, in particular for developing countries, sustainable economic development requires both: foreign direct investment and the protection of human rights.[9]

The aim of this think piece is to provide a basis to fill the gaps in both discussions by firstly describing the international human rights framework and in particular discussing whether and which human rights are available to investors and a state's citizens. The paper will then examine how a human rights analysis is relevant in an investment arbitration and why there is no need for the investment arbitration community to have "Berührungsängste". By doing so the paper proposes a framework that will allow for the consistent inclusion of the International Bill of Human Rights ("IBR") and customary international human rights as a benchmark in investor-state dispute settlement. A consistent human rights benchmark is important since investor state dispute settlement can take place in competing jurisdictions, such as national courts, investment arbitration, regional human rights courts, or the International Court of Justice. There is therefore a need for promoting consistent human rights benchmarking among diverse national, regional and worldwide courts, and alternative dispute settlement proceedings.

The paper is also a contribution against the fragmentation of international law.[10] It is the thesis of this paper that the IBR and customary international human rights provide the international constitutional framework in which any investment treaty is situated and in which international arbitral tribunals have to operate. To

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Yannik Radi, *Realizing Human Rights in Investment Treaty Arbitration: A Perspective from within the International Investment Law Toolbox*, 37 N.C. J. INT'L L. & COM. REG. 1107, 1116 (2011). However, as an exception to the rule discussion of art 14 International Covenant on Civil and Political Rights, see Hersham Talaat v. Indonesia, UNCITRAL (Dec. 14, 2015).

[9] *See* Megan Wells Scheffer, *Bilateral Investment Treaties: A Friend or Foe to Human Rights?*, 39 DENV. J. INT'L L. & POL'Y 483, 483 (2011).

[10] *See* Ursula Kriebaum & Christoph Schreuer, *The Concept of Property in Human Rights Law and International Investment Law*, http://www.univie.ac.at/intlaw/wordpress/pdf/88_concept_property.pdf.

illustrate the difference, the proposed framework will make to the discussion of investors' rights versus citizens' rights, the new framework will be applied to a case scenario. It is noteworthy to stress that the investment treaty perspective on human rights significance is not the main focus of this paper,[11] albeit some reference will be made.[12]

II. HUMAN RIGHTS FRAMEWORK

> Human rights and fundamental freedoms are the birthrights of all human beings; their protection and promotion is the first responsibility of Governments.[13]

There are several human rights frameworks which could be used to determine the citizens' and the investor's rights: particular domestic human rights frameworks, regional frameworks in some parts of the world, and the international human rights framework. The international human rights framework encompasses the IBR containing the Universal Declaration of Human Rights, the International Covenant on Civil and Political Rights ("ICCPR") and the International Covenant on Economic Social and Cultural Rights ("ICESCR").[14] As Stephen Gardbaum convincingly argues, the IBR has to be seen as part of the international constitutional order.[15] It

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[11] *See* for very detailed discussion from the investment law perspective Bruno Simma, *Foreign Investment Arbitration: A Place for Human Rights?*, 60 INT'L & COMP. L.Q. 573 (2011); Yannik Radi, *Realizing Human Rights in Investment Treaty Arbitration: A Perspective from within the International Investment Law Toolbox*, N.C. J. INT'L L. & COM. REG. 1107 (2011); Vivian Kube & Ernst-Ulrich Petersmann, *Human rights law in international investment arbitration*, EUI Working Papers (Law 2016/02).

[12] See below II.D.

[13] Vienna Declaration, sec. 1.

[14] *Fact Sheet No.2 (Rev.1), The International Bill of Human Rights*, OHCHR, http://www.ohchr.org/Documents/Publications/FactSheet2Rev.1en.pdf.

[15] Stephen Gardbaum, *Human Rights as International Constitutional Rights*, 19 EUR. J. INT'L L. 749 (2008); *see also* Erika de Wet, *The International Constitutional Order*, 55 INT'L & COMP. L.Q. 51 (2006); *see also,* Andreas Paulus, *The International Legal System as a Constitution* in JEFFREY DUNOFF & JOEL TRACHTMAN, RULING THE

specifies the limits on how governments treat people within their jurisdictions. It enshrines and clarifies the distinct normative basis for the protection of fundamental rights as rights of human beings rather than as rights of citizens. That means international human rights do not make a difference between nationals and foreigners. The human rights obligations contained in the ICCPR and ICESCR have *erga omnes* effect to the extent that they have acquired customary international law status.[16] That means that those rights enshrined in the IBR are applicable whether or not states are member states to the IBR or its parts.[17] As a result, the IBR is applicable in every country around the world as part of the international constitutional order,[18] laying down a global human rights standard[19] for every

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WORLD? CONSTITUTIONALISM, INTERNATIONAL LAW & GLOBAL GOVERNMENT 69 (CUP, Cambridge, 2009).

[16] JAMES CRAWFORD, BROWNLIE'S PRINCIPLES OF PUBLIC INTERNATIONAL LAW 642 (8th ed., 2012); Pierre-Marie Dupuy, *L'unité de l'ordre juridique international* in RECUEIL DES COURS DE L'ACADÉMIE DE DROIT INTERNATIONAL, vol. 297, 382-85 (2002); Erika de Wet, *The International Constitutional Order*, 55 INT'L & COMP. L.Q. 51, 61 (2006); for IESCR, *see* U.N. Committee on Economic, Social and Cultural Rights, *Substantive Issues Arising in the Implementation of the International Covenant on Economic, Social and Cultural Rights: Poverty and the International Covenant on Economic, Social and Cultural Rights*, U.N. Doc. No. E/C.12/2001/10, para 16 (May 2001). Ernst Ulrich Petersmann states: "Human rights have thus become part also of the *general principles of law recognized by civilized nations* (Article 38 of the Statute of the International Court of Justice)" in *Time for Integrating Human Rights into the Law of Worldwide Organizations Lessons from European Integration Law for Global Integration Law*, NYU INSTITUTES ON THE PARK, http://jeanmonnetprogram.org/archive/papers/01/012301-05.html.

[17] Based on the global recognition of those rights as the essence of what somehow natural right to every human being belongs just by being born as one, those rights cannot leave out any single individual, regardless of their nationality. See *Horst Dreier,* in: Dreier (Hrsg.), GG, Bd. 1, 2. Aufl., 2004, Vorb. Rdn. 25, Gerhard Herdegen in Maunz/Dürig, Grundgesetz-Kommentar, 78. EL September 2016, Art. 1 Abs. 2, marginal no. 31, 32, Herbert Bethge in Maunz/Schmidt-Bleibtreu/Klein/Bethge, Bundesverfassungsgerichtsgesetz, 49. EL Juli 2016, BVerfGG Rn. 90, marginal no. 65.

[18] Stephen Gardbaum, *Human Rights as International Constitutional Rights*, 19 THE EUR. J. OF INT'L L. 749, 768 (2008) ("international human rights law also functions to enshrine and clarify the distinct normative basis for the protection of fundamental rights as rights of human beings rather than as rights of citizens").

[19] *Compare with* Stephen Gardbaum, *Human Rights as International Constitutional Rights*, 19 THE EUR. J. OF INT'L L. 749, 768 (2008); *see also* Lucas Lixinski, *Treaty Interpretation by the Inter-American Court of Human Rights: Expansionism at the Service of the Unity of International Law*, 21 THE EUR. J. OF INT'L L. 585 (2010).

human being notwithstanding whether they are a citizen or foreigner. The IBR provides the baseline global human rights protection.[20] Whether, or in which circumstances, (additional) human rights enshrined in regional and/or domestic human rights standards have to be taken into account in investor state dispute resolution, is not within the scope of this paper.

How investment tribunals have to have regard to the IBR will be discussed under II.C.2. In the following the paper will outline the rights of the state's citizens and that of the investor under the IBR.

A. The Rights of the State Citizens

The human rights lobby is claiming in particular the following rights as being jeopardized by investor state relationships and the resulting disputes: the right to health[21], the right to water[22], the right

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[20] As Ernst-Ulrich Petersmann points out "Dictatorial governments can no longer freely 'contract out' of their human rights obligations by withdrawing from UN human rights covenants or ILO conventions" in *Time for Integrating Human Rights into the Law of Worldwide Organizations Lessons from European Integration Law for Global Integration Law*, THE JEAN MONNET CENTER FOR INT'L AND REG. ECON. L. AND JUST., http://jeanmonnetprogram.org/archive/papers/01/012301-05.html (last visited Apr. 3, 2016) (That must be true not only for dictatorial governments but generally in regard to the inability of states to contract out of "human rights").

[21] The IECSR Committee has interpreted the "right to health, as defined in article 12.1, as an inclusive right extending not only to timely and appropriate health care but also to the underlying determinants of health, such as access to safe and potable water and adequate sanitation, an adequate supply of safe food, nutrition and housing, healthy occupational and environmental conditions, and access to health-related education and information, including on sexual and reproductive health. A further important aspect is the participation of the population in all health-related decision-making at the community, national and international levels." The right to health encompasses the control over one's health and body, including sexual and reproductive freedom, and the right to be free from interference, such as the right to be free from torture, non-consensual medical treatment and experimentation; the right to a system of health protection which provides equality of opportunity for people to enjoy the highest attainable level of health, including, for example, access (non-discriminatory, economic, physical, information) to functioning public health and health-care facilities [ICESCR *General Comment No. 14: The Right to the Highest Attainable Standard of Health* (Art. 12) Adopted at the Twenty-second Session of the Committee on Economic, Social and

to a sustainable or healthy environment[23], the right of indigenous peoples to their ancestral lands[24], and the right to development[25] of

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Cultural Rights, on Aug. 11, 2000 (Contained in Doc. E/C.12/2000/4), paras 8, 11, 1). In regard to a comprehensive treatment of the right to health, see JOHN TOBIN, THE RIGHT TO HEALTH IN INTERNATIONAL LAW (2012) and VALENTINA VADI, PUBLIC HEALTH IN INTERNATIONAL INVESTMENT LAW AND ARBITRATION (2012).

[22] The right to water encompasses, inter alia, sufficient, safe, acceptable, physically accessible and affordable water for personal and domestic uses. States need to take steps on a non-discriminatory basis to prevent threats to health from unsafe and toxic water conditions. General Comment No. 15: *The Right to Water (Arts. 11 and 12 of the Covenant),* Adopted at the Twenty-ninth Session of the Committee on Economic, Social and Cultural Rights, on Jan. 20, 2003 (Contained in Doc. E/C.12/2002/11, paras. 2, 8). With regard to a comprehensive treatment of the right to health, *see* EIBE RIEDEL & PETER ROTHEN, THE HUMAN RIGHT TO WATER (Berliner Wissenschafts-Verlag, 2006).

[23] The right encompasses the right to a non-polluted environment, which does not endanger health, life and development. The right also comprises the obligation of the state and the community of states to repair any damage done by pollution. Gheorghe Durac, *Granting the Right to a Quality Environment -A Premise of Sustainable Development*, 9 PESD 153, 154 (2015); John Lee, *Underlying Legal Theory to Support a Well-Defined Human Right to a Healthy Environment as a Principle of Customary International Law*, 25 COLUM. J. OF ENVTL. L. 283. (2000). For an overview of the protection of the environment in regional and domestic human rights instruments, *see* Alan Boyle, *Human Rights and the Environment: A Reassessment*, UNEP, http://www.unep.org/environmentalgovernance/Portals/8/documents/Events/HumanRightsEnvironmentRev.pdf (last visited Apr. 12, 2016).

[24] UN Indigenous Peoples Declaration, Art 1(1): "Indigenous peoples have the right to the lands, territories and resources which they have traditionally owned, occupied or otherwise used or acquired." The central right is the right to the enjoyment of ancestral lands. Mihail Krephchev, *The Problem of Accommodating Indigenous Land Rights in International Investment Law*, 6 J. OF INT'L INVESTMENT L., 42; *see generally* JAMES ANAYA, INDIGENOUS PEOPLES IN INTERNATIONAL LAW (OUP, 1996).

[25] Declaration on the Right to Development (1986), Art 1(1): "The right to development is an inalienable human right by virtue of which every human person and all peoples are entitled to participate in, contribute to, and enjoy economic, social, cultural and political development, in which all human rights and fundamental freedoms can be fully realized." The Declaration in its 10 articles requires states to guarantee rights in a manner applicable to globalisation, ie it compels states to cooperate with each other to the best of their abilities and resources to achieve development throughout the world: see for a general discussion DANIEL AGUIRRE, THE HUMAN RIGHT TO DEVELOPMENT IN A GLOBALISED WORLD (2008); Stephen Marks, Beate Rudolf, Koen De Feyter, & Nicolaas Schrijver, *The role of international law* in U.N., OFFICE OF THE HUMAN

the citizens in the particular country.[26] Those citizens' rights, the human rights claims, are given no weight by investment tribunals. Tribunals were only concerned with the rights of investors.

The right to health and the right to water are enshrined in the IBR.[27] Thus, human beings have a right to health and to water notwithstanding the country they live in. The right to a sustainable or healthy environment and the right to development did not find their way explicitly into the IBR. Today, both rights are afforded at least near close to customary international law status.[28] The right of indigenous peoples to their ancestral lands is protected by the UN Declaration on the Rights of Indigenous Peoples. The Declaration is

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RIGHTS COMMISSIONER, REALIZING THE RIGHT TO DEVELOPMENT: ESSAYS IN COMMEMORATION OF 25 YEARS OF THE UNITED NATIONS DECLARATION ON THE RIGHT TO DEVELOPMENT 445, 454 (U.N. Publication, 2013).

[26] In regard to general criticism, *see Investor State Dispute Settlement- The Arbitration Game,* THE ECONOMIST, Oct. 11, 2014, http://www.economist.com/news/finance-and-economics/21623756-governments-are-souring-treaties-protect-foreign-investors-arbitration; Claire Provost and Matt Kennard, *The obscure legal system that allows corporations to sue countries,* THE GUARDIAN, June 10, 2015, http://www.theguardian.com/business/2015/jun/10/obscure-legal-system-lets-corportations-sue-states-ttip-icsid; *Still not loving ISDS: 10 reasons to oppose investors' super-rights in EU trade deals*, CORPORATE EUROPE OBSERVATORY, July 14, 2014, http://corporateeurope.org/international-trade/2014/04/still-not-loving-isds-10-reasons-oppose-investors-super-rights-eu-trade.

[27] ISECR Art 12, Art 11 (1); in addition, the U.N. General Assembly recognised the right to water and sanitation as a human right specifically in U.N.G.A. Res. 64/292, 64th Session A/RES/64/292 (July 28, 2010).

[28] For the right to a sustainable environment *see* John Lee, *The Right to a Healthy Environment*, 25 COLUM. J. ENVTL. L. 283, 338 (2000); *see* Susan Glazebrook, *Human Rights and the Environment*, VUWLR: HUMAN RIGHTS IN THE PACIFIC 293 (2009); Prue Taylor, *From Environmental to Ecological Human Rights: A New Dynamic in International Law?*, 10 GEO. INT'L. ENVTL. L. REV. 309 (1997); For the right to development *see* Isabella Bunn, *The Right to Development: Implications for International Economic Law*, 15 AM. U. INT'L. L. REV. 1425, 1436 (2000). It also should be noted that due to human rights law establishes a responsibility on part of the state toward those under its jurisdiction, and not solely an obligation between states, the Restatement has drawn a subtle distinction between the manner in which customary human rights law is established from that which creates customary international law in general. RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW § 701 (1987), reporter's note 2.

not binding law. The formulation of the rights therein, however, reflects emergent customary international law.[29]

It is the nature of human rights law to create obligations on the part of the state towards those under its jurisdiction. The IBR clearly stipulates states' obligations, for example, Article 2 (1) of the ICESCR reads:

> [T]o take steps, individually and through international assistance and co-operation, especially economic and technical, to the maximum of its available resources, with a view to achieving progressively the full realization of the rights recognized in the present Covenant by all appropriate means, including particularly the adoption of legislative measures.

Article 2(1) of ICESCR compels the community of states to work towards attaining the best standard of health possible for its citizens. It also requires every state to make every effort to provide for sufficient clean water. Of particular interest are the states' obligations in regard to the right to development. The right to development encapsulates a resonance of the core principles of all human rights including, primarily, equity, non-discrimination, active and meaningful participation, accountability and transparency.[30] For the right to be effective, another core part of the right to development is that states have a duty by themselves, and in

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[29] Mihail Krephchev, *The Problem of Accommodating Indigenous Land Rights in International Investment Law*, 6 J. INT'L. INVESTMENT L. 42, 52 et seq. (2015); *see also* James Anaya & Siegfried Wiessner, *The UN Declaration on the Rights of Indigenous Peoples: Towards Re-empowerment*, JURIST.ORG (Oct. 3, 2007), http://www.jurist.org/forum/2007/10/un-declaration-on-rights-of-indigenous.php; In regard to the general application under the American Convention on Human Rights *see*, *Norms and Jurisprudence of the Inter-American Human Rights System-Indigenous And Tribal Peoples' Rights over their Ancestral Lands and Natural Resources*, INTER-AMERICAN COMMISSION ON HUMAN RIGHTS, http://cidh.org/countryrep/Indigenous-Lands09/Chap.V-VI.htm (last visited Apr. 16, 2016).

[30] See the reports of the Working Group on the Right to Development on its: Fifth Session, U.N. Doc. E/CN.4/2004/23, para. 43(a); Sixth session, U.N. Doc. E/CN.4/2005/25, para. 42; Seventh Session E/CN.4/2006/26, paras. 31, 40, 46, 67(g).

conjunction with the community of states, to accomplish the utmost possible within their available resources to attain the highest level of development in their respective states, but also globally.[31] The same is true for the right to a sustainable and healthy environment.[32]

Even though there is no unified global understanding of whether and how an individual can assert the right to health, water, a healthy environment, and a right to development (which are categorized as second and third generation rights[33]), there is no doubt that in regard to those rights it is the state's and the community of states' obligation to constantly work towards the highest fulfillment and execution of those rights for its citizens and the global citizenry.

The right of indigenous peoples to their ancestral land is different to the other rights discussed as it is first and foremost a negative right. It obligates the states which are the home of indigenous peoples to provide them with the protection not to be deprived of their land.[34] It does not compel the particular state to

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[31] Ibrahim Salama, *The right to development at 25: renewal and achievement of its potential*, in U.N., OFFICE OF THE HUMAN RIGHTS COMMISSIONER, REALIZING THE RIGHT TO DEVELOPMENT: ESSAYS IN COMMEMORATION OF 25 YEARS OF THE UNITED NATIONS DECLARATION ON THE RIGHT TO DEVELOPMENT 485, 486 (2013).

[32] John Lee, *The Right to a Healthy Environment*, 25 COLUM. J. ENVTL. L. 283, 338 (2000); *see also* Draft Declaration on Human Rights and the Environment, U.N. Doc. E/CN.4/Sub.2/1994/9, Annex I (1994), art. 22 ("All States shall respect and ensure the right to a secure, healthy and ecologically sound environment. Accordingly, they shall adopt the administrative, legislative and other measures necessary to effectively implement the rights in this Declaration").

[33] *See* PAUL O'CONNELL, VINDICATION SOCIO-ECONOMIC RIGHTS: INTERNATIONAL STANDARDS AND COMPARATIVE EXPERIENCES (2012); HELENA ALVIAR GARCIA, KARL KLARE, & LUCY WILLIAMS, SOCIAL AND ECONOMIC RIGHTS IN THEORY AND PRACTICE: CRITICAL INQUIRIES (2015).

[34] *Compare* Kaliña y Lokono v. Surinam, Inter-Am. Ct. H.R. (Nov. 25, 2015), http://www.corteidh.or.cr/docs/casos/articulos/seriec_309_esp.pdf (last visited May 10, 2016) (The ACtHR found that Suriname had violated Art 3 ACHR by failing to recognize the collective legal personality asserted by the indigenous and tribal people in this case. It further noted that the lack of demarcation, delimitation, and failure to award legal title of the territory of Kaliña and Lokono violated the villagers' collective right to property recognized under Art 21 ACHR), The Ituango Massacres v. Colombia*,* Preliminary Objection, Merits, Reparations, and Costs, Inter-Am. Ct. H.R. (ser. C) No 148, paras. 169-200 (July 1, 2006) (The Court concluded that the State violated Article 21 (right to property) to the

progressively attain their ancestral land nor does the right require states to work as the community of states to attain those rights.

In summary, the human rights at play on the side of citizens are the right to health, water, a healthy environment, and the right to development. It is generally recognized that in regard to those rights, states have the obligation to safeguard their citizens against human rights abuses, including those of (transnational) corporations.[35] In particular, they are commissioned to work as part of the community of states towards the highest possible attainment of the fulfillment of those rights. The right of indigenous peoples to their ancestral lands has been conceptualized as a negative right, thought of as rooted in the right to property. Its justiciability is unquestioned.[36]

B. The Right of the Investor

1. *Legal Persons as Human Rights Bearers*

Human rights are generally conceptualized as a safeguard for the individual against the state. If the investor is an individual there is no doubt human rights will extend to the investor.[37] However, the

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detriment of the fifty-nine victims because its agents collaborated with the paramilitary group to destroy the victims' homes and steal their livestock, unlawfully depriving them of their property.).

[35] Human Rights Council, *Business and Human Rights: Mapping International Standards of Responsibility and Accountability for Corporate Acts*, U.N. Doc A/HRC/4/035, para. 19 (Feb. 19, 2007) (prepared by John Ruggie): "..the state duty to protect against non state abuses is part of the international human rights regime's very foundation. The duty requires states to play a key role in regulating and adjudicating abuse by business enterprises or risk breaching their international obligations."

[36] *E.g.,* Kaliña y Lokono v. Surinami, *supra* note 34; Sawhoyamaxa Indigenous Community v. Paraguay, Merits, Reparations and Costs, Inter-Am. Ct. H.R. (ser. C) No. 146, para. 113(a) (Mar. 29, 2006); Yakye Axa Indigenous Community v. Paraguay, Merits, Reparations and Costs, Inter-Am. Ct. H.R. (ser. C) No. 125, para 157(c) (June 17, 2005).

[37] *See, e.g.,* Chaparro Álvarez and Lapo Íñiguez v. Ecuador, Inter-Am. Ct. H.R. (ser. C) No. 170 (Nov. 21, 2007), http://www.corteidh.or.cr/docs/casos/articulos/seriec_170_ing.pdf (last visited

extension of human rights protections to legal persons is less clear. The IBR does not afford legal persons[38] protection.[39] The exclusion of legal persons from the scope of the IBR, however, does not necessarily follow from the IBR's purpose.[40] It does correspond to the preamble though, which asserts that human rights derive from the inherent dignity of the human person, and with the intention of its drafters.[41]

Looking more regionally, the Inter American Convention of Human Rights ("ACHR") does not offer rights protection to legal persons either.[42] On the other hand, the European Convention on Human Rights ("ECHR")[43] and the African Charter on Human and Peoples Rights ("ACHPR")[44] have extended rights protection, at least in part, to legal persons.[45]

May 10, 2016) (The individual investors were imprisoned and their property seized due to being suspected of drug trafficking.).

[38] The term "legal person" is used for the purposes of this paper in a rather broad sense, as including all natural entities.

[39] U.N. Human Rights Committee, General Comment No. 31, *The Nature of the General Legal Obligation Imposed on States Parties to the Covenant,* 9 (Mar. 29, 2004).

[40] Louis Henkin, *The Universal Declaration at 50 and the Challenge of Global Markets*, 25 BROOK. J. INT'L L. 17, 24-25 (1999).

[41] Universal Declaration of Human Rights preamble reads "Whereas recognition of the inherent dignity and of the equal and inalienable rights of all members of the human family is the foundation of freedom, justice and peace in the world,…"; *see also* Human Rights Council, *Business and Human Rights: Mapping International Standards of Responsibility and Accountability for Corporate Acts,* U.N. Doc. A/HRC/4/035, para. 37 (Feb. 19, 2007).

[42] ACHR, Art. 61(1); ACHR, Art. 1(2); Cantos v. Argentina, Preliminary Objections, Inter-Am. Ct. H.R., para. 22 et seq. (Sept. 7, 2001); Perozo v. Venezuela, Preliminary Objections, Merits, Reparations, and Costs, Inter-Am. Ct. H.R., paras. 74, 399 (Jan. 28, 2009).

[43] ECHR, Art 34; *see, e.g.,* Société Colas Est v. France, Eur. Ct. H.R. App. No. 37971/97, para. 41 (Apr. 16, 2002) (right to privacy in Art 8 ECHR).

[44] Art. 19 v. The State of Eritrea, Decision on the Merits, Afr. Comm'n. on Human and People's Rights 275/ 2003 (May 2007); Civil Liberties Organization v. Nigeria, Decision on the Merits, Afr. Comm'n. on Human and Peoples' Rights 101/93, para 37 (1995).

[45] For a full discussion on the protection of legal persons under international and regional human rights instruments albeit in regard to their criminal liability, see Piet Hein Van Kempen, *The Recognition of Legal Persons in International Human Rights Instruments: Protection Against and Through Criminal Justice?*, in

There is recognition that legal persons, in particular transnational or multinational companies, should be the bearer of (international) human rights.[46] That recognition is anchored in the fact that two regional human rights instruments afford human rights protection to legal persons and that human rights duties of transnational corporations have developed through soft-law mechanisms, such as the UN Guiding Principles on Human Rights and Business[47] and the OECD Guidelines for Multinational Enterprises.[48] Those soft law instruments contain express provisions on the human rights responsibilities of transnational corporations.[49] However, efforts are under way to convert those soft law instruments into legally enforceable standards. In 2014 the Human Rights Council with Resolution 26/9 established a working group which is tasked to develop an international legally binding instrument to regulate the activities of transnational corporations and other business enterprises in regard to human rights.[50] The Resolution clearly identifies the responsibility of transnational corporations and businesses to respect human rights.[51] The European Union has directed that its member states implement the UN Guiding Principles through national action

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CORPORATE CRIMINAL LIABILITY: EMERGENCE, CONVERGENCE, AND RISK, 9, 355 (Mark Pieth & Radha Ivory, 2011).

[46] *See* Peter Oliver, *Companies and their Fundamental Rights: A Comparative Perspective*, 64 INT'L & COMP. L.Q. 661 (2015); *see also* Louis Henkin, *The Universal Declaration at 50 and the Challenge of Global Markets*, 25 BROOK. J. INT'L L. 17 (1999).

[47] *Guiding Principles On Business And Human Rights*, UNITED NATIONS HUMAN RIGHTS OFFICE OF THE HIGH COMMISSIONER, http://www.ohchr.org/Documents/Publications/GuidingPrinciplesBusinessHR_EN.pdf (last visited Apr. 12, 2016)

[48] *OECD Guidelines for Multinational Enterprises*, OECD, http://mneguidelines.oecd.org/text/ (last visited Apr. 12, 2016).

[49] Guiding Principles on Business and Human Rights, Principle 17; OECD Guidelines for Multinational Enterprises: Recommendations for Responsible Business Conduct in a Global Context, Part I, Chap IV Human Rights, No 5 (May 25, 2011).

[50] Human Rights Council Res. 26/9, U.N. Doc. A/HRC/RES/26/9 (July 14, 2014), http://www.ohchr.org/EN/HRBodies/HRC/WGTransCorp/Pages/IGWGOnTNC.aspx (last accessed April 17, 2016).

[51] *Id.*

plans and has incorporated the Principles in its external policy.[52] The (growing) responsibility of transnational companies in regard to the implementation of human rights must go hand in hand with their right of being protected by human rights. In other words, the human rights lobby cannot have their cake and eat it, too.[53]

2. *A legal person's human rights*

(i) General introduction

It is nearly trite to state that not every human right is applicable to legal persons. The IBR rights that could be applicable to legal persons are, inter alia, freedom of expression[54], freedom from discrimination[55], the right to freedom of movement, access to justice[56], fair trial rights[57], or the right not to be searched

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[52] European Commission, *Commission Staff Working Document on Implementing the UN Guiding Principles on Business and Human Rights - State of Play*, SWD, 144 final (July 14, 2015).

[53] See H.R.C. Res. 26/9, *supra* note 50 (acknowledging the double role of transnational corporations and other business as having "the capacity to foster economic well-being, development, technological improvement and wealth, as well as causing adverse impacts on human rights").

[54] The Sunday Times v. United Kingdom, Eur. Ct. H.R. App. No. 6538/74 (1979); Krone Verlag GmbH & Co. KG v. Austria (no. 3), Eur. Ct. H.R. App. No. 39069/97 (2003); Matter of the "Golobvision" Television Station, Provisional Measure Regarding Venezuela, Inter-Am. Ct. H.R. (Nov. 21, 2007).

[55] Church of Scientology Moscow v. Russia, Eur. Ct. H.R. App No 18147/02 (Apr. 5, 2007); Moscow Branch of the Salvation Army v. Russia, Eur. Ct. H.R. App. No. 72881/01 (Oct. 5, 2006); *also compare* Alexkor Ltd. and Another v. The Richtersveld Community and Others, S. Afr. S.C. (2003).

[56] Access to justice encompasses the notion of denial of justice. Denial of justice has been recognised as jus cogens independent from being a right contained, as an aspect of access to justice, in the IBR. *See* Chevron Corporation (USA) and Texaco Petroleum Corporation (USA) v. Ecuador, UNCITRAL, Interim Award, at 2-3 (Dec. 1, 2008).

[57] British-American Tobacco Company v. the Netherlands, Eur. Ct. H.R. App. No. 19589/91 (Nov. 20, 1995); Central Mediterranean Development Corporation Ltd. v. Malta (no. 2), Eur. Ct. H.R. App. No. 18544/08 (Nov. 22, 2011); Mevopal SA v. Argentina, Inter-Am. Comm'n H.R., Report No. 39/99 (Mar. 11, 1999).

unreasonably.[58] The probably most important right for any investor is, however, the right to property.[59] The right to property is only protected in the UDHR[60]; it is not directly protected in the ICCPR or ICESR.[61] Until recently, it was general opinion that a right to property could only arise under national law.[62] However, sweeping economic and political changes in recent decades have laid the foundation for recognizing a global right to property. The ideological opposition against property rights has disappeared with China, Russia, and other socialist states having transitioned to market economies which are premised on private property. In addition, the globalization of trade has enhanced international support for protecting property rights. Furthermore, the increasing recognition of (property) rights of indigenous people has also aided a change in

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[58] See Peter Oliver, *Companies and their Fundamental Rights: A Comparative Perspective*, 64 INT'L & COMP. L.Q. 661 (2015), for an in-depth comparative discussion.

[59] "And while one could argue that human rights treaties are fundamentally different from investment treaties with regard to their purpose of the protection of individuals compared to the promotion of friendly economic relations between two states, it should not be forgotten that a fundamental investor right under investment treaties is the right to property, which is itself a human right, recognized in most international human rights conventions." HELGE ELISABETH ZEITLER, in STEPHAN W. SCHILL (ed.), INTERNATIONAL INVESTMENT LAW AND COMPARATIVE PUBLIC LAW 199 *et seq*.

[60] Universal Declaration of Human Rights, G.A. Res. 217A (III), U.N. Doc. A/810, Art. 17 (1948) ("(1) [e]veryone has the right to own property alone as well as in association with others" and "(2) no one shall be arbitrarily deprived of his property").

[61] Eibe Riedel in THEORIE DER MENSCHENRECHTSSTANDARDS 39 (Dunker & Humbolt, Berlin, 1986) concludes that the travaux préparatoires indicate that the non-inclusion of property rights in both Covenants originates in the antagonistic ideological views of the Western and Eastern blocs, as well as those of the North and South. *See also* John Sparkling, *The Global Right to Property*, 52 COLUM. J. TRANSNAT'L L. 464, 469 (2014); Jacob Mchangama, *The Right to Property in Global Human Rights Law*, Cato Policy Report (Washington, June/July 2011), http://www.cato.org/policy-report/mayjune-2011/right-property-global-human-rights-law (last accessed Apr. 18, 2016) (article maintains a certain political angle).

[62] Sparkling, *supra* note 61, at 464; *see also* Luis Valencia Rodriguez, *The Right of Everyone to Own Property Alone as Well as in Association with Others*, 90 U.N. Comm'n on H.R., UN Doc E/CN.4/1994/19 (Nov. 25, 1993).

finding that property is a customary human right.[63] The three regional human rights treaties (the ECHR, the ACHPR, and the ACHR) all protect property.[64] National constitutions and national laws overwhelmingly protect the right to property.[65] Importantly, even though the right to property was not included in the ICCPR or the ICESCR the omission did not equate with the states' denial of the right to property. As the Annotation to the Draft International Covenant on Human Rights clearly declares, "no one questioned the right of the individual to own property".[66] A close reading of the travaux préparatoires aids the conclusion that since the ideological obstacles in regard to property ownership have been "overcome", a redrafted 2016 IBR would include the right to property; it would not only exist as a principle in the UDHR.[67] Therefore, as Golay and Cismas conclude:[68]

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[63] In regard to the European Union countries, see: Case C-402/05 P and C-415/05 P, Yassin Abdullah Kadi & Al Barakaat International Foundation v. European Commission, 2008 E.C.R. I-06351, at 355.

[64] Eur. Ct. H.R. Optional Protocol No. 1, art 1; African [Banjul] Charter on Human and Peoples' Rights, OAU Doc. CAB/LEG/67/3 rev. 5, 21 I.L.M. 58 (1982), Art. 21; American Convention on Human Rights, 1114 U.N.T.S. 123, art 21. That means that 2/3 of all nations are parties to regional human rights treaties that contain the right to property.

[65] In regard to extensive discussions on the protection of the right to property under national constitutions, see: THEO VAN BANNING, THE HUMAN RIGHT TO PROPERTY 139-46 (Intersentia, Antwerpen, 2002). *See also* TOM ALLAN, THE RIGHT TO PROPERTY IN COMMONWEALTH CONSTITUTIONS 36-82(CUP, Cambridge, 2000); Luis Valencia Rodríquez, *The right of everyone to own property alone as well as in association with others*, U.N. Doc. E/CN.4/1994/19, at 64 et seq. (Nov. 25, 1993); Christophe Golay/Ioana Cismas, *The Right to Property from a Human Rights Perspective*, International Center for Human Rights and Democractic Development, at 2.3 (legal opinion, 2010), http://www.geneva-academy.ch/docs/publications/ESCR/humanright-en.pdf (last accessed Apr. 18, 2016).

[66] *See* U.N. Docs. E/CN.4/SR.230-232; E/CN.4/SR.302, 303; E/CN.4/SR.413-418, para. 197, available at http://www2.ohchr.org/english/issues/opinion/articles1920_iccpr/docs/A-2929.pdf (last accessed Apr. 14, 2016). See also the concern expressed in U.N. Doc. E/CN.4/SR.413-418, para. 198 ("To omit [the right to property] might create the impression that it was not a fundamental human right").

[67] U.N. Docs. E/CN.4/SR.230-232; E/CN.4/SR.302, 303; E/CN.4/SR.413-418, para. 197-212, available at

The review of provisions of international instruments, regional treaties and national constitutions reveal the universal recognition of the human right to property. It appears that generalized and consistent State practice and opinio juris reflect the customary nature of the first paragraph of Article 17 of the UDHR 'everyone has the right to own property alone as well as in association with others'".

(ii) The ambit of the right to property

An important question is what the right to property entails. Any attempt to discuss the ambit of the right to property in a comprehensive manner would go well beyond the scope of this article.[69] The following sets out the basic features of the ambit of the right to property.

The UN General Assembly has stated that the right to property extends to both "[p]ersonal property, including the residence of one's self and family"[70] and "[e]conomically productive property, including property associated with agriculture, commerce

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http://www2.ohchr.org/english/issues/opinion/articles1920_iccpr/docs/A-2929.pdf (last accessed Apr. 14, 2016).

[68] Christophe Golay/Ioana Cismas, *The Right to Property from a Human Rights Perspective*, International Centre for Human Rights and Democratic Development, at 2.4 (legal opinion, 2010) http://www.geneva-academy.ch/docs/publications/ESCR/humanright-en.pdf (last accessed Apr. 18, 2016); see also Sparkling, *supra* note 61, who extensively and detailed discusses the right to property as a right recognized as international law. Denying the jus cogens quality of the right to property, Joern Axel Kaemmerer, *Der Schutz des Eigentums im Voelkerrecht*, (Apr. 20, 2016) (denying the jus cogens quality of the right to property), https://www.uni-trier.de/fileadmin/fb5/inst/IRP/Bitburger_Gespraeche_Einzeldokumente/BitburgerGespr_2004_I_Kaemmerer_151_175_geschuetzt.pdf.

[69] *See, e.g.,* URSULA KRIEBAUM, EIGENTUMSSCHUTZ IM VOELKERRECHT (Duncker & Humbolt, Berlin, 2008); THEO VAN BANNING, THE HUMAN RIGHT TO PROPERTY (Intersentia, Antwerpen, 2002); RUDOLF DOLZER, EIGENTUM, ENTEIGNUNG UND ENTSCHÄDIGUNG IM GELTENDEN VÖLKERRECHT (Springer, Heidelberg, 1985); Adolph A. Berle, *Property, Production and Revolution*, 6 COLUM. L. REV. 1, 1-20 (1965); *generally*, FRIEDRICH CARL V. SAVIGNY, DAS RECHT DES BESITZES (Heyer, Gießen, 1803).

[70] U.N. Doc. A/RES/45/98, para. 3 (Dec. 14 1990).

and industry"[71] In the absence of the right to property being stipulated by the ICCPR, the Human Rights Committee has not dealt with the right directly.[72] The Inter American Court of Human Rights and the European Court of Human Rights, on the other hand, have filled the relative void under the respective Covenants.[73] According to their jurisprudence, the right to property encompasses a wide range of economic interests like movable and immovable property; tangible and intangible interests, such as shares, an arbitration award and intellectual property;[74] pension rights[75]; a business operation[76]; a customer base[77]; vested, asset like, rights[78]; a license or concession[79]; and the right to exercise a profession[80]

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[71] *Id.*

[72] The Human Rights Committee dealt with the right to property in the negative. *E.g.,* Kétényuéré Ackla v. Togo, Communication No. 505/1992, U.N. Doc. CCPR/C/51/D/505/1992, 1996, para. 6.3 ("the Committee noted that, irrespective of the fact that the confiscation took place prior to the date of entry into force of the Optional Protocol for Togo, the right to property was not protected by the Covenant. Accordingly, the Committee decided that this claim was inadmissible ratione materiae, under article 3 of the Optional Protocol").

[73] In regard to an overview of the jurisprudence of the European Court of Human Rights, *see*: Helene Ruiz Fabri, *Approach taken by the European Court of Human Rights to the Assessment of Compensation for Regulatory Exprorpriations of the Property of Foreign Investors*, 11 N.Y.U. ENVIR. L. J. 148 (2012); in regard to the jurisprudence of the Inter-American Court of Human Rights: LAURENCE BURGORGUE-LARSEN & AMAYA UBEDA DE TORRES, THE INTER-AMERICAN COURT OF HUMAN RIGHTS (OUP, Oxford, 2011).

[74] Lithgow v. United Kingdom, 1986 ECHR 8 (1986); Ivcher Bronstein Case, Inter-Am. Ct. H.R. (ser. C) No. 74 (Feb. 6, 2001), available at http://wwwl .umn.edu/humanrts/iachr/C/74-ing.html; Palamara-Iribarne v. Chile, Merits, Reparations, and Costs, (ser. C) No. 135, para. 96 (Nov. 22, 2005); Salvador Chiriboga v. Ecuador, Preliminary Objections and Merits, (ser. C) No. 179 (May 6, 2008).

[75] Azinas v. Cyprus*,* Eur. Ct. H.R. App. No. 56679/00 (Apr. 28, 2004); Torres Benvenuto et al v. Peru (*Five Pensioners Case*), Inter-Am. Ct. H.R. (ser. C) No. 98 (Feb. 28, 2003); Acevedo Buendía et al (*Discharged and Retired Employees of the Office of the Comptroller*) v. Peru, Preliminary Objection, Merits, Reparations, and Costs, Inter-Am. Ct. H.R. (ser. C) No. 198, para. 80–91 (July 1, 2009).

[76] Van Marle v. Netherlands, Eur. Ct. H.R. App. No. 8543/79; 8674/79; 8675/79; 8685/79 (June 26, 1986)

[77] Latridis v. Greece, Eur. Ct. H.R. App. No. 31107/96, ECHR 1999-II 75 (Mar. 25, 1999).

[78] Holy Monastries v. Greece, Eur. Ct. H.R., 20 EHHR 1 (1995).

Importantly the ECHR has extended the concept of protected property to rights arising from contracts and other types of claims[81], including, for example, claims to restitution under national law[82] Furthermore, the Court has held that a legitimate expectation of a property right is protected under Article 1(1) Optional Protocol to the ECHR. In *Slivenko v Latvia* the Court stated:[83]

> [p]ossessions" can be "existing possessions" or assets, including claims by virtue of which the applicant can argue that he or she has at least a "legitimate expectation" of acquiring effective enjoyment of a property right.

The Inter-American Court of Human Rights has summarized the right to property as[84]

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[79] Tre Traktörer AB Garamond v. Sweden, Eur. Ct. H.R., A159, para. 53 (1989); Fredin v. Sweden, Eur. Ct. H.R., 13 EHRR 784 (Feb. 18, 2991).

[80] Gospodinova v. Bulgaria, Eur. Comm'n H.R. App. No. 37912/97 (Apr. 16, 1998) (decision on admissibility); Jantner v. Slovakia, Eur. Ct. H.R. App. No. 39050/97, para. 34 (Mar. 4, 2003); Kopecký v. Slovakia, Eur. Ct. H.R. App. No. 44912/98 (GC) 2004-IX, para. 35 (2004); von Maltzan et al v. Germany, Eur. Ct. H.R. App. No. 71916/01, 71917/01, 10260/02, para. 74 (Mar. 2 2005) (decision on admissibility).

[81] *Compare, e.g.*, Pressos Compania Naviera SA v. Belgium, Eur. Ct. H.R. 21 EHHR 301 (1995) (tort claim); Monica Carss-Frisk, *A guide to the implementation of Artice 1 of the Protocol No. 1 to the European Convention on Human Rights*, Human Rights Handbooks, No. 4, para. 29 et seq. (Strasbourg, 2001).

[82] *Compare*, *e.g.*, Kirilova and Others v. Bulgaria, Eur. Ct. H.R. App. No. 42908/98 et al: (June 9, 2005) (final, Sept. 9 2005), and (June 14, 2007) (final, Sept. 14, 2007).

[83] Slivenko and Others v. Latvia, Eur. Ct. H.R. App. No. 48321/99, (GC) ECHR 2002-II, para. 121 (2002); *see also,* Vander Mussele v. Belgium, Eur. Ct. H.R. App. No. 8919/80 (ser. A) 70, para. 48 (1983); Pine Valley Developments Ltd. v. Ireland, Eur. Ct. H.R. App. No. 12742/87 (ser. A) 222 (1991).

[84] Mayagna (Sumo) Awas Tingni Community v. Nicaragua, Judgment of Aug. 31, 2001, Inter-Am. Ct. H.R. (ser. C) No. 79, para. 144; *see also*, Yakye Axa Indigenous Community v. Paraguay, Merits, Reparations and Costs, Inter-Am. Ct. H.R. (June 17, 2005); Sawhoyamaxa Indigenous Community v. Paraguay, Merits, Reparations and Costs, Inter-Am. Ct. H.R. (Mar. 29, 2006); Saramaka People v. Suriname, Preliminary Objections, Merits, Reparations and Costs, Inter-Am. Ct. H.R. (ser. C) No. 172 (Nov. 28, 2007).

> those material things which can be possessed, as well as any right which may be part of a person's patrimony; that concept includes all moveables and immovables, corporeal and incorporeal elements and any other intangible object capable of having value.

What is not protected is the right or guarantee to acquire property in the future.[85]

It is undisputed that the right to property protects the right's bearer from the direct expropriation of their property.[86] Right's bearers are also protected from a de facto deprivation of property.[87] As the ECHR observed:[88]

> In the absence of formal expropriation, that is to say a transfer of ownership, the Court considers that it must look behind the appearances and investigate the realities of the situation complained of . . . Since the Convention is intended to guarantee rights that are "practical and effective" . . . it has to be ascertained whether th[e] situation amount[s] to a de facto expropriation….

(iii) Summary

In the present day, not only individual investors but also corporations have to be afforded human rights. The inclusion of (transnational) legal persons in the protection sphere of international human rights has to be the consequence of requiring corporations to

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[85] Marckx v. Belgium, Eur. Ct. H.R. App. No. 6833/74 (1979); X v. the Federal Republic of Germany, Eur. Ct. H.R. App. No. 8410/78 (1979).

[86] Ursula Kriebaum & Christoph Schreuer, *The Concept of Property in Human Rights Law and International Investment Law*, in HUMAN RIGHTS, DEMOCRACY AND THE RULE OF LAW: LIBER AMICORUM LUZIUS WILDHABER 748 (Zurich, 2007), *available at* http://www.univie.ac.at/intlaw/wordpress/pdf/88_concept_property.pdf (last accessed Apr. 18, 2016) (p. 5 of the linked publication)

[87] Sporrong and Lönnroth v. Sweden, Eur. Ct. H.R. App. No. 7152/75 (1982); Monica Carss-Frisk, *supra* note 81, para. 67 et seq.

[88] Sporrong and Lönnroth v. Sweden, *supra* note 87, para. 63.

be protectors of human rights. The most important right for an investor, the right to property, has attained customary international law status. At this point in time the ambit of the right has to be ascertained through the analysis of (especially) the European Court of Human Rights and the Inter American Court of Human Rights jurisprudence. Such an analysis reveals that the right to property extensively protects the economic interests of corporations in regard to direct, and importantly also de facto expropriation, and the curtailment of the use and enjoyment of their property.[89] The right to property protects the physical assets of a corporation but also its intangible assets. Importantly, the right to property also protects the business operation including legitimate expectations.

3. *Conclusion*

Both citizens as well as investors are afforded rights under international human rights law. However, at this point in time the state's citizens' enjoyment of human rights is on more solid foundations than those of legal persons in general and investors in particular. Citizens' rights most likely to be at stake in an investor-state dispute are so called second and third generation rights. Those rights are enshrined in the ICESCR or rights which have attained customary international law status. Even though generally their justiciability is not without doubt, it is generally accepted that those rights demand a constant progressive realization from states.[90] For most investors, their human rights protection will depend on the acknowledgment that they can, as legal persons, be bearers of international human rights, in particular the IBR. Since (transnational) corporations are relied upon for the progressive realization of human rights, those obligations must come with the right to be a human rights bearer. A number of rights which have

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[89] See European Court of Human Rights, *Factsheet: Companies-Victims or Culprits* (July 2013); Ursula Kriebaum & Christoph Schreuer, *supra* note 86 (discussing the differences between investment law and human rights law in regard to the issues arising in the limitation of the investor's economic interest. However, the different treatment does not necessitates a different outcome in regard to protection).

[90] See above II.A. in regard to the concept of the states' duty to progressive realization.

been or could be the focus of human rights violations by the state are ICCPR rights which are unquestionably justiciable. The right to property, which is undoubtedly the most important right to be upheld for the investor, has come into its own and has achieved at least near customary international law status. Therefore, international human rights law does afford investors protection in regard to the investment they have made.

No human rights bearer, however, holds their rights absolutely. Article 29(2) of the UDHR generally acknowledges that, in the exercise of

> rights and freedoms, everyone shall be subject only to such limitations as are determined by law solely for the purpose of securing due recognition and respect for the rights and freedoms of others and of meeting the just requirements of morality, public order and the general welfare in a democratic society.

Some rights in the IBR have specific limitations.[91] Whether specific limitations apply to the right to property is at this point in time not generally recognized since the right to property has just emerged on the international plane. Guidance can again be sought from the ECHR and the ACHR. Article 1 of the Optional Protocol No 1 to the ECHR[92] grants the state the possibility to limit the individual's right to property due to public interest. The ACHR also allows the limitation of the right to property due to public interest.

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[91] The right to freedom of expression (art. 19(2), ICCPR), for example, can be limited when it is necessary for the country's national security (art. 19(3)(b)).

[92] Optional Protocol No 1, Art. 1 reads: "Every natural or legal person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law. The preceding provisions shall not, however, in any way impair the right of a State to enforce such laws as it deems necessary to control the use of property in accordance with the general interest or to secure the payment of taxes or other contributions or penalties." See Yukos v. Russia, Judgement, Eur. Ct. H.R. App. No. 14902/04, para. 554 (Sept. 20, 2011), in regard to the general interpretation of Art. 1.

The ACHR only allows a limitation to the right to property for just compensation.[93]

The citizen's rights in question are rights that require a progressive realization by the state.[94] To justify preventing the realization of one right at the expense of another right, the realization must be reasonable.[95] It is beyond the scope of this article to discuss the limitations on the right to property and the citizen's rights at any length. For the purpose of this article it is important to state that neither the investor's rights nor those of the citizens are absolute. Human rights law has developed internal limitation mechanisms to take account of the fact that the individual's enjoyment of rights take place within the community of other rights holders.

In addition to internally accepted limitations on a right, the commonly used analytical framework to balance the rights of human

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[93] ACHR, Art. 21(2) : "No one shall be deprived of his property except upon payment of just compensation, for reasons of public utility or social interest, and in the cases and according to the forms established by law." In Salvador Chiriboga v. Ecuador, Inter-Am. Ct. H.R. (ser. C) No. 179 (May 6, 2008), the city had expropriated applicant's land for use as a public park but failed to pay any compensation. The Court held that the public interest or social utility standard was satisfied since the park provided a recreational and ecological protected area for the benefit of city residents. However, the Court found a violation of the right to property due to the city's failure to comply with expropriation procedures required under domestic law (*i.e.*, failure to pay compensation). The Court also observed that a restriction on the right to property must be proportionate to the legitimate interest that justifies it, which requires a fair balance between the interests of the public and owner. The ECtHR also generally requires compensation for a limitation of the right to property. James et al v. United Kingdom, Eur. Ct. H.R. App. No. 8793/79 (ser. A) No. 98, para. 54 (Feb. 21, 1986) ("[T]he taking of property in the public interest without payment of compensation is treated as justifiable only in exceptional circumstances not relevant for present purposes"); Lithgow and Others v. the United Kingdom, Eur. Ct. H.R. App. No. 9006/80 et al., para. 120 (July 8, 1986) ("[T]he taking of property in the public interest without payment of compensation is treated as justifiable only in exceptional circumstances")..

[94] See above II.B.2.(i).

[95] The principle of reasonableness as an inherent limit of socio-economic rights has been best developed by the South African Constitutional Court, *see* Khosa v. Minister of Social Development, 2004 (6) SA 505 (CC) (Mar. 4, 2004); *see also,* Kevin Iles, *Limiting Socio-Economic Rights: Beyond the Internal Limitation Clause*, 20 S. AFR. J. OF HUM. RTS. 448 (2004).

rights holders to allow for the fullest human rights fulfillment is proportionality. Proportionality has been received inter alia into the constitutional doctrine of courts in continental Europe[96], the United Kingdom[97], Canada[98], New Zealand[99], Israel[100], South Africa[101], and the United States[102], as well as the jurisprudence of treaty-based legal systems such as the European Convention on Human Rights[103], the American Convention on Human Rights,[104] the European Court of Justice,[105] and the ICCPR[106107] The core proportionality analysis requires the following inquiries to be made:

a) Is there a legitimate aim in regard to the measure in question?

b) Is the measure suitable to achieve the aim?

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[96] *E.g.*, Bundesverfasungsgericht 1 BvR 2378/98 (Mar. 3, 2004) (police surveillance powers in regard to living space).

[97] R (Daly) v. Secretary of State for the Home Department [2001] UKHL 26; Huang v. Secretary of State for the Home Department [2007] UKHL 11; Kashmiri v. Secretary of State for the Home Department [2007] UKHL 11.

[98] R v. Oakes [1986] 1 S.C.R. 103 (Can.).

[99] R v. Hansen [2007] N.Z.S.C. 7, para. 102 (N.Z.).

[100] CA 6821/93 United Mizrahi Bank Ltd. v. Migdal Cooperative Village 49(4) PD 221, 353 (1995) (Isr.).

[101] S v Makwanyane and Another 1995 (3) SA 391 (CC) (S. Afr.).

[102] In regard to the United States, see Iddo Porat, *Mapping the American Debate over Balancing* in GRANT HUSCROFT/BRADLEY MILLER/GREGOIRE WEBBER, PROPORTIONALITY AND THE RULE OF LAW 397 (CUP, Cambridge, 2016).

[103] Handyside v. United Kingdom, Eur. Ct. H.R., [1976] ECHR 5 (Dec. 7, 1976); Soering v. United Kingdom, Eur. Ct. H.R., 11 EHRR 439 (1989); Helene Ruiz Fabri, *Approach taken by the European Court of Human Rights to the Assessment of Compensation for Regulatory Exprorpriations of the Property of Foreign Investors* (2002) 11 N.Y.U. ENVTL. L.J. 148, 163 (2002).

[104] *Compare* IACHR, Art. 27(1) and discussion in YUTAKA ARAI-TAKASHI, THE MARGIN OF APPRECIATION DOCTRINE AND THE PRINCIPLE OF PROPORTIONALITY IN THE JURISPRUDENCE OF THE ECHR 186 (intersentia, Antwerp, 2001).

[105] *E.g.,* Sky Österreich, E.C.J. (GC) C-283/11, para. 50 et seq. (Jan. 22, 2013).

[106] U.N. Human Rights Committee, General Comment No. 31, para. 6 (Mar. 29, 2004).

[107] For an in depth discussion on the framework of proportionality in different jurisdictions, see GRANT HUSCROFT, BRADLEY MILLER and GREGOIRE WEBBER, PROPORTIONALITY AND THE RULE OF LAW (CUP, Cambridge, 2016).

c) Is the measure necessary to achieve the aim?

d) Is the measure the least rights infringing means to achieve the aim?

e) Considering the competing interests of the different rights bearers at hand is the measure proportional?

The human rights framework demands a balancing of the investor's rights with the rights of the citizens, i.e. the state's right to make public policy decisions to safeguard its citizens' rights. The human rights framework internally limits a state's measure in regard to the realization of the rights in question, like the right to health or water. The proportionality paradigm gives the balancing a tested structure. It is therefore curious that a review of arbitral awards reveals that arbitral tribunals have turned a blind eye to the human rights of the state's citizens, as an extensive study by Jason Fry determined.[108] The argument generally advanced is that the arbitral tribunal gets its power by virtue of the parties set out in an investment treaty between the host state and the investor's state. And as long as the investment treaty does not stipulate an authority for the investment tribunal to have regard to the citizens' human rights, tribunals do not have the authority to do so.[109] That has resulted in, as Bruno Simma put it:[110]

> a problem of aiming at two moving targets: for the foreign investor, how to accurately estimate the political risks of the investment before, or at the time of, its establishment in the host State so as to enable the investor to price the contract cost correctly according to its projected returns on investment; and for the host State, how to determine the optimal degree of police powers and regulatory authority to be retained during the life of the investment, needed to perform its international human rights obligations.

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[108] Jason Fry, *International Human Rights Law in Investment Arbitration: Evidence of International Law's Unity*, 18 DUKE J. OF COMP. & INT'L L. 77 (2007).

[109] Bruno Simma, Foreign Investment Arbitration: A Place for Human Rights?, 60 INT'L & COMP. L.Q. 573, 582 (2011).

[110] *Id.* at 579.

The non-use of the human rights framework by arbitral tribunals is problematic. The reason is that the right which is at the heart of investment arbitration – the right to access to justice – is the right which puts the investor, at least sometimes, in a better position than a state's citizens. In a country with a non-functioning adjudication system[111] the investors, unlike the citizens, have through investor-state arbitration an avenue open to them that allows access to justice to independent adjudicators who are outside that non-functioning adjudication system. In this inequality lies the potential human rights violation of investor-state arbitration but also the potential for investor-state arbitration.

C. International Arbitration Approaches

Having set out the human rights framework applicable to the investor-state relationship the paper will briefly set out the currently proposed approaches of how tribunals can be compelled to take human rights into account.

1. *Current Approaches*

Broadly speaking three approaches are advanced. All approaches are centered on the investment treaty. They have as their underlying premise that human rights can only be taken into account if, and as far as, an investment tribunal is allowed to consider rules of international law. They allow any kind of human rights analysis only in so far as human rights can be placed in a particular relationship with the investment treaty concerned.[112] The core premise of those approaches is illustrated by the *travaux prepartoires* of Article 42(1) of the Convention on the Settlement of Investment Disputes ("ICSID Convention) which refers to "such rules of international law as may be *agreed by the parties*."[113]

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[111] "non- functioning" for the purposes of this article is meant in the widest sense including a legal system that does grant effective justice.

[112] *See* Bruno Simma, *supra* note 109, at 581-82.

[113] ICSID Report of the Executive Directors, I ICSID Rep. 31 (2006) (*emphasis added*) (cited in *CHRISTOPH SCHREUER, THE ICSID CONVENTION: A*

(i) Explicit Referencing Approach

The first approach advanced is to draft (in the future) investment treaties that clearly state that a tribunal has to take the state's human rights commitments into account.[114] Among the rare investment treaties that do make reference to human rights already, human rights are addressed in two different ways none of which gives the tribunal an explicit mandate to incorporate a human rights analysis into its decision making process. First, certain treaty clauses, such as Article 1114(1) of the North American Free Trade Agreement (NAFTA), allow a host state under its respective regimes to enact measures aimed at protecting human rights.[115] However, such measures are only allowed to the extent that they are consistent with the terms of the investment treaty.[116] Second, other treaty clauses provide that the provisions of the investment treaty do not limit the regulatory power of states regarding the protection of human rights. Article 10(1) of the Canadian BIT Model provides such an example.[117] The Comprehensive Economic and Trade

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COMMENTARY 609 (CUP, Cambridge, 2001)). Pursuant to the report by the Executive Directors, the term 'international law' as used in the context of the Convention has to be understood in the sense given to it by Article 38(1) of the Statute of the International Court of Justice. In light of this statement, the applicable rules of international law are those contained in treaties, customary law, and general principles of law recognized by civilized nations. Therefore, under the ICSID Convention the IBR has to be taken into account if the investment treaty makes reference to international law.

[114] Bruno Simma, *supra* note 109, at 579.

[115] *See, e.g.,* North American Free Trade Agreement, U.S.-Can.-Mex., art. 1114(1), Dec. 17, 1992, 32 I.L.M. 289 (1993) [hereinafter NAFTA].

[116] NAFTA, art 1114(1) ("Nothing in this Chapter [11] shall be construed to prevent a Party from adopting, maintaining or enforcing any measure *otherwise consistent with this Chapter* that it considers appropriate to ensure that investment activity in its territory is undertaken in a manner sensitive to environmental concern") (*emphasis added*).

[117] Model Agreement for the Promotion and Protection of Investments, art. 10(1) (2004): "Subject to the requirement that such measures are not applied in a manner that would constitute arbitrary or unjustifiable discrimination between investments or between investors, or a disguised restriction on international trade or investment, nothing in this Agreement shall be construed to prevent a Party from adopting or enforcing measures necessary: (a) to protect human, animal or plant life or health." *Available at* http://www.italaw.com/documents/Canadian2004-FIPA-model-en.pdf (last accessed 3 April 2016); see also the Norwegian Draft Model BIT (2015), which has

Agreement (CETA) between Canada and the European Union as a recent instance includes a clause which protects human rights explicitly.[118] Those express references to the state's ability to regulate with the aim to foster human rights are stating the obvious. As set out in the previous part of this paper states are compelled by the IBR to attain the highest standard in human rights compliance for their citizens. A reminder of that in an investment treaty is undoubtedly useful. In addition what is proposed is to clearly state in an investment treaty a tribunal's ability to weigh the state's aim to foster human rights compliance through its social and economic policy against the investor's right to its investment.

In regard to existing investment treaties two approaches have been proposed:

(ii) Dynamic Interpretation Approach

The first approach promulgates a dynamic interpretation as set out by the International Court of Justice in *Kasiliki, Sedudu Island (Botswana v Namibia)*:[119] where treaties use known legal terms whose content the parties expected would change through time,[120] the meaning of these terms will be determined by reference to international law as it has evolved and stands at present, rather than to the state of the law at the time of the conclusion of the treaty.[121]

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an equivalent to art. 10 in its art. 25. In addition, art. 31 reads: "The Parties agree to encourage investors to conduct their investment activities in
compliance with the OECD Guidelines for Multinational Enterprises, the UN Guiding Principles on Business and Human Rights and to participate in the United Nations Global Compact."

[118] Consolidated Comprehensive Economic and Trade Agreement Text, EU-Canada, Oct. 30, 2016, Annex 8-E (". . . . the Parties confirm their understanding that measures that are 'related to the maintenance of international peace and security' include the protection of human rights"), available at http://trade.ec.europa.eu/doclib/docs/2014/september/tradoc_152806.pdf (last accessed Feb. 15, 2017).

[119] Kasiliki, Sedudu Island (Botswana v Namibia), Judgment, 1999 I.C.J. Rep. 1045.

[120] *Id.* at 2 (Declaration of Judge Rosalyn Higgins).

[121] The same technic was utilized in Ronald Lauder v. Czech Republic, Final Award of Sept. 3, 2001, at para. 200,

The European Court of Human Rights applies this principle as a matter of routine, basing it inter alia on articles 31(1) and 31(2) of the Vienna Convention on the Law of Treaties.[122]

(iii) Interpretative Presumption Approach

The other school of thought emphasizes the interpretative presumption that treaties are intended to produce effects which accord with existing rules of international law.[123] This presumption is used to resolve issues of interpretation relating to the broader normative content of a treaty rather than to the meaning of a specific term. This argument is based on article 31(3)(c) of the Vienna Convention on the Law of Treaties[124] which states that in the interpretation of a treaty between the parties has to take account of "[a]ny relevant rules of international law applicable in the relations between the parties." However, as Bruno Simma points out article 31(3)(c) of the Vienna Convention can only be employed as a means of harmonization qua interpretation, and **not** for the purpose of modification, of an existing treaty.

