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# GLOBAL LAW
## CONTEMPORARY CHALLENGES, FUTURE PERSPECTIVES

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*Maria Lucia Padua Lima*
*José Garcez Ghirardi*
Editors

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Universidad de los Andes
Facultad de Derecho

IDRC | CRDI
International Development Research Centre
Centre de recherches pour le développement international

Canada

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# GLOBAL LAW
## CONTEMPORARY CHALLENGES, FUTURE PERSPECTIVES

***Contents***






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# INTRODUCTION

**José Garcez Ghirardi**

This book offers a synthesis of the main debates which have taken place within the pioneer Global Law Program at FGV Law School in São Paulo, Brazil. It presents a selection of papers discussing, from the Brazilian perspective, some of the most challenging contemporary problems of globalization. With emphasis on the interconnectedness of these problems, the chapters discuss a set of complex issues such as tax policies harmonization, environmental protection, the restructuring of state machinery and its changing nature, the problem of immigration, and the novel conceptual framework for discussing law and development.

The complexity of each individual theme, coupled with the various viewpoints from which they are discussed, underscores the relevance of rethinking the connection between theoretical models springing from markedly diverse national realities, a proposal which is at the heart of the Global Law Program at FGV. The chapters in this volume display such variety, either from a geographical standpoint (with contributions by scholars working in Brazil, Europe, United States, and Asia), or from the methodological perspective adopted (case studies, theoretical discussions, analyses of normative texts). Taken together, they allow a concrete expression of the role that different theoretical strategies have on our perception of globalization.

The urgent need for a new conceptual framework to face the sweeping, fast-paced changes in the wake of globalization is also the focal point of Michael Schillig's "EU Framework for Reservation of Title" and John I. Forry's "Taxing Multinational Enterprises: Basic Issues of International Income Tax Harmonization". Nuno Cunha Rodrigues's "The Use of Public Procurement as a Non-Tariff Barrier: Relations between the EU and the BRICS in the Context of the New EU Trade and Investment Strategy" discusses the tension between national and regional regulation in face of new global regulatory spaces. These texts scrutinize the challenges that unprec-

edented political-economic designs present to law and, more specifically, to the theoretical-practical models of economic regulation.

Courts all around the world have played an important role in this effort to enable law to cope with the new globalized context. "Law and Economics in the Civil Law World: The Case of Brazilian Courts", by Bruno M. Salama and Mariana Pargendler, is an in-depth case study of the limits and possibilities for judicial intervention in this arena. Their findings closely dialogue with Zeynep Derya Tarman's argument in "Jurisdiction and Governing Law in International Business Contracts under Turkish Law".

The recreation of institutional designs represents another major strategy to cope with a global context which is, at the same time, more integrated and more diverse. Institutional reengineering has been discussed in different areas, as exemplified in this book by Weitseng Chen's "Institutional Arbitrage: China's Economic Power Projection and International Capital Markets" (economy); Cristina Barettini's "The Valletta Summit on Migration" (human rights); and Alexandre Pacheco da Silva and Victor Nóbrega Luccas's "Picking the Wrong Winners: Evaluating a Legal Policy beyond the Law" (cultural goods). José M. de Areilza's "Law and Politics to Formulate the Next European Utopia" suggests that these new arrangements are indices of deeper transformations in the legal-political global order.

New legal professionals will be needed to make law function in this transformed world. The trials to educate these professionals are discussed in Lynn P. Cohn's "The Case for Including Negotiation, Dispute Resolution and Problem-Solving Teaching in the Law School Curriculum and How to Get Started" and in Jedidiah J. Kroncke's "Teaching International Labor and Employment Law: The Comparative Foundations of Transnational Pedagogy".

The collection of texts in this volume aims at fostering debates over traditionally accepted theoretical models and enhancing the role local realities play on global thinking. This is the idea at the heart of the Global Law program which it synthesizes.

# TEACHING INTERNATIONAL LABOR AND EMPLOYMENT LAW: THE COMPARATIVE FOUNDATIONS OF TRANSNATIONAL PEDAGOGY

**Jedidiah J. Kroncke**[1]

## Introduction

In any pedagogical enterprise it is a persistent challenge to step outside oneself as a teacher and imagine the classroom experience you are providing through the lens of your students. Largely, law professors' experiences of the classroom diverge from that of the median student who views law school as a pathway to a myriad of professional endeavors exclusive of academia. One must avoid the trap of the ardent literature instructor who is felled by the discovery that his or her students may not feel their life wholly transformed by Shakespearean verse, and instead grapple with such dissonance to nonetheless find ways to educate and inspire.

We teachers of labor/employment law often find ourselves in a similar stead. Our work is fueled by a sense of urgency and indignation at the inequalities and injustices we perceive in modern economic organization. It is also often a minority passion in the academic institutions we inhabit, doubly so if comparative in orientation. We recurrently argue that underneath what appears to be esoteric to the future professional are the keys to a robustly catholic view of law, and that what we teach unlocks analytical capacities relevant to understanding the deep relationships of law to society, culture and politics. Furthermore, such understanding is not simply limited to self-referential academic dialogues, but one that lends itself to the fashioning of a cognitive agility advantageous to any professional legal endeavor. But to do this, we have to develop classroom strategies that do not presume that such advantage is either obvious or arrived to by our students in the same manner as we did in our own legal education.[2]

My thoughts in this piece primarily emerged from the challenges and stimulations of teaching these subjects in an arena that directly tests this pedagogical ambition. In my first experience teaching international labor and employment law, I was tasked with creating a curriculum for students in a Brazilian "Global Law" program that brought together not only students from varied national backgrounds, but also those at undergraduate, graduate, professional and continuing legal education stages of their careers. Some had already worked as employer-side labor lawyers and were seeking to broaden their professional horizons into the international arena. Some were precocious teenagers who had already crafted dreams of advocacy to end forms of employment discrimination. As such, there was no hope to build a curriculum that could speak narrowly to all of their individual aspirations. This multiplicity in student interests and potential involvement with workplace law is what Michael Zimmer attempts to capture with his idea of the "two halves of a whole teaching."[3]

The provocations of this teaching experience reinforced three foundational beliefs about transnational pedagogy: (1) the core necessity of comparative methodological training for any international or cross-border oriented class; (2) the necessity of interdisciplinarity for comparative methods and its potential to enhance the analytic capacities of any creative legal professional, and; (3) the reality that addressing empirical approaches to law need not undermine students' faith in the coherence of legal practice but instead can build a curiosity to identify the social and cultural assumptions that often inhibit understanding their clients and other lawyers from disparate backgrounds.

## THERE IS NO CHOICE BETWEEN COMPARATIVE THEORY AND PRACTICE, ONLY METHODOLOGY

Even in today's ever-globalizing world, formal courses on comparative law are far less common than those on international law. In many law schools, "international law" was first implicitly presumed to be public international law, with its more readily available texts and conventions. In recent decades, the recognition that private international transactions constitute the bulk of

actual global legal activity has since diversified the subjects of "international law". As academies catch up with the deepening and broadening scope of the international legal world, they struggle with how to teach these fast-moving subjects, and their intersection with domestic legal practices now impacted and reshaped by the same global forces.

Part of this struggle is that in all of these cases the subject is one small step removed, save for the most naive and unproductive formalism, from comparative law. Here, I invoke comparative law not as a substantive and distinct field of law, rather as the core methodological challenge of how one navigates a realm of activity that may label itself "international" in some taxonomic sense, but is in almost every instance a relative blending of domestic legal cultures, if not domestic legal systems. Boris Mamlyuk and Ugo Mattei coined the term "comparative international law" to capture the fact that every country relates to international legal sources differently.[4] Even international courts which seek to claim an internal coherence to their jurisprudence are invariably made of justices trained in different traditions and with assorted interpretive dispositions.[5] In the realm of private international transactions, reducing the intentions and expectations of clients into contracts may ultimately end in a process of mechanical drafting, but such drafting relies on a legal art that amplifies all the traditional challenges of negotiating multiple client strategic and psychological variables.

What this ultimately means is that while comparative law as a field is often segregated from these courses, comparative methodology is a core competency required to enact them. In the transnational context, there is no real boundary between international and comparative law, they are simply refractions of the same legal phenomenon. The historical twists and turns of what has been considered "comparative law" has helped obscure this,[6] readily on display in the now well-worn debate over whether comparative law is a field or a methodology.[7] While I have addressed this in other venues, suffice it to say that the value of comparative law as a method of knowledge production makes itself clear in the transnational pedagogical context.[8]

In the specific arena of labor law, the utility of comparative methods has been routinely, if aspirationally, acknowledged.[9] The regulation of the workplace in the United States has always had a comparative component

given the strength of its federalist organization,[10] and now similar dynamics prevail in contemporary attempts at supranational legal integration/coordination.[11] Today, the deep interdependence of the global economy has made the transnationalization of labor regulation a given,[12] and presented national traditions of labor law with the parallel challenges of regulatory pluralism and the fracture of national social contracts as the sole battleground for shaping workplace organization.

This broader regulatory shift has generated a clear demand-side growth in the desire for transnational employment law courses, especially in those systems whose lawyers dominate the international legal arena, the United States[13] and the European Union.[14] But these courses are rarely labeled "comparative labor law" or "comparative employment law;" they are instead prefaced with "international." There is certainly a corpus of non-domestic legal sources that may be relevant in these areas of practice, but no single course can hope to capture all of the substantive law potentially implicated, for example, in either helping manage the labor relations of a Chinese firm moving into Brazil, or integrating an Indian IT team into the operations of a multinational firm based in the United Kingdom. The pressure then in constructing an international labor and employment law course is to make it into a loose survey course, the type of roving academic tourism classically critiqued by Clyde Summers.[15] It would be a herculean task in one course to relate all the substantive differences in employment law even between historically close systems, such as the United States and Canada, which similarly structured a national form of collective bargaining regulation, but diverge on at-will termination.

In the context of a course where the interests and aspirations of your students are diverse, even such potential narrowing would only exclude far more students than it would include. The only real alternative left is to try and give all of these students some sense of how to proceed when faced with the initially unintelligible legal scenarios that they will invariably face. In many ways, this is an amplification of the traditional challenges of teaching comparative law, which is again an amplification of educating any lawyer to find legal answers to questions for which they do not know an immediate answer. The ability to function within and between multiple legal systems is

an ecological challenge which invokes the full host of creative skills involved in any legal practice. In a transnational context, one may erect signposts to common legal sources, such as relevant conventions and treaties, but the gulf between ever-expansive experiential knowledge and new legal questions in practice will always be wide. What is left then is not the seemingly irascible canard of choosing between theory and practice, but the criteria of how generalizable any content in your course is to students' future ambitions. Transnational pedagogy, I argue, can thus only be a process of methodological sensitization.

In concrete terms, it is often best to start such courses without a coherent theoretical frame, and even without any explicitly comparative material. What is required is the presentation of discrete case studies on conceptually comparable legal topics, such as race in employment discrimination law, and work with students on how to proceed from a state of unease. Later in the course, one can present good and bad comparative work (at least from the instructor's perspective) and see what can be divined from each about how such an analysis should proceed and potentially yield. In the end, material can be introduced that looks at actual transnational regulation in practice, say public-private monitoring of supply chain labor conditions, to question how such regulation is enforced in different national contexts, akin to what Carrie Menkel-Meadow promotes as "experiential transnational learning."[16]

By contrast, consider two very different reactions to these transnational dilemmas. One is to attempt to give students a single coherent theoretical framework within which to view their potential legal work. Ralf Rogowski uses the work of Niklas Luhmann and Gunther Teubner to create such a framework, what he calls "reflexive labour law."[17] Here Rogowski tries to capture the breakdown of the state as the sole locus of legal regulation and embraces the self-regulatory possibilities often associated with "new governance" models of law. Perhaps this type of framework might help a student cognize a particular transnational phenomenon, but it risks making the gap between their imagined professional life and the content of the course seem insufferably wide. It also places all of its pedagogical capital in a single theoretical basket, full of its own assumptions potentially not shared by students. Furthermore, it also has little time to show how theoretical nuance

can be connected to the applied complexities of legal practice, and leaves students overconfident that a single frame will always yield the best concrete understandings. The fully theoretical course is apt to induce the alienation of the ardent literature professor alluded to earlier; it is perhaps a fine starting point for a future academic but is unlikely to grip other students in a similar manner. It is highly general knowledge, but is not necessarily generalizable to the varied trajectories of the students themselves.

The second tactic is to eschew theory for a focus on very specific problematics in transnational labor practice. Roger Blainpain and his co-authors bring in many possible transnational subjects in their voluminous casebook *The Global Workplace*, and begin the book with the dilemmas of an employment lawyer working for a multinational.[18] It is not uncommon to find attempts to frame internationally-oriented courses within this more practical frame, including directions on mock exercises in drafting employment agreements for parties in diverse national legal settings.[19] For some students, such a construct has the benefit of greatly reducing the gap between course content and an imagination of their own future practice. It is not general knowledge, but it is generalizable to students who see their career paths as implicating such legal work. In a CLE (continuing legal education) context which can attract a self-selected demographic who directly fits this mold, this is then potentially sufficient. But in a course which seeks to speak also to future lawyers with other aspirations, it completely shuts them out from the process. It also risks, though does not necessitate, over-reliance on the fiction that legal techniques can be mechanically isolated from the very logistical quandaries inherent in transnational contexts which agitate against legal formalism.

If neither a fully theoretical nor a technical course is sufficient, what are we left with? So goes a familiar challenge of legal teaching, and the common resort to a middling way somewhere in between. In the transnational domain, what a course with an explicit methodological focus can offer is not the still popular taxonomic approach to comparative law, but the problem-solving emphasis of functionalism. The rise of functionalism as a frame for comparative legal research has generated its own controversies,[20] but in the pedagogical context its advantages are evident. Students

can be presented with certain common legal problems and their solutions in various comparative contexts, and try to make sense of them not as specific answers to specific legal questions but as creative attempts to solve problems in uncertain legal territory. This is the basis of a generalizable knowledge from which all students, no matter their future aspirations, can benefit from, and ultimately leaves to them to imagine how it would enable their later work. For it takes what law demands professionally – its representation as an internally coherent and authoritative practice – and proactively opens up the many forms of creativity required to sustain such necessary fiction, even when there is very little social ground in common. The production of legal knowledge in transnational settings sometimes requires a cognitive openness that in some places demands an undoing of the lessons learned from domestic experience, but again this is only an amplification of the creativity expected in legal practice generally. It leaves the student at the same place, if with different ends, as any accomplished comparative labor scholar – that of where to start.[21]

## Legal practice as inherently interdisciplinary, labor law as inherently relational

After advancing the argument that comparative methodology is at the core of any international or transnational course, the question then arises about what exactly comparative legal methodology is. Herein, comparative methodology diverges from strictly positivist conceptions of law which emphasize identifying and reconciling discrete sources of legal authority. But the gap is, I would argue, one of degree and not of nature. The preceding argument about transnational pedagogy as inherently comparative could give the impression that international legal practice is a sort of American Wild West, full of uncertainty and for which the practitioner is best armed only with the ability to build order out of chaos. As with any social arena, even in the absence of a clear sovereign, or in a space of competing sovereigns, humans create systems of order, and lawyers are the modern architects (or perhaps foremen) of the international order. Choice of law provisions are a powerful tool in cabining the legal complexity of a transnational transaction, though far from

complete.[22] The very utilization of customary practices in public and private international law is an attempt to sync trailing formal legal instruments with the more spontaneous social and economic practices of the moment. Yet, the pluralism of legal regimes in the international sphere remains a patchwork, and clarity is still a challenge when this patchwork has to interface with the harder networks of domestic law, as in the enforcement of arbitral awards.[23]

In the context of teaching, the lens of generalizability again returns to help filter what type of comparative method is useful for recognizing an array of factors that complicate international legal practice and inform the creative efforts that give it shape. As such, it is useful to return to the now classic image of legal practice as existing in "the shadow of law" as much as it is determined by it.[24] Legal creativity may, at points, subvert the spirit of a particular legal regime, but can also give meaning to its various omissions or underspecifications. Thus, transnational legal practice is here another amplification of the general interdisciplinarity of legal practice. The positive corpus of law never contains its own full meaning, and the demands of its representation as a bounded system require translating non-legal factors and interests into law. It follows then that comparative methodology is best considered as a heightened form of interdisciplinary problem solving, expressed in a functionalist frame.

This interdisciplinarity presents specific opportunities and difficulties for the comparative labor and employment teacher. Labor scholars have long argued for interdisciplinarity in their field, as it is hard to suppress the fact that the workplace is a relational domain.[25] The workplace is formally governed by regimes of contract, but such contracts only formally initiate relationships that shift in meaning and content over time. Moreover, the labor law of any given country is an expression of its general social contract, and devolves directly from assumptions about morality and political economy. Nowhere is this clearer than in the variety of ways in which labor regulation is constitutionalized in different countries, either explicitly or through constitutional silence.[26]

Yet, when faced with this gap between the classroom experience of a student and an academic instructor, this rich interdisciplinarity at the core of labor law can be problematic. Scholars of employment relations are rarely

dispassionate about their work, or restrain its implications to narrow transactional niches. Traditionally, labor scholars are passionately engaged with reform in their home country, and see such reform as central to improving or validating the proper legal order in which all citizens exist.[27] And many see the value of teaching workplace law to the non-workplace lawyer as using labor law as a form of political sensitization enabled through this interdisciplinarity of law in practice.[28]

However I may empathize with some of these goals, how to achieve them is not so easy, and, especially for an agenda of political sensitization, again risks alienating students. The more interconnected we portray labor law to other interdisciplinary factors, the more remote the law as such becomes. Even if the relationship is reciprocal between, say, economic norms of fairness and employment discrimination law, our students are by and large not going to engage in broad-spectrum interdisciplinary research. Furthermore, explicit attempts to reproduce political sensibilities in the classroom are even more treacherous than attempts to show how Shakespeare should change one's life. In the same way as we must make the interdisciplinarity of workplace law meaningful to the future practitioners, we must have faith that we derive whatever social sensibilities we have from the resultant virtues of our methodologies, not from direct persuasion in the classroom.