2. *The Human Rights Centric Approach*

However, is the Vienna Convention on Treaties really the glue that prevents international law to disintegrate into a 1000 pieces? In domestic law the respective constitution (generally containing a human rights catalogue) is allowed comfortably to be the overarching umbrella that gives the law legitimacy and provides a framework in what the state but also its citizens can engage in and are allowed to

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http://www.italaw.com/sites/default/files/case-documents/ita0451.pdf (last accessed Feb. 15, 2017).

[122] *See, e.g.,* SE Golder v. United Kingdom, Eur. Ct. H.R. App. No 4451/70, Report of the Commission, CE doc. D-60-355, 25 (June 1, 1973); *also Id.*, Judgment, 29-36 (Feb. 21, 1975).

[123] Case Concerning Right of Passage over Indian Territory (Portugal v. India), Preliminary Objections, 1957 I.C.J. Rep. 142; Corfu Channel case (U.K. v. Albania), Judgment, 1949 I.C.J. Rep. 104.

[124] *See also* Ciaran Cross & Christian Schliemann-Radbruch, *When Investment Arbitration curbs Domestic Regulatory Space: Consistent Solutions through Amicus Curiae Submissions by Regional Organisations*, 6 L & DEV. REV. 67, 87 (2013).

do. On the international plane this paper argues the IBR provides this overarching umbrella. The IBR sets out the paradigm in which states but also the arbitrators and the investors have to operate in. If states would not have to adhere to the IBR (and as stated at the beginning since those rights embodied in the IBR are customary so every state has to adhere to them) then human rights protection would be illusory. The IBR has to be treated as *jus congens* by any tribunal in investment treaties decisions. Article 53 of the Vienna Convention on the Law of Treaties provides that "a treaty is void if, at the time its conclusion, it conflicts with a peremptory norm of general international law." The general principle that is extrapolated is that domestic as well as international law follows a hierarchy whereby treaty obligations are of no effect in the event that they conflict with a fundamental *jus congens*.[125] The IBR contains the most globally recognized norms. International investment law itself should not be blind to human rights.[126] By signing an investment treaty states cannot relieve themselves from any human rights obligation towards their citizens. It should not matter whether the state includes human rights protection in those treaties or not. It cannot lie in the hands of the states or the investors whether human rights are applicable.[127] Regarding that international investment law constitutes a public law discipline[128], neither states nor investors can "flee into private law"[129]

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[125] Luke Eric Peterson & Kevin R. Gray, *International Human Rights in Bilateral Investment Treaties and in Investment Treaty Arbitration* 18 (International Institute for Sustainable Development Research Paper, Apr. 2004), https://www.iisd.org/pdf/2003/investment_int_human_rights_bits.pdf (last accessed Feb. 15, 2017).

[126] *Filip Balcerzak, Jurisdiction of Tribunals in Investor–State Arbitration and the Issue of Human Rights, 29 ICSID Rev. 216, at VI (2016),* https://academic.oup.com/icsidreview/article/29/1/216/2356645/Jurisdiction-of-Tribunals-in-Investor-State *(last accessed Feb. 15, 2017).*

[127] For a different opinion, see Tamar Meshel, *Human Rights in Investor-State Arbitration: The Human Right to Water and Beyond*, 6 J. OF INT'L DISP. SETTLEMENT 277, 281 (2015), https://academic.oup.com/jids/article/6/2/277/819997/Human-Rights-in-Investor-State-Arbitration-The (last accessed Feb. 15, 2017), who points out in his conclusion that the highest responsibility for human rights protection bears the state while building an investment treaty, even though he recognizes the possible influence of investment arbitration tribunals regardless of investment treaties clauses at least for the human right to water.

[128] STEPHAN W. SCHILL, INTERNATIONAL INVESTMENT LAW AND COMPARATIVE PUBLIC LAW 17 et al. (2010).

when it comes to violation of basic general law principles.[130] The ability of states to contract out, even partially, of the IBR would seriously undermine human rights protection globally. As set out above under B the IBR provides not only protection for citizens but also for the investor. And also the arbitrator is part of the paradigm as Lalive so clearly pointed out:[131]

> While he is clearly not an organ of the State, the international arbitrator is not acting in a legal vacuum and is not called upon to decide, so to speak, as if he did not belong to this world! The question may be raised here, in passing [. . .] whether the arbitrator is not, perhaps, the organ of the international community, be it the community of States or the 'international community of businessmen' (in which more and more States and State organs appear to be active) or both international communities.

The investor-state relationship illustrates the private-public divide on the international plane. The private-public divide, i.e. when is a state action private when public, is one of the most contested in every jurisdiction.[132] One of the fundamental issues is that the

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[129] Compare the principle in German Public Law "keine Flucht ins Privatrecht", *see* Ferdinand Kirchhof, *Art. 83*, n.103, *in* GRUNDGESETZ-KOMMENTAR, 78 (Maunz & Dürig eds., Sept. 2016); Thorsten Kingreen, *AEUV Art. 36*, n.111, *in* EUV/AEUV 5 (Calliess & Ruffert eds., 2016).

[130] *Compare* Wolfgang Friedmann, *The Use of "General Principles" in the Development of International Law*, 57 AM. J. INT'L L. 279, 295 (Apr., 1963) ("The science of international law can no longer be content with the analogous application of private law categories. It must search the entire body of the 'general principles of law recognized by civilized nations' for proper analogies. With the growing importance of international legal relations between public authorities and private legal subjects, public law will be an increasingly fertile source of international law").

[131] Pierre Lalive, *Transnational (or Truly International) Public Policy and International Arbitration*, *in* COMPARATIVE ARBITRATION PRACTICE AND PUBLIC POLICY IN ARBITRATION, ICCA Congress Series No. 3 at 258, 302 (1986).

[132] For an overview of the German discussion, See Ulrich Stelkens, The Public-Private Divide: Annual Report – 2010 – Germany, IUS PUBLICUM NETWORK REV. (Nov. 2011), http://www.ius-publicum.com/repository/uploads/23_11_2011_10_39_Stelkens.pdf (last accessed May 28, 2016), for an overview of the German discussion. For an overview of the

arbitration community seems to view the investor-state relationship from a private law lens centering its analysis of the relationship between in the investor and the state solely on the investment treaty. The investment treaty, a treaty between two or more states, does have to be the starting point of the analysis. The object of an investment treaty is to attract investment, i.e. business, something commonly associated with private law. However, only because the subject matter of the treaty is private does not mean that public law principles, i.e. human rights, do not apply to its interpretation. As the German Constitutional Court has convincingly and regularly stated: a state cannot resort to a private measure to circumvent its human rights commitments since otherwise human rights protection would be illusive.[133]

To accept the proposed paradigm in this article would mean that human rights, as enshrined in the IBR, have to be taken into account by the arbitral tribunal whether or not there is an interpretative "hole" or "hook" in the respective investment treaty. Human rights are the structure in which the investment treaty is fixed to and which ultimately limits it. In other words, the paradigm proposed is the opposite paradigm of, what is at this stage, the general opinion where the investment treaty provides the structure in which human rights have to find a hook to be able to find hold in that structure. Thereby, while balancing the interests of the investor against the interests of the citizens, arbitrators not only harmonize two potentially conflicting regimes of international law (investment law and human rights law) but, in substance, also highlight the human dimension of investment law.[134]

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discussion regarding the United Kingdom, see Dawn Oliver, *common values in public and private law and the public/private divide*, in BA Rider (ed), LAW AT THE CENTRE 119 (Kluwer, London, 1999); *see generally* Christine Chinkin, *A Critique of the Public/Private Dimension*, 10 EUR. J. INT"L LAW 387 (1999); LAW COMMISSION OF CANADA, NEW PERSPECTIVES ON THE PUBLIC-PRIVATE DIVIDE (2007).

133 *See* BVerfGE 15, 256, 262; BVerfGE 21, 362, 369, 370; BVerfGE 115, 205, 237.

134 Yannik Radi, *Realizing Human Rights in Investment Treaty Arbitration: A Perspective from within the International Investment Law Toolbox*, N.C.J. INT'L L. & COM. REG. 1107, 1114 (2011).

D. Conclusion

An analysis of the international human rights framework demonstrates that states' citizens as well as the foreign investors are human rights bearers. Human rights methodology provides for a balancing of conflicting rights' positions. The current inclusion of human rights into the decision making of arbitral tribunals occurs through an investment treaty centered interpretation. That general approach limits the tribunal's ability, if not discourages, to consider the relevant human rights of citizens and investors alike in its decision-making. Arbitrators are part of the international community and their mandate is not only determined by their appointment and the relevant investment treaty provisions but also by the international constitutional framework, i.e. the applicable human rights norms. Even if an arbitral tribunal would ignore an exciting investment treaty a human rights analysis would not disregard the rights of the investor. Therefore, if a human rights analysis does not differ in its outcome significantly from the analyses of tribunals under the relevant investment treaty then it evidences that an arbitral tribunal does not have to fear the inclusion of a human rights analysis in its decision-making process. On the contrary, an inclusion of a human rights analysis will aid the decision-making process and most importantly will foster a constructive dialogue with the human rights lobby and thereby would promote the legitimacy of investment arbitration.

III. THE CASE

Investors have successfully sought relief in front of regional human rights courts[135] and domestic courts[136] for government interference with their investment. An analysis in light of the international human rights framework adds an important dimension.

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[135] *See*, *e.g.,* Chaparro Álvarez and Lapo Íñiguez v. Ecuador, Inter-Am. Ct. H.R. (ser. C) no. 170 (Nov. 21, 2007), available at http://www.corteidh.or.cr/docs/casos/articulos/seriec_170_ing.pdf (last accessed May 10, 2016); Oao Neftyanaya Kompaniya Yukos v. Russia, Eur. Ct. H.R. App. No. 14902/04 (Mar. 8, 2012).

[136] *See* Overview in Helene Brubowski, *Internationale Investionsschiedsverfahren und nationale Gerichte*, Jus Internationale et Europaeum 79 (Mohr Siebeck, Tübingen, 2013).

As set out earlier the international human rights framework provides the global human rights standard available to every international arbitral tribunal by virtue of being international. It provides the globally accepted minimum human rights standard.

The general way human rights cases are approached are by defining the ambit of the right that is potentially infringed and once an infringement is established to balance the limiting of that right with the rights of other rights holders since it is accepted that rights can be justifiably limited by the rights of others. In the following that methodology will be applied to *TECMED v Mexico*.[137] The tribunals approach in the judgement was also followed by other tribunals later on, for example, in *Azurix v Argentina*.[138]

A. The Investment Arbitration Tribunal Decision

TECMED, a Spanish company with its two Mexican subsidiaries, brought a claim against Mexico alleging several violations of the Spain-Mexico BIT. The claim concerned TECMED's investment in a hazardous waste landfill site acquired in 1996. TECMED alleged that Mexico failed to renew a license for the site.

In the investment arbitration proceedings TECMED alleged the failure to renew the license rendered the investment completely lost, as it did not have any economic value as an ongoing business. TECMED alleged violations of the BIT, including expropriation, fair and equitable treatment and full protection and security. The tribunal found that Mexico's action in effect expropriated TECMED's investment, and that it failed to provide fair and equitable treatment. The Tribunal interestingly did balance Mexico's interest in its

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[137] TECMED v Mexico, ICSID Case no. ARB(AF)/00/2 (May 29, 2003) (the author chose this case as one of the earlier cases where the arbitral tribunal payed regard to balancing the rights of the investor against the rights of Mexico's citizens).

[138] Azurix Corp. v. Argentine Republic, ICSID Case No. ARB/01/12, Award of July 14, 2006, para. 311, http://www.italaw.com/sites/default/files/case-documents/ita0061.pdf (last accessed Feb. 15, 2017).

environment and the investor's right to property. The Tribunal stated:[139]

> After establishing that regulatory actions and measures will not be initially excluded from the definition of expropriatory acts, in addition to the negative financial impact of such actions or measures, the Arbitral Tribunal will consider, in order to determine if they are to be characterized as expropriatory, whether such actions or measures are proportional to the public interest presumably protected thereby and to the protection legally granted to investments, taking into account that the significance of such impact has a key role upon deciding the proportionality. Although the analysis starts at the due deference owing to the State when defining the issues that affect its public policy or the interests of society as a whole, as well as the actions that will be implemented to protect such values, such situation does not prevent the Arbitral Tribunal, without thereby questioning such due deference, from examining the actions of the State in light of Article 5(1) of the Agreement to determine whether such measures are reasonable with respect to their goals, the deprivation of economic rights and the legitimate expectations of who suffered such deprivation. There must be a reasonable relationship of proportionality between the charge or weight imposed to the foreign investor and the aim sought to be realized by any expropriatory measure. To value such charge or weight, it is very important to measure the size of the ownership deprivation caused by the actions of the state and whether such deprivation was compensated or not. On the basis of a number of legal and practical factors, it should be also considered that the foreign

[139] TECMED v Mexico, *supra* note 137, at para. 122. Also recently quoted in Philip Morris v. Uruguay, ICSID Case no. ARB(AF)/10/7, para. 295 (July 8, 2016), where it stressed that the tribunal relied on the jurisprudence of the European Court of Human Rights, based on Article 1 of Protocol 1 of the Convention..

> investor has a reduced or nil participation in the taking of the decisions that affect it, partly because the investors are not entitle to exercise political rights reserved to the nationals of the State, such as voting for the authorities that will issue the decisions that affect such investors.

B. The Human Rights Tribunal Decision

This paper will limit its human rights analysis to the right to property.

1. *Ambit of the right infringed?*

The first step in a human rights analysis is to define the ambit of the right that is potentially involved to determine whether the act or omission is protected by the right. As discussed under II.B.2.(ii). the right to property encompasses a license[140] as well as legitimate expectations in proprietary positions[141] In TECMED the investor sustained a complete loss of the profits and income from the economic and commercial operation of the landfill as an ongoing business. The damage sustained included the impossibility of recovering the cost incurred in the acquisition of assets for the landfill, its adaptation and preparation and, more generally, the investments relating to or required for this kind of industrial activity. That included, but was not limited to, constructions relating to the landfill; lost profits and business opportunities; the impossibility of performing contracts entered into with entities producing industrial waste. Thus the government's action lead to the termination of such contracts and to possible claims relating thereto. Furthermore, the government's action resulted in a loss of reputation for TECMED

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[140] *Compare* Tre Traktörer ABGaramond v. Sweden, Eur. Ct. H.R. App. No. 10873/84, para. 53 (1989); Fredin v. Sweden, Eur. Ct. H.R. App. No. 12033/86 (1991); Latridis v. Greece, Eur. Ct. H.R. App. No. 31107/96 (1999).

[141] *Compare* Slivenko v. Latvia, Eur. Ct. H.R. App. No. 48321/99 (2003), para. 121; *see also* Vander Mussele v. Belgium, Eur. Ct. H.R. App. No. 8919/80 (ser. A), para. 48 (1983); Pine Valley Developments Ltd. v. Ireland, 222 Eur. Ct. H.R. App. No. 12742/87 (ser. A) (1991).

and to its subsidiaries in Mexico. The consequence was a negative impact on TECMED's capacity to expand and develop its activities in Mexico. Even though the government did not expropriate TECMED its actions rendered the property of TECMED de facto useless. In addition, TECMED's expectation in the license and the license itself are protected by the right to property. Therefore, TECMED's activities and expectations in regard to the operation of the landfill were protected by the customary right to property. TECMED's right to its property was infringed by the actions of Mexico's government. As set out above under II.B.2.(ii). the right to property can be limited if the property owner is compensated fairly for the expropriation.[142] If the state compensates fairly for the expropriation the right to property is not infringed.

2. *Proportionality Analysis*

After establishing that TECMED's right to property in the landfill was infringed through the government's action the next inquiry is whether the government's action is a justified limitation on TECMED's right to property. That inquiry is particularly fact specific. Since the arbitral tribunal did not engage in a human rights analysis the government did not provide the facts to the standard needed for a proportionality analysis according to the record. The analysis is limited to the facts set out in the award.

(i) Is there a Legitimate Aim in Regard to the Measure in Question?

As set out under II.A. the right to health is a right protected by ICESCR which the state has to progressively realize. The Tribunal itself observed that:

> the Arbitral Tribunal has to resolve any dispute submitted to it by applying international law

[142] What constitutes a "fair", "just", or "reasonable" compensation is of course a matter of contention. It is beyond the scope of this article. For further reading in regard to the ECtHR: Helene Ruiz Fabri, *Approach taken by the European Court of Human Rights to the Assessment of Compensation for Regulatory Expropriations of the Property of Foreign Investors*, 11 N.Y.U. ENVTL. L.J,., 148, 165 et seq. (2002).

> provisions (Title VI.1 of the Appendix to the Agreement), for which purpose the Arbitral Tribunal understands that disputes are to be resolved by resorting to the sources described in Article 38 of the Statute of the International Court of Justice considered, also in the case of customary international law, not as frozen in time, but in their evolution.[143]

Interestingly, the Tribunal only applied international law and customary international law in regard to its understanding of the right to property and the question whether indirect de facto expropriation amounted to expropriation. It did not discuss international law or customary international law applicable to the citizens of Mexico. Instead the tribunal found that it was not concerned with whether non-renewal of the permit was legal under domestic law. It held:[144]

> The Arbitral Tribunal will not review the grounds or motives of the Resolution in order to determine whether it could be or was legally issued. However, it must consider such matters to determine if the Agreement was violated. That the actions of the Respondent are legitimate or lawful or in compliance with the law from the standpoint of the Respondent's domestic laws does not mean that they conform to the Agreement or to international law.

Even if the Tribunal is correct by not reviewing the legality of the non-renewal of the permit under domestic law the Tribunal in accordance with its own reliance on Article 38 of the Statute of the International Court of Justice has to take into account the international law and the international customary law applicable to the citizens of the state.

The state is obligated under Article 12 ICESCR to safeguard and to progressively realise the highest attainable standard of the health of its citizens. To protect its citizens from the health effects of

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[143] TECMED v Mexico, *supra* note 137, at para. 116 n.133 (May 29, 2003) (*citing* Mondev Int'l Ltd. v. United States, ICSID Case no. ARB (AF)/99/2, para. 116 (Oct. 11, 2002)).

[144] *Id.* at para. 120.

hazardous waste is an obvious obligation. The denial to renew a permit for a landfill where hazardous waste is deposited due to the urbanisation of the area is a measure that is in accordance with the state's duty to safeguard its citizens' health and an aim the state is under an international obligation to realise.

(ii) Is the Measure Suitable to Achieve the Aim?

On the available facts the closure and relocation of the landfill is a suitable measure to avoid a hazard for the citizens of the close by urban centre. The municipality's motivation was stated as:[145]"[to] secure environmental safety in view of the rapid urban growth of Hermosillo, provide a response to the concerns that had been expressed and guarantee, in the long term, the environmental infrastructure to handle and dispose of industrial waste".

(iii) Is the Measure Necessary to Achieve the Aim?

The facts indicate that TECMED operated the landfill in accordance with all safety regulations and that the operation and even a proposed extension of the operation did not and would not threaten the public health of the citizens of the nearby town or the environment.[146] Therefore the non-renewal of the permit was not necessary to achieve the aim of safeguarding the citizens of Hermosillo from a public health threat and environmental disaster. However, it can be argued that a landfill that contains hazardous waste even if compliant with all safety regulations poses an inherent threat to the health of a nearby urban centre. By closing landfills containing hazardous waste close to urban centres is a preventative measure progressively realizing the right to health under Article 12 ICESCR.

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[145] *Id.* at para. 110.

[146] *Id.* at para. 131.

(iv) Is the Measure the Least Rights Infringing Means to Achieve the Aim?

If the non-renewal of the license is the only measure suitable to prevent a health threat to the citizens of the nearby urban centre. It has to be borne in mind, that the need to dispose of hazardous waste is a necessary by-product of modern civilisation. Therefore, the state would potentially breach its obligations under Article 12 ICESCR by closing one landfill where hazardous waste can be disposed of without allowing for the hazardous waste to be disposed of somewhere else since it would risk the illegal dumping of hazardous waste. With that in mind the question arises whether the blanket non-renewal of the license is the least infringing measure or whether the non-renewal of the license accompanied with either compensation for the loss of the business and/or the offer of a different site to resume TECMED's business would have been a least infringing measure. According to the facts, it is worthy to note that negotiations in regard to relocating TECMED's business to a different site had taken place during and after the non-renewal of the perm it but had ultimately ceased.[147] The least infringing measure in regard to TECMED's property interest would have been to either offer a new site for its operation or adequately compensate them for its loss of business. As noted above, II.B.3. (especially footnote 92), the right to property has the inherit limitation that generally expropriation has to be accompanied with fair compensation to be justified. Even though the facts are silent on the issue it seems that for the state to fulfil its obligation under ICESCR and its obligation towards TECMED the least infringing measure would have been to offer an alternative site for TECMED's operation. However, it is acknowledged that the state can make choices in how to realize its obligations. Therefore, the state instead of relocating TECMED's business could have compensated TECMED for its loss of property and organised the disposal of hazardous waste differently. By not doing either the state did not use the least infringing measure to achieve its aim. The non-renewal of the permit without either fair compensation or re-location of TECMED's business is therefore disproportionate to the state's aim to safeguard the health of its citizens. It is an justified limit on TECMED's right to property.

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[147] *Id.* at para. 112.

(v) Considering the competing interests of the different rights bearers at hand is the measure proportional?

Since the non-renewal of the licence is not the least infringing measure available to the state TECMED's right to property is disproportionally limited in balance with the citizens' right to health.

3. *Conclusion*

Using a human rights methodology to analyze TECMED's claim against Mexico in regard to the expropriation of its business demonstrates that a human rights analysis will take the rights of the investor into account. A human rights analysis will provide for an analytical framework that will allow a tribunal to balance the rights of the investor with that of the state's citizens. The use of a human rights framework will lead to more fully developed arguments under international law. It is significant that in TECMED the Tribunal relied on Article 38 of the Statute of the International Court of Justice in regard to the investor but not in regard to the state's citizens. Using the human rights framework in aiding its decision tribunals would combat what, commentators generally agree, that international investment law and arbitration have an adverse impact on the promotion and protection of human rights.[148]

Having established a breach of the investor's right to property the question becomes what the appropriate remedy for a breach of the human rights violation is. The question of compensation is without doubt of utmost importance for the victims

[148] *See* Ryan Suda, *The Effect of Bilateral Investment Treaties on Human Rights Enforcement and Realization* 2 (N.Y.U. Global Law, Working Paper No. 1, 2005).

of human rights abuses.[149] In regard to the violation of the right to property the ECtHR has generally held that:[150]

> the protection of the right to property … would be largely illusory and ineffective in the absence of any equivalent principle. Clearly, compensation terms are material to the assessment whether the contested legislation respects a fair balance between the various interests at stake and, notably, whether it does not impose a disproportionate burden on the applicant.

The aim of this paper was to demonstrate that using a human rights framework to analyze an investor-state dispute will adequately address the rights of the investor and the state's citizens. Using a human rights methodology will aid a tribunal's analysis of the dispute and will contribute to the legitimacy of its decision. The question of a fair remedy is outside the scope of this paper.

IV. GENERAL CONCLUSION

There is no need for an arbitral tribunal in an investor-state dispute to have any "Berührungsängste" in regard to human rights. International human rights do provide a methodological framework that allows for a balanced consideration of both the investor's position but also the respective state's citizens' rights which the state has to safeguard and/or progressively implement. The investor's right to property which is at the center of the contention is not an isolated

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[149] *See, e.g.,* DINAH SHELTON, REMEDIES IN INTERNATIONAL HUMAN RIGHTS LAW (2015); EWA BGINSKA, DAMAGES FOR VIOLATIONS OF HUMAN RIGHTS: A COMPARATIVE STUDY OF DOMESTIC LEGAL SYSTEMS (Springer, Heidelberg, 2015); JASON VARUHAS, DAMAGES AND HUMAN RIGHTS (Hart, 2016); JAGMOHAN MISHRA, HUMAN RIGHTS VIOLATION: CONTEMPORARY CONCERNS & REMEDIES (Akansha Publishing, 2011); *see also* G.A. Res. 60/147 (Dec. 16, 2005).

[150] James v. United Kingdom, 98 Eur. Ct. H.R. (ser. A), para. 54 (1986); *see also* Lithgow v. United Kingdom, 102 Eur. Ct. H.R. (ser. A), para. 120 (1986); Holy Monasteries v. Greece, 301-A Eur. Ct. H.R. (ser. A), paras. 70-75 (1994); Hentrich v France, 209-A Eur. Ct. H.R. (ser. A), para. 48 (1994); Pressos Compania Naviera SA v. Belgium, A332 Eur. Ct. H.R. (ser. A), para. 38 (1995); Guillemin v. France, 1997-I Eur. Ct. H.R., paras. 52-57 (1997).

right but a right which is instrumental, in the company with other rights, in fostering socio-economic well-being[151] Only the interplay and inclusion of all members of a society, natural and legal persons, nationals or foreigners, can society strive and attain the highest possible standard of well-being. The international human rights framework recognizes this and has tasked the state with the duty through fair and reasonable government, i.e. through balancing the rights of every member of society, to progressively achieve the highest possible standard of well-being.

An international arbitral tribunal, as part of the international community, is charged with overseeing whether the state has balanced the rights at play justifiably. In essence, there can be no doubt that the state has to be able to take any measure which enhances the human rights of its citizens or safeguards them from harm. If that measure infringes the rights of the investor the measure will be justified if the investor is compensated. In other words, the state can do anything as long as it compensates the investor. There might be situations where the measure is of such importance that in balance the property infringement of the investor does not warrant compensation.[152]

For an investment tribunal to include a human rights analysis into its decision-making process will increase its legitimacy. Even though desirable, there is no need for stronger human rights clauses in investment treaties. The investment tribunals bear the responsibility to implement the law, regardless whether states and investors felt before responsible for including a human rights clause in their investment treaties. Since human rights provide the overarching framework any investment treaty, bi-lateral or multi-lateral, has to be interpreted in light of human rights and is limited by them. Accordingly, also lawyers should be aware that they enjoy the opportunity to introduce human rights considerations into the arbitral conversation[153], as already mentioned no matter for which

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[151] Luis Valencia Rodríquez, *The right of everyone to own property alone as well as in association with others*, para. 116, UN Doc. E/CN.4/1994/19 (Nov. 25, 1993).

[152] As noted earlier, it is outside the scope of this paper to discuss what constitutes fair compensation.

[153] Luke Eric Peterson & Kevin R. Gray, *International Human Rights in Bilateral Investment Treaties and in Investment Treaty Arbitration* 20 (International

side they argue. Then red riding hood and the wolf may have a break from playing tag and come more often together for a cup of tea on eye level.

Institute for Sustainable Development Research Paper, Apr. 2004), https://www.iisd.org/pdf/2003/investment_int_human_rights_bits.pdf (last accessed Feb. 15, 2017).

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WATER AS A HUMAN RIGHT: A CASE STUDY OF THE PAKISTAN-INDIA WATER CONFLICT

*Waseem Ahmad Qureshi**

The Indus Waters Treaty was signed between India and Pakistan in 1960, with the World Bank taking a mediatory role between the two countries. The treaty allocated the Ravi, Sutlej, and Bias Rivers to India, while Pakistan was assigned the water from the Chenab, Jhelum, and Indus Rivers. Nonetheless, Pakistan has alleged that India violated the Indus Waters Treaty by initiating the construction of Baglehar Dam in 1999. Pakistan further claimed that India exasperated the issue by proceeding to initiate new projects such as the Ratle Dam on the Chenab River and Kishan Ganga on the Neelum–Jhelum River. The completion of these projects, in addition to the modifications in the allocation of river waters to Pakistan, could deprive the people of the Indus Basin region the basic human right of access to water; a region strongly dependent on these rivers, and that basic right, for drinking, agricultural, and domestic purposes. Access to water is a "basic human right," as endorsed in different international conventions and declarations. Therefore, India's draconian act of restricting water flow to Pakistan could directly result in human rights violations.

* Advocate Supreme Court of Pakistan.

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I. INTRODUCTION

Water is a basic human right[1] because it is essential for human survival. This paper is focused on the distribution of water between India and Pakistan and the resulting conflict. The historical and contemporary nature of the conflict, alongside the human rights issues pertinent to the conflict, will be evaluated in the first section of this paper. The Indus Waters Treaty resolved this conflict to a great extent; however, the recent statements from Indian Prime Minister Narendra Modi, regarding blocking the rivers that flow from India to Pakistan, have reignited the conflict.[2] India is also constructing the Kishan Ganga and Ratle Dams on the Jhelum and Chenab rivers, respectively,[3] and has also completed the Baglehar Dam on the Chenab River. Pakistan has serious reservations about the construction of these dams. The implications of India's construction of dams, its attempt to revoke or modify the terms of Indus Waters Treaty ("IWT"), and its threats to block rivers to Pakistan will also be discussed in the first section of this paper. The second section will include the interpretations and positions of the international conventions and declarations, which recognize "access to water" as a fundamental human right. The role of the World Bank as a "mediator" between India and Pakistan for resolving the water conflict and, consequently, protecting the "human right to water" will be explained in the third section. The fourth section will include the options available to Pakistan, along with the proposal of a suitable strategy to overcome the water conflict with India.

II. SUMMARY OF THE CONFLICT

A. The Historical Developments Toward Water Conflict and the

[1] Amanda Cahil Ripley, *The Human Right to Water and its Application in the Occupied Palestinian Territories*, 14 (TAYLOR & FRANCIS, 2011).

[2] Hugh Tomlinson, *Modi Threatens to cut Pakistan's water in revenge for militant attack*, THE TIMES, September 27, 2016, http://www.thetimes.co.uk/article/modi-threatens-to-cut-pakistan-s-water-in-revenge-for-militant-attack-j2vsgn8jf (last visited December 22, 2016).

[3] Aziz Z. Azad, *Indus Water Treaty and India's Agitation*, DAILY JANG NEWSPAPER, December 18, 2016.

IWT

At the time of the partition of the subcontinent, the British rulers assigned an independent commission, named the "Radcliffe Award" and under the supervision of Sir Cyril Radcliffe, for drawing the international boundary between India and Pakistan.[4] As a result, India became the upper riparian state, while Pakistan became the lower riparian region.[5] The water of six major rivers in the lower riparian Pakistan comes from the upper riparian India.

Immediately after partition, India suddenly suspended all the river water flowing to Pakistan, which threatened Pakistan's agricultural and agrarian infrastructure because it was heavily reliant on the river water for irrigation.[6] In response, Pakistan approached the international community and, eventually, after a decade of strained relations between India and Pakistan, the World Bank took the very noble initiative of mediating between India and Pakistan for the allocation and distribution of river water between the two countries. As a result of the mediation of the World Bank, the Indus Waters Treaty was signed by the rulers of both countries, Indian Prime Minister Jawaharlal Nehru and Pakistani Field Marshal Ayub Khan, in 1960.[7]

The IWT allocated the eastern rivers—the Ravi, Sutlej, and Bias—to India, while the western rivers—the Sindh, Chenab, and Jhelum—were allocated to Pakistan. Both countries were also given the right of conditional usage of water of each other's rivers for domestic reasons, such as power generation, agricultural, and other non-consumptive purposes; however, it was required that such usage

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[4] Lucy Chester, *The 1947 Partition – Drawing the Indo-Pakistani Boundary,* AMERICAN DIPLOMACY, February 2002, http://www.unc.edu/depts/diplomat/archives_roll/2002_01-03/chester_partition/chester_partition.html (last visited December 20, 2016).

[5] Miriam R. Lowi, *Water and Power: The Politics of a Scarce Resource in the Jordan River Basin*, 63 (CAMBRIDGE UNIVERSITY PRESS, 1995).

[6] Danta Caponera, *National and International Law and Administration*, 230 (KLUWER LAW INTERNATIONAL, 2003) [hereinafter Caponera].

[7] Michael Glantz and Igor Zonn, *Scientific, Environmental, and Political Issues in the Circum-Caspian Region*, 285 (SPRINGER, 1997).

must not lower the quantity and natural flow of the water in the river of the other country.[8]

As a result of the IWT, the water conflict was resolved to a great extent until 1999, when India announced the construction of the Baglehar Dam on the Chenab River and completely disregarded Pakistan's concerns over the design of the dam. According to Pakistani government sources, the design of the dam could affect the quantity of water in the Chenab River.[9] Meetings of the Permanent Indus Commission — a commission comprising members from both countries to discuss issues related to the IWT — were also held, but no consensus was reached[10] and eventually Pakistan had to rely upon the judgment of the neutral expert of the World Bank, whose final verdict did not prevent the completion of the dam[11]

B. The Contemporary Nature of the Conflict

At present, the buried conflict of the past between India and Pakistan seems to have been reborn after aggravated statements from Indian Prime Minister Narendra Modi that he would be bringing Indus water back to India;[12] he also announced the formation of a task force to "review" the Indus Waters Treaty.[13] This has raised

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[8] Niranjan Das Gulhati, *Indus Water Treaty: An Exercise in International Mediation*, 148–312 (ALLIED PUBLISHERS, 1973).

[9] Laurence Boisson, Christina Leb, and Mara Tignino. *International Law and Fresh Water: The Multiple Challenges*, 417 (EDWARD ELGAR PUBLISHING LIMITED, 2013); *see also* Aparna Pande, *Explaining Pakistan's Foreign Policy: Escaping India* (ROUTLEDGE, 2011).

[10] UNECE, River Basin Commissions and Other Institutions for Transboundary Water Cooperation, 20 (UNITED NATIONS, 2009).

[11] 2007: Neutral expert gives his judgement on Baglihar Dam, DAWN, July 02, 2011, https://www.dawn.com/news/640989, (last visited April 03, 2017).

[12] Varinder Singh, *PM: Will Bring Indus Water Back. Tribune News Sources*, THE TRIBUNE, November 26, 2016, http://www.tribuneindia.com/news/nation/pm-will-bring-indus-water-back/328690.html (last visited December 5, 2016).

[13] Hindustan Times Correspondent, *India forms task force on Indus Water Treaty*, HINDUSTAN TIMES, December 17, 2016, http://www.hindustantimes.com/india-news/india-forms-task-force-on-indus-waters-treaty-pakistan-says-won-t-accept-changes-to-pact/story-fuzmtjpvi94ivzggp3epzn.html (last visited December 20, 2016).

tensions for Pakistan as the Indus river was legally allocated to Pakistan under the IWT, and Modi's statement about the Indus river has been regarded by Pakistan as very contentious. Reviewing the IWT, or even modifying or changing its clauses, is also unacceptable to Pakistan: the special assistant to the Pakistani prime minister confirmed that no changes or modifications of the IWT would be accepted by Pakistan.[14] The Indian threat to revoke the IWT is also alive, which has concerned Pakistan. If the treaty is cancelled, there will be no consensus between the countries on the distribution of waters. As a result, the peace of the region could be at risk.

Moreover, India has initiated the construction of dams on the western rivers—the Chenab, Jhelum, and Neelum rivers in occupied Kashmir and within the Indian territory. Pakistan has serious objections to the Ratle, Kishan Ganga, and Sawalkot Dams and the Wullar Barrage[15] because they could impact the flow of the Chenab and Jhelum rivers to a great extent, which would put in danger Pakistan's irrigation system and availability of water for drinking and domestic purposes. Although, the Permanent Court of Arbitration's verdict on the Kishan Ganga Dam partially favors Pakistan,[16] it also allows India to build the Kishan Ganga dam in accordance with the IWT's requirement of minimum level of water flow ($9m^3/s$) in the Chenab river.[17] However, the dispute still exists in relation to other dams. These contentions are strengthening the India–Pakistan water conflict.

C. Human Rights Issues Related to the Conflict

Water is a basic human necessity and recognized as a fundamental human right. India's threats and its construction of dams on the western rivers are paving the way for the deprivation of

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[14] Anwar Iqbal, *Pakistan not to accept alteration in Indus Water Treaty*, DAWN, December 17, 2016, http://www.dawn.com/news/1302848 (last visited December 18, 2016).

[15] A.K. Chaturvedi, *Water: A Source for Future Conflicts*, 164 (VIJ BOOKS INDIA PVT LTD, 2013). [hereinafter Chaturvedi].

[16] Robert G. Wirsing and Zafar Adeel, *Imagining Industan: Overcoming Water Insecurity in the Indus Basin*, 79. (SPRINGER, 2016).

[17] Gustaf Olsson, *Water and Energy: Threats and Opportunities*, 19 (IWA PUBLISHING, 2015).

the people of Pakistan of this basic right. India has also committed violations of human rights in Kashmir and it would feel no harm in repeating the same for the people of Pakistan by depriving them of adequate water supply.

The main issue concerning the India–Pakistan water conflict is related to the "human right to access water." The construction of dams by India on Pakistani-allocated rivers could lower the quantity of water in the western rivers,[18] which will affect the "access to water" of the people who regularly consume the water of these rivers in Pakistan, especially in the Punjab region. Moreover, blocking the Indus and other rivers from India could cause a shortage of water in Pakistan, which would deprive a large number of people who are dependent on access to this river water for drinking, agricultural, and domestic needs.

Agriculture is the only means of subsistence and earning for almost half of the Pakistani population. Forty-five percent of the Country's labor force is associated with agriculture;[19] therefore, any harm done to the agriculture of Pakistan will cause a direct negative effect on the lives of these people. Pakistan's citizens' well being, standards of living, employment, access to health care, food, water, and sanitation will all be directly affected. Moreover, around 70 percent of the region's agricultural area is in the Punjab;[20] therefore, if India pursues its ambitions of constructing dams or barrages to deprive the Pakistani Punjab of the river water, then it would cause severe harm to the basic rights[21] — the right to access water, food, sanitation, employment, health care, etc. — of the people who are dependent on the river water in Punjab.[22]

Another issue is related to threatening the agricultural infrastructure of Pakistan. Almost the entire agricultural

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[18] *Id.*

[19] Aaron Marcus, *Design, User Experience, and Usability: User Experience Design for Everyday Life Applications and Services*, 574 (SPRINGER, 2014).

[20] Peter Blood, *Agriculture – Pakistan: A Country Study.* (U.S. LIBRARY OF CONGRESS, 1994). Chapter available at: http://countrystudies.us/pakistan/49.htm (page 1) (last visited December 22, 2016).

[21] *Id.*

[22] *Id.*

infrastructure of Pakistan follows the canals and barrage systems for irrigation,[23] and all of the water in the canals and barrages comes from the western rivers,[24] of which the Indus River shares the maximum quantity of water supply. Any hindrance caused by India to the flow of the Indus river will reduce the flow of water reaching to Pakistan, and blocking the flow of this river would cause a shortage or total lack thereof water available for irrigation; this would directly threaten the very survival of the entire Pakistan population because the absence of irrigation could result in crop failure, as well as food and water shortages.

III. INTERNATIONAL CONVENTIONS & DECLARATIONS ENDORSING THE "ACCESS TO WATER" AS A BASIC HUMAN RIGHT

There are a number of internationally accepted declarations, conventions, and resolutions that shed light on the importance of the access to water for every human-being residing in any region or state. Some of these declarations explicitly mention the importance of the "right to access water," along with other basic amenities of life, while others implicitly highlight it. In this regard, the United Nations has been an essential international body, providing a platform to the international community for issuing conventions. The notable clauses that discuss this basic human right are mentioned below with reference to the universally acclaimed declarations and conventions.

A. The United Nations Charter

The United Nations Charter[25] has essential goals for human development. For instance, Article 55 includes the following points:[26]

> a. Higher standards of living, full employment, and conditions of economic and social progress and development;

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[23] *Id.*

[24] Chenab, Jhelum, and Indus rivers.

[25] Charter of the United Nations, 1945.

[26] Chapter IX, Charter of the United Nations, 1945.

> b. Solutions of international economic, social, health, and related problems; and international cultural and educational cooperation; and
>
> c. Universal respect for, and observance of, human rights and fundamental freedoms for all without distinction as to race, sex, language or religion.[27]

The need is to ensure all the required living conditions for realizing the aforementioned goals of human development, and these conditions must entail the right to water for basic life subsistence, because, the access to water is the fundamental requirement for not only the survival of life, but also human development.[28]

On the other hand, the climactic changes, population increases, and conflicts between upper and lower riparian states over the distribution of water resources are some of the prominent challenges of the contemporary era that may hinder the progress to fulfillment of human development goals.[29]

B. The Universal Declaration of Human Rights

The Universal Declaration of Human Rights (the "Declaration") was adopted by the General Assembly of the United Nations in 1948[30] This Declaration is a fundamental part of international law; a body of law that every state heavily weighs when deciding on matters related to international jurisdiction[31] Article 25 of this declaration states:

> Everyone has the right to a standard of living adequate for the health and well-being of himself and

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[27] *Id.*

[28] Stephen M. Wheeler and Timothy Beatley, *Sustainable Urban Development Reader*, 217. (ROUTLEDGE, 2014).

[29] Shimon Anisfeld, *Water Resources*, 100 (ISLAND PRESS, 2010). *See also* Tamin Younus and Caitlin Grady, *Climate Change and Water Resources*, 146 (SPRINGER. 2013).

[30] S.Prakash Sinha, *Asylum and International Law*, 93. (SPRINGER, 2013).

[31] Burns H. Weston and Richard Pierre Claude, *Human Rights in the World Community: Issues and Action*, 94. (UNIVERSITY OF PENNSYLVANIA PRESS, 2006).

> of his family, including food, clothing, housing and medical care and necessary social services.[32]

This clause highlights the importance of the well-being of every human and their right to access the basic necessities of life. The word "water" has not been used explicitly in the Declaration, but it is a basic necessity for human life and well being, as human health and subsistence are impossible without it. As a result, "access to water" is required to ensure human rights.[33]

C. The International Covenant on Civil and Political Rights ("ICCPR")

The ICCPR has emphasized the importance of the right to life for every human being by stating:

> The ICCPR affirms the "right to life" which has conventionally been interpreted to mean that no person shall be deprived of his or her life in a civil and political sense.[34]

This statement implies the notion that no state or individual should create circumstances that may harm an individual's life through any means. The ICCPR also follows the Human Rights Committee's ("HRC") principle that emphasizes the "right to life" and access to water in the following words:

> [HRC] has noted that the right to life has been too often narrowly interpreted. The expression "inherent right to life" cannot properly be understood in a restrictive manner, and the protection of this right requires that States adopt positive measures. Disregarding this new development in the

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[32] Article 25, Universal Declaration of Human Rights.

[33] Phillip Aston and Ryan Goodman, *International Human Rights*, 369 (OXFORD UNIVERSITY PRESS, 2013).

[34] Angela Cassar, John Scanlon, and Noemi Nemes, Water as a Human Right, 4 (IUCN-UNDP, 2004). *See also* Taniya Malik, *Recognition of Human Right to Water under International Law Regime,* 170*,* INTERNATIOANL JOURNAL OF APPLIED RESEARCH, 1(4).

> understanding of Article 6 and assuming a narrow interpretation of such a right would nevertheless require the inclusion of the protection against arbitrary and intentional denial of access to sufficient water, because this is one of the most fundamental resources necessary to sustain life.[35]

Here, the ICCPR, in accordance with the HRC, is recommending that states adopt the necessary measures for the protection of the "inherent right to life" for every human being, and classifies access to water as an integral part of the "right to life."

D. The Convention on the Elimination of All Forms of Discrimination Against Women ("CEDAW")

CEDAW is an organization that is pro-actively working for the well being and development of womens' lives, and has also highlighted the access to water as a fundamental right and requirement for the quality of life for women.[36] It also particularly articulates the importance of access to water for women residing in rural and under-developed areas where there could be fewer resources of water[37] Women may require water not only for drinking, but also for essential child and family care, in addition to the other basic domestic needs.

E. The Convention on the Rights of the Child

The Convention on the Rights of the Child highlights the need to fulfill the fundamental necessities of life for the well-being of children. It mentions access to healthcare, food, and clean water, among other necessities set out in Article 24(2)(c) as follows:

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[35] Taniya Malik, *Recognition of Human Right to Water under International Law Regime, 170* INTERNATIOANL JOURNAL OF APPLIED RESEARCH, 1(4).

[36] Article 14(2)(h), Convention on the Elimination of All Forms of Discrimination against Women (CEDAW).

[37] *Id.*

> [To] combat disease and malnutrition, including within the framework of primary health care, through, inter alia, the application of readily available technology and through the provision of adequate nutritious foods and clean drinking-water, taking into consideration the dangers and risks of environmental pollution.[38]

Therefore, every child must have access to these fundamental necessities of life to ensure their health, stability, well-being, and survival.

F. The United Nations Watercourses Convention

This UN Convention is focused on highlighting the importance of the "access to water" as a fundamental right for every human being. Above all, Article 10 of this Convention recognizes the right to access water for drinking purposes as being more important than the right to access water for agriculture or electricity generation, or any other use within a state, as well as in another riparian state.[39] In this regard, the states should observe this comparison and adhere to such in practice.

In light of this Convention, one country cannot deprive another country access to drinkable water, and further, that specific right must be prioritized over building infrastructure for storage, hydroelectricity generation, irrigation, or any other non-consumptive purpose. This clause is relevant to the upper riparian states, from where rivers flow to the lower riparian states.[40] If the former stops the water flow, then the availability of water in the latter will certainly decline.

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[38] Article 24(2)(c), Convention on the Rights of the Child.

[39] Takele Soboka Bulto, *The Extraterritorial Application of Human Right to Water in Africa*, 260 (CAMBRIDGE UNIVERSITY PRESS, 2014). *See also* Antoinette Hildering, *International Law, Sustainable Development and Water Management*, 101 (EBURON, 2006).

[40] Parasan Rangarajan, Daniel Tan, and Veronica Fynn, *International Law Journal of London*, 235 (INTERNATIONAL LAW JOURNAL OF LONDON, 2014).

Stephen McCaffrey, former Special Rapporteur on The Law of the Non-Navigational Uses of International Watercourses[41], has further interpreted this clause and added the term "economic development," stating that a country cannot stop water flow to a lower riparian state on the grounds of economic development, particularly when this could harm the subsistence of people dependent on that water in the lower riparian state.[42]

H. The Stockholm Declaration

This declaration was approved during the United Nations Conference on the Human Environment, held in Stockholm in 1972.[43] Stockholm Declaration explicitly mentioned the access to water as a fundamental right for present and future generations:

> The Declaration is one of the earliest environmental instruments that recognizes the fundamental right to an environment of a quality that permits a life of dignity and wellbeing [sic] and also that the natural resources of the earth including, the air, water, land, flora, and fauna … must be safeguarded for the benefit of present and future generations.[44]

I. The Mar del Plata Action Plan

The Mar del Plata Action Plan was approved during the United Nations Water Conference, held in March 1977 in Mar del Plata, Argentina. The main purpose of the conference was to evaluate the contemporary challenges related to water availability,

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[41] Stephen McCaffrey has been considered an expert in International Law of Watercourses and he has written on the geographical and other issues pertaining to the watercourses. For instance, see his book: *The Law of International Watercourses*, (OXFORD UNIVERSITY PRESS, 2007).

[42] *Id.*; *and see* Caponera, *supra* note 7, at 41.

[43] David Weissbrodt and Connie de Vega, International Human Rights Law: An Introduction, 197 (UNIVERSITY OF PENNSYLVANIA PRESS, 2007).

[44] Declaration of the United Nations Conference on the Human Environment.

management,[45] efficiency of usage, cleanliness, and agricultural and socioeconomic uses, and to devise a plan to meet these challenges and avert future global water crises.[46] The Mar del Plata Action Plan, presented by this conference, identified "water as a [fundamental human] right, declaring that all people have the right to drinking water in quantities and of a quality equal to their basic needs."[47]

J. The Dublin Statement

The Dublin Statement was the result of the International Conference on Water and Environment held in Dublin, Ireland in January of 1992.[48] The main purpose of this conference was to evaluate the scarcity and inefficient use of water, and any scarcity-related threats to sustainable development.[49] Experts from the varying states in attendance arrived at the mutual consensus that "access to clean water and sanitation" is among the basic rights of human beings.[50]

The four principles of the Dublin Statement highlight the importance of water for all human beings[51] The first principle evaluates the essentiality of water for life and environments and confirms that the resource is in-fact finite[52] The second principle suggests a participatory approach for better management of water usage. The third principle discusses the role of women in the

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[45] Malin Falkenmark, UN Water Conference: Agreement on Goals and Action Plan, 222–227 (SPRINGER, 1977).

[46] WHO, *United Nations Conference on Water (Mar del Plata 1977)* (WORLD HEALTH ORGANIZATION. 2005.)

[47] United Nations Division for Economic and Social Information, *Mar del Plata Action Plan: United Nations Water Conference, Mar del Plata, Argentina, 78*. UN DESI/DPI, 1983.

[48] Ana Maria Daza-Clark, *International Investment Law and Water Resources Management: An Appraisal of Indirect Expropriation*, 39. (BRILL, 2016). *See also:* Takele Soboka Bulto, *The Extraterritorial Application of the Human Right to Water in Africa*, 48. (CAMBRIDGE UNIVERSITY PRESS, 2013).

[49] *The Dublin Statement on Water and Sustainable Development – UN Documents: Gathering of a Body of Global Agreements,* UNGO, January 31, 1992.

[50] *Id.*

[51] Hannatjie Jacobs, Jo-Ansie van Wyk, and Richard Meissner. *Future Challenges of Providing High-Quality Water*, 152. (EOLSS PUBLICATIONS, 2009).

[52] Tim Davie, *Fundamentals of Hydrology*, 157. (TAYLOR & FRANCIS, 2008).

management and usage of water. The fourth and final principle sheds light on the economic value of water, along with the importance of clean water and sanitation.[53]

Hence, the Dublin Statement explicitly discusses the importance of water and urges states to evaluate the Statement's suggestions and principles so that states may devise and implement effective measures to manage water resources and fulfill the basic water needs of humanity[54]

K. Agenda 21

"Agenda 21" is an international action plan that was devised by the United Nations for achieving sustainable human and economic development worldwide[55] The Agenda includes the fundamental principles and requirements for sustainable development.[56] It also mentions that adequate water resources are essential for achieving sustainable development.[57] Agenda 21 further highlights the importance of maintaining good quality of pure and fresh water resources in order to fulfill the human needs related to water, and for the protection of the natural ecosystem.[58]

In this regard, Chapter 18 of Agenda 21 considers "access, quality, and quantity" as the three basic elements of the "right to water."[59] It also highlights the importance of maintaining an adequate water supply for the entire population.[60]

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[53] *Id.*

[54] Desheng Hu, *Water Rights*, 112. (IWA PUBLISHING, 2006).

[55] Raymond Charles Rauscher and Salim Momtaz, *Brooklyn's Bushwick - Urban Renewal in New York, USA: Community, Planning and Sustainable Environments*, 50. (SPRINGER, 2014).

[56] Delyse Springett and Michael Redclift, *Routledge International Handbook of Sustainable Development*, 137. (ROUTLEDGE, 2015).

[57] Donald A. Brown and J. Lemons, *Sustainable Development: Science, Ethics, and Public Policy*, 201. (SPRINGER, 2013).

[58] *Id.*

[59] *Chapter 18, point 47: Agenda 21,* UNEP*, October 2011.*

[60] *Id.*

L. The Political Declaration in 2016

The last Political Declaration meeting held in accordance with Resolution 70/183 of the UN General Assembly took place at the United Nation's New York headquarters in September of 2016.[61] The main focus of this meeting was related to antimicrobial resistance.[62] In addressing antimicrobial resistance, the U.N determined that access to clean water, improved health care and sanitation facilities, antimicrobial medications, and the protection of biodiversity were considered among the essential goals for the millennium and recognized as basic human rights.[63]

All of the aforementioned declarations and agendas classify "access to water" as a basic human right. This basic right should be implicit when considering other fundamental non-water related human rights, all of which having already been accepted in the Declaration of Human Rights, the UN Charter, and the various conventions discussed above.[64]

In light of these declarations, India's plan to block Indus waters to Pakistan is a direct threat to the fundamental human right of access to water for the people residing in those regions of Pakistan where the population is entirely dependent on the river's accessibility and ability to provide consumable water. The resultant harm of such an act could also negatively impact domestic, agriculture, and sanitation initiatives effectuated by the harmed region[65] More

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[61] *Draft Political Declaration of the High-level Meeting of the General Assembly on Antimicrobial Resistance,* 2 (UNITED NATIONS GENERAL ASSEMBLY, 2016).

[62] Antimicrobial resistance is an activity induced by the micro-organisms like bacteria, etc. to prevent the nurturing and spread of hazardous bacteria. For details, *see* Mark H. M. M. Montforts and Patricia L. Keen, *Antimicrobial Resistance in the Environment*, (JOHN WILEY & SONS, 2012). *See also* I.W. Fong and Karl Drlica, *Antimicrobial Resistance and Implications for the 21st Century*, (SPRINGER, 2007).

[63] *Draft Political Declaration of the High-level Meeting of the General Assembly on Antimicrobial Resistance,* 2 (UNITED NATIONS GENERAL ASSEMBLY, 2016).

[64] *Id.*

[65] Natalie Nax, *Looking to The Future: The Indus Waters Treaty and Climate Change*, 17 (UNIVERSITY OF OREGON, 2016), http://www.transboundarywaters.orst.edu/publications/publications/nax%20-%202016%20%20indus%20treaty%20and%20climate%20change%20-%20thesis.pdf (last visited December 24, 2016).

importantly, there are no alternate sources of water with the capability to fulfill the threatened region's needs in terms of water usage and supply.[66]

Therefore, India's government should reevaluate the decision to construct dams on the western rivers of the Indus Basin and revise the language of the IWT to avoid modifying the rivers' paths, as these actions can result in the deprivation of the fundamental human right of access to water for the rural populations of Pakistan as a whole.

IV. THE WORLD BANK AND THE INDIA–PAKISTAN WATER CONFLICT

The World Bank has an essential role related to the implementation of Indus Waters Treaty. The major responsibilities of the World Bank are discussed below.

A. Responsibilities:

The World Bank is tasked with the role of "facilitator"[67] for IWT related matters between India and Pakistan. The World Bank brokered the IWT between India and Pakistan in 1960[68] In addition, it also plays the role of mediator whenever a staunch conflict arises between India and Pakistan related to the IWT.[69] Particularly, it follows a procedure suggested in the IWT to resolve water related conflicts between both countries through the following steps.

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[66] *Id.*

[67] It facilitated the signing of IWT back in 1960.

[68] Deepa Viswam, *Role of Media in Kashmir Crises*, 66 (GYAN PUBLISHING HOUSE, 2010).

[69] World Bank Urges Mediation for India, Pakistan over Indus, THE WORLD BANK – WORLDBANK.ORG, November 10, 2016, http://www.worldbank.org/en/news/press-release/2016/11/10/world-bank-urges-mediation-for-india-pakistan-over-indus (last visited April 2, 2017).

1. *Appointment of a Neutral Expert*[70]

The World Bank appoints a "neutral expert" when severe disagreements occur between the relevant parties and the Permanent Indus Commission becomes unable to resolve these disagreements.[71] After being appointed, the neutral expert obtains opinions from both parties and makes their determination on the matter at issue in accordance with the principles illustrated in the IWT that is the governing body of law for water related conflicts between the two states.[72] In this type of scenario, the judgment of the neutral expert is considered binding on both parties.[73] However, if the neutral expert is unable to resolve the disagreement between the two parties, the matter becomes a "dispute" and is then referred to the Court of Arbitration.[74]

India has requested the World Bank to appoint a neutral expert for the IWT.[75] In response, the World Bank has sent an official[76] as its envoy, but has not appointed the neutral expert yet, to mediate between India and Pakistan[77] The envoy will attempt to reduce tensions between the two countries in hopes of reestablishing some form of dialogue.[78]

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[70] Annexure F, Indus Waters Treaty, 1960.

[71] *See* Article IX, Indus Waters Treaty, 1960.

[72] *Id.*

[73] Deepa Viswam, *Role of Media in Kashmir Crises*, 135 (KALPAZ PUBLICATIONS, 2010).

[74] Article IX, Indus Waters Treaty, 1960.

[75] Alex Ferguson, *World Bank Urges Mediation for India, Pakistan over Indus*. THE WORLD BANK, November 10, 2016.

[76] Mr. Ian H. Solomon, a senior official of World Bank, has been sent by the World Bank as an envoy to India and Pakistan.

[77] Moushumi Das Gupta, *World Bank envoy to meet India, Pakistan officials over Indus water dispute*, HINDUSTAN TIMES, January 05, 2017, http://www.hindustantimes.com/india-news/world-bank-official-to-meet-india-pakistan-officials-over-indus-waters-treaty/story-OVBkJH6P83uY0sVZ3iCjFO.html (last visited April 5 2017).

[78] Wajid Ali Syed, *World Bank appoints an envoy to save Indus Waters Treaty*. GEO.TV, December 18, 2016, https://www.geo.tv/latest/124192-world-bank-appoints-envoy-to-save-indus-waters-treaty (last visited December 29, 2016) [Hereinafter: Syed].

2. *The Expenses of the Neutral Expert*

The World Bank is also responsible for establishing and maintaining a trust fund for meeting the expenses of the neutral expert. Both India and Pakistan provide funds as reimbursements for that trust fund.[79]

3. *The Establishment of a Court of Arbitration*[80]

The World Bank also facilitates both countries by referring cases to the Court of Arbitration when the neutral expert cannot reach a conclusion. For such cases, the World Bank provides assistance in selecting judges with relevant legal expertise to comprise the panel that will ultimately issue the final ruling in the dispute.[81] However, the World Bank does not participate itself in the hearings[82]

3.2. *Human Rights and the World Bank's Role of "Mediator"*

The World Bank should effectively fulfill its role as the "mediator" between India and Pakistan, and should further "facilitate" in assuring the protection of basic human rights. For this, the World Bank should try to create an opportunity to arrive at a mutual consensus on the water conflict between India and Pakistan. It should prevent India from breaking or suspending the treaty and from blocking river water flowing to Pakistan. If successful this could help to protect the "right to access water" for people living around the Indus Basin.

Moreover, if the World Bank is able to stop India from constructing dams on the western rivers, then the other basic human rights—the access to water for domestic, agriculture, and drinking purposes—as well as amenities such as sanitation and health care for the rural population, will be protected as well. This population is largely reliant on the river water for meeting their aforementioned

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[79] The Acting Secretary of World Bank, *Supplemental President's Report and Recommendations,* 2 (THE WORLD BANK, April 25, 1960).

[80] Annexure G, Indus Waters Treaty 1960.

[81] *Id.*

[82] *Id.*

needs. Therefore, the role of the World Bank is crucial in protecting the basic human rights of the population residing on the Indus Basin in Pakistan. The World Bank should take note of this situation and place importance on the protection of human rights over other economic needs, which are put forth by India as the basis behind constructing dams and as a rationale for the Country's ambition to modify the IWT to change the course of rivers toward its lands.

V. OPTIONS AND PROPOSED STRATEGIES FOR PAKISTAN

A. Options Available to Pakistan

At the moment, there are three options available to Pakistan.

1. *Bilateral Talks*

The first option is that Pakistan can accept India's offer[83] and try to resolve the conflict bilaterally. For this purpose, Pakistan would need to provide opportunities for sessions of dialogues with India. Both countries can assign representatives for the discussions and decide on IWT related issues mutually.

2. *World Bank Mediation*

The second option that is available to Pakistan is approaching the World Bank to resolve the water conflict with India. The World Bank has the role of a mediator,[84] but not an arbitrator or guarantor,[85]

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[83] Indian Prime Minister Narendra Modi has offered to resolve the water conflict bilaterally instead of via mediation from the World Bank.

[84] Narottam Banskota, *South Asia Trade and Energy Security: The Role of India*, 81 (UNIVERSAL PUBLISHERS, 2012).

[85] Daily Times, 'WB not a guarantor of Indus Water Treaty'. DAILY TIMES, September 30, 2016, http://dailytimes.com.pk/pakistan/30-sep-16/wb-not-a-guarantor-of-indus-water-treaty (last visited December 20, 2016]. *See also* (Indian source): It's not a guarantor of Indus Water Treaty: World Bank, *Zeenews*, http://zeenews.india.com/news/south-asia/its-not-a-guarantor-of-indus-treaty-world-bank_197037.html (last visited December 20, 2016).

for matters involving the IWT; therefore, the World Bank's role is limited as it can only propose ways for the countries to resolve the water conflict as the mediator in negotiations, but ultimately lacks any real enforcement ability..[86]

Currently, the World Bank has appointed a special envoy to hold meetings with officials of both countries in an attempt to establish a bilateral dialogue between the two regarding the IWT.[87] Pakistan can accept the suggestions of the envoy to maintain the dialogue with India so that both countries can agree on certain points; the envoy may also be present during the dialogue meetings, if both countries permit such, to avoid any severe disagreements between the officials of the two states. However, if consensus is not reached, Pakistan can either request the World Bank to appoint a neutral expert, whose judgment will be binding on both states, or alternatively, Pakistan may take its case to the Court of Arbitration.

3. *Approaching China*

The third and last option for Pakistan is to request its closest ally, China, to pressure India to not obstruct water flow in the western rivers. The water that flows into a major Indian river — the Brahamaputra — comes from the Yarling Tsango river in China.[88] As a result, China has the upper riparian position and India is the lower riparian state in this river system.[89] It is pertinent to mention here that China has already blocked one tributary, which had flows from China's Tibet region and had previously reached the Brahmaputra, for the construction of a hydroelectricity project.[90] If China stops all of the major tributaries' flow of water to India this would threaten

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[86] Guatem Sen, Conceptualizing Security for India, 181 (ATLANTIC PUBLISHERS & DISTRIBUTORS, 2007).

[87] *See* Syed, *supra* note 50.

[88] Verghese Koithara, *Managing India's Nuclear Forces*, 37 (BROOKINGS INSTITUTIONS PRESS, 2012).

[89] *See* Chaturvedi, *supra* note 15, at 190.

[90] Jagran josh, Current Affairs, 50 (2016).

India's crop production in the Assam and Arunachal Pradesh states, both of which are dependent on these rivers' for water.[91]

Nonetheless, Pakistan can exercise its option to push China to stop the flow of its river water to India if favorable results do not come from World Bank arbitration attempts. Being a staunch supporter of human rights, Pakistan cannot deprive the population of India the basic human right of "access to water"; however, if India attempts to steal this basic human right from the Pakistani people, who are dependent on the Indus River and other western rivers, then Pakistan may have to utilize this third option to ensure its own survival.

B. A Proposed Strategy for Pakistan

To clarify its position, Pakistan should cooperate with the World Bank's special envoy and show its willingness to hold talks with India. This will demonstrate a positive and peaceful image of Pakistan.

Pakistan should officially provide notice to the World Bank of the human rights violations that could arise from India's construction of dams and blockage of water flow from the western rivers, so that they may then appoint a neutral expert or refer the conflict to the Court of Arbitration to resolve it in accordance with the IWT's principles under a proper jurisdiction.[92] In this regard, Pakistan's showing of the violation of human rights needs to be in accordance with the human rights endorsements provided by the UN Charter, the Universal Declaration of Human Rights, the Stockholm Declaration, the Dublin Statement, and other international conventions, which categorize the "right to access water" as one of the most fundamental human rights; one which must be provided to all human beings.

Furthermore, should share with the Court of Arbitration – if the dispute reaches to the Court for hearing – the current statistics

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[91] Aziz Zafar Azad, *Indus Water Treaty and India's Agitation*, DAILY JANG, December 18, 2016.

[92] Indus, Chenab, and Jhelum rivers.

related to the total number of people that would lose access to water if India blocks river waters flowing into Pakistan.

In addition, Pakistan must also stress the totality of the size of the Agrarian area of two million acres[93] that will be directly affected by India's harmful conduct; this conduct includes the construction of dams on the Chenab, Jhelum, and Indus rivers and the current work being done in the Ratle, Wuller, and Sawalkot projects.[94] All of these projects have the potential to affect water flow in the Jhelum and Chenab rivers.[95] Pakistan should emphasize the need to halt these projects or even just change the design of these projects so that affected rivers could still provide adequate quantities of water to the Pakistani people to use for drinking, domestic, and irrigation purposes.

Pakistan should also express its fears related to the violations of human rights and international law arising from the revocation or cancellation of the IWT[96] The Country should point out that the revocation of the treaty could give birth to another, and potentially even more intense, conflict between India and Pakistan. The unbearable severity of the conflict that would arise could create warlike situations with detrimental consequences for the South Asian region, especially because both countries possess nuclear weapons[97]

VI. CONCLUSION

The "access to water" has been universally recognized as being one of the most fundamental human rights. All human beings should have access to an adequate water supply for consumption, irrigation, sanitation, and domestic purposes. Most international

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[93] Bilal Shafiq, *Atomic Pakistan and Indus Water Treaty*, DUNIYA, December 2016.

[94] A.K. Chaturvedi, *Water: A Source for Future Conflicts*, 164 (VIJ BOOKS INDIA PVT LTD, 2013).

[95] *Id.*

[96] Sartaj Aziz, *Revocation of Indus Waters Treaty can be taken as an act of war*, DAWN, September 27, 2016, https://www.dawn.com/news/1286437, (last visited 2 April 2017).

[97] *Id.*

states have signed the UN Charter, the Universal Declaration of Human Rights, the Political Declaration, the ICCPR, the United Nations Watercourses Convention, and other relevant declarations;[98] therefore, these states should express their approval of basic human rights, including the right to access water, and no state should cause the hindrance of such for any other state's residents.

However, India is harboring ambitions that are otherwise in compliance with international declarations on human rights. For instance, India plans to build dams on its western rivers, which are allocated to its neighboring country, Pakistan, for hydroelectric power generation. Although, the power generation projects can be good for the public of India, simultaneously, these projects deprive the people of Pakistan, and residents of the Punjab region especially, the "right to access water."[99] Therefore, India's actions constitute a human rights violation.

The World Bank should play the role of "facilitator," to mediate and lessen tensions between India and Pakistan, as it did in the past when the World Bank facilitated the promulgation of the IWT in the 1960's[100] Without mediation, it may be difficult for the two states to reach a consensus. However, resolution of this conflict is vital to the region for the retention of peace and to ensure the protection of residents' fundamental human rights, including the fundamental human right to access water.

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[98] *Draft Political Declaration of the High-Level Meeting of the General Assembly on Antimicrobial Resistance,* 2 (UNITED NATIONS GENERAL ASSEMBLY, 2016).

[99] Russ Wellen, *Will Pakistan Counter India's "Water bomb" With a Nuclear Bomb?* FOREIGN POLICY IN FOCUS, December 31, 2011, http://fpif.org/will_pakistan_counter_indias_water_bomb_with_a_nuclear_bomb (last viewed December 24, 2016).

[100] Fact Sheet: the Indus Waters Treaty 1960 and the World Bank, THE WORLD BANK – WORLDBANK.ORG, January 24, 2017, http://www.worldbank.org/en/region/sar/brief/fact-sheet-the-indus-waters-treaty-1960-and-the-world-bank, (last visited 3 April 2017).

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BEHAVIORAL ECONOMICS IN INTERNATIONAL INVESTMENT LAW: BOUNDED RATIONALITY AND THE CHOICE OF RESERVATION LIST MODALITY

*Tae Jung Park**

The RCEP ("Regional Comprehensive Economic Partnership") is viewed as an alternative to the TPP ("Trans-Pacific Partnership") agreement, which included the United States but excluded China. The RCEP was launched in November 2012, but failed to conclude in 2015, the original agreed-upon deadline. The investment chapter working group contributed to this delay. For the last four years, the member states have failed to agree on any of the terms in the investment agreement, instead debating over the modality of the reservation list of the main text. This reservation list is structured as either a positive or a negative list, however the two frameworks should yield the same legal consequences in principle. So why do member states have different preferences regarding the modality of the reservation list? This article employs behavioral economics to explain why member countries have different preferences regarding the framework.

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TABLE OF CONTENTS

I. INTRODUCTION

The Regional Comprehensive Economic Partnership ("RCEP")[1] is a proposed free trade agreement ("FTA") between the ten member states of the Association of Southeast Asian Nations ("ASEAN") (Brunei, Burma (Myanmar), Cambodia, Indonesia, Laos, Malaysia, the Philippines, Singapore, Thailand, and Vietnam) and the six states with which ASEAN has existing FTA's (Australia, China, India, Japan, South Korea, and New Zealand). The RCEP negotiations were formally launched in November 2012 at the ASEAN Summit in Cambodia, and the 10th round of negotiations ended in South Korea around early October 2015.

RCEP members originally agreed to conclude all the negotiations by the end of 2015, but they failed to do so. As of May 2017, they are still in the process of negotiating. Among the many working groups involved in the negotiations, the investment working group has showed the slowest progress; its members simply debating over the framework that should be chosen for listing the reservations of the investment treaty. That is, for the last four years, they have done nothing but debate the framework of the reservation list[2] and have agreed on nothing in text.

This raises the question of why host nations (i.e. countries inviting and receiving foreign investment) pay so much attention to the framework of the reservation list? They probably do so because the reservation list is the most realistic and practical instrument that a

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[1] Regional Comprehensive Economic Partnership, DEPARTMENT OF FOREIGN AFFAIRS AND TRADE (2017), http://dfat.gov.au/trade/agreements/rcep/pages/regional-comprehensive-economic-partnership.aspx (last visited May 23, 2017).

[2] There are two approaches for preparing a reservation list. One is the negative list approach ("top-down" approach), which lists exceptions to the general obligation of the main text of a treaty; the other is the positive list approach ("bottom-up" approach or "GATS" approach), which lists the specific sectors to which the general obligation applies. An advantage of the positive list approach is that it gives a greater level of discretion over what to include and when. Politically sensitive industries can be kept outside the scope of the agreement. The negative list approach can automatically include new types of investment, while the positive list approach cannot. *See* Preserving flexibility in IIA's: The Use of Reservation, UNCDAD series on International Investment Policies for Development, 2006.

host nation can use to carve out regulatory power, given their tendency for less developed negotiation skills and unequal bargaining power. The host nations are usually developing nations which do not have a legal department sophisticated enough to fully analyze and examine the investment treaties. Moreoever, they lack training programs and human resources to competently negotiate the treaties.[3]

The beauty of the International Investment Agreement ("IIA") lies in the way it balances the regulatory power of host nations with investor protection. The host nations do their utmost to carve out maximum domestic sovereignty, and home nations do their best to protect their investors.[4]

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[3] Zeng Huaqun, *Balance, Sustainable Development, and Integration: Innovative Path for BIT Practice*, 17 J. INT'L ECON. L, 299, 302-304 (2014) **(**explains that BIT gives home states a negotiating advantage since the party who drafts the model controls the negotiation. On the contrary, most of the host nations are suffering from unequal bargaining power and low negotiation skills in a negotiation because they have not prepared model BITs. Therefore, their position is merely accepting or slightly modifying to a model BIT prepared by home states' negotiating partner. Only a few host states have prepared their model BITs and these are heavily influenced by the model BIT of home nations); *see also* M. Sornarajah, The International Law on Foreign Investment, 207-208 (Cambridge University Press, 2004)(the book points out that it is hard to expect host nations to have a legal department sophisticated enough to understand and analyze the nuances in the variations of the terms used in IIA).

[4] *See e.g.* Suzanne A. Spears, *The Quest for Policy Space in a New Generation of International Investment Agreements* 13 J. INT'L ECON. L, 1037, 1071 (2010)(Argues that general exceptions clauses and new preambular language provide flexibility. The article classifies three types of general exceptions clauses found in IIA's. The new preambular languages could include some non-investment policy objectives such as labor or environment protection.); Zeng Huaqun, *Balance, Sustainable Development, and Integration: Innovative Path for BIT Practice*, 17 J. INT'L ECON. L, 299, 324 (2014) (Classifies three types of goals- 1) balance 2) sustainable development 3) integration- that IIA's should pursue. The article introduces the idea that the Investment Policy Framework for Sustainable Development (hereinafter "IPFSD") emphasizes the insertion of "special and differential treatment (SDT)". It pointed out that SDT provisions could be an option where a negotiating party to an IIA has significantly different levels of development, especially when one of the parties is a less developed country); Joshua Boone, *How Countries Can Adapt Current Bilateral Investment Treaties to Provide Benefits to Their Domestic Economies* 187 GLOBAL BUS. L. REV.187, 196-7 (2011) (explains the importance of modifying the Performance-Based Requirement provisions. The article notes that Performance-based requirements such as technology transfers or limitations to technology licensing

However, there has been much criticism that many IIA's which are being ratified are biased towards investor protection. The claim is that these ratified IIA's are being drafted in favor of protecting investors rather than securing policy spaces in the host nations. This is due to home nations negotiating based on their model bilateral investment treaties ("BITs"), aiming for a high level of market opening and liberalization.[5] They try their best to persuade host nations not to deviate from any terms in the Model BIT, and ask them to carve out as little as possible. The host nations lack the bargaining power and negotiation skills necessary to modify the Model BIT and, thus, accept most of the terms therein. It is well

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fees are probably the most powerful regulation methods for host nations. These help to establish new markets, increase efficiency and production within new domestic markets because they allow for the host nation to use, acquire, produce and adapt the foreign technology. All these can be done by not prohibiting performance based requirements through modifying IIA); Markus Wagner, *Regulatory Space in International Trade Law and International Investment Law* 36 U. PA. J. INT'L L. 3, 35-53 (2014) (The article compares the WTO dispute settlement system in cases concerning human, animal or plant life, or health protection with international investment regimes. The article suggests that international trade and investment law can offer insights for one another. While international trade has been more adept at incorporating health or environmental concerns, changes in IIA's should close the gap. Particularly, the article argues that such policy space over health and environmental issues could be done through a provision of expropriation in IIA).

[5] Lei Cai, *Where does China Stand: The Evolving National Treatment Standard in BITs?* 13 J. WORLD INVESTMENT & TRADE, 373 384 (2012)(addresses how host nations merely accept the terms in the Model BITs due to their low bargaining power. "Based on Guzman's "prisoner's dilemma" theory, the host nations compete with each other to attract foreign investment. As a result, they are frequently at a disadvantaged position with poor bargaining power in the negotiation process and thereby compelled to accept the model BIT proposed by the home states"); Amit M. Sachdeva, *International Investment: A Developing Country Perspective* 8 J. WORLD INVESTMENT & TRADE 533, 547 (2007)(Argues that IIA's result in a substantial reduction in regulatory power in host nations. The article points out that well regulated national policy is what they actually needed. Neo liberalism policy through IIA leads a reduction of infant indigenous industry and all of these issues are difficult to overcome by host nations because of their low bargaining power in IIA negotiation).

known that most ratified IIA's are extremely similar in appearance, and almost identical to the terms in the model BIT.[6]

On this basis, host nations believe that the reservation list framework is a practical and realistic solution to carve out and protect their regulatory powers. Host nations devote meticulous care to negotiating a reservation list,[7] rather than the main text. In particular, their concerns focus on the framework or modality of the reservation list.

The framework is either a positive,[8] or negative list.[9] A positive list inserts domestic measures that conform to the main obligations of the treaty, while a negative list inserts non-conforming measures (i.e. exceptions to the main text), with all other unlisted measures automatically following the obligations of the main text. In principle, these two frameworks should yield the same legal consequences.

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[6] Huaqun, *Supra* note 3 at 324 (explains that most BITs follow either the Draft International Convention on Investments Abroad or OECD 1967 Draft Convention on the Protection of Foreign Property. Because of the common origins, the terms used in BITs look remarkably similar across countries. This similarity is due to the 'innate' priority of home nations and also reflects the historically weak and passive positions of host nations as contracting parties in IIA's); *see also* Jason Webb Yackee, *Conceptual Difficulties in the Empirical Study of Bilateral Investment Treaties* 33 BROOKLYN J. INT'L. L. 405, 415-416 (2008) (explains that home nations have long been preoccupied with persuading host nations to provide certain treatments such as MFN, National Treatment, Fair and Equitable Treatment, which all yield a high level of liberalization).

[7] IIA's consist of two parts: the main text and the reservation list. While the main text in the IIA's determine the overall obligations (and rights) of both parties, the reservation list includes either conforming measures to the obligation of the main text (positive list) or non-conforming measures (negative list).

[8] A positive list approach means the positive listing of sectors, sub-sectors and individual modes of supply in which countries voluntarily undertake liberalization commitments. The selective nature of liberalization under this approach implies that the treaties' obligations apply only to the activities listed in a country's schedule and solely on the terms described therein.

[9] Under the negative list, countries agree on a set of obligations in the main text and list all domestic measures for which such obligations do not apply. That is, the measures that do not appear in reservation lists are automatically under the effect of obligations in the main treaty text. Thus, this approach is most appropriate in countries aiming for a high degree of liberalization.

To address why this is so, this article employs a behavioral approach. This article seeks to answer the question of why negotiators have different preferences regarding the two frameworks. Fortunately, a few scholars have taken initial steps in determining the methodological foundations of behavioral international law and economics,[10] and thus have examined how behavioral law and economics can be applied to international law.[11]

Using the theoretical foundation of behavioral international law and economics, this article primarily argues that host nations strongly prefer a positive list over a negative list as they know that they have limited cognitive capacities to fully collect and analyze the existing domestic measures and determine which ones to carve out. Simply put, they know they are suffering from bounded rationalityin

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[10] Anne van Aaken, *Behavioral International Law and Economics* 55 HARV. INT'L L. J. 421,421-481 (2014); Tomer Broude, *Behavioral International Law*, 163 U. PENN. L. REV. 1099, 1099-1056 (2015).

[11] In fact, the rational choice approach to international law has been widely accepted and the rational approach was recently applied to the field of international investment law. However, while the rational choice paradigm has been thoroughly challenged in the field of economics since the 1970's and has changed a significant part of economics, challenges to the rational choice paradigm have not been systematically explored in the field of international law. . The literature of international law never responded to this challenges of the rational choice and thus, there is no systematic analysis of international law using behavioral economics. For more references in applying rational choice to the field of international law. *See generally* Robert E. Scott & Paul Stephan, The Limits of Leviathan: Contract Theory and the Enforcement of International law (2006); Joel P. Trachtman, The Economic Structure of International Law(2008); Eric Posner & Alan O. Sykes, Economic Foundations of International law(2013), Andrew Guzman, How International Law works: A Rational Choice Theory(2008); For more reference in applying rational choice to the field of international investment law, *See* Anne van Aaken*, International Investment Law Between Commitment and Flexibility: A Contract Theory* 12 J. INT'L ECON. L. 507, 507 (2009) (argues that Contract theory could be utilized in IIA's. The author points out that Contract theory has been applied to international trade law, but investment law has not yet been applied to IIA's. IIA's may be regarded as a mechanism for overcoming commitment problems between investors and host nations for mutual and reciprocal benefits. Contract theory deals with the uncertainty problem and could solve this issue); For more references on the literature of behavioral economics, *See generally*, Nick Wilkinson & Matthias Klaes, An Introduction to Behavioral Economics (2012); Matthew Rabin, Psychology and Economics, 36 J. Econ. Lit. 11 (1998).

the drafting of the negative list.[12] This article does not seek to present a normative argument regarding the framework that should be used in BITs, it simply seeks to indicate why negotiating partners show different preferences regarding frameworks, which in theory, yield the same legal consequences. In addition, the article does not pinpoint the types of bounded rationality from which the host nations are suffering, it merely argues that the negotiators are experiencing trouble processing the limited information available to maximize their profits by drafting the reservation list under the negative list.

II. THEORETICAL FOUNDATIONS

A. Reservation Lists in IIA's

A positive approach means there is a positive listing of sectors, sub-sectors, and individual modes of supply in which countries voluntarily undertake liberalization commitments. The selective nature of liberalization under this approach implies that a treaty's obligations apply only to the activities listed in a country's schedule and solely to the terms described therein.

Alternatively, negotiating partners may utilize a negative list approach. In this case, countries agree on a set of obligations in the main text and list all domestic measures for which such obligations do not apply. That is, the measures that do not appear in reservation lists are automatically subject to the obligations in the main treaty text. Thus, this approach is most appropriate for countries aiming for a high degree of liberalization.

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[12] Christine Jolls & Cass R. Sunstein, Debiasing Through Law, 35 J. LEGAL STUD. 199 199 (2006); (Bounded rationality, an idea first introduced by Herbert Simon, refers to the obvious fact that human cognitive abilities are not infinite. We have limited computational skills and seriously flawed memories. People can respond sensibly to these failings; thus it might be said that people sometimes respond rationally to their own cognitive limitations, minimizing the sum of decision costs and error costs. To deal with our limited memories we make lists; to deal with our limited brain power and time we use mental shortcuts and rules of thumb; but even with these remedies, and in some cases because of these remedies, human behavior differs in systematic ways from that predicted by the standard economic model of unbounded rationality. Even when the use of mental shortcuts is rational, it can produce predictable mistakes).

In summary, in a positive list schedule, a party sets out the sectors it has agreed will be covered by the relevant rules in the main text and if a sector is not stated in the list, it is not subject to those rules. In a negative list schedule, a party sets out those sectors or measures that are not subject to the relevant rules in the main text and if a sector; activity; or measure is not listed, then it is automatically covered (unless it has been excluded in the text itself). In theory, both approaches yield the same result in terms of liberalization.

1. *Positive List Approach*

This approach recognizes four "modes" of trading in services: across the border (e.g. the Internet); consumption abroad (e.g. tourism); establishing a commercial presence (foreign direct investment ("FDI")); and temporary presence of a natural person to deliver a service. Governments can make different levels of commitment for each mode in relation to market access and national treatment rules.

Sector or sub-sector	Limitations on market access	Limitations on national treatment	Additional commitments
8. HEALTH-RELATED SERVICES			
Hospital Services (9311)	(1) None (2) None (3) Unbound (4) None (Registration and Certification)	(1)None (2)None (3)None (4)None[13]	

Different entries under numbers 1 to 4 indicate the approach the government is taking to each of the four "modes of supply" for each service. When a country does not wish to limit or restrict market

[13] For a detailed explanation of drafting a positive list, see http://wtocentre.iift.ac.in/CBP/GENERAL%20PRINCIPLES%20&%20GUIDELINES%20ON%20SCHEDULING%20SERVICES%20COMMITMENTS.pdf (accessed May 23 2017).

access or national treatment in a sector or subsector in any of the four modes of supply, it uses the word "None", which indicates that there are "no limitations." So, for instance, in the chart above, a full commitment using "None" means the country cannot restrict access to its market of foreign suppliers who want to supply any aspect of hospital services (9311) through modes 1 and 2 by using any of the market access measures that are specifically prohibited. If a country decides to restrict market access through Mode 3, thereby protecting the hospital services market, the word "Unbound", meaning no bound commitments, is used in the column to block FDI by foreign investors looking to establish a hospital business.

If a country wants to commit to a sector, but only under certain circumstances or in a particular way, it needs to clearly spell out the limitations that it wants to maintain. For instance, if a country wanted to open the market only with respect to the registration and certification of the hospital services, it could stipulate that limitation in a column. In that way, foreign investors with temporary stay authority would have an opportunity to work in the area of registration and certification in hospitals. As noted above, the obligations of the main text apply to the measures that are listed in the column. If the country decided not to list the hospital services area, then the government would have no obligations to comply with the main text with respect to hospital services.

2. *Negative List Approach*

Under the negative listing approach, the main features of the non-conforming measures must be specified in detail. These measures include the following elements: the economic sector in which the reservation is taken; the specific industry in which the reservation is taken; the activity covered by the reservation; the substantial or procedural obligation to which the reservation is taken (e.g. MFN or national treatment); and a description of the specific law, regulation, or other measure for which the reservation is taken.

The following is an example of a reservation list in the Korea-India Comprehensive Economic Partnership Agreement ("CEPA").[14]

Sector	Manufacture of Chemical Products
Sub-Sector	Manufacture of Biological Products
Industry Classification	KSIC 24212 Manufacture of Biological Products
Type of Reservation	Performance Requirements (Article 10.5)
Reservation Measure	Pharmaceutical Affairs Act (Law No. 8552, February. 29, 2008), Article 42 Enforcement Regulations of the Pharmaceutical Affairs Act (Ordinance of the Ministry of Health and Welfare No. 71, October. 16, 2008), Article 21
Description	A person who manufactures blood products must procure raw blood materials from a blood management body in Korea.[15]

The above example shows that Korea reserves the right not to comply with the investment treaty obligations regarding performance requirements with respect to Indian investors' manufacturing chemical products in Korea. Because of this reservation, foreign manufacturers of blood products in Korea must procure raw blood materials from a blood management body in Korea, .

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[14] The Comprehensive Economic Partnership Agreement (the CEPA) is a free trade agreement between India and South Korea. CEPA was signed on August 7, 2009. The signing ceremony took place in Seoul and the Agreement was signed by the Indian Commerce Minister, Sharma, and South Korean Commerce Minister, Kim Jong-Hoon. The negotiations took three-and-a-half years, with the first session being held in February 2006. The agreement was passed in the South Korean Parliament on 6 November 2009. Available at http://commerce.nic.in/trade/INDIA%20KOREA%20CEPA%202009.pdf (Last visited May 25, 2017).

[15] Id.

The negative list may consist of several annexes and reservations for future measures.[16] These may be listed in Annex II (reservations for future measures), in addition to the current domestic measures, which are usually listed in Annex I (reservations for existing measures). Annex II sets out the economic sector and the activities where new restrictive measures can be implemented in the future. For example, if a country believes that it may implement some laws within the steel industry in the future, they would list the sector, without having to provide any information about domestic measures in Annex II.

B. Behavioral International Law and Economics

Recent literature has reconciled international law with the field of behavioral economics to establish behavioral international law and economics ("BIntLE"). BIntLE is the study of "how states really behave."[17] It explains how behavioral assumptions may change the strategies of states and negotiators, as well as the outcomes of games. Some scholars employ three categories to explain the foundations of BIntLE: the economic analysis of international law, behavioral economics, and psychological approaches in international relations.[18]The scholars believe that the three areas can complement each other and reveal new insights into the behavior of actors in international law. For instance, behavioral economics can enrich the economic analysis of international law.

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[16] In addition to Annex I (Reservation for Existing Measures) and Annex II (Reservation for Future Measures), there are more annexes that can be drafted, as agreed by negotiating partners. For instance, under NAFTA, Mexico has an Annex III (Activities reserved to the State) which reserves measures governing the regulations of activities reserved to the State as decreed in the Mexican Constitution (primarily in the oil and gas sector). The unique nature of Annex III is that it has no requirement to specify the exact nature of non-conforming measures maintained in sectors like Annex II. Another example is the Annex on Exceptions from MFN. This annex carves out a number of sectors from MFN treatment (as opposed to individual measures as per Annex I). Thus, this Annex gives greater flexibility of reservations, allowing host nations to secure whole industries (e.g. "steel") without the level of specificity applied to Annex I. For more reference, see UNCDAD, Supra note 2.

[17] Aaken, Supra note 9 at 439.

[18] *Id.* at 424.

Some caveats with respect to applying individual decision theory to international law should be discussed as a preliminary matter because generally, the actor in international law is assumed to be the state.

The application of behavioral economics to international law depends on who the actor to be analyzed is. In other words, it is uncertain whether we could apply individual decision theory to the state and consider the factors in applying that theory to the international sphere. There is no clear answer to this problem in relevant literature since commentators are not sure who really acts in international law.[19] Both international organizations and individuals contribute to the implementation of international law, but the direct applicability of individual decision-making is in question. Some argue that individual decision theory is directly applicable to international judges, arbitrators, and treaty negotiators since they are individuals.[20] However, others counter by saying that the behavior of elites in making decisions seems to be different from that of the normal population, where various types of biases are concerned. This is because elites tend to have higher levels of trust and cooperation skills.[21] That is, the behavior of judges and treaty negotiators may differ from that of general participants in the experimental lab.

The application of BIntLE to IIA's is still at an early stage. Some analysts have begun research how the proliferation of IIA's can be interpreted in the field of behavioral economics. They argue that host nations' irrational decisions in signing IIA's arise from their "over-optimism" that IIA's will support their economic growth.[22] They want to believe that signing IIA's will help attract FDI, which, in turn, will boost a country's economy. However, once they face an

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[19] *Id.* at 441.

[20] *Id.* at 443.

[21] See Emily M. Hafner –Burton et al, *The Cognition and the Political Psychology of Elite Decision Making*, 11 PERSP. ON POL. 369 369 (2013) (Arguing that experienced policy elites differ from inexperienced subjects in how they make decisions, rooted in "sophistication," a learned skill that is derived from experience and tends to be greater in elite than non-elite populations).

[22] Lauge N. Skovgaard Poulsen, *Bounded Rationality and the Diffusion of Modern Investment Treaties*, 58 INT'L STUD. Q. 1, 5 (2014)

investor-state dispute claim, they may realize that they made their decisions without any consideration of a cost-benefit analysis.[23]

Historically, the literature for this subject has never touched on the application of the behavioral approach to the decision-making process of investment treaty negotiators. Investment treaty negotiators are imperfect, irrational human beings and behavioral economics would have many implications for the negotiations. This article is the first to raise the behavioral issue in the context of investment treaty negotiators. The following section will argue that the bounded rationality problem arises especially when host nations draft the reservation list in the form of a negative list.

III. APPLYING THE BEHAVIORAL APPROACH TO INTERNATIONAL INVESTMENT LAW

This section illustrates why home and host nations have different preferences regarding the reservation list framework. The first part argues that host nations prefer the positive list to the negative list because they know that preparing the negative list will result in self-suffering due to the bounded rationality problem. The second part of this section examines various real world examples of how host nations end up with incomplete and defective negative lists, and their negative consequences when attracting investments. These consequences explain why host nations avoid the negative approach.

A. Bounded Rationality in the Choice of Reservation List Framework

Bounded rationality, an idea introduced by Herbert Simon, refers to the finiteness of human cognitive abilities. People have limited computational skills and seriously flawed memories, but they can respond sensibly to these failings. Thus, it could be said that people sometimes respond rationally to their own cognitive limitations, minimizing the sum of decision costs and error costs. People deal with limited memories, they make lists, and to deal with

[23] *Id.* at 12.

limited brainpower and time, they use mental shortcuts and rules of thumb.[24]

The point of bounded rationality is not that people might decide differently if they have more information or different information, or decide differently with different items in the utility function. Rather, the point is that they would not be able to process all of the information even if they had it. Thus, if we are to predict people's actions, it is not enough to know the amount or quality of available information, we must also know what the cognitive process entails for selecting information and choosing rules of thumb.

There are various types of bounded rationality. For instance, the framing effect[25] relates to situations where people favor option A when a question or problem is posed in one way but favor option B when the same problem is posed in a different way. The endowment effect[26] is another example of bounded rationality which leads

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[24] Jolls & Sunstein, *Supra* note 12, 199.

[25] The framing effect is an example of cognitive bias in which people react to a particular choice in different ways depending on how it is presented; e.g. as a loss or as a gain. People tend to avoid risk when a positive frame is presented but seek risks when a negative frame is presented. Gain and loss are defined in the scenario as descriptions of outcomes (e.g. lives lost or saved, disease patients treated and not treated, lives saved and lost during accidents, etc.). *See e.g.* Tversky et al. *The Causes of Preference Reversal,* 80 AM. ECON. REV. 358-361 (1990); Wansink et al. *Mindless Eating and Healthy Heuristics for the Irrational,* 99 AM. ECON. REV 165-9 (2009)(argues that people's eating habits including quantity consumed, can be affected by the size of plates, packages or serving bowl used); Amos Tversky & Daniel Kahneman, *The Framing of Decisions and the Psychology of Choice*, 211 SCIENCE 453, 455 (1981); Daniel Kahneman, *A Perspective on Judgment and Choice: Mapping Bounded Rationality* 58 AM. PSYCHOL. 697, 703 (2003).

[26] In a traditional sense, the endowment effect is described as one's preference to place a higher value on objects one owns relative to objects one does not own. This is evidenced by the experiment of Kahneman, Knetsch and Thaler. In other words, willingness to accept ("WTA") as a seller is higher than willingness to pay ("WTP") as a buyer. Many researchers have conducted experiments that support this finding using different goods such as wine, chocolates, and basketball tickets. The most common explanation for the endowment effect is loss aversion. Simply put, a disutility from losing something is greater than the utility from acquiring that same thing; therefore WTA is higher than WTP. *See generally* Kahneman, D. et al., *Experimental Tests of the Endowment Effect and the Coase Theorem* 98 J. Pol. Econ. 1325,1325-1348 (1990); For reference on experiment with wine, *See* Van Dijk, E., & Van Knippenberg, D., *Trading Wine: On the Endowment Effect, Loss*

individuals to value goods differently depending on whether or not they possess them. If they already possess the goods, the individuals value them higher than they would if they were not in their possession. In other words, the people who have the goods at their disposal show greater willingness to pay for them than the people who do not have them at their disposal.

The "status quo bias" explains that individuals tend not to deviate from their original positions. Depending on how the default is set, people make different choices because they simply have a tendency to not change their decisions.[27] Organ donation, for instance, can be set up on an opt-in (no donation by default) or an opt-out (donation by default) basis. For example, an empirical study has shown that an opt-in default leads to fewer individuals making donations than an opt-out design.[28] Last but not least, "over-optimism"[29] shows that people are, on average, overconfident about their future and about their predictions for their future. This relates not only to their own situations and capacities, but also to their evaluations of their control over a given situation.

Host nations are well aware of their limited capacity to fully analyze domestic measures and prepare the optimal reservation list in the form of a negative list. In order to prepare a negative list, they should have the full capacity to examine all existing domestic measures in their nations and precisely determine which measures to

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Aversion, and the Comparability of Consumer Goods 19 J. Econ. Psychol. 579, 579-597 (2009); For reference on experiment with chocolate, *See* Knetsch J.L., *The Endowment Effects and Evidence of Nonreversible Indifference Curves* 79 Am. Econ. Rev. 1277, 1277-1284 (1989); For reference on experiment with basketball tickets, *See* Carmon, Z. & Ariely, D., *Focusing on the Forgone: Why Value Can Appear so Different to Buyers and Sellers,* 27 J. Consumer Res. 360, 360-370 (2000).

[27] Richard H. Thaler & Cass R. Sunstein, Nudge: Improving Decisions About Health, Wealth, and Happiness (2008).

[28] Eric J. Johnson & Daniel Goldstein, *Do Defaults Save Lives?* 302 SCI. 1338, 1338 (2003).

[29] *See generally* Neil D. Weinstein, *Unrealistic Optimism about Future Life Events*, 39 J. PERS. SOC. PSYCHOL. 806 806 (1980) For more detail on studies of excess optimism, *see* Marie Helweg-Larsen & James A. Shepperd, *Do Moderators of the Optimistic Bias Affect Personal or Target Risk Estimates? A Review of the Literature*, 5 PERS. SOC. PSYCHOL. REV. 74 74 (2001).

list. In principle, under the rational choice model,[30] rational negotiators would easily achieve this maximized result. With their infinite cognitive ability, the rational negotiators would analyze all the data and information regarding the domestic measures perfectly, and distinguish the non-conforming measures without error. They could produce an optimal reservation list by perfectly examining the domestic measures without any errors and figure out which one should be carved out from the present IIA. This optimal reservation list would maximize the gains of host nations and indicate to foreign investors exactly which measures had been carved out from the treaty. The imposition of carve-outs and specificities on the reservation list would be optimal for attracting foreign investments.

However, host nations know they cannot produce the optimal reservation list under the negative approach. They fully recognize the variety of cognitive problems associated with processing the data and information. They know they have insufficient information available to create an optimal reservation list that would maximize domestic profits. The limited access of host nations to resources makes it difficult to collect all of the required data and fully predict what measures should be carved-out from the main text. For example, host nations may face extreme difficulties in obtaining cooperation from other line ministries.[31] Of course, there

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[30] The research of applying rational choice perspective under Contract theory to International law is accelerating. A classic definition of rationality by Gary Becker: "All human behavior can be viewed as involving participants who maximize their utility from a stable set of preferences and accumulate an optimal amount of information and other inputs in a variety of markets". The central principles of Rationality are thus, utility maximization, stable preferences, rational expectations and optimal processing of information. Applying Rational choice to international law is basically transferring these principles to collective actors such as states or international organizations. It is assumed that potential biases cancel each other out on the aggregate level or do not even occur within corporate actors) *See generally* Kenneth Abbott, *Modern International Relations Theory: A Prospectus for International Lawyers* (1989) 14 YALE J. INT L L. 335, 348-54 (discussing methodology in international relations theory that is relevant for this paper); Jeffrey L. Dunoff & Joel P. Trachtman, Economic Analysis of International Law (1999) 24 YALE J. INT'L L. 1 ; Jack L. GoldSmith & Eric A. Posner, The limits of International law (2005); Anne van Aaken, *To Do Away with International Law? Some Limits to 'The Limits of International Law'* 17 EUR. J. INT'L L. 289 (2016).

[31] People debate whether trade representatives should be placed under the Ministry of trade (or foreign affairs) or a part of the executive office of the

are exceptions when the negotiation team has strong political power and is prioritized, such as the United States Trade Representative ("USTR"),[32] which is a part of the Executive Branch of the United States Government. However, almost all negotiators from host nations experience difficulties in cooperating with line ministries, especially with respect to collecting measures for the preparation of a reservation list. For instance, a negotiation team under a Ministry of Foreign Affairs or Trade may send a request to the Ministry of Land to prepare a reservation list, with respect to land measures, because it has no expertise in this area. However, in many cases, the Ministry of Land frequently postpones submitting the reservation list to the negotiation team because it is simply not one of its principal functions. Thus, even if the domestic measures are easily obtainable by line ministries, the administrative inefficiencies and lack of cooperation between ministries may become big hurdles to listing the measures in the reservation list.

Because of their incapacity to fully analyze and prepare the reservation list, negotiators frequently fail to insert the reserving sector that they would otherwise have to insert in the reservation list. They sometimes leave blank the domestic measures section of the reserving sector or stipulate unspecified domestic measures such as a law without specific article numbers.

President. Many suggest host developing countries conduct structure reform of the trade representative so that it becomes an independent entity under the executive office of the President see e.g. Kim, *supra* note 20, at 69 (argues that Korea's current negotiation agency under Ministry of Trade lacks: the mechanism through which the opinions of the interested-party are transmitted to the agency; the mechanism of checks and balances between the parliament and the agency; the lack of a horizontal decision-making process. The article ultimately argues that Korea's negotiation agency should follow the US model and establish a Korea trade representative).

[32] The USTR is the United States Government agency responsible for developing and recommending United States trade policy to the President of the United States, conducting trade negotiations on bilateral and multilateral levels, and coordinating trade policy within the Government through the interagency Trade Policy Staff Committee (TPSC) and Trade Policy Review Group (TPRG). Established as the Office of the Special Trade Representative (STR) under the Trade Expansion Act of 1962, the USTR is part of the Executive Office of the President. With over 200 employees, the USTR has offices in Geneva, Switzerland, and Brussels, Belgium. The current U.S. Trade Representative is Michael Froman, who assumed the office on June 21, 2013.

These incomplete reservation lists represent a significant loss for host nations. The unlisted measures may be critical policy measures that should have been carved-out. The unspecified measures or blanks in the reservation lists make it difficult for foreign investors to draw permissible boundaries for their investments, which can reduce transparency and predictability for foreign investments.

In short, host nations are fully aware of their limited capacity to conclude a benefit-maximizing reservation list in the form of the negative list. They also recognize the negative consequences associated with an incomplete and defective reservation list in the form of the negative list.

In this regard, the positive list is less burdensome because host nations do not face any significant pressure in the analysis of their measures. If they fail to find a measure, the missed measure does not have to comply with the highly liberalized main text. Thus, it avoids a high level of liberalizations. There are also no unspecified or blank measures in the positive list since the positive list does not require the parties to specify the domestic measures. The positive list mainly requires the parties to stipulate whether they will open or close the market in a certain sector.

By contrast, home nations strongly prefer the negative list because they believe the benefits of such outweigh its costs. Home nations expect host nations to open more markets in various sectors of the economy so that their foreign investors can make informed investment decisions. Knowing that the host nations will fail to include many economic sectors in the reservation obligations list of the highly liberalized text, home nations will automatically bind all of those sectors. They expect all unexamined sectors or measures to conform to a main text that aims for high liberalization and market openings.

For instance, if a host nation forgets to list a biotechnology sector, this is clearly an advantage for the relevant home nations involved because they know that the sector will automatically conform to the main text of the treaty, thus achieving high liberalization and market openings in the host nations. Of course, the negative list has a downside for home nations being that the incomplete and defective domestic measures may potentially confuse

the investors. For example, if host nations successfully insert the biotechnology sector in the negative list, but fail to put the domestic measures of the biotechnology sector in the reservation list, foreign investors have difficulty finding out which exact local rules have been carved-out. However, home nations generally believe that this is a minor cost because they anticipate additional benefits from unexpected market openings within different sectors of the economy, which the host nations failed to take into account. Moreover, home nations believe that, to a certain extent, inserting a renegotiation clause could cure the incomplete and defective domestic measures in the reservation list. In fact, the home nations frequently include the renegotiation clause for the host nations to specify and update the reservation list.[33]

In this respect, home nations do not prefer the positive list because their unlisted measures do not have to conform with the main text of the relevant treaty. Home nations can no longer anticipate the unexpected market opening from host nations' failure to carve-out certain terms that they would get under a negative list approach.

So far, this article has concluded that host nations prefer the positive list and avoid selecting the negative list because they suffer from the bounded rationality problem, which makes it difficult to examine and identify local domestic measures.

B. Issues with the Negative List – The Incomplete Reservation List

This section illustrates host nations' poor drafting tendencies with reservation lists and the negative consequences of such, which

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[33] e.g. Trilateral Investment Agreement between ASEAN, Australia, and New Zealand:
Article 16 Work Program
1. The Parties shall enter into discussions of
(a) schedules of reservations to this Chapter; a
(b) treatment of investment in services which does not qualify as commercial presence in Chapter 8 (Tradein Services). *See also* Japan-India Economic Partnership Agreement:Article 90. Reservation and Exceptions. 5. Each Party shall endeavour, where appropriate, to reduce or eliminate the exceptions specified in its Schedules in Annexes 8 and 9 respectively.

in turn, explains why they prefer the positive list. The article will classify two types of incomplete reservation lists.

The first is the missing measures problem which comes in two forms, and involves a failure to insert domestic measures. One way this may occur is through a host nation's failure to carve out the economic sector itself, for instance, land acquisitions, so the number of reservations is less than intended. When this is the case, the host nation has no way to insert domestic measures with respect to land measures. The other way this occurs is when, even if they do successfully carve out a sector, host nations fail to insert domestic measures in the reservation list. That is, the domestic measures section of the reservation list is left blank. This type of incomplete reservation list is the unspecified measures problem. This is the case when host nations successfully carve out the economic sector and even insert the domestic measures, but the measures are not clear or specific enough to draw a clear boundary for permissible investments.

The third type of incomplete reservation list arises from the failure to continuously update treaties and their text to reflect any amendments. Even if host nations successfully carve out the sector and specify the measures, they frequently fail to reflect the specifications in the later treaty. This section illustrates these three types of problems through examples of IIA's that demonstrate how incomplete reservation lists negatively impact host nations' ability to attract foreign investment. Consequently, this illustration is best understood by considering why host nations avoid the negative list.

1. *Missing Measures*

The missing measures problem is the predominant reason why host nations choose to avoid using the negative list. The problem appears when countries leave a blank space in the domestic measures section for the reserved sector. The following is an example of missing measures in the Singapore-New Zealand Closer Economic Partnership ("CEP"):

Sector:	Printing & Publishing Manufacture & Repair of

	Transport Equipment Power/Energy
Types of Limitation:	National treatment (Article 29)
Legal Citation:	
Description:	More favourable treatment may be accorded to Singapore nationals and the permanent residents in the above sectors.[34]

In this reservation list, Singapore tried to carve-out regulatory power in the area of Printing & Publishing, Manufacture & Repair of Transport, and Equipment Power/Energy. However, a legal citation section is missing indicating that Singapore failed to insert the domestic laws that reflect the reservation, creating many problems. For one, its absence reduces transparency and predictability for foreign investors, especially when these investors have no idea what domestic measures they should look at before making an investment. Also, the legal consequences of the missing measures are not clear.

Suppose Act A is the law that should be inserted in the above reservation list. Should this Act A be covered by the main text? The answer is unclear. One may even argue that Act A is not carved-out because it was not listed in the reservation list, so it should therefore conform with the main text. All these uncertainties make it difficult for host nations to attract foreign investment.

2. *Unspecified Measures*

Host nations sometimes insert domestic measures that are not clear or specific enough. For example in the CEP Singapore

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[34] The CEP entered into force on 1 January 2001. It is the most comprehensive trading agreement, outside of the Closer Economic Relations with Australia, that New Zealand has negotiated. The CEP aims to build on the close historical ties between Singapore and New Zealand by improving opportunities for trade in goods, services and investment. The two governments announced their intention to negotiate an agreement in September 1999 and negotiations were completed within one year.

carved out their Companies Act with respect to the establishment, reporting, and filing of accounts. However, the legal citation is not clear as the article numbers are missing:

All Sectors	
Type of Limitation:	National treatment (Article 29)
Legal Citation:	Companies Act, Cap 50(1994)
Description:	Compliance by Foreign Companies with the Companies Act as in establishing, reporting and filing of accounts.[35]

In the present example, the unspecified measures may have a negative effect for the Governments of both Singapore and New Zealand. For example the unspecified measures reduce transparency and predictability for investors from New Zealand, the main readers of the reservation lists, and thus, the Singapore Government may have difficulty attracting FDI from New Zealand.[36] New Zealand investors may have difficulty ascertaining legally permissible boundaries for investments in Singapore. The Companies Act of 1994 includes all sorts of laws and regulations about companies, which creates uncertainty in determining whether

[35] Id.

[36] *See generally* UNCTAD, Transparency (UNCTAD Series on Issues in International Investment Agreements II) (Unite Nation 2012) (The report has a comprehensive analysis of how IIA could enhance transparency and predictability for investors. The report examines: the way in which traditional transparency issues have been addressed in IIA's since 2004; the emergence of investor responsibilities as a consideration within transparency issues; and the introduction of a transparency dimension into investor-state dispute settlement (ISDS). In analyzing these issues, this report outlines possible sustainable development implications of the different transparency-related formulations used in IIA's and points to some of the most progressive provisions that are appearing more frequently in investment instruments. The report reviews transparency regarding investor conduct, transparency in ISDS, and other obligations that are related to transparency in IIA's. This report does not address transparency relating to reservation lists. This article is the first piece to argue the ways to enhance transparency and predictability in IIAs)

Singapore only carved-out measures related to establishing, reporting, and filing of accounts. Thus, the question remains: Did the Singapore Government reserve the right to adopt all of the provisions in the Companies Act, or just the provisions relating to establishing, reporting, and filing accounts?

IV. A HYBRID APPROACH AND A RENEGOTIATION CLAUSE

As home and host nations display dramatic differences in their preferences for reservation list frameworks, it can sometimes be very difficult to reach a consensus. To resolve the conflict, both parties often conclude the treaty with a combined approach for reservation lists: negative and positive. The Australia-Chile FTA is a good example of such.[37] The Agreement first grants market access for all investments, then adds a reservation list in the market access column. It is uncertain whether this complex structure really confers transparency to the measures, but its intent is to combine the best aspects of both frameworks.

Another method involves simply deciding to renegotiate the reservation list when host nations have prepared their measures.[38]

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[37] The Australia–Chile FTA is a trade agreement between the countries of Chile and Australia. It was signed on July 30, 2008 and went into effect in the 1st quarter of 2009. The FTA is available at http://dfat.gov.au/trade/agreements/aclfta/pages/australia-chile-fta.aspx (accessed on Mar 6 2016).

[38] Some international agreements are renegotiated while others remain stable. Despite growing interest in agreement flexibility and design, the literature has not addressed this question in depth. Some provide a theoretical framework for explaining why some treaties contain limited duration and renegotiation provisions, while others are rigid. Others explore the more general question of why states design agreements with flexibility allowing obligations to be adjusted over time, temporarily or permanently. The issue of renegotiation in the field of IIA is still in an early stage. Some argue that the negotiating partners renegotiate when they have learned something new about the state of the world, for instance faced a investor-state dispute settlement. That is, a direct experience with investment disputes, which reveals new information about the consequences of the IIA, is associated with a greater propensity to renegotiate. However, the literature has not examined in depth why nations renegotiate after the ratification of the treaty. See Koremenos, Barbara, *Loosening the Ties that Bind: A Learning Model of Agreement Flexibility* 55 INT'L ORG. 289 289-325 (2001); Koremenos, Barbara, *Contracting around International Uncertainty*, 99 AM. POL. SCI. REV. 549, 549-565 (2005); Helfer, Lawrence R.

Singapore and New Zealand recognized the problems associated with unspecified measures in the reservation list, and as a result, put the following clause in the main text to renegotiate the narrowing-down of the measures:

> Article 32 Limitations
>
> 2. As part of the reviews of this Agreement provided for in Article 68, the Parties undertake to review at least every two years the status of the limitations set out in Annex 3 with a view to reducing the limitations or removing them.

This allows Singapore to narrow-down the measures by specifying the relevant article numbers. If the stated measures do not reflect the "description," then Singapore should reduce or eliminate such measures in the reservation list.

The following is the renegotiation clause of the trilateral investment agreement between ASEAN, Australia, and New Zealand ("AANZFTA").

> Article 16 Work Programme
>
> The Parties shall enter into discussions on:
>
> (a) schedules of reservations to this Chapter; and..[…]
>
> 3. The Parties shall conclude the discussions referred to in Paragraphs 1 and 2 within five years from the date of entry into force of this Agreement unless the Parties otherwise agree. These discussions shall be

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Flexibility Mechanism in International Agreements in International law and International Relations (Jeffrey Dunoff &Mark A. Pollack eds., 2012); Kal Raustiala, *Form and Substance in International Agreement,* 99 AM. J. INT'L L. 581,581-614 (2005); Yoram Z. Haftel & Alexander Thompson, *When Do States Renegotiate International Agreements? The Case of Bilateral Investment Treaties* (Univ. Of Maryland Presentation Working paper, 2013).

> overseen by the Investment Committee established pursuant to Article 17 (Committee on Investment). [39]

As can be seen above, this is a different renegotiation clause from the one found in the CEP in the sense that the three parties signed the treaty without including a reservation list. Australia and New Zealand successfully persuaded the 10 ASEAN host nations to choose the negative list, but they all agreed to draft the list after the ratification of the Treaty. Paragraph 2 states that the three parties decided to start drafting and to conclude the negotiations on the reservation list within five years of the ratification of the Treaty.

V. CONCLUSION

In reality, host nation negotiators are not rational agents because they are just normal human beings. [40] They do not have sufficient cognitive capacity to accurately examine the measures and determine which domestic measures should be protected from the highly liberalized text of a treaty. Because of this, host nations frequently fail to put domestic measures that should otherwise be inserted in the negative reservation list. They sometimes fail to insert the name of a certain domestic measure in the reservation list and frequently insert unspecified domestic measures (i.e. domestic laws without article numbering).

Host nations are fully aware that these incomplete and defective lists, which fall under the negative approach, will have

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[39] The AANZFTA was executed on 27 February 2009 and entered into force on:1 January 2010 – Brunei, Malaysia, Myanmar, the Philippines, Singapore, Vietnam, Australia and New Zealand;12 March 2010 – Thailand;1 January 2011 – Laos; 4 January 2011 – Cambodia; and 10 January 2012 – Indonesia. (accessed on Mar 6 2016, at http://www.thaifta.com/engfta/Home/FTAbyCountry/tabid/53/ctl/detail/id/75/mid/480/usemastercontainer/true/Default.aspx).

[40] Herbert Simon, *A Behavioral Model of Rational Choice,* 69 Q. J. ECON. 99, 99 (1955) (argues that individuals do not seek to maximize their benefit from a particular course of action because they have no capacity to digest all the information that would be needed to do such a thing. They do not have the capacity to access all the information required and even if they did, their mind would not be able to process it properly).

negative consequences. This awareness leads the parties to have different preferences over the modality of the framework of the reservation list.

This article is merely the beginning of the efforts to apply the behavioral approach to international investment law. This article examined the issues from the perspective of the bounded rationality, however there are many other issues in the international law regime that can be described from the behavioral economics viewpoint. For instance, bounded self-interest may explain the existence of a question and answer session during the negotiation phase.[41] This would involve the negotiators from the home nations giving the negotiators from the host nations brief lectures about the terms of international investment agreements and answering the questions of the host nations' representatives. Why would negotiating partners cooperate each other, instead of compete each other? Why are the developed countries so altruistic that they would give a lecture to the host developing countries? This may be able to be explained from the perspective of bounded self-interest. More research should be done in reconciling behavioral economics with international investment law and international law in general.

[41] Surprisingly, for most of the readers of this article, negotiators with expertise from home nations frequently hold question and answer (Q & A) sessions parallel to main investment negotiations in order to facilitate the negotiation. Apparently, this shows a dramatic inequality of bargaining power between negotiating parties. The Q&A sessions usually consist of discussions about the meanings of provisions or articles and the consequences of adopting them. The lecturers - negotiators from home nations- would have the maximum amount of bargaining power depending on how they shape their Q & A sessions.

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CHINA'S NINE DASH LINE CLAIM IN LIGHT OF THE RULING BY THE PERMANENT COURT OF ARBITRATION (12 JULY 2016)

Ekrem Korkut & Woo Hyun Kang

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I. INTRODUCTION

In 2009, Malaysia and Vietnam made a joint submission to the Commission on the Limits of the Continental Shelf ("CLCS"), to establish outer limits of the continental shelf beyond 200 nm.[1] China immediately objected to the submission, and sent a *note verbale* to the United Nations General Secretary to be delivered to the UN member States.[2] In its *note verbale*, China alleged that the insular features and maritime areas within the nine-dash line belonged to China and added "it has indisputable sovereignty over the islands in the South China Sea and the adjacent waters."[3] China said it enjoys "sovereign rights and jurisdiction over the relevant waters as well as the seabed and subsoil thereof."[4] The language used by China in the *note verbale* was ambiguous and did not indicate what kind of maritime jurisdiction China was claiming. There was also ambiguity in China's position regarding the status of the insular features in the South China Sea ("SCS") whether they are low tide elevations, rocks or islands. In another *note verbale*, China claimed sovereignty over the Spratly Islands and added they were islands under Article 121 of

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[1] "Receipt of the joint submission made by Malaysia and the Socialist Republic of Viet Nam to the Commission on the Limits of the Continental Shelf," CLCS.33.2009.LOS (Continental Shelf Notification) (7 May 2009). Article 4 of the Annex II of the Law of the Sea Convention provides:

Where a coastal State intends to establish, in accordance with article 76, the outer limits of its continental shelf beyond 200 nautical miles, it shall submit particulars of such limits to the Commission along with supporting scientific and technical data as soon as possible; but in any case, within 10 years of the entry into force of this Convention for that State. The coastal State shall at the same time give the names of any Commission members who have provided it with scientific and technical advice.

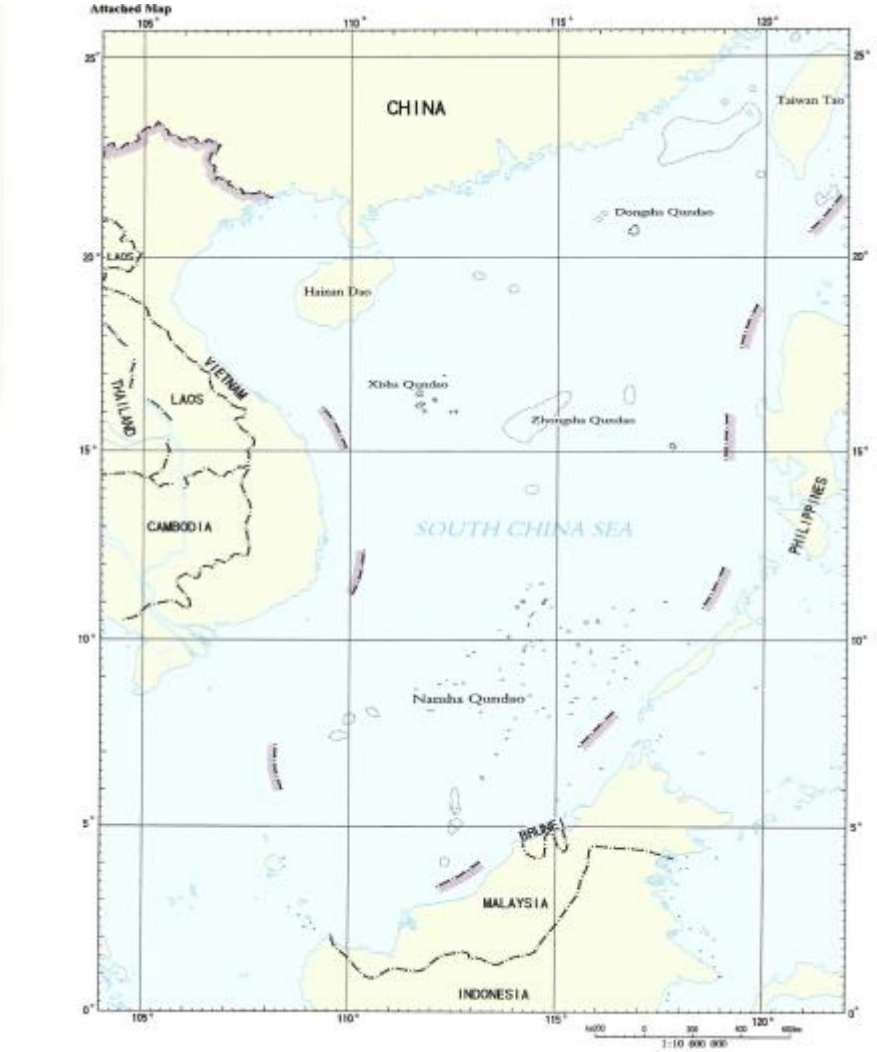
UN Convention on the Law of the Sea, adopted December 10, 1982, 1883 *UNTS* 396, http://www.un.org/depts/los/convention_agreements/convention_overview_convention.htm [hereinafter "LOSC"].

[2] People's Republic of China, Note Verbale CML/17/2009 of May 7, 2009.

[3] *Id.*

[4] *Id.* (China reiterated its position in the *note verbal* of 14 April 2011).

UNCLOS, therefore they were entitled to territorial sea, exclusive economic zone and continental shelf.[5]



Map 1. The nine-dash line map which China attached its note verbal in 2009

[5] The nine–dash line if connected would cover ninety percent of the SCS. Ronald O'Rourke, *Maritime Territorial and Exclusive Economic Zone (EEZ) Disputes Involving China: Issues for Congress*, CONGRESSIONAL RESEARCH SERVICE, 21 (Dec. 22, 2015); *see* People's Republic of China, Note Verbale CML/8/2011 (April 14, 2011).

Assuming China owns all of the insular features in the SCS, this paper evaluates the China's nine-dash line claim under international law in light of the ruling by the Permanent Court of Arbitration over the dispute between the Philippines and China ("South China Sea Arbitration"),[6] and evaluates the effect of the ruling on the delimitation of the maritime areas in the SCS. The ruling by the Permanent Court of Arbitration about the SCS is the first decision by an international tribunal attempting to clarify the difference between islands, rocks and low tide elevations.

II. AN ANALYSIS OF THE CHINESE CLAIMS IN THE PERSPECTIVE OF 'HISTORIC TITLE' THEORY

Some scholars argue that the Chinese claims can be justified in the perspective of "historic title" theory.[7] Gao argues that "support for this view may be found in the resolution adopted at the 1947 inter-ministry meeting; the expression "limits of territory in the South China Sea" was employed in the resolution," and that "the precise meaning of the reference in Chinese Note I [*note verbale* of 2009][8] to "adjacent waters" over which it has sovereignty (…) has never been defined by China."[9]

The Arbitration Tribunal in *Government of the State of Eritrea and Government of the Republic of Yemen* has made an important distinction between the doctrine of "historic title" and "historical consolidation." It goes as follows:

> The notion of historic title is well known in international law, not least in respect of 'historic bays', which are governed by rules exceptional to the normal rules about bays. Historic bays again rely upon a kind of "ancient title": a title that has so long been

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[6] *The South China Sea Arbitration*, PERMANENT COURT OF ARBITRATION (July 12, 2016), https://pca-cpa.org/wp-content/uploads/sites/175/2016/07/PH-CN-20160712-Award.pdf.

[7] Zhiguo Gao and Bing Bing Jia, *The Nine-Dash Line in the South China Sea: History, Status, and Implications*, 107 Am. J. of Int'l. L. 98, 109 (Jan. 2013).

[8] Note Verbale CML/17/2009*, supra* note 2.

[9] *Id.*

> established by common repute that this common knowledge is itself a sufficient title. But an historic title has also another and different meaning in international law as a title that has been created, or consolidated, by a process of prescription, or acquiescence, or by possession so long continued to have become accepted as law as a title. These titles too are historic in the sense that continuity and the lapse of a period of time is of the essence.[10]

This implies that 1) historic title is based on "common repute" that has been established since time immemorial, meaning that whoever inquires the existence of historic title will focus on historical documents documenting the perception of States and individuals in different historical times, and will be less focused on material evidence of effective control. 2) Whereas in historical consolidation a combination of modern titles, such as prescription and occupation, that has existed over long periods of time will be the determinant in a State's land claim. So the doctrine of historical consolidation is more related to modern territorial titles recognized in international law today; this is probably why the International Court of Justice, in its *Land and Maritime Boundary between Cameroon and Nigeria* decision, noted that "The Court notes that the theory of historical consolidation is highly controversial and cannot replace the existing modes of acquisition of title in international law."[11] Brownlie refers to historical consolidation as being "not much more than a compendium of pre-existing modes of acquisition", and says that "the accepted view is that consolidation does not exist as a concept independent of the established rules governing effective occupation and prescription."[12]

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[10] *Eritrea v. Yemen*, Territorial Sovereignty and Scope of Dispute, Reports of International Arbitral Awards, Vol. XXII pp. 209-332, para. 106 (Oct. 9, 1998).

[11] *Land and Maritime Boundry between Cameroon and Nigeria* (*Cameroon v. Nigeria: Equitorial Guinea Intervening*), Judgment, 2002 I.C.J. Reports 303, para. 103 (Oct. 10, 2002).

[12] JAMES CRAWFORD, BROWNLIE'S PRINCIPLES OF PUBLIC INTERNATIONAL LAW 236 (8th ed., Oxford University Press, 2012); *See also* MALCOLM SHAW, INTERNATIONAL LAW 520 (6th ed., Cambridge University Press, 2008).

A. Historic Title: Common Repute

A state's claim to historic title, otherwise called "original title"[13] or "ancient title,"[14] as mentioned above, depends upon whether that State can establish that there was a common perception since time immemorial that a certain area of territory or water were within their possession. Examining a series of arbitral and judicial decisions on this issue reveals that courts take the following factors into account when examining whether a state's claim to historic title is valid:

1. *Whether the Parties Involved had a Common Perception of the Island's Existence*

The International Court of Justice ("IC") in its *Sovereignty Over Pedra Branca/Pulau Batu Puteh, Middle Rocks and South Ledge* case examined whether the islands under dispute between Malaysia and Singapore were *terra incognita* in the colonial periods when Britain and the Sultan of Johor were in existence as predecessor states to the disputing parties.[15] This is important because in order to have a common perception that a certain piece of land or maritime territory belongs to some party, that piece itself has to be at least recognized as existing to all parties involved.

2. *The Territorial Regime of the Region and Time*

In the *Eritrea v. Yemen* case, the arbitral court noted that the "concept of territorial sovereignty was entirely strange to an entity such as medieval Yemen," and henceforth dismissed the Yemeni claims that it had "ancient title" over the disputed islands.[16] This implies that in order for a State to claim ancient title over a land or maritime territory, the parties involved must share, at the very least, a common perception that a state have also been used by other States,

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[13] *Id.*

[14] *Id.*

[15] *Sovereignty Over Pedra Branca/Pulau Batu Puteh, Middle Rocks and South Ledge (Malaysia/Singapore),* Judgment, 2008 ICJ Reports, 27 (May 23, 2008), available at http://www.icj-cij.org/docket/files/130/14492.pdf.