For example, I firmly believe that the conceptual distinction between labor and corporate law is itself a pernicious ideological reification.[29] I see this reification as core to the global trend toward labor flexibilization, to which I strongly object normatively.[30] However, to foreground a class with these assumptions, even if my object was self-replication, would be again to prioritize my own lens before that of my students. Very few students will seek to produce the same sort of legal knowledge I will, or will use all the same methods as I do in my research. And such an approach would obscure to them the very real vitality of interdisciplinarity to their own careers.

Instead, the creativity inherent in transnational practice opens up a fertile ground for students to observe on their own terms not only that legal issues are inherently relational issues, but also that an interdisciplinary sensibility enables, rather than complicates, functional legal problem solving. Thus, between high theory and mechanical legal techniques lies a sequence of

relational questions that orders comparative legal methodology. It lays out a terrain of actors whose assumptions about law, both law-making and interpretation, need to be mapped out to craft effective strategies. Here, teaching international labor and employment law shares its common interdisciplinary core with other transnational courses.

Students first have to be sensitized to the fact that the legal sources which order their familiar legal universe are the first set of assumptions to be set aside. Classically confronted when teaching the historical divergence between case and code-based reasoning, transnational lawyering requires asking basic questions of legal authority for the transaction at hand, as well as for the lawyers involved. Take the above-cited constitutionalization of labor law. In some countries, labor constitutionalization is quite expansive, and in others it is near absent.[31] One might object that for a multinational's employment law contracting this is far too remote a concern, but such is not the case if the domestic enforcement of a contract is held as violating constitutionalized norms, especially in the antidiscrimination context.[32] It is a mistake to limit our imagined student to the future multinational employee, and remember that for the labor activist seeking to modify a labor regime, from whatever political stance, understanding the comparative constitutional status of workplace law is undeniably central.[33] Even for the lawyer simply moving to a new firm abroad, or engaging with culturally diverse clients, their social assumptions about workplace norms can complicate wholly unrelated areas of law.[34]

Beyond organizing and understanding the varied legal sources concerning workplace law, students need to unmoor their reflexive assumptions about who produces authoritative knowledge in a particular system.[35] Is judicial case law most persuasive for the legal actors involved in a particular regulatory space? What role do academic commentaries play? Such knowledge is required for making specific legal arguments, but also in deciding who to hire as a consultant or what type of expertise would be useful for a union-organizing drive. It also implicates the very practical questions of anticipating jurisdictional issues of what constitutes the "practice of law" in different national contexts.[36]

This type of functional sequencing can then potentially begin to address basic comparative institutional questions, such as: is the forum of legal action a "court" or an "administrative hearing" and, again, how these categorizations diverge from the lawyer's experiential baseline.[37] Progressively this sequencing meets its most specific point of analysis when evaluating individual legal actors. In the labor context, this begins by simply asking who and what is an "employee."[38] Choice of law clauses may be a tool for narrowing legal complexity, but the process of choosing an arbitral body or individual arbitrator/s requires understanding their set of legal assumptions and experiences.[39] Just as engaging in transnational labor advocacy requires knowing who to approach in a regulatory space and how to engage them persuasively, international workplace regulation is a realm where "soft law" is ascendant internationally,[40] if not already domestically in many countries. Thus, much of private international employment practice is about finding internal solutions to workplace issues just as public advocacy is about constructing systems of monitoring and disseminating highly variable strategies for collective organization. Such dispute avoidance and collective legal action issues directly echo Ruben Garcia's argument that international labor and employment law is a powerful forum for teaching the sensibilities required for "preventative law,"[41] which looks at legal creativity as enabling *ex ante* solutions for sustaining relationships as much as for their breakdown *ex post*.

For the impassioned labor scholar, this requires accepting that the more generalizable their curricular content, the less satisfied they may be that students are moving from the unsettling of their analytical assumptions into the unsettling of their assumptions about the place of labor law in their political economy. Yet, if one truly believes that their own beliefs follow from a rigorously interdisciplinary view of law, then one should have faith that such transfer can happen without its open advocacy. And to the extent that it may not, forcing or even explicating that transfer risks portraying to students that what is being studied is simply a set of strictures to be accepted, rather than a personally relevant method for producing legal knowledge.

In sum, the power of comparative methodology is tied to its inherent interdisciplinarity. This power is contingent on disciplining interdisciplinarity in the classroom with the same concern for generalizability expressed earlier.

The interdisciplinarity of workplace law may always nettle the legal academic as they struggle to fully capture the complexities of whirling admixtures of various social and cultural factors.[42] But for a student it can provide a firmer ground from which to start asking the types of questions which will allow them to engage the specific legal problem they are looking to solve. This likely will not require inventorying the academic's full range of human variables, and it may not resolve itself in the formation of a new political sensibility about the workplace. Yet, it will allow students to search more efficiently for the barriers to their own complex legal solutions.

## Empiricism as reflexive curiosity, removing barriers to creativity

So far, in arguing for transnational pedagogy as grounded in comparative method, I have invoked several times thin the endpoint of such teaching is to enable the creative production of functional legal knowledge. This legal knowledge is sometimes not of the sort that makes up the regular matter of the internal language of legal argumentation. But in arguing for a pedagogy that enables a generalizable form of knowledge production useful for a diverse range of law students, this is necessary. To teach only internal legal knowledge requires a much narrower purview of legal practice, excluding that which most students will ultimately engage in.

In some legal academies, it is still popular to advance the false choice between the practitioner as instructor versus the academic as instructor. Certainly, this choice has different composite variables in various national settings, but it still commonly invokes another round of debate concerning the value of experiential versus theoretical knowledge. However, even the most experienced practitioner faces a parallel challenge to that of the academic instructor addressed to date, the generalizability of the knowledge to be communicated. The academic faces a classroom full of students unlikely to follow their career course, but the practitioner is similarly unlikely to have pursued a career course whose experience will map directly onto that of their students. Again, we may narrow the ambit of a course to try and self-select students who map onto this experiential knowledge, but, the desirability of

this narrowing aside, we are very unlikely to achieve the desired overlap in transnational contexts.

In transnational contexts, we often encounter another false choice in methodology, if not teaching: that of qualitative versus quantitative methods. What the previous argument about comparative method as inherently interdisciplinary makes clear is that comparison requires empirical forms of data to deconstruct and reconstruct conceptual assumptions. How do we know what a "law firm" is in South Africa versus a "law firm" in the Netherlands? We can recur to positive legal sources in each country, but any form of functional analysis requires empirical data about what these entities do in practice. What type of cases or clients do they take? How are they owned/funded? Who are the "lawyers" that work at them, or who are the "non-lawyers" that do so as well? Some of this can be derived from quantitative surveys, albeit always with qualitative coding decisions of varying subtlety at their core,[43] and some from history or ethnography.[44] Here I prefer the position of Tewskbury and Gerring that the tension between quantitative and qualitative methods is really one about comparability,[45] which returns us to our concern with what comparative legal methods mean in practice.

As a subset of general eclecticism, I want to forward that comparative pedagogy requires a form of inductive empiricism. Earlier, it was detailed how a comparative course should begin with non-comparative case studies before progressing to explicitly comparative and then transnational materials.[46] This progression reflects the position that confidence in conceptual understandings in the transnational context requires a bottom-up approach, where questions need to be asked before one starts to classify, say, the opposing counsel in a negotiation as a "lawyer" or a foreign enforcement body as a "court."

Comparative functionalism thus needs a form of empiricism best described as reflexive curiosity. The problem-solving lawyer helping standardize the paternal leave policies of a multinational or a lawyer crafting a regional anti-human trafficking regime both need to be able to inform legal solutions with empirical data. Some may not need to go to great reconstructive ontological depths in each and every instance, but they should instinctively seek empirical data to validate their assumptions. Again, every transaction

need not be a dissertation, but one needs to know the unauthorized practice of law boundaries in a country to know who is included and excluded from certain venues of dispute resolution. Such a question is deceptively simple, as was the modern case of American lawyers, practitioners and academics alike, who first saw few "lawyers" in Japan and presumed that Japan had an anti-legal culture.[47] Reciprocally, this was the same mistake of Japanese lawyers, again practitioners and academics alike, who thought they could copy aspects of American legal education to produce more "transactional lawyers."[48] Or of American labor scholars who looked to import Japanese workplace regulations into the United States during the 1980s.[49] Instances abound in and outside of labor law, and make up the bulk of the general debate about "legal transplantation."[50] Yet, these academic debates aside, the only other alternative to empiricism is conceptual formalism, which is a potential liability of both qualitative and quantitative comparative approaches.

At the outset of this argument, I mentioned that my thoughts were refined when thinking through an international labor and employment course for a Brazilian "Global Law" program. As my students for the course were international in composition, I have not focused on the Brazilian context itself in my argument, though several of my students were Brazilian undergraduates and practitioners.

The Brazilian backdrop for the course is, however, far from orthogonal. Following the global trend, Brazilian legal culture is undergoing numerous changes from pressures national and international. Some of the debates about Brazilian labor law still revolve around what Tzehainesh Tekle calls the "colonial rationality" of law imposed from abroad.[51] Yet, like many countries today, Brazil's colonial legal heritage has already gone through multiple indigenizations, and through labor indigenizations impacted by transnational dialogue.[52] In the last few decades, whatever postcolonial aversion may still have purchase intellectually or academically, in the legal arena there has been growing awareness that how the Brazilian legal profession engages with internationalization is impacted by a long-standing reality of relative insulation.[53]

In this vein, attempts to address the place of internationalization in the Brazilian legal profession have been refracted through debates about interdisciplinarity and empiricism in legal teaching. Except in extreme cases, one

cannot say simply "yes" or "no" to international pressures, but must answer "how." Nowhere has this been more acute than in the specific context of Brazilian workplace law. At first glance, the teaching of labor law appears a high priority in Brazilian law schools, where labor law is considered a core subject that many professors specialize in and in which students generally must take multiple required courses. Yet, this teaching has traditionally suffered from the limits of purely doctrinal teaching, a limit not remedied by the predominance of practitioner-instructors in Brazilian law schools.[54] By contrast, attempts to reform legal education, such as this same Global Law curriculum, have advanced empirical understandings of law not as a threat to law, but as a necessary adjunct to making law teaching more practical.[55]

At the same time, the highly constitutionalized status of Brazilian labor law reflects the pervasiveness of widespread ideological assumptions about the nature of Brazilian employment. Unions are strong, even overbearingly so. Employment rights are strong, and employees always win disputes that reach the labor courts. And this presumed reality is the grist for debates about whether such a state of affairs is good or bad for Brazil, and shapes students' assumptions about possible careers in the field. Brazil is now awash in polarizing political and economic challenges, so the assumed terms of such debates have become more entrenched.[56]

However, the reality of these presumptions is contingent at best, eliding the reality which Roberto Filho describes where employment in Brazil is "flexible, precarious, and insecure, even though still strongly regulated."[57] Other empirically-oriented scholars are similarly overturning long-standing assumptions about the function of Brazilian unions, or the international obligations of Brazilian workplace regulation.[58] For Brazilian students, this new work is not an existential threat to the coherence of their future practice, but is necessary for them to support a legal system that does not implode from its own rigidity. Whatever arena of workplace law they encounter, they will need to be able to check their assumptions, and this is doubly true in the international legal arena. Sensitivity to questioning one's assumptions when engaging in the international arena is, again, simply an amplification of the same dynamic domestically.

Therefore, an international labor and employment law course in a specific national context would have to differ from that of a wholly transnational one. Often comparative instruction requires as much deprogramming as it does reprogramming. The international arena in workplace law has been powerfully decentered from the age in which the International Labor Organization was born, when assumptions about the corporatist future of collective bargaining were more broadly shared.[59] The struggle of the ILO to define its mission in the contemporary era has stemmed in part from the lack of a universal labor model to replace the corporatist mold. Instead, it has been replaced by a set of intellectual memes more akin to analytical assumptions than a positive social model, what Sanford Jacoby called "econocentrism" and which has been routinely critiqued but shows great durability.[60]

Thus, law students face a world where their legal problem solving is likely beset by the vagaries of international legal development paired with ongoing turmoil in the stability of their domestic legal regimes. In some countries this means defining the content of international treaty obligations, and in others the rise and fall of union organizing. And in some it may implicate changes internal to the regulation of the legal profession and legal work itself.[61] All of which will require an ability to consume and deploy empirical data about law, and then inductively reconstruct inapt conceptual frameworks. Such adaptability is at the functional heart of the high theory of autopoiesis and the daily creativity of legal practice.

## Teaching law as building disciplined creativity

This argument about teaching international labor and employment law is in many ways not new. Arguing that law teaching should be methodologically oriented, interdisciplinary, or inductively empirical has been routinely explored in many national contexts.[62] What is special about workplace law is simply that it heightens these positions. And what is special about transnational law is that it intensifies this effect. Looking at their juxtaposition helps expose many of the false choices that legal pedagogical debates present, from theory/practice to doctrine/empiricism. It is true that the median domestic lawyer confronts less daily ambiguity than the now folkloric actors

who shaped the international legal system, fluent in innumerable legal and cultural languages.[63] And transnational labor regulation is distinct precisely because it uniquely stretches the limits of any coherent internal system of law to process rapid social and economic change.[64]

Here is where I return to the basic pedagogical challenge with which I began, the subjective gap between comparative labor and employment instructors and their students. Perhaps this gap is less for the domestic instructor. Perhaps it is less for the civil procedure instructor. But such possibilities only determine how acute the problem of generalizability is in the classroom, not whether it exists.

The teaching of law can never be a pure science since it takes as its subject human society. There may be pockets of legal practice that can become mechanical enough for a period of time that they can develop their own parallels to the laws of thermodynamics. Yet, such stability, if the world's legal professions today are any indication, is inherently temporary. What we can best bequeath to our students is a set of cognitive skills that allow them to be at once disciplined in their legal argumentation and creative in their legal problem solving. Teaching a course in international workplace law may emphasize the latter by necessity, but it is again a matter of degree.

Our students may ultimately be curious about different things than we are, but if we can guide how this curiosity manifests itself then we have done them a great practical service. They may not love Shakespeare, but they will know that the human condition is one worth exploring.

# ENDNOTES

**1.** Professor of Law, FGV São Paulo School of Law.

**2.** This argument does not directly reach the issue of teaching this subject to non-lawyers. However, this is a relevant concern in legal systems where a sizable percentage of undergraduate law students will not become certified legal professionals, or at least something akin to "lawyers" in the strictest sense. Such design decisions in the structure of legal education do not undermine the potential of comparative or workplace instruction, just as they do not argue for specifically non-legal education. David Doorey, "Harry and the Steelworker," 14 *Canadian Labour and Employment Law Journal* 107 (2008).

**3.** Michael Zimmer, "Two Halves of a Whole Teaching," 25 *The International Journal of Comparative Labour Law and Industrial Relations* 29-30 (2009).

**4.** Boris Mamlyuk and Ugo Mattei, "Comparative International Law," 36 *Brooklyn Journal of International Law* 386 (2011).

**5.** For the inherent legal diversity of international legal actors and bodies, see Anthea Roberts, "Comparative International Law?," 60 *International and Comparative Law Quarterly* 57 (2011).

**6.** This is a broad subject that has quite diverse national differences. A systemic overview of the field that touches on many national traditions is Mathias Siems, *Comparative Law* (2014). For the author's particular critique of modern issues in American comparative law, see Jedidiah J. Kroncke, "Law and Development as Anti-Comparative Law," 45 *Vanderbilt Journal of Transnational Law* 477 (2011).

**7.** For a summary of these debates, which has since been recycled without clear resolution, see Lawrence Baxter, "Pure Comparative Law and Legal Science in a Mixed Legal System," 56 *Comparative and International Law Journal of Southern Africa* 85 (1983).

**8.** Jedidiah J. Kroncke, "Disciplining Comparativism: Thinking Through Comparative Law as Comparative Jurisprudence," *Revista Brasileira de Filosofia* (forthcoming 2016).

**9.** For a survey and evaluation of an early collaborative project on comparative labor law, see Harry Arthurs, "Compared to What? The UCLA Comparative Labor Law Project and

the Future of Comparative Labor Law," 28 *Comparative Labor Law and Policy Journal* 591 (2007).

**10.** Alvin Goldman, "Methods of Comparative Labor Law in the United States," *Comparative Labor Law* 319 (1986).

**11.** Catherine Barnard and Simon Deakin, "'Negative' and 'Positive' Harmonization of Labor Law in the European Union," 8 *Columbia Journal of European Law* 389 (2002).

**12.** Brian Langille, "Seeking Post-Seattle Clarity," in *Labour Law in an Era of Globalization* 137 (Joanne Conagahan *et al*. ed., 2002).

**13.** Henry Drummonds, "Cross-Border Employment Contracts, Choice of Law, Choice of Forum, and the Enforcement of Cross-Border Judgments in the European Union," in *Global Labor and Employment Law for the Practicing Lawyer* 7 (Andrew Morris ed., 2010).

**14.** Ruben Garcia, "Teaching Problem-Solving and Preventive Law Skills through International Labour and Employment Law," 25 *The International Journal of Comparative Labour Law and Industrial Relations* 16 (2009).

**15.** Clyde Summers, "Comparative Labor and Employment Law and Policy in the Next Quarter Century," 25 *Comparative Labor Law and Policy Journal* 115 (2003).

**16.** Carrie Menkel-Meadow, "Why and How to Study 'Transnational' Law," 1 *UC Irvine Law Review* 97 (2011). The teaching model advanced by Menkel-Meadow is ambitious in leaping straight into specific transnational legal problems. In my experience, the ability to do so is highly contingent on the background of the students in question.

**17.** Ralf Rogowski, *Reflexive Labour Law in the World Society* (2013).

**18.** Roger Blainpain *et al*., *The Global Workplace* 1 (2007).

**19.** Wendi Lazar, "Negotiating and Drafting Expatriate Employment Agreements," in *Global Labor and Employment Law for the Practicing Lawyer* 173 (Andrew Morris ed., 2010).

**20.** Ralf Michaels, "The Functional Method of Comparative Law," in *The Oxford Handbook of Comparative Law* 339 (Mathias Reimann ed., 2006).