[16] *Supra* note 11, at 248.

whether there was something similar to a *condominium* arrangement or not.[17]

3. *The Existence of Rival Claims*

In the *Pedra Branca* case, the ICJ took into account that there was no challenge to the Sultanate of Johor's claim to the island, citing the lack of Norwegian claim to the lands in Eastern Greenland in the Permanent Court of International Justice's infamous *Legal Status of Eastern Greenland* case.[18]

B. Historical Consolidation

We have established above[19] that historical consolidation is a mixture of pre-existing modes of territorial acquisition, namely prescription and occupation. The question to be raised here is could maritime territory be acquired in the same way as land territory? And, this question arises due to the following reason: In land territory, it is established that any piece of land that is not terra nullius belongs to a particular State, and that even terra nullius can be occupied by a State if that State fulfills all requirements of occupation prescribed in international law.[20] The concept of "res communis" or the modern "common heritage or mankind" has little place in land-territorial regimes, unless some States establish condominium agreements or other *sui generis* regimes in some of their territories.[21]

However, when it comes to maritime territory, or internal waters or territorial sea in terms of modern international law of the sea, there was always a conflict between the doctrine of open seas, known as the doctrine of *mare liberum,* which dictates that maritime

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[17] Andrea Gioia, *Historic Titles*, in MAX PLANCK ENCYCLOPEDIA OF PUBLIC INTERNATIONAL LAW, para. 13 (Oxford University Press, 2013); D.P. O'CONNELL, THE INTERNATIONAL LAW OF THE SEA: VOLUME 1 423(Oxford University Press, 1982).

[18] *Legal Status of Eastern Greenland (Den. v. Nor.),* 1933 P.C.I.J. (ser. A/B) No. 53, 27 (Apr. 5, 1933).

[19] *See* p. 5.

[20] Malcolm Shaw, *supra* note 12, at 503.

[21] Lea Brilmeyer and Natalie Klein, *Land and Sea: Two Sovereignty Regimes in Search of a Common Denominator*, 33 N.Y.U. J. INT'L L. & POL. 703, 704 (2001).

areas be open to all States for navigation and economic activities, and that of *mare clausum,* which argued for occupation of the seas by certain States. Dutch jurist Huig de Groot (known in common literature as Hugo Grotius) argued in his infamous booklet, *Mare Liberum*, that the sea must be free and not susceptible to occupation.[22] Grotius, on the premise that only what is subject to occupation be subject to possession, made the aforementioned distinction between the land and the sea, saying that the limitlessness of the latter,[23] as well as the fact that the sea belongs to "all things which can be used without loss to anyone else."[24] In contrast, John Selden published in 1635 a treatise named Mare Clausum, the main argument of which is that the territorial sea is indeed subject to occupation by a State.[25]

The Grotian conception of the open seas was accepted in international law by the 18th and 19th centuries. In the 19th century Huebner tried to justify maritime blockades by championing a "territorial-occupation theory of blockade" Neff explains it to mean that "a blockading squadron occupies the portion of the sea which is enclosed within the line of the ships and consequently that a blockade involves a 'substitution of sovereignty' over the enveloped sea area."[26] This notion, that enclosure might actually mean occupation of a certain patch of ocean water, is heavily criticized by British and American commentators such as Hall.[27] The consensus was actually possible due to the proposal of Cornelius van Bynkershoeck- in his book, De Dominio Maris Disseratatio, he based his argument on the premise that 'no sea was (currently) possessed by anyone, and went on to suggest that "the control of the land extends as far as cannon will carry." Bynkershoeck's proposal was accepted in State practice as the so-called "three-mile rule,"[28] which Great Britain,

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[22] RALPH VAN DEMIAN MCGOFFIN, FREEDOM OF THE SEAS: A DISSERTATION BY HUGO GROTIUS 32 (1916).

[23] *Id.* at 34.

[24] *Id.* at 27.

[25] John Selden, MARE CLAUSUM: THE RIGHT AND DOMINION OF THE SEA IN TWO BOOKS 72 (London, 1663).

[26] STEVEN J. NEFF, THE RIGHTS AND DUTIES OF NEUTRALS: A GENERAL HISTORY 92 (Manchester: Manchester University Press, 2000).

[27] *Id.* at 93.

[28] "The old rule of the cannon-shot, crystallized into the present three marine miles measured from low water mark, may be modified at a later period inasmuch as certain nations claim wider jurisdiction […]. There is an obvious

the United States, and France accepted.[29] The Grotian concept still lives on in the modern law of the sea, subject to a few tweaks, such as the introduction of the "twelve-nautical-mile rule" and the introduction of the sovereign rights concept on the resources of the exclusive economic zone and continental shelf, which is a limitation of the States' high-sea rights but actually conforms to the Grotian notion of the separability of *dominium* and *imperium*.[30] Also, the sovereign rights of States do not rely on occupation; they rely on rights *ab initio* and the proclamations of States, as established by the United Nations Convention on the Law of the Sea ("UNCLOS").

An overview of this history on the of the seas reveals that (i) the seas are, not in principle, subject to any forms of occupation; (ii) whatever sovereignty enjoyed by states due to the seas derives from the concept of "the land dominates the sea" – in other words, it is the occupying of land, and the resulting need to assume control of some of the waters around it, that is the basis of sovereignty over the waters. Occupation of the waters themselves does not ensure sovereignty over the waters.[31] Historical consolidation, as well as its subcomponents, cannot serve as the territorial title for oceans. This notion also applied to China when it was incorporated into the international legal order in the mid-19th century.

C. Customary International Law

Even though occupation or prescription cannot themselves serve as territorial title over the oceanic waters, there remains the

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reason for that. The marginal strip of territorial waters based originally on the cannon-shot, was founded on the necessity of the riparian State to protect itself from outward attack, by providing something in the nature of an insulating zone, which very reasonably should be extended with the accrued possibility of offense due to the wider range of modern ordnance." *North Atlantic Coast Fisheries Case (Great Britain, United States),* Arbitral Award of Sept. 7, 1910, Reports of International Arbitral Awards (RIAA) XI, 167, 205.

[29] ROTHWELL ET AL., OXFORD HANDBOOK ON THE LAW OF THE SEA 26 (Oxford University Press, 2015).

[30] *Id.*

[31] Lea Brilmeyer and Natalie Klein, *supra* note 21, at 707; *ee Report of the International Law Commission to the General Assembly,* U.N. GAOR, 11th Sess., Supp. No. 9, art. 68, Commentary, U.N. Doc. A/3159 (1956).

possibility that even without the existence of historic rights recognized by the relevant parties since the beginning of their respective nations, the relatively recent sovereign claim over the seas, accompanied by explicit or implicit acceptance by the relevant States, can alter the existing territorial sea regime and allow for additional patches of ocean water to fall under the sovereignty of a State. This possibility was recognized in the ICJ's *Anglo-Norwegian Fisheries Case* in 1951, in which Norway's argument that its straight-baseline system was acquiesced by the government of Britain and accepted by the Courts of other States.[32] Shaw has confirmed that this case is irrelevant to the doctrine of historical consolidation.[33]

Since this way of assuming sovereign control over a patch of water depends on the implicit consent or acquiescence of other States, the Claimant State's claims must satisfy a number of criteria to ensure that the other States can genuinely consent to that State's claim. Before jumping into the contents of each criterion one has to recognize the unique nature of acquiescence in modern law of the sea. On land, acquiescence or explicit acceptance is usually done by the state with competing claims to the particular piece of land in question; this means that the legal relationships arising under acquiescence tend to be bilateral. However, when it comes to expanding the internal waters or territorial sea, the relationship is rarely bilateral; all nations have an interest in the freedom of the high seas.[34] This means that the law of the sea is more general in nature than the system of land boundaries – which implies that changing this regime is akin to changing general rules of customary international law. So the scope of acceptance for a sui generis regime when it comes to internal waters or territorial sea has to be extensive and substantially uniform[35] – if one is to borrow from the terminology used in the *North Sea Continental Shelf* case.

The three commonly recognized criteria for acquiescence to the State's historic waters claim is stated as follows: (i) the claim has to be formally made by the appropriate governmental authorities and

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[32] *Fisheries Case (United Kingdom v. Norway),* 1951 ICJ Reports 137 (1951).

[33] Shaw*, supra* note 12, at 507.

[34] CLIVE R. SYMMONS, HISTORIC WATERS IN THE LAW OF THE SEA: A MODERN RE-APPRAISAL 55 (2008).

[35] *Id.* at 57.

must be clear and consistent,[36] (ii) the claim has to be made public to other states,[37] (iii) the claim has to be continued long enough for other states to make implicit acceptance of that claim.[38] The first requirement is in place because no state can make implicit acceptance of another state's territorial claim if the original State never made an official claim to the international community. The United Nations study on the juridical regime of historic bays says that the declarations "must emanate from the State or its organs;"[39] and I) the claim must come from the authorities competent to state the official positions of that government, preferably the executive branch,[40] II) The official claim must be clear in its content- "the coastal State must leave no doubt about its intention to claim the water area as part of its national territory,"[41] III) The claim must be consistent- the ICJ based its decision on the El Salvador/Honduras case on the "consistent claims of the three States."[42]

Second, the claim must show sufficient "notoriety." If the claim is not made public, the other states, with a certain interest in the freedom of the seas in that area, would miss the chance to be aware of the other State's claim. This means that the fellow States would not develop the will to implicitly accept that other State's claim. Therefore, I) a claim has to be made *public* enough for States to make effective protests; claimed buried in domestic documents or voluminous pleadings is not sufficient to make a claim "public"[43]; II) the claim may be made in *bilateral notifications to other states, or by unilateral declarations*;[44] III) *Open exercise of jurisdiction* might suffice, given that other states have other ways to be aware of the legal nature of that claim.

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[36] *Supra* note 34, at 117.

[37] *Id.* at 141.

[38] *Id.* at 151.

[39] United Nations, *Juridical Regime of Historic Waters, Including Historic Bays*, U.N. Doc. A/CN.4/143, 14 (1962)

[40] *Supra* note 34, at 121.

[41] *Id.* at 128.

[42] *El Salvador/Honduras*, 1992 ICJ Reports 601.

[43] *Supra* note 34, at 140.

[44] *Id.* at 144.

Third, the claim must have continued for a certain period of time long enough for acquiescence to occur. "Mere sporadic enforcement of sovereign rights in allegedly historic waters will not suffice."[45] The exact extent of the time requirement is not clear, although, as the United Nations Juridical Regime study confirms, the extent is closely related to the "extent that an inference of acquiescence may be drawn from it." If international reaction to the historic claim is strongly pointing toward implicit acceptance of that claim, then only a relatively short passage of time might be required. The ICJ accepted this interrelationship between the passage of time requirement and the acceptance of states requirement when it confirmed in the seminal North Sea Continental Shelf case that a norm of customary international law might be formed in a relatively short period of time if the States with an interest in that particular norm made an "extensive and virtually uniform" acceptance of that norm.[46]

The logical questions that follow entail (i) the extent of knowledge that the States must have in acquiescing to the historic waters claim, and (ii) the number of the States that must be involved in the acquiescence. The accepted premise is that full knowledge of the claim's 'nature' and 'geographical extent' must be known by the states making implicit acceptance. Libya argued during its Tunisia/Libya case before the ICJ that Tunisian actions on its claimed historic waters reflect[ed] substantial variations and fluctuations in the size of the territorial sea, methods of establishing baselines, and designations of a reserved and contiguous fishing zones[47] and therefore argued there could not be acquiescence on the part of Libya. As Regarding the requirement on the extent of the participation, since the historic waters claim entails an encroachment of the high seas and therefore means a limitation of fishing and navigation rights within that area, the states with a navigational or fishing interest in the area claimed as historic waters by another state must, at minimum, participate in the implicit acceptance.

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[45] *Id.* at 152.

[46] *North Sea Continental Shelf*, 1969 ICJ Reports 38.

[47] *Continental Shelf (Tunisia/ Libyan Arab Jamahiriya),* Judgment, 1982 I.C.J. Reports 45.

D. The Relationship Between the Historic Waters Regime and UNCLOS

The United Nations Convention on the Law of the Sea (UNCLOS) makes only few statements on historic waters – Article 10(6) of UNCLOS refers to historic bays, and Article 15 refers to historic title as constituting one of the "special circumstances" that allow states to derogate from the "equidistance" or "median" rule in territorial sea delimitation. In other rules regarding the territorial sea, UNCLOS sets quite clear and uniform rules on the extent of the territorial sea that coastal states may enjoy, meaning that exceptions to such uniform rules should be limited to those explicitly accepted in UNCLOS. Failure to limit such exceptions would result in unacceptable variations of claims in regard to baselines, which would mean a loss of limits on the states' claims to its Exclusive Economic Zone (EEZ) and Continental Shelf areas, leading to uneven encroachment of the *res communis* principle. So this means that the historic waters regime would only have meaning in UNCLOS regimes with regard to (i) "historic bays" and (ii) territorial sea delimitation.

Even though Article 15 allows States to account for historic rights or waters in territorial sea delimitation, this provision actually limits the scope in which historical waters claims might be articulated. The premise of Article 15 is that states have overlapping claims in regard to its territorial sea, even when said claims are limited by Article 3 of UNCLOS, which limits its scope to 12 nautical miles from its baselines. So Article 15 would not apply when the length of maritime areas between states extends beyond 24 nautical miles between their respective baselines. A State might argue that their historic waters constitute internal waters, a scheme accepted by the ICJ in its Fisheries Jurisdiction (United Kingdom v. Iceland) case (which would mean that its historic waters would be actually "within" the baselines of that State). Even so, Articles 5 and 7 of UNCLOS explicitly limit the ways in which baselines are drawn with Article 7 accepting the formula developed by the ICJ in its Fisheries Case (United Kingdom v. Norway). So any historic "internal waters" claim that does not fit with the baselines regime developed by UNCLOS would be incompatible with the UNCLOS regime. These two limitations seriously limit the scope in which historic waters claims

could be made in regard to internal waters or territorial sea. Even if one could pass through these limitations, the historic waters claim would only serve as "special circumstances" in delimiting the territorial sea in which overlapping claims exist, meaning that such claims are subject to negotiations between two countries or judicial review based on equity.

One could argue that since Article 10(6) allows states to derogate from the definition of juridical bays, as defined in Article 10(2),[48] might fall into the scope of bays and thus be included in the list of historical waters regimes that UNCLOS explicitly proposes. Even though this might be true, especially with bays that do not have low-water marks of the natural entrance points that are more than 24 nautical miles apart, it would be satisfactory for our discussion here to point out that the most traditional definitions of bays was based on the so-called headland theory.[49] This theory requires bays to be enclosed "by reference to straight lines linking the headlands wherever the geographical situation really withdrew the waters within them for the traffic of nations."[50] This is in line with the Grotian argument that enclosed features of the sea are exceptionally subject to occupation and, therefore, *imperium* by individual States.[51] This means that maritime features not encompassed by straight lines between headlands cannot be regarded as bays, even in terms of Article 10(6) of UNCLOS.

A further argument is that the UNCLOS regime co-exists with the customary law regime regarding baselines and the territorial sea, which means that historic title may coexist with normal or straight baselines drawn up by UNCLOS. If this argument is to be valid, there has to be no legal conflict between the historical waters regime put forward by China and the regime for internal waters and

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[48] "For the purposes of this Convention, a bay is a well-marked indentation whose penetration is of such proportion to the width of its mouth as to contain land-locked waters and constitute more than a mere curvature of the coast. An indentation shall not, however, be regarded as a bay unless its area is as large as, or larger than, that of the semi-circle whose diameter is a line drawn across the mouth of that indentation."

[49] *Supra* note 17, at 380.

[50] *Id.* at 382.

[51] *Supra* note 22.

territorial sea. However, such a proposition suffers from the fact that if the territorial sea boundaries of supposed historic waters exceed that of the 12-mile limit set from the normal or straight baselines drawn up by UNCLOS, it conflicts with Article 3 of UNCLOS which has a clear intent of forbidding that exact phenomenon. This can be seen as a conflict between customary international law and new treaty law, in which the principle ***lex*** *posterior derogate legi priori* would apply. One might argue that the lex specialis principle would apply and so the special regime of historic waters might prevail over the general regime defined by UNCLOS, but UNCLOS, as stated above, is clearly intent on limiting the scope of historical regimes that could be used to derogate from its rules. Thus, rules that contradict this limitation of scope cannot be considered *lex specialis* rules that can derogate from UNCLOS.

Our conclusion is reinforced by the fact that Article 311(2) of UNCLOS stipulates "this Convention shall not alter the rights and obligations of States Parties which arise from other agreements compatible with this Convention and which do not affect the enjoyment by other States parties of their rights and the performance of their obligations under this Convention." As the *Philippines v. China* arbitral tribunal accurately pointed out, the logical corollary of this provision is that if the rights and obligations of a particular State Party are "incompatible with the Convention" or "affects the enjoyment by other States parties of their rights and the performance of their obligations," those rights and obligations are altered by the provisions of UNCLOS.[52]

E. An Analysis of the Chinese Claim

The arbitral tribunal in the *Philippines v. China* case did not rule on the possibility that China might be claiming the waters within the nine-dash line as part of their historical waters because China declared an optional exception according to Article 298(1)(a)(i) of UNCLOS on disputes regarding "historical bays or titles."[53] The tribunal moved on to establish its jurisdiction (by virtue of its

[52] South China Sea Arbitration, *supra* note 6, para. 252.

[53] *Id.* at 21.

competence de a competence (French) or Kompetenz-Kompetenz (German) on this case by declaring that China's claims are actually claims concerning historical rights, not historic title or historic waters.[54] In examining the validity of China's potential historic waters claims, therefore, it is not necessary to make an examination of the specific findings of the arbitral tribunal. However, some of the points made by the tribunal, such as the tribunal's findings on whether China's claims satisfied the criteria for acquiescence is worth a glance.

1. *Does China Have Historic Title Over the Waters Within the Nine-dash Line?*

China has never clearly explained the legal nature it holds on the islands or waters within the nine-dash line. Even though its reference to historic rights in its *notes verbales* simply that China is indeed making a historic waters or rights claim over the waters within that line, China, perhaps in an attempt to keep strategic ambiguity, never made clear whether it was claiming "historic rights" in the meaning similar to "sovereign rights" recognized under UNCLOS on its EEZ regime, or referring to the "historic waters" regime of internal waters or territorial sea. As a corollary, China has never officially presented evidence that backs up its claims for historic title over the waters within the nine-dash line.

Even though official presentations by the government of relevant evidence is scarce, a number of Chinese scholars have tried to back up its claims by presenting historical evidence that the waters in the SCS were perceived as Chinese waters since time immemorial. These scholars cite (i) records on fishing; (ii) records on sporadic military expeditions, particularly the one conducted by Zheng He during the Ming era; (iii) records on naming; and (iv) records on administrative boundaries.[55] The main weakness in the Chinese scholars' works is that they are only focused on records kept by the Chinese imperial government; it does not show enough records from neighboring countries, or countries that shared the maritime routes at

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[54] *Id.* at 31.

[55] Jianming Shen, *China's Sovereignty Over the South China Sea Islands: A Historical Perspective*, 1 CHINESE J. OF INT'L L. 103, 107 (2002).

time, to show that there was a "common perception" among China and other countries that the waters in question belonged to China.

Indeed, records on expeditions show that these expeditions were rather sporadic, and China did not amass a stationary army to solidify their new occupation; rather, the expeditions often resulted in a tributary relationship between the Chinese imperial house and the local residents residing in the islands in question. Zhang He's expeditionary fleet carried presents that were presented to the so-called "nomads," a tradition which was a distinctive feature of the Chinese tributary system in which the "Son of the Skies," the Chinese emperor, presented gifts to its underlying nomads in order to spread the culture of Chinese civilization to the so-called "uncivilized" areas.[56] Also, Zhang He's expeditions did not result in continuous military rule over the areas he covered; maritime expeditions were suspended shortly after the expeditions, allowing new influential civilizations to grow on the outer areas.[57]

2. *The Problem of Acquiescence*

The other way China can justify its historic waters claims over the waters within the nine-dash line is to claim that other States surrounding the area have acquiesced its claims. This differs from the historic waters claim that mainly relies on recent evidence of implicit acceptance, opposed to the ancient evidence of common perception that traditional historic waters claims rely upon, which accompany the relatively recently formulated claim that the waters are historically part of that State's sovereignty.

Taking into account the above-mentioned criteria, there are a few problems that significantly undermine the persuasiveness of the possible Chinese claim of acquiescence. First, the Chinese claim of historic waters has not been geographically consistent, nor has it clearly identified the legal nature of its claim. The Atlas of the Administrative Areas of China, published by the *Kuomintang*

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[56] JOO KYUNG-CHUL, THE AGE OF MARITIME EXPANSION 13 (Seoul National University Press, 2002).

[57] *Id.* at 17.

government in 1948 refers to an "eleven-dash line,"[58] which differs from the "nine-dash line" published in *Notes Verbales* to Vietnam and the Philippines in 2009.[59] These are the only two times in which China has officially identified the geographical scope of its claims, and they do not match each other geographically. The very notion that a series of dashes, and not a straight line, can mark a maritime territorial boundary seems odd and causes geographical ambiguity.

Even if one accepts that China was actually consistent geographically when making aforementioned claims, one needs to note that China has never made clear the legal basis on which it placed its claims. China, in its *Notes Verbales* to Vietnam and the Philippines claimed that waters within the nine-dash line are within its "sovereignty," but it is not clear whether this means that the waters within the nine-dash line are China's internal waters or territorial sea. Indeed, some Chinese scholars acknowledge that the Chinese claims can be interpreted as a case for historic "fisheries rights,"[60] not historic waters; which means that the notion of "sovereignty" in the Chinese documents can actually be interpreted to mean "sovereign rights," which is based on the Grotian separation of dominium and imperium. Unless China makes its legal basis clear, it is difficult for other States to provide effective acquiescence to its claims.[61]

Second, the time in which China has placed its historic claims is insufficient for other States to make effective acquiescence. As mentioned above, only in 2009 did China clarify that its claims on the waters within the nine-dash line is subject to its "sovereignty"(subject to more ambiguity).

Third, there were actually serious protests by other States after the 2009 claim. Here, one has to note the previous discussion that acquiescence of maritime claims is different from the

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[58] United States State Department, *Limits in the Seas: No. 143, Maritime Claims in the South China Sea*, 3 (Dec. 5, 2014), available at https://www.state.gov/documents/organization/234936.pdf.

[59] *Id.*

[60] Zou Keyuan and Liu Zinchang, *The Legal Status of the U-Shaped Line in the South China Sea,* 14 CHINESE J. OF INT'L L. 57, 63 (2015).

[61] *Supra* note 58, at 22.

acquiescence of land claims because, unlike land claims, the interests involved are barely bilateral and many states share a common interest in maintaining freedom of navigation and overflight in the particular sea area. This is especially true in the case of the SCS, given its large proportion of global shipping that passes through this area and proximity to the Malacca Strait. This means that the position of global shipping power States, such as the United States, is of significance; the US, however, in its *Limits in the Seas* report, made clear that if the Chinese claims are based on the notion of acquiescence, then China does not have a legal basis to support its claim.[62]

3. *UNCLOS*

Even if the Chinese claim of historic waters can be justified by the traditional rules of acquiescence and historic title, it is reasonable to interpret this regime to have been overridden by the UNCLOS regime. First, the nine-dash line is not encompassed by headlands that mark the lands surrounding it, which means that the area is not an example of a "bay" in customary international law. This strips the area of the eligibility to be qualified as a "historic bay" in the meaning of Article 10(5) of UNCLOS. Second, the historic waters claim that the nine-dash line represents stretches far beyond the twelve-mile territorial sea zone that can be drawn up from its baselines, even if one assumes that all the islands and rocks within the nine-dash line belong to China and that the low-tide elevations that China claims to be "islands" are actually islands in the meaning of Article 121(1) of UNCLOS. This means that the overlapping sovereignty claims between China, Philippines and Vietnam are not overlapping twelve-mile claims envisioned by Article 15 of UNCLOS, which means that the "historic circumstances" cannot serve as "special circumstances" in territorial sea delimitation between these countries.

Article 311(2), explained above, reinforces this conclusion. The historic waters claims of China, for reasons explained above, is indeed incompatible with the territorial sea regime put forward by

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[62] *Id.*

UNCLOS, and seriously affects the navigational rights of States within the area.

III. AN ANALYSIS OF THE CHINESE CLAIMS IN THE PERSPECTIVE OF 'HISTORICAL RIGHTS' THEORY

A. Legal Basis for Historical "Sovereign Rights"

Claims to historical sovereign rights means "a State is claiming to exercise certain rights, usually fishing rights, in what is usually deemed to be international waters."[63] This means that the State is not claiming exclusive sovereignty over the disputed waters, but arguing for historical rights over the resources of those waters. This lack of exclusivity in their claims makes historical rights claims different from those of the historical waters claims. As a logical corollary, this leads to two further differences: (i) the lack of exclusivity means that several "historical sovereign rights" can exist within the same body of water; (ii) claims to historic rights tend to be specific in its scope, such as specific rights to fish specific species or catch specific resources.

Despite the differences, any historical rights claims put forward by a State, just like historic waters claims, must be supported by customary international law. With both types of claims, the consent of the interested parties is rarely given explicitly through the form of a treaty. Even if relevant treaties are concluded, the treaties usually only mean a post facto acceptance of the historical right already established such as the boundary agreement between Australia and Papua New Guinea.[64] Therefore, the practice of the Claimant State must be supported by non-action or acceptance of the parties involved, followed by opinion juris of the involved parties. This consideration makes the criteria for acquiescence important for

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[63] Leonardo Bernard, *The Effect of Historic Fishing Rights in Maritime Boundaries Delimitation*, in *Securing the Ocean for the Next Generation*, LOSI Conference Papers, 2012.

[64] *Id.* at 9.

recognition of historic rights as well, which means the Claimant State must establish the criteria of acquiescence.

B. The Relationship Between UNCLOS and the Historical "Sovereign Rights" Claim

Even if a States' historical rights claims are established by international law, the question still arises as to whether the impending imposition of UNCLOS, and the resultant activation of the Exclusive Economic Zone (EEZ) and Continental Shelf regimes, actually nullifies States' title to aforementioned historical rights. This question relates to the topic of legal conflicts between the EEZ or Continental Shelf regimes, and States' historical rights Claims. If there is no conflict, Article 311(2) of UNCLOS ensures that the historical rights regime remains intact. If there is a conflict, as a reverse induction of the same article, the EEZ and Continental Shelf systems prevail over individual State's continental shelf claims'.

In order to determine whether such a conflict exists, a deep probe is required on whether the sovereign rights over the natural resources in the EEZ or Continental Shelf is exclusive to the rights of other states. One can argue that since Article 56 of UNCLOS ensures that States enjoy sovereign rights over the totality of "resources" within the EEZ, and, since Article 62 allows the coastal State to determine its capacity to "harvest the living resources of the exclusive economic zone,"[65] and only allows other States to intervene when the coastal State "when the Coastal state does not have the capacity to harvest the entire allowable catch," the EEZ regime envisions a total replacement of the pre-UNCLOS historical rights to that of the rights stipulated to in the EEZ regime. The same line of reasoning can be applied to the relationship between historical rights claims and the continental shelf regime because Article 77 of

[65] "The coastal State shall determine its capacity to harvest the living resources of the exclusive economic zone. Where the coastal State does not have the capacity to harvest the entire allowable catch, it shall, through agreements or other arrangements and pursuant to the terms, conditions, laws and regulations referred to in paragraph 4, give other States access to the surplus of the allowable catch, having particular regard to the provisions of articles 69 and 70, especially in relation to the developing States mentioned therein." Article 62(2), LOSC.

UNCLOS guarantees coastal states sovereign rights over the entirety of resources within its continental shelf, without the same type of limitations stipulated to in Article 62 in case of the EEZ. This is the exact line of reasoning adopted in the *Philippines v. China* case, where the Arbitral Tribunal concluded that even if China's historical rights claims over the resources within the nine-dash line are valid, any historical rights held by China are overridden by the EEZ and continental shelf regimes envisioned by UNCLOS.[66]

This argument suffers from two weaknesses. First, even though the sovereign rights envisioned in the EEZ and continental shelf regimes are deemed to be exclusive, there is nothing that stops the coastal state from entering into agreements that allow non-coastal state parties to harvest some of the non-living or living resources within the EEZ.[67] This is addressed in Article 62, where the coastal State can determine its own capacity to harvest the living resources within its EEZ, and allocate the leftover resources to other States. Article 62 essentially means that the coastal state enjoys wide discretion in the distribution of its resources to other States. If new distribution agreements are allowed under UNCLOS, maintaining old arrangements that are solidified under customary international law is permissible as well. Even though the provisions on the continental shelf lack distributive arrangements like those envisioned in Article 62, there is nothing in those provisions that blocks such arrangements from remaining intact under UNCLOS.[68]

Secondly, in EEZ cases, UNCLOS envisions a regime of functional distribution of resources, signified by Article 62. In giving access to the EEZ, Article 62(3) stipulates that "the coastal State shall take into account all relevant factors, including, inter alia, … the need to minimize economic dislocation in States whose nationals have habitually fished in the zone or which have made substantial efforts in research and identification of stocks." This means that the historical rights of States must to be taken into account when allocating any living stock within the EEZ. Thus, the legal

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[66] *Supra* note 6, para. 262.
[67] *Supra* note 63, at 18.
[68] *Supra* note 63, at 18.

significance of historical rights held by a State remains a relevant consideration.

The Tribunal left open the possibility of the EEZ regime being amended or modified by customary international law after the conclusion of UNCLOS, adding, "such a claim would require the same elements discussed above with respect to historic rights."[69] This also leaves open the possibility that the regime could be modified by way of treaty, provided that the treaty satisfies the conditions aligned in Article 41 of the Vienna Convention on the Law of Treaties.[70]

C. An analysis of the Chinese claims

As in the analysis of whether China's claims are acceptable under the jurisprudence of historic waters, two determinative issues arise in establishing whether China has historical rights over the waters resources within the nine-dash line: (i) whether China's historical rights' were part of customary international law due to explicit acceptance or acquiescence by other States, and (ii) whether China's historical rights, even if accepted under customary international law, are not overridden by the EEZ and Continental Shelf regimes envisioned by UNCLOS.

As to the first question, the criteria required to establish acquiescence in historic waters claims also applies to China's claims' for historical rights. As noted above,[71] China's historic waters Claims lack the requisite level of clarity, notoriety, and longevity to be accepted by other states adopting the theory of acquiescence. As it follows, the criteria for acquiescence will not be met for historical rights as well. In the *Philippines v. China* case mentioned above, the

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[69] *Supra* note 6, para. 275.

[70] Article 41(1) of the Vienna Convention on the Law of Treaties reads: Two or more of the parties to a multilateral treaty may conclude an agreement to modify the treaty as between themselves alone if: (a) the possibility of such a modification is provided for by the treaty; or (b) the modification in question is not prohibited by the treaty and; (i) does not affect the enjoyment by the other parties of their rights under the treaty and performance of their obligations; (ii) does not relate to a provision, derogation from which it is compatible with the effective execution of the object and purpose of the treaty as a whole.

[71] *See* page 17.

Arbitral Tribunal stated that China's historical rights claims lack sufficient historical grounds to be justified under international law.[72] The Tribunal ruled that the little evidence that exists can be evidence of sovereignty over the islands within the nine-dash line, but not evidence of historical rights.[73]

Up to this point, the Tribunal's reasoning is acceptable. However, the Tribunal made an error by oversimplifying the situation when it declared that any historical rights China potentially had prior to UNCLOS are overridden by the EEZ and Continental Shelf regimes of the 1982 convention. The Tribunal based its judgment on the premise that UNCLOS establishes an exclusive sovereign rights regime that is wholly incompatible with the regime riddled by historical rights.[74] However, as demonstrated above, the Tribunal's reasoning was flawed: historical rights that predate the adoption of UNCLOS may still co-exist with the sovereign rights guaranteed under the EEZ and continental shelf.[75]

The question remains of whether any historical rights held by China over resources within the nine-dash line stay intact under UNCLOS. To answer this question, one must look to the intent of the Chinese and Philippine delegations, the point at which the two parties acceded to the UNCLOS regime. Negotiation records show that China's delegates, unlike delegates from Australia and New Zealand, argued for a strong EEZ with little possibility of preservation of historical rights.[76] This was one of the decisive points

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[72] *Supra* note 6, para. 275.

[73] *Id.* at para. 267-271.

[74] *Id.* at para. 278.

[75] *See* page 23.

[76] *Summary Records of Meetings of the Second Committee, 24th Meeting*, U.N. Doc. A/CONF.62/C.2/SR.24 at para. 2 (Aug. 1, 1974), *Official Records of the Third United Nations Conference on the Law of the Sea, Volume II,* 187 *(Summary Records of Meetings of the First, Second and Third Committees, Second Session)*; *see also Summary Records of Meetings of the Second Committee*, *26th Meeting*, U.N. Doc. A/CONF.62/C.2/SR.26 at para. 108 (Aug. 5, 1974), *Official Records of the Third United Nations Conference on the Law of the Sea, Volume II*, 120 *(Summary Records of Meetings of the First, Second and Third Committees, Second Session)*; *Summary Records of Meetings of the Second Committee, 30th Meeting*, U.N. Doc. A/CONF.62/C.2/SR.30 at para. 22 (Aug. 7, 1974), *Official Records of the Third United Nations Conference on the Law of the Sea, Volume II*, 228 *(Summary Records of Meetings of the First, Second and Third Committees, Second Session)*;

that led the tribunal to deny China the opportunity to invoke historical rights. According to the tribunal, China "was resolutely opposed to any suggestion that coastal States could be obliged to share the resources of the exclusive economic zone with other powers that had historically fished in those waters."

IV. AFFECT OF THE RULING BY PERMANENT COURT OF ARBITRATION ON THE DELIMITATION OF THE MARITIME AREAS IN THE SCS

A. The Insular Features of the SCS

The SCS is a semi enclosed or enclosed sea surrounded by Taiwan, China, Vietnam, Malaysia, Brunei and Philippines.[77] The SCS measures about 550-650 nautical miles East-to-West and more than 1200 nautical miles North-to-South.[78] There are five bulks of insular features located in the SCS, which are disputed by the riparian States regarding the their ownership, status and the maritime entitlenments of such features: the Spratly Islands, the Paracel islands, Scarborough Reef, Pratas Islands and Macclesfield Bank.[79]

The Spratly Islands are located in the southern quadrant of the SCS, and composed of 140 islets, rocks, reefs, shoals and sandbanks; all of which currently claimed by China, Taiwan, Vietnam,

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Summary Records of the Meetings of the Second Committee, 48th Meeting, U.N. Doc. A/CONF.62/C.2/SR.48 at para. 29 (May 2, 1975), *Official Records of the Third United Nations Conference on the Law of the Sea, Volume IV*, 77 *(Summary Records, Plenary, General Committee, First, Second and Third Committees, as well as Documents of the Conference, Third Session)*.

[77] Because status of Taiwan is disputed as a state, it is excluded all of the procedures relating to the South China Sea. Nien-Tsu Alfred Hu, *Semi-enclosed Troubled Waters: A New Thinking on the Application of the 1982 UNCLOS Article 123 to the South China Sea*, 41 OCEAN DEV. & INT'L L. 281, 301 (2010) (between riparian states to the SCS only Taiwan is not a party to UNCLOS).

[78] Robert Beckman, *The UN Convention on the Law of the Sea and the Maritime Disputes in the South China Sea*, 107 AM. J. OF INT'L L. 142, 143 (2013).

[79] *South China Sea*, LOWY INSTITUTE, https://www.lowyinstitute.org/issues/south-china-sea (last accessed Mar. 6, 2017)

the Philippines, Malaysia and Brunei.[80] The largest of the Spratly Islands is Itu Aba is a mere 0.56 km^2 in size.

The Paracels, which are under Chinese control, are located in the northwestern quadrant of the SCS and consists of 35 islets, shoals, sandbanks and reefs. Woody Island is the largest of the Paracel Islands and has an area of 2.1 km^2.[81]

The Scarborough Shoal, another feature in the SCS, is a "large atoll with a lagoon of about 150 km^2 surrounded by reef" and located 124 nautical miles from the Philippines and is claimed by China, Taiwan and the Philippines.[82] The Pratas Islands are located in the northern quadrant of the SCS and currently occupied by Taiwan. The Macclesfield Bank is in the middle of the SCS, "a large atoll that is totally submerged at low tide," claimed by Taiwan and China.[83]

B. Status of the Islands, Rocks and Low Tide Elevations under UNCLOS

According to Article 121(1) of UNCLOS, "an island is a naturally formed area of land, surounded by water, which is above water at high tide."[84] Because of the word *naturally,* "artificially wrought changes in its elevation will not entitle a rock of naturally lower elevation to serve as a base point to generate various maritime zones (unless it qualifies, in its natural state, as a low tide elevation, in which case it may have a limited effect on the baseline)."[85] China has been piling sand onto reefs and low tide elevations located within the Spratly Islands and Scarborough Shoal. In addition, China has constructed military bases, airstrips, ports and radar facilities on those features.[86] Since these changes to the reefs are artificial and man-

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[80] *Supra* note 78, at 143.

[81] *Id.* at 144.

[82] *Id.* at 145.

[83] *Id.*

[84] Art. 121(1), UNCLOS.

[85] Jonathan I. Charney, *Rocks that cannot Sustain Human Habitation*, 93 AM. J. OF INT'L L. 863, 867 (1999).

[86] For an interactive feature that show construction activities by China in the SCS, see Derek Watkins, *What China Has Been Building in the South China Sea*, N.Y. TIMES, (Feb. 29, 2016),

made, they will not change their legal status to "islands" or "rocks" as defined under UNCLOS.

Like a land territory of a State, an island has the capacity to produce its own maritime zones: the territorial sea, the contiguous zone, the exclusive economic zone, and the continental shelf.[87]

An island is distinguished from a low tide elevation based on how water covers the land. A low tide elevation is under water at a high tide but above water at low tide. An island is never submerged under water during a low or high tide. A low tide elevation is not entitled to any maritime zones. Nevertheless, a low tide elevation can be used as a baseline for measuring the breadth of the territorial sea if it is situated within the territorial sea of the mainland or an island.[88] A low tide elevation may not be appropriated because they are part of the territorial sea or the continental shelf of a State.

UNCLOS states that "rocks which cannot sustain human habitation or economic life of their own" do not produce any economic zone or continental shelf.[89] On the other hand, they have the capacity to produce a territorial sea and a contiguous zone. It can be understood that an island is capable of sustaining human habitation or economic life of its own.[90] A rock does not need to satisfy both requirements of "human habitation" and of "economic life of its own" to be called an island because the Article 121(3) uses the word "or" instead of "and" between these two requirements.[91] While some commentators have argued that the key factors in determining if a rock constitutes status an island are "if it can provide fresh water, food, and shelter to human inhabitants and if the island possesses sufficient resources of its own to sustain economic life."[92] Additionally, Van Dyke and Brook look to "whether the island can in

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http://www.nytimes.com/interactive/2015/07/30/world/asia/what-china-has-been-building-in-the-south-china-sea-2016.html?ref=asia&_r=0

87 Art. 121(2), UNCLOS.

88 Art. 13, UNCLOS.

89 Art. 121(3), UNCLOS.

90 CRAIG H. ALLEN, INTERNATIONAL LAW FOR SEAGOING OFFICERS 70 (6th ed., New York: Naval Institute Press, 2014).

91 Marius Gjetnes, *The Spratlys: Are They Rocks or Islands*?, 32 OCEAN DEV. & INT'L L. 191, 199 (2001); Charney, *supra* note 85, at 868.

92 *Id.* at 199

fact support a stable population" as a key factor, further stating that, "islands should generate ocean space if stable communities of people live on the island and use the surrounding ocean areas."[93]

Charney opposes those standards on the ground that nothing in the *travaux preparatoires* mentions such an interpretation.[94] Moreover, Charney infers from the *travaux preparatoires* of UNCLOS that "human habitation does not require that people reside permanently on the feature or that the economic life be capable of sustaining a human being throughout the year."[95] He further stated that economic activity of a rock may be met by the exploitation of the living and non-living resources found in its territorial sea.[96]

The case between the Philippines and China decided by the Arbitral Tribunal constituted under Annex VII to UNCLOS is the first decision by an international tribunal to elaborate on Article 121(3) of UNCLOS.[97] Accordingly, the Arbitral Tribunal concluded that the use of the term "rock" in Article 121(3) does not require a feature be composed of rock in the geologic sense.[98] The Tribunal also tried to explain the intent behind the use of the word "cannot" in Article 121(3) of UNCLOS as following:

> The use of the word "cannot" in Article 121(3) indicates a concept of capacity…it (the enquiry) is concerned with whether, objectively, the feature is apt, able to, or lends itself to human habitation or economic life. That is the fact that a feature is currently not inhabited does not prove that it

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[93] Jon M. Van Dyke and Robert A. Brooks, *Uninhabited Islands: Their Impact on the Ownership of the Oceans' Resources*, 12 OCEAN DEV. & INT'L L. 165, 286 (1983).

[94] See Charney, *supra* note 85, at 870.

[95] *Id.* at 868.

[96] *Id.* ("Consequently, a feature would not be subject to Article 121(3) disabilities if it were found to have valuable hydrocarbons (or other characteristics of value, e.g., newly harvestable fisheries in its territorial sea, or perhaps even a location for a profitable gambling casino) whose exploitation could sustain an economy sufficient to support that activity through the purchase of necessities from external resources").

[97] South China Sea Arbitration Award, *supra* note 6.

[98] *Id.* at paras. 480-482.

> uninhabitable. The fact that it has no economic life does not prove that it cannot sustain an economic life.

Nevertheless, historical evidence of human habitation and economic life in the past may be relevant for establishing a feature's capacity. If a known feature proximate to a populated land mass was never inhabited and never sustained an economic life, this may be consistent with an explanation that it is uninhabitable. Conversely, positive evidence that humans historically lived on a feature or that the feature was the site of economic activity could constitute relevant residence of a feature's capacity.[99]

Regarding the "human habitation" requirement, the Tribunal said that "at a minimum, sustained human habitation would require that a feature be able to support, maintain and provide food, drink and shelter to some humans to enable them to reside there permanently or habitually over an extended period of time."[100] The term "habitation" is said to imply "the habitation of the feature by a group or community of persons."[101] The Arbitral Tribunal said that the military or governmental personnel stationed on the Spratly Islands do "not suffice to constitute 'human habitation' for the purposes of Article 121(3)" because "these groups are heavily dependent on outside supply, and it is difficult to see how their presence on any of the SCS features can fairly be said to be sustained by the feature itself, rather than by a continuous lifeline of supply and communication from the mainland."[102] The Tribunal pointed out military or governmental personnel are actually deployed "in an effort to support the various claims to the sovereignty that have been advanced."[103]

Like the scholars mentioned above, the Tribunal came to the conclusion that an island would be given an EEZ and a continental shelf if it is able sustain either human habitation or an economic life

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[99] *Id.* at paras. 483-484.
[100] *Id.* at para. 490.
[101] *Id.* at para. 491.
[102] *Id.* at para. 620; *see also* para. 550.
[103] *Id.* at para. 620.

of its own.[104] The Tribunal however indicated: "humans will rarely inhabit areas where no economic activity or livelihood is possible. The two concepts are thus linked in practical terms, regardless of the grammatical construction of Article 121(3)."[105]

Regarding the criteria of "economic life of its own," the Tribunal concluded that economic life must "pertain to the feature as 'of its own'."[106] According to the Tribunal, economic life of its own does not cover activities from a possible EEZ or continental shelf, however economic activities from the territorial sea may be part of economic life of a feature.[107] It was pointed out in the award:

> Distant fishermen exploiting the territorial sea surrounding a small rock and making no use of feature itself, however, would not suffice to give the feature an economic life of its own. Nor would an enterprise devoted to extracting the mineral resources of the seabed adjacent to such a feature and making no use of the feature itself.[108]

China has not released any information regarding the status of insular features in the SCS. In the *note verbale* of 2011, China said its Nansha (Spratly) Islands are "fully entitled to territorial sea, exclusive economic zone ("EEZ") and Continental Shelf" without differentiating low tide elevations, rocks or islands from each other.[109] Since these insular features include low tide elevations, rocks and islands, they cannot produce the same maritime zones. The Arbitral Tribunal in the South China Sea Arbitration concluded the high tide elevations in the Spratlys were not capable of sustaining human habitation or economic life of their own, therefore they were rocks.[110]

Indeed, most of the features in the SCS are low tide elevations. For example, all the formations in the Macclesfield Bank

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104 *Id.* at para. 496.
105 *Id.* at para. 497.
106 *Id.* at para. 543
107 *Id.* at paras. 502-03.
108 *Id.* at para. 503.
109 For the *note verbal* of 2011, *see supra* note 4.
110 South China Sea Arbitration, *supra* note 6, para. 622.

are permanently submerged.[111] Hence they may not be entitled to any maritime zones. The Arbitral Tribunal in the SCS Arbitration, said that Hughes Reef, the Gaven Reef (South), the Subi Reef, the Mischief Reef, Second Thomas Shoal were low tide elevations.[112] With regard to the Scarborough Shoal, the Tribunal concluded it was a rock which can not sustain human habitation or economic life of its own and went on saying:

> The protrusions above high tide at Scarborough Shoal are minuscule… They obviously could not sustain human habitation in their naturally formed state; they have no fresh water, vegetation, or living space and are remote from any feature possessing such features. Scarborough Shoal has traditionally been used as a fishing ground by fishermen from different States, but the Tribunal recalls that economic activity in the surrounding waters must have some tangible link to the high tide feature itself before it could begin to constitute the economic life of the feature. There is no evidence that the fishermen working on the reef make use of, or have any connection to, the high tide rocks at Scarborough Shoal. Nor is there any evidence of economic activity beyond fishing. There is, accordingly, no evidence that Scarborough Shoal could independently sustain economic life of its own.[113]

Similarly, the Tribunal reached the same conclusion regarding the Curteron reef, the Fiery Cross Reef, the Johnson Reef, the McKennan Reef, the Gaven Reef (North), accordingly it concluded that they were rocks which cannot sustain human habitation or

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[111] "The submerged bank at its shallowest is covered by some 30 feet of water. Of course China may claim it as part of its extended continental shelf but it has not yet done so." Mark J. Valencia, *China's Maritime Machinations: The Good, the Bad and the Ugly*, THE DIPLOMAT (Dec. 10, 2014), available at http://thediplomat.com/2014/12/chinas-maritime-machinations-the-good-the-bad-and-the-ugly/.

[112] South China Sea Arbitration, *supra* note 6, paras. 358, 366, 373, 378, 380.

[113] *Id.* at para. 556.

economic life of their own.[114] Therefore, they may not be entitled to any EEZ or continental shelf.

Chinese position against Japanese claims over the Okinotorishima is worth to be mentioned at this point. Japan claims EEZ and continental shelf around the Okinotorishima Atoll.[115] Its area at high tide is "one size of a twin bed and of a small bedroom."[116] Since 2004, China opposes Japanese claims concerning legal status of the Okinotorishima on the ground that it is a rock, which "on its natural conditions" cannot sustain human habitation or economic life of its own, and therefore can not be entitled EEZ or continental shelf.[117] Most of features in the SCS does not allow "on its natural conditions" to sustain human habitation or have economic activity of its own. This situation actually highlight China's inconsistent position taken with respect to its interpretation of Article 121(3) of UNCLOS. Smith said: "Yet, if China claims all the islands in the Spratly group with a view to claiming EEZs and continental shelves from them, then there must be some inconsistency in its position on Article 121, paragraph 3."[118]

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[114] *Id.* at paras. 557-570.

[115] *See* Yann-huei Song, *Okinotorishima: A "Rock or an "Island"? Recent Maritime Boundary Controversy between Japan and Taiwan/China*, in MARITIME BOUNDARY DISPUTES, SETTLEMENT PROCESSES, AND THE LAW OF THE SEA 145-76 (eds. Seoung-Yong Hong and Jon M. Van Dyke, 2009) (the writer said the island was unsuitable for human habitation and was not able to economic activity of its own); *see also* Robert W. Smith, *Maritime Delimitation in the South China Sea: Potentiality and Challenges*, 41 OCEAN DEV. & INT'L L. 214, 223 (2010).

[116] Herber Smith, *A Rock or an Island? The significance of Okinotorishima and its Status under the International Law of the Sea*, PUB. INT'L L. E-BULLETIN, available at http://www.herbertsmithfreehills.com/-/media/HS/HKTSIBEBASHL0407122110.pdf (last accessed May 2, 2016)

[117] *See* China's Note Verbale to the U.N. Secretary General, CML/2/2009 of Feb. 6, 2009, available at http://www.un.org/depts/los/clcs_new/submissions_files/jpn08/chn_6feb09_e.pdf; Note Verbale CML/59/2011 of Aug. 3, 2011, available at http://www.un.org/depts/los/clcs_new/submissions_files/jpn08/chn_3aug11_e.pdf

[118] Robert W. Smith, *supra* note 115.

C. Practice of States Regarding Status of Insular Features and Effects of the SCS Arbitration over the Practice of States

The Arbitral Tribunal stated, "there is no agreement based upon State practice on the interpretation of the Tribunal of Article 121(3) which differs from the interpretation of the Tribunal as outlined in the previous sections."[119] Several countries have claimed fully fledged EEZs around high tide elevations, which are actually incompatible with the SCS Arbitration award. Mark E. Rosen, in a published article in a magazine, gave examples of such proclamations established by the United States and France.[120] The United States claims an EEZ of 407, 635 sq km around the Johnson Atoll, which is an uninhabited atoll and located 860 miles south of Hawaii.[121] Accordingly, this feature has never had any indigenous populations and has no fresh water and tillable soil.[122] Similarly Howland and Baker Islands, located in the equatorial Pacific, have no fresh water or arable land however they have phosphorite and guano deposits, and they have an EEZ of 434, 921 sq km.[123] Jarvin Island, another US uninhabited island located in the South Pacific have scant vegetation but have no fresh water and it is alleged that the island has never supported "a self sustaining population."[124] Yet, it produces an EEZ of 316, 665 sq km.[125]

Similarly, France has some tiny, uninhabited features, yet they generate fully entitled EEZs. Although Austral Islands in French

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[119] South China Sea Arbitration, *supra* note 6, para. 553.

[120] Mark E. Rosen, *China Has Much to Gain From the South China Sea Ruling*, THE DIPLOMAT (July 18, 2016), http://thediplomat.com/2016/07/china-has-much-to-gain-from-the-south-china-sea-ruling/; Peter Coy, *Is it an Island or a Rock? Ruling Could Cost U.S. a Huge Swath of Ocean?,* BLOOMBERG (July 28, 2016), http://www.bloomberg.com/news/features/2016-07-28/u-s-japan-and-other-nations-could-lose-exclusive-economic-zones.

[121] *Id.*, Rosen.

[122] *Id.*

[123] The US District Court for the District of Guam in 2008 said that an insular feature does not have to satisfy both the requirement of "human habitation" and "economic life" to be called an island and ruled that Howland and Baker were islands in terms of Article 121(1) of the LOSC. *United States v. Marshalls* 201, 2008 U.S. Dist. LEXIS 38627 (D. Guam May 8, 2008).

[124] Rosen, *supra* note 120.

[125] *Id.*

Polynesia are uninhabited, they were given effect in the EEZ generation.[126] Rosen argued these features nearly gave rise to an increase of 4.7 sq km in the EEZ generation.[127] The French Clipperton Island, located in 671 miles southwest of Mexico, is a ring shaped atoll, which have no freshwater and arable land, yet it has an EEZ of 431, 263 sq km.[128] Similarly French Crozet Islands, uninhabited tiny features between Africa and Antarctica, does not have any arable land or fresh water. However their EEZs amount to 574,558 sq km.[129]

Japan claims a 200 nautical miles EEZ zone around tiny Okinotorishima and the Senkakus features. As mentioned above the Okinotorishima Island is uninhabited and does not have economic activity of its own. Japan has an EEZ of over 400,000 sq km around this feature.[130] Senkakus are also uninhabited islets, which have no fresh water and tillable soil.[131]

Most of the features above do not sustain human habitation in their natural conditions. Although some of them seem to have economic resources like seabed mining and fishing,—as Arbitral Tribunal in the SCS arbitration put it—"economic activity in the surrounding waters must have some tangible link to the high tide feature itself before it could begin to constitute the economic life of the feature."[132] People who make use of these resources actually have no connection to those features. The Arbitral Tribunal also stated: "Purely economic activities, which accrue no benefit for the feature or its population, would not amount to an economic life of the feature as 'of its own'."[133] Therefore those insular features do not sustain economic activity of their own. Following the Arbitral Tribunal decision, it is likely that most of the aforementioned States will get objections from the international community about their EEZs around these insular features. However, a writer said that "it

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126 *Id.*
127 *Id.*
128 *Id.*
129 *Id.*
130 *Id.*
131 *Id.*
132 South China Sea Arbitration, *supra* note 6, para. 556
133 *Id.* at para. 500.

seems higly unlikely that these states will revise their legal position in light of the tribunal's award in the *South China Sea Arbitration* and treat these 'islands' in future as mere 'rocks' without an EEZ and continental shelf."[134]

Even if we assume the features in the SCS are regular islands under Article 121(1) of UNCLOS, maritime delimitations are required with States whose coasts are opposite or adjacent.

D. Maritime Delimitations Involving Islands

UNCLOS has parallel provisions regarding the delimitation of the continental shelf and the exclusive economic zone (EEZ). According to UNCLOS, "the delimitation of the continental shelf (and the EEZ) between States with opposite or adjacent coast shall be effected by agreement on the basis of international law, as referred to in Article 38 of the Statute of the International Court of Justice, in order to achieve an equitable result."[135] Unlike the 1958 Convention on the Continental Shelf, which applies the median line method, UNCLOS does not regulate a standard delimitation method but asks to come to an equitable result.[136]

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[134] Stefan Talmon, *The South China Sea Arbitration and the Finality of 'Final' Awards*, 8 J. OF INT'L DISP. SETTLEMENT 388, 400 (2017).

[135] Art. 74 and 83, UNCLOS.

[136] Art. 6 of the 1958 Convention on the Continental Shelf provides:

1. Where the same continental shelf is adjacent to the territories of two or more States whose coasts are opposite each other, the boundary of the continental shelf appertaining to such States shall be determined by agreement between them. In the absence of agreement, and unless another boundary line is justified by special circumstances, the boundary is the median line, every point of which is equidistant from the nearest points of the baselines from which the breadth of the territorial sea of each State is measured.

2. Where the same continental shelf is adjacent to the territories of two adjacent States, the boundary of the continental shelf shall be determined by agreement between them. In the absence of agreement, and unless another boundary line is justified by special circumstances, the boundary shall be determined by application of the principle of equidistance from the nearest points of the baselines from which the breadth of the territorial sea of each State is measured.

3. In delimiting the boundaries of the continental shelf, any lines which are drawn in accordance with the principles set out in paragraphs 1 and 2 of this article should

According to UNCLOS, the outer border of the EEZ and the continental shelf may extend up to 200 nm from the baselines from which the breadth of the territorial sea is measured.[137] A State's continental shelf may be wider than 200 miles if its continental margin extends beyond 200 nm, although such extension may not be longer than 350 nm from the baselines or longer than 100 nm from the 2,500-meter isobaths.[138] States that claim an extended continental shelf shall submit relevant information and data to the CLCS.[139]

Article 2 of China's "Law on the Exclusive Economic Zone and the Continental Shelf" establishes a 200 nm limit of continental shelf and EEZ from the baselines.[140] The dash lines lays much closer to the coasts of other coastal States rather than China's coastal line. For example, in the Philippines situation, the nine-dash line is 50 nm far away from the island of Luzon and 30 nm away from the island of Palawan.[141] At its farthest point, the nine-dash line is 800 nm away from the Chinese mainland.[142] Therefore, China's claims extend beyond the entitlement under UNCLOS. The ICJ said: "no maritime delimitation between States with opposite and adjacent coasts may be affected unilaterally by one of those States."[143] As Tanaka put it: "maritime delimitation is international by nature."[144]

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be defined with reference to charts and geographical features as they exist at a particular date, and reference should be made to fixed permanent identifiable points on the land.

137 Art. 57 and 76(1), UNCLOS.

138 Art. 76(6), UNCLOS.

139 *See supra* note 2.

140 Zhiguo Gao and Bing Bing Jia, *supra* note 9, at 105 (citing to the "Law on the EEZ and the Continental Shelf of China" of June 26, 1998).

141 Emma Kingdon, *A Case for Arbitration: The Philippines' Solution for the South China Sea*, 38 B.C. INT'L & COMP. L. REV. 129, 157 (2015) (citing Audio tape: A Discussion on the Philippines' South China Sea Arbitration Case, held by the Center for Strategic & International Studies (Dec. 3, 2013), *available at* https://csis.org/multimedia/audio-discussion-philippines-south-china-sea-arbitration- case, *archived at* http://perma.cc/5XE7-SY35).

142 *Id.*

143 *Delimitation of the Maritime Boundary in the Gulf of Maine Area,* Judgment, 1984 I.C.J. Reports 299, para. 112.

144 YOSHIFUMI TANAKA, THE INTERNATIONAL LAW OF THE SEA 197 (2nd ed., Cambridge University Press, 2015).

Regardless of the issue surrounding whether insular features are islands or rocks, international tribunals gave less or even no effect to islands in maritime delimitations, on the ground that situation of the islands affected maritime delimitations disproportionally. In general, international tribunals avoided addressing the issue if an insular feature is an island or a rock. The following are some of the decisions reached by the ICJ and arbitral tribunals regarding maritime delimitation involving an island.

The Arbitral Tribunal in the Anglo-French maritime delimitation case applied a median line between the French and British mainland without taking into consideration the British Channel islands located in front of the French mainland and giving a 12 nm continental shelf area to the Channel Islands.[145]

In the Tunisia-Libya maritime delimitaiton case,[146] the Kerkennah Islands were given half effect, as was the Seal Island in the Gulf of Maine Case.[147] In the 1985 Libya-Malta maritime delimitaion case, the court stated that dependent islands would be given less effect than independent island States in maritime delimitation.[148]

In the 1992 Canada-France maritime delimitation case, the Arbitral Tribunal observed that with respect to "western seaward projection (of the French islands located in front of the Canadian mainland), it is unavoidable that any seaward extension of the French coasts beyond their territorial sea would cause some degree of encroachment and cut off the seaward projection towards the south from points located in the southern shore of Newfoundland (the

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[145] *Case concerning the Delimitation of the Continental Shelf between the United Kingdom of Great Britain and Northern Ireland, and the French Republic*, 18 REP. OF INT'L ARB. AWARDS 3, para. 202 (June 30, 1977), available at http://legal.un.org/riaa/cases/vol_XVIII/3-413.pdf.

[146] *Supra* note 47, para. 129.

[147] *Delimitation of the Maritime Boundary in the Gulf of Maine Area, supra* note 143, para. 222.

[148] *Continental Shelf (Libyan Arab Jamahiriya/ Malta),* Judgment, I.C.J. Reports 1985, para. 53 (June 3, 1985), available at http://www.icj-cij.org/docket/index.php?sum=353&p1=3&p2=3&case=68&p3=5.

Canadian coast)."[149] The French islands St. Pierre and Miquelon, located in front of the Canadian mainland, were given a 24 nm maritime area and a narrow 200 nm EEZ towards the high seas.[150]

In the Romania-Ukraine maritime delimitation case, the Ukrainian Serpents' Island was only entitled to a 12 nm territorial sea and the court did not take into account the Serpents in the maritime delimitation.[151] The status of Serpents as to whether it was a rock was not addressed or event taken into consideration by the ICJ because the Court said that any reliance on the Serpents would create a disproportionate effect in the delimitation line.[152]

V. CONCLUSION

All the above-mentioned islands in the delimitation cases satisfy the definition of an island under Article 121(1) of UNCLOS. Even so, they were not given a fully-fledged EEZ or continental shelf or sometimes they were given no EEZ or continental shelf. Since most of the features in the SCS are disputed as an island and since most of them are barely above water at high tide, they should not be taken into consideration in the maritime delimitation. Giving full effect to these features would affect the maritime delimitations disproportionally in the SCS. After the South China Sea Arbitration, in which the Tribunal decided most of the insular features are not island for the purposes of Article 121(3), even the equidistant/median line method may not be a defensible claim for China since most of the features will barely produce a territorial sea. Because the Chinese nine-dash line does not comply with UNCLOS nor prior and current decisions by the international tribunals, it is invalid under international law norms and should not be given any recognition or effect.

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[149] *Court of Arbitration for the Delimitation of Maritime Areas Between Canada and France: Decision in Case Concerning Delimitation of Maritime Areas (St. Pierre and Miquelon),* 31 *I.L.M.* 1145, para. 67 (Sept. 1992), http://www.jstor.org/stable/20693736.

[150] *Id.*

[151] Serpents' Island has a 0.17 km^2 land area. *Maritime Delimitation in the Black Sea (Romania* v. *Ukraine),* Judgment, *I.C.J.* Reports 2009, 61.

[152] *Id.* at 110.

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WE DON'T NEED NO EDUCATION[1] – IS THE U.S. AT RISK OF LOSING ITS CLEAR EDGE IN HIGHER EDUCATON?

*Ann M. Murphy**

[1] PINK FLOYD, ANOTHER BRICK IN THE WALL (Sony/Columbia 1987).

* Professor of Law, Gonzaga University School of Law. Professor Murphy expresses her profound gratitude to the Fulbright U.S. Scholar Program, U.S. Department of State, Bureau of Educational and Cultural Affairs. Through the generosity of this program, Professor Murphy taught law during the 2007-2008 academic year as a Fulbright Scholar in Beijing, PRC and during the 2014-2015 academic year as a Distinguished Chair, Fulbright Scholar in Shanghai, PRC. Special thanks to Zhou Jiali (law graduate of the Shanghai University of Finance and Economics and member of the Chinese bar), my Chinese research assistant, aide, and friend.

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I. INTRODUCTION

"My dream is to attend university in the United States!" These are words I heard countless times while teaching law as a Fulbright Scholar in China for two years. My initial reaction was that he or she must want to study, travel, and experience life in the United States (U.S.). I soon realized that my colleagues on the faculties of Chinese universities, students' parents, and nearly every educated Chinese person I spoke with yearned to study in the United States. Our system of higher education is a precious commodity that we must not squander. Education is not an area where one may rest on one's laurels. In the words of Bob Dylan, "that he not busy being born is busy dying"[2] – a country must move ahead in education or risk falling behind.

The U.S. is clearly a global leader in higher education, and it is essential that we maintain our edge, both for the benefit of American students and for the export of our educational system to international students. Most U.S. universities have discovered that Chinese students help their bottom line economically, but the true benefit is so much greater than just that. Currently, China has the world's largest economy and is home to one-fifth of the worldwide population.[3] Due to economic reforms in China over the past ten years, 203 million people are now included in their middle class. As a result, the demand for a world-class education has increased with the growth of this middle class.

II. CHINESE STUDENT ENROLMENT IN US UNIVERSITIES

Chinese students have been enrolling in higher education institutions of the United States in record numbers since 2010.[4] From

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[2] BOB DYLAN, IT'S ALRIGHT, MA (I'M ONLY BLEEDING) (Columbia 1965).

[3] Rakesh Kochhar, *Mapping the Global Population: How Many Live on How Much, and Where*, PEW RESEARCH CENTER (2015).

[4] *Open Doors Fact Sheet: China,* INST. OF INT'L EDUC., 2015, http://www.iie.org/Research-and-Publications/Open-Doors/Data/Fact-Sheets-by-Country/2015#.WBI53pMrLdc .; Glen M. Vogel, *A Study of the Language &*

2007 to 2015, there has been a 166 percent increase in the number of students from China studying in the U.S.[5] In 2015, Chinese students made up over 30 percent of the total international students enrolled in higher education institutions within the U.S.[6] Even the daughter of the President of China, Xi Mingze, attended and graduated from Harvard College in 2015.[7] In the past five years, applications to Boston University alone from Chinese students increased by a whopping 236 percent.[8] The University of Illinois (Urbana-Champaign) has the largest number of international students of any public higher education institution in the U.S., and "nearly 5,000 of whom are Chinese."[9] There has also been a "remarkable growth of foreign attorneys enrolled at U.S. law schools and particularly in LL.M. programs."[10]

Previously, Chinese students "tended to be graduate students living on tight budgets,"[11] but recently the number of undergraduate students has surged, and now there are more undergraduate Chinese students than graduate Chinese students.[12] Although many of these

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Cultural Challenges Facing Business & Legal Studies Faculty in the Ever-Expanding Global Classroom, 13 J. INT'L BUS. & L. 127, 129 (2014).

[5] *Id.*

[6] *Open Doors Data: International Students: Leading Places of Origin*, INST. OF INT'L EDUC., 2015 http://www.iie.org/Research-and-Publications/Open-Doors/Data/International-Students/By-Academic-Level-and-Place-of-Origin/2014-15.

[7] Evan Osnos, *What Did China's First Daughter Find in America?*, THE NEW YORKER, Apr. 6, 2015 (Magazine), http://www.newyorker.com/news/news-desk/what-did-chinas-first-daughter-find-in-america.

[8] Laura Krantz, *Number of Foreign College Students in Boston Surges*, THE BOSTON GLOBE, Nov. 17, 2015, https://www.bostonglobe.com/metro/2015/11/16/number-foreign-students-boston-surges/0rrwqyAoHbSjn6f7chxxMI/story.html.

[9] Sarah Svoboda, *Why Do So Many Chinese Students Choose US Universities?,* BBC NEWS, June 2, 2015, http://www.bbc.com/news/business-32969291.

[10] Lmindie Lazarus-Black & Julie Globokar, *Foreign Attorneys in U.S. LL.M. Programs: Who's In, Who's Out, and Who They Are,* 22 IND. J. GLOBAL LEGAL STUD. 3, 5 (2015).

[11] Matt Schiavenza, *The Tenuous Relationship between American Universities and Chinese Students*, THE ATLANTIC, May 30, 2015 (Magazine), http://www.theatlantic.com/education/archive/2015/05/american-universities-are-addicted-to-chinese-students/394517/.

[12] *Open Doors Data: International Students: Academic Level and Place of Origin*, INSTITUTE OF INTERNATIONAL EDUCATION, http://www.iie.org/Research-and-Publications/Open-Doors/Data/International-Students/By-Academic-Level-and-

students are from affluent families who own Lamborghinis and flashy clothes,[13] a growing number are from lower middle-class families.[14] The number of international students has grown so dramatically that the University of California Regents voted "to cap the number of out-of-state and international students at UCLA and UC Berkeley at their current levels – about 30%."[15] The number of out-of-state and international students has become so high that two California legislators introduced Assembly Bill No. 1711 to the California legislature on January 26, 2016; if passed, this bill will "limit the percentage of undergraduate nonresident students enrolled at the University of California system-wide to 15.5% of total undergraduate student enrollment."[16] Similar measures have been enacted in Iowa and Washington.[17] Although in the past students from China were enrolling in post-graduate education, now Chinese students are applying to attend U.S. high schools and even primary schools."[18]

Place-of-Origin/2014-15. ; *Chinese Enrollment in the US Shifting Increasingly to Undergraduate Studies,* INTERNATIONAL CONSULTANTS FOR EDUCATION AND FAIRS (ICEF) MONITOR , May 27, 2015, http://monitor.icef.com/2015/05/chinese-enrolment-in-the-us-shifting-increasingly-to-undergraduate-studies/ ("Data reveals that the flow of Chinese students into US undergraduate programmes is speeding up at the same time as demand for American graduate programmes (the historic core of Chinese enrolment in the US) has been slowing.")

[13] *See* Christopher Beam, *Children of the Yuan Percent: Everyone Hates China's Rich Kids*, BLOOMBERG BUS., Sept. 30, 2015, http://www.bloomberg.com/news/features/2015-10-01/children-of-the-yuan-percent-everyone-hates-china-s-rich-kids. (The young, fabulously wealthy second-generation rich Chinese are referred to as *feurdai*).

[14] Frank Shyong, *Not Only China's Wealthy Want to Study in America*, THE L.A. TIMES, Dec. 28, 2015, http://www.latimes.com/local/california/la-me-chinese-students-20151228-story.html.

[15] *Id.*

[16] University of California: Nonresident Student E, Cal. S. AB-1711 (2016), http://leginfo.legislature.ca.gov/faces/billTextClient.xhtml?bill_id=201520160AB1711.

[17] Miriam Jordan, *International Students Stream into U.S. Colleges,* THE WALL ST. J., Mar. 24, 2015, http://www.wsj.com/articles/international-students-stream-into-u-s-colleges-1427248801.

[18] Miriam Jordan, *U.S. Schools Draw More Chinese*, THE WALL ST. J , Dec. 17, 2015, http://www.wsj.com/articles/u-s-schools-draw-more-chinese-1450400223.

The top six states with foreign students are California, New York, Texas, Massachusetts, Illinois, and Pennsylvania.[19]

There are a number of reasons for this rapid increase in the number of Chinese students attending U.S. universities. The United States is considered to have the best higher education institutions in the world. Of the several published best university rankings in the world, each of them shows the U.S.'s dominance over the rankings. The U.S. News and World Report rankings published near the end of 2015 rates eight U.S. universities in the top ten of universities worldwide.[20] Of the top 100 universities, the U.S. houses 53.[21] The Times Higher Education World University Rankings for 2015-2016 lists the U.S. as having 39 of the top 100, and six of the top ten higher education institutions.[22] The Center for World University Rankings for 2015 lists the U.S. as having eight of the top ten institutions and 54 of the top 100 universities.[23] The CS World University Rankings for 2015/16 shows U.S. universities as six of the top ten and 30 of the top 100 institutions in the world.[24] Clearly, the United States is the global leader in higher education.

Conversely, Chinese universities are ranked relatively lower in global rankings of universities according to the above-referenced rankings. The U.S. News and World Report rankings include three Chinese universities in the top 100 global university rankings, where Peking University is tied for #41, Tsinghua University is #59, and Fudan University at #96.[25] The Times Higher Education World University rankings show two Chinese universities in the top 100:

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[19] Krantz, *supra* note 9.

[20] *Best Global Universities Rankings 2017*, U.S. NEWS & WORLD REPORT, http://www.usnews.com/education/best-global-universities/rankings.

[21] *Id.*

[22] World University Rankings 2015-2016, THE TIMES HIGHER EDUCATION, https://www.timeshighereducation.com/world-university-rankings/2016/world-ranking#!/page/0/length/25.

[23] *CWUR 2015: World University Rankings*, CENTER FOR WORLD UNIVERSITY RANKINGS (CWUR), http://cwur.org/2015/.

[24] QS World University Rankings 2015/16, QS TOP UNIVERSITIES, http://www.topuniversities.com/university-rankings/world-university-rankings/2015#sorting=rank+region=+country=+faculty=+stars=false+search=.

[25] U.S. NEWS & WORLD REPORT *supra* note 21.

Peking University at #42 and Tsinghua University at #47.[26] The Center for World University Rankings lists two Chinese universities, Peking University at #56 and Tsinghua University at #78.[27] Finally, QS World University Rankings include four Chinese universities in its top 100 with Tsinghua University at #25, Peking University at #41, Fudan University at #51, and Shanghai Jiao Tong University at #70.[28]

The rankings are certainly uppermost in the minds of Chinese students and their parents,[29] but Chinese students are interested in U.S. universities for more reasons than the prestige of the top universities.[30] "The ambitions of Chinese students are shifting. No longer are they attracted just by the glittering names. Pursuit of education abroad is becoming an end in itself."[31] The growing Chinese middle class prefers a "well-rated university overseas to a second-tier option at home." As noted above, only Peking University and Tsinghua University are ranked in the world top 100. These two schools have room for only 6,000 new students a year.[32] That is one-twentieth of one percent of the Chinese college entrance exam takers.[33]

Chinese students and their parents are also attracted to American methods of teaching. In the U.S., students are encouraged to be curious, which is generally not true of Chinese higher

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[26] THE TIMES HIGHER EDUCATION, *supra* note 23.

[27] CENTER FOR WORLD UNIVERSITY RANKINGS (CWUR), *supra* note 24.

[28] QS TOP UNIVERSITIES*, supra* note 25.

[29] TEA LEAF NATION STAFF, *For Chinese Students in America, a Transformative Journey*, FOREIGH POLICY, Dec. 9, 2015, http://foreignpolicy.com/2015/12/09/for-chinese-students-in-america-a-transformative-journey-fp-survey-exclusive-results/, ("Respondents overwhelmingly said they were drawn by the quality of American education, with over 77 percent listing it as their primary reason for studying abroad.")

[30] *Georgia on their Minds*, THE ECONOMIST, China ed., Feb.21, 2015 (Magazine).

[31] *Id.*

[32] Doug Bandow, *Transforming China from Within: Chinese Students Head to American Universities*, FORBES, Sept. 22, 2014, http://www.forbes.com/sites/dougbandow/2014/09/22/transforming-china-from-within-chinese-students-head-to-american-universities/#339da382918f.

[33] *Id.*

education.[34] Many Chinese find their higher education system "too rigid and ideologically stifling."[35] There is a great difference between the American style of critical thinking (particularly in law school) versus the Chinese style of rote memorization.[36] "In China, people often humorously compare the traditional method of conveying information to a student to "feeding a duck': you feed it, and feed it, and feed it until the duck is full, and then you're done."[37] Chinese students and their parents find that study abroad "is more student-centered and individualized."[38] Some residents of China believe the education in China, which rewards rote-style learning, stifles students' creativity and critical thinking abilities.[39]

One important difference between the U.S. and Chinese higher education systems is the flexibility of choice in the U.S. The American education system gives students the freedom to choose their field of study.[40] My students in China were astounded by the fact that my son changed his major four times in college. In China, a student's test score determines his or her field of study.[41] In fact, only the highest scoring students are able to study lucrative majors such as finance and economics.[42] According to one student, "Chinese education makes you memorize a lot of things but don't let [sic] you have your opinion to exercise your mind." Indeed, the U.S. education

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[34] Janet Eom, *The Eagle, the Dragon, and the "Excellent Sheep,"* FOREIGN POLICY, Oct. 20, 2015, http://foreignpolicy.com/2015/10/20/china-us-america-education-ivy-league-college-testing-innovation/.

[35] *Georgia on their Minds, supra* note 31.

[36] Erin Ryan, Xin Shuai, Yuan Ye, You Ran, Li Haomei, *When Socrates Meets Confucius: Teaching Creative and Critical Thinking Across Cultures Through Multilevel Socratic Method*, 92 NEB. L. REV. 289 (2013); TEA LEAF NATION STAFF*, supra* note 30.

[37] Ryan, at 307.

[38] Andrew Ross, *How the Children of China's Elite Learned to (By)pass the Gaokao,* CHINA ECON. REV., July 11, 2015, http://www.chinaeconomicreview.com /how-children-chinas-elite-learned-bypass-gaokao.

[39] Duncan Hewitt, *Fraud Rings, Drone Surveillance and Extra Police – It's China's 'Killer' University Exams,* INT'L BUS. TIMES, June 9, 2015, http://www.ibtimes.com/fraud-rings-drone-surveillance-extra-police-its-chinas-killer-university-exams-1957897.

[40] Svoboda*, supra* note 10.

[41] *Id.*

[42] Janet Eom, *supra* note 33.

system has been described as offering "the freedom to be indecisive and the ability to change your mind."[43]

The price of a U.S. university education far exceeds the price of a Chinese education.[44] In China, Tsinghua University charges 40,000 CNY (Chinese Yuan Renminbi), or $6,140 USD, while Fudan University charges 25,000 CNY, or $3,838, for tuition.[45] On the other hand, an international student is charged $45,000 per year for tuition at Harvard College and anywhere between $32,096 and $41,376 for tuition at the University of Illinois.[46] Additionally, most Chinese students are ineligible for federal financial aid.[47] Nevertheless, "Chinese parents see American education as the most valuable of commodities and are willing to make sacrifices to get it."[48] A sacrifice it is. The tuition is "the equivalent of nearly ten times the average annual disposable income of urban households" in China.[49] In somewhat of a win-win situation for U.S. universities and Chinese students, "foreign students have become crucial to many public universities" because the universities may charge these students full tuition.[50] The Greater Boston Convention & Visitors Bureau President referred to this as "a Super Bowl of education spending."[51]

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[43] Shyong, *supra* note 15.

[44] *Tuition Fee Less than $4,000 in Top 100 China Universities: Most Affordable China Universities*, CHINA'S UNIVERSITY AND COLLEGE ADMISSION SYSTEM (CUCAS), http://news.cucas.edu.cn/Admission_Express/Tuition-fee-less-than—4,000-in-Top-100-China-Universities%EF%BC%9AMost-Affordable-China-Universities-_2644.html.

[45] *Id.*

[46] *Tuition and Expenses*, HARVARD COLLEGE: HARVARD UNIVERSITY, https://college.harvard.edu/financial-aid/how-aid-works/cost-attendance; *Tuition*, UNIVERSITY OF ILLINOIS: ADMISSIONS, https://admissions.illinois.edu/Invest/tuition.

[47] TEA LEAF NATION STAFF, *The Most Chinese Schools in America*, Foreign Policy, Jan. 4, 2016, http://foreignpolicy.com/2016/01/04/the-most-chinese-schools-in-america-rankings-data-education-china-u/.

[48] *U.S. Schools Draw More Chinese, supra* note 19.

[49] *Chinese Enrollment in the US Shifting Increasingly to Undergraduate Studies*, *supra* note 13.

[50] *International Students Stream into U.S. Colleges, supra*, note 18.

[51] Laura Krantz, *For Some Foreign Students, a Driving Passion for Luxury,* THE BOSTON GLOBE, Oct. 10, 2015, https://www.bostonglobe.com/metro/2015/10/10/for-some-foreign-students-driving-passion-for-luxury/eYkBwYnXa4ZRDmT2s3mhUO/story.html.

In a move that bucks the recent trend of limiting the number of international students, lawmakers in Colorado "passed a law in 2010 that exempts state colleges from a 45% cap on out-of-state students."[52]

III. THE TROUBLE WITH CHINESE EDUCATION

A. Chinese Entrance Exam – the *Gaokao*

There is only one road to a university education in China – a certain passing score on the *gaokao*, the National College Entrance Exam (NCEE).[53] "Unlike in the U.S., no amount of community service, interview prep, or athletic heroics will help you get into a top school."[54] A high score on the *gaokao* means entry into a prestigious university with an expected lucrative major.[55] The Chinese Ministry of Education sets two "cutoff" points.[56] There is a higher cutoff point for prestigious universities and a lower cutoff point for general university admission.[57] Additionally, students' *gaokao* score determine their major.[58] The Chinese entrance exam is referred to as "the SAT on steroids."[59] The top scorers on the *gaokao* are referred to as the

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[52] *International Students Stream into U.S. Colleges, supra* note 18.

[53] Tessa Wong, *China's Gaokao: High Stakes for National Exam*, BBC NEWS, June 9, 2015., http://www.bbc.com/news/world-asia-china-33059635.

[54] Yuling Yang, *Take the Test to Get into China's Top Universities*, BLOOMBERG NEWS, June 2, 2015, http://www.bloomberg.com/news/articles/2015-06-02/take-the-test-to-get-into-china-s-top-universities.

[55] Vogel, *supra* note 5.

[56] Amy Burkhoff, "*One Exam Determines One's Life": The 2014 Reforms to the Chinese National College Entrance Exam*, 38 FORDHAM INT'L L.J. 1473 (2015).

[57] *Id.*

[58] Terry Crawford, *What Students in China Have Taught Me About U.S. College Admissions*, THE ATLANTIC, Jan. 6, 2015 (Magazine), http://www.theatlantic.com/education/archive/2015/01/what-students-in-china-have-taught-me-about-us-college-admissions/384212/.

[59] Yang, *supra* note 55.

zhuangyuan, or principal graduate, and "often become brief media darlings."[60]

The *gaokao* was first administered in 1952. The exam is loosely based on the imperial exam system that was used to reward merit rather than birthright for job opportunities as government officials from 1644 to 1911.[61] Between 1911 and 1949, universities had their own individual tests for admission.[62] This system was replaced by a uniform exam given across the country (the test does vary by province). The exam was seen as a way to "countervail nepotism and inherited wealth."[63] The use of the *gaokao* was suspended from 1966 through 1976 during the Great Proletarian Cultural Revolution, commonly known as the Cultural Revolution.[64] In fact, during the Cultural Revolution, schools and universities were closed from 1966 through the beginning of 1970.[65] When schools reopened, "revolutionary purity" was the basis of college admissions from 1970 until 1973.[66]

The Cultural Revolution ended in 1976 with the death of Chairman Mao Zedong, China's supreme leader, and the arrest of the

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[60] *See* Yifu Dong, *China's Cutthroat Academic Competition is Ruining a generation of Youth,* FOREIGN POLICY, June 30, 2015, http://foreignpolicy.com/2015/06/30/in-chinas-cutthroat-academic-competition-ruining-generation-of-youth-gaokao-wealth-power/ ; *see also, Girls Outperform Boys among Gaokao Top Scorers,* PEOPLE'S DAILY, July 1, 2015, http://en.people.cn/n/2015/0701/c90782-8914129.html (Interestingly, women are more often the *zhuangyuan* in the regions of China).

[61] Edward Wong, *Test That Can Determine the Course of Life in China Gets a Closer Examination*, N.Y. TIMES, June 30, 2012, http://www.nytimes.com/2012/07/01/world/asia/burden-of-chinas-college-entrance-test-sets-off-wide-debate.html ; Luo Wangshu, *History in the Making: the Classes of 1977, 1978 and 1979,* CHINA DAILY, Mar. 31, 2015. http://usa.chinadaily.com.cn/epaper/2015-03/31/content_19963835.htm; Crawford*, supra* note 59 ("The practice of using exams to locate talent and distribute scarce educational opportunities began as early as 650 AD.")

[62] Wangshu, *supra* note 62.

[63] *Dong, supra* note 61.

[64] *Id.*

[65] Stephanie Lamb, *Introduction to the Cultural Revolution* (adapted from Jonathan Spence, THE SEARCH FOR MODERN CHINA,(2001)), *S*PICE DIGEST, (2007), http://spice.fsi.stanford.edu/sites/default/files/CRintro.pdf.

[66] *Id.*

"Gang of Four."[67] When the *gaokao* was first reinstated, 5.7 million students took the exam and only 278,000 were placed in universities, constituting a placement rate of approximately one half of one percent of all those who took the exam.[68] Opportunities improved slightly by 1984, when 1.6 million students took the exam and 430,000 won spots in Chinese universities, an increased chance of nearly three percent.[69] By 2011, the Chinese higher education system had grown so substantially that one's chance of being accepted to a higher education institution increased to nearly 69 percent.[70] Today, a Chinese student's chances are greatly improved. China now has approximately 1,145 universities.[71] In June of 2015, 9.42 million students took the *gaokao*, a number close to the entire population of the state of Michigan.[72] During the same year, 7.5 million students graduated from Chinese colleges. Although data is not available for the percentage of those taking the *gaokao* who were admitted to Chinese universities, it currently appears to be close to 80 percent, quite a change from the 1970's. Nevertheless, the chance of being admitted to a top-100 globally ranked university in China is still extremely slim. One must also keep in mind that for those who do not pass the *gaokao*, a university education in China is impossible and the individual is essentially relegated to a low-income job.[73] There is a

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[67] Paul L. Barresi, *The Chinese Legal Tradition as a Cultural Constraint on the Westernization of Chinese Environmental Law and Policy: Toward a Chinese Environmental Law and Policy Regime with More Chinese Characteristics*, 30 PACE ENVTL. L. REV. 1156, 1193 (2013).

[68] Jeffery Hays, *The Gaokao: the Chinese University Entrance Exam*, FACTS AND DETAILS, 2008, http://factsanddetails.com/china/cat13/sub82/item1649.html.

[69] *Id.*

[70] Vogel, *supra* note 5, at 137.

[71] Embassy of Switzerland in China, *Research and Higher Education in China* (Jan. 27, 2015), http://www.swissnexchina.org/wp-content/uploads/sites/4/2014/07/Higher-Education-in-China-2014.pdf.

[72] Xinhua, *9.42m to Sit for College Entrance Exam*, CHINA DAILY, June 6, 2015. http://www.chinadailyasia.com/nation/2015-06/07/content_15273341.html.

[73] *Vogel*, *supra* note 5, at 138.

lot at stake. Moreover, Chinese teenagers' chances of university education depend upon where they reside in China.[74]

B. The Chinese Registration System – the *Hukou*

A major barrier to higher education in China is the *hukou,* the country's registration system.[75] "Chinese students from rural China are at a great disadvantage compared to their urban counterparts when taking the *gaokao* and have lower chances of gaining admission to top tier universities."[76] The *hukou* system began in 1958 and was designed to ensure the country's agricultural system.[77] Prior to the *hukou* system, China experienced a large influx of rural peasants to the cities.[78] Officials were fearful that the mass migration could destabilize the relatively new system of government.[79] The *hukou* system was borrowed from the Soviet Union, which had a "model of rapid industrialization, political organization, and legal institutions."[80] Under the system, every citizen in China "inherits a household registration at birth, which may be altered only under very limited exceptions."[81] From 1958 until the late 1970's, rural to urban migration was "essentially halted."[82] Beginning in the late 1970's, the ban on migration was eased.[83]

During the 1980's, 1990's, and early 2000's, approximately 140 million Chinese citizens migrated from rural villages and towns to cities.[84] Despite their new homes, they are not entitled to public

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[74] Yiqian Fu, *China's Unfair College Admissions System*, The Atlantic, June 19, 2013, (Magazine), http://www.theatlantic.com/china/archive/2013/06/chinas-unfair-college-admissions-system/276995/.

[75] Yang, *supra* note 55, at p. 1499.

[76] *Id.* at 1476.

[77] *Id.* at 1478.

[78] Margaret Y.K. Woo, Christopher Day, & Joel Hugenberger, *Migrant Access to Civil Justice in Beijing,* 4 LOY. U. CHI. INT'L L. REV. 167, 173-174. (2007).

[79] *Id.*

[80] Hilary K. Josephs, *Residence and Nationality as Determinants of Status in Modern China*, 46 TEX. INT'L L.J. 295 (2011).

[81] *Id.* at 297.

[82] Woo*, supra* note 77, at 174.

[83] *Id.*

[84] *Id.*at 167.

services available to urban residents.[85] They are treated as second-class citizens and are referred to as *liudong renkou*, or the "floating population."[86] Though millions of workers have migrated to larger cities for jobs,[87] children of migrant workers must return to their home provinces to take the university entrance exam.[88] Due to a quota system, it is much easier for a student who has a Beijing or Shanghai *hukou* to attend the universities considered the best in China.[89] The two top ranking Chinese universities, Peking University and Tsinghua, both located in Beijing, admit Beijing resident students at a much higher rate than students from other provinces.[90] The score required by a Beijing-based test-taker may be much lower than the qualifying score for a rural test-taker.[91] The top two universities admitted an average of 84 students out of every 10,000 Beijingers and two out of every 10,000 from the Guangdong province in 2014.[92] Due to the *hukou* system, "an examinee from wealthy Beijing or

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[85] Andrew Scheineson, *China's Internal Migrants*, COUNCIL ON FOREIGN RELATIONS, May 14, 2009, http://www.cfr.org/china/chinas-internal-migrants/p12943.

[86] *Id.*; Matt Sheehan, *13 Million People in China Don't Have the Document that Would Guarantee Them Rights*, THE HUFFINGTON POST: THE WORLD POST, Dec. 10, 2015, http://www.huffingtonpost.com/entry/china-undocumented-residents_us_56692ca3e4b080eddf570d99.

[87] Huaxia, ed., *China to Orderly Urbanize Migrant Workers: Premier Li,* XINHUA, Feb. 1, 2016 (By 2014, China estimated its number of migrant workers at approximately 274 million, or 20 percent of China's population).

[88] Fu, *supra* note 75.

[89] Id.; Wong, *supra* note 62.

[90] Fu, *supra* note 73.

[91] *Id.*; Indeed, a widely circulated joke on Weibo (a microblogging network, referred to as the Twitter of the East) is the following:
In Beijing: "Dad, I got a 530 [on the *gaokao*], 50 points higher than the lowest qualifying score for top-tier universities!" "Great job, son! Let's go to Shanghai for our vacation!"
In Shandong: "Dad, I got a 530, 20 points lower than the lowest qualifying score for second-tier universities!" "You're not so bright…Don't go [to college]. Get out of here and go become a migrant worker in Shanghai."
In Shanghai: "Dad, I got a 330. Send me abroad." "Okay, son. Go get an MBA, then come back and help me. I got another group of migrant workers from Shandong this year."

[92] *Id.*

Shanghai may gain admission to elite education with a lower score than someone from impoverished Anhui."[93]

China has announced that it plans to change the *hukou* system in order to "promote greater equality between urban residents and migrant workers and their children."[94] On February 1, 2016, Chinese Premier Li Keqiang stated that the government would improve the permit system.[95] In the meantime, an increasing number of Chinese students are opting out of the *gaokao* and instead taking the American SAT, the U.S. standard test for college admission.[96]

IV. THE US ENTRANCE EXAM – THE SAT

The precise number of Chinese students who have taken the SAT is unknown, although the College Board, the non-profit agency that owns the exam, indicated it will publish the number in the future.[97] One online test preparation company estimates that 55,000 Chinese took the SAT in 2014.[98] It is known that overseas registrants for the SAT have increased dramatically since 2009.[99] The number of registrants from "East Asia and Pacific" has increased by 76 percent in just the past five years.[100] This trend may not continue. The SAT exam has been recently revised and the changes are viewed as

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[93] Josephs, *supra* note 81 at 303.

[94] Burkoff, *supra* note 57 at 1479.

[95] Huaxia, ed*., supra* note 88.

[96] EL Borromeo, *Over 9 Million Chinese Students Take National College Entrance Exam,* YIBADA, June 9, 2015, http://en.yibada.com/articles/37346/20150609/over-9-million-chinese-students-take-national-college-entrance-exam.htm.

[97] Nick Anderson, *How Many Chinese Take the SAT Every Year? We May Soon Learn*, THE WASH. POST, Oct. 31, 2014, https://www.washingtonpost.com/local/education/how-many-chinese-take-the-sat-every-year-we-may-soon-learn/2014/10/31/7ba6b35a-6124-11e4-9f3a-7e28799e0549_story.html.

[98] Alexa Olesen, *China's Hot New Luxury Product: the SAT*, FOREIGN POLICY, June 8, 2015, http://foreignpolicy.com/2015/06/08/chinas-hot-new-luxury-product-the-sat-scholastic-aptitude-test/.

[99] Te-Ping Chen and Abby Schultz, *Cheating Concerns in Asia Cloud SAT Testing*, THE WALL ST. J., June 5, 2015, http://www.wsj.com/articles/cheating-concerns-in-asia-cloud-sat-testing-1433549895.

[100] *Id.*

disadvantageous to Chinese students.[101] The new SAT includes more reading passages, passages from US founding documents, no mandatory writing section, and "wordier math problems."[102] Interestingly, China's new official China News Agency criticized the change in the SAT due to "worries [that] the materials may impose the American values system on students."[103] A Chinese student may opt to take the ACT instead of the SAT, as American universities accept students based on ACT scores as well. A very small number of U.S. universities accept scores on the *gaokao* in lieu of the SAT or ACT.[104]

The record number of foreign students taking admission exams to gain entry to U.S. universities has unfortunately resulted in increased cheating on these entrance exams. On May 21, 2015, a federal grand jury in Pittsburgh, Pennsylvania indicted fifteen Chinese nationals on charges of conspiracy, counterfeiting foreign passports, mail fraud, and wire fraud by having imposters take college and graduate school standardized entrance examinations.[105] The United

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[101] Zhao Xinying, *Students Urged to Seek SAT Alternatives*, CHINA DAILY, Feb. 23, 2016, http://www.chinadaily.com.cn/china/2016-02/23/content_23601140.htm.

[102] *Id.*; Amy He, *Overhauled SAT Exam May Pose Hurdles for Chinese*, CHINA DAILY, Feb. 23, 2016, http://www.chinadaily.com.cn/world/2016-02/23/content_23598053.htm.

[103] Tommy Yang, *China Complains SAT may impose American Values on its Best Students,* THE L.A. TIMES, Aug. 30, 2014, http://www.latimes.com/world/asia/la-fg-sat-exam-american-values-chinese-students-20140829-story.html.

[104] Abby Schultz, *U.S. Colleges Put China's Gaokao to the Test*, BARRONS, Oct. 30, 2015, http://www.barrons.com/articles/u-s-colleges-put-chinas-gaokao-to-the-test-1446188818, (These universities are reportedly Suffolk University, St. Thomas University, The University of San Francisco (pilot program) and the Illinois Institute of Technology.) ; Elizabeth Redden, *Giving 'Gaokao' a Go*, INSIDE HIGHER ED, May 20, 2015, https://www.insidehighered.com/news/2015/05/20/u-san-francisco-gives-gaokao-based-admissions-try-china; Amy He, *Gaokao Exam Looks for Wider Acceptance*, CHINA DAILY, June 5, 2015, http://usa.chinadaily.com.cn/china/2015-06/05/content_20923416.htm.

[105] Press Release, *Fifteen Chinese Nationals Charged in Fraud Scheme*, U.S. DEPT. OF JUSTICE, Office of Public Affairs (May 28, 2015). https://www.justice.gov/opa/pr/fifteen-chinese-nationals-charged-fraud-scheme.

States Attorney in the Western District indicated that he "believed the issue extended beyond the 15 people charged."[106]

In 2015, the College Board, which administers the SAT "delayed thousands of scores in Asia."[107] The College Board cancelled the SAT exam in five countries, including 43 sites in China in January 2016.[108] Previously, Chinese students needed to travel to Hong Kong to take the SAT,[109] but in August of 2012, the test was made available to Chinese students who attended one university prep school in mainland China.[110] Currently, the SAT is offered at "select international schools" in China.[111] The exam was cancelled however in January of 2016 because some students "may have already seen copies of the tests."[112] A magazine based in Beijing demonstrated in an article from September of 2015 just how easy it is to cheat on the SAT in China.[113]

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[106] Jess Bidgood, *15 Chinese Accused of Using Test-Taking Impostors for College Entrance Examinations*, N.Y. Times, May 28, 2015, http://www.nytimes.com/2015/05/29/us/15-chinese-accused-of-using-test-taking-impostors-for-college-entrance-exams.html.

[107] Chen, *supra* note 100.

[108] Abby Schultz, *SAT Integrity Falls Victim to China Cheating Scandal*, BARRON'S, Jan. 25, 2016, http://www.barrons.com/articles/sat-integrity-falls-victim-to-china-cheating-scandal-1453713163.

[109] Ernest Kao, *Thousands of Mainland Students Flock to Hong Kong for SAT Exams*, SOUTH CHINA MORNING POST, Dec. 4, 2012, http://www.scmp.com/news/china/article/1096372/thousands-mainland-students-flock-hong-kong-sat-exams.

[110] Mike Liberty, *Summer SAT Administration Now Available to Chinese Students*, BUSINESS WIRE, Apr. 15, 2012, http://www.businesswire.com/news/home/20120415005096/en/Summer-SAT-Administration-Chinese-Students.

[111] Te-Ping Chen & Abby Schultz, *Battle to Thwart SAT Cheating in Asia Continues*, THE WALL ST. J., June 7, 2015, http://blogs.wsj.com/chinarealtime/2015/06/07/battle-to-thwart-sat-cheating-in-asia-continues/.

[112] Joe Mandak, *College Board Cancels SATs in China Over Cheating Concerns*, US News and World Report, Jan. 22, 2016, http://www.usnews.com/news/us/articles/2016-01-21/sat-tests-canceled-in-china-macau-over-cheating-concerns.

[113] An Ran & Qian Wei, *Put to the Test*, NEWSCHINA MAGAZINE, Sept. 2015, http://old.newschinamag.com/magazine/put-to-the-test.

V. FIERCE COMPETITION PROMOTES UNETHICAL MEASURES

It is not surprising that, given the importance of exams, and the fact that "one exam determines one's life," unethical tactics abound.[114] Moreover, there is a perception that "the system is rigged."[115] Students and schools are "getting a lot of community and parental pressure" for students to attend a top-ranked school.[116] Application materials to U.S. universities may be forged and falsified. By one estimate, "90 percent of Chinese applicants submit fake recommendations, 70 percent have other people write their essays, 50 percent have forged high school transcripts, and 10 percent list academic awards and other achievements they did not receive."[117] Undoubtedly, these estimates are high, but "when Chinese students are taught by their parents, teachers, and governmental officials to cheat in order to succeed on the *gaokao* and their admissions endeavors in their homeland, it is not surprising that the dishonesty would spill over to their efforts to get accepted into an American college or university."[118]

Universities in the U.S. are taking notice. At the 2015 Overseas Association for College Admission Counseling (OACAC) conference, the participants discussed the problems, the reasons, and the need "to make [the application process] safe for honest applicants."[119] One of the main reasons for the unethical conduct is the use of agencies to assist in the application process. There are over 400 educational consulting firms that are certified by the Chinese Ministry of Education and thousands more that are unlicensed.[120]

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[114] Vogel, *supra* note 5; Nicola Davison, *Revealed: The Extreme Revision Measures Taken by Chinese University Hopefuls*, THE TELEGRAPH, Aug. 15, 2015, http://www.telegraph.co.uk/education/11794171/Revealed-the-extreme-revision-measures-taken-by-Chinese-university-hopefuls.html.

[115] Elizabeth Redden, *In China, No Choice But to Cheat?*, INSIDE HIGHER ED, July 9, 2015, https://www.insidehighered.com/news/2015/07/09/admissions-process-broken-chinese-students.

[116] *Id.*

[117] Vogel, *supra* note 5; Schiavenza, *supra* note 12.

[118] Vogel, supra note 5 at 139.

[119] *In China, No Choice But to Cheat?*, *supra* note 116.

[120] Shen Lu and Katie Hunt, *Fraud Frenzy? Chinese Seek U.S. College Admission at any Price,* CNN, July 14, 2015, http://www.cnn.com/2015/07/12/asia/china-education-agencies/.

These agencies often promise to help a student gain acceptance to a Top-50 U.S. university, and may be paid partially on a success basis, increasing the incentive to falsify applications.[121] One prominent agent estimated that one half of the transcripts were "doctored" to make the candidate more competitive.[122] In one instance, ten different applicants from the same school claimed to be the top student in the class.[123] It is no small wonder that honest students believe they are unable to compete with students who use agents. One student interviewed stated, "I did feel slightly guilty but all my friends did the same thing."[124]

Another reason for unethical behavior is that there is virtually no punishment if one is caught cheating on U.S. exams or on their application materials. One participant at the OACAC Conference stated "it blows my mind that students who cheat on the SAT get to take the test again – why aren't they outed to all of your schools?"[125] In China, students "face expulsion and even jail time for cheating on their country's rigorous college entrance exam."[126] However, there is essentially no price to pay if one is caught cheating on the SAT.[127]

Finally, the entire U.S. university application process is perplexing for Chinese citizens. In a country that sees test scores as the only way to get ahead ("in rural China a top *gaokao* score can lift the fortune of an entire family, promising a life beyond the fields for generations to come"),[128] the listing of extracurricular activities is

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121 Crawford, *supra* note 59.

122 *Id.*

123 Stephanie Yang, *The Unbelievable Things Some Chinese Students are Doing to Get into US Colleges,* BUS. INSIDER, Feb. 27, 2015, http://www.businessinsider.com/chinese-students-go-to-crazy-lengths-in-us-university-applications-2015-2.

124 Johan Nylander, *How Chinese Students are 'Cheating' to Get into U.S. Universities,* FORBES, July 13, 2015, http://www.forbes.com/sites/jnylander/2015/07/13/how-chinese-students-are-cheating-to-get-into-u-s-universities/#14375e6d1573.

125 *In China, No Choice But to Cheat*?, *supra* note 116.

126 Laura Krantz and Jessica Myers, *Fight to Find Cheats Takes Schools Around the World,* THE BOSTON GLOBE, Jan. 16, 2016, https://www.bostonglobe.com/metro/2016/01/19/chinese-students-hungry-attend-universities-caught-fraudulent-application-process/gpRB06mqBVAsxZ6eAbFKCJ/story.html.

127 Davison, *supra* note 115.

128 Nicola Davidson, *Revealed: The Extreme Revision Measures Taken by Chinese University Hopefuls*, The Telegraph, August 15, 2015, http://www.telegraph.

quite foreign. Also, many times the students' teachers are not sufficiently proficient in English to write letters of recommendations.[129] Further, Chinese students are not particularly familiar or comfortable with admission essays.[130] If a family has the financial means, of course they consult these "expert" agencies.

The falsification of application material hurts both potential students and students who do in fact "make it" to U.S. universities. In the period between 2012 and 2015, U.S. universities expelled 8,000 Chinese students due to low grades and cheating.[131] Schools in the U.S. have recently begun to verify information through U.S. agencies and Skype interviews with students to combat the fraudulent applications.[132] American universities must ensure Chinese candidates are submitting accurate application materials in order to maintain the integrity of U.S. universities. Perhaps U.S. and Chinese authorities would be willing to work together to monitor questionable application agents operating in China. This equally benefits China, as approximately 75 percent of Chinese students who study abroad return to China.[133]

VI. INVESTMENT IN HIGHER EDUCATION

During the same time frame as the increased demand for higher education, U.S. state support for higher education has decreased significantly.[134] In fact, since my first year teaching in

co.uk/education/11794171/Revealed-the-extreme-revision-measures-taken-by-Chinese-university-hopefuls.html.

129 Krantz, *supra* note 127.

130 *Id.*

131 Max Kutner, *U.S. Colleges Expelled as Many as 8,000 Chinese Students in 3 Years,* NEWSWEEK, May 29, 2015, http://www.newsweek.com/us-colleges-expelled-many-8000-chinese-students-3-years-337445.

132 Krantz, *supra* note 127.

133 *Number of Chinese Outbound Students up by 11% in 2014,* ICEF MONITER, Mar. 31, 2015, http://monitor.icef.com/2015/03/number-of-chinese-outbound-students-up-by-11-in-2014/.

134 Michael Mitchell and Michael Leachman, *Years of Cuts Threaten to Put College Out of Reach for More Students*, CENTER ON BUDGET AND POL'Y PRIORITIES, May 13, 2015, http://www.cbpp.org/research/state-budget-and-tax/years-of-cuts-threaten-to-put-college-out-of-reach-for-more-students.

China, "forty-seven states are spending less per student in the 2014-15 school year than they did at the start of the recession," in 2008.[135] Conversely, the Ministry of Education in China has increased spending on an average of 20 percent per year over the past decade.[136] Certainly the spending in China improves access to basic education in its developing economy, but it also indicates government priorities. Recently, the budget cuts of many U.S. higher education institutions has been dramatic. State appropriations for higher education has decreased by 14.6 percent since 2007.[137] The States' budget choices will determine whether they can successfully rebuild their higher education systems."[138]

The U.S. is currently the global leader in higher education, but efforts must be made to continue this leadership. In 2010, Richard C. Levin, the President of Yale University predicted the rise of Asia's universities.[139] He correctly indicated the Chinese goal of creating world-class universities as a benefit to all economies. The President further stated, "Competition in education, like the phenomenon of globalization itself, is a positive sum game."[140]

China is investing approximately $250 billion annually in higher education, and the number of Chinese universities had doubled over the past decade.[141] According to former Yale President Levin, "in 25 years, only a generation's time, these universities could rival the Ivy League."[142] In a new book published by the Institute of International Education and the American Institute for Foreign Study Foundation, "leading scholars, practitioners, and education policy

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[135] *Id.*

[136] *China's Education Spending on the Rise*, XINHUA, Nov. 20, 2015, http://news.xinhuanet.com/english/2015-11/20/c_134838051.htm.

[137] Mitchell, *supra* note 134.

[138] *Id.*

[139] President Richard C. Levin, Speech at the Royal Society, *The Rise of Asia's Universities,* (Jan. 31, 2010) (transcript available at Yale Office of Public Affairs & Communications).

[140] *Id.*

[141] Doug Bandow, *Transforming China from Within: Chinese Students Head to American Universities*, FORBES, Sept. 22, 2014, http://www.forbes.com/sites/dougbandow/2014/09/22/transforming-china-from-within-chinese-students-head-to-american-universities/#230e278b918f.

[142] *Id.*

experts from 10 different countries" predict that Asia will be the next higher education superpower.[143] In an interview with Inside Higher Ed, Mark S. Ferrara, the author of *Palace of Ashes: China and the Decline of American Higher Education,* Ferrara compares the "substantial and enduring investments in higher education" in China with America's decline in spending on higher education.[144]

VII. CONCLUSION

Without question, increased access to higher education and the improvement of universities, no matter where situated, mutually benefit every society. Nevertheless, if the quality of education in the United States continues to decrease, the U.S. will be harmed. In the past five years, Congress has cut federal funding for elementary and high school education by 20 percent.[145] If higher education in the U.S. becomes less desirable, other counties will fill the void. It would be a shame if the United States lost its place as the world leader of higher education. Education must not go the way of the steel industry. This Author hopes to be able to return to China again and continue hearing "My dream is to attend university in the United States!"

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[143] Press Release, Asia: the Next Higher Education Superpower?, INSTITUTE OF INTERNATIONAL EDUCATION, (Mar. 11, 2015), http://www.iie.org/en/Who-We-Are/News-and-Events/Press-Center/Press-Releases/2015/2015-03-10-Asia-the-Next-Higher-Education-Superpower#.WBbAbpMrJR0.

[144] Elizabeth Redden, *Palace of Ashes: Author Discusses New Book Arguing that China's Universities are Rising while America's Decline,* INSIDE HIGHER ED, Nov. 12, 2015, https://www.insidehighered.com/news/2015/11/12/author-discusses-new-book-arguing-chinas-universities-are-rising-while-americas.

[145] Allie Bidwell, *Report: Federal Education Funding Plummeting,* U.S. New and World Report, June 24, 2015, http://www.usnews.com/news/blogs/data-mine/2015/06/24/report-federal-education-funding-cut-by-5-times-more-than-all-spending.

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FCPA COMPLIANCE SHOULD NOT 'COST AN ARM AND A LEG': ASSESSING THE POTENTIAL FOR ENHANCED COST-EFFICIENCY AND EFFECTIVENESS FOR AN ANTI-CORRUPTION COMPLIANCE PROGRAM WITH THE IMPLEMENTATION OF AN ENTERPRISE LEGAL RISK MANAGEMENT FRAMEWORK.

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I. INTRODUCTION

This article presents an overview of the benefits of an enterprise legal risk management ("ELRM") Framework when deployed as a tool by multinational companies ("MNCs") to strengthen their corporate U.S. *Foreign Corrupt Practices Act* ("FCPA") compliance programs.[1] The article identifies and discusses important benefits of the Framework, including improved effectiveness and efficiency in in-house and related outside legal costs.[2] According to Forbes magazine, legal services costs associated with FCPA

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[1] R. Walker, *International Corporate Compliance Programs*, 3 INT'L J. OF DISCLOSURE AND GOVERNANCE 70, 70-81 (2006) (explaining the increased importance of compliance and ethics programs both outside and within the United States). *See also* Evan Peterson, *Compliance And Ethics Programs: Competitive Advantage Through The Law*, 17 J. OF MGMT. & GOVERNANCE 1027, 1027–1045 (2013) (advocating that corporate compliance programs offer a sustainable competitive advantage from the law by assisting organizations in achieving a better understanding of the law, a cost-effective approach for coping with an organization's legal issues, as well as aiding organizations by preventing these legal issues from occurring in the future and by supporting organizations in reframing legal issues as business opportunities.). *See also* Shaun Cassin, *The Best Offense Is a Good Defense: How the Adoption of An FCPA Compliance Defense Could Decrease Foreign Bribery*, 36 HOUS. J. INT'L L. 19, 19-58 (2014) (providing a brief historical overview of FCPA, arguments for and against adding a compliance defense to the FCPA, a five-part compliance defense proposed by the former assistant chief of FCPA enforcement at the U.S Department of Justice (DOJ) William Jacobson and options available to a company for designing of a compliance program).

[2] Garrick Apollon, *The Intersection between Legal Risk Management and Dispute Resolution in the Commercial Context*, 15 PEPP. DISP. RESOL. L.J. 284, 284-285 (2015) [Hereinafter Garrick Apollon, The intersection between LRM & DR] *available at* http://digitalcommons.pepperdine.edu/drlj/vol15/iss2/2 (last visited Jan. 28, 2017) (explaining that the implementation of an ELRM Framework promotes: strong corporate governance for the client organization by reducing the negative impacts of legal risk across the organization; gives access to better insurance; enables the client to make informed decisions and avoid surprises; accomplishes its corporate policies and objectives using more objective and reliable information; improves client's engagement and intake management vis-à-vis legal issues for a better working relationship between lawyer-client; reduces monetary and other possible impacts of litigation; improves cost control and cost effectiveness of legal fees; assists in taking "calculated" or smart risks that are balanced against possible benefits; fosters necessary controls and due diligence; promotes better business planning; and generally enhances decision making from an organization-wide perspective.).

compliance incurred by MNCs run to several million dollars every year without necessarily achieving the desired legal compliance results. [3] FCPA compliance is a very lucrative business for law firms because MNCs are paying several million dollars in legal fees while often still paying several million dollars in fines to U.S. regulators.[4] Forbes magazine also went so far as to label the FCPA as the "milk cow" for the Department of Justice ("DOJ").[5] In light of the foregoing, this article presents ELRM Framework as the solution for MNCs looking to prioritize their FCPA legal services efforts in a risk-based approach and as a means of keeping a tighter rein on their in-house and outside legal costs.[6] After all, a Chief Legal Officer ("CLO") or General Counsel ("GC") in the legal department of a MNC is responsible not just for supervising the delivery of excellent legal services, but also for justifying and controlling the cost of legal

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[3] Lisa Prager, *FCPA Compliance: Don't Blow Your Budget Just Yet,* FORBES MAGAZINE, Mar. 27, 2012, available at http://digitalcommons.pepperdine.edu/drlj/vol15/iss2/2 (last visited Jan. 28, 2017) http://www.forbes.com/sites/insider/2012/03/27/fcpa-compliance-dont-blow-your-budget-just-yet/#3e88127c7e89

[4] *The anti-bribery business*, THE ECONOMIST, May 9, 2015, available at http://www.economist.com/news/business/21650557-enforcement-laws-against-corporate-bribery-increases-there-are-risks-it-may-go (last visited Jan. 28, 2017). See also Nathan Vardi, *The FCPA Fiasco: Pressure Tactics In Corruption Cases Backfiring*, Forbes Magazine, Jan. 17, 2012, available at http://www.forbes.com/sites/nathanvardi/2012/01/17/the-fcpa-fiasco/#454e7e55be45 (stating that the Government's track record on FCPA cases in court has been terrible. For many years the FCPA, which prohibits bribery of foreign government officials, was hardly been enforced. But for the last decade the federal government has greatly increased its FCPA enforcement, threatening to bring an indictment against any company that does not cooperate and act harshly if companies don't voluntarily report any potential sins. This game has been cheered on by lawyers and accountants, even journalists, who benefit immensely from the expensive internal investigations companies initiate to deal with this new reality).

[5] Forbes, *supra* note 3 (explaining that FCPA enforcement has long been considered a cash cow for the Department of Justice. It should not be a surprise, therefore, that complying with the FCPA and other anti-corruption laws comes with its own hefty price tag.).

[6] Garrick Apollon, The intersection between LRM & DR, *supra* note 2, at 284-285 (discussing the key advantages and challenges of using legal risk management to help lawyers manage substantive matters related to commercial negotiations and disputes).

fees for the MNC.[7] In practice, GC get fired not only for poor delivery of legal services but also over excessive legal billing against the MNC.[8]

As Susskin's best-selling book *The Future of the Law* mentions, the next generation of lawyers will have to embrace a proactive perspective focused on dispute prevention rather than just dispute resolution, as well as legal risk management rather than just legal problem-solving.[9] Susskind's message in the *Future of the Law* remains a stark one: in order to guarantee a stake in the legal and regulatory system of the future, lawyers must adapt their work practices or die.[10] A recent article in the Harvard Business Review went as far as to say that "Technology Will Replace Many Doctors, Lawyers, and Other Professionals" by asserting that "within decades the traditional professions will be dismantled, leaving most, but not all, professionals to be replaced by less-expert people, new types of experts, and high-performing systems."[11] As an illustration, Thomson Reuters, the world's leading source of intelligent information for businesses and professionals, and Blue J Legal (company owned by University of Toronto tax law professor Benjamin Alarie) are launching Tax Foresight, a new suite of artificial intelligence-based

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[7] E. NORMAN VEASEY AND CHRISTINE T. DI GUGLIELMO, INDISPENSABLE COUNSEL: THE CHIEF LEGAL OFFICER IN THE NEW REALITY 56 (Oxford University Press, 2012). (discussing the challenges of budget constraints and the financial dependence of GC on a single client).

[8] This statement is based on conventional wisdom, *but see* Frederic S. Ury, Jordan Furlong, *What The Future Legal Market Means For Lawyers And Bar Associations*, ABA JOURNAL, Vol. 37 No. 6 (2013), available at http://www.americanbar.org/publications/bar_leader/2012_13/july_august/what_future_legal_market_means_lawyers_bar_associations.html (last visited Jan. 28, 2017) (asserting that too many clients, both consumer and corporate, believe that attorneys drive up the cost of legal transactions without adding commensurate value).

[9] RICHARD E. SUSSKIND, THE FUTURE OF LAW: FACING THE CHALLENGES OF INFORMATION TECHNOLOGY (Oxford: Clarendon Press, 1996) (theorizing on the future of the law in the face of the technological evolution of the world).

[10] *Id.*

[11] Richard Susskind and Daniel Susskind, *Technology Will Replace Many Doctors, Lawyers, and Other Professionals*, HARV. BUS. REV. (Oct. 11, 2016), available at https://hbr.org/2016/10/robots-will-replace-doctors-lawyers-and-other-professionals.

tax case outcome predictors, to Canadian corporate tax professionals; tax preparers; accountants; and tax lawyers. Tax Foresight leverages the power of machine learning and artificial intelligence ("AI"), enabling practitioners to rapidly receive a legal risk assessment to predict how courts will rule in new tax decisions, based on facts provided by users and analysis of prior judicial decisions.[12] In other words, we can expect in the future that routine work can be taken on by machines with AI or "robot lawyers"[13], and that human experts will only be needed for the tricky stuff that calls for judgment, creativity, and empathy.[14]

It is in this context that the implementation of ELRM Framework has risen to the top of the list of priorities of companies' in-house legal departments.[15] CLO or GC are now directed by the Chief Risk Officer ("CRO") and/or Chief Compliance Officer ("CCO") to supervise the implementation of mandatory ELRM Framework in their companies.[16] Accordingly, the idea behind this article is based on the fact that the largest in-house public legal department in Canada (the Department of Justice Canada) has recently established a mandatory ELRM Framework with a business analytics software called iCase to modernize the delivery of legal services for all litigation, legislative and advisory legal files for the Government of Canada.[17] This framework is mandatory and supports the day-to-day practice of law in all federal departments and agencies

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[12] *Thomson Reuters and Blue J Legal Deliver Artificial Intelligence-Based Tax Foresight*, THOMSON REUTERS, Nov. 15, 2016, available at http://thomsonreuters.com/en/press-releases/2016/november/thomson-reuters-and-blue-j-legal-deliver-artificial-intelligence-based-tax-foresight.html

[13] Chris Sorensen, *Big Law is having its Uber Moments*, Maclean's Magazine, Jan. 16, 2017, available at http://www.macleans.ca/economy/business/big-law-is-having-its-uber-moment/ (last visited Feb 7, 2017).

[14] *Supra* note 11.

[15] Garrick Apollon, The intersection between LRM & DR, *supra* note 2, at 271.

[16] *Id.*

[17] *Legal Risk Management in the Department of Justice*, CANADA DEPARTMENT OF JUSTICE, http://www.justice.gc.ca/eng/rp-pr/cp-pm/eval/rep-rap/08/lrm-grj/p2.html (last modified Jan. 7, 2015) (presenting the legal risk management initiative and an overview of legal risk management today within the Government of Canada).

of the Government of Canada.[18] The International Organization for Standardization ("ISO") is currently working on the development of international standards named the ISO/AWI 31022 Guidelines for Implementation of Enterprise Legal Risk Management to respond to the shift in public and corporate sector accountability.[19] These ISO standards aim to strengthen and modernize the practice of legal risk management in private and public organizations around the world and as a result improve the rule of law and anti-corruption and regulatory compliance.[20]

The FCPA is now the top legal risk facing American multinational companies.[21] The FCPA is a United States ("U.S.") federal criminal law known primarily for two of its main provisions; one that addresses accounting transparency requirements under the U.S. *Securities Exchange Act* ("SEC") and the other concerning bribery of foreign officials.[22] The FCPA applies to any person who has a

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[18] *Id.*

[19] *See* ISO/AWI 31022, Guidelines for Implementation of Enterprise Legal Risk Management, available at http://www.iso.org/iso/home/store/catalogue_tc/catalogue_detail.htm?csnumber=69295

[20] Lalonde, C., & Boiral, O., *Managing risks through ISO 31000: A critical analysis*, 14 RISK MGMT. 4, 272-300 (explaining that the ISO 31000 standard is intended to help organizations to manage in a systematic and comprehensive manner diverse types of risk, by offering a universal framework to assist the organization to integrate risk management into its overall management system).

[21] GORDON E. KAISER, CORPORATE CRIME AND CIVIL LIABILITY 587 (Lexis Nexis, 2012) (stating that for the past 50 years, the greatest threat to multinational corporations in terms of criminal liabilities fell under the competition and anti-trust laws. Serious enforcement of the U.S. FCPA by U.S. prosecutors have led to fines to the tune of 3.6 billion from 2012-2009 alone, and U.S. prosecutors continue to aggressively enforce the FCPA.). *See also* R. Christopher Cook & Stephanie Conner, Jones Day LLP, *The Foreign Corrupt Practices Act: Recent Enforcement Trends*, THOMSON REUTERS (2010), http://us.practicallaw.com/ (explaining recent trends in actions against individuals, sector-wide investigations, record fines that include large amounts of disgorged profits, anti-corruption enforcement outside the US because jurisdictions like the U.K., Germany and Canada have strengthened their own anti-corruption legislation and activities, increasing mutual enforcement and legal assistance, impact on cross-border transactions such as M&As and increase in civil actions (while civil actions are rare, they present an expensive risk of additional litigation)).

[22] *A Resource Guide to The U.S. Foreign Corrupt Practices Act*, THE CRIMINAL DIVISION OF THE U.S. DEPARTMENT OF JUSTICE AND THE ENFORCEMENT

certain degree of connection to the United States and engages in foreign corrupt practices.[23] The Act also applies to any act by foreign corporations trading securities in the U.S.[24] Therefore, the FCPA has strong extraterritorial reach[25] and, like most anti-corruption legislation based on the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions, can apply to foreign companies and individuals.[26] FCPA enforcement in the recent years by DOJ and SEC has been marked by record prosecutions against companies, often resulting in multi-million dollar financial penalties and a greater prosecutorial effort leading to fines and imprisonment against individuals.[27] By focusing on prosecution against individuals, DOJ and SEC attract more

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DIVISION OF THE U.S. SECURITIES AND EXCHANGE COMMISSION, 2 (2012), available http://www.sec.gov/spotlight/fcpa/fcpa-resource-guide.pdf (last visited July 19, 2015).

[23] *Id.*

[24] *Id.*

[25] Nicholas M. McLean, *Cross-National Patterns in FCPA Enforcement*, 121 YALE L.J. 1970 (2012). (providing an empirical examination of U.S. enforcement actions under the Foreign Corrupt Practices Act (FCPA) in order to explore the cross-national patterns associated with United States' international antibribery enforcement).

[26] Robert D. Tronnes, *Ensuring Uniformity in the Implementation of the 1997 OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions*, 33 GEO. WASH. INT'L L. REV. 97, 97-130 (2001) (discussing that since the passage of the Foreign Corrupt Practices Act (FCPA) in 1977, the United States has worked to persuade other nations to forbid bribery of foreign public officials in an effort to secure business abroad. As a result of pressure from the United States and the increased costs associated with corruption, the international tide is turning against transnational bribery. 3 In order to capitalize on this global shift towards condemnation of corruption, twenty-nine Organization for Economic Cooperation and Development (OECD) member countries and five non-member countries signed the Convention on Combating Bribery of Foreign Public Officials in International Business Transactions (Convention) on December 17, 1997. The Convention is an effort to cut off transnational bribery at its source. Consequently, in signing the Convention all signatory countries made the commitment to "pass legislation necessary for [the Convention's] ratification and implementation into national law.").

[27] Kaiser, *supra* note 21, at 587-588 (discussing bribery and anti-corruption).

cooperating witnesses and generate even more investigations.[28] The Dodd-Frank *Wall Street and Consumer Protection Act* ("Dodd-Act") grants significant protections and rewards to whistleblowers.[29] Whistleblowers who provide original information that leads to the assessment of monetary sanctions in excess of $1 million are entitled to receive between 10% and 30% of the sanction amount as a reward.[30] For instance, a record award of $30M was recently obtained by a foreign whistleblower pursuant to the Dodd-Act.[31]

An ELRM Framework serves as a continuous, proactive and systematic or integrated process to understand, manage and communicate legal risk from an organization-wide or enterprise-wide perspective in a cohesive, consistent and cost-efficient manner.[32] It is about supporting strategic decision-making that contributes to the achievement of an organization's overall objectives.[33] Legal risks cannot be managed effectively in silos; hence an ELRM Framework must be part of an Integrated or Enterprise Risk Management Framework (IRM or ERM).[34] It requires an ongoing assessment of all risks such as financial, corporate and reputational at every level and in every sector of the organization, and aggregating these results at the

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[28] Murdock, Charles W., *The Dodd-Frank Wall Street Reform and Consumer Protection Act*: *What Caused the Financial Crisis and Will Dodd-Frank Prevent Future Crises*, 64 S.M.U. L. REV. 1243 (2010).

[29] *Id.*

[30] *See* Rachel Louise Ensign, SEC to Pay $30 Million Whistleblower Award, Its Largest Yet, WALL STREET J., Sept. 22, 2014, available at http://www.wsj.com/articles/sec-to-pay-30-million-whistleblower-award-its-largest-yet-1411406612 (last visited July 19 2015).

[31] *Supra* note 24.

[32] Garrick Apollon, the intersection between LRM & DR, *supra* note 2, at 283-287 (explaining that based on international standards (ISO 31 000) a risk management framework serves as a set of components that provide the foundations and organizational arrangements for designing, implementing, monitoring, reviewing and continually improving risk management through the organization).

[33] *Id.*

[34] *Integrated Risk Management Framework*, TREASURY BOARD OF CANADA SECRETARIAT, http://www.tbs-sct.gc.ca/pol/doc-eng.aspx?section=text&id=12254#appA (last modified Apr. 1, 2001) (discussing shared leadership-suggested roles and responsibilities in risk management).

corporate level, communicating them and ensuring adequate monitoring and review.[35]

ELRM Framework has four main objectives: 1) identifying issues early and assessing potential legal risks; 2) avoiding and mitigating legal risks; 3) managing legal risks as they occur for an organization in consistent; enterprise-wide and cost-efficient manner; and 4) using business analytics software to modernize the ELRM practices and ensuring the use of data and business analytics as a means to improve organizational performance.[36] In this current context, this article encourages MNCs to strengthen their anti-corruption and anti-bribery ("ABC") compliance program with an ELRM Framework.[37] The main goal is to further "prevent FCPA violations prior to their occurrence, quickly detect any violations and mitigate penalties if violations occur."[38] "The DOJ and SEC have indicated that the existence of an ABC compliance program is a significant factor taken into account in deciding whether to bring charges, what charges to bring and what penalties to impose".[39] As observed, "despite increased FCPA enforcement, U.S. corporations continue to pay bribes out of business necessity because of the leniency of other countries".[40] For instance, President Donald Trump in a national television interview with CNBC in 2015 made the controversial comment that "this country is absolutely crazy" to

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[35] *Id.*

[36] Garrick Apollon, The intersection between LRM & DR, *supra* note 2, at 284-285.