**21.** Guy Mundlak and Matthew Finkin, "Introduction to the Comparative Labor Law Handbook," in *Comparative Labor Law* 6 (Guy Mundlak and Matthew Finkin ed., 2015).

**22.** Robert Wai, "The Interlegality of Transnational Private Law," 71 *Law and Contemporary Problems* 107, 124-25 (2008).

**23.** See *e.g.* Randall Peerenboom, "The Evolving Regulatory Framework for Enforcement of Arbitral Awards in the People's Republic of China," 1 *Asian-Pacific Law and Policy Journal* 12 (2000).

**24.** Robert Mnookin and Lewis Kornhauser, "Bargaining in the Shadow of Law," 88 *The Yale Law Journal* 950 (1979).

**25.** Robert Bird, "Employment as a Relational Contract," 8 *University of Pennsylvania Journal of Labor and Employment Law* 149 (2005) ("Employment scholarship focuses too much on laws and not enough on norms").

**26.** Ruth Dukes, *The Labour Constitution* (2014).

**27.** Alvin Goldman, "Methods of Comparative Labor Law in the United States," *Comparative Labor Law* 319 (1986).

**28.** C. John Cicero, "The Classroom as Shop Floor," 20 *Vermont Law Review* 117 (1995). By contrast, this is exactly the proper role of union labor education efforts. See *e.g.* Robert Bruno and Lisa Jordan, "Building Class Identity," in *New Working-Class Studies* 221 (John Russo and Sherry Linkon ed., 2005).

**29.** Simon Deakin, "The Corporation as Commons," 37 *Queens Law Journal* 330 (2012) and Alice Carse and Wanjiru Njoya, "Labour Law as the Law of the Business Enterprise," in *The Autonomy of Labour Law* 311 (Alan Bogg *et al*. ed., 2015).

**30.** Jedidiah J. Kroncke, "Property Rights, Labor Rights & Democratization: Lessons from China and Experimental Authoritarians," 45 *NYU Journal of International Law and Politics* 101 (2013).

**31.** Marilyn Pittard and Stuart Butterworth, "The Rich Panoply of Sources of Labor Law," in *Comparative Labor Law* 22 (Guy Mundlak and Matthew Finkin ed., 2015)

**32.** Donna Young, "Exploring the Boundaries of Antidiscrimination Law and Equality in the Global Workplace," 22 *Berkeley La Raza Law Journal* 215 (2015).

**33.** Jennifer Gordon, "Transnational Labor Citizenship," 80 *Southern California Law Review* 503 (2007).

**34.** James Faulconbridge, "Negotiating Cultures of Work in Transnational Law Firms," 8 *Journal of Economic Geography* 497 (2008).

**35.** Matthew Finkin, "An Introduction to National Styles in Labor Law Scholarship," 23 *Comparative Labor Law and Policy Journal* 639 (2002).

**36.** Michael Zimmer, "Two Halves of a Whole Teaching," 25 *The International Journal of Comparative Labour Law and Industrial Relations* 31 (2009).

**37.** Donald Clarke, "Puzzling Observations in Chinese Law: When Is a Riddle Just a Mistake?" in *Understanding China's Legal System* 93 (Stephen Hsu ed., 2003).

**38.** For a historical exploration of how varied this concept has been in just Euro-American law, see Jean-Christian Vinel, *The Employee* (2013).

**39.** Carlos Lopez, "Practical Criteria for Selecting International Arbitrators," 31 *Journal of International Arbitration* 795 (2014).

**40.** Manfred Weiss, "The Future of Comparative Labor Law as an Academic Discipline and as a Practical Tool," 25 *Comparative Labor Law and Policy Journal* 170 (2004).

**41.** Ruben Garcia, "Teaching Problem-Solving and Preventive Law Skills through International Labour and Employment Law," 25 *The International Journal of Comparative Labour Law and Industrial Relations* 15 (2009).

**42.** David Gerber, "Method, Community & Comparative Law: An Encounter With Complexity Science," 16 *Roger Williams University Law Review* 110 (2011).

**43.** Kevin Davis, "What Can The Rule of Law Variable Tell us About Rule of Law Reforms?," 26 *Michigan Journal of International Law* 141 (2004).

**44.** John Flood, *What Do Lawyers Do?* (2013).

**45.** John Gerring and George Thomas, "A Question of Comparability," in *International Encyclopedia of Political Science* 2189 (Betrand Badie *et al*. ed., 2011).

**46.** This is partially reflective of the progression outlined by Edward Eberle under the rubric of the "skills of a comparativist." See Edward Eberle, "The Method and Role of Comparative Law," 8 *Washington University Global Studies Law Review* 451 (2009). While students cannot attain the depth of particular knowledge advanced by Eberle as the core competencies of an academic comparativist, they can simulate the analytic progression he describes for addressing more focused legal problems.

**47.** See the introduction to Eric Feldman, *The Ritual of Rights* (2000).

**48.** Sihigenori Matsui, "Turbulence Ahead: The Future of Law Schools in Japan," 62 *Journal of Legal Education* 3 (2012).

**49.** Roberto Gonzalez, "Brave New Workplace," 92 *Kroeber Anthropology Society* 107 (2005).

**50.** Pierre Legrand, "The Impossibility of Legal Transplants," 4 *Maastricht Journal of European and Comparative Law* 111 (1997).

**51.** Tzehainesh Tekle, "Labour Law and Worker Protection in the South," in *Labor Law and Worker Protection in Developing Countries* 17 (Tzehainesh Tekle ed., 2010).

**52.** John French, *Drowning in Laws* (2004), and Paulo Garcia Neto, "A influência do realismo jurídico norte-americano no direito constitucional brasileiro" (M.A. Thesis, University of São Paulo School of Law, 2008).

**53.** Fabiano Engelmann, "Globalização e poder do Estado: circulação internacional de elites e hierarquias do campo jurídico brasileiro," 55 *Dados* 487 (2012).

**54.** Luis Aparicio Valdez and Juan Raso Delgue, "Teaching Labor Law in Latin American Universities," 23 *Comparative Labor Law and Policy Journal* 753 (2002).

**55.** Luis Aparicio Valdez and Juan Raso Delgue, "Teaching Labor Law in Latin American Universities," 23 *Comparative Labor Law and Policy Journal* 753 (2002).

**56.** Carolina Mercante, "As raízes autoritárias da atual Lei de Greve brasileira," 7 *Revista Direito Mackenzie* 42 (2014).

**57.** Roberto Filho, "Celebrating Twenty-Five Years and Speculating over the Future from a Brazilian Perspective," 25 *Comparative Labor Law and Policy Journal* 21 (2004). Also see Kathleen Millar, "The Precarious Present," 29 *Cultural Anthropology* 32 (2014).

**58.** Ana Gomes and Mariana Prado, "Flawed Freedom of Association in Brazil: How Unions Can Become an Obstacle to Meaningful Reforms in the Labor Law System," 32 *Comparative Labor Law and Policy Journal* 843 (2011) and Ana Gomes, "Legal Protection of Workers' Rights as Human Rights," in *Human Rights at Work* 87 (Colin Fenwick and Tonia Novitz ed., 2010).

**59.** Francis Maupain, *The Future of the ILO in the Global Economy* 254-255 (2013).

**60.** Sanford Jacoby, "Economic Ideas and the Labor Market," 25 *Comparative Labor Law and Policy Journal* 43 (2004).

**61.** Laurel Terry *et al*., "Trends and Challenges in Lawyer Regulation: The Impact of Globalization and Technology," 80 *Fordham Law Review* 2661 (2012).

**62.** A cross-cutting analysis of some of the more global trends is Fiona Cownie, *Legal Academics: Culture and Identities* (2004).

**63.** Such are the figures described, in the modern development of international arbitration, in Yves Dezalay and Bryant Garth, *Dealing in Virtue* (1996).

**64.** For an overview of these tensions through the lens of books by three leading scholars, see David Trubek, "The Emergence of Transnational Labor Law," 100 *The American Journal of International Law* 725 (2006).

# THE CASE FOR INCLUDING NEGOTIATION, DISPUTE RESOLUTION AND PROBLEM-SOLVING TEACHING IN THE LAW SCHOOL CURRICULUM AND HOW TO GET STARTED

**Lynn P. Cohn**[1]

## Introduction

I have been teaching negotiation, dispute resolution and problem-solving (hereinafter referred to as "NADRPS") courses to law students for over 25 years and currently serve as the Director of the Center on Negotiation and Mediation at the Northwestern Pritzker School of Law.[2] I also teach these skills to lawyers and other professionals in one to three day training programs both in the United States and internationally. One of the benefits of my position is the opportunity to travel throughout the world to teach law students and lawyers about NADRPS. This includes serving as a visiting professor at law schools abroad to teach a basic NADRPS course. Some of my host schools do not regularly offer any curriculum in the topics that I teach. Similarly, when I conduct training programs for lawyers in the United States or abroad, I find that many participants have no formal education in these areas because the law school that they attended offered little or no relevant curriculum.[3]

Law schools that do not provide NADRPS curriculum do their students a disservice. Given the changing world of legal services and the shrinking job prospects for law graduates both in the United States and abroad, students must leave the legal academy with both a solid foundation in key substantive legal areas as well as the ability to work with their clients, colleagues and counterparts to solve their clients' problems through the implementation of a variety of skill sets. Exposure to NADRPS teaching and experiences will be essential to developing such proficiencies.

The goal of this article is to encourage law schools both in the United States and abroad to offer basic curriculum in NADRPS if they are not already doing so.[4] This article will start by describing the reasons that many law schools do not include NADRPS in their curriculum. This is followed by a description of the reasons that law schools should include these topics in their curriculum. Finally, I will conclude with ideas regarding how to start teaching NADRPS in an effective and efficient manner.

## Obstacles to including NADRPS in the law school curriculum

There is a variety of explanations for the lack of NADRPS courses at some law schools. There may be a low level of awareness about these skill sets and their role in various legal contexts on the part of both law faculty and law students, particularly in some developing countries. This might be because resolution processes such as mediation and arbitration may not be fully adopted in the judicial system in which the law school resides. This is not to say, however, that lawyers in these countries do not regularly employ NADRPS skills. For example, in virtually every conceivable context in which lawyers act, they will be negotiating either on behalf of a client, a constituency or for their own benefit.

Law schools are sometimes situated in locales with tight governmental control over the content of the curriculum. NADRPS topics that encourage dialog regarding the sharing of resources and instituting a variety of dispute resolution mechanisms, some of which like mediation or direct negotiation put decision-making power in the hands of the parties, might be inconsistent with the political power dynamics at play.

Some law schools choose not to focus on developing these skills. Such schools do not prioritize the value and benefits of teaching these topics. This may be due to a belief that legal education should focus on the development of legal scholars in more traditional doctrinal areas of the law such as property or constitutional law rather than on the development of legal practitioners. In other words, time devoted to learning about NADRPS is time taken away from what the law school views as more relevant topics that law students

must learn.[5] Several elite law schools in the United States may fall into this category given their lack of offerings on these topics.[6]

Other law schools might be aware of the importance of NADRPS, but lack the focus or resources (or both) to develop curriculum and hire faculty.[7] Law schools face multiple pressures including shrinking applicant pools, ranking and status concerns, rising tuition costs, fewer legal job opportunities for graduates, bar passage rate issues, diverse faculty views about educational goals and budget constraints.[8] For some law schools these issues serve as a catalyst for increased NADRPS offerings in order to meet the needs of the legal market.[9] For other law schools, these pressures lead to inertia and stagnation.[10]

NADRPS courses do not sit squarely in either the academic or the clinical camp of law school teaching. Indeed, many of the top United States law school programs on these topics include both research and clinical faculty. This leads to the question of which faculty should teach NADRPS topics in the law school setting. On the international front, academic law faculty might not be drawn to these areas due to the lack of developed law or dispute resolution mechanisms in their country. In addition, legal research faculty might shy away from a focus on NADRPS scholarship due to the view in some academic circles that NADRPS is not as prestigious or serious a focus for scholars as traditional doctrinal topics such as constitutional law, intellectual property law, and evidence.[11] To the extent that teaching these topics is viewed as a task for the clinical arm of a law school, this type of legal education is in its infancy in some locales. Further, for some law schools that have embraced clinical legal education, the focus may be on the development of adversarial litigation skills.[12]

## THE CASE FOR OFFERING NADRPS TEACHING IN THE LAW SCHOOL CURRICULUM

There are many good reasons to include NADRPS topics in law school curriculum. First, NADRPS skills have been long identified as essential for the practice of law. In 1979, the ABA Task Force on Lawyer Competency recommended that law schools teach negotiation skills.[13] In 1992, the Amer-

ican Bar Association Section of Legal Education and Admissions issued the MacCrate Report which included a Statement of Skills and Values which listed problem solving, negotiation, litigation, and ADR among the ten key skills an attorney must possess in order to effectively represent a client, and charged law schools with adding curriculum to effectively teach these skills.[14] In 2007, the Carnegie Report on Educating Lawyers noted that law schools should prepare students for the practice of law with increased emphasis on skills training.[15] While the reports focused on legal training in the United States and Canada, law schools in other regions should also consider how well their curriculum prepares their students to practice in the real world.

The most compelling reason to include NADRPS teaching in a law school setting is the fact that virtually every lawyer in every area of their professional and personal lives will engage in negotiation, problem solving and conflict management. Throughout my 25 years as a professor, I have challenged my students to identify a lawyer who would not need these skills. While this exercise has led to many humorous and far-fetched hypothetical examples, not a single example has been identified that warrants mention.

Along the same lines, the vast majority of disputes, in some United States jurisdictions well over 90 percent, are resolved through negotiation, mediation or arbitration.[16] There is evidence that these processes are on the rise on the international front as well.[17] Both litigators in the business of managing disputes for their clients as well as transactional lawyers drafting contractual clauses regarding how potential disputes might be best managed need down the road an understanding of NADRPS topics. This education should begin in law school.

Add to this the sobering impact that the Great Recession of 2008 in the United States has had on job prospects for law graduates. Legal employers can be selective when hiring for fewer open positions, and they are sending the message loud and clear that they value candidates with practical, interpersonal, counseling and problem-solving skills.[18]

There are several collateral benefits to offering NADRPS teaching. My students in NADRPS courses report either in their student evaluations or directly to me that these courses provide a unique opportunity to get to know their classmates on a deeper level that in a traditional large lecture class.

Northwestern Law enrolled all first-year law students in a two-year JD program in a mandatory negotiation class during their first semester in part to take advantage of the community-building aspect of the course. Enrolling practicing lawyers from other countries from Northwestern Law's LLM program in the negotiation courses has provided students from both the JD and LLM programs to develop cross-cultural awareness as well as personal relationships resulting in a more integrated law school community.

Finally, student evaluations indicate the NADRPS courses are enjoyable and meaningful to students, particularly when taught in an interactive small enrollment format. On its own, this might not be a sufficient reason to offer NADRPS curriculum. It is nice to know, however, that students appreciate and enjoy the effort to build the NADRPS offerings.

## Approaches to NADRPS curriculum

Law schools in the United States employ a wide variety of approaches to NADRPS education. Michael Moffitt, Dean of the University of Oregon School of Law, eloquently identifies these approaches as "islands," "vitamins," "salt," and "germs."[19] Law schools are "islands" when they create and focus on NADRPS curriculum in order to distinguish themselves from other law schools.[20] "Islands" typically have a wide variety of course and clinical offerings as well as opportunities for concentrations and advanced degrees in NADRPS.[21] Law schools that require a basic course in NADRPS treat the topics as a "vitamin" with a recommended dosage.[22] Some law schools use NADRPS primarily as "salt," meaning that they use them to add context to traditional doctrinal courses across the curriculum such as contracts or civil procedure.[23] Finally, at some law schools, NADRPS infiltrates a small number of courses like a "germ" due to the faculty member's commitment to incorporating NADRPS concepts into a class.[24] It seems that moving from a germ culture to a salt culture is the expectation that professors will incorporate NADRPS into their courses rather than allowing law faculty to do so if desired. The upside of incorporating NADRPS into traditional doctrinal courses and non-NADRPS clinics, or a "salt" approach in Moffitt's lexicon, is the opportunity to demonstrate to law students the strong connection that

these skills have to all areas of legal practice.[25] The challenge to making the "salt" approach a reality is the need to obtain buy-in and class time from law faculty that may not want to change their tried and true approaches to teaching their course. As Moffitt points out, one law school might incorporate several of these approaches in order to turn law students into practice-ready lawyers.[26]

## Northwestern law school's curriculum in NADRPS

During my time at Northwestern Law, the Center on Negotiation and Mediation's NADRPS curriculum has expanded greatly. In the early eighties, Northwestern Law Professor Stephen Goldberg was among the first law faculty to teach a negotiation course using multiple simulations and performance feedback. The Center currently offers 12 to 15 sections of the evolved version of this basic negotiation course. It is a mandatory course for some of our non-traditional JD programs. Over 75 percent of our traditional JD students enroll in this course on a voluntary basis.[27]

Over the course of several decades, the Center's offerings have grown to include the following courses:

- Dispute Resolution Survey;
- Advanced Dispute Resolution;
- Mediation Process;
- Mediation Advocacy;
- International Business Transactions and Negotiations;
- Colloquium on Negotiation and Dispute Resolution;
- Conflict Resolution and the Law;
- Mediation Practicum (students mediate cases for the court system);
- Mediation Advocacy Clinic (students represent parties in mediations);
- Advanced Negotiation Workshop;
- Power Status and Negotiations;
- Dispute Resolution in Sports;
- Restorative Justice Practicum.[28]

In 2000, to celebrate the changing role of lawyers in the new millennium, Northwestern Law inaugurated the Lawyer as Problem Solver ("LPS") curriculum for all first-year law students. In this mandatory program, topics including cultural literacy, mindfulness, emotional intelligence, negotiation and dispute resolution, public speaking, interviewing skills, improvisation, understanding financial data, communication in a legal setting and technology and the law are introduced in interactive two-hour modules. The goal of the LPS program is not to cover these topics in depth but to introduce, at the earliest stages of legal education, the concept that lawyers are called upon to do much more than deal with the legal aspect of a client's needs. Opportunities to refine these skills are provided throughout the second and third-year curriculum offerings.[29]

In 2015, Northwestern Law established the Center for Practice Engagement and Innovation with the goal of engaging thought leaders from the legal community, corporate world, and government sector to identify and develop curriculum to teach the critical aptitudes that lawyers need in order to be effective problem solvers and partners in today's legal services environment. Emphasizing input from the ultimate consumers of legal services will allow Northwestern Law to focus on developing the skill sets that will ensure that our law students are successful when they enter the profession.