[37] *See* Daniel L. Goelzer, *Designing an FCPA Compliance Program: Minimizing the Risks of Improper Foreign Payments*, 18 NW. J. INT'L L. & BUS. 282 (1998) (explaining the importance of a FCPA compliance program), available at http://scholarlycommons.law.northwestern.edu/cgi/viewcontent.cgi?article=1474&context=njilb (last visited Feb. 7, 2017) (this article asserts that a FCPA compliance program must be complemented by an ELRM Framework).

[38] Kaiser, *supra* note 21, at 593 (explaining the goals of an anti-corruption compliance program).

[39] *Id.*

[40] *Id.* See also the academic work of Professor Eugene Soltes, Jakurski Family Associate Professor of Business Administration at Harvard Business School, author of the celebrated book *Why They Do It: Inside the Mind of the White-Collar Criminal* (Hachette, 2016). Professor Soltes research focuses on corporate misconduct and fraud, and how organizations design cultures and compliance systems to confront these challenges.

prosecute alleged FCPA violations in places like Mexico and China.[41] Moreover, President Trump said that the FCPA is a "horrible law and it should be changed" and that it puts U.S. business at a "huge disadvantage."[42] As pointed out by Professor Koehler (founder and editor of the FCPA Professor website[43]), the FCPA is here to stay because "the FCPA's legislative history makes clear that in passing the FCPA Congress intended to capture only a narrow category of payments and chose not to capture so-called facilitating payments given the difficult and complex business conditions encountered in many foreign countries".[44]

Legal scholarship emphasizes the power of reframing and the manner in which a legal practitioner frames or describes legal problems to help create a new dynamic and achieve better results.[45] In a similar vein, this article presents the implementation of an ELRM Framework as a necessary additional step for MNCs to ensure effective and cost-efficient anti-corruption compliance program for the MNC. This article argues that MNCs should reframe their problems with FCPA and anti-corruption compliance as not just a compliance risk but also a legal risk that needs to be managed with an ELRM Framework.

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[41] CNBC SquawkBox interview (beginning at the 14-minute mark) http://video.cnbc.com/gallery/?video=3000089630&play=1 and FCPA Professor (FCPA Professor website is the website of Professor Koehler, respected authority in the field of FCPA), see Donald Trump: The FCPA Is a "Horrible Law and It Should Be Changed", August 6, 2015, available at http://fcpaprofessor.com/donald-trump-the-fcpa-is-a-horrible-law-and-it-should-be-changed/ (last visited Feb. 7, 2017).

[42] *Id.*

[43] *Id. See also* F. Joseph Warin, Michael Diamant, Patrick Doris, Mark Handley and Melissa Farrar,
Gibson Dunn Offers Update on Non-Prosecution and Deferred Prosecution Agreements, Columbia Law School's Blog on Corporations and the Capital Markets, Jan. 16, 2017 (explaining Donald J. Trump assumes the Presidency on January 20, 2017, and his inauguration will bring inevitable changes to the composition and mandate of DOJ).

[44] *Id.*

[45] Ran Kuttner, The *Wave/Particle Tension in Negotiation*, 16 HARV. NEGOT. L. REV. 331, 359-60 (2011) (discussing the power of reframing in scholarship for the practice of law).

This article explains the general steps and benefits to a GC and its legal department in MNCs in implementing an ELRM Framework specifically designed for FCPA compliance and risk management. An ELRM Framework helps in-house and outside legal counsel to move away from a specific and narrow legal analysis focused on problem-solving to a more preventative style. This allows them to better select which FCPA risk management strategy to apply to better prevent FCPA liability and help their clients to achieve better decision-making in their international business transactions.[46]

ELRM is also all about linking the practice of the law with technology.[47] For instance, an ELRM should incorporate business analytics software to assist the GC and senior management of the MNC with monitoring the number of hours and lawyers involved in a FCPA files based on their legal risk and complexity level.[48] This means in practice that in-house lawyers, and most importantly outside lawyers, will be accountable for the legal risk and complexity level of the FCPA file and the numbers of hours they spend on it based on objective criteria.[49] Therefore, "an ELRM Framework presents as its main advantage the prevention of lawyers who score highly on Machiavellianism and who are process-oriented from manipulating legal risk communication and assessments to get their client to perceive what they want them to perceive, and for the benefit of their own unethical agendas, such as overbilling or from raising their profiles by ranking legal risks high when in reality the level of complexity and risk is medium or low."[50]

Above all, the implementation of an ELRM Framework is designed to avoid making the ABC compliance program a "paper

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[46] *Supra* note 7, at 56 (explaining that the GC and in-house counsel are the managers of legal and reputational risk and educators for the company. They need to perform the increasingly important function of assessing legal risks and translating those risks into business terms in order to facilitate decision-making considering those risks).

[47] Garrick Apollon, The intersection between LRM & DR, *supra* note 2, at 285-286.

[48] *Id.*

[49] *Id.*

[50] *Id.*

program".[51] This is achieved through the implementation of a strong legal risk assessment process for the delivery of day-to-day FCPA legal services that will help the lawyers to play their role as gatekeepers of corporate integrity and as problem solvers in the execution of international business transactions for the MNC.[52]

I. WHAT IS AN ELRM FRAMEWORK?

The author defines an ELRM Framework as a compliance management system for the effective and cost-efficient delivery of legal services in an organization.[53] The ISO 19 600 international standard broadly defines a compliance management system such as an ELRM Framework as a set of interrelated or interacting elements of an organization to establish policies, objectives, processes and tools to achieve legal (regulatory) compliance requirement that an organization must comply with and chooses to voluntary comply with.[54] Therefore, an ELRM Framework aims to go beyond the

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[51] Patrick Head, *The development of compliance programs: one company's experience*, 18 NW. J. INT'L L. & BUS. 535 (1997) (explaining that companies have run into the difficulty for having a FCPA compliance program fully conceived on paper, but no real compliance or financial controls. A "paper program" means a failure to implement a culture of legal compliance and ethics).

[52] David Nersessian, *Business Lawyers as Worldwide Moral Gatekeepers: Legal Ethics and Human Rights in Global Corporate Practice*, 28 GEO. J. LEGAL ETHICS 1135, 1135-1188 (2015). *See also*, Joseph W. Yockey, *FCPA Settlement, Internal Strife, and the Culture of Compliance,* WIS. L. REV. 689 (2012) (explaining that though cooperation generally remains the prerequisite to obtaining a DPA or NPA, regulators also stress that they are more likely to offer leniency to firms with a strong "culture of compliance." Like before, this follows from the use of the OSG as a framework for settlement negotiations. The OSG was amended in 2004 in response to the *Sarbanes-Oxley Act* of 2002 to allow for lower sanctions for firms that have "effective compliance and ethics programs" in place. Programs that meet this requirement will be found in firms that "exercise due diligence to prevent and detect criminal conduct" and "otherwise promote an organizational culture that encourages ethical conduct and a commitment to compliance with the law.)

[53] Garrick Apollon, The intersection between LRM & DR, *supra* note 2, at 306-307.

[54] *See* ISO 19600:2014 Compliance management systems – Guidelines, INTERNATIONAL ORGANIZATION FOR STANDARDIZATION (ISO), available at http://www.iso.org/iso/home/store/catalogue_tc/catalogue_detail.htm?csnumber=62342 (last visited Feb. 7, 2017).

required legal compliance by building an organization's approach to legal compliance that is ideally shaped by objective standards and an ethical leadership and corporate culture that apply core anti-corruption values and the highest corporate governance standards in decision-making.[55] The long term goal of an ELRM Framework is to contribute to building an exemplary "compliance culture"[56] in an organization. As a result, an ELRM Framework should never be perceived as unnecessary red tape or a burdensome internal administrative process, but instead an organizational design built to promote a real dialogue and partnership between lawyer-client towards ethical leadership.

The need to implement objective standards with an ELRM Framework for the day-to-day practice of FCPA risk communication in an organization arises from the fact that risk is emotionally, socially, culturally, economically and politically constructed and is therefore subjective by nature.[57] For instance, an international VP of sales might prefer to see an international business transaction as low risk for corruption because the business benefit outweighs the legal threat for him and his unit. However, this same international business transaction might be assessed as high risk by his compliance officer and in-house counsel. The goal of an ELRM Framework in practice is to improve the legal risk communication between the VP of sales and counsel so that they can share the responsibly to manage the FCPA risk in order for a sound legal and ethical decision risk response commensurate to the corruption risk level that the MNC is facing. FCPA risk management is not only the business of compliance officers or lawyers but this is a shared responsibility for all employees in an organization.[58] However, we live in an

[55] Barbara Mescher & Bryan Howieson, 1 *Beyond Compliance: Promoting Ethical Conduct by Directors and Corporations,* CORP. GOVERNANCE L. REV., 93-114 (2005) (examining the relationship between legal and moral perspectives of directors' behaviour and corporate governance).

[56] Sow Wei Wong, *A Culture, Not a Programme*, INT'L FIN. L. REV. (2010) (explaining that a compliance culture is where the management and all the employees share the common belief, value or goal that doing the right thing, even when no one is looking is an important part of what defines the organization.).

[57] Garrick Apollon, The intersection between LRM & DR, *supra* note 2, at 275.

[58] *Id.*

individualist culture where the collective interests of the organization do not always come first.[59] An ELRM Framework serves to standardize and objectify the organizational ELRM practices in order to mitigate the risk that the self-interest of the individuals involved in the compliance process supersede the collective interests of the organization.[60] The author also argues that the implementation of an ELRM Framework specific to FCPA risk is the first step for a MNC to later develop a more comprehensive ELRM Framework that will be applied to all their advisory and litigation files and covers all the legal risks facing the MNC every day.

An ELRM Framework also helps to deal with the inherent complexity of FCPA risks.[61] FCPA is a complex legal risk that is influenced by many factors such as foreign legal, economic, cultural and political environments.[62] For instance, the MNC must take into consideration that the vast majority of anti-corruption laws such as U.K. *Bribery Act* or Canada's *Corruption of Foreign Public Officials Act* ("CFPOA") have an extraterritorial reach just like the FCPA.[63] This means a FCPA risk assessment must also assess the likelihood of adverse outcomes with other anti-corruption foreign laws such as the U.K. *Bribery Act* and CFPOA. For instance, an American company registered and trading stocks on the London Stock Exchange is also

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[59] GEERT HOFSTEDE, CULTURE'S CONSEQUENCES: COMPARING VALUES, BEHAVIORS, INSTITUTIONS, AND ORGANIZATIONS ACROSS NATIONS (2nd ed., Thousand Oaks, CA: SAGE Publications, 2010).

[60] Garrick Apollon, The intersection between LRM & DR, *supra* note 2, at 309-310 (explaining that lawyers who score highly on Machiavellianism and who are process-oriented can manipulate communications and assessments to get their client to perceive what they want them to perceive for the benefit of their own unethical agendas, such as overbilling or raising their profiles by ranking legal risks high when they are in reality medium or low).

[61] Adam Seligman, *Role Complexity, Risk, and the Emergence of Trust*, 81 B.U. L. REV. 619, 619-634 (2001) (theorizing that trust emerged as a dimension of social relations in modern society along with risk. Risk became inherent in behaviours when, with the segmentation of social roles, there developed an in-built limit to systemically based expectations. Potential dissonance between the different aspects of roles increased, revealing these two new phenomena characteristic of modern forms of social relations: risk and decided trust).

[62] *See* McLean, *supra* note 21.

[63] Anna Simonova, *Extraterritorial Reach of the Foreign Corrupt Practices Act*, 8 J. COMP. L. 211, 211-231 (2013) (discussing the Extraterritorial Reach of the FCPA).

subject to the U.K. *Bribery Act*.[64] The U.K. *Bribery Act* sets out in Section 7 the corporate offence of failure to prevent bribery in the course of business; the section legally obligates companies to maintain an effective ABC compliance program, as the only statutory defence to this offence is to prove the existence of adequate systems and controls.[65] This strict liability corporate offence (Section 7 - failure of commercial organizations to prevent bribery) is unique to the U.K. *Bribery Act*.[66] The U.K. *Bribery Act* also prohibits facilitation payments that are somewhat permitted under the FCPA.[67] Therefore, the breadth of the application of the new U.K. *Bribery Act* is generally seen as part of a global trend of requiring higher ethical standards and is broader in scope than the FCPA in a number of respects.[68]

II. ADVANTAGES TO AN MNC OF HAVING AN ELRM FRAMEWORK SPECIFIC TO FCPA RISK

If MNCs are spending millions on FCPA compliance, they are not spending enough money and resources on developing an ELRM Framework to ensure the effective and cost-efficient delivery

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[64] Jessica Lordi, *The U.K. Bribery Act: Endless Jurisdictional Liability on Corporate Violators*, 44 CASE W. RES. J. INT'L L. 955, 955-998 (2012), available at http://scholarlycommons.law.case.edu/cgi/viewcontent.cgi?article=1139&context=jil (last visited Feb. 7, 2017); *see also* Sharifa G. Hunter, *Article & Essay: A Comparative Analysis Of The Foreign Corrupt Practices Act And The U.K. Bribery Act, And The Practical Implications Of Both On International Business*, 18 ILSA J. INT'L & COMP. L. 89 (2011).

[65] *The Bribery Act*, TRANSPARENCY INTERNATIONAL UK, available at http://www.transparency.org.uk/our-work/business-integrity/bribery-act (last visited Feb. 7, 2017).

[66] *Id.*; *See also* Kaiser, *supra* note 21, at 627 (explaining the U.K. Bribery Act).

[67] Kaiser, *supra* note 21, at 637 (explaining that FCPA accepts as a defence the grating of facilitation payments but these payments are not allowed under U.K. Bribery Act).

[68] *See* Natalie Shu Ying Wee, *The OECD Convention on Combating Bribery of Foreign Public Officials and the Impact of the United Kingdom's Bribery Act 2010 on Corporations: Is the Act Too Harsh*, 17 INT'L TRADE & BUS. L. REV. 126 (2014). *See also* Dominic Saglibene, *U.K. Bribery Act: A Benchmark for Anti-Corruption Reform in the United States*, 23 TRANSNAT'L L. & CONTEMP. PROBS. 119, 119-146 (2014).

of day-to-day FCPA legal services in their organization.[69] As evidence, the United Nations ("UN") Global Compact published in 2013 a Guide for Anti-Corruption Risk Assessment, where it noted that the principal weakness of ABC compliance programs is often the absence of process to establish robust measures and practices for day-to-day anti-corruption legal risk assessment.[70] It specifically observed that "The Global Corporate Sustainability Report 2013 shows that only 25% of UN Global Compact business participants conduct anti-corruption risk assessments, and there are substantial differences in implementation levels among large and small companies."[71]

Risk management principles and frameworks are nothing new to other professionals such as actuaries, accountants, engineers or medical doctors, but they are a new discipline for lawyers.[72] In practice, a ELRM Framework that brings objective standards and guidelines into decision-making in international business transactions is needed because anti-corruption legal risk assessments are dependent on three basic determinants: 1) lack of information and knowledge; 2) lack of power and control; and 3) lack of time and resources in relation to the execution of international business transactions for all companies operating globally.[73]

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[69] Garrick Apollon, The intersection between LRM & DR, *supra* note 2, at 271

[70] United Nations Global Compact, *A Guide for Anti-Corruption Risk Assessment* (2013) (explaining that the Global Corporate Sustainability Report 2013 shows that only 25% of UN Global Compact business participants conduct anti-corruption risk assessments, and there are substantial differences in implementation levels among large and small companies), available at https://www.unglobalcompact.org/docs/issues_doc/Anti-Corruption/RiskAssessmentGuide.pdf (last visited Feb. 7, 2017).

[71] This article focuses on the implementation of LRM Framework for large companies such as MNCs.

[72] Garrick Apollon, The intersection between LRM & DR, *supra* note 2, at 287 (explaining that ELRM is relatively new in the legal profession—as with anything new, a period of adjustment is expected, and senior management of law firms and legal departments must support the implementation of an ELRM Framework in their organizations. This means change management is required, especially since lawyers usually do not like to be managed and told what to do).

[73] *Id.* at 306 (explaining that social-psychological measures are also important because lawyers do not have the information necessary to accurately

As part of the advantages already discussed, an ELRM Framework provides technological, financial and corporate compliance value to an organization by offering the following strategic and monetary benefits to an organization.[74] It:

- promotes ethical leadership and an integrity-based corporate compliance culture where unethical and illegal bribery and corruption activities and other white-collar crimes such as fraud, insider trading, money laundering are anticipated, detected and prevented;

- allows the CRO and/or CCO to implement a ELRM Framework in accordance with the IRM or ERM Framework of the organization to ensure more cost-certainty, efficiency and business value for corporate decision-making in the management of legal risks (i.e. deter a culture of risk taking or risk aversion to encourage a culture of smart risk-taking based on an integrity-based corporate compliance culture);

- the main driving force for organizations to implement a legal risk management framework is to ensure more cost-certainty, efficiency and business value for corporate decision-making (i.e. deter a culture of risk aversion to encourage a culture of smart risk-taking);

- allows the GC to generate customized timekeeping legal risk reports (in real-time) for senior management and the Board of Directors (i.e. the GC is in a better position to explain the legal risks that the company is facing (risk profile of the company) and justify its budget and the legal expenses/legal costs for the organization);

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judge the legal risks of the bargaining or dispute resolution situation. A lawyer's ability to complete an accurate legal assessment may be dampened by several factors, such as lack of information, lack of time, situational constraints based on resources or power, and self-selection processes. The lawyer and the client's judgments are biased, and biases are associated with inefficient performance.)

[74] Garrick Apollon, The intersection between LRM & DR, *supra* note 2, at 285.

- improves the overall quality and objectivity of lawyers' legal services (the risk and complexity level must be assessed on the basis of objective criteria based on the universally accepted risk management principles of ISO 31000);

- contributes to mitigating the risk of lawyers overbilling by manipulating the risk level or complexity of a legal file (the subjective elements of risk perception and treatment are mitigated);

- improves information sharing and eliminates the duplication of work through enhanced information governance by the use of business analytics software;

- enables the use of a common language in communicating FCPA risks;

- enhances the ability of lawyers to manage legal risks from an IRM or ERM perspective, where they can see the 'big picture' (all legal and non-legal consequences are assessed such as the operational/corporate, financial, values and ethics, and reputational) and concentrate energy and attention to areas of highest legal risk facing the organization (risk-based approach);

- increases the respect of governmental regulators and helps to attract shareholders, investors and stakeholders by showing that the company has a strong corporate compliance program for the management of legal risks; and

- helps the organization to attract investors and secure better rates and/or prices from lenders and insurance companies by showing that it has a strong corporate compliance program for the management of its legal risks.

III. BENEFITS OF ELRM FRAMEWORK FOR LAWYERS AND LAW FIRMS

Legal risk management has been identified by the Canadian Bar Association (sister organization of the American Bar Association in Canada) as the future of the law for lawyers.[75] While an ELRM Framework helps MNCs to manage FCPA risk and keep legal services providers accountable, ELRM Framework also helps lawyers and law firms to highlight their good work and justify their legal fees billed to their clients (or the legal costs associated with an in-house legal department). Therefore, ELRM Framework should not be perceived as a threat for law firms and lawyers (providers of outside legal services to MNCs) because an ELRM framework aims to improve the lawyer-client relationship and is equally beneficial for lawyers and law firms by doing the following:

- improves the overall quality and objectivity of lawyers' legal services (the risk and complexity level must be assessed on the basis of objective criteria based on the universally accepted risk management principles of ISO 31 000). It contributes to mitigating the risk of clients questioning the risk level or complexity of a legal file to avoid paying a legal bill (the subjective elements of risk perception and treatment for the client is mitigated). Therefore, this reduces the time lawyers spend to explain or justify invoices to their clients. It also prevents against disputes and complaints at the Law Society (bar) for overbilling, thus preserving the integrity reputation of the law firm and its lawyers;

- the general practice of ELRM for lawyers is legal work and therefore billable time. For instance, lawyers have a financial incentive to insert all the ELRM information such as timekeeping, risk and complexity level in ELRM business

[75] *The Future of Legal Services in Canada: Trends and Issues*, Canadian Bar Association, 6 (2013) (explaining that emerging fields of competency may include legal risk management, legal project management, legal process analysis, and legal knowledge engineering), available at http://www.cba.org/CBAMediaLibrary/cba_na/PDFs/CBA%20Legal%20Futures%20PDFS/trends-isssues-eng.pdf (last visited Feb. 7, 2017).

analytics software. This is because tasks completed in relation to ELRM should always be considered as billable legal work and not administrative work (since ELRM is the main responsibility of a lawyer to his client and ELRM information such as legal risk assessments should always be shared with his client);

- ISO 31 000 standards help to protect lawyers and law firms by ensuring that all key legal risks are documented and communicated (also increase efficiency, save time and effort by eliminating duplication);

- enables the use of a common language in communicating risks among colleagues from the same law firm or legal department; and consistency among clients and other stakeholders;

- improves reliability, consistency and timeliness of organizational legal risk information, thus providing more accurate and reliable contingent liability reports, and standardized and effective ELRM services to clients. It ensures effective reporting to clients, improves cost-control and cost-effectiveness, assists in the allocation of financial and human resources, and attention and effort to each file; improves capacity to plan, forecast and manage high-risk and high-profile files in a risk-based management approach (i.e. priority to high risk files is guaranteed); and improves the communication of legal risk and leadership of files;

- leads to better working lawyer-client relationships because the ELRM framework facilitates communication between lawyer and client and legal risks are managed from an IRM or ERM standpoint (in other words counsel would always consider not just the legal consequences but also the non-legal consequences such as operational, financial, ethical and reputational impacts when they assesse a legal risk – this generates more relevant and practical legal advice for senior management and corporate decision-makers);

- provides a competitive advantage for a law firm by helping to standardize the delivery of their legal services and using technology such as business analytic software;

- allows access to business analytics for benchmarking and performance management (allows the law firm to improve internal processes and rank its effectiveness and efficiency in delivering solutions compared to other market competitors); and

- reduces the costs of professional liability assurance (or insurance).

IV. HOW AN ELRM FRAMEWORK IS IMPLEMENTED IN A MNC?

Overall, just like a house alarm system detects security risks, an ELRM Framework or system helps the MNC to detect, deter, and prevent the occurrence of FCPA risk.[76]

The full implementation of an ELRM Framework can be estimated to take up to 1-2 years because this requires a change of corporate culture. However, the implementation time is always dependent on the personal endorsement and commitment of senior management (Tone at the Top)[77] along with an appropriate allocation of financial and human resources.[78] For optimal results, it is recommended that implementation plan be based on the Transparency International ("TI") Business Integrity Toolkit[79] for

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[76] Garrick Apollon, The intersection between LRM & DR, *supra* note 2, at 285 (using the analogy that a LRM and compliance system for a company should be viewed as an alarm system for your house. Just like your house alarm system detects security risks, your LRM system will works to detect, deter, and prevent the occurrence of legal risks in an organization.)

[77] ISO 19600:2014 Compliance management systems—Guidelines, *supra* note 54.

[78] *Id.*

[79] *Business Integrity Toolkit*, TRANSPARENCY INTERNATIONAL, https://www.transparency.org/whatwedo/tools/business_integrity_toolkit/0/ (last accessed Dec. 6, 2015).

building an effective ABC program.[80] The complete six steps and their sequence are summarized below:

Commit 'Tone at the top' to a strong corporate compliance agenda in managing FCPA legal risks and the implementation of the ELRM framework.[81] The 'buy-in' and full participation of senior management, board of directors and other stakeholders is critical to success. The "Tone from the Top"[82] is often the greatest challenge

[80] *Id.*

[81] ISO 19600:2014 Compliance management systems – Guidelines, *supra* note 54, at 8-10 (explaining the importance of senior management support in the development of a corporate compliance system). Mark S. Schwartz, Thomas W. Dunfee & Michael J. Kline, *Tone at the Top: An Ethics Code for Directors?*, 58 J. BUS. ETHICS 79 (2005) (explaining that legal reforms without proper attention to ethical obligations will likely prove ineffective. The ethical role of directors is critical. Directors have overall responsibility for the ethics and compliance programs of the corporation. The tone at the top that they set by example and action is central to the overall ethical environment of their firms).

[82] *Id.*

for the implementation of an ELRM Framework in practice because the CEO is often more focussed on profit and strategic planning than risk management. However, with the example of corruption scandals such as Siemens[83], Wal-Mart[84], SNC Lavalin[85], etc., this article argues that in this new era where "reputation rules"[86] CEOs should be equally concerned by managing, not just the legal risk, but the reputational and financial risk that FCPA poses to their MNC rather than just focusing on making profit. These corruption scandals also reinforce that an ELRM Framework is even more necessary in time of crisis management. For instance, Wal-Mart, reported that it spent $439 million in FCPA compliance (i.e. legal fees, forensic and investigative fees) only in the first two years of the scandal (2012

[83] Siri Schubert & T. Christian Miller, *At Siemens, Bribery Was Just a Line Item*, N.Y. TIMES, Dec. 20, 2008, available at http://www.nytimes.com/2008/12/21/business/worldbusiness/21siemens.html (covering the largest corruption scandal in the corporate world. Siemens, one of the world's biggest companies, ended up paying $1.6 billion in the largest fine for bribery in modern corporate history).

[84] Tom Schoenberg & Matt Robinson, *Wal-Mart Balks at Paying $600-Million-Plus in Bribery Case*, BLOOMBERG, Oct. 6, 2016, available at https://www.bloomberg.com/news/articles/2016-10-06/wal-mart-said-to-balk-at-paying-600-million-plus-in-bribe-case (last visited Feb. 10, 2017) (discussing the possibility that officials have proposed that the world's biggest retailer pay at least $600 million to resolve probes by the Justice Department and the Securities and Exchange Commission into whether it bribed government officials in markets from Mexico to India and China. Such a settlement would rank among the largest in four decades under a U.S. law against bribing foreign officials to obtain business. The Justice Department and the SEC have spent half a decade investigating allegations that Wal-Mart representatives paid government officials over the course of 10 years to fast-track store openings). *See also* Ben W. Heineman, Jr, *Who's Responsible for the Walmart Mexico Scandal?*, HARV. BUS. REV., May 15, 2014, available at https://hbr.org/2014/05/whos-responsible-for-the-walmart-mexico-scandal (last visited Feb. 10, 2017) (discussing that the Walmart bribery scandal is one of the most closely-watched cases of alleged malfeasance by a global company. It broke into the open in April, 2012, when the New York Times published a lengthy investigative piece alleging Walmart bribery in a Mexican subsidiary and a cover-up in its Bentonville, Arkansas, global headquarters).

[85] *See* Snc Lavalin Corruption, HUFFINGTON POST, available at http://www.huffingtonpost.ca/news/snc-lavalin-corruption/ (last visited Feb. 10, 2017).

[86] DANIEL DIERMEIER, REPUTATION RULES: STRATEGIES FOR BUILDING YOUR COMPANY'S MOST VALUABLE ASSET (2011)

2013), making it one of the most expensive probes in U.S. history.[87] The Economist, reported that "by the time bribe-busters at America's Department of Justice (DOJ) are done with their own investigation, which began in 2012, Walmart's bill for lawyers' and forensic accountants' fees will be well above $1 billion—and perhaps closer to $2 billion".[88]

Assess the organization's current risk environment and risk exposure using ELRM Framework to detect areas of the greatest inherent risk in order to prioritize and allocate resources (financial and human) appropriately to these areas.[89] *Assess* also refers to benchmarking the current ELRM practices of the organization to identify its strengths and weaknesses.[90]

Plan the scope and activities that the organization will undertake to prevent, detect, avoid, transfer/shift if possible, mitigate and in general strategically manage legal risks by using ELRM framework.[91]

Act by implementing internal checks and balances, as well as documenting with business analytics software and communicating legal risks, to promote an integrity-based corporate compliance culture where unethical and illegal activities are prevented and detected and FCPA risks are mitigated in a risk-based approach.[92]

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[87] David Voreacos & Renee Dudley, *Wal-Mart Says Bribe Probe Cost $439 Million in Two Years*, BLOOMBERG, Mar. 26, 2014, available at https://www.bloomberg.com/news/articles/2014-03-26/wal-mart-says-bribery-probe-cost-439-million-in-past-two-years (last visited Feb. 10, 2017).

[88] The Economist, *supra* note 4.

[89] ISO 19600:2014 Compliance management systems – Guidelines, *supra* note 54, at 11 (explaining that senior management should allocate adequate and appropriate resources to establish, develop, implement, evaluate, maintain and improve the compliance management system and performance outcomes).

[90] *Id.* at 24-25 (asserting the importance of report-keeping for compliance management).

[91] *Id.* at 7 (asserting the importance of identification, analysis and evaluation of compliance risks for compliance management).

[92] *Id.* at 24-25 (asserting the importance of report-keeping for compliance management). *See also Id.* at 16-17 (discussing the concept of compliance culture or integrity-based compliance that aims to establish a culture of ethical leadership and goes beyond required legal compliance).

Monitor processes to ensure that strengths and weaknesses are identified and that the ELRM framework is continuously improved to remain effective and up to date.[93]

Report on the sincerity of the organization's commitment to an effective FCPA compliance program to raise awareness among employees and positively influence the organization's reputation in the marketplace.[94] ELRM Framework presents a performance management plan for continuous monitoring and improvement designed on the basis of ISO 19600:2014 - Compliance Management Systems.[95] This performance management plan provides guidance for establishing, implementing, evaluating, monitoring, maintaining and improving an effective and responsive compliance management system within an organization.[96]

V. CHALLENGES TO IMPLEMENTING AN ELRM FRAMEWORK IN AN ORGANIZATION

First, like any corporate compliance program the "Tone from the Top" is crucial and senior management must support the ELRM Framework implementation.[97]

Second, lawyers must remain vigilant and not provide legal risk assessment on a corporate decision that is illegal or immoral like in the case of the infamous Ford Pinto case.[98] Law and morality cannot be separated and a strong commitment to business ethics and integrity must remain present at all times when legal risk assessments

[93] *Id.* at 21-22 (discussing monitoring to ensure performance management).

[94] *Id.* at 22-23 (discussing information analysis and classification).

[95] *Id.* at 22 (discussing the sources of feedback on compliance performance).

[96] *Id.* at 23 (discussing compliance reporting and that the compliance function should ensure that they are effectively informed on the organization's compliance performance).

[97] *Id.* at 8-10. (explaining the importance of senior management support in the development of a corporate compliance system).

[98] Garrick Apollon, The intersection between LRM & DR, *supra* note 2, at 286 (disusing Pinto case in the context of legal risk management)

are conducted by lawyers for corporate decision-makers.[99] Lawyers must have strong legal advisory and legal advocacy skills to facilitate corporate decisions that are based on integrity.[100] In other words, the role of the lawyers is not to find legal "loopholes" but to help their client to manage their legal risks in a spirit that promotes ethical leadership and an integrity-based corporate compliance culture where unethical and illegal activities are prevented and detected by the lawyer to the benefit of its client's reputation.[101]

Third, while it assists in objectifying and standardizing legal practice, ELRM is not a science (a decision of a court can never be predicted with complete certainty).[102] The ELRM approach must be a flexible one that relies on the legal virtuosity of the lawyer, but also the honesty, business judgment and conventional wisdom of each participant.[103] This means risk reports and risk profiles based on business analytics software rely on the accuracy of the FCPA risk assessments conducted by lawyers when human errors are frequent, and also all information are not always shared with the lawyer.

Fourth, change management is required.[104] The ELRM Framework like any corporate compliance program is mandatory and professionals (especially lawyers) don't like to be told what to do.[105]

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[99] M.E. Stucke, *In search of effective ethics & compliance programs*, 39 J. CORP. L. 769, 769-832 (2014) (explaining that the US Sentencing Commission's Organizational Guidelines provided firms strong financial incentives to have effective ethics and compliance programs ("ethics programs"). Since then, compliance has become big business. To incentivize compliance, some statutes require public firms to disclose their compliance efforts. Directors of Delaware corporations owe a duty "to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists." Companies listed on the New York Stock Exchange and NASDAQ must have an ethics code. But unethical and illegal corporate conduct is still pervasive. The economic crisis heightened concerns of widespread unethical and illegal conduct among financial institutions, ineffectual compliance, and corporate crime).

[100] *Id.*

[101] *Id.*

[102] Garrick Apollon, The intersection between LRM & DR, *supra* note 2, at 286.

[103] *Id.*

[104] *Id* at 287.

[105] *Id.*

As with any new initiative within an organization, a period of adjustment is expected.[106]

Finally, an ELRM Framework must be developed by ELRM experts working in close collaboration with the compliance and legal departments of the MNC to benchmark their current practices. A consultation committee chaired by the CRO or CCO with as many representatives of the legal team led by the CLO or GC and his senior counsel, senior and middle management of the MNC should be created to ensure the buy-in of all organizational players for the implementation of the ELRM framework, while also consulting with external stakeholders.[107]

VI. FOUR MAIN COMPONENTS OF THE ELRM FRAMEWORK

The ELRM Framework applies international risk management standards to FCPA risk such as ISO 31 000 Risk Management[108] and ISO 19600:2014 Compliance Management Systems[109] The utilization of the ISO 37 001 Anti-Bribery Management System should also be considered.[110] The implementation of an ELRM Framework should include the following four elements:

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106 *Id.*

107 *See* Mark Bandsuch, Larry Pate, Jeff Thies, *Rebuilding Stakeholder Trust in Business: An Examination of Principle-Centered Leadership and Organizational Transparency in Corporate Governance*, 113 BUS. & SOC. REV. 99, 99-127 (2008).

108 *See* ISO 31000 - Risk Management, International Organization for Standardization (ISO), http://www.iso.org/iso/home/standards/iso31000.htm (last visited Feb. 10, 2017).

109 ISO 19600:2014 Compliance management systems – Guidelines, *supra* note 54.

110 *Id.*

A. FCPA risk assessment process or how the FCPA legal services are delivered to assist the day-to-day execution of international business transactions for the MNC;[111]

B. ELRM Toolbox;[112]

C. Business analytics software utilized by the MNC for FCPA risk management and reporting;[113] and

D. Implementation of a performance measurement plan for the ELRM Framework.[114]

A. FCPA risk assessment process or how the FCPA legal services are delivered in the day-to-day execution of international business transactions for the MNC

First, the MNC needs to benchmark and compare their approach to FCPA risk assessment against the well-tested ISO 31 000 LRM process[115] and the anti-risk management guidelines developed by the UN Global Compact[116], while highlighting any gaps in their anti-corruption legal risk assessment process approach. For instance, the ISO 31 000 process is used by the Department of Justice Canada for the Government of Canada Legal Risk Management (LRM) Framework.[117]

Based on the ISO 31 000 model and the LRM Framework at the Department of Justice Canada, the LRM Framework for FCPA

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[111] ISO 31000, *supra* note 108, at 2 (explaining that a risk management policy is a statement of the overall intentions and direction of an organization related to the daily practice of risk management).

[112] *Id.*

[113] *Id.*

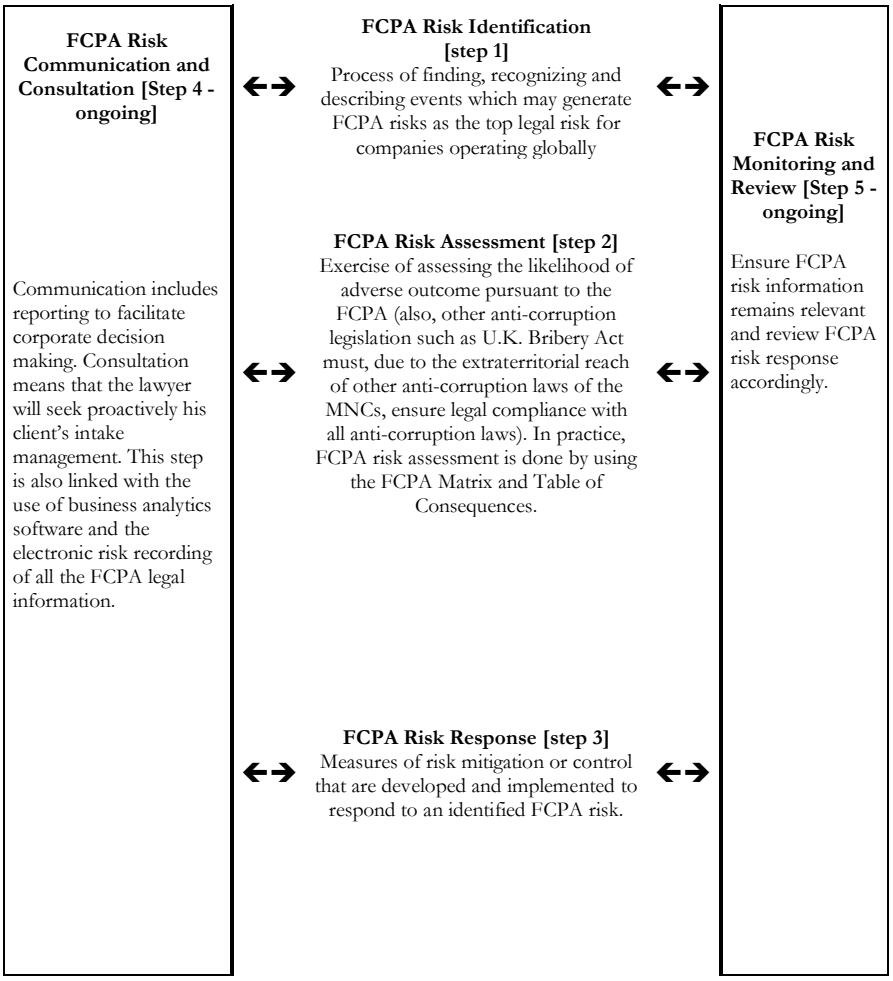
[114] ISO 19600:2014 Compliance management systems – Guidelines, *supra* note 54.

[115] ISO 31000, *supra* note 108, at 13 (explaining risk management process).

[116] United Nations Global Compact, A Guide for Anti-Corruption Risk Assessment, *supra* note 70.

[117] Garrick Apollon, The intersection between LRM & DR, *supra* note 2, at 288-290.

risks should be based on a five- step approach that can be illustrated by the following graphic:[118]



1. *FCPA Risk Identification [step 1]*

The employee needs to identify FCPA risk by using the e-library of pre-identified and pre-assessed FCPA risks.[119] In practice, these pre-identified and pre-assessed FCPA risks are called "red

[118] *Id.*

[119] ISO 31 000, *supra* note 108, at 11 (explaining the need to be creative in developing resources for risk management).

flags".[120] ISO 31 000 recommends using tools to identify the risk.[121] The tools need to address the particular foreign bribery risks faced by the MNC, including but not limited to, the following:[122]

(i) Tools and Sources for Analyzing the Risk of Corruption by Country

The UN Global compact anti-corruption risk assessment guide provides an appendix with a list of tools and their brief description for analyzing the risk of corruption by country such as the well-known Corruption Perceptions Index from Transparency International[123] or the Governance Indicators from the World Bank.[124]

(ii) Nature of the International Business Contract being Negotiated

As MNCs are often involved in cross-border strategic alliances, due diligence is crucial for these transactions.[125] As noted,

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[120] Charles Kenny & Maria Musatova, *Red Flags Of Corruption' In World Bank Projects: An Analysis Of Infrastructure Contracts*, WORLD BANK E-LIBRARY, (2010), available at http://elibrary.worldbank.org/doi/abs/10.1596/1813-9450-5243 (last visited Feb. 10, 2017).(discussing "Red flags" are indicators of potential issues regarding governance failure, collusion or corruption in projects).

[121] ISO 31 000, *supra* note 108.

[122] Transcript of Proceedings Taken in the Court of Queen's Bench of Alberta, Calgary Courts Centre, Calgary Alberta, Her Majesty the Queen v. Niko Resources Ltd., E-File No.: CCQ11NIKORESOURCES (June 24, 2011). This this list is based on Niko Probation Order, Appendix A par. C., available at https://www.scribd.com/document/61566823/Niko-Resorces-Probation-Order (last visited Feb. 10, 2017). *See Canada's Corruption of Foreign Public Officials Act: Niko Resources Ltd. Receives a $9.5 Million Fine for Bribery*, MILLER THOMSON (Oct. 2011), available at http://www.millerthomson.com/en/publications/communiques-and-updates/criminal-law-regulation-enforcement/october-2011-criminal-law-regulation-enforcement/canadas-corruption-of-foreign-public/ (last visited Feb. 10, 2017).

[123] *Corruption Perceptions Index*, TRANSPARENCY INTERNATIONAL, available at http://www.transparency.org/research/cpi/overview (last visited Feb. 10, 2017).

[124] *Worldwide Governance Indicators*, WORLD BANK, available at http://data.worldbank.org/data-catalog/worldwide-governance-indicators (last visited Feb. 10, 2017).

[125] Niko Probabtion Order, *supra* note 122.

"the U.S. regulatory authorities have made it clear through their FCPA enforcement activity that extensive FCPA due diligence is expected in connection with any merger, acquisition, joint venture or other cross-border business transactions involving entities subject to the FCPA." [126] In the case of cross-border M&As due diligence serves not only to avoid unwanted FCPA liability but also to avoid the risk of overpaying for the target's business.[127] This is particularly important if the country and industrial sector have a reputation for corrupt practices, "which the DOJ views, in and of itself, as potential "red flag" from a compliance standpoint".[128]

The DOJ has instituted an FCPA opinion procedure to assist MNC in their legal risk assessment and due diligence prior to the execution of their cross-border business transaction, particularly M&A, because of successor liability.[129] The request must be related to a real (not hypothetical) transaction and creates a rebuttable presumption applicable in a subsequent enforcement action.[130] However, requests for an opinion have not been frequent and the reluctance may be partly due to a concern that the request for an opinion may open a Pandora's box and trigger a DOJ investigation, as the opinion does not in any way limit the enforcement intentions or the litigating positions of the U.S. authorities. [131]

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[126] *Id.*

[127] *A Resource Guide to the U.S. Foreign Corrupt Practices Act*, DEPARTMENT OF JUSTICE AND SECURITIES AND EXCHANGE COMMISSION (Nov. 2012), available at https://www.justice.gov/sites/default/files/criminal-fraud/legacy/2015/01/16/guide.pdf (last visited Feb. 10, 2017) (discussing Mergers and Acquisitions: Pre-Acquisition Due Diligence and Post-Acquisition Integration).

[128] *Id.*

[129] *Id.*

[130] *Id.*

[131] *Id.*

(iii) Third Parties or Intermediaries are Involved in the International Business Transaction

In accordance with an OECD report, intermediaries were involved in 3 out of 4 foreign bribery cases.[132] 75% of cases were agents, such as local sales and marketing agents, distributors and brokers, in 41% of cases.[133] Another 35% of intermediaries were corporate vehicles, such as subsidiary companies, local consulting firms, companies located in offshore financial centres or tax havens, or companies established under the beneficial ownership of the public official who received the bribes.[134] It is important to also consider local foreign accountants and lawyers as agents.[135] A foreign agent is a "red flag" and the overwhelming use of intermediaries in foreign bribery cases demonstrates the need for enhanced and effective legal due diligence and risk assessment.[136] ELRM Framework should obligate an individual/separate FCPA risk assessment to be conducted on all foreign agents.[137]

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[132] OECD Foreign Bribery Report, *An Analysis of the Crime of Bribery of Foreign Public Officials*, OECD (2014), available at http://www.oecd.org/newsroom/scale-of-international-bribery-laid-bare-by-new-oecd-report.htm (last visited Feb. 10, 2017).

[133] *Id.*

[134] *Id.*

[135] *Id.*

[136] *A Resource Guide to the U.S. Foreign Corrupt Practices Act*, *supra* note 127.

[137] *Id.* at 34.

(iv) The Perceived Legal Culture of the Counterpart: American Universalism Versus Particularism (Rules Versus Relationships): American Universalism is based on Rule of Law, while Particularism is based on Rule of Men[138]

The need to identify if the legal culture of the foreign counterpart is Universalist or Particularistic is a highly practical one.[139] Despite the influence of culture and cultural factors which are controversial to measure corruption in specific countries.[140] This

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[138] Nicole Hines, *Cultural Due Diligence: The Lost Diligence That Must Be Found by U.S. Corporations Conducting M&A Deals in China to Prevent Foreign Corrupt Practices Act Violations Duquesne Business Law,* DUQ. BUS. L.J. BLOG, 9-19 (May 16, 2007) (discussing the importance of cultural due diligence to prevent FCPA liability).

[139] CHARLES HAMPDEN-TURNER & FONS TROMPENAARS, RIDING THE WAVES OF CULTURE: UNDERSTANDING CULTURAL DIVERSITY IN GLOBAL BUSINESS 252-64 (2d ed. 1998). Trompernaars and Hampden-Turner's statistical approach and empirical results are explained in detail in Appendix 2 of their book. For instance, the data for the Universalist/Particularist dimension were collected from the results of a hypothetical dilemma presented to approximately 70,000 managers across 65 countries. *See also* Garrick Apollon, *Sino-American Contract Bargaining and Dispute Resolution*, 13 PEPP. DISP. RESOL. L.J. Iss. 3, 396-397 (2013) (discussing the application of this theory for comparative law and management with foreign cultures).

[140] Kathleen A Getz & Roger J. Volkema*, Culture, Perceived Corruption, and Economics A Model of Predictors and Outcomes*, 40 BUS. & SOC. 7, 7-30 (2001) (asserting that corruption can impede commerce and economic development, yet it seems to be tolerated in many countries. The purpose of this study was to develop and test a model that integrates socioeconomic factors related to corruption. The analysis revealed that a negative relationship between economic adversity and wealth was mediated by corruption. Economic adversity was positively related to corruption, and corruption was inversely related to wealth. Uncertainty avoidance moderated the relationship between economic adversity and corruption, whereas power distance and uncertainty avoidance were positively associated with corruption. The implications of these results for enhancing the effectiveness of international agreements are discussed). *See also* Abigail Barr and Danila Serra, *Corruption and culture: An experimental analysis*, 94 J. OF PUB. ECON., 862-869 (2010) (discussing: why do some people choose corruption over honesty and others not? Do the social norms and values prevailing in the societies in which they grew up affect their decisions? In 2005, we conducted a bribery experiment and found that, among undergraduates, we could predict who would act corruptly with reference to the level of corruption in their home country. Among graduate students we could not. In 2007, we replicated our result and also found that time spent in the UK was

article argues that based on Montesquieu's Spirit of the Laws the "*state of law is a state of mind (l'état de droit est un état d'esprit)*"[141] that a wise lawyer should first conduct anti-corruption legal risk assessment that aims to uncover not just the "*law-in-book" and "law-in-action*" of its foreign counterparts, but most importantly their "*law-in-minds.*"[142] To achieve this lawyers should use the well-tested empirical comparative management tool by Trompenaars-Hampden-Turner called the Seven Cultural Dimension with the Universalism Versus Particularism dimension. [143] The empirical data for this cultural dimension where collected from "Did the Pedestrian Die?" as an accumulation of a decade of research into cultural diversity across the globe[144]:

> The title is taken from a hypothetical dilemma Trompenaars presents to managers - so far to about 70,000 managers in over 65 countries. He asks them to consider the situation in which they are a passenger

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associated with a decline in the propensity to bribe, although this does not explain our inability to predict graduate behaviour. We conclude that, while corruption may, in part, be a cultural phenomenon, individuals should not be prejudged with reference to their country of origin). See also Eugene Soltes, *Why they do it: inside the mind of white-collar criminals* (PublicAffairs, 2016) at 133-135 (discussing the immunity from parking violations in New York City for United Nations diplomats. Explaining that a study found that the numbers of tickets received from diplomats was the highest from high-perceived corruption countries such as Chad, Sudan, Pakistan, Mozambique, and Bulgaria. Diplomats from low-perceived corruption countries like Norway and Canada received the least). See also, John Bruner, Forbes Magazine, *The World's Most Corrupt Diplomats, As Told Through Parking Tickets* (Jul. 2011), available at https://www.forbes.com/sites/jonbruner/2011/07/12/the-worlds-most-corrupt-diplomats-as-told-through-parking-tickets-map/#c8395c82a3b7 (last visited June 21 2017).

[141] *See also* Garrick Apollon, *Sino-American Contract Bargaining and Dispute Resolution*, *supra* note 138, at 393-394 (arguing with inspiration from Montesquieu's Spirits of the Laws, that *"l'état de droit est est un état d'esprit"* (the rule of law is a rule of mind) that Montesquieu's mirror theory has some practical relevance. Yet to truly understand a foreign negotiator, a skilled negotiator should not just aim to superficially enter the mind of the foreign negotiator, but rather aim to uncover the deeper multilayers of their minds).

[142] *Id.* at 394.

[143] FONS TROMPENAARS, DID THE PEDESTRIAN DIE?: INSIGHTS FROM THE GREATEST CULTURE GURU (Capstone 2003) (explaining an accumulation of a decade of research into cultural diversity across the globe with a wide range of client organizations).

[144] *Id.*

> in a car driven by a close friend. That friend knocks down a pedestrian. The friend was travelling well above the speed limit - say 35 miles an hour in a 20-mile-an-hour-zone. There are no witnesses. The friend's lawyer suggests that testifying under oath on the friend's behalf that he was only doing 20 miles an hour may save him from serious consequences. Trompenaars asks whether the friend has a definite right, some right or no right at all to expect someone (the manager being as asked the question) to testify to the lower figure. He also asks whether - irrespective of such right - the manager would testify to the lower figure. The answers received have varied around the world and, to some extent, comply with existing stereotypes. The American and Swiss almost unanimously feel that the friend has no right to expect his friend to perjure him/herself, and that in no circumstances should this be considered. However, in Venezuela and, interestingly, in China, less than 35 per cent of people agree with this line.[145]

In sum, for particularistic cultures the application of the Rule of Law is influenced by societal or relational ethical considerations at the expense of the application of the universal legal principles of the Rule of Law. [146] Therefore, while Americans, Canadians or the British follow the rule of law, in contrast Asian, Africans, Arabs or Latin Americans tend to follow the *Rule of Men*.[147] It is important to note that certain European cultures like the French or Italians are more oriented towards Particularism.[148] This cultural orientation does not necessarily explain the propensity for a particularistic party to be corrupted but if corruption is defined as complying with the rule of law and honoring the terms and conditions of a contract that can be enforced by a court-of-law, as the Governance Indicators also known

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[145] *Id.*

[146] *See also* Garrick Apollon, *Sino-American Contract Bargaining and Dispute Resolution*, *supra* note 138, at 393-396-398 (discussing the principle of Rule of Law vs. Rule of Men).

[147] *Id.* at 396.

[148] *Id.*

as the Rule of Law Ranking from the World Bank[149] defines it, it is conventional wisdom to assert that particularistic cultures could present a higher risk of engaging in corrupt practices. However, "the *Rule-of-Law* and *Rule of Men* distinction should not be based on a philosophy of law comparison that is too moralistic and too black–and–white in order to keep its practical "analytic utility."[150] It is important to remember that "sometimes culture matters a lot, sometimes not at all".[151] Also, a legal ethnocentric approach that will see all foreign Particularistic counterparts as corrupt will "foreclose the possibility of meaningful cross-cultural relationship between American' and its foreign Particularistic counterparts".[152]

(v) Due Diligence or Audit on the Foreign Counterpart by the American Party (MNC must acquire intelligence on the field about their foreign business partners or third parties)

MNCs are starting to conduct active, often intrusive, due diligence or ethical audits not just on their prospective foreign business partners, but also on the foreign third parties they do business with.[153] The goal is to avoid corporate scandals like the case of Nike with child labor.[154]

A good example of ethical due diligence is presented in the documentary "The Factory" showing an ethical audit conducted by Nokia on the labor practices of their suppliers in China.[155] U.S.

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[149] Worldwide Governance Indicators, WORLD BANK, available at http://databank.worldbank.org/data/databases/rule-of-law (last visited Feb. 10, 2017).

[150] Garrick Apollon, *Sino-American Contract Bargaining and Dispute Resolution*, *supra* note 138, at 397.

[151] Garrick Apollon, *Cross-Cultural Deal Mediation as a New ADR Method for International*, 20 L. & BUS. REV. AM. 255, 283 (2014).

[152] *Id.*

[153] Kristen Bell DeTienne & Lee W. Lewis, *The pragmatic and ethical barriers to corporate social responsibility disclosure: The Nike case*, 60 J. OF BUS. ETHICS, 359-376 (2005) (discussing the benefits of CSR audits). See also World Economic Forum, Third party audits to prevent bribery by agents or third parties, available at http://www3.weforum.org/docs/WEF_PACI_ConductingThirdPartyDueDiligence_Guidelines_2013.pdf (last visited Feb. 10, 2017).

[154] *Id.*

[155] A DECENT FACTORY (2004).

Department of State with their American embassies and consulates abroad also provide useful information about the foreign party. However, it is crucial for the MNC in practice to conduct their own ground "ethical audits or investigations" by hiring a lawyer for the investigation or audit to remain confidential (preserve the attorney-client privilege). The MNC should also make sure to send representatives on international business trips in the field in order to interview third parties and various stakeholders (e.g. local chambers of commerce or local authorities). This approach can be related to Sun Tzu's concept of "foreknowledge".[156] According to Sun Tzu, such knowledge "cannot be gotten from ghosts and spirits, cannot be had by analogy, and cannot be found out by calculation. It must be obtained from people, people who know the conditions of the enemy."[157] Experienced international business people know that because of the complexity of cross-cultural communication and relationship-building there is so much that can be accomplished in the home office without actually going to the "field" and meeting people "face-to-face".[158]

2. *FCPA Risk Assessment [Step 2], FCPA Risk Assessment Comprises Two Fundamental Components: Likelihood and Consequences*

Following the international standard ISO 31 000, Risk Assessment [Step 2], risk assessment is defined by two components of a risk: 1) likelihood adverse outcome[159] or strength of legal position;[160] and 2)

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[156] Garrick Apollon, *Sino-American Contract Bargaining and Dispute Resolution*, *supra* note 138, at 402.

[157] *Id.*

[158] *Id.*

[159] The "likelihood of adverse outcome" means the likelihood that a point of law in accordance with the FCPA, should it be litigated, would yield an unfavorable result for the MNC. This means the likelihood of adverse outcome needs to be conceptualized on the basis that the FCPA investigation or legal challenge (prosecution) is already taking place. The likelihood of being challenged (odds of being investigated or sued/prosecuted), however, is a practical and relevant consideration that influences the level of detail for the legal risk assessment (step #2) and the proposed legal risk response (step #3) by the counsel. When counsel is privy to information that helps them to predict the likelihood of being

consequences or impacts.[161] If these two components are not assessed, then it is not a comprehensive legal risk assessment.[162] Therefore, for the purpose of the proposed ELRM process in this article, FCPA risk assessment is the exercise of assessing the likelihood of adverse outcome (FCPA liability) in the international business transaction and the negative potential consequences (such as legal, corporate, financial, ethical and reputational) of noncompliance with the FCPA.[163] The legal risk assessment is conducted with the assistance of tools, methods, and principles developed by the international standard ISO 31 000 and customized by the MNC for their own specific needs, such as the FCPA Matrix:

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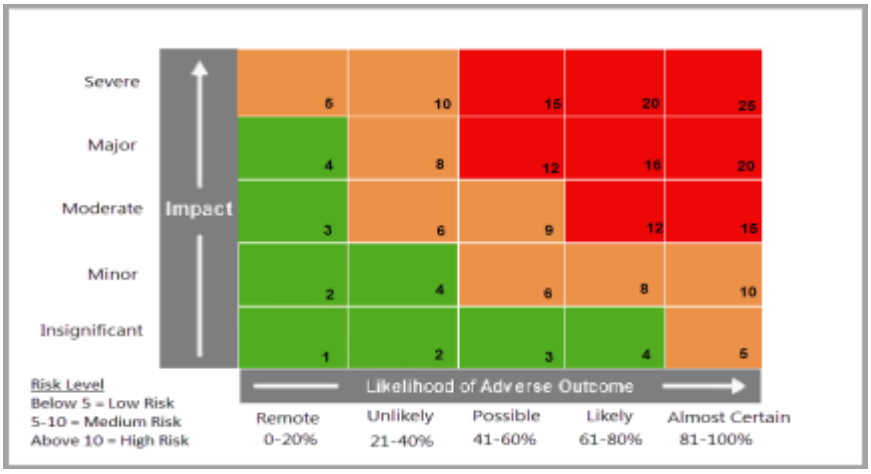
investigated or challenged pursuant to the FCPA before a court and communicates this information to his client, the legal risk assessment should clearly indicate that the likelihood of being investigated or prosecuted does not influence the risk ratings that result from using the FCPA risk assessment grid. In other, this is a separate information practical to determine the level of efforts that should be invested to manage the FCPA risk.

[160] Counsel may alternately use the "strength of legal position" when assessing the likelihood of an adverse outcome occurring in commercial advisory context. This alternative way to define likelihood of an adverse outcome reinforce the communication of the legal risk and prevent the confusion that the legal risk will be conceptualized in terms of the likelihood of being challenged. The strength of a legal position will be inversely proportional to the likelihood of an adverse outcome. This means in accordance with the FCPA Grid if the likelihood is remote (0-20%) the legal position will be very sound, if the likelihood is unlikely (21-40%) the legal position will be sound but may have some vulnerabilities, if the likelihood is possible (41-60%) the legal position is vulnerable, if the likelihood is likely (61-80%) the legal position is very vulnerable and if the likelihood is almost certain (81-100%), the legal position is extremely vulnerable. This alternative wording also help to avoid to prevent confusion by avoiding that decision-makers understand the FCPA risk in terms of the odds of the company facing an FCPA investigation or prosecution.

[161] ISO 31 000, *supra* note 108.

[162] *Id.*

[163] ISO 19600:2014 Compliance management systems – Guidelines, *supra* note 54.



Graph 1: FCPA Legal Risk Assessment Grid

LEGAL CONSEQUENCES					
Criminal liability for the corporation or directors or officers	Severe	Major	Moderate	Minor	Insignificant
Contractual liability for the corporation (breach of anti-corruption representations and warranties made)	Severe	Major	Moderate	Minor	Insignificant
Tort liability for the corporation or directors or officers (e.g. negligence)	Severe	Major	Moderate	Minor	Insignificant
Debarment of the company from public contracts	Severe	Major	Moderate	Minor	Insignificant
Liability pursuant to foreign laws anti-corruption laws (e.g. U.K. *Bribery Act* or Canada's *Corruption of Foreign Public Officials Act* (CFPOA)) that could lead to an anti-corruption	Severe	Major	Moderate	Minor	Insignificant

investigation and prosecution from a foreign regulator.					

CORPORATE/OPERATIONAL CONSEQUENCES					
Damage to viability of corporate policies	Severe	Major	Moderate	Minor	Insignificant
Business planning, resources and operations affected	Severe	Major	Moderate	Minor	Insignificant
Horizontal consequence on the operations of the organization (e.g. the subsidiaries of a multinational corporation will be affected).	Severe	Major	Moderate	Minor	Insignificant
Damage to the viability of the corporate programs, projects or initiatives affected	Severe	Major	Moderate	Minor	Insignificant

FINANCIAL CONSEQUENCES					
Stock devaluation	Severe	Major	Moderate	Minor	Insignificant
Fine, award or penalty to be paid	Severe	Major	Moderate	Minor	Insignificant
Legal and forensic accounting cost incurred	Severe	Major	Moderate	Minor	Insignificant
Loss of business customers and investors	Severe	Major	Moderate	Minor	Insignificant

Overall profitability and productivity reduced	Severe	Major	Moderate	Minor	Insignificant

ETHICAL CONSEQUENCES (CONSEQUENCES ON VALUES AND ETHICS FOR THE ORGANIZATION)					
Breach of the company's anti-corruption program	Severe	Major	Moderate	Minor	Insignificant
Breach of the company's ethical code of conduct or code on conflict of interests	Severe	Major	Moderate	Minor	Insignificant
Corporate social responsibility practices questioned internally and externally	Severe	Major	Moderate	Minor	Insignificant
Damage on the tone-at-the-top or exemplary ethical leadership to be showed by senior management	Severe	Major	Moderate	Minor	Insignificant
Damage to the organizational ethical leadership climate affecting the compliance culture that may cause the recurrence of illegal and unethical behaviors in the organization	Severe	Major	Moderate	Minor	Insignificant
Damage to the organizational ethical leadership climate affecting the compliance culture that may cause the recurrence of illegal and unethical behaviors in the organization	Severe	Major	Moderate	Minor	Insignificant

REPUTATIONAL CONSEQUENCES					
Loss of respect of the stakeholders, investors and public through negative media coverage.	Severe	Major	Moderate	Minor	Insignificant
Loss of trust of employees and other stakeholders	Severe	Major	Moderate	Minor	Insignificant
Reputation or brand affected	Severe	Major	Moderate	Minor	Insignificant
External relations with U.S. government enforcement agencies affected	Severe	Major	Moderate	Minor	Insignificant
Stockholders affected	Severe	Major	Moderate	Minor	Insignificant
Potential partners or buyers for mergers and acquisitions or strategic alliances are scared away.	Severe	Major	Moderate	Minor	Insignificant

In conclusion, it is important to understand that the level of effort and detail for each FCPA risk assessment will vary and is primarily based on the judgment of the lawyer.[164] This will also depend on many other factors such as FCPA risk and complexity level (more effort and detail will be put in a high risk or complex file), importance of the file for senior management or the client department in order to meet client's expectations, what is possible within the time and resources allowed by the client to the lawyer,

[164] Garrick Apollon, The intersection between LRM & DR, *supra* note 2, at 308.

information available, and complexity or novelty of the corruption-related legal issue in question.[165]

3. *FCPA Risk Treatment and Response [step 3]*

Following the international standard ISO 31 000, Risk Treatment Risk Response [step 3], is the process of selecting and implementing measures to determine the appropriate course of action to follow in responding to the identified FCPA risk and managing its potential negative consequences.[166] Usually, a legal risk management strategy is proposed by the lawyer and it is the responsibility of the corporate client as the decision maker to select the best risk response option (FCPA risk management is a shared responsibility).[167] The four common risk treatments or responses are: 1) risk avoidance, this means to avoid or cancel the transaction because the likelihood of adverse outcome is too high and the MNC was unable to mitigate the FCPA risk to an acceptable risk tolerance level;[168] 2) risk mitigation means improving the legal position of the MNC to a risk tolerance level that is acceptable;[169] 3) risk shifting/transferring is a usual risk response in ELRM but this is not a valid option with FCPA risk because of third party liability and successor liability;[170] 4) risk acceptance (status quo) is not a valid option unless the FCPA risk has been identified as insignificant by the lawyer. A FCPA risk is a serious risk that should always be mitigated to an acceptable risk tolerance level for the MNC.[171]

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165 *Id.* at 306 (discussing that a lawyer's ability to complete an accurate legal assessment may be dampened by several factors, such as lack of information; lack of time; situational constraints based on resources or power; and self-selection processes. etc.).