Northwestern Law's NADRPS approach is part island, part vitamin, part germ and needs more salt. The NADRPS curriculum is island-like in that the NADRPS curriculum cuts deep in terms of the number of basic courses that we offer and wide in terms of the diverse offerings in our curriculum outlined above. The Center on Negotiation and Mediation is often included in the US News & World Report of top programs in Dispute Resolution at American Law Schools. Yet, Northwestern Law does not offer an LLM in Dispute Resolution like other island law schools.

Consistent with both the island and vitamin approaches to NADRPS curriculum, all first-year Northwestern Law students participate in the LPS Program during their first year. The LPS Program sends the message to first-year law students that lawyering is broader than the development of case law emphasized in their traditional doctrinal classes. There is no doubt, however, that the LPS program could do much more to support the framework of NAD-

RPS for our first-year law students if it were a condensed course or offered throughout a thirteen-week semester rather than a series of short modules.[30]

A number of Northwestern Law's clinical and traditional doctrinal courses include some NADRPS teaching, consistent with the germ approach to curriculum. For example, all of the students who participate in our International Team Projects in which students travel abroad to conduct research on a topic of their choice receive training in cultural sensitivity, teamwork and conflict management.

As discussed above, instituting the salt approach to NADRPS curriculum by sprinkling these teachings throughout the curriculum in both traditional doctrinal and clinical courses is challenging. Such a transition at Northwestern Law or elsewhere would require strong messaging from the law school's administration about the need to incorporate these topics across the curriculum and support for faculty who have not previously used NADRPS concepts to teach their classes.[31] I am not aware of any law school that has accomplished more than a pinch of salt in their curriculum.

## How to start offering an NADRPS curriculum

I am keenly aware that Northwestern Law enjoys the privilege of being an elite school with significant resources and history. For the many law schools that are at the start of their NADRPS curriculum journey, I would like to propose an approach to beginning that journey. In keeping with the Moffitt framework of islands, vitamins, germs and salt, this approach might be called the "seed" approach: a way to get started with NADRPS teaching. My recommendation is based on my experience developing the Northwestern Law curriculum outlined above over the course of several decades as well as the numerous opportunities that I have had to share parts of our curriculum with other law schools all over the world. My intention is to be sensitive to the challenge that some law schools face in terms of resources and support.

Before I outline my suggestions for initiating NADRPS curriculum at a law school, I need to confess that advocating for specific curriculum at the expense of other courses in some ways is like choosing a favorite child. Yet, I truly believe that one can accomplish a lot with a basic approach to NADRPS.

In my view, a one semester simulation-based negotiation course with a significant module dedicated to exploring a variety of dispute resolution processes would give law students a solid foundation in NADRPS. There are several reasons for this choice.

As previously mentioned, negotiation is part of the personal and professional lives of all attorneys. A basic negotiation course provides a framework for approaching negotiations that is valuable across all practice areas.[32] This course is not intended to teach substantive law or negotiation protocol in any specific practice area. Instead, the learning objectives focus on acquiring a structure for approaching negotiations, providing opportunities to negotiate in simulations or actual negotiations, and creating feedback opportunities for students on a regular basis in order to meet each student where they are at in terms of skill development. Every law student would benefit from such a course.

In addition, a negotiation course can incorporate a number of important NADRPS concepts into the curriculum beyond negotiation and dispute resolution theory and strategy. For example, client interviewing and counseling, teamwork, professionalism, communication, creativity, ethics, and cultural differences can be addressed either organically as issues arise or intentionally in the readings or exercises. To illustrate, it is almost certain that complaints regarding negotiators' perceived or real misrepresentations at the table will arise throughout the course. This leads to discussions and learning about ethics, reputation and professional identity that resonate because they are personally experienced in context rather than in a hypothetical scenario about a third party.

Identifying able faculty to teach the basic negotiation course is essential. A member of the existing research or clinical law faculty with some exposure to NADRPS topics as well as an interest in taking on the challenge of offering a basic course in negotiation is a potential candidate. Law schools can also recruit faculty with specific expertise in NADRPS. Alternatively, many law schools employ adjunct instructors with experience in legal negotiations to serve as faculty for these courses. At Northwestern Law, we use both full-time faculty and adjunct faculty to teach our basic negotiation course with great success.

The topics that should be covered in a basic negotiation course for law students include:

- Distributive and Integrative Negotiation Approaches and Strategies;
- Prenegotiation Planning (including gathering information, identifying interests and best alternative to a negotiated agreement ("BATNA"), and setting aspiration and reservation points);
- Communication Skills (including listening and speaking);
- Process Strategies (including agenda setting, option creation, caucus, schmoozing and package deals);
- Ethical Considerations (including truthfulness);
- Lawyer/Client Dynamics;
- Gender, Race and Culture in Negotiations;
- Understanding and Responding to a Variety of Negotiation Styles; and
- Dispute Resolution Processes beyond Negotiation (including mediation and arbitration).[33]

There are many additional relevant subjects that can be addressed, such as inter-cultural negotiations, negotiating via technology, psychology and negotiations, and multi-party negotiations. Faculty always face the tension between allotting sufficient time to the key concepts and striving for a fuller treatment of the plethora of negotiation topics. I favor covering fewer topics in depth over the kitchen sink approach in order to provide sufficient time for sharing diverse views and experiences.[34]

I also select class topics based on the needs and characteristics of my students in any given basic negotiation course. For example, if a basic negotiation course draws students from various countries, I will generally allot additional time to cross-cultural negotiations. For negotiation courses or trainings geared toward female lawyers or law students, I will allocate additional time to the research regarding gender dynamics in negotiation and strategies to manage those issues.

After teaching the basic negotiation course close to 100 times, I have several suggestions regarding the structure of the course. First, it is ideal for class enrollment to have a cap of 24 students. This number is small enough

to ensure that students can be heard in class discussions and large enough to increase the variety of negotiation styles that students will encounter throughout the course. In addition, with 24 students, the students can be evenly paired in exercises calling for 2, 3, 4, 6, 8, or 12 roles. A larger number may make individualized feedback sessions with a single faculty member impossible due to faculty time constraints. During these sessions, students can learn about themselves as negotiators through the eyes of the knowledgeable faculty.[35]

If possible, one should teach the course in two-and-a-half to three-hour time blocks. This schedule allows a single class to include some lecture, a simulation, project or other activity, and a debrief of that experience. For most law schools, this would result in having one class session per week throughout the semester for a three-credit hour class.

The most difficult part of teaching a basic negotiation course is selecting teaching materials and preparing the initial syllabus. Faculty teaching the basic negotiation course for the first time at law schools like Northwestern have a curriculum and teaching materials outlined for them by the existing faculty. For faculty facing the daunting task of creating the course for the first time, there are a number of resources available to you that will allow you to see the course syllabi for other negotiation courses and to review course materials including simulations.[36]

Some basic negotiation courses use legal textbooks covering negotiation and dispute resolution that include simulations, readings, and class discussion questions.[37] Some of these textbooks also include a teaching manual to guide faculty through the course. The upside to using these texts is that the authors guide faculty through the class structure with assigned readings and exercises in order to ensure that key topics are covered. Of course this means that the instructor must agree with the perspectives promoted by the authors of the textbook. One downside to using one of these textbooks in a basic negotiation course is that they are often expensive and not within the reach of students at some law schools.

*Getting to Yes*, first published in 1981, is viewed as a seminal primer in the negotiation field and is a required textbook for the basic negotiation course at Northwestern Law.[38] Virtually every negotiation and mediation

course includes some or all of the theoretical constructs set forth in *Getting to Yes* including:

- Focusing on interests rather than positions;
- Separating the people from the problem;
- Assessing the leverage in the negotiation through the analysis and development of BATNA;
- Inventing options for mutual gain;
- Using objective criteria; and
- Analyzing the perspectives of all parties to the negotiation.[39]

*Getting to Yes* offers several advantages over other negotiation textbook choices. The book is easy to read and shares profound yet basic principles. *Getting to Yes* has been translated into 18 languages and is available online as well as in many bookstores. In addition, the book is relatively inexpensive. A basic negotiation course would need to supplement the ideas shared in *Getting to Yes* with additional reading on specific topics throughout the course.

*The Mind and Heart of the Negotiator* is also a required textbook in the Northwestern Law basic negotiation course.[40] This textbook translates current research findings regarding the best practices in negotiation into straightforward advice about negotiation strategy. *The Mind and Heart of the Negotiator* includes stories and examples from actual negotiations that bring theoretical concepts to life. Because the book has a business rather than a legal focus, law faculty must sometimes find examples from legal negotiations to help law students connect to the material. The relatively high cost of *The Mind and Heart of the Negotiator* may prevent its usage at some institutions.

As described earlier, the use of simulations and other experiential teaching approaches such as adventure learning and observations of others engaged in negotiation is the favored approach to teaching a basic negotiation course.[41] Quite simply, the best way to learn about negotiation is to negotiate. A student's interest in negotiation skills and motivation to learn is piqued by his or her personal involvement in the exercises which bring the readings and

lectures to life. This is evidenced by the high energy that students typically bring to the classroom debriefs of the simulations that they have completed.

The following organizations offer negotiation and dispute resolution simulations that can be used for educational purposes either without charge or by paying a user fee:

- The Dispute Resolution Research Center ("DRRC") housed at the Northwestern Kellogg School of Management offers over 100 negotiation exercises with teaching notes;[42]
- The Program on Negotiation ("PON") at Harvard Law School offers more than 200 negotiation simulations;[43]
- The Center for Dispute Resolution at Willamette University offers negotiation simulations with teaching notes;[44]
- The ABA Section on Dispute Resolution offers lawyer as problem solver exercises free of charge for educational purposes.[45]

A basic negotiation course should incorporate both peer and faculty feedback. Debriefing each negotiation simulation with the whole class allows students to share their experiences and receive feedback from the group. Explicitly directing students to spend some time providing feedback to each other after each negotiation exercise is essential, as the task of every negotiator is to understand and dance with the specific negotiator across the table. The course professor should also give students individualized feedback by watching the students in live negotiations and/or recorded negotiations.[46]

Employing teaching assistants for the course can be beneficial. They can assist with administration of the course, provide feedback to students, and play assigned roles in negotiation simulations. Teaching assistants also provide insight about the class experience as they serve as the professor's eyes and ears among their peers. I select teaching assistants for my upcoming classes from the pool of students who have previously enrolled in the course. The opportunity to serve as a teaching assistant allows a student to explore what he or she has learned as a member of the class on a deeper level. A number of my former teaching assistants remain committed to NADRPS

concepts and a few of them have gone on to teach the class at a number of institutions.

Approaches to assessing law students in basic negotiation courses vary greatly. I recommend using assessment methods that reflect the experiential learning approach outlined above. I have never used a traditional essay final exam as an assessment tool for a basic negotiation course. I have considered journals, presentations, team projects, peer feedback, faculty observations, class participation, prenegotiation analysis papers and post-negotiation reflection submissions when grading students.[47]

## Conclusion

I have a few final thoughts to share with new instructors of a basic negotiation course for law students both in the United States and abroad. Teaching negotiation skills to law students is a true adventure. In virtually every class session, issues will arise that were previously unforeseen. This can be challenging the first few times that the course is taught because of the need to react to questions and situations that go beyond prepared lesson plans. For many faculty using an experiential approach to teaching negotiation, this makes each teaching experience fresh and engaging. Virtually every issue that could arise in this course provides a teaching opportunity. For example, students who disagree about a strategy can practice listening to and finding merit in alternative perspectives. Working with the class to schedule a makeup session due to a school holiday can borrow from the brainstorming curriculum shared in the course. Because NADRPS skills can be useful in almost any situation, faculty and student experiences inside and outside the classroom are fair game for application of the lessons.

In addition, NADRPS curriculum is relatively new to many law schools and most NADRPS faculty remember the beginning of our journey as NADRPS teachers. Furthermore, collaboration is a concept that NADRPS faculty typically embrace as it is a cornerstone of much of our teaching. As a result, many of your colleagues in the field are keen to provide support and share ideas.[48]

Without NADRPS education, law students lack exposure to skills that are crucial for understanding how lawyers operate in the real world. This deficit will likely prove detrimental to these students both in their job search and in their initial placements in legal practice. I encourage you to be the seed of NADRPS at your law school. Start with the basic negotiation course. From there, the opportunities to expand NADRPS into the curriculum are plentiful.

# ENDNOTES

1. Clinical Professor of Law and Director of the Center on Negotiation and Mediation at Northwestern Pritzker School of Law.

2. Law school negotiation courses generally address the strategies that lawyers use in direct communication with their clients and the opposing side to maximize value for their clients. Dispute resolution courses typically focus on an understanding of processes including negotiation, mediation and arbitration that serve as alternatives to adjudication by a court or other tribunal. Dispute resolution curriculum can also cover consensual processes such as conciliation, circles, consensus building and facilitation. Problem-solving curriculum is an umbrella category of curriculum that covers a number of topics that support the view that lawyers are charged with helping clients understand and creatively resolve the issues they face. For example, the Legal Education, ADR and Practical Problem Solving (LEAPS) Task Force of the ABA Section on Dispute Resolution includes fact gathering and research, client interviewing and counseling, claim assessment, communication, collaboration, negotiation, representation in ADR processes, drafting documents, cross cultural competence and professionalism as the core of the practical problem-solving curriculum that they are gathering and creating. See Legal Education, ADR and Practical Problem Solving (LEAPS) Project Home Page, http://leaps.uoregon.edu (last visited Nov. 20, 2015). For one example of an approach to designing a problem-solving curriculum, see the discussion regarding Northwestern Law's curriculum at page _. Defining NADRPS subject matters precisely is futile due to the wide variety of philosophical and curricular approaches that law faculty employ. To add to the confusion, the ADR acronym can stand for either "alternative" dispute resolution or more recently "appropriate" dispute resolution to reflect the reality that negotiation, mediation and arbitration are more frequently employed to resolve disputes than traditional adjudication processes, rendering litigation the alternative approach. See Deborah R. Hensler, "Our Courts, Ourselves: How the Alternative Dispute Resolution Movement is Re-Shaping Our Legal System", 108 *Penn. St. L. Rev.* 165 (2003) for an example of ADR being used to stand for alternative dispute resolution, with the traditional usage, and see Carrie Menkel-Meadow, "Ethics in ADR: The Many 'Cs' of Professional Responsibility and Dispute Resolution", 28 *Fordham Urb. L.J.* 979 (2001) p. 979 for a description of why the term appropriate dispute resolution is used in place of alternative dispute resolution.

**3.** According to the ABA Directory at the University of Oregon Law School, Dispute Resolution Center, 121 out of 203 United States law schools offer a negotiation course(s) and 110 out of the 203 law schools offer a dispute resolution course(s). ABA Directory, http://law.uoregon.edu/explore/abadirectory (last visited Nov. 20, 2015). That leaves 82 United States law schools without curriculum related to negotiation and 93 United States law schools without curriculum related to dispute resolution. Another issue to be considered is how frequently these courses are offered and how many students can enroll in the course at any given institution. For example, offering a single section of a course on NADRPS topics with an enrollment cap of 24 at a law school with a 300-person entering class results in only a handful of students able to take the course. While I am aware of no data regarding how many law schools abroad offer courses in NADRPS, I believe that the numbers will be significantly less.

**4.** This article is not directed at law schools who offer significant NADRPS curriculum and are exploring ways to direct future growth in this area.

**5.** John M. Lande & Jean R. Sternlight, "The Potential Contribution of ADR to an Integrated Curriculum: Preparing Law Students for Real World Lawyering", 25 *Ohio St. J. on Disp. Resol.* 247 n. 101 (2010) p. 273; NADRAC, "What are the Obstacles to Teaching ADR", Teaching Alternative Dispute Resolution in Australian Law Schools, (2012). Available at: https://www.ag.gov.au/LegalSystem/AlternateDisputeResolution/Documents/NADRAC%20Publications/teaching-alternative-dispute-resolution-in-australian-law-schools.pdf.

**6.** See ABA Directory *supra* note 2.

**7.** NADRPS courses can be costly given the typically low faculty to student ratio at play in these classes.

**8.** For a discussion of the competing pressures law schools currently face, see John Lande, Reforming Legal Education to Prepare Law Students Optimally for Real World Practice", 2013 *J. Disp. Res.* 1 p. 5-8.

**9.** *Id.* p. 5.

**10.** *Id.* p. 13.

**11.** *Id.*, Jennifer Reynolds, "The Lawyer with the ADR Tattoo", 14 *Cardozo J. Conflict Resol.* 395 (2013).

**12.** See generally Frank S. Bloch, "The Global Clinical Movement, Educating Lawyers for Social Justice" (2011).

**13.** ABA Task Force on Lawyer Competency: The Role of Law Schools (1979) p. 10.

**14.** Section on Legal Educ. and Admissions to the Bar, American Bar Ass'n, "Legal Education and Professional Development – An Educational Continuum" (Report of the Task Force on Law Schools and the Profession: Narrowing the Gap, 1992) [hereinafter MacCrate Report] p. 3.

**15.** William M Sullivan, Ann Colby, Judith Welch Wegner, Lloyd Bond & Lee S. Shulman, Educating Lawyers for the Profession of Law (2007).

**16.** Richard M. Calkins, "Mediation: A Revolutionary Process That Is Replacing the American Judicial System", 13 *Cardozo J. Conflict Resol.* 1, 2 (2011).

**17.** Lela B. Love & Brian Farkas, "Silver Linings: Reimagining the Role of ADR Education in the Wake of the Great Recession", 6 *NE. L. J.* 221 p. 225.

**18.** *Id.* p. 223.

**19.** See generally Michael Moffitt, "Islands, Vitamins, Salt, Germs: Four Visions of the Future of ADR in Law Schools (and a Data-Driven Snapshot of the Field Today)", 25 *Ohio St. J. on Disp. Resol.* 25, (2010).

**20.** *Id.*

**21.** *Id.*

**22.** *Id.*

**23.** *Id.*

**24.** *Id.*

**25.** For a discussion of the University of Missouri Law School's attempt to use the "salt" model for its first-year curriculum with NADRPS concepts, see Leonard L. Riskin & James E. Westbrook, "Disseminating the Missouri Plan to Integrate Dispute Resolution Courses into Standard Law School Courses: A Report on a Collaboration with Six Law Schools", 50 *Fla. L. Rev.* 589 (1988). In 2003, the law school shifted its focus to a first-year lawyering course.

**26.** *Id.*

**27.** A number of legal educators have argued that a basic negotiation course should be mandatory for all law students. See Howard Katz, "Why Negotiation Should Be a Required

Course in Law School (and how to deliver it in a cost-effective manner)", *Transactions: The Tenn. J. of Bus. Law* (2011). Available at: http://works.bepress.com/howardekatz/2.

**28.** Law schools offer a host of other courses in NADRPS including international dispute resolution, cross-cultural negotiations, dispute system design, the theory of conflict, and covering specific topics such as workplace disputes, family law, human rights and entertainment. See Search the ABA Directory, Disseminating the Missouri Plan to Integrate Dispute Resolution Courses into Standard Law School Courses: A Report on a Collaboration with Six Law Schools, https://law.uoregon.edu/explore/aba-search/?abamode=allclasses (last visited Nov. 20, 2015).

**29.** Adding NADRPS curriculum to the first year of legal education can be challenging given the longstanding tradition of focusing on the core curriculum of civil procedure, contracts, constitutional law, criminal law, legal writing, torts and property. Lela B. Love & Brian Farkas, "Silver Linings: Reimagining the Role of ADR Education in the Wake of the Great Recession", vol. 6, no. 1, *Northeastern Law Journal*, p. 244.

**30.** In 2010, Hamline University School of Law added a one-semester course to their curriculum entitled Practice, Problem Solving and Professionalism. Other schools offer courses in lawyering which include NADRPS curriculum. For a discussion of the value of adding a first-year course on NADRPS, see "Silver Linings", *supra* note 16 p. 243-252.

**31.** For law schools or law faculty who would like to add some NADRPS curriculum to their syllabus, there are a number of helpful suggestions and materials on the Legal Education, ADR, and Practical Problem Solving (LEAPS) Task Force of the ABA Section on Dispute Resolution website. See generally Jill Gross & John Lande, "Integrating Alternative Dispute Resolution and Problem Solving Across the Curriculum", in *Building on Best Practices: Transforming Legal Education in a Changing World* 384, fn 5. (Deborah Maranville, Lisa Radtke Bliss, Carolyn Wilkes Kaas & Antoinette Sdeillo Lopez ed., 2015).

**32.** The course instructor could note possible differences in approach based on practice area where appropriate. These differences will likely be most pronounced when comparing a general litigation approach to a general transactional approach to negotiation, though other differences exist.

**33.** For a discussion of relevant topics to be addressed in curriculum regarding mediation and arbitration, see Andrea Kupfer Schneider, Jill Gross & John Lande, "Teaching Students to be Problem-Solvers and Dispute-Resolvers", in *Building on Best Practices: Transforming Legal Education in a Changing World* 376 (Deborah Maranville, Lisa Radtke Bliss, Carolyn

Wilkes Kaas & Antoinette Sdeillo Lopez ed., 2015). In some locales, other dispute resolution processes are widely used and should be addressed in the discussion. For example, restorative justice practices were first introduced in New Zealand through the Children, Young Persons, and Their Families Act in 1989. In 2002, restorative justice processes received statutory recognition through the Sentencing Act 2002, Parole Act 2002, and the Victims' Rights Act 2002. The Ministry of Justice funds 24 restorative justice providers and works with three voluntary restorative justice providers. Ministry of Justice: Tāhū o te Ture, "Restorative justice in New Zealand best practice" (2013), available at http://www.justice.govt.nz/publications/global-publications/r/restorative-justice-in-new-zealand-best-practice.

**34.** This may be attributed to the fact that at Northwestern Law I am able to include additional topics in advanced or specialized classes that students may take after they complete the basic class.

**35.** At the other end of the spectrum, I have successfully taught the basic negotiation course to groups as small as six students. Class enrollment may be low the first few times that a law school offers the negotiation course simply because it is new and undiscovered.

**36.** One resource for these materials is http://law.missouri.edu/drle/syllabi/negotiation/ (last visited Nov. 30, 2015).

**37.** See Jay Folberg & Dwight Golann, *Lawyer Negotiation Theory, Practice and Law* (2011); Russell Korobkin, *Negotiation Theory and Strategy* (2014); Carrie Menkel-Meadow, Andrea Kupfer Schneider & Lela Porter Love, *Negotiation: Processes for Problem-Solving* (2006) (2nd ed. 2014); Stephen B. Goldberg, Frank E. A. Sander, Nancy H. Rogers & Sarah Rudolph Cole, *Dispute Resolution Negotiation, Mediation, and Other Processes* (2012); Jay Folberg, Dwight Golann, Thomas J. Stipanowich & Lisa A. Kloppenberg, *Resolving Disputes: Theory and Practice* (2010).

**38.** Roger Fisher, William Ury & Bruce Patton, *Getting to Yes* (3rd ed. 2011) (1981). Note that there are critics of parts of the book. See James J. White, "The Pros and Cons of *Getting to Yes*", 34 *J. Legal Educ*. 111 (1984).

**39.** *Id*.

**40.** Leigh L. Thompson, *The Mind and Heart of the Negotiator* (2001) (5th ed. 2012).

**41.** Adventure learning involves participation in a real negotiation rather than a simulated role-play in order to allow students to have an authentic negotiation experience. See Lynn P. Cohn & Noam Ebner, "Bringing Negotiation Teaching to Life: From the Classroom to the

Campus to the Community", in *Rethinking Negotiation Teaching: Innovations for context and cultures* 329 (Christopher Honeyman *et al*. ed., 2009) for a list of possible adventure learning activities.

**42.** Welcome to the DRRC's Electronic Delivery System, https://www.negotiationexercises.com/ (last visited Nov. 20, 2015).

**43.** Role Simulations, http://www.pon.harvard.edu/shop/category/role-simulations/ (last visited Nov. 20, 2015).

**44.** Center for Dispute Resolution Simulation Bank, http://www.willamette.edu/modules/simbank/login.cgi (last visited Nov. 20, 2015).

**45.** Lawyer as a Problem Solver, http://www.americanbar.org/groups/dispute_resolution/resources/lawyer_problem_solver.html (last visited Nov. 21, 2015).

**46.** Increasingly, students all over the world have the ability to record and watch negotiations on their mobile devices or computers. Students can learn a great deal about their negotiation style by watching themselves negotiate and re-experiencing the negotiation through their own eyes and the eyes of others. Melissa Manwaring & Kimberlee Kovach, "Using Video Recordings: A Mirror and a Window on Student Negotiation", in *Rethinking Negotiation Teaching: Assessing Our Students, Assessing Ourselves* (Noam Ebner, James Coben & Christopher Honeyman ed., 2012).

**47.** For a thorough and thoughtful discussion regarding assessing students in negotiation courses, see *Rethinking Negotiation Teaching: Assessing Our Students, Assessing Ourselves* (Noam Ebner, James Coben & Christopher Honeyman ed., 2012).

**48.** Many NADRPS faculty have joined the ABA Section on Dispute Resolution. The Section offers publications and a variety of materials that are helpful to faculty and practitioners of NADRPS. In addition, the Section hosts an annual conference including a Legal Educators' Colloquium to explore topics related to NADRPS teaching.

# LAW AND ECONOMICS IN THE CIVIL LAW WORLD: THE CASE OF BRAZILIAN COURTS[1]

**Mariana Pargendler**[2]
**Bruno M. Salama**[3]

## Introduction

It is difficult to overstate the influence of law and economics on US law.[4] Yet, in contrast to numerous instances of US legal imperialism during the 20th century[5] – culminating in what is sometimes referred to as the "Americanization of law"[6] around the globe –, the diffusion of law and economics elsewhere has apparently proceeded at a far slower pace.[7] Common and civil lawyers alike repeatedly portray civil law jurisdictions as the province of abstract, doctrinal scholarship, with law students being instructed early in their careers to reason about the law exclusively in terms of the broad principles that it presupposes, rather than in terms of the consequences that it entails.[8]

A large body of literature documents the rejection of law and economics in the civil law world, and offers an extensive list of possible reasons for this apparent incompatibility. The catalog of potential culprits includes the alleged singularity of American ideology,[9] divergent attitudes toward legal science and practice in the civilian world,[10] the lack of mathematical and economic skills among civilian legal scholars,[11] language barriers and inertia,[12] the comparatively greater power of US courts,[13] the different incentives faced by law professors,[14] the degree of protectionism within the legal profession,[15] misconceptions about the comparative method,[16] other cultural differences,[17] and even Marxist domination of economics faculties.[18] Even if the progress of law and economics scholarship in some civil law countries has been acknowledged from time to time,[19] conventional wisdom still holds that the legal profession in civil law jurisdictions is impervious to economic reasoning.

At least in Brazil, however, the assumed insulation of legal practice from economic reasoning is plainly mistaken. To be sure, although law and economics scholarship in Brazil is rapidly gaining ground, it admittedly remains far from dominant. Perhaps surprisingly, most of the action in integrating economic and legal reasoning has not taken place within the Ivory Tower, but outside of it. Unbeknownst even to most educated observers,[20] Brazilian courts are increasingly receptive to economic arguments. They have taken the lead in employing economic concepts to illuminate the application of the law and have repeatedly shown concern with incentives, cost-benefit analysis, and aggregate consequences of different legal regimes.

This suggests that those who decry the resistance to economic analysis in Brazil may simply have been looking at the wrong places. Moreover, we argue that the growing use of economic reasoning by Brazilian courts is not the product of blind imitation of foreign fads. Instead, it is the result of a profound transformation in the character and operation of the Brazilian legal system – to the effect that courts are increasingly in the business of shaping and implementing core public policies. While others have reflected on the new role for "the common law in the age of statutes,"[21] we here address the implications of what we term the "civil law in the age of judicial empowerment."[22]

This article proceeds as follows. The next section defines what we mean by the use of economic reasoning in Brazilian courts. The section "The rise of economic reasoning in judicial adjudication: the driving factors" outlines the ideological, political, and legal factors that are spurring judicial demand for economic insights in the adjudication of legal disputes. The section "The use of economics by Brazilian courts" documents and analyzes the use of economic reasoning in paradigmatic judicial decisions by Brazil's higher courts. The last section concludes by suggesting possible implications of these developments for legal education and scholarship in civil law jurisdictions.

## Economic reasoning in court

Before proceeding to substantiate our claim that Brazilian judges have increasingly employed economic reasoning in their opinions, we should

clarify what we mean by the use of economic reasoning by Brazilian courts. For these purposes, it is helpful to begin by clarifying what it is not.

First, the use of economic reasoning in court is not to be confused with the recognition that certain legal developments are at least partially influenced by economic considerations.[23] This should be a fairly uncontroversial proposition even in civil law jurisdictions. Prominent civil law scholars have long explained the evolution of key legal institutions and rules as practical responses to shifting economic needs.[24]

Also, it is no secret that a number of legal rules (such as the legal restrictions to self-contracting and self-dealing under Brazil's civil and corporate law, among many others) are based on the behavioral assumption that individuals act as self-interested maximizers of their own utility (*i.e.* as a *homo economicus*) – a propensity that can at times clash with societal objectives. Moreover, economic concepts such as monopoly, markets, and competition are known to be an integral part of antitrust law.[25]

Still, the fact that a legal rule is inspired by economic considerations does not necessarily entail the use of economic reasoning by courts. When a judge applies the Brazilian Civil Code to declare void a non-authorized sales contract entered into between an attorney (representing the principal) and the same attorney (acting for herself), economic reasoning will most likely be absent from her decision[26] – and appropriately so. In most cases where economic considerations are embedded in legal rules, the usual tenets of legal reasoning and interpretation will still suffice in their application.

Second, it is also important to distinguish the use of economic reasoning by Brazilian courts from the original aspirations of the law and economics movement of US lineage.[27] As articulated by Richard Posner, "economic analysis can illuminate, reveal as coherent, and in places improve [the law]."[28] These are academic ambitions of both descriptive and normative character – the chief idea being that economics can be used both to explain the underlying logic of the law and to evaluate whether the current legal regime is desirable from a cost-benefit standpoint. Accordingly, such a project has been widely criticized as subordinating or subsuming the law to economics.[29]

Conversely, the use of economic reasoning by Brazilian courts is the appropriation of key tenets and lessons from economics (especially micro-

economics) as an instrument for the application of legal rules or principles.[30] Economic insights illuminate legal interpretation not only when the law implicates economic concepts (as is often the case in antitrust and monetary law) but also when the legal principles or rules in question call for a forecast of the likely consequences of certain events or legal regimes. Economics is thus at the service of the law, not the other way around. In this context, the concept of economic efficiency carries comparatively little weight.[31]

For a simple illustration, consider the well-established rule that the victim of an unlawful act is entitled to recover lost profits (*lucrum cessans*). The rule requires monetary damages to be fixed so as to put the aggrieved party in the position it would have been but for the unlawful act.[32] The concrete application of this rule thus calls for a prediction of what the victim's profits would have been had the unlawful act not been committed. And yet the law provides no theory of human behavior on which to ground such a prediction. Be it viewed as a science, an art or a social practice, legal thinking is essentially normative in character: it speaks about what ought to be, but has comparatively little to say about how the social world works – which is precisely the province of economics as well as of other social sciences.

In the Special Appeal 771,787, the issue before Brazil's Superior Court of Justice (Superior Tribunal de Justiça – STJ)[33] was whether the government's imposition of price ceilings on sugar cane derivatives below the actual cost of production was unlawful and, if so, what the appropriate measure of damages payable to the aggrieved producers should be.[34] In approaching these issues, the dissenting opinion by Justice Herman Benjamin relied squarely on economic lessons. Specifically, the opinion rejected the measure of damages claimed by the plaintiffs, which was calculated solely based on the difference between the price ceiling imposed by the government and what the price would have been had it been duly fixed according to the actual costs of production.

Quoting elementary lessons from a Portuguese law-and-economics textbook on the concept of demand elasticity, the Justice concluded that the proposed formula would likely overestimate the amount of damages, since the artificially low price likely increased the amount of the product sold.[35] As the Justice himself emphasized, such use of economic insights was instrumental

in the application of the law. In his words, although his analysis "resorted to economic tools and concepts in its interpretative effort," it was "purely legal" in nature.[36]

This simple, almost trivial example, is however illustrative of a broader trend. In this case, as in others, the use of economics explicitly replaces more intuitive forms of reasoning or rules of thumb. An important – and, as we shall argue, growing – number of legal norms in Brazil require adjudicators to ponder over the likely factual consequences of different events or legal regimes. Although the trend is partly driven by advancements in economic theory vis-à-vis the distant past (as is the case in the more nuanced application of the ancient legal concept of lost profits), it was significantly bolstered by a transformation in the underlying structure of the legal system, to which we now turn.

## THE RISE OF ECONOMIC REASONING IN JUDICIAL ADJUDICATION: THE DRIVING FACTORS

One could be tempted to view the greater use of economic reasoning in a Latin American country as the artificial transplant of foreign academic fads that have corrupted the cohesion and purity of the civil law tradition. We suggest that such an assumption is unwarranted, for it places too much weight on the role of intellectual elites while failing to capture broader societal and legal forces at play. Our basic hypothesis is that contemporary Brazilian law – a typical exemplar of a civil law jurisdiction[37] – is particularly amenable to economic reasoning for related and mutually reinforcing (i) ideological, (ii) political, and (iii) legal factors, to which we now turn.[38]

### THE IDEOLOGICAL FACTOR: THE RISE OF PROGRESSIVISM

The first driving factor of the growing demand for economic reasoning is the ascent of progressive ideology as the underpinning of the modern Brazilian state. Progressivism – here loosely understood as the antithesis of conservatism[39] – is the ideology of advancement and development, which is based on a strong belief in human capacity to deliberately alter reality and ameliorate

human condition. In Brazil, the rise to power of president Getúlio Vargas in the early 1930s marked the triumph of progressivism as the dominant state ideology, which is one that resorts to the "instrumental use of law" as a tool for "social engineering."[40] While conservatism typically presupposes the wisdom embedded in existing rules and institutions, progressive ideology constantly puts it to test.

The state that embraces the mission of actively ordering and perfecting society – in short, the progressive state – is the institutional incarnation of progressive ideology. Brazilian Constitution of 1988 is far from timid about its progressive ambitions. Art. 3 explicitly articulates that "ensuring national development," "eliminating poverty and marginalization, and reducing social and regional inequalities," as well as "promoting the well-being of all" are "fundamental objectives of the Federative Republic of Brazil."

Brazilian progressive state is significantly involved in the pursuit of a series of concrete objectives or public policies – be they the elimination of illiteracy or the reduction of pollution, the promotion of industrialization or the fight against domestic violence. The formulation and implementation of public policies, in turn, creates the need of tailoring legal instruments and solutions to the goals of achieving concrete normative ends. In order to accomplish such a task, the traditional techniques of legal reasoning – based on grammar, history, logic, and internal coherence – no longer suffice. Once the legal ends are given, the legal debate turns to the question of the proper means to further such ends.

The legal controversy involving Law 11,340 of 2006 ("Lei Maria da Penha") – a statute that, according to its preamble, was designed to create "mechanisms for deterring domestic and familial violence against women" – is illustrative of these types of challenges. The main legal debate surrounding the statute did not lie in the legitimacy of its objectives (which were fairly uncontroversial[41]), but in whether the mechanisms provided by the statute were consistent with such goals. Accordingly, the Brazilian Supreme Court (Supremo Tribunal Federal – STF) had to decide on the constitutionality of the statutory provision that conditioned the criminal prosecution of wrong-doers to the "representation" (request) of the victim.