166 *Id.* at 289.

167 *Id.* at 275 (discussing that legal risk management is shared responsibility between lawyer-client).

168 *Id.* at 289.

169 *Id.* at 289.

170 *Id.* at 289.

171 ISO 31 000, *supra* note 108.

4. *FCPA Risk Communication and Consultation [Step 4-ongoing]*

Following the international standard ISO 31 000, Risk Communication and Consultation is an integral and on-going part of the decision-making process because legal risk management is a shared responsibility between lawyer-client.[172] It refers to the efficient communication and consultation of the FCPA risk between the lawyer-client, to ensure that the client as the decision-maker is aware of the identified FCPA risks and will respond to it appropriately.[173] Lawyer-client risk communication and consultation is on-going.[174] Risk communication and consultation is challenging because this is not just a technical task but also a human one.[175] Risk communication and consultation is intrinsically linked with negotiation and dispute resolution because it aims to resolve issues that the company is facing due to FCPA risk.[176] Therefore, there is not just the objective to deal with substantive issues such as legal compliance issues that are subject to legal interpretation, but also crucially the non-substantives issues such as issues in relation to the organizational culture and conflicts that can cause bad emotions.[177] For instance, it is obvious that when a huge bonus, promotion or performance appraisal is at stake for an employee, such employee might be biased in his or her perception and assessment of the FCPA risk.[178]

The effectiveness of the ELRM communication and consultation process is based on good negotiation and dispute

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[172] *Id.*

[173] *Id.*

[174] *Id.*

[175] Garrick Apollon, The intersection between LRM & DR, *supra* note 2, at 298 (explaining that LRM is primordial because negotiations and disputes are formed by rational arguments based on the law and facts. However, in negotiation and dispute resolution, there is always more than rational argument based on what the law and facts present because human beings are not computers or robots that can be programmed. Even though LRM exists to objectify and rationalize the practice of law, we cannot stop having emotions any more than we can avoid all risks at all times).

[176] *Id.* at 276.

[177] Garrick Apollon, The intersection between LRM & DR, *supra* note 2, at 297-303 (discussing the importance for the legal to manage emotions in relation to the legal risk).

[178] *Id.* at 309-310.

resolution skills.[179] Therefore, this article also invites MNCs to reframe FCPA compliance as a negotiation and dispute resolution issue and provide training in this field to their employees.[180] First, this will help employees to resolve internal conflicts in relation to the application of the ABC compliance program and ELRM Framework. Second, this will help the international business negotiators and deal makers for the MNC on the field to resolve FCPA compliance issues with foreign public official requesting bribes by finding creative and ethical solution to this problem. After all, corruption and bribery is as an illegal and immoral bargaining tactic occurring during the negotiation of international deals or settlement of international disputes (e.g. environmental or tax disputes with local foreign governments). Therefore, an international negotiator needs great cultural intelligence[181] and a lot of creative negotiation and dispute resolution skills to comply with the FCPA at all times while securing international deals.[182] This means that employees need training and skills in the field of cultural intelligence and negotiation ethics.[183]

Finally, this step is linked with the use of business analytics software and the electronic risk recording of all the FCPA legal information. Counsel should be mandated to enter timekeeping, complexity and risk information in the business analytics software within a determined number of days of the legal file being opened, and to select one of the option buttons in the software for risk recording such as: 1) "FCPA risk is insignificant" (i.e. the risk is so low that it is not considered negligent to not conduct a comprehensive legal risk assessment and avoid the cost/time

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[179] *Id.* at 314 (explaining that risk communication between lawyer and client, and with the other party, is key to a successful commercial mediation because it contributes to defining both the substantive and non-substantive issues and interests, generating options, and working on a more durable and efficient settlement agreement.).

[180] Garrick Apollon, *MMA Negotiation*, 15 U. DENV. SPORTS & ENT. L. J. 3, 11-12 (2013) (theorizing that MMA Negotiation should be viewed and practiced on the foundation of four core disciplines, like the four elements of nature, to allow the negotiator to reframe his reality).

[181] *Id.* at 19 (theorizing on the cross-border and cross-cultural discipline).

[182] *Id.*

[183] *Id.* (theorizing on the cross-border and cross-cultural discipline that must be aligned with the discipline the legal risk management discipline).

associated with it– e.g. an international contract is signed by a Delaware company with the Government of Canada); 2) "FCPA risk may materialize now or in a near future" (i.e. FCPA risk must be managed and monitored on an on-going basis and updated when necessary). When the FCPA risks may materialize now or in the near future should it be mandatory to conduct the legal risk assessment. It is also key to have a third option button for "Unauthorized or Illegal" (i.e. the international business transaction is unauthorized following the ABC policies of the MNC (e.g. in the context of a political contribution to a foreign political party for an act against the ABC policies or an expensive gift or lavish dinner that could be interpreted as 'illegal' in accordance with the FCPA).[184]

5. *FCPA Risk Monitoring and Review [Step 5 - ongoing]*

Following the international standard ISO 31 000 FCPA Risk Monitoring and Review, the ongoing monitoring by the lawyer and his client is essential to ensuring that FCPA risk information remains relevant and up-to-date.[185] FCPA risk-reviewing and monitoring must be based on analytic software to store the risk information "before evidence is lost and panic sets in."[186] The goal is to establish an advanced secured internet repository to insert, review and report on the FCPA risk.[187] Overall, business analytics software facilitates data acquisition and analysis by using the most up-to-date analytic software to measure and monitor the performance of the ABC

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[184] *A Resource Guide to the U.S. Foreign Corrupt Practices Act*, *supra* note 127, at 15 (explaining that FCPA does not ban gifts and travel. It prohibits payment of bribes, including those disguised as gifts. Most companies and their employees are clear that large payment for gifts, travel and entertainment can constitute FCPA violations, if they are given to government officials or to employees of state-owned enterprises to obtain or retain business).

[185] ISO 31 000, *supra* note 108, at 20 (theorizing on risk monitoring and review).

[186] Garrick Apollon, The intersection between LRM & DR, *supra* note 2, at 286 (asserting that LRM is about effective business intelligence, business analytics, and electronic file management—more generally referred to as law practice management and technology).

[187] *Id.*

compliance program and ELRM Framework in the day-to-day international business transactions of the MNC.[188]

Review can occur every five (5) days or every day for high risk international business transaction.[189] If no change, the lawyer will simply indicate and click on the business analytics software option button "no change" but at least this will protect him and his client by showing that he is diligently monitoring the FCPA file for the benefit of his client and organization.[190] This means a policy should be established for lawyers to know when to open and close their FCPA files in the business analytics software in order to ensure compliance but also avoid unnecessary workload such as monitoring inactive files that should be closed.[191]

B. ELRM tools

It is important to have a friendly ELRM user Toolbox on the organization's secured website that is translated into other languages so that all employees and third parties can easily gain access to it. ELRM Toolbox must offer flexible tools to account for distinctiveness between the legal advisory function of preventing FCPA risk and the function of reacting to a corruption risk that might cause an investigation or worse a conviction pursuant to the FCPA.[192] The ELRM Toolbox must be customized to the reality and needs of the organization.[193] The ELRM Toolbox should include but not be limited to, the following tools:

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[188] *Id.*

[189] ISO 31000, *supra* note 108, at 20 (explaining that both monitoring and review should be a planned part of risk management process and involve regular checking or surveillance. It can bed periodic or *ad hoc*. Therefore, the idea of five days is just an example).

[190] Garrick Apollon, The intersection between LRM & DR, *supra* note 186.

[191] ISO 31 000, *supra* note 108, at 21 (explaining that recording the risk management process should provide the foundation for improvement in methods and tools, as well as in the overall process).

[192] *Id.* at 20.

[193] *Id.*

1) A guide with frequently asked questions (FAQs) on the ELRM Framework;

2) A one-pager explaining the FCPA risk assessment process;

3) A guide for with the FCPA risk assessment techniques for lawyers;

4) FCPA Matrix and Table of Consequences (see Graph 1 in this article);

5) E-library of pre-identified and assessed FCPA risks by country, industrial sector of operations, legal foreign culture, interactions with various types and levels of government officials, involvement in strategic alliances (e.g. IJV, M&A, R&D, etc.), importance of licences and permits in the company's operations, degree of governmental oversight and inspection, and volume and importance of goods and personnel clearing through customs and immigration;

6) FCPA Consequences Assessment Sheet (i.e. standard E-form for legal counsel to obtain necessary factual information and intake from their clients to conduct an appropriate FCPA risk assessment with all the non-legal consequences, a good lawyer usually understands the business of their clients but clients are often best placed to know more about the corporate, financial, ethical and reputational consequences);

7) ELRM Committee (to review and approve high FCPA risk international business transactions);

8) A Guide that will serve as core training tool for the MNC similar to RESIST[194] with real-life FCPA scenarios collected over the years from the MNC corporate memory;

[194] RESIST: Resisting Extortion and Solicitation in International Transactions. A company tool for employee training, TRANSPARENCY INTERNATIONAL (Mar. 21, 2011) available at https://www.transparency.org/whatwedo/publication/resist_resisting_extortion_and_solicitation_in_international_transactions.

9) FCPA Communication Guide- provides legal counsel with practical tips on how to communicate FCPA risk to their clients in an effective manner for better results.[195]

C. Business analytics software utilized by the MNC for FCPA risk management and reporting

ELRM is all about effective business intelligence, business analytics, and electronic file management—more generally referred to as law practice management and technology.[196] The goal is to use a business analytics software to bring periodic FCPA risk reports to senior management, the Board, but also to stockholders, insurers, investors, lenders, regulators or stakeholders in order to build trust and show that the MNC is managing its FCPA risk in international business transactions in a proactive, diligent, ethical, transparent, accountable and cost-efficient manner.[197]

D. Performance measurement plan for the ELRM framework

The international standard ISO 19 600 – Compliance Management Systems provides useful guidelines for the performance evaluation of the monitoring, measurement, analysis and evaluation of a compliance system such as an ELRM Framework.[198] The monitoring of the ELRM Framework should include effectiveness of the ELRM training[199], effectiveness of the controls and inspections (audits)[200], effectiveness of the audits conducted with the FCPA reports from the analytic software on the performance of lawyers in managing their FCPA files (e.g. quantitative reports about the

195 ISO 31000, *supra* note 108, at 14-15 (discussing risk communication and consultation).

196 Garrick Apollon, The intersection between LRM & DR, *supra* note 186.

197 Evan Peterson, *supra* note 1 (explaining the strategic advantages of effective corporate compliance).

198 ISO 19600:2014 Compliance management systems – Guidelines, *supra* note 54, at 21-25.

199 *Id.* at 15-16.

200 *Id.*

compliance rate for the insertion of the FCPA risk information in the system and qualitative reports on the quality of the legal advice provided by the lawyers for their FCPA files), effective allocation of the ELRM role and responsibilities for the lawyer-client, surveys about the practicality and acceptance of the ELRM Framework in the organization, effectiveness in addressing failures of ELRM Framework previously identified, etc.[201]

VII. CONCLUSION

This article shows that it is not too difficult for a MNC to implement an ELRM Framework specific to FCPA risk. This article also demonstrates that the strategic and economic benefits of an ELRM fFramework outweigh the cost of its implementation in order for the MNCs to better control their in-house and outside legal fees and strengthen their FCPA compliance program.[202] Generally, this article shows that an ELRM Framework helps legal departments to not just improve their FCPA compliance but also modernize their legal practices.[203] This article, shows like my mother always says, that "an ounce of prevention is worth a pound of cure"!

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[201] *Id.*

[202] Garrick Apollon, The intersection between LRM & DR, *supra* note 2, at 307

[203] *Id.* at 271 (Susskind's message for lawyers remains a stark one: in order to guarantee a stake in the legal system of the future, lawyers must adapt their work practices or die. Therefore, the importance of effective legal risk management has risen to the top of the list of priorities of many law firms and in-house legal departments).

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INTERNATIONAL TAX PLANNING AS A BUSINESS DRIVER

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I. INTRODUCTION

Taxation is unique as the single most consistent function of government. For as long as the world has needed governments, governments have needed taxes. There have been few options available for governments to raise money that have been as successful and as simple. The word 'tax' itself first appeared in English in the 14th century. The Latin word *Taxare* means "to assess." In England, the related words 'tax' and 'task' were commonly used referring to labour and money as a 'duty' respectively.[1] Because of their compulsory nature – as long as there have been taxes – there have also been strategies to avoid them. The imposition of duties has driven mass migrations, transitions in governments, riots and even wars.

Under the Egyptian Pharoahs 'scribes' raised funds however possible, including a tax on cooking oil. To ensure that the citizenry was using the taxed cooking oil and not a substitute, these early scribes conducted regular 'audits' of the citizens' homes.[2] Governments have also emphasized one type of tax over another, relying on the value system of their citizenry, or even political goals in funding government operations. For example, some jurisdictions like the member states of the European Union rely more heavily on a consumption tax (or "Value Added Tax"). A consumption tax has the advantage of being easier to levy than an income tax or estate tax, because a consumption tax is collected automatically by a merchant whereas an income or estate tax requires a semi-voluntary declaration to be issued by the party being taxed.

In the world of tax, not only the rules, but also the enforcement mechanisms are varied based upon the values of the people. As people have run from taxes, governments have run after people. Governments around the world have taken different positions on which avoidance strategies are legal and which are forbidden. As an example of enforcement leniency, the Swiss authorities have implemented a system that is quite different than

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[1] *A Short History of Taxation*, NEW INTERNATIONALIST MAGAZINE (2008), https://newint.org/features/2008/10/01/tax-history/ (last visited May 1, 2015).

[2] *Id.*

what is applied in much of the rest of the world. In Switzerland, failure to disclose a taxable event is an infringement that is among the lowest categories of criminal offenses and only subject to a fine.[3] In the United States, the use of tax enforcement is at the extreme opposite, drawing criticism over its alleged use as a political tool. Across the Atlantic, former tennis star, Boris Becker was accused of living in Germany while claiming tax residency in Monaco whereby he avoided paying 1.7 million Euros in taxes to the German government from 1991 to 1993. After admitting to evasion and being sentenced to pay a $500,000 fine and serve 2 years of probation in Germany, Becker moved to Switzerland.[4]

The stakes are of course much higher among Corporate Multinationals. Boards of Directors owe a fiduciary duty to their shareholders, and that duty embraces obligations to deliver bottom line performance and yield.[5] This is counterbalanced by external obligations to ensure that the company meets its tax and regulatory obligations. These obligations are inversely correlated. As the board errs on the side of safety in its tax strategy, it returns less to its shareholders. This also drives down stock price and makes the company less competitive in cash draining activities like Research and Development. Contrarily as companies take greater risks in their tax strategies, they better meet their obligations to effectively manage the individual company's capital, optimize its competitiveness, and of course – its returns. This is directly reflected on the financial statements of the largest publicly traded companies. In 2013, Apple, Inc. made headlines when the United States Senate reported that America's largest company had avoided paying tax on $102 billion of profits anywhere in the world by exploiting rules that made income

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[3] Pietro Sansonetti, *Tax evasion: The evolution of the Swiss Criminal Tax Law Tax evasion: The evolution of the Swiss Criminal Tax Law*, INT'L TAX REV. (Mar. 12, 2013), http://www.internationaltaxreview.com/Article/3167155/Tax-evasion-The-evolution-of-the-Swiss-Criminal-Tax-Law.html (last visited Apr 1, 2015).

[4] *Ex-Tennis Star Given 2 Years' Probation*, N.Y. TIMES (2002), http://www.nytimes.com/2002/10/25/world/ex-tennis-star-given-2-years-probation.html (last visited Mar 15, 2015).

[5] William M. Lafferty, Lisa A. Schmidt & Donald J. Wolfe, *A Brief Introduction to the Fiduciary Duties of Directors Under Delaware Law*, 116 PENN ST. L. REV. 837, (2012), http://www.pennstatelawreview.org/116/3/116%20Penn%20St.%20L.%20Rev.%20837.pdf.

from its European operations "sourceless," and thus, not subject to tax anywhere.[6]

The realities of the varied sovereign tax opportunities are no surprise to authorities around the world. Tax systems have grown up organically and selfishly. In order to accommodate business in a rapidly globalizing world, governments have needed to make agreements with one another to preserve fairness in the way their tax systems interact; namely to avoid or limit double-taxation and to preserve equity by taxing all income as equally and fairly as possible. In January 2003, the Organization for Economic Co-operation and Development ("OECD") introduced the Model Tax Convention, which was designed to provide a framework by which countries were to mitigate the effects of double taxation.[7] Apple was nonetheless ultimately able to accomplish its tax plan by manipulating tax treaties, residency rules and the specific treatment of certain types of income in different jurisdictions.[8]

Governments are held politically accountable through the ballot box and their leaders want to earn votes and political capital by attracting large corporations to their geographic and economic bases. In response to these pressures, leaders of high-tax countries like the United States, Germany and the United Kingdom in particular, have called for a treaty system to limit tax jurisdiction competition of this nature.[9] This war cry resulted in the creation of a project. Spearheaded by the OECD, this project is known as the Action Plan on Base Erosion and Profit Shifting ("BEPS") and it was issued by the OECD on July 19, 2013 with the goal of reviewing the

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[6] Emily Cohn, *Apple Paid Little Or No Taxes To Any Government On Billions In Profits: Senate Report,* HUFFINGTON POST (May 20, 2013), http://www.huffingtonpost.com/2013/05/20/apple-senate-report-offshore-tax-structure_n_3308741.html (last visited Mar 1, 2015).

[7] OECD, *Articles of the Model Convention With Respect to Taxes on Income and on Capital* (2003), http://www.oecd.org/tax/treaties/1914467.pdf (last visited Feb 12, 2015).

[8] *Supra* note 6.

[9] *Who are the BEPS supporters?,* TAX ADVISER MAGAZINE (2014), http://www.taxadvisermagazine.com/article/who-are-beps-supporters (last visited Feb. 10, 2015).

interaction of nations' tax systems and proposing changes in international taxation laws.[10] According to the OECD:

> Base erosion and profit shifting (BEPS) is a global problem which requires global solutions. BEPS refers to tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity, resulting in little or no overall corporate tax being paid. BEPS is of major significance for developing countries due to their heavy reliance on corporate income tax, particularly from multinational enterprises (MNEs).
>
> In an increasingly interconnected world, national tax laws have not always kept pace with global corporations, fluid movement of capital, and the rise of the digital economy, leaving gaps that can be exploited to generate double non-taxation. This undermines the fairness and integrity of tax systems. Fifteen specific actions are being developed in the context of the OECD/G20 BEPS Project to equip governments with the domestic and international instruments needed to address this challenge. The first set of measures and reports were released in September 2014. Combined with the work to be completed in 2015, they will give countries the tools they need to ensure that profits are taxed where economic activities generating the profits are performed and where value is created, while at the same time give business greater certainty by reducing disputes over the application of international tax rules, and standardising [sic] requirements. For the

[10] OECD BEPS Project - EY Canada, EY CANADA - EY - CANADA (2016), http://www.ey.com/CA/en/Services/Tax/Tax-BEPS (last visited Jun 20, 2017).

> first time ever in tax matters, non-OECD/G20 countries are involved on an equal footing.[11]

As tax jurisdiction competition becomes limited, the central questions presented by our modern world is (i) can tax still drive business decisions for multinational corporations and (ii) to what extent does tax drive those decisions in today's globalized environment?

II. TAX JURISDICTION COMPETITION AS A THEME

In tax planning it is easy to become myopic — only seeing tax as a reason to make a decision about where to locate a business component. However, a number of factors drive major business decisions and more often there is a balancing act between the interests and value proposition of each business driver especially in choosing a venue for a business headquarters, operation, subsidiary or branch. Consider the non-tax reasons driving these decisions. These include preserving logical group and legal structure that appeals to simplicity and predictability, which is something appealing prospective investors. They also include preserving the subsidiaries' balance sheets and thus their financing capabilities. Decision makers cannot ignore political and economic stability in the jurisdiction nor the regulatory requirements.

In 2009 McKinsey Consulting conducted a global study entitled *How companies make good decisions* in which 34% of executive respondents cited "expansion into new products, services or geographies" as the driving factor in decision making compared to 21% citing "organizational change for other reasons," which based upon the alternatives would encompass tax and regulatory reasons. When asked about the "general goal of [any] given type of decision," 78% cited revenue growth as the driving factor, while only 22% cited cost savings, which would likewise encompass tax planning.[12]

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[11] *About BEPS and the inclusive framework*, OECD http://www.oecd.org/tax/beps-about.htm (last visited Jun 20, 2017).

[12] Massimo Garbuio, Dan Lovalla & Patrick Viguerie, *How companies make good decisions, McKinsey Global Survey Results*, MCKINSEY & COMPANY (Jan. 2009),

The implications of these results show that in essence tax jurisdiction competition can have a marginal impact on business decisions, however the implications of even the most favorable structure is limited because of competing drivers influencing executive decision making. Based upon the McKinsey study and the OECD BEPS response to tax jurisdiction competition, we can draw the conclusion that if we assume for the sake of discussion that the risk factors among different tax strategies are the same, then the attractiveness of a tax regime will drive a business decision toward a tax strategy encompassing that regime:

(1) to the extent it doesn't compete with other factors;

(2) is relatively simple to implement; and

(3) provides for a real and appreciable tax savings.

A. How Tax Jurisdiction Competition Works

There are several tax-oriented factors that can drive a tax strategy and the corresponding establishment of basic holding structures implicating low-tax and no-tax jurisdictions.

The first and most obvious goal is that companies seek to reduce withholding taxes, or the combined income taxes that the company must pay on its operations both locally in the investors' country and in the country which hosts the operations by using tax treaties. The second goal is to protect corporate profits from local capital gains tax by using tax treaties. These factors are what the OECD BEPS project has addressed in what is called BEPS Actions 2 (Hybrid mismatch arrangements) and 6 (Preventing Treaty Abuse).[13]

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http://www.mckinsey.com/insights/strategy/how_companies_make_good_decisions_mckinsey_global_survey_results (last visited May 1, 2015).

[13] *BEPS - Frequently Asked Questions*, OECD, http://www.oecd.org/ctp/beps-frequentlyaskedquestions.htm (last visited Mar 1, 2015); *BEPS Action 2 - Branch Mismatch Structures*, OECD (2016), http://www.oecd.org/tax/beps/Discussion-draft-Action-2-Branch-mismatch-structures.pdf (last visited Mar. 15, 2017).

The third goal is to provide tax efficiency for the movement of cash, and the fourth is to implement tax-efficient financing structures. This fourth factor is addressed by the OECD BEPS project in BEPS Actions 8 (Transfer pricing of intangibles) and 13 (Transfer pricing documentation).[14]

1. *Tax Treaties and Source and Residency Rules*

People move around, but have the advantage for tax purposes of only being able to be in one place at a time. If a miner mines for gold in South Africa, most would agree that the source of that gold is South Africa. Let's assume that miner is paid for his work and work-product (the gold) in South Africa; he of course is subject to tax in South Africa. This is called his "Source Income" and is taxed at the source.[15] If however, it happens that this miner is a resident of neighboring Zimbabwe then he is also subject to tax on his income on the basis of his residency in Zimbabwe.[16] This is called "Residency Income." To go a step further, if it happens that this miner is a citizen of the United States as defined by the United States tax code, the United States tax code provides that his income wherever in the world it may be sourced will be taxed by the United States.[17] This is where the OECD model convention comes into play. Article 23 governs how to handle the above scenario. There are two basic options Article 23A, known as the "Exemption Method" and Article 23 B, known as the "Credit Method."[18] As the names indicate, the Exemption Method involves exempting income from taxation in one of the two contracting states from any tax whatsoever. The Credit Method involves crediting the tax paid in one state against the tax paid in the other contracting state. The model treaty distinguishes income derived from various types of activities and allocates the income to more closely align with the source country.

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[14] *Id.*

[15] BLACK'S LAW DICTIONARY (2d ed.).

[16] Clive Mphambela, *Residence-based tax system commendable,* THE ZIMBABWE INDEPENDENT (Mar. 1, 2013), http://www.theindependent.co.zw/2013/03/01/residence-based-tax-system-commendable (last visited Mar 12, 2015).

[17] INTERNAL REVENUE CODE, § 7701(b).

[18] *Supra* note 7.

Unfortunately for our miner, there is no double-taxation treaty between the United States and Zimbabwe. As a result the miner must pay tax on the income "in the same way and at the same rates shown in the instructions for the applicable U.S. tax return."[19] In other words, our miner will be subject to taxation on the same income, both at the applicable rate in Zimbabwe and the United States.

If however, our miner moves across the border to South Africa, his income is taxed only once in South Africa and pursuant to Article 23 of the Tax Convention with South Africa, our Miner would be able to apply as a credit, the tax paid in South Africa against the tax due in the United States.[20]

Unlike a natural person, an entity such as a Corporation, Limited Liability Company or Trust is much more difficult to locate geographically for residency purposes when these entities operate on a global level. Consider that a Corporation might be formed in one jurisdiction, but have operations in many foreign jurisdictions and be managed in yet another jurisdiction. Out of 23 major economies surveyed by the accounting firm Deloitte, four placed their residence in the place of incorporation and sixteen placed it by using some form of a "place of effective management" standard.

Incorporation	**Place of effective management**	**Incorporation and place of effective management**	**Registration**
Estonia, Hong Kong, Russia, United States	Denmark	Austria, Canada, China, Cyprus, Czech Republic, Germany, Greece, Hungary, Ireland, Luxembourg, Malta, The Netherlands, Portugal, Romania, South Africa	Denmark, Sweden, Ukraine [21]

[19] *United States Income Tax Treaties - A to Z*, INTERNAL REVENUE SERVICE, http://www.irs.gov/Businesses/International-Businesses/United-States-Income-Tax-Treaties---A-to-Z (last visited July 2, 2015).

[20] *Tax Convention With South Africa*, INTERNAL REVENUE SERVICE (Jan. 1, 1998), http://www.irs.gov/pub/irs-trty/safrica.pdf (last visited July 2, 2015).

[21] *Survey into substance, place of residence and tax avoidance*, DELOITTE (Dec. 6, 2012), http://www2.deloitte.com/content/dam/Deloitte/nl/Documents /tax/deloitte-nl-nederland-geen-belastingparadijs.pdf (last visited June 10, 2015).

As discussed in the Deloitte survey:

> When a company is subject to tax because the place of effective management is in the state concerned, most countries take into account facts and circumstances. This usually is an open standard, but several factors can be taken into account. In almost all cases it would be decisive where the central management is performed and the main business decisions are taken. This is not necessarily the place where the day-to-day management takes place. Other relevant factors that can be taken into account are the place where the directors reside or, more formally, the place of the registered office. Some countries apply only one of above criteria to determine the tax liability of a company, other countries apply both criteria besides each other.
>
> * * *
>
> *In addition to this table, please note that most countries stated the place of effective management under bilateral tax treaties to be decisive for determining the place of residence in the event of dual resident companies.*[22]

It is the very nature of this difference in establishing tax residency that tax planners have traditionally sought to take advantage of in planning zero-tax strategies like those employed by Apple, Inc. identified and discussed generally above.

2. *Intra-Europe and International Tax Competition*

One of the broadest differences between the European Union and the United States is the federal/supranational competency to levy taxes. Although such a power is contemplated within the EEA treaty, it has never been exercised by European Authorities and has otherwise been left to the Member States.[23] The United States however, has exercised its direct authority to tax and levy pursuant to

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[22] *Id.*

[23] EEA Treaty art. 115, *opened for signature* May 2, 1992.

the United States Constitution, which has been powerfully implemented from the beginning.[24]

This distinction is significant because these factors give the European Union a powerful pro-jurisdictional competition slant. The United States on the other hand consolidates its power through its tax base and collects the lions share of corporate and personal income taxes paid by its subjects through its Internal Revenue Service ("IRS"), as opposed to the much smaller rates collected by the states.

Thus, while certain states are more attractive because they levy no corporate income tax, all U.S. Corporations are subject to tax at 35% for their 2014 taxable income at or above $18,333,333, which covers every major U.S. Corporation.[25] In the United States, as in most parts of the world, a Corporation is taxed as an entity itself on its annualized taxable gross income. The income that it distributes to its shareholders is subsequently taxed a second time at the shareholder level as a dividend. The dividend tax is calculated on a bracket scale that corresponds to that person's ordinary income tax bracket.[26] There are two scales divided into Ordinary Dividends and Qualified Dividends, which are subject to a lower level of taxation, provided that the investor held the shares in the company for a minimum holding period prior to the ex-dividend date. The maximum ordinary dividend tax is 39.6% and the maximum qualified dividend tax is 20%.[27]

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[24] U.S. CONST. ART. I § 8.

[25] Internal Revenue Service, *2014 Instructions for Form 1120*, Ctat. No. 11455T (Jan. 8, 2015).

[26] For the purposes of discussion all references to "Person" or "person" unless specified as applying only to "natural person(s)" shall mean an individual, a trust, estate, partnership, agency, branch or corporation organized or incorporated under the laws of the relevant jurisdiction.

[27] *Tax Law Changes for 2008*, KIPLINGER'S (2009), http://www.kiplinger.com/features/archives/2008/11/tax-planning-tax-law-changes4.html?kipad_id=44 (last visited Jun 20, 2017); *Supra* note 19. Qualified Dividends must (a) be paid after December 31, 2002, by (i) a U.S corporation, (ii) a foreign corporation located in a jurisdiction subject to a U.S. tax treaty or (iii) on stock in a foreign corporation traded on a U.S. exchange by way of an American Depository Receipt (A.D.R.), and (b) the stock must have been held by the investor for more than 60 out of the 121 days preceeding the ex-dividend date.

III. SURVEY OF LOW TAX JURISDICTIONS

The nominal corporate tax rate, although a significant consideration in tax planning, is often neither the central operative factor in a tax planning strategy for a multinational corporation nor is it a business driver. Instead it is more often the special tax treatment of certain types of income in a certain jurisdiction that plays a major factor. However, it is important in understanding basic structures to evaluate the nominal rate of a jurisdiction to provide a baseline for understanding the tax efficiency of the given strategy.

High Tax	**Medium-High**	**Medium-Low**	**Low Tax**	**No Tax**
Japan (33.06%)	Australia (30%)	China (25%)	Bulgaria (10%)	British Virgin Islands
USA (40%)	Brazil (34%)	Hungary (19%)	Cyprus (12.5%)	Cayman Islands
	Canada (26.5%)	Poland (19%)	Ireland (12.5%)	Estonia
	France (33.33%)	Romania (16%)	Latvia (15%)	Jersey
	Germany (29.65%)	Russia (20%)	Netherlands (25%)	UAE[28]
	India (34.61%)	Slovenia (17%)	Switzerland (17.92%)	
	Malta (35%)	UK (20%)		
	Spain (28%)			

[28] *Tax tools & resources*, KPGM, http://www.kpmg.com/Global/en/services/Tax/tax-tools-and-resources/Pages/corporate-tax-rates-table.aspx (last visited Jun 20, 2017).

IV. PAST: TRADITIONAL TAX STRUCTURES

A. Limited Liability Companies and Corporations

As a preamble to understanding basic holding structures, it is important to understand the tax distinction in business entity types and how tax rules evolved organically to permit these types of arrangements. For tax purposes, most places in the world classify business entities into two types: pass-through or disregarded entities, and entities with a corporate personality; the two most common American varieties being the Limited Liability Company[29] and the Corporation, respectively.[30] These types of forms have an equivalent structure in most jurisdictions, for example, in Switzerland and Germany the *Gesellschaft mit beschränkter Haftung (GmbH)*[31] (Farlex) and *Aktiengesellschaft (AG).*[32]

The primary feature shared by both Limited Liability Companies and Corporations is "Limited liability."

Limited liability is a type of liability that does not exceed the amount invested in a partnership or limited liability company. The limited liability feature is one of the biggest advantages of investing in publicly listed companies. While a shareholder can participate wholly in the growth of a company, his or her liability is restricted to the amount of the investment in the company, even if it subsequently goes bankrupt and racks up millions or billions in liabilities.

In a partnership, the limited partners have limited liability, while the general partner has unlimited liability. The limited liability feature protects the investor's or partner's personal assets from the

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[29] *Small Business/Self-Employed Topics, Limited Liability Company (LLC)*, INTERNAL REVENUE SERVICE, https://www.irs.gov/businesses/small-businesses-self-employed/limited-liability-company-llc (last visited Jun 20, 2017).

[30] *Id.*

[31] *The Free Dictionary*, GMBH, http://acronyms.thefreedictionary.com/GmbH (last visited Jun 26, 2015).

[32] *The Free Dictionary*, AKTIENGESELLSCHAFT, http://financial-dictionary.thefreedictionary.com/Aktiengesellschaft (last visited Jun 24, 2015).

risk of being seized to satisfy creditor claims in the event of the company's or partnership's insolvency.[33]

Civil Law jurisdictions generally have differing capitalization requirements for the Limited Liability Company versus the Corporation. The Italian *Società per azioni (S.p.A.)* for example carries an initial capitalization requirement of €50,000. Like an *AG* or Corporation, the capital is split amongst the shares "*azioni*" that can be transferred by endorsement or bought and sold on a stock exchange. In Italy, only an SpA can be quoted in a stock exchange, issue corporate bonds, and other financial instruments.[34] The SpA is also the required form for protected businesses such as banks, leasing companies, etc. The Italian Civil Code also provides for the *Società a responsabilità limitata (Srl).* An Srl has a lesser initial capitalization requirement of €10,000. Like a Limited Liability Company or *GmbH*, in an *SrL* capital is split into stakes "*quote*" which can be traded by notarial act in Civil Law countries or by Contract in Common Law Countries. In the United States for example, no notarial act is required for the transfer of shares.[35] As in an Italian *SrL*, a United States Limited Liability Company traditionally could not be listed on most public exchanges including the New York Stock Exchange or NASDAQ because of the added uncertainty associated with a Limited Liability Company by virtue of its "Operating Agreement." According to Black's Law Dictionary, an LLC Operating Agreement is:

> [A] document that customizes the terms of a Limited Liability Company (LLC) according to the specific needs of the owners, and outlines the financial and functional decision-making in a structured manner. Though writing an Operating Agreement is not a mandatory requirement for most states, it is

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[33] *Limited Liability*, INVESTOPEDIA, http://www.investopedia.com/terms/l/limitedliability.asp#ixzz3fhHLZ1Vn (last visited Jun 26, 2015); *supra* note 15.

[34] Italian Civil Code of 1942 (as amended by Government Act 6/2003).

[35] Gesuato Elisabetta, *La S.p.A. si costituisce con capitale minimo di 50.000 €,* FISCO E TASSE (July 3, 2014), https://www.fiscoetasse.com/approfondimenti/11929-la-spa-si-costituisce-con-capitale-minimo-di-50-000.html (last visited June 25, 2015).

> nonetheless considered a crucial document that should be included when setting up a Limited Liability Company. The document, once signed by the members (owners), acts as a binding set of rules for them to adhere. The document is drafted to allow owners to govern the internal operations according to their own rules and specifications.[36]

These provisions fill in for state law, which would govern a Corporation. In popular states for corporate formations like Delaware, the body of law is well developed and provides a level playing field for prospective investors.[37] Traditionally the uncertainty associated with varying terms in LLC operating agreements could not be overcome by the rather substantial tax benefits a Limited Liability Company could sustain through the elimination of double-taxation. However, so called "widely held partnerships" or "publicly traded partnerships" ("PTPs") have become more of a reality; specifically in oil, gas and natural resource projects. The rise of PTPs lead to the implementation of rules that cause these types of entities to be treated as corporations by the United States Internal Revenue Service in most instances.[38]

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[36] *LLC Operating Agreement*, INVESTOPEDIA http://www.investopedia.com/terms/l/llc-operating-agreement.asp (last visited June 26, 2015); *How To Change Ownership Of A Limited Liability Company,* THE LAW DICTIONARY, http://thelawdictionary.org/article/how-to-change-ownership-of-a-limited-liability-company/ (last visited Jun 26, 2015).

[37] *Facts and Myths*, STATE OF DELAWARE http://corplaw.delaware.gov/eng/facts_myths.shtml (last visited June 26, 2015).

[38] Daniel M Dunn, Michael Hirschfield & Michael A Lehmann, *Publicly traded partnership proposed regulations,* LEXOLOGY (2015), http://www.lexology.com/library/detail.aspx?g=0af9fa15-9a54-40ea-ad4d-ae780edfe247&utm_source=Lexology%2BDaily%2BNewsfeed&utm_medium=HTML%2Bemail%2B-%2BBody%2B-%2BGeneral%2Bsection&utm_campaign=Lexology%2Bsubscriber%2Bdaily%2Bfeed&utm_content=Lexology%2BDaily%2BNewsfeed%2B2015-06-25&utm_term (last visited Jun 26, 2015); *Internal Revenue Bulletin: 2015-21, Notice of Proposed Rulemaking Qualifying Income from Activities of Publicly Traded Partnerships With Respect to Minerals or Natural Resources*, INTERNAL REVENUE SERVICE (May 26, 2015), http://www.irs.gov/irb/2015-21_IRB/ar14.html (last visited June 26, 2015).

The elimination of double-taxation is the largest tax distinction between a Corporation and a Limited Liability Company. The Limited Liability Company is treated by default as a pass-through or "disregarded" entity, which means that the profits and losses flow through the entity as if the owners had engaged in those activities personally. The Corporation on the other hand is treated as a "person" which is subject to taxation independent of its shareholders on the basis of a corporate income tax and its shareholders are subject to a second tax when the profits of the corporation are distributed in the form of a dividend.[39]

B. Basic Holding Structures

1. *Reduction of Withholding Taxes*

Consider the following scenario. Investors in Sweden invest in an active operating company in Canada that manufactures cars. The Canadian company is a corporation for the purposes of the Canadian Revenue Code and thus taxed at 26.5%.[40] The company retains a small amount in reserves and distributes the remainder of its profits to the Swedish company in the form of a dividend. Pursuant to subsection 215(1) of the *Canadian Income Tax Act*, dividends to non-resident shareholders would normally be taxed at a rate of 25% to be withheld and paid to the Canadian Revenue Authority. However, because of the *Canada-Sweden Tax Treaty*, the Canadian company would only be required to apply the reduced rate of 15%.

Consider now that the Swedish company takes on a partner in the United Kingdom and this partner desires to invest into 50% of the shares of the Canadian company. If the British company acquired 50% of the shares of the Canadian company directly, it would be subject to a reduced rate of taxation of 10% pursuant to the *Canada-United Kingdom Tax Treaty*. However, the Swedish company and the

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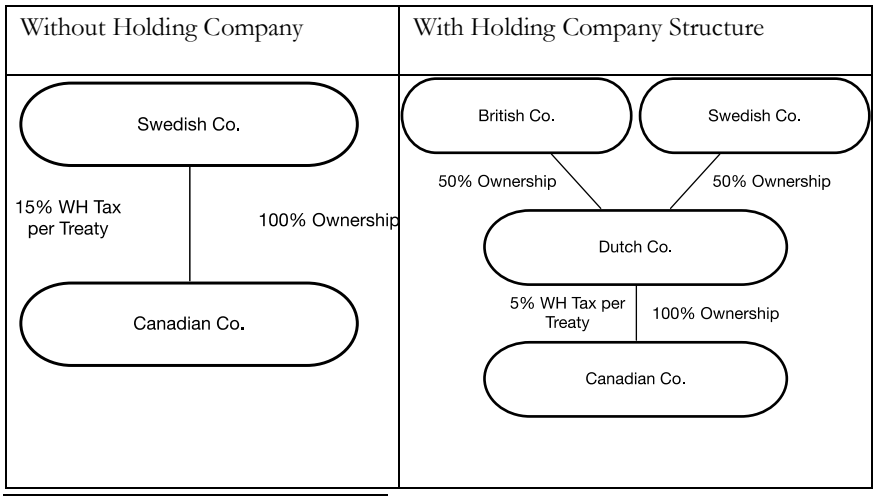
[39] *Classification of Taxpayers for U.S. Tax Purposes*, INTERNAL REVENUE SERVICE, https://www.irs.gov/individuals/international-taxpayers/classification-of-taxpayers-for-u-s-tax-purposes (last visited Jun 26, 2015); *Limited Liability Company (LLC),* INTERNAL REVENUE SERVICE, https://www.irs.gov/businesses/small-businesses-self-employed/limited-liability-company-llc (last visited June 26, 2015); *supra* note 29.

[40] *Id.*

British company decide instead to form a jointly-owned subsidiary holding company that will own the Canadian company. This company would be formed in the Netherlands and consist merely of a post office box and have no employees. The Swedish and British companies agree as shareholders to pay 80% of all profits of the Dutch company to the Swedish and British shareholders by way of a dividend. Thus, the applicable tax treaties would become the *Canada-Netherlands Tax Treaty*, which provides for a reduced rate of 5%. The Dutch company is not subject to Income Tax on the foreign dividends received and Dutch law provides for certain credits reducing the tax on re-distributed dividends which originate from dividends received from other countries reducing the Dutch tax to virtually zero.[41]



[41] Joseph Peters, Netherlands: A Dutch Tax Credit For Foreign Dividend W/H Tax, Even Though The Dividend Received Is Not Taxed In The Netherlands, Due To The Dutch Participation Exemption, MONDAQ (2013), http://www.mondaq.com/x/228050/Corporate+Tax/A+Dutch+Tax+Credit+For+Foreign+Dividend+WH+Tax+Even+Though+The+Dividend+Received+Is+Not+Taxed+In+The+Netherlands+Due+To+The+Dutch+Participation+Exemption (last visited Jun 7, 2015); Dutch withholding taxes on outbound payments, TAX CONSULTANTS INTERNATIONAL, https://www.tax-consultants-international.com/read/Dutch_withholding_taxes (last visited Jun 7, 2015); Dentons, Landmark treaty case: Prévost Car Inc. v. The Queen, LEXOLOGY, http://www.lexology.com/library/detail.aspx?g=50700034-20f4-4677-826b-a36d4ee3923e (last visited June 20, 2017); 2008 TCC 231 (CanLII), Prevost Car Inc. v. The Queen, http://canlii.ca/t/lwpfq (last visited June 7, 2015).

Thus by shifting profits from Canada through a Dutch Holding Company, the result is that the total effective tax on the dividends can be reduced from 25% assuming no treaty is in place to approximately 5%. These types of structures have been subject to attack by revenue-losing governments. Many governments have put into play "substance requirements," which require that the entity have some purpose and basic existence in the host country other than mere incorporation.

The *OECD Model Treaty* and the *Canada-Netherlands Tax Treaty* also contain provisions in Article 10, Section 2 which made the treaty benefits only applicable if the person was the "beneficial owner," to wit: "if the recipient is the beneficial owner of the dividends the tax so charged shall not exceed . . . ." However, this scenario was based upon a 2008 Canadian case in which the Canadian Revenue authority had ruled that the Dutch company was not the "beneficial owner" of the dividend and that the term "beneficial owner" is in fact not defined anywhere in the treaties.[42] This is inapposite to the UK High Court's finding in the case of *Indofood International Finance Ltd. V. JPMorgan Chase Bank, London Branch*. In *Indofood*, the English High Court held "that a newly interposed Dutch company used purely to take advantage of the treaty would not be the beneficial owner of the interest and, therefore, the purported tax objective of any theoretical restructuring to avoid the 20% withholding would not be effective".[43] Contrarily in *Prevost*, in rendering the Court's decision, Justice Rip held that *Indofood* was distinctive from *Prevost* because in *Indofood*, there was no discretion left to any party as to whether income could be passed through the structure making the Dutch company merely a "conduit." Alternatively, in *Prevost*, the Dutch company was not bound by its articles of formation to make a subsequent dividend payment to the UK Company and the Swedish Company. The Swedish and UK Companies did in fact however have a side agreement to which the Dutch company was not a party agreeing to

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[42] *Id.*

[43] *Indofood Decision: UK Tax Authorities' Guidance on Treaty Claim,* (Oct 23, 2006), https://www.clearygottlieb.com/news-and-insights/publication-listing/indofood-decision--uk-tax-authorities--guidance-on-treaty-claims9 (last visited June 28, 2015)

vote in favor of at least an 80% dividend. Justice Rip determined that because the Dutch company was not a party to the side agreement the remedies for failure to issue a dividend would be decided in litigation amongst the shareholders directly and not by suing the Dutch company. The Court held this distinction sufficient to distinguish the facts before it from *Indofood* in finding that the Dutch company was in fact the beneficial owner of the dividends issued by the Canadian company for the purposes of treaty benefits.[44]

The tax imposed by Canada on the Dutch company is what is known as "inbound" taxation, while the tax imposed by Holland on the Dutch company's dividends paid to foreign entities is what is known as "outbound" taxation. Each term is so defined based upon the direction of the movement of capital. This example is not the end of the story with respect to what Governments are doing to limit these types of structures. Substance Requirements and CFC Rules will be further addressed in Article V.

2. *Protection from Local Capital Gains Taxation*

Taxation on income from operations of a business is taxed as ordinary income at the applicable rate for that business. As discussed *supra* at Ch. III, Art. A, such income is either taxed at the corporate level applying the applicable corporate income tax rate or at the level of the individual owners in the case of a pass-through entity like a Limited Liability Company. When a person engages in investment into a capital asset, such as an investment or real estate that:

> gives it a higher worth than the purchase price. The gain is not realized until the asset is sold. A capital gain may be a short term (one year or less) or long term (more than one year) and must be claimed on income taxes. A capital loss is incurred when there is a decrease in the capital asset value compared to an asset's purchase price.[45]

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[44] 2008 TCC 231, *supra* note 41.

[45] Investopedia, *Capital Gain*, http://www.investopedia.com/terms/c/capitalgain.asp (last visited June 1, 2015); *supra* note 15.

In Ch. 1 Art. 2 *supra* we analyzed the Qualified vs. Ordinary dividend tax rates in the United States. These rates are mimicked by the rates imposed for Long-Term Capital Gain and Short-Term Capital Gain taxes. Long-Term Capital Gains are capital gains on assets which are held for longer than one-year. These types of capital gains are subject to taxation at the lesser amount of 20% for most types of transactions.[46]

These types of capital gains are particularly applicable to investment companies and private equity funds which trade assets regularly. Private equity funds typically have a longer horizon for their investments and hold them for longer than a year making most of their income subject to long-term capital gains tax. Moreover, private equity funds are typically structured as pass-through entities and its managers are paid by receiving a share of the profits, thus receiving the vast majority of their compensation in capital-gains and subject to a lesser tax than the 40% they would otherwise be subject to at normal U.S personal income tax rates.[47]

The OECD conducted a survey of Long-Term Capital Gains taxation by country in 2011, resulting in the following with a few additions for discussion purposes:[48]

High Tax	**Medium-High**	**Medium-Low**	**Low Tax**	**No Tax**
Italy (44.5%)	Norway (28%)	United States (19.1%)	Japan (10%)	Mexico
Denmark (42%)	Germany (25%)	Israel (20%)	Hungary (16%)	Luxembourg
France (31.3%)	Finland (28%)	Estonia (21%)		Portugal

[46] Internal Revenue Service, *Topic 409 Capital Gains and Losses*, https://www.irs.gov/taxtopics/tc409.html (last visited June 1, 2015).

[47] MARK JICKLING & DONALD MARPLES, TAXATION OF HEDGE FUND AND PRIVATE EQUITY MANAGERS (2014).

[48] Robert Carroll & Gerald Prante, *Corporate Dividend and Capital Gains Taxation: A comparison of the United States to other developed nations,* (2012), http://www.theasi.org/assets/EY_ASI_Dividend_and_Capital_Gains_International_Comparison_Report_2012-02-03.pdf (last visited June 25, 2015)

Sweden (30%)	UK (28%)	Iceland (20%)		Austria
	Australia (22.5%)	Poland (19%)		Netherlands
	Spain (21%)	Slovak Republic (19%)		Korea
	Canada (22.54%)	Chile (20%)		Switzerland
	Ireland (25%)			Greece
				Slovenia
				Turkey
				Czech Republic
				Cayman Islands[49]
				Bermuda[50]
				Mauritius[51]

The OECD model convention addresses Capital Gains in Article 13, which provides the following in substance:

[49] Cayman Island Government, *Taxes*, (2011), http://www.gov.ky/portal/page/portal/cighome/cayman/theeconomy/taxes (last visited June 24, 2015).

[50] Trading Economics, *Bermuda Corporate Tax Rate*, https://tradingeconomics.com/bermuda/corporate-tax-rate (last visited Jul 22, 2017).

[51] Gary Gowrea, *Standard Chartered – Publicised tax avoidance strategy,* ACTIONAID (Jan. 2015), http://www.actionaid.org/sites/files/actionaid/standard_chartered-_publicised_tax_avoidance_strategy_0.pdf (last visited June, 25 2015)

1. Gains derived by a resident of a State A from alienation of immovable property State B may be taxed in State B.

2. Gains derived by resident of State A forming part of the "business property of a permanent establishment" which an enterprise of State A has in State B, including gains from the alienation of the permanent establishment itself may be taxed in State B.

3. Gains from the alienation of ships or aircraft operated in international traffic, or movable property pertaining to the operation of ships, aircraft or boats shall be taxed in the state "where place of effective management is situated."

4. Gains derived by resident of State A from alienation of shares deriving more than "50 per cent of their value directly or indirectly from immovable property" situated in State B may be taxed in State B.

5. All other gains than in Paragraphs 1-4 shall be taxable only in the state where the alienator is a resident.[52]

Consider the following scenario. A Chinese company wishes to invest in a Mozambique Company that holds immovable property in Mozambique. Pursuant to Mozambique law capital gains are taxed at a rate of 32%. In 2014, Texas-based Andarko, an oil and gas company paid Mozambique $520 million USD in capital gains after a transaction yielded a capital gain of $1.625 billion USD.

Instead, if the Chinese company interposes a holding company in Mauritius that owns 100% of the shares in the

[52] *Supra* note 7.

Mozambique Co., the capital gains tax can be eliminated per the tax treaty between Mauritius and Mozambique, which states to wit:

> Mauritius has the exclusive right to tax any gains derived by the Mauritius Holding Company on the sale of shares held in the Mozambique Company.
>
> As opposed to other tax treaties signed by Mozambique, Mauritius has exclusive rights to tax capital gains on the sale of shares held in the Mozambique Company even if the assets of the Mozambique Company consist (sic) principally of immovable property.[53]

"As per the tax treaty between Mauritius and Mozambique, dividend [sic] paid to the Mauritius Holding Company will be subject to a reduced withholding tax rate of 8% in Mozambique."[54] Capital Gains are also not taxed in Mauritius on this type of transaction because the Mauritius-Mozambique double taxation treaty excludes Paragraph 4 of the Model Convention applying to immovable property, thus pushing this transaction into the catchall Article 13, Paragraph 5 of the OECD Model Convention.[55]

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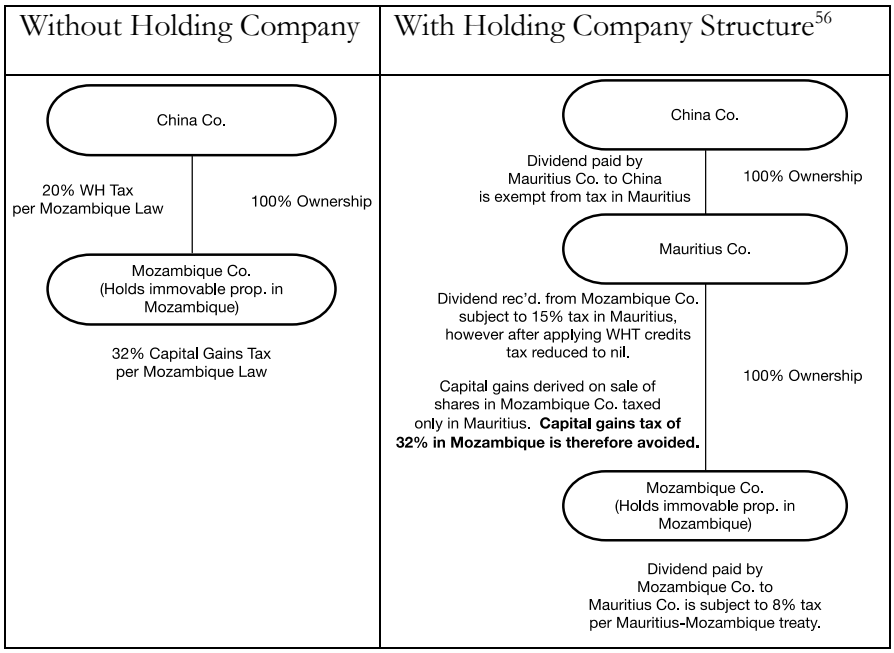
[53] *Supra* note 51.

[54] Gary Gowrea, *Mauritius: Investment Gateway to Africa* in *Maximising Business Opportunities in Asia, Africa and the Middle East – a Treasury Guide*, CIM TAX SERVICES (2014), https://www.cim.mu/files/cgb/mauritius%20-%20investment%20gateway%20to%20africa%20(insights%20201314)%20a%20publication%20of%20standard%20chartered%20bank.pdf (last visited June 21, 2017).

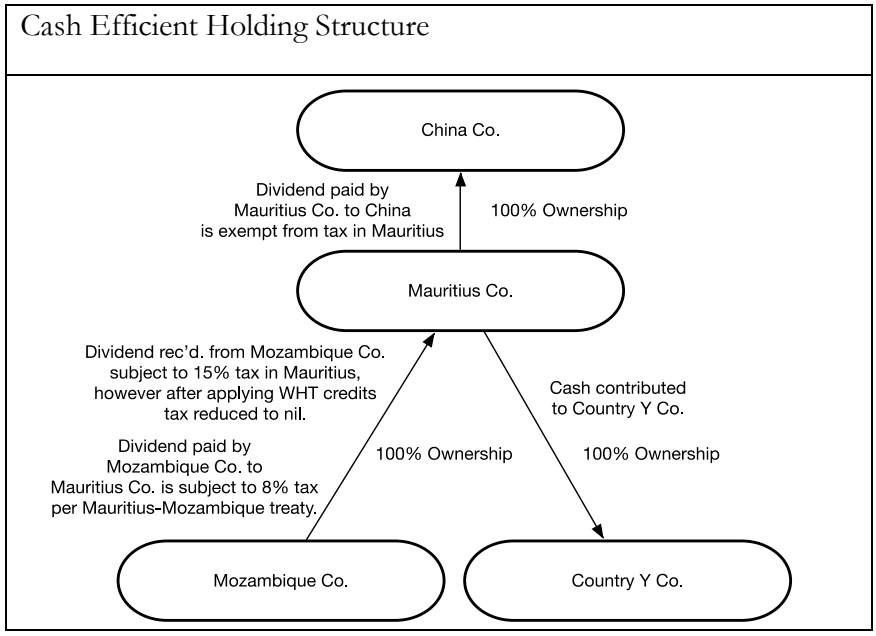
[55] *Supra* 53; *Agreement between the Republic of Mauritius and the Republic of Mozambique for the Avoidance of Double Taxation with Respect to Taxes on Income*, LEGAL SUPPLEMENT TO THE GOVERNMENT GAZETTE OF MAURITIUS (1997).



3. *Tax Efficient Movement of Cash*

A major consideration of any business with operating entities in foreign jurisdictions is how to get cash to those entities without suffering a debilitating tax. Consider the previous scenario. Investor parent company in China invests in an Operating Company in Mauritius, but now also invests in another Operating Company in Country Y. The Chinese company wants a way to move cash easily into the Operating Company in Country Y. As discussed *supra,* dividends paid would be subject to a 20% withholding tax in Mozambique, thus limiting the capital available for movement from China to Country Y.

[56] *Supra* note 52.



Using a similar structure, the Chinese investors would interpose Country Y's Operating Company as a wholly owned subsidiary of the Mauritius Co. subject to the same reduced 8% withholding tax.[57] However, instead of the Mauritius Co. redistributing the dividend to China it would make a capital investment either as equity or debt into Country Y's Operating Company.

C. Financing Structures

Another reason that companies develop holding structures is for tax efficient financing. In financing structures, the primary driver is often not tax efficiency, but rather non-tax considerations like the availability of external financing sources. Tax only becomes the bigger consideration when internal financing is proposed (e.g., the Holding Co. lending to the Operating Co. or CFC 1 lending to CFC 2).

[57] *Id.*

As discussed *infra* Article IV, Section D, Chapter 4 (the Amazon.com, Hybrid and Reverse Hybrid examples), lending internally is an effective way of reducing income in a high-tax country and shifting it to a low-tax country. Some basic financing structures apply in this regard.

1. *Spain – Swiss Finance Branch*

Consider the following scenario:

1. ParentCo. in High-Tax Jurisdiction owns Spanish Co., which is a corporate subsidiary.

2. Spanish Co. owns subsidiaries in high-tax jurisdictions.

3. Spanish Co. establishes a branch office in Switzerland.

4. The Swiss Branch loans money to the high-tax subsidiaries for operating capital and the interest is sufficient to wipe-out the profits of the subsidiaries in the high-tax countries.

5. Pursuant to Swiss Law, the branch is subject to a low-level of taxation in Switzerland on interest income and no withholding tax on profits redistributed to the Spanish head office, because the branch is a disregarded or non-existent entity. [58]

6. Pursuant to Spanish law there is no deemed interest income in Spain so the interest income in tax exempt in Spain. [59]

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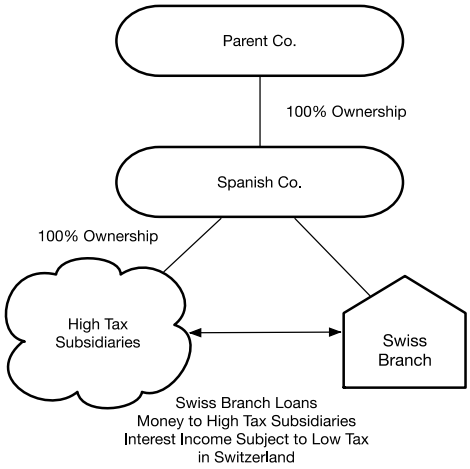
[58] Corporate Taxation System In Switzerland, INT'L TAX REV. (2015), http://www.internationaltaxreview.com/pdfs/taxdata/tax_data_switzerland_000226.pdf (last visited July 6, 2015).

[59] Barbra Mambrilla & Jose Manuel Calderon, *The new Tax Protocol to the Spain-Switzerland Tax Treaty,* GOMEZ-ACEBO & POMBO (Feb. 2013), http://www.gomezacebo-pombo.com/media/k2/attachments/the-new-tax-protocol-to-the-spain-switzerland-tax-treaty.pdf (last visited July 6, 2015).

7. The end-result is a deferral strategy whereby the profits are shifted from the high-tax subsidiaries to the Swiss Branch.

8. The effectiveness of this strategy is subject to avoidance of Spanish CFC legislation, which is discussed *infra* in Article IV, Section D, Chapter 2.

The Swiss Finance Branch[60]



2. *Malta Financing Structure*

Consider the following scenario:

1. Parent Co. in high-tax jurisdiction owns Malta Co., a Maltese subsidiary company.

2. Malta taxes interest income at a low rate.

3. Malta Co. loans money to the subsidiaries of Parent Co. in high tax jurisdictions.

4. The high tax companies get the interest deduction.

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[60] Madeleine Syré, MODULE 6 – M&A - TAX PLANNING (2014), University of St. Gallen, EMBL-HSG.

5. The interest is initially taxed at 35% in Malta.[61]

6. The money is distributed by the Malta Co to the Parent Co. in the form of a dividend and subject to no withholding tax pursuant to Maltese law.[62]

7. Under Maltese law, interest income is classified as "Passive Interest" if the interest income is not derived, directly or indirectly, from a trade or business and the interest income has not suffered or has suffered foreign tax of less than 5%. "Then a registered shareholder of a Malta company who has: (i) received a dividend from a Malta company, from (ii) profits of the company which arise from Passive Interest, is entitled to claim a 5/7$^{th's}$ refund of the CIT paid by the Malta company on the Passive Interest." [63] If the income is not "Passive Interest" the fallback is that the interest is classified as "Non-Passive Interest" an subject to a 6/7$^{th's}$ refund of the CIT paid by the Malta company on the interest.[64]

8. The effectiveness of this strategy is subject to avoidance of CFC legislation in the high-tax country, which is analyzed in detail in Section D, however it is likely given the fact that the tax is charged and a refund paid, that double-taxation treaty benefits would likely be available to the Parent Co. for the taxes paid in Malta at 35%.

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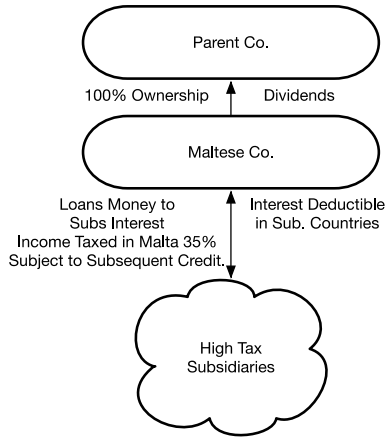
[61] Jonathan Pisani, *Taxation of interest income*, CHETCUTI CAUCHI ADVISORS (May 23, 2012), https://www.ccmalta.com/publications/taxation_of_interest_income (last visited Jul 6, 2015).