In a split decision, the Court ultimately decided to grant an interpretation "in accordance with the Constitution" to the effect of permitting the criminal prosecution of offenders notwithstanding the absence of representation by the victim. The court's majority considered women's well-known reluctance to file representations against their spouses, and concluded that the imposition of such requirement would effectively "eliminate the constitutional protection afforded to women,"[42] thus making it particularly inept to accomplish the desired objective of curbing domestic violence. Tellingly, the disagreement expressed in Justice Cezar Peluso's dissenting opinion concerned precisely the presumed concrete factual consequences of mandating or dispensing the victim's representation – the type of inference that is typical of social sciences such as economics, but foreign to the deductive mode of legal reasoning that is said to characterize the civilian tradition.[43] A behavioral theory – such as that offered by economics and other social sciences – about how actors respond to different rules and policies is therefore badly needed.

To be sure, portraying progressivism as a propeller of law and economics may sound oxymoronic, especially for American audiences.[44] The law and economics movement that flourished in the United States in the 1960s decade was premised on a *laissez-faire* agenda that is still today routinely labeled as "conservative."[45] In the Brazilian legal context, however, the rise of progressivism has gradually undermined strong versions of legal formalism that conceived legal categories as exclusively derived from history, logic or reason.[46] The advancement of the progressive ideology in Brazil opened space for the sort of policy-based reasoning that so distinctively characterizes US law up to the present day, and that is so often deemed to be a catalyst for forward-looking approaches within law.

## THE POLITICAL FACTOR: THE ASCENT OF THE JUDICIARY

The growing demand by lawyers and judges for theories of human behavior is due not only to the widespread pursuit of public policies by the Brazilian progressive state, but also and especially by the ever greater role of courts in the formulation and implementation of such policies. Since 1988 the judiciary shifted from the periphery to the center of political power in Brazil.[47]

Following redemocratization, the Brazilian Supreme Court took on the role of arbiter of the country's great institutional and political conflicts, a function previously exercised by the armed forces. Oscar Vilhena Vieira aptly termed the country's current regime as a "supremocracy."[48]

The worldwide trend toward the expansion of judicial power assumed a particularly extreme configuration in Brazil. The avenues for judicial review of legislation – which is arguably the main mechanism for courts' interference in policymaking – are exceptionally broad. Whereas the vast majority of jurisdictions adopt either concentrated or diffuse modes of judicial review (that is, when they do not fail to recognize *ex post* judicial review altogether),[49] Brazilian law contemplates both forms of constitutional challenges to legislation.[50] This hybrid system, combined with a long, detailed, and ambitious constitution,[51] creates enormous leeway for judicial protagonism.

This new prominence of the judicial branch in public policymaking has not gone unnoticed, and has triggered related innovations in institutional design. Law 9,868 of 1999, which regulates the procedure for concentrated judicial review, innovates by permitting the STF to call "public hearings" (*audiências públicas*) to hear "the testimonies of persons with experience and expertise on the subject." By admitting public hearings before the court – a tool for information-gathering and accountability which is characteristic of typical policymaking arenas, such as the legislature and administrative agencies –, the statute both underscores and reinforces the court's role in shaping public policy.

This function, indeed, is ever more explicit. Breaking with the classical separation of powers[52] and the archetypical conceptions of the role of courts in civil law jurisdictions,[53] the STF is at present constitutionally empowered both to issue "binding statements" (*súmulas vinculantes*) that must be followed by lower courts and other branches of government and to pick its cases based on what it deems to be their "general repercussion."[54] Law 11,418 of 2006 defines "general repercussion" as the "relevant questions from an economic, political, social and legal standpoint that transcend the subjective interests of the case."[55] It should come as no surprise that, having been asked explicitly by the legislature to factor economic considerations into their decisions, the STF has obliged.

Indeed, the STF has expressly asserted that correcting a "forecast error by the legislator" is a legitimate ground for judicial review.[56] But then again, the business of forecasts falls outside the scope of the law's essentially normative enterprise. In order to fulfill such a task, judges face a choice between resorting to common sense or personal experience on how the world works[57] or employing more systematic knowledge generated by the social sciences, such as economics.

## THE LEGAL FACTOR: THE CHANGING STRUCTURE OF THE LAW

Finally, the greater judicial role in policymaking does not operate in a legal vacuum. On the contrary, under a system that purports to uphold the rule of law, the growth in the power of the judiciary was accompanied by changes in the structure of legal rules.[58] These changes, in turn, create increasing demand for economic reasoning in two ways: by directly incorporating economic consequences into the content of legal rules and by rendering the application of a given legal regime conditional on the desirability of its consequences.

In its canonical form, a legal rule contains both a description of a (past) fact and its legal consequences. Art. 121 of Brazil's Criminal Code offers a representative example: "To kill someone. Penalty: imprisonment from six to twenty years." Economic reasoning might be useful in determining whether such a rule is desirable before its enactment by the legislature, but it plays essentially no role in its concrete adjudication. The main tasks before the decision-maker are interpretative and evidentiary in nature: circumscribing the meaning of the rule's wording (*i.e.*: What is the meaning of killing? What is the meaning of someone?) and determining whether the fact described in abstract form therein has in fact materialized (by resorting to standard evidentiary procedures). Although legal rules adhering to such a structure continue to exist – and, indeed, should continue to exist –, a growing number of legal commands follow a different model which is far more conducive to economic thinking.

First, there is a greater incidence of legal rules that prescribe sanctions that, instead of invariably applying to past facts, will apply or not depending on the expected consequences of the facts. This latter technique has, in fact,

become the hallmark of modern antitrust law, which originated in the United States and then quickly spread to other jurisdictions, including Brazil. In lieu of so-called *per se* rules (which followed the classic legal rule structure of assigning sanctions to certain predetermined factual descriptions), virtually all conducts that receive competition law scrutiny are now subject to what is known in the United States as "the rule of reason" standard and in Europe by the more eloquent label of "effects-based analysis."[59]

The recent change in the legal treatment of the commercial practice of minimum "resale price maintenance" in distribution agreements in the United States illustrates this point. While the practice agreement used to be illegal in all circumstances, it is now subject to the rule of reason, which means that the restriction will be permitted or not depending on a case-specific analysis of whether its likely effects are pro- or anticompetitive.[60] Economic analysis therefore becomes essential for the application of such rules, since traditional legal methods of interpretation are of little help in ascertaining the actual market effects of any given conduct.

Second, the contours and methods for the application of legal principles also depart from those of a canonical legal rule. It is a well-known fact that legal principles, as opposed to legal rules, have become increasingly influential in the adjudication of legal disputes, in Brazil as elsewhere.[61] But legal rules and legal principles have a markedly different structure. While legal rules are norms that "immediately describe behavior," legal principles are norms that "instead of describing behavior, establish an 'ideal state of affairs' (that is, an objective) whose realization implies the adoption of certain behaviors."[62] Under Robert Alexy's influential definition, legal principles are "optimization mandates," that is, norms that direct the realization of a value or objective to the greatest extent possible given the existing legal and factual constraints.[63]

Following the German tradition, the most popular test for deciding conflicts between legal principles in Brazil is that of "proportionality."[64] The application of the proportionality test, in turn, incorporates to legal decision-making elements traditionally viewed as "nonlegal," since they pertain to the possible factual consequences of different regimes. In its conventional formulation, proportionality requires the decision-maker to scrutinize differ-

ent dimensions of the regime in question: (i) its suitability (does the means promote the end?), (ii) necessity (among all available means equally apt to promote the end, are there other means that are less restrictive?), and (iii) proportionality in the narrow sense (do the advantages in promoting the end outweigh the disadvantages brought about by the adoption of the means in question?).[65] In a significant number of cases, answering the questions posed by the proportionality test requires a style of reasoning that is fundamentally different from the deductive endeavor that historically distinguishes the civilian method of "syllogism" or "subsumption." It often becomes necessary to employ a theory of human behavior to predict if a certain measure is adequate or necessary to promote the ends.

In sum, the application of a canonical legal rule requires the determination of whether a fact has occurred, leaving generally little room for economic analysis in its enforcement. Effects-based rules, by contrast, condition the application of legal sanctions on a finding about the likely factual consequences of a given fact or conduct – an inference for which economic reasoning is very helpful, if not utterly indispensable. The application of legal principles, in turn, depends on the evaluation of the likely factual consequences, not of a fact, but of the application of the norm itself.

As a result, the distinctive trait of the legal system vis-à-vis other systems – the focus on discerning between what is lawful and what is unlawful[66] – can no longer be readily addressed by appealing to purely abstract and conceptual interpretation of legal norms. Probabilistic judgments about the likely effects of different legal regimes are increasingly indispensable. These, in turn, are empirical questions for which the traditional analytical methods provide no ready answer – but with respect to which the social sciences can be of considerable assistance. In other words, the presumed consequences of one or another legal regime will ultimately determine the weight afforded to different principles in a given case. In this context, it is particularly useful to resort to lessons from the social sciences – including, but not limited to, economics – in order to evaluate the probable effects of different legal regimes with a minimum degree of rationality.

## THE USE OF ECONOMICS BY BRAZILIAN COURTS

Having laid out factors that have increased demand for economic reasoning in legal adjudication, we now turn to an overview of the most common forms by which economic reasoning has made an appearance in Brazilian judicial decisions. Our aim is not to scrutinize whether any specific argument was sound from an economic or legal standpoint: economics, like law, only seldom provides definitive or uncontroversial answers to any given problem. Neither do we make an attempt to systematically quantify the incidence of economic arguments in Brazilian judicial decisions, though the fact that the opinions described below come from important cases decided by Brazil's most prominent courts suggest that they are not mere rarities or aberrations.[67] Evidently, most court opinions, in Brazil as elsewhere, do not resort to economic arguments, and for good reasons.

Moreover, in referring to specific cases where judges employ economic reason we do not wish to deny that there are judges who are completely oblivious to economic thinking. Yet the decisions documented below, which implicitly or explicitly rely on economic lessons to solve legal problems, are surprising, not only in light of conventional wisdom, but also of the hurdles that had to be overcome for these arguments to surface: namely the lack of in-depth economic training by the vast majority of Brazilian judges,[68] the dearth of instruction in law and economics in law schools, the relative scarcity of law and economics scholarship in Portuguese language, and the rarity of studies applying economic insights to problems specific to Brazilian law. The cases described below, however, reveal that economic reasoning is no stranger to at least a part of Brazil's judiciary and that Brazilian judges are not nearly as hostile to economic reasoning as the prototype of a common law judge would suggest.

### THE APPLICATION OF CONSTITUTIONAL PRINCIPLES

A particularly fertile, if surprising, area for the use of economic reasoning in Brazil has been the application of constitutional principles by the Supreme Court. The STF's 2003 decision in Direct Action of Unconstitutionality (Ação

Direta de Inconstitucionalidade – ADI) 1,946 is illustrative in this regard. First, the decision concerned the rare delicate case of a constitutional challenge raised against a constitutional amendment. Second, the Court's bold decision to restrict the scope of a literal interpretation of the amendment was critically motivated by the use of economic reasoning.

The case dealt with the funding of the social right to maternity leave provided by the Brazilian Constitution. Prior to the amendment, employers were constitutionally and legally required to grant eligible women 120 days of maternity leave, but were at the same time entitled to obtain reimbursement of the salaries paid during the leave period from Brazilian social security system. In 1998, the newly-enacted Constitutional Amendment No. 20 – widely known as the "social security reform" (*reforma da previdência*) – capped all social security payments to the amount of R$ 1,200 (approximately US$ 1,000 at the time). If the new limit were to apply to maternity leave, any difference between the new ceiling and a woman's actual salary would need to be funded by the employer. The Brazilian Socialist Party (Partido Socialista Brasileiro – PSB) filed suit, arguing that the application of the cap to maternity leave payments violated the Constitution, in view of its explicit provision requiring the "protection of women's labor market" (art. 7, XX).

The Court's unanimous opinion written by Justice Sydney Sanches posited that shifting the financial burden of maternity leave onto employers would "facilitate and stimulate their option for male, instead of female, workers," so the ceiling would precisely "foster the discrimination that the Constitution sought to undercut."[69] The outcome of the case was clearly driven by the Court's forecast of the effects that a literal interpretation of the constitutional amendment would have on the rate and form of women participation in the workforce. Justice Sanches further emphasized the "perceived lack of adequacy between the legal means (a limitation on payments by the social security system and the transfer of the burden to the employer) and the normative end established under the Constitution to combat the discrimination of women in the labor market."[70] Although the decision makes no formal reference to economics, its reasoning is evidently based on a key tenet of price theory, driven by the law of supply and demand: namely that an increase in the price of a production input will trigger a reduction in its demand.

Notice that at no point did the Court ponder about the economic efficiency of encouraging women's participation in the workforce – a theme on which economists' views can and do differ.[71] The promotion of women's workforce participation is a given, that is, a prior political choice inscribed in the Constitution itself. The role of economics was to aid the attainment of a legal objective by providing a theory about the concrete effects of different legal regimes.

Another paradigmatic case involving social rights dealt with the scope of the Brazilian statute providing a homestead exemption to the so-called "family home" (*bem de família*), according to which the personal residence of a debtor cannot be foreclosed.[72] The same statute specifies a number of exceptions to this exemption, including one that authorizes foreclosure of the home of a lease guarantor.[73] The constitutionality of the guarantor exception was challenged before the STF based on the argument that it violated the constitutional right to housing (*direito à moradia*) inserted by Constitutional Amendment No. 26 of 2000.

In affirming the constitutionality of the exception, the majority opinion written by Justice Cezar Peluso argued that the right to housing was not synonymous with home ownership. Instead, the fact that "there are few property owners in Brazil" justified, in his view, the "stimulus to lease arrangements," which was presumably achieved by the challenged exception.[74] Justice Peluso's opinion concluded that eliminating the exception "would disrupt market equilibrium, systematically requiring costlier kinds of guarantees for residential leases, thereby harming the constitutional right to housing."[75] The opinion not only alludes to facts that are apparently outside the scope of the legal rule in question (such as the proportion of Brazilians that do not own real property), but also implicitly employs a standard model of supply and demand to infer causality between the interpretation of the law by the Supreme Court and the available supply of residential homes and their respective prices.

The use of economic reasoning in the decisions above – with a particular focus on the incentives structure generated by different rules – was by no means exceptional in STF jurisprudence. In its 2013 decision in Reclamação 4,374, the STF reversed its prior ruling to deem unconstitutional the statutory

provision that excluded welfare payments to the elderly whose family earned more than one-fourth of a minimum salary per month. The majority opinion by Justice Mendes acknowledged that "it was not up to the Federal Supreme Court to assess the political and economic convenience of the sums that can or should serve as the basis for measuring poverty."[76]

Nevertheless, in deeming the existing threshold unconstitutional, the decision not only referred to the changes in legal and economic conditions since the Court's original ruling, but also to the fact that the current system "ends up discouraging contributions to the social security system, further increasing informality."[77]

An even more explicit use of incentives rhetoric took place in the decision of ADI 4,425, in which the STF found unconstitutional a number of provisions of Constitutional Amendment No. 62 of 2009, which addressed the system of enforcement of monetary judgments against the state (*precatório*). Among the amendment's innovations was the ability of the government to institute a reverse auction, which would permit private parties to escape the lengthy line to receive payment by agreeing to receive a haircut. The majority opinion written by Justice Luiz Fux maintained that "the existence of a reverse auction system would represent an incentive for the state not to perform its obligations, aggravating the illiquidity of the judgments and increasing the discount […]. In other words: the system of incentives generated by the auction model promoted opposite results to those desired by the Constitution."[78] Similar decisions employing the language of incentives to reach constitutional law conclusions abound, being far too numerous to be described in full.

In other cases, the STF went so far as to draw specific inferences about the implications of certain legal institutions for Brazil's economic development more generally. In the AgReg 5,206-7, decided in 2001, the question was whether Brazil's Arbitration Law of 1996 – which sought to regulate and enforce the contractual parties' agreement to submit their disputes to arbitration – was valid in view of the constitutional rule that "the law shall not exclude from judicial appraisal any violation or threat to a right" (art. 5, XXXV). Concluding that the Arbitration Law passed constitutional muster, Justice Ilmar Galvão explicitly reasoned that the observed "avalanche of law-

suits" in the judiciary, combined with a "slowness that surpassed maximum tolerable limits," constituted a "serious disincentive to business, precisely in a moment in which one expects a sharp increment in business activities among us, especially due to the celebrated flows of foreign capital in view of exploring new enterprises of an economic nature." In this context, he argued, "the Brazilian legislator came up with the alternative of an Arbitral Tribunal as a solution for this serious problem, aiming to ensure the country's economic development."[79]

In the same vein is the opinion of Justice Joaquim Barbosa in ADI 1,194, which challenged, *inter alia*, the provision of the Statute of the Brazilian Bar Association (Estatuto da OAB) attributing to the lawyer of the winning party of a lawsuit the judicial award of attorney's fees. The Justice concluded that the destination of the award of attorney's fees shall be a matter of freedom of contract, a solution which "not only unlocks the access channels to the Judiciary, but also permits the essential imperatives of economic rationality, which are fundamental for the country's growth, to apply, without discrimination, to lawyers, in the same way that they apply to other categories of professionals."[80] Similarly, in the Extraordinary Appeal 422,941, the reporting Justice Carlos Velloso claimed that the government's imposition of price ceilings below the cost of production "constituted a serious obstacle to the exercise of economic activity, in violation of the principle of free enterprise."[81] He added that the "establishment of well-defined rules of state intervention in the economy, and their compliance, are fundamental for the maturation of Brazilian institutions and market, ensuring the necessary economic stability that conduces to national development."[82]

Moreover, there are decisions in which different Justices employ economic reasoning to reach disparate conclusions. In ADI 4,167, one of the questions before the Court was the scope of the expression salary "floor" for elementary school teachers, as specified by a new federal statute applicable to all Brazilian states. Justice Joaquim Barbosa argued that the term "floor" "can be interpreted in accordance with the intention of strengthening and improving public education services."[83] He then argued that "adequate compensation of teachers and other education professionals is one of the useful mechanisms for the attainment of such objective."[84] In his view, "if the floor

comprises the teacher's global remuneration, the additional payments (*gratificação*) may equal or exceed the minimum, so as to annul or mitigate the incentives for the diligent professional,"[85] hence resulting in the "perceptible deterrence to the incentive and responsibility policies that are necessary for the provision of quality educational services by the state based on a most relevant criterion: merit."[86]

Conversely, Justice Gilmar Mendes contended that the interpretation of floor as synonymous with basic salary, as advocated by Justice Barbosa, could lead to the "impossibility of expansion of education services,"[87] due to a substantial increase in teacher compensation. Moreover, he reasoned, such an interpretation would create an incentive for the states to restructure existing compensation packages so as to eliminate any bonus payments in addition to the basic salary – a conclusion which, in his words, derived from "pure game theory."[88]

## TELEOLOGICAL OR PURPOSIVE INTERPRETATION OF STATUTES

The STF, however, is not alone in resorting to economic lessons in its opinions. Economic reasoning is also prevalent in the decisions of the STJ. The use of economic insight is particularly noticeable when the Court employs a teleological or purposive method of statutory interpretation, a method with a long pedigree in the Western tradition.[89]

For instance, in the early 2000s, the STJ had to determine the scope of art. 6 of the statute regulating the concession of public services.[90] The rule in question expressly allowed concessionaires to suspend the provision of public services to clients in default. The question before the court was whether the rule applied to the provision of "essential services," such as water, gas or energy, given that art. 22 of the Brazilian Consumer Protection Code[91] requires utilities to provide essential services in a "continuous" fashion. The majority opinion by Justice Gomes de Barros repudiated the interpretation that prevented concessionaires from suspending the provision of services, a regime which, in his view, would generate a "domino effect."[92] Indeed, he maintained, "in finding out that a neighbor is receiving energy for free, the citizen will tend to bestow on himself such tempting benefit."[93] The result would be that "soon enough, nobody will honor the electricity bill."[94]

The STJ has also recently resorted to economic reasoning in interpreting Brazil's consumer protection law, so as not to hurt the people the law is trying to help.[95] In the Special Appeal 1,232,795, the issue before the Court was whether the company operating a private parking lot was liable for the armed robbery of a client inside its facilities. The unanimous opinion written by Justice Nancy Andrighi stated that no such liability existed, among other reasons, because assigning this burden to private parking lots would also be detrimental to consumers, for they would require investments that "would certainly reflect upon the price of the [parking] service, which is already high."[96]

## CITATIONS TO ACADEMIC WORKS

While most uses of economic reasoning by Brazilian courts are implicit in nature, this is not always the case. Indeed, there are numerous court decisions – from all levels of the judiciary – that explicitly cite works by economists or law and economics scholars. For instance, in ruling at ADI 2,340 that a state law could not obligate municipalities to provide water with water trunks whenever the regular provision of water was suspended, STF Justice Gilmar Mendes reasoned that "the service of basic sanitation is a natural monopoly […] rendering interstate competition not only impracticable, but also suggesting that the consolidation of demand from neighbor cities can reduce costs and render the service more attractive to private concessionaires."[97] The same opinion expressly relies on the concept of natural monopoly as described in the books *Law & Economics*, by Robert Cooter and Thomas Ulen, and *Economic Analysis of Law*, by Richard Posner. On another occasion, Justice Mendes also cited Cooter and Ulen's celebrated handbook in discussing the possible effects of disparate tax regimes "on the offer of products on the spare parts market, with a relevant impact on market equilibrium, internal consumption and inflation."[98]

In citing economics bibliography, Justice Gilmar Mendes – who, before joining the Court, was a distinguished constitutional law scholar who obtained his PhD in Germany – is not an outlier. Economic lessons also made their way into the STF decision in ADI 3,510, the high-profile constitutional challenge

against Brazil's Biosecurity Law, which regulates stem cell research. In his dissenting opinion on the unconstitutionality of stem cell research, Justice Cezar Peluso underscored what he viewed as flaws in the enforcement devices outlined by the statute. He argued that the mechanism for the appointment of members of a certain Committee of Ethics and Research was deficient because its composition was to be determined by the respective research institution. In his view, "this rule entails, at least, a serious risk of what economic theory calls an agency problem, that is, a critical conflict of interest that harms the independency of the entity immediately responsible for ensuring the zealous adherence of the grave constitutional and legal restrictions of the authorized research." He then goes on to quote a definition of the principle-agent problem from Joseph Stiglitz's book on the *Economics of the Public Sector*.[99]

State courts have also directly cited law and economics scholarship. In a recent decision by the Court of Appeals of the State of São Paulo, the issue was whether a shop had recourse against a credit card company for a purchase later cancelled due to fraud. Specifically, an appliances store had sold an air conditioner to a client who paid with a cloned credit card. The true holder of the credit card requested the cancellation of the purchase, which the credit card company did and then denied payment to the appliances shop. The shop then sued the credit card company for the amount due, arguing that the contract clause excluding liability of the credit card company in such instances was "abusive" and, therefore, void.

In upholding the exclusion of liability, and effectively assigning the loss to the shop, Judge Andrade Marques used law and economics scholarship to shed light on the rationale behind the contract clause. He argued that, at least with respect to face-to-face sales, "in comparison with the credit card company, the merchant has greater capacity to control and prevent the risk of trickery by customers. In other words, the seller is the superior risk bearer in this contractual relationship."[100] After a short digression about the concept of good faith in the Brazilian Civil Code, the opinion directly quoted a passage from George Triantis's entry on "Risk Allocation in Contracts" from the *Encyclopedia of Law and Economics*, which describes in detail the concept of a superior risk bearer. The opinion then went on to conclude that "the assignment of risks to the superior risk bearer is more efficient from an

economic standpoint because this is the party that can avoid and mitigate the risk at a lower cost."[101]

In another decision concerning a damages claim against a company that had outsourced its transportation services, Judge Marcelo Banacchio of the Court of Appeals of the State of São Paulo cites the famous opus by Cooter and Ulen to ground his observation that in its business activities a company "constantly balances costs against means to seek profits, of which outsourcing some of its crucial activities are an example, and in so doing it considers marginal costs, among which lies the payment of damages, it being understood that the optimal activity level will take place whenever precautionary costs are lower than the [expected] payment of caused damages."[102] He then concludes that the company "cannot act in the market as if third parties did not exist, so it must consider the possibility of damages and their internalization within the productive process, meaning that if the outsourced activity such as the one at hand generates more losses than profits it will certainly […] be discarded [by the company]".[103] Likewise, in a dissenting opinion that deemed valid the administrative proceeding that summoned only the legal representative of a company (and not all of its partners, as defended by the plaintiffs), Judge Beretta da Silveira from the Court of Appeals of the State of São Paulo stated that "it is worth recalling the doctrine of prominent law and economics scholar Richard Posner, according to which one should consider the balance of costs/benefits involved in judicial decisions."[104]

Brazilian judges have also expressly referred to prominent figures of the law and economics literature. In ruling on the value of damages to be paid by a news company, Justice Nancy Andrighi, of the Superior Court of Justice, cited Richard Posner and Robert Bork in support of the proposition that "in deciding on whether to publish a defamation, [a news company] takes into account, on one hand, the damages established in court and, on the other hand, the expected income that such publication will bring."[105] Justice Andrighi then concluded that "in establishing the damages the judge shall take into account the income of the news company with the unlawful act, for otherwise it will stimulate those that seek to maximize their profit to the detriment of society as a whole."[106] Nothing could be closer to the familiar notion within law and economics literature that a company's calculation for profit maximization

is influenced by the prospects of legal sanctions and rewards,[107] and that a judge should be forward-looking while calibrating her decisions.[108]

Richard Posner is cited by several other court decisions. In finding that the exclusivity requirement imposed by a doctors' cooperative was unlawful under Brazil's competition law, STJ Justice Humberto Martins examines the concept of entry barriers by quoting a long passage in English from Richard Posner's classic, *Economic Analysis of Law*.[109] In rejecting the filing of a "rescissory action" (*ação rescisória*),[110] Judge Osvaldo Cruz, of the Court of Appeals of the State of Rio Grande do Norte, refers to the works of Ronald Coase and Richard Posner to argue that "the judge must pay attention to the economic incentives and disincentives produced by court precedents."[111] All of the preceding cases are merely illustrative, rather than exhaustive. It is possible to find various other court decisions citing law and economics scholars or containing sparse references to "economic analysis of law" or the "law and economics" movement.[112]

## Conclusion: the prospects for law and economics in the civil law

The preceding analysis of the Brazilian case suggests that the conventional assumption that economic reasoning is absent from legal practice in the civil law world is flawed. Brazilian judges habitually employ concepts borrowed from economics to forecast the likely consequences of events or rules when such a prediction is called for by the relevant legal norms. Since Brazilian judges are not abandoning the time-honored practice of formally grounding their decisions on a preexisting legal provision that controls the relevant set of facts, economics seems to be at the service of law, not the other way around. Consequently, the Brazilian court system cannot be deemed to be undergoing the much-feared process of intellectual "colonization" by economics in any meaningful way.

Neither are Brazilian courts undergoing a process of ideological colonization. Whatever the merits of the claim that law and economics has a conservative bias, the Brazilian case highlights the potential of using economics to further progressive legal objectives as well. At least in the Brazilian

context, economics works more like a knife (that can cut both ways) than as a rhetorical platform that is inextricably linked to a certain political agenda.

Admittedly, we make no attempt to articulate the precise place of economic reasoning in legal discourse – a deep philosophical issue that is outside the scope of this article. Neither do we delve into the intricate relationship between the use of economic reasoning and the resulting quality of legal adjudication. Rather, we conclude by briefly reflecting on the implications of our findings for legal education and scholarship.

If, as suggested above, the use of economic reasoning as part of legal analysis is a function of the broader transformation in the character and operation of the Brazilian legal system, demand for law and economics scholarship in Brazil seems to be there to stay. And, given that the traditional role of legal scholarship in civil law countries is both to explain and to assist in the application of the law,[113] we expect to see a corresponding rise in the pursuit of law and economics studies by the legal academy, both in terms of research and teaching.

Finally, we have no reason to believe that the ideological, political, and legal factors that have increased demand for economic knowledge by courts are unique to Brazil. We can thus speculate that it is not only in Brazil that commentators have been looking at the wrong places in their apparently fruitless search for integration of economic analysis into the law. This suggests that the future of law and economics scholarship in civil law jurisdictions more generally rests on the understanding that this line of inquiry is increasingly consistent with the traditional vocation of civilian jurists of producing work that is instrumental in the application of the law.

# ENDNOTES

**1.** John M. Olin Program in Law and Economics, Stanford Law School, Working Paper Series, Paper no. 471, October 2014. This paper can be downloaded without charge from the Social Science Research Network Electronic Paper Collection http://ssrn.com/abstract=2514577. Editors' note: For this book, the abstract was excluded.

**2.** Visiting Professor of Law, Stanford Law School (2014-2015); Professor of Law, Fundação Getulio Vargas School of Law (FGV Direito SP); Global Associate Professor of Law, New York University School of Law.

**3.** Professor of Law, Fundação Getulio Vargas School of Law (FGV Direito SP). We are grateful to Diego Arguelhes, Owen Fiss, Nuno Garoupa, Martin Gelter, Jed Kroncke, José Reinaldo Lima Lopes, Ejan Mackaay, Rafael Maffei, Erickson Oliveira, and participants in the faculty workshop at FGV Direito SP and the 2014 edition of Yale's Seminario en Latinoamérica de Teoría Constitucional y Política (SELA) for very helpful comments to an earlier version of this article. Alberto Barbosa Jr. provided research assistance. All errors are our own.

**4.** The prominence of law and economics in the United States is widely acknowledged by its supporters and detractors alike. See *e.g.* Robert Cooter & Thomas Ulen, *Law and Economics* 2-3 (5th ed. 2007) ("economics has changed the nature of legal scholarship, the common understanding of legal rules and institutions, and even the practice of law"); and Anthony T. Kronman, "Remarks at the Second Driker Forum for Excellence in the Law", 42 *Wayne L. Rev.* 115, 160 (1995) ("[law and economics] continues and remains the single most influential jurisprudential school in this country"). The importance of law and economics has also been documented quantitatively. See *e.g.* William M. Landes & Richard A. Posner, "The Influence of Economics on Law: A Quantitative Study", 36 *J. L. & Econ.* 385 (1993); and Fred R. Shapiro, "The Most-Cited Law Review Articles Revisited", 71 *Chi.-Kent L. Rev.* 751 (1996).

**5.** Ugo Mattei, "Why the Wind Changed: Intellectual Leadership in Western Law", 42 *Am. J. Comp. L.* (2004).

**6.** The phenomenon is so robust that France's prestigious *Archives de Philosophie du Droit* devoted its entire forty-fifth volume to this theme in 2001.

**7.** Ejan Mackaay, *Law and Economics for Civil Law Systems* 26 (2013) ("In continental Europe, reception [of law and economics] came later, no doubt because of differences in language and legal system"). For an earlier survey reporting the slow pace of the diffusion of law and economics outside of the United States, see *Encyclopedia of Law and Economics* (Boudewijn Bouckaert & Gerrit De Geest ed., 2000) [hereinafter "Encyclopedia of Law and Economics"].

**8.** John Henry Merryman, *The Civil Law Tradition: An Introduction to the Legal Systems of Europe and Latin America* 67 (2007).

**9.** Catherine Valcke, "The French Response to the World Bank's *Doing Business* Reports", 60 *U. Toronto L. J.* 197, 200 (2010).

**10.** See Kristoffel Grechenig & Martin Gelter, "The Transatlantic Divergence in Legal Thought: American Law and Economics vs. German Doctrinalism", 31 *Hastings Int'l & Comp. L. Rev.* 295 (2008); Juan Javier del Granado & M. C. Mirow, "The Future of the Economic Analysis of Law in Latin America: A Proposal for Model Codes", 83 *Chi.-Kent L. Rev.* 293 (2008); and Christian Kirchner, "The Difficult Reception of Law and Economics in Germany", 11 *Int'l Rev. L. & Econ.* 277 (1991).

**11.** Dennis W.K. Khong, "On Training Law and Economics Scholarship in the Legal Academia", 1 *Asian J. L. & Econ.* (2010).

**12.** Robert Cooter & James Gordley, "Economic Analysis in Civil Law Countries: Past, Present, Future", 11 *Int'l Rev. L. & Econ.* 261, 262 (1991).

**13.** Richard Posner, "The Future of the Law and Economics Movement in Europe", 17 *Int'l Rev. L. & Econ.* 3 (1997).

**14.** Nuno Garoupa & Thomas S. Ulen, "The Market for Legal Innovation: Law and Economics in Europe and the United States", 59 *Ala. L. Rev.* 1555 (2008); Oren Gazal-Ayal, "Economic Analysis of Law in North America, Europe and Israel", 3 *Rev. L. & Econ.* 485, 486-487 (2007); and J. Mark Ramseyer, "Law and Economics in Japan", 2011 *U. Ill. L. Rev.* 1455.

**15.** Nuno Garoupa, "The Law and Economics of Legal Parochialism", 2011 *U. Ill. L. Rev.* 1517.

**16.** Ugo Mattei & Roberto Pardolesi, "Law and Economics in Civil Law Countries: A Comparative Approach", 11 *Int'l Rev. L. & Econ.* 265, 273 (1991). See also Roberto Pardolesi

& Giuseppe Bellantuono, "Italy", in *Encyclopedia of Law and Economics* ("the hindrances encountered by the economic analysis of law stem from a misconception of both the economic and the comparative method").

**17.** Kenneth G. Dau-Schmidt & Carmen L. Brun, "Lost in Translation: The Economic Analysis of Law in the United States and Europe", 44 *Colum. J. Transnat'l L.* 602, 616 (2006).

**18.** J. Mark Ramseyer, "Law and Economics in Japan", 2011 *U. Ill. L. Rev.* 1455.

**19.** See *e.g.* Ben Depoorter & Jef Demot, "The Cross-Atlantic Law and Economics Divide: A Dissent", 2011 *U. Ill. L. Rev.* 1593 ("the gap between the United States and Europe regarding the development of law and economics is greatly exaggerated"); Carole M. Billiet, "Formats for Law and Economics in Legal Scholarship: Views and Wishes from Europe", 2011 *U. Ill. L. Rev.* 1485 ("Europe's internationally visible law and economics outputs do not give the full measure of its total law and economics production"); Hans-Bernd Schäfer, "Law and Economics in Germany", Eur. Ass'n L. & Econ. (May 30, 2009), http://ealeorg.blogspot.com/2009/05/third-in-series-on-development-of-law.html ("the authors write in their national language and publish in national law journals"); and Erich Schanze, "What is Law and Economics Today? A European View", in *New Frontiers of Law and Economics*, 99, 107 (Peter Nobel ed., 2006) (in German speaking Europe "there are hundreds of dissertations […] containing major chapters on law and economics").

**20.** See *e.g.* Decio Zylbersztajn & Rachel Sztajn, *Direito e economia* vii (2005) ("The field of economics of law, whose scope has expanded to include the field of organizations, is little developed in Brazil. Except for the area of competition, other topics […] are mostly ignored"); Armando Pinheiro & Jairo Saddi, *Direito, economia e mercados* xxv (2006) ("the movement of law and economics, established in the United States and Europe, has always suffered great resistance in Brazil, especially due to the lack of understanding of some paradigms and because it is viewed as a 'gringo thing,' given that it comes from a common law regime, perpetuating the basic, but common, error that only countries with such type of legal system could do law and economics"); and Luciano Benetti Timm, "Lições do Nobel de Economia para o direito", *Valor Econômico*, Nov. 27, 2009 ("[i]t is well known that our jurists, well-versed in Latin and French, solemnly refused to adopt the suggestions coming from the Anglo-American legal system ("common law"), as well as the legal and economic theories originating in English language"). See also José R. Rodriguez, "The Persistence of Formalism: Towards a Situated Critique Beyond the Classic Separation of Powers", 3 *L. & Dev. J.* 39, 41 (2010) ("Formalism

persists everywhere despite 100 years of critical legal theory […] While this is a general phenomenon, it seems to be especially acute in Brazil").