[62] Nicholas Gouder, *Malta: Withholding Taxes,* MONDAQ (Oct. 1, 2013), http://www.mondaq.com/x/266212/withholding%20tax/Malta%20Withholding%20Taxes (last visited Jul 6, 2015).

[63] *Supra* note 61.

[64] *Id.*

The Maltese Finance Subsidiary[65]



3. *Malta – BeNeLux Interest Free Loan with Notional Interest Deduction ("NID")*

   Consider the following scenario:

   1. Parent Co. in high-tax jurisdiction owns Malta Co., a Maltese subsidiary company and BeNeLux Co., a Belgian subsidiary company.

   2. Parent Co. makes an equity contribution to Malta Co.

   3. Malta Co. makes an interest free loan to BeNeLux Co.

   4. BeNeLux Co. makes a loan to OpCo in a high tax jurisdiction.

   5. OpCo deducts the interest paid to BeNeLux Co.

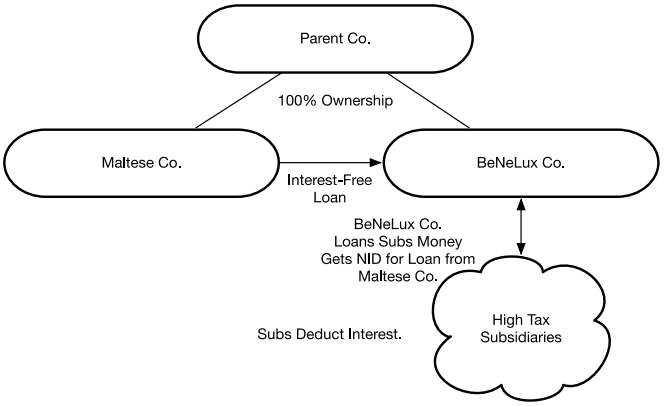
   6. BeNeLux Co. receives a "Notional Interest Deduction" equal to the amount of Belgium's published rates. "The deduction for risk capital or more commonly called "notional interest deduction" (NID) is a unique tax

[65] *Supra* note 60.

measure allowing a tax-free return on qualified equity by allowing a deemed interest deduction calculated as the qualifying equity multiplied by the applicable NID rate".[66]

7. This creates a tax deferred cash accumulation in BeNeLux Co. and only principal amounts remain owing to Malta Co.

The BeNeLux Co. with Notional Interest Deduction[67]



4. *Finance Structures Do Not Drive Business Substantively*

In evaluating structures both in the context of treaty application and financing structures, the question of whether or not tax is a business driver is ever present. Choosing where to establish a mailbox company and where to loan money for the purposes of deductions like the Notional Interest Deduction are strategies that haven't truly driven business in a measurable way. These are tactics that allow business to function in more tax efficient ways, but do not introduce new lines of business or otherwise drive business out of a market. The end result is ultimately the same, profits are drained from high-tax subsidiaries into low-tax countries. That does not

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[66] *What NID Could Mean for Your Company's Effective Tax Rate,* ERNST & YOUNG (2015), http://www.ey.com/Publication/vwLUAssets/Notional_Intrest_Deduction_2011/$FILE/NID%202011.pdf (last visited July 6, 2015)

[67] *Supra* note 60.

mean that the company has truly ceased any operations in those jurisdictions.

D. Multinational Corporations

1. *International vs. Intra-Europe*

Across the world companies have applied the disparate treatment of tax available from various double taxation treaties to their business model to create holding structures that are tax efficient both for the purposes of driving the bottom line and efficiently moving cash between subsidiaries. However, companies also have additional rules which apply to their activities when those activities take place within the European Internal Market. Two major European Union directives apply, they are the E.U. Parent/Subsidiary Directive and the E.U. Interest and Royalty Directive.

Article 31 EEA provides in relevant part that:

> [T]here shall be no restrictions on the freedom of establishment of nationals of an EC Member State or an EFTA State in the territory of any other state of these States. This shall also apply to the setting up of agencies, branches or subsidiaries by nationals of any EC Member State or EFTA State established in the territory of any of these states.[68]

The language of Article 34 of the EEA (like Article 54 of the Treaty on the Functioning of the European Union) provides that:

> Companies or firms … shall, for the purpose of this Chapter, be treated in the same way as natural persons who are nationals of EC Member States or EFTA States.[69]

In light of this core treaty language, the European Union has taken competence in this area. The E.U. Parent/Subsidiary Directive

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[68] *Supra* note 23 at art. 31.

[69] *Id.* at art. 34.

was adopted on December 22, 2003 "to eliminate tax obstacles in the area of profit distributions between groups of companies in the E.U. by: abolishing withholding taxes on payments of dividends between associated companies of different Member States and preventing double taxation of parent companies on the profits of their subsidiaries".[70] In sum, this language provides a mechanism that sidesteps the necessity of the holding structure described *supra* in Article IV, Section B.

The E.U. Interest and Royalty Directive was adopted on June 3, 2003 "to eliminate withholding tax obstacles in the area of cross-border interest and royalty payments within a group of companies by abolishing withholding taxes on royalty payments arising in a Member State, and withholding taxes on interest payments arising in a Member State."[71] In essence, interest and royalty payments arising in one member state are exempt from any taxes in that state if the beneficial owner of the payment is in another member state.[72]

All initial time periods for phased and member-state specific transitional implementation for both directives have passed.[73]

2. *CFC Rules, United States (Subpart F) and International*

The United States tax system is built on two fundamentally inconsistent principles that drive the need for tax structures such as those discussed thus far. These principles are (1) that corporations are treated as independent fictitious persons for the purposes of taxation and (2) that all U.S based taxpayers are subject to worldwide taxation.[74] The tax treatment of corporations was previously

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[70] *Parent companies and their subsidiaries in the European Union*, EUROPEAN COMMISSION, TAXATION AND CUSTOMS UNION, http://ec.europa.eu/taxation_customs/business/company-tax/parent-companies-their-subsidiaries-eu-union_en (last visited June 21, 2015).

[71] *Id.*

[72] *Id.*

[73] *Id.*

[74] Office of Tax Policy, *The Deferral of Income Earned Through U.S. Controlled Foreign Corporations: A Policy Study*, DEPT. OF THE TREASURY, 1 (Dec. 21, 2000), https://www.treasury.gov/resource-center/tax-policy/Documents/Report-SubpartF-2000.pdf.

addressed herein. One distinctive and unique feature of the U.S. tax system is that it taxes all U.S. citizens, residents and corporations on worldwide income.[75] Corporations are determined as U.S. domestic or foreign on the basis of their place of organization contrary to many other places in the world as described herein. Foreign corporations are taxed on income that is from "sources within the United States" or that is "effectively connected with the conduct of a trade or business within the United States".[76] There is a tension between the two principles insofar as tax Persons are incentivized to use offshore corporations as a barrier to U.S taxation of the income earned through those corporations.

From 1913 when the U.S Income Tax was enacted through 1962, a number of tax avoidance techniques were developed by international investors and were subsequently addressed through legislation, including transfers of property to foreign corporations to avoid U.S tax on the capital gains, the incorporation of the personal or foreign personal holding companies or "incorporated pocketbook" used to hold all personal holdings in stocks bonds or other income producing property and foreign operating and investment companies in the wake of World War II.[77] In 1962, the United States enacted what is known as "subpart F" regulations at I.R.C. §§ 951 – 964.[78]

The Code provides:

> [E]very person who is a United States shareholder … of such corporation and who owns … stock in such corporation on the last day, in such year, on which such corporation is a controlled foreign corporation shall include in his gross income, for his taxable year in which or with which such taxable year of the corporation ends . . . . (i) his pro rata share … of the corporation's subpart F income for such year[.][79]

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[75] *Id.* at 2.
[76] *Supra* note 17 at §§ 881 and 882.
[77] *Supra* note 74 at 8.
[78] *Id.* at 12.
[79] *Supra* note 17 at §§ 951.

In summary:

Subpart F applies to certain income of "controlled foreign corporations" ("CFCs"). A CFC is a foreign corporation more than 50% of which, by vote or value, is owned by U.S. persons owning a 10% or greater interest in the corporation by vote ("U.S. shareholders"). "U.S. persons" includes U.S. citizens, residents, corporations, partnerships, trusts and estates. If a CFC has subpart F income, each U.S. shareholder must currently include its pro rata share of that income in its gross income as a deemed dividend.[80]

Subpart F income includes the following:

- **Foreign personal holding company income** (FPHCI), A major category of subpart F income is foreign personal holding company income ("FPHCI").[81] (I.R.C. § 954(c)) This category includes interest, dividends and rents and royalties. It also includes gains from the sale of property that produces passive income or that is held for investment, gains from commodities transactions, and gains from foreign currency transactions, as well as certain other income that is, in effect, the equivalent of interest or dividends. Because of its passive nature, such income often is highly mobile and can be easily deflected.[82] . . . . Generally, rents and royalties earned by a CFC in an active business are excluded from FPHCI.[83] This exception does not apply, however, if the CFC's rents or royalties are received from a related person.

- **Foreign base company sales income** [S]ales income is active income and subpart F generally does not apply to active income. However, certain sales income, referred to as foreign base company sales income ("FBCSI"), is subject to current inclusion under subpart F because, when the manufacturing function is separated from its sales

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[80] *Supra* note 74 at 8-10; *supra* note 17 at §§ 957, 951(b), 957(c), 7701(a)(30), 951(a).

[81] *Supra* note 17 at § 954(c).

[82] *Supra* note 74 at 10.

[83] *Supra* note 17 at § 954(c)(2)(A).

function, the sales income can easily be deflected from the jurisdiction in which the major economic activity that produced the value in the goods occurred, often a high-tax jurisdiction, to a low-tax jurisdiction where the "sales" activities occur.[84] This is particularly true in the case of related party transactions. Thus, the FBCSI rules require current inclusion of income of a CFC from the sale of property (a) that is purchased from, or on behalf of, or sold to, or on behalf of, a related person, and (b) that is manufactured and sold for use, consumption or disposition outside the jurisdiction where the CFC is incorporated.[85]

- **Foreign base company services income** Foreign base company services income is another category of subpart F income that applies to active income that can be deflected to a low-tax jurisdiction through related party transactions, in this case, through the performance of services.[86] Foreign base company services income includes income from services performed outside the CFC's country of incorporation for, or on behalf of, a related person. These rules generally were intended to address circumstances in which service activities are separated from the other business activities of a corporation into a separate subsidiary located in another jurisdiction to obtain a lower rate of tax for the services income. [87]

- **Foreign base company oil-related income** includes income from all oil activities outside the CFC's country of incorporation.[88]

- **Insurance income** includes all income derived from insurance and annuities related to risks that are situated outside the CFC's country of incorporation.[89]

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[84] H.R. Rep. No. 1447, 87th Cong., 2d Sess. 62 (1962) (1962 House Report); S. Rep. No. 1881, 87th Cong., 2d Sess. 84 (1962) (1962 Senate Report).

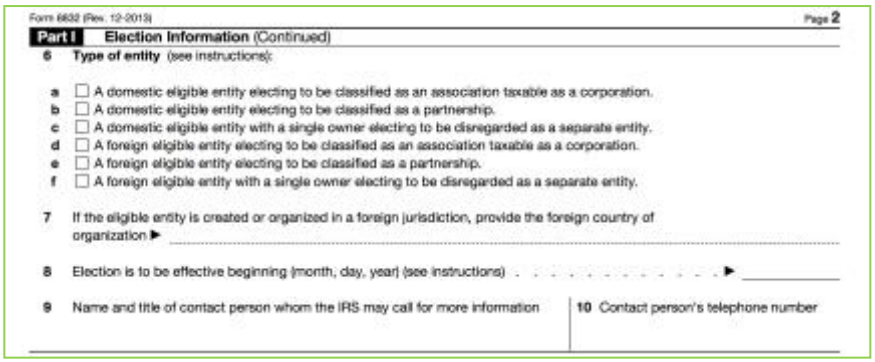
[85] *Supra* note 17 at § 954(d); *supra* note 74 at xiii.

[86] *Supra* note 17 at § 954(e)(2).

[87] Treas. Reg. § 1.954-4(b)(1)(iv); *supra* note 74 at xiv.

[88] *Supra* note 17 at § 954(g).

All other income earned by a CFC is not subject to U.S. tax until the income is repatriated to the U.S. The United States is no longer alone in implementing CFC rules, however it is alone in its application of worldwide taxation. Although, Germany, Sweden, United Kingdom, Italy, France, Spain, Denmark, Finland and Portugal have enacted CFC regimes that bear some resemblance to the U.S scheme, the United States has a special provision which permits the creation of what are known as "Hybrid Entities" and arrangements known as "Hybrid Mismatch Arrangements."[90] A Hybrid Entity is an entity that is taxed as a corporation in a foreign jurisdiction but treated as a partnership or disregarded pass-through entity for U.S. tax purposes. Conversely, a "Reverse Hybrid Entity" is an entity that is taxed as a partnership or disregarded pass-through entity in a foreign jurisdiction and treated as a corporation for U.S. tax purposes.[91] This is a feature of the United States tax code known as Entity Classification Election or "Check the Box." In order to receive treatment as a corporation or partnership, the eligible entity simply completes IRS Form 8832, which provides the following election:[92]



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Part I Election Information (Continued)

6 Type of entity (see instructions):

- **a** ☐ A domestic eligible entity electing to be classified as an association taxable as a corporation.
- **b** ☐ A domestic eligible entity electing to be classified as a partnership.
- **c** ☐ A domestic eligible entity with a single owner electing to be disregarded as a separate entity.
- **d** ☐ A foreign eligible entity electing to be classified as an association taxable as a corporation.
- **e** ☐ A foreign eligible entity electing to be classified as a partnership.
- **f** ☐ A foreign eligible entity with a single owner electing to be disregarded as a separate entity.

7 If the eligible entity is created or organized in a foreign jurisdiction, provide the foreign country of organization ▶

8 Election is to be effective beginning (month, day, year) (see instructions) ▶

9 Name and title of contact person whom the IRS may call for more information | **10** Contact person's telephone number

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89 *Supra* note 17 at § 953.

90 HRMC's International Manual, *Income and Corporation Taxes Act 1988, as amended (hereafter ICTA88)*, sec. 747 *et seq*., INTM20000; Inkomstskattelag (1999:1229); §§ 7-14 AStG, Foreign Tax Act; Ernst & Young, *An Overview of CFC Rules in Key EU Countries and an Analysis of Cross-Border Planning Structures to Avoid the Application of CFC Rules*, UNIVERSITAT HAMBURG, http://www.m-i-tax.de/content/Wichtige_Links/Alumni_Netzwerk/documents/cfcrules_000.pdf (last visited July 7, 2015).

91 *Supra* note 74 at 62.

92 Form 8832, INTERNAL REVENUE SERVICE, https://www.irs.gov/pub/irs-pdf/f8832.pdf.

(i) Scenario: Deflect Profit to Low Tax Country

Consider the following scenario:

1. Company A is a U.S. company with a wholly owned subsidiary, CFC X in Country X, a high-tax jurisdiction.

2. In order to transfer operating income from CFC X in Country X where it would be taxed at a high rate to Country Y, which is a low-tax country, CFC X creates a wholly owned subsidiary Company Y in Country Y that is treated as a corporation in Country X and of course in Country Y, but would be disregarded for U.S. tax purposes.

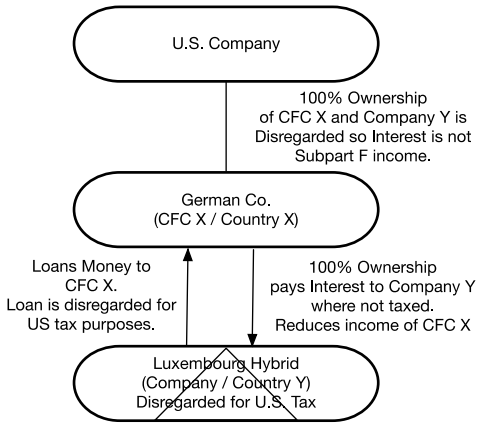
3. Company Y makes a loan to CFC X. Country X treats CFC X as a corporation and so the interest payments from CFC X to Company Y are deductible in Country X and thus reduces operating income of CFC X. Interest payments received by Company Y in Country Y, are subject to low-taxation in Country Y.

4. Because the United States treats CFC X as disregarded for U.S. tax purposes, the taxpayer takes the position that interest payments between CFC X and Company Y should be disregarded for U.S. tax purposes and thus should not be considered subpart F income.[93]

5. The end result is that CFC X pays tax significantly reduced income (by the amount of interest paid) in Country X and subject to any applicable double-taxation treaty benefits, tax on equally reduced income in the United States.

[93] *Supra* note 74 at 64.

CFC Use of Hybrid to Deflect Income to Low-Tax Country[94]



(ii) Scenario: Shelter From Tax in All Jurisdictions

Now consider an alternative scenario.

1. Company A is a U.S. company with a wholly owned subsidiary, CFC X in Country X, a high-tax jurisdiction.

2. Company A could establish Company X in Country X, the same high-tax jurisdiction, but the entity would not be a corporation, it would be a disregarded pass-through entity, such as a Partnership or Limited Liability Company.

3. Company A would elect to treat Company X as a Corporation for U.S. tax purposes but the law of Country X would provide that the entity would be disregarded for tax purposes.

4. Company A would make a cash contribution to Company X.

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[94] *Id.*

5. Company X would make a loan to CFC X.

6. CFC X would get a deduction in Country X for the interest paid to Company X.

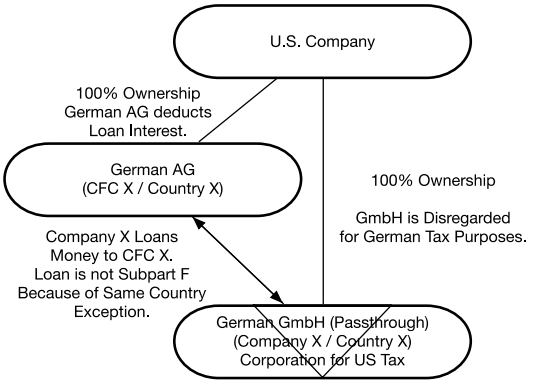
7. For purposes of Country X, Company X is a disregarded entity and no tax would be imposed on Company X for the interest paid to it. Assuming a double taxation treaty existed between Country X and the United States, the interest would likely be subject to minimal withholding tax in Country X.

8. From the United States perspective, the U.S. would treat Company X as a Country X corporation as well as CFC X and thus interest payments between CFC X and Company X would not be subpart F income pursuant to the same country exception in section 954(c)(3)(A)(i) which "exempts from FPHCI dividends and interest received from a related corporation organized under the laws of the same country as the recipient, provided that the related payer corporation has a substantial part of its assets used in a trade or business in the same foreign country."[95]

9. The end result is CFC X has little or no income for U.S or Country X tax purposes because it deducts interest paid to Company X. Company X, a disregarded entity pays no tax in Country X because it is disregarded in Country X and no tax in the United States because the U.S. treats it as a Corporation.

[95] *Id.*

Use of Reverse Hybrid to Shelter Income from Tax in All Jurisdictions[1]



This is of course, as in the first example, a tax deferral strategy as compared to an avoidance strategy. Whenever Company X in this example or Company Y in the prior example repatriates profits to the U.S. Company, these profits would be subject to taxation as dividends pursuant to the applicable double-taxation treaties between the United States and Country X or Y depending on the applicable example above.

(iii) Scenario: Dual-Resident Corporation and Stateless Income

Consider the following scenario:

1. U.S. Company A owns CFC X1, which is a manufacturing corporation incorporated in Country X, a high-tax jurisdiction.

2. The U.S. Company forms a sister corporation, CFC X2 in Country X.

3. CFC X2 is effectively managed and controlled in the United States and so it is a non-resident for the purposes of Country X's tax code.

4. CFC X2 enters into a contract manufacturing arrangement for CFC X1 to manufacture goods from

raw materials that CFC X2 will purchase from the U.S. company and provide to CFC X1, thus reducing CFC X1's profit.

5. CFC X2 will then sell through a branch established in the country of sale.

6. CFC X2 will not be taxed on its sales profits in Country X, because Country X treats it as a non-resident because its place of management is in the U.S.

7. The U.S. tax law treats CFC X2 as a Country X corporation because it was incorporated in Country X.

8. Because the income of CFC X2's sales is derived from the sale of products manufactured in Country X, this does not constitute Foreign Base Sales Company Income (FBCSI). In order for FBCSI to apply the sales income would have to be derived in connection with the sale of products both manufactured and sold for use outside CFC X2's country of incorporation (Country X).

9. Thus, CFC X1 will have reduced its tax payable to Country X without any subpart F income arising in CFC X2 because of CFC X2 is a foreign corporation to both Country X and the United States.[96]

10. CFC X2 is stateless.[97]

This is a key component of case studies to be examined subsequently in Article IV, Section E, where this article will be examining the tax structures of Apple, Inc. and Google, Inc.

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[96] *Id.*

[97] Edward D. Kleinbard, *Stateless Income*, 11 FLA. TAX REV. 699 (2011), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1791769## (last visited July 8, 2015).

3. *Transfer Pricing*

Tax strategies have two major overlapping goals: (a) deferral and (b) avoidance. In large part the tax strategies described above focus on the avoidance aspect, e.g. how applying disparate treatments of treaties escapes a high level of taxation in the source country by interposing a holding country with a favorable treaty network. Although avoidance is the goal, the practical result of most modern tax strategies is deferral. Sooner or later the reality is that shareholders will pressure companies to repatriate offshore profits to reinvest or distribute in the form of dividends.[98]

Each of the strategies described above involve the use of treaty provisions to legally reduce the amount of tax due and owing in one country versus another and shift the profits of a company from a high tax country to a low tax country. Contrarily, tax evasion would involve an illegal reduction in tax by relying on sovereign privacy laws to hide foreign profits and assets. Alternatively, some corporations use what is known as transfer pricing in order to further reduce tax. Depending on the methods used to establish the transfer pricing, some legal experts have argued that such techniques might also qualify as illegal tax evasion especially as the pricing applies to hard goods.[99]

Transfer pricing involves the application of prices to goods and services sold between related companies. The price of the goods sold should be the same as the prices that would be paid by unrelated parties, or a so-called "arms-length transaction." "By lowering the price of goods and services sold by parents and affiliates in high-tax jurisdictions and raising the price of purchases, income can be shifted."[100] The OECD Transfer Pricing Guidelines provide five

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[98] Jane G. Gravelle, *Tax Havens: International Tax Avoidance and Evasion*, CONGRESSIONAL RESEARCH SERVICE (Jan. 15, 2015), http://fas.org/sgp/crs/misc/R40623.pdf (last visited July 5, 2015); *Apple under pressure for new dividends, repatriation of cash*, MACNN (Mar. 11, 2013), http://www.macnn.com/articles/13/03/11/wall.street.government.wants.more.of.companys.growing.cash.hoard/ (last visited July 5, 2015).

[99] *Id.*

[100] Gravelle. *supra* note 99 at 12.

methods to estimate an arm's length price of transactions and allocate profits between companies:

(i) **the comparable uncontrolled price method (hereinafter "CUP"),** which involves observing comparable transactions between two independent companies and applying the same price for group companies;

(ii) **the cost plus method**, which involves approximating income from goods sold or services provided to the company within the group for a fair income level;

(iii) **the resale minus method**, which involves approximating the costs of goods bought from and services provided by a group company for a fair cost of goods;

(iv) **the transactional net margin method (hereinafter "TNMM")**, which involves using a net profit indicator, referring in principle to the ratio of profit per item compared to the profit and loss account of the firm, a fair margin is applied to be considered "arm's length"

(v) **the transactional profit split method**, which involves considering each of the related parties relative value of their contributions to the profit or loss and splitting the profit appropriately.[101]

It is relatively simple to police a simple product that has a markup and other competitive goods offered for sale in the marketplace. Failure to sell those goods between related companies at fair market value, which is what parties negotiating at arms-length would pay, is a violation of the transfer-pricing rules. Intellectual property and intangible assets are the primary assets where transfer pricing remains relevant within international tax planning, largely for one reason: there is no competitive market to license these assets and there is only one customer and only one licensee – the company that

[101] TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS, OECD (2010), http://www.oecd.org/ctp/transfer-pricing/transfer-pricing-guidelines.htm (last visited July 6, 2015).

exploits the intellectual property. New inventions, new pharmaceutical drugs, trademarks have nothing to be compared to that would effectively affix a value to the intellectual property.[102]

By transferring the intellectual property to a subsidiary in a low-tax jurisdiction and requiring every use of the intellectual property to pay high-royalties, the royalties are deductible in the high-tax jurisdictions and the income flows to the low-tax jurisdictions.

4. *State Aid & Subsidies*

State Aid is a tool that is used by many jurisdictions to attract specific companies. It is "A grant of money made by government in aid of the promoters of any enterprise, work, or improvement in which the government desires to participate, or which is considered a proper subject for state aid, because [it's] likely to be of benefit to the public."[103]

As a domestic American example of State Aid consider Mercedes-Benz. In 2015, Mercedes-Benz USA ("MBUSA") the United States subsidiary of Daimler, AG negotiated a subsidy with the Governor of Georgia, whereby MBUSA would relocate its headquarters from the high-tax state of New Jersey, which imposes its own corporate income tax of 9% in addition to the United States corporate income tax.[104] The State of Georgia imposes a corporate income tax of 6% in addition to the United States corporate income tax.[105] Although 300 basis points is a significant reduction, the State of Georgia also agreed to enact an "incentive package" valued at $27,000 per job. MBUSA estimates that it will create 800 to 1,000

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[102] *Id.*

[103] *Supra* note 15.

[104] *Corporation Business Tax Overview*, STATE OF NEW JERSEY DEPARTMENT OF TREASURY http://www.state.nj.usU.S/treasury/taxation/corp_over.shtml (last visited July 6, 2015).

[105] *Corporate Income and Net Worth Tax*, GEORGIA DEPT. OF REV., http://dor.georgia.gov/corporate-income-and-net-worth-tax (last visited July 6, 2015).

jobs in Georgia by moving its headquarters. This amounts to a subsidy of up to $27 million USD.[106]

Article 107 of the Treaty for the Functioning of the European Union provides that "any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market."[107] In 2014, the European Commission opened an investigation into Amazon.com, Inc.'s arrangements with Luxembourg over favorable tax treatment of income from Amazon's transfer pricing arrangements.[108] The decision involves Luxembourg's validation of Amazon's Advance Pricing Arrangement ("APA"). An APA is an agreement between various subsidiaries and branches of a multi-national group to set prices based upon comparable prices, pricing methods and adjustments for various factors.[109]

Amazon's structure is as follows:

1. Amazon Company 1 (AC1) and Amazon Company 2 (AC2) are based in the United States and own 100% of Amazon Europe Holding Technologies SCS (Lux SCS), a limited liability partnership.

2. For the purposes of Luxembourg law, Lux SCS is a transparent entity.

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[106] James Salzer, *Gov. Deal signs tax breaks for Mercedes-Benz staffers, private college*, THE ATLANTA JOURNAL CONSTITUTION (May 6, 2015), http://www.ajc.com/news/news/state-regional-govt-politics/gov-deal-signs-tax-breaks-for-mercedes-benz-staffe/nk9y6/ (last visited July 6, 2015).

[107] TFEU Treaty, art. 107 *opened for signature* March 25, 1957.

[108] David Meyer, *EU Publishes Details of Amazon Luxembourg "State Aid" Tax Probe*, GIGAOM (Jan. 16, 2015), https://gigaom.com/2015/01/16/eu-publishes-details-of-amazon-luxembourg-state-aid-tax-probe/ (last visited July 6, 2015).

[109] STATE AID SA.38944 (2014/C) – *Luxembourg Alleged aid to Amazon by way of a tax ruling*, EUROPEAN COMMISSION, Brussels (Oct. 7, 2014).

3. For the purposes of U.S. law, Lux SCS is a corporation and tax is deferred on its profits until they are repatriated to the U.S. as a dividend.

4. Lux SCS owns all Amazon's intangibles and intellectual property, and licenses both of them to Amazon EU Sarl (LuxOpCo) for which Lux OpCo must pay a royalty to Lux SCS.

5. LuxOpCo operates all of Amazon's European Sites and owns all of the shares in Amazon's E.U. subsidiaries located outside of Luxembourg in the European Union.

6. Lux SCS also loans LuxOpCo and other related companies cash to provide operating capital to the group and the group pays Lux SCS deductible interest payments. [110]

7. As a result of this arrangement, Amazon shifts most of its profits from subsidiaries located in high tax European jurisdictions to Luxembourg, where they are not subject to tax and deferred under U.S. taxation until those profits are repatriated back to the U.S. in the form of a shareholder dividend or distribution.

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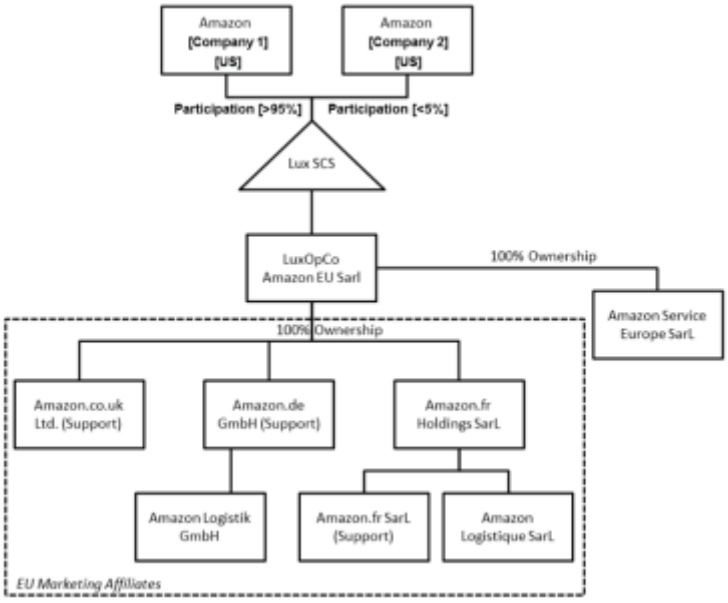
[110] *Id.*; *Proposed Treasury Regulations under Section 385 would have profound impact on related party financings*, PwC (Apr. 7, 2016), https://www.pwc.com/U.S/en/tax-services/publications/insights/assets/pwc-proposed-section-385-regs-would-impact-related-party-financings.pdf (last visited Mar. 15, 2017).



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Luxembourg applied the Transactional Profit Split Method to determine that Amazon's transfer pricing arrangement, which favored placing profits in Luxembourg over other E.U. member states, was a fair practice and in compliance with Article 164 of the Luxembourgish tax code of 1967 ("LIR") which gives no discretion to tax authorities.[112]

In comparing the U.S. example of Mercedes-Benz USA, whereby the State of Georgia enacted tax law solely for the purpose of attracting a single firm, and the E.U. example of Amazon obtaining a ruling that its APA was in compliance with Luxembourg law, it can be seen that a far greater latitude is given to United States taxpayers than to member states of the European Union, in this regard. However, in both cases, the governments will toe the line of legality in order to attract large businesses to their jurisdiction. The fact that Mercedes-Benz USA moved to Georgia, and that Amazon setup their European headquarters in Luxembourg, evidences that, at

111 *Id.*

112 Article 164 of the Luxembourg Income Tax Law of 1967; *supra* note 110.

the extremes, when governmental assurances are provided, tax can act as a major business driver.

E. The Present: Intellectual Property and Modern Tax Structures

In the context of intellectual property, the very nature of the property itself makes it a valuable tool for international tax planning. The features of intellectual property make it portable and relatively easy to relocate either by contractual terms or re-registering in foreign jurisdictions. When a product or good exploits a trademark or patent the company that manufactures that product or good must pay a royalty or licensing fee to the company that owns the intellectual property. In order for one company to control all rights to intellectual property that property must be sold and assigned to the other and those rights include the rights to receive royalties and licensing fees from that property. In other words, intellectual property could be compared to real estate in the sense that an assignment is a transfer of title to the property and the right to receive rental income for the property's use. Whereas a manufacturing company has to pay rent to use a warehouse, it would also have to pay a licensing fee to use the applicable trademark for a good, the patent in the way that the good operates or is constructed, and even a sum for confidential access to a trade secret in how the product is manufactured or what the recipe consists of.

By relocating intellectual property from a high tax jurisdiction to a low tax jurisdiction, as in the Amazon example above, the royalties and licensing fees relating to that intellectual property are booked in the low tax country, and thus, subject to taxation there.

Two major multinational companies, Google, Inc. and Apple, Inc., provide a good example of how these tax rules can be used to their benefit with *avant garde* tax strategies that take advantage of both intra-European and international tax rules.

1. *Back-to-Back License Structure with Double Irish Dutch Sandwich Case Study : Google, Inc.*

The first example, Google, utilizes many of the strategies described thus far. Google primarily derives its taxation benefits through use of the double Irish-Dutch sandwich strategy, U.S.

Check-the-Box Rules, the E.U. Interest & Royalties Directive, and general arbitrage between definitions of terms such as Tax Residence and Transfer Pricing Opportunities. To illustrate:

1. Google, Inc. transfers all of its intellectual property to an Irish holding company, Google Ireland Holdings, Inc., which has its company management and tax residency in Bermuda where the corporate income tax rate is 0%.

2. This company has subsidiary sales companies that sell advertising, Google's main source of revenue, to European markets ("High-tax OpCos").

3. However, sandwiched between the Irish holding company and the European subsidiaries is a Dutch subsidiary, Google, BV., and an Irish subsidiary, Google Ireland, Ltd.

4. Google Ireland, Ltd. collects royalties from the subsidiaries at market value and transfers them by paying nominal royalty fees to Google, BV. in the Netherlands. Google Ireland, Ltd. incurs these nominal royalty fees by licensing hard-to-price intangible assets from Google, BV., using one of the OECD transfer pricing methods, as explained by the Amazon example

5. Google BV. is incorporated in the Netherlands and the Company's management is located in the U.S.[113]

6. Google, BV. distributes its income to Google Ireland Holdings and is not subject to withholding tax on that distribution under Dutch law.

7. Google Ireland Holdings is a tax resident of Bermuda and subject to 0% corporate income tax.

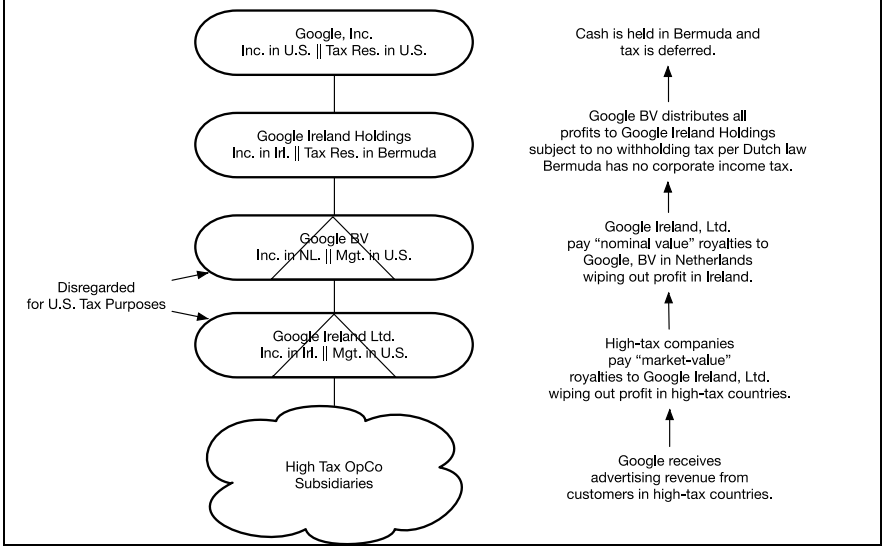
8. This strategy allows the Irish operation to avoid "even the low Irish tax of 12.5% and, by using the Dutch sandwich, to avoid Irish withholding taxes -- which are

[113] *Supra* note 98.

not due on payments to European Union companies -- per the E.U. Interest & Royalties Directive".[114]

9. Because Google "Checks the Box" on Google Ireland Holdings and Google, BV. for U.S. taxation purposes, the royalty payments disappear when the entities disappear and all the U.S. sees are the fees from the operating company engaged in active business with Google Ireland Holdings, Inc., which has its tax residency in Bermuda.[115]

Google's European Operations[116]



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[114] Jane G. Gravelle, *Tax Havens: International Tax Avoidance and Evasion*, CONGRESSIONAL RESEARCH SERVICE, 12 (Jan. 15, 2015), http://fas.org/sgp/crs/misc/R40623.pdf (last visited July 5, 2015).

[115] Ruth Mason, *Tax Planning for U.S. Multinationals*, UNIVERSITY OF VIRGINIA SCHOOL OF LAW (2015).

[116] *Id.*; Jesse Drucker, *Google Joins Apple Avoiding Taxes with Stateless Income*, BLOOMBERG BUSINESS (May 22, 2013), http://www.bloomberg.com/news/articles/2013-05-22/google-joins-apple-avoiding-taxes-with-stateless-income (last visited July 8, 2015).

2. *Case Study: Apple, Inc.*

While Google takes advantage of intellectual property, transfer pricing, and royalty payments, Google also sells advertising, which is also intangible. Apple, Inc., America's largest company applies a tax that is quintessentially Apple as it is perhaps the most simple and innovative modern international tax planning technique in use. Here's how it works:

1. Apple, Inc. is a U.S. corporation and U.S. tax resident pursuant to U.S. law.

2. Apple sells goods to end consumers around the world through its retail stores in Europe, which are located in the various member states where they do business and are incorporated. The retail stores are tax residents in the relevant member states and are all disregarded entities for U.S. taxation purposes.

3. The retail stores are owned by Apple Sales International, incorporated in Ireland with Management and Control in the United States.

4. Apple Sales International is owned by Apple Operations Europe, incorporated in Ireland with Management and Control elsewhere.

5. Apple Operations Europe is owned by Apple Holdings, incorporated in Ireland with Management and Control in the United States.

6. Using arbitrage of the rules, Ireland considers Apple Sales International, Apple Operations Europe and Apple Holdings to be non-tax residents in Ireland because management and control lies outside of Ireland.

7. The United States considers these entities to be tax resident in Ireland because of their incorporation in Ireland but Apple anyway checks the box on the Retail Subsidiaries, Apple Sales International and Apple Operations Europe.

8. Apple transfers its Intellectual Property including the patents, trademarks and know-how that go into making its products into Apple Sales International.

9. Apple contracts with third party manufacturing companies in China at market price to manufacture its products for it.

10. Once each product is complete, the third party manufacturing companies transfer written title to the products to Apple Sales International, which also owns all of the Intellectual Property.

11. Apple then sells its products from Apple Sales International to its retail subsidiaries in Europe by transferring title and the items themselves are drop-shipped to the retail stores. The retail subsidiaries pay a high mark-up price for the hard goods, which include a component for the intellectual property licensing.

12. The retail subsidiaries re-sell the hard products to the end-consumers at a mark-up that is just sufficient to cover the cost of the retail subsidiary's operations leaving minimal profit in the high tax jurisdiction.

13. This leaves most of the income in Apple Sales International, which has a very large profit but is not taxable in Ireland because it is stateless.

14. As a result of this strategy, Apple has $102 billion in offshore cash stored in Ireland, which cannot be repatriated because it would become subject to U.S. Taxation.[117]

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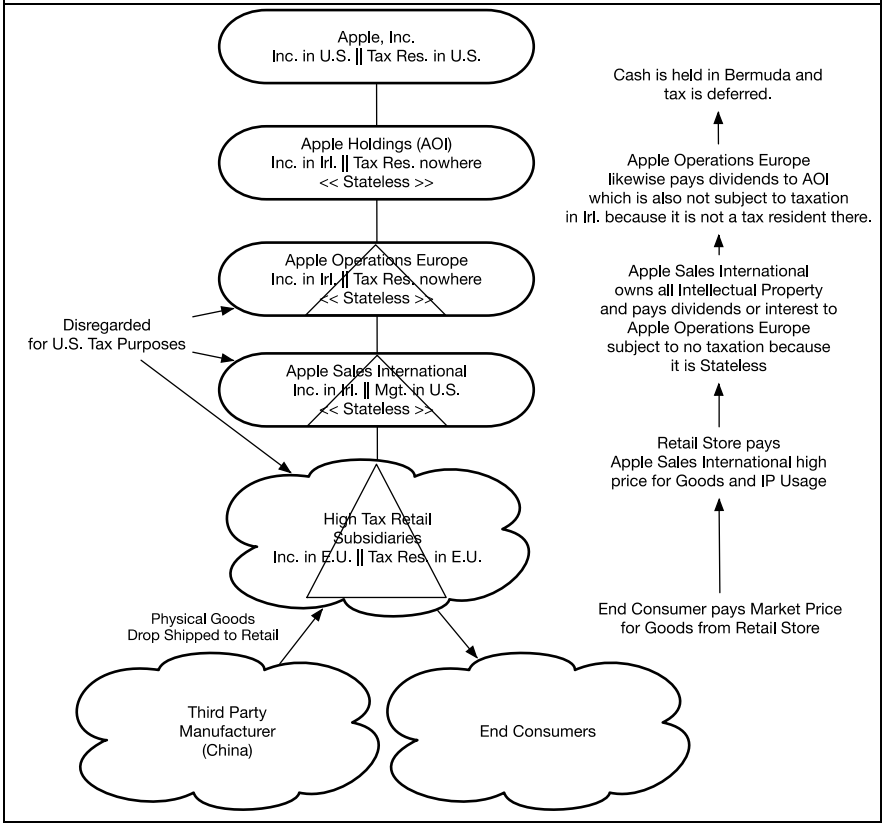
[117] Hearing Before the Permanent Subcommittee on Investigations of the Committee on Homeland Security and Governmental Affairs United States Senate, One Hundred Thirteenth Congress, First Session, United States Senate (May 21, 2013), http://www.gpo.gov/fdsys/pkg/CHRG-113shrg81657/pdf/CHRG-113shrg81657.pdf (last visited July 10, 2015).

15. Like Google, Inc. the United States only sees the payments from the end consumers to Apple Holdings in Ireland. These streams through these stateless, check-the-box companies are disregarded so it is as if the customers are dealing directly with Apple Operations International.[118]

Apple's Worldwide Operations[119]



[118] *Supra* note 116.

[119] *Id.*; *supra* note 118.

V. FUTURE: PROACTIVE TAX PLANNING – CAN TAX DRIVE THE DECISION

Tax strategies such as those implemented by Apple, Inc. and Amazon.com have been subjected to public disclosure because governments and in particular the United States Senate and European Commission respectively have conducted inquiries into the practices of these multinationals and called upon representatives of these companies to testify publicly about their tax practices.[120] As a publicly traded company, exposure to publicity affects investor confidence and thus stock price in a more qualitative way.[121]

Perhaps one of the simplest resolutions would be for the United States to abolish the "check-the-box" rules. By doing so, the IRS Subpart F regulations would resume their intended meaning because companies would not be able to use payments of interest or royalties to a hybrid entity in order to eliminate taxable offshore Subpart F income. It is important to recognize that the IRS' official justification for enacting the "check-the-box" provided in part:

> Because the complexities and resources devoted to classification of domestic unincorporated business organizations are mirrored in the foreign context, the Service and Treasury are considering simplifying the classification rules for foreign organizations in a manner consistent with the approach . . . for domestic organizations.[122]

In other words, "check-the-box" was about providing simplicity in the tax code for multinationals. Although the IRS has implemented anti-abuse rules related to "check-the-box," these rules

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[120] *Id.*; State aid SA.38944 (2014/C) – *Luxembourg Alleged aid to Amazon by way of a tax ruling*, EUROPEAN COMMISSION, Brussels, (Oct. 7, 2014).

[121] Ben Rooney, *Apple's Tim Cook is Wall Street hero for a day*, CNN MONEY (May 21, 2013), http://buzz.money.cnn.com/2013/05/21/apple-tim-cook-congress/ (last visited July 8, 2015).

[122] Internal Revenue Service, *Notice 95-14*, 1995-1 CB 297, 298 (Mar. 29, 1995).

do not apply for internal payments within a corporation.[123] According to the Office of Chief Counsel of the Internal Revenue Service, loans between a corporation and its disregarded branch in another country are disregarded for U.S. tax purposes.[124]

After the implementation of "check-the-box," in countries like the United Kingdom and Germany where corporations are taxed at rates comparable to the United States, the tax bases dropped dramatically as profits were shifted offshore to low tax jurisdictions. In 1998, the IRS proposed new regulations to close the loophole and U.S corporations began a massive lobbying effort to stop the implementation.

General Electric, PepsiCo, Morgan Stanley, Merrill Lynch, Monsanto and other major companies urged Congress to resist the change. The U.S., they said, was trying to be "the tax policeman for the world." Allies in Congress dug in, and Treasury quickly rescinded the proposal.[125]

By 2000, over 8,000 disregarded entities were in existence with large concentrations in the Netherlands because of their specific treatment of royalties and interest discussed *supra*. By 2004, billions had built up in the Dutch bank accounts of major U.S. corporations and the United States Congress approved a tax holiday allowing these companies to repatriate the profits at a rate of 5.25 percent. Over $90 billion USD was repatriated from the Netherlands alone.[126]

In 2009 when President Obama was elected, he included elimination of "check-the-box" loopholes as part of his agenda, however due to vehement opposition and threats that American companies would be bought by their foreign competitors, Obama

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[123] Jeff Gerth, *Corporations Couldn't Wait to 'Check the Box' on Huge Tax Break*, PROPUBLICA (Sept. 26, 2011), http://www.propublica.org/article/corporations-couldnt-wait-to-check-the-box-on-huge-tax-break (last visited July 8, 2015).

[124] *Memorandum 201420017*, OFFICE OF THE CHIEF COUNSEL INTERNAL REVENUE SERVICE (May 16, 2014), http://www.irs.gov/pub/irs-wd/1420017.pdf (last visited July 8, 2015).

[125] *Supra* note 124.

[126] *Id.*

retracted his position leaving "check-the-box" on the table as a valuable tool.[127]

A. The Value of Tax to Management Compared with Other Business Drivers: Case Study: Inversion

Although society has seen tax impact business in the context of structures and branch operations, perhaps the single biggest impact that tax can have on major corporations is the inversion, or the inversion merger. In the introduction, we examined how Boris Becker moved his residency for taxation purposes. We have also addressed how taxation based upon source and residence rules allows companies like Apple to take advantage of stateless income that is not subject to tax anywhere on the basis of residence. As discussed, the United States is unique in its approach to the taxation of worldwide income. Because the United States views the place of incorporation as the determining factor for tax residency, many U.S. corporations have moved their legal headquarters overseas by reincorporating. To do this, the U.S. company establishes or acquires another company in a country with a lower corporate tax rate and then calls the new country home.[128] As explained by The Economist:

> When a company becomes foreign through a merger, or "inverts", it no longer owes American tax on its foreign profit. It still owes American tax on its American profit. But that, too, can be minimised [sic]. Often, the group can shift debt to the American unit, or have it borrow from the foreign parent. It can then pay interest to the parent while deducting the sums involved from its American taxes. Several studies have found such "earnings stripping" common when companies invert. When Walgreens, an American chemist, announced plans to merge with Swiss-based

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[127] *Id.*

[128] John W. Schoen, *How Does a Corporate 'Tax Inversion' Work?*, NBC NEWS (Sept. 23, 2014), http://www.nbcnews.com/business/taxes/how-does-corporate-tax-inversion-work-n209701 (last visited July 8, 2015).

> Alliance Boots, Barclays, a bank, reckoned the move could save $783m a year in taxes in this way.[129]

In practice, this is a relatively simple solution to a complex problem, however, the United States has changed the rules, so simply opening an office in London or Ireland, or even declaring a foreign country as the corporation's tax residence is insufficient to change the tax base of the corporation as further discussed below.[130]

The September 2014 regulatory change resulted in an increased fervor of actual substantive business acquisitions. In 2014, U.S. based medical device manufacturer Medtronic signed a deal for $42.9 billion USD to buy Irish competitor Covidien. The new conglomerate's headquarters: Ireland; the effective reduction in corporate income tax: over 65% (from the U.S. rate of 40% down to the Irish rate of 12.5%). Shortly after announcing the merger, Medtronic announced a $10 billion USD investment in new U.S.-based research and development commitments. We can surmise that the ability to make this investment may have been afforded as a result of the tax savings. With these figures, it is hard to imagine how tax could not drive these types of decisions in every major multinational corporation.[131]

According to Bloomberg News, as of April 2015, over 48 companies had reincorporated in low-tax countries since 1982, out of these 48, 17 have occurred since 2012. These include some of America's most cherished and valuable brands like Burger King, Mylan, and Aon.[132]

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[129] *Inverse logic*, THE ECONOMIST (Sept. 20, 2014), http://www.economist.com/news/finance-and-economics/21618912-america-weighs-action-discourage-corporate-exodus-inverse-logic (last visited July 9, 2015).

[130] Kevin Drawbaugh, *U.S. Treasury Moves Against Tax-Avoidance 'Inversion' deals*, REUTERS (Sept. 23, 2014), http://www.reuters.com/article/2014/09/23/usU.S-tax-inversion-treasury-idUSKCN0HH2TM20140923 (last visited July 8, 2015).

[131] Charles Riley, *Medtronic buys Covidien for $42.9 billion*, CNN MONEY (June 15, 2014), http://money.cnn.com/2014/06/15/investing/medtronic-covidien/index.html (last visited July 9, 2015).

[132] Zachary R. Mider, *Tax Inversion: How U.S. Companies Buy Tax Breaks*, BLOOMBERG NEWS (Apr. 21, 2015),

Inversion Decade

Year	U.S. company	Foreign acquisition target	New incorporation
Pending	Cyberonics	Sorin	England
Pending	Wright Medical	Tornier	Netherlands
Pending	Steris	Synergy Health	England
Pending	Civeo	–	Canada
Pending	Applied Materials	Tokyo Electron	Netherlands
2015	Mylan	Abbott's generics unit	Netherlands
2015	Medtronic	Covidien	Ireland
2014	Burger King	Tim Hortons	Canada
2014	Horizon Pharma	Vidara Therapeutics	Ireland
2014	Theravance Biopharma	–	Cayman Islands
2014	Endo International	Paladin Labs	Ireland
2013	Perrigo	Elan	Ireland
2013	Actavis	Warner Chilcott	Ireland
2013	Liberty Global	Virgin Media	England
2013	Tower Group	Canopius Holdings Bermuda	Bermuda
2012	Stratasys	Objet Geometries	Israel
2012	Eaton	Cooper Industries	Ireland
2012	DE Master Blenders 1753	–	Netherlands
2012	Tronox	Exxaro Resources	Australia
2012	Rowan	–	England
2012	Aon	–	UK
2012	Jazz Pharmaceuticals	Azur Pharma	Ireland
2011	Alkermes	Elan Drug Technologies	Ireland
2010	Valeant	Biovail	Canada
2009	Altisource Port. Solut.	–	Luxembourg
2009	Hungarian Telephone	–	Denmark
2009	Ensco	–	England
2009	Tim Hortons	–	Canada
2007	Western Goldfields	–	Canada
2007	Argonaut Group	PXRe	Bermuda
2005	Lazard	–	Bermuda

[133]

B. Substance Requirements, Anti-Avoidance and Anti Treaty-Shopping

One area that has been subjected to significant scrutiny in many tax structures is overall substance. As discussed in the context of inversions, the U.S. Treasury used a form of Substance Requirements to curb U.S. corporations' ability to simply

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http://www.bloombergview.com/quicktake/tax-inversion (last visited July 9, 2015).

[133] *Id.*

reincorporate elsewhere, or to use the acquisition of a much smaller foreign rival to change the company's overall tax residency.

Substance Requirements however, arise most prominently in the area of treaty shopping and the use of Special Purpose Vehicles ("SPVs"):

> In order to qualify for tax treaty benefits, which is what SPV's are all about, the SPV will in most cases have to meet two criteria generally contained in tax treaties: (i) the SPV must be a tax resident of the State it is registered in; and (ii) the SPV must be the 'beneficial owner' of the income flow.[134]

The OECD model convention addresses substance in its "permanent establishment" and "beneficial ownership" rules. Revisiting the prior examples of *Prevost* and *Indofood*, we see two examples where courts treat similar situations differently. What occurred in *Prevost* could have been characterized as treaty-shopping. In 2011, the OECD introduced new language intended to address the ambiguities of the term "beneficial owner" contained in the model convention. In its summary, the OECD provided that in the case of the conduit company,

> the recipient of the dividend is not the "beneficial owner" because that recipient does not have the full right to use and enjoy the dividend that it receives and this dividend is not its own; the powers of that recipient over that dividend are indeed constrained in that the recipient is obliged (because of a contractual, fiduciary or other duty) to pass the payment received to another person.[135]

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[134] Joseph Peters, *Netherlands: Worldwide Developments in the Tax Concept of Substance*, (Nov. 23, 2012), http://www.mondaq.com/x/207914/tax+treaties/Worldwide+Developments+In+The+Tax+Concept+Of+Substance (last visited July 8, 2015).

[135] *Clarification of the Meaning of "Beneficial Owner" in the Model Tax Convention*, OECD (Apr. 29 – July 15, 2011), http://www.oecd.org/tax/treaties/47643872.pdf (last visited July 8, 2015).

The European Commission has recently devoted a lot of attention to the Netherlands and whether by allowing the IP structures discussed herein they are creating harmful tax competition within the European Union. In response to European pressure, the Netherlands has also implemented its own national regime for holding companies and conduit companies that are established for the purpose of lessoning the tax liability incurred from capital gains, dividends, and interest and royalty payments. These rules are as follows:

1. The entity should have sufficient equity (transfer pricing study required).

2. The equity should actually be at risk (no non-recourse situations).

3. The entity's gross profit margin should beat arm's length standards (transfer pricing study required).

4. At least 50% of the directors should be permanent Dutch residents (nationality irrelevant).

5. The directors should have proper professional qualifications in order to manage not only the entity but also its money flows; no 'dummies' allowed.

6. The books must be kept, and the annual accounts should be prepared, in the Netherlands.[136]

Additionally, in order to avail itself of treaty benefits, an entity must have a "permanent establishment" in the jurisdiction of one of the treaty parties. The OECD applies a "fixed place of business" test.[137] To wit: there must be a "fixed place of business through which the business of an enterprise is wholly or partly carried on." [138]

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[136] *Id.*

[137] *OECD: Revised Proposals on Article 5 (Permanent Establishment) of the OECD Model Tax Convention*, PwC (Nov. 6, 2012), http://www.pwc.com/en_GX/gx/tax/newsletters/tax-policy-

- **Fixed** means that there is a link between the place of business and the specific location, as well as a degree of permanence. An "office hotel" or "virtual office" may constitute a fixed place for a business for an enterprise that regularly uses different offices within the space. Contrarily, where there is no commercial coherence, the fact that activities may be conducted within a limited geographic area should not result in that area being considered a fixed place of business.

- A **place** of business. Means facilities used by an enterprise for carrying out its business. The premises must be at the disposal of the enterprise. The mere presence of the enterprise at that place does not necessarily mean that it is a place of business of the enterprise. The facilities need not be the exclusive location, and they need not be used exclusively by that enterprise or for that business. However, the facilities must be those of the taxpayer, not another unrelated person. Thus, regular use of a customer's premises does not generally constitute a place of business.

Business of the enterprise must be carried on wholly or partly at the fixed place.[139]

The European Union also has repeatedly upheld the "Freedom of Establishment" as one of the four fundamental freedoms available to E.U. citizens pursuant to the European Union treaty. According to the European Court of Justice's holding in *Cadbury Schweppes v. Commissioners of Inland Revenue*:

> "[F]reedom of establishment is intended to allow the nationals of the EMBL States to participate, on a

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bulletin/assets/pwc-revised-proposals-article-5-oecd-model-tax-convention.pdf (last visited July 9, 2015).

[138] *Id.*

[139] *Model Tax Convention on Income and on Capital: Condensed Version, Commentary,* OECD (2014), http://www.oecd-ilibrary.org/taxation/model-tax-convention-on-income-and-on-capital-condensed-version-2014_mtc_cond-2014-en (last visited July 9, 2015).

> stable and continuing basis, in the economic life of another State" meaning "the concept of establishment involves the actual pursuit of an economic activity through a fixed establishment for an indefinite period."[140]

Only the establishment in the host State and the pursuit of genuine economic activity falls within the scope of the provisions on freedom of establishment. The Court in *Cadbury* found that concept of establishment has a specific meaning and must not be interpreted narrowly. Any person or entity that pursues economic activities that are real and genuine must be regarded as taking advantage of its right of establishment.[141]

In order to determine whether or not an entity pursues real and genuine business activity in the host country, the Court must look to:

> "[T]he extent to which the CFC physically exists in terms of premises, staff and equipment . . . If checking those factors leads to the finding that the CFC is a fictitious establishment not carrying out any genuine economic activity in the territory of the host Member State, the creation of that CFC must be regarded as having the characteristics of a wholly artificial arrangement."[142]

As a final catchall measure, many jurisdictions have sought to combat the types of tax structures analyzed herein using what is known as a General Anti-Avoidance Rule ("GAAR"). Although there is no uniform or model GAAR, there are consistencies in their formulation.

1. Identification of a *scheme* (Australia) or *arrangement* as is seen in China, Ireland, South Africa and New Zealand.

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[140] *Cadbury Schweppes*, ECJ C-196/04, para. 53 and 54.

[141] *Id.* at para. 68.

[142] *Id.* at para. 67; Robert Agresta, *Written Observations by the Principality of Liechtenstein to the EMBL Moot Court in Cases E-28/13 and E-30/13 Sailorman a.o. v. Norway*, Sept. 22, 2014.

2. Quantification of a *tax benefit* (Australia, Canada, Hong Kong and South Africa) or *tax advantage* (for example in Ireland) associated with that arrangement.

3. A *purpose test*. Identification of a *sole purpose* (Brazil), *dominant purpose* (Australia) or *main purpose* (South Africa) of obtaining a tax benefit associated with the arrangement.[143]

The United Kingdom however, only applies targeted anti-avoidance rules and has not enacted a catchall measure. The United States does not have any form of GAAR and relies upon common-law doctrines of statutory interpretation to prevent certain types of arrangements. "In 2011, the judicially developed economic substance doctrine, under which certain types of tax benefits are disallowed if the impugned transaction lacks economic substance or lacks a business purpose, was codified in legislation".[144]

VI. SUMMARY, CONCLUSIONS AND PROPOSALS

In light of the forthcoming OECD BEPS proposals as well as the promulgation of GAARs and clarification of Model Treaty provisions, the core question becomes: will tax be a business driver in the future? In this Author's opinion, tax will always be a business driver, however it will not drive business in the same way it does today. Sovereign nations want to attract major corporations to their tax base. Although their abilities to freely adapt laws to do so may be hamstrung by their existing obligations in treaties, or subjected to international pressures, countries will always want to compete in this regard.

The author cannot discount the success that the OECD has had in obtaining ratification of the Model Convention among major world powers. However, internal political pressures as described in

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143 *General Anti-Avoidance Rules: What are key elements to a balanced approach?,* PWC TAX CONTROVERSY AND DISPUTE RESOLUTION ALERT (2012), http://www.pwc.com/en_GX/gx/tax/newsletters/tax-controversy-dispute-resolution/assets/pwc-general-anti-avoidance-rules.pdf (last accessed July 8, 2015).

144 *Id.*

the United States have successfully preserved seemingly absurd loopholes like "check-the-box." These indicators seem to be contrary to the ideals presented by the OECD in the BEPS project. While diplomatic relations seem to drive international discussions for an equitable tax system in one direction, domestic pressures demand attention. Even the Netherland's revised substance rules take little effort for a large multi-national to fulfill. Moreover, the incentive has proven fruitful to low-tax countries. The prevalence of inversions and tax driven cross-border mergers are proof of this.

In introducing this topic, this Article broke tax into categories, e.g. taxes on consumption and taxes on income. However, what if both taxes could be replaced with another option. Felix Bolliger, lic.oec., HSG argues in his whitepaper "Micro Tax on All Monetary Transaction / Automatic Micro Tax on Debiting (AMTD)" that an automated tax could be implemented "free of any ideology and extremely abundant." Bolliger argues that this type of tax "relieves stress and strain on producers and individual tax payers. Existing direct and indirect taxes become obsolete. The automatic micro tax on debiting helps to resolve the current international debt crisis.".[145] Moreover, the AMTD would force intra-European tax compliance with the E.U. principles against state aid and in favor of a free internal market.

Bolliger argues that the AMTD fulfills the goals of a tax system to be "fair, easy to understand and easy to apply," and better than any other presently available tax methodology. Bolliger states:

> In Switzerland, total fiscal income for year 2011 amounts to CHF 170 billion, which represent 30% of CHF 585 billion gross domestic product. *A micro tax of 0.2% on CHF 95'000 billion monetary transactions equally generates a national tax income of CHF 190 billion.*
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[145] Felix Bolliger, *Reinvent the System: Micro Tax on all Monetary Transactions / Automatic Micro Tax on Debiting (AMTD)* (working paper, Jan. 2013), http://www.microtax.ch/wp-content/uploads/2016/12/AMTDC-Automatic-Micro-Tax-Concept-English-07.12.2016.pdf.

> Statistics issued by NYSE, Nasdaq, London Metal Exchange (LME) give a first idea about the size of international money flows. We are confronted with figures beyond common understanding. Foreign exchange transactions (Forex) alone amount to a daily volume of USD 4'000 billion, or roughly 7% of world GNP.[146]

While the proposal is radical, it addresses the fundamental paradigm laid out in the Introduction hereto. As long as there have been governments – there have been taxes. As long as there have been taxes – there have been strategies to avoid them. By eliminating pressures, automating the collection of taxes, and taking responsibility for their payment, the ability to avoid taxes is effectively eliminated. To the knowledge of this author, the AMTD has never been proposed to the OECD as an alternative solution. The tax is however, fair, equitable and international. If the OECD were braver and more innovative, it would take-on the AMTD or another similar automated means of taxation as a goal and abandon the BEPS project, which in the opinion of this Author, will ultimately be largely ignored at the last moment by the United States because of its own internal political pressures.

[146] *Id.* (*emphasis added*).