**21.** See Guido Calabresi, *A Common Law for the Age of Statutes* (1985).

**22.** The recent trend toward ever-greater judicial empowerment around the globe is well documented. See *e.g*. Ran Hirschl, "The Political Origins of the New Constitutionalism", 11 *Ind. J. Global Legal Stud*. 71, 71 (2004) (arguing that "in numerous countries and in several supranational entities, fundamental constitutional reform has transferred an unprecedented amount of power from representative institutions to judiciaries").

**23.** Max Weber, *Economy and Society* 655-6, 883 (Guenther Roth & Clauss Wittich ed., Ephraim Fischoff *et al*. trans., 1978) ("Economic factors can therefore be said to have had an indirect influence only"; "economic conditions have […] everywhere played an important role, but they have nowhere been decisive alone and by themselves").

**24.** See *e.g*. Tullio Ascarelli, *Panorama do direito comercial* 22 (1947) (explaining the emergence of a separate body of commercial law in terms of the inadequacy of Roman-canonic law to the economic exigencies of a capitalist system).

**25.** Posner attributes the development of law and economics in the United States in large part to "the curious American fascination with monopoly." Richard Posner, The Future of the Law and Economics Movement in Europe, 17 *Int'l Rev. L. & Econ*. 3, 4 (1997). The very field of antitrust law, however, was comparatively a latecomer in civil law jurisdictions.

**26.** Brazilian Civil Code, art. 117 ("Except as authorized by law or by the principal, the contract that the attorney, in his interest or on behalf of someone else, celebrates with himself is annullable"). The economic rationale for such a provision is straightforward: the underlying assumption is that a self – interested attorney would favor his own interests over those of the principal; as a result, the law offers as a default rule the regime that the parties presumably would have wanted – one that forbids the attorney from acting in a conflicted transaction).

**27.** This is emphatically not to suggest that the use of economic reasoning in courts as we describe it here does not exist in the United States. It certainly does, having in fact preceded the law and economics movement (See *e.g*. *United States v. Carroll Towing Co*., 159 F.2d 169 (2d Cir. 1947), where judge Learned Hand laid out the famous formula that uses cost considerations to establish negligence). Since the inception of the law and economics movement, the use of economic arguments in court has flourished, decisively shaping the development of various areas of law. See *e.g*. Posner & Landes, *supra* note 1, at 386-7 ("[t]he impress of economics is

strong on the calculation of damages in tort, contract, securities, and other types of cases and even on monetary relief in divorce cases. […] Judges are increasingly receptive to economic arguments"); and Roberta Romano, "After the Revolution in Corporate Law", 55 *J. Legal Educ*. 342 (2005) (describing the impact of finance and economic theory on the development of US corporate and securities law).

**28.** Richard Posner, *Economic Analysis of Law* xix (6th ed. 2003).

**29.** See *e.g*. Kronman, *supra* note 1, at 161 (decrying the "built-in imperial instinct" in law and economics, "where the case is there to serve the theory, and not the other way around").

**30.** One must bear in mind that is a broader definition of the practice of law and economics than that typically employed by the scholars investigating the reception of law and economics outside of the United States. For instance, in a widely cited article, Garoupa and Ulen consider law and economics as the application of economics to non-obvious areas of law. Garoupa & Ulen, *supra* note 11, at 1567-8 ("for our purposes we adopt a definition suggested to us informally by Professor Louis Kaplow: 'law and economics' is the application of economic analysis to any area of the law except those areas where its application would be obvious").

**31.** On this topic, see Ugo Mattei & Roberto Pardolesi, "Law and Economics in Civil Law Countries: A Comparative Approach", 11 *Int'l Rev. L. & Econ*. 265, 274 (1991) (correctly predicting that allocative efficiency would not necessarily be the "polar star" of the practice and study of law and economics within the civil law tradition).

**32.** For its current formulation under Brazilian law, see arts. 402, 403 and 927 of the Brazilian Civil Code.

**33.** The STJ is Brazil's court of last resort on the interpretation of federal law other than constitutional law. Federal law, in turn, accounts for the lion's share of Brazil's legal system.

**34.** STJ, Resp no. 771.787, Órgão Julgador: 2ª Turma, Relator: Otávio de Noronha, 15.04.2008, STJJ (Braz.).

**35.** The Portuguese book quoted is Vasco Rodrigues, *Análise econômica do direito* 24 (2007).

**36.** STJ, Resp no. 771.787, Órgão Julgador: 2ª Turma, Relator: Otávio de Noronha, 15.04.2008, STJJ (Braz.), at 19.

**37.** Brazil is consistently classified as a civil law jurisdiction subject to strong French influence. Nevertheless, as one of us has previously argued, Brazilian law has long incorporated influences from both civil and common law origins. See Mariana Pargendler, "Politics in the Origins: The Making of Corporate Law in Nineteenth-Century Brazil", 60 *Am. J. Comp. L.* 805 (2012). See also Mariana Pargendler, "The Rise and Decline of Legal Families", 60 *Am. J. Comp. L.* 1043 (2012) (describing the historical evolution and contingency of legal family classifications).

**38.** We developed an earlier version of this argument in Mariana Pargendler & Bruno Salama, "Direito e consequência no Brasil: em busca de um discurso sobre o método", 262 *Revista de Direito Administrativo* 95 (2013).

**39.** For present purposes, the term conservatism can be understood as a positional ideology against dismantling existing institutions (rather than an ideational one, which provides specific views about how society ought to be organized). See Samuel P. Huntington, "Conservatism as an Ideology", 51 *Am. Pol. Sci. Rev.* 454, 468 (1957).

**40.** See José Reinaldo Lima Lopes, "Regla y Compás, Metodología para un Trabajo Jurídico Sensato", in *Ensayos sobre metodología de la investigación jurídica* 41, 44 (Christian Courtis ed., 2006).

**41.** The exceptions prove the rule. A lower court judge who declared the statute unconstitutional for depriving men of their regular means of control over women – arguing that "the world is, and shall continue to be, masculine" – was sanctioned by Brazil's judicial oversight body National Council of Justice (Conselho Nacional de Justiça – CNJ). The conviction was later reversed by STF. STF, MS 30.320, Relator: Ministro Marco Aurélio, 28.02.2011, STFJ (Braz.).

**42.** STF, ADI no. 4.424, Relator: Ministro Marco Aurélio, 09.02.2012, STFJ (Braz.), as summarized on the STF website, http://stf.jus.br/portal/cms/verNoticiaDetalhe.asp?idConteudo=199853&caixaBusca=N. The final version of the opinion had not yet been published when this article was finalized.

**43.** *Id*. Noticeably, Justice Peluso's dissenting opinion specifically referred to "studies of several entities of civil society and also the Applied Economic Research Institute (IPEA)" and also to "several elements brought by people from the fields of sociology and human relations," including "public hearings that presented data justifying the [relevant] conception of the criminal lawsuit."

**44.** See Herbert Hovenkamp, "Knowledge About Welfare: Legal Realism and the Separation of Law and Economics", 84 *Minn. L. Rev.* 805, 810 (2000) ("progressive legal thought from roughly 1925 to 1960 [in the United States] is characterized by an unprecedented separation of law and economics"); and Herbert Hovenkamp, "The Mind and Heart of Progressive Legal Thought", 81 *Iowa L. Rev.* 149 (1995).

**45.** See *e.g.* Steven M. Teles, *The Rise of the Conservative Legal Movement: The Battle for Control of the Law* 90-134 (2010). But see Pierre Schlag, "An Appreciative Comment on Coase's *The Problem of Social Cost*: A View from the Left", 1986 *Wis. L. Rev.* 919 (1986) ("Coase's insights can yield some left-leaning implications for the understanding of law and its relation to economics") and "Four Conceptualizations of the Relations of Law to Economics (Tribulations of a Positivistic Social Science)", 33 *Cardozo L. Rev.* 2357 (2012) (comparing the approaches of Frank Knight, Ronald Coase, Richard Posner and Cass Sunstein). See also Richard Posner, *Law, Pragmatism and Democracy* 274-288 (arguing that Hayek's position, in requiring judges to enforce custom without regard to consequences, is therefore antithetical to economic analysis).

**46.** Merryman, *supra* note 5, at 91 ("While common lawyers tend to think of the division of the law as conventional, *i.e.* as a the product of some mixture of history, convenience, and habit, the influence of scholars and particularly of legal science has led civil lawyers to treat the matter of division of the law in more normative terms […] definitions and categories are thought to be scientifically derivable from objective legal reality").

**47.** Matthew M. Taylor, *Judging Policy: Courts and Policy Reform in Democratic Brazil* (2008); and Marcos Paulo Veríssimo, "A Constituição de 1988, vinte anos depois: Suprema Corte e ativismo judicial "à brasileira"", 4 *Revista Direito GV* 407 (2008) (the Constitution of 1988 "has transformed [the Brazilian Supreme Court] into one of the country's major political actors").

**48.** Oscar Vilhena Vieira, "Supremocracia", 4 *Revista Direito GV* 441 (2008).

**49.** Tom Ginsburg, *Judicial Review in New Democracies* 7-8 (2003).

**50.** For an overview in English language, see Maria Angela Jardim de Santa Cruz Oliveira, "Reforming the Brazilian Supreme Court: A Comparative Approach", 5 *Wash. U. Global Stud. L. Rev.* 99 (2006); and Stephen Zamora, "Judicial Review in Latin America", 7 *Sw. J. L. & Trade Am.* 227 (2000).

**51.** Carlos Portugal Gouvêa, "The Managerial Constitution: The Convergence of Constitutional and Corporate Governance Models" (working paper, 2013), http://ssrn.com/abstract=2288315.

**52.** Bruce Ackerman, "The New Separation of Powers", 113 *Harv. L. Rev.* 633 (2000).

**53.** Rodriguez, *supra* note 17, at 52 ("The [civilian] judge subsumes [facts to legal provisions] because the political discussion is supposed to have been resolved in the Parliament: society has already decided on its differences and adopted a rule of conduct – the general and abstract law – that will serve as a reference for settling potential conflicts on that particular subject.").

**54.** Art. 543-A, §3º and §7º of the Brazilian Civil Procedure Code.

**55.** Art. 2, which introduced art. 543-A to the Civil Procedure Code (emphasis added).

**56.** STF, ADI no. 1.194-4, Relatora: Ministra Cármen Lúcia, 20.05.2009, STFJ (Braz.).

**57.** *Id*. (as when Justice Mendes concluded at the requirement of attorney review of a legal person's constitutional documents did not decrease the number of errors, which, in his view, made such a mandate unconstitutional).

**58.** For an early recognition of these changes see Weber, *supra* note 20, at 882-889 (analyzing the anti-formalistic tendencies of modern legal development). See also Merryman, *supra* note 5, at 94-98 (laying out several reasons for the "crisis" in the crucial distinction within the civil law between public and private law).

**59.** Damien Geradin & Caio Mário da Silva Pereira Neto, "For a Rigorous 'Effects-based' Analysis of Vertical Restraints Adopted by Dominant Firms: A Comparison of EU and Brazilian Competition Law", 9 *Competition Pol'y Int'l* 1-16 (2013).

**60.** *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, 551 US 877 (2007) (overruling the longstanding precedent *Dr. Miles Medical Co. v. John D. Park & Sons Co.*, 220 US 373 (1911), according to which minimum vertical price restraints were unlawful *per se*).

**61.** Alec Stone Sweet & Jud Mathews, "Proportionality Balancing and Global Constitutionalism", 47 *Colum. J. Transnat'l L.* 72, 112 (2008); David S. Law, "Generic Constitutional Law", 89 *Minn. L. Rev.* 652, 687 (2005); and Humberto Ávila, *Teoria dos princípios* 15-16 (2005). See also Moshe Cohen-Eliya & Iddo Porat, "Proportionality and the Culture of Justification", 59 *Am. J. Comp. L.* 463 (relating the increased use of proportionality tests worldwide as a shift from a culture of authority to a culture of justification).

**62.** Pontes de Miranda, *Tratado de Direito Privado I* 80 (RT, 2012) (note included by revisors Judith Martins Costa *et al*.).

**63.** Robert Alexy, *A Theory of Constitutional Rights* 44-61 (Julian Rivers trans., Oxford University Press 2002) (1986).

**64.** Bernhard Schlink, "Proportionality in Constitutional Law: Why Everywhere But Here?", 22 *Duke J. Comp. & Int. L.* 291, 296 (2012) ("In comparative constitutional law, the principle of proportionality is often traced back to German roots […]. But there is nothing inherently German about the roots of the principle of constitutionality […]. It is a response to a universal legal problem").

**65.** For a description of the proportionality test, see Mathews & Sweet, *supra* note 58, at 75.

**66.** Niklas Luhmann, "Law as a Social System", 83 *Nw. U. L. Rev.* 136, 139 (1989) ("Only the law can say what is lawful and what is unlawful, and in deciding this question it must always refer to the results").

**67.** On this topic See Horacio Spector, "Fairness and Welfare from a Comparative Law Perspective", 79 *Chi.-Kent L. Rev.* 521, 537 (2004) (arguing that economic considerations are not completely absent from legal science as practiced in the civilian world but are limited to hard cases).

**68.** This is so even though an introductory course in economics is a mandatory part of Brazilian law schools' curriculum, as required by art. 5, I, of Resolution no. 9/04 issued by the National Council of Education. In fact, a course on political economy has been part of law schools' curriculum since the mid-19th century in Brazil (as explained in Opinion CNE/CES no. 211/04). Anecdotal evidence however suggests that there has always been great variance in the quality and coverage of such courses, ranging from fairly structured introductory discussions of political economy to shallow, quasi-philosophical discussions on the relationship between law and ideology.

**69.** STF, ADI no. 1.946, Relator: Ministro Sydney Sanches, 03.04.2003, STFJ (Braz.).

**70.** *Id*.

**71.** Contrast Gary Becker, *A Treatise on the Family* (1991) (positing that married women's specialization in domestic work can be efficient) with Edward J. McCaffery, "Slouching Towards Equality: Gender Discrimination, Market Efficiency, and Social Change", 103 *Yale L. J.* 595 (1993) (advancing an efficiency argument in favor of women's labor force participation).

**72.** Law no. 8,009 of 1990.

**73.** *Id*., art. 3.

**74.** STF, RE no. 407.688-8, Relator: Ministro Cezar Peluso, 08.02.2006, STFJ (Braz.).

**75.** *Id*.

**76.** STF, Rcl. no. 4.374, Relator: Ministro Gilmar Mendes, 18.04.2013, STFJ (Braz.).

**77.** *Id*.

**78.** STF, ADI no. 4.425, Relator: Ministro Luiz Fux, 16.03.2013, STFJ (Braz.).

**79.** STF, AgRg no. 5.206-7 Relator: Ministro Sepúlveda Pertence, 12.12.2001, STFJ (Braz.).

**80.** STF, ADI no. 1.194-4, Relatora: Ministra Cármen Lúcia, 20.05.2009, STFJ (Braz.).

**81.** STF, RE no. 422.941, Relator: Ministro Carlos Velloso, 06.12.2005, STFJ (Braz.).

**82.** *Id*.

**83.** STF, ADI no. 4.167, Relator: Ministro Joaquim Barbosa, 27.04.2011, STFJ (Braz.).

**84.** *Id*.

**85.** *Id*.

**86.** *Id*.

**87.** *Id*.

**88.** *Id*.

**89.** José Reinaldo Lima Lopes, "Raciocínio jurídico e economia", 8 *Revista de Direito Público da Economia – RDPE* 137,146-147 (2011).

**90.** Law no. 8,987 of 1995.

**91.** Law no. 8,078 of 1990.

**92.** STJ, Resp no. 363.943, Órgão Julgador: 1ª Seção, Relator: Humberto Gomes de Barros, 10.12.2003, STJJ (Braz.).

**93.** *Id*.

**94.** *Id*.

**95.** This is in fact a familiar argument within the law-and-economics literature. See *e.g*. Richard Craswell, "Passing on the Costs of Legal Rules: Efficiency and Distribution in Buyer-Seller Relationships", 43 *Stan. L. Rev*. 361 (1990-1991) (for a sophisticated discussion of this point).

**96.** STJ, Resp no. 1.232.795, Órgão Julgador: 3ª Turma, Relatora: Nancy Andrighi, 02.03.2013, STJJ (Braz.).

**97.** STF, ADI no. 2.340, Relator: Ministro Ricardo Lewandowski, Voto: Gilmar Mendes, 06.03.2013, STFJ (Braz.).

**98.** STF, RE 405.579, Relator: Ministro Joaquim Barbosa, 01.12.2010, STFJ (Braz.).

**99.** STF, ADI no. 3.510, Relator: Ministro Cezar Peluso, Voto: Cezar Peluso, 29.05.2008, STFJ (Braz.) (also arguing that the "big risk is that the Committees of Ethics and Research would be subordinated and would become agents of the institutions, instead of keeping the necessary self-reliance and independence. The alignment of interests, in this case, is ostensibly deleterious for the whole system").

**100.** TJSP, Ap. Civ. no. 0202965-46.2009.8.26.0100, Órgão Julgador: 22ª Câmara de Direito Privado, Relator: Des. Andrade Marques, 31.01.2013 (Braz.).

**101.** *Id*.

**102.** TJSP, Ap. Civ. no. 954.795-0/3, Órgão Julgador: 28ª Câmara de Direito Privado, Relator: Des. Marcelo Banacchio, 13.02.2007 (Braz.).

**103.** *Id*.

**104.** TJSP, Ap. Civ. no. 629.521-4/9-00, Órgão Julgador: 3ª Câmara de Direito Privado, Relator: Des. Beretta da Silveira, 28.04.2009 (Braz.).

**105.** STJ, Resp no. 355.392, Órgão Julgador: 3ª Turma, Relatora: Nancy Andrighi, 26.03.2002, STJJ (Braz.).

**106.** *Id*. Justice Andrighi also cited a U. S. Supreme Court case in her opinion, namely *New York Times Co., v. Sullivan*, 376 U. S. 254 (1964).

**107.** See *e.g*. Herbert Hovenkamp, "Rationality in Law & Economics", 60 *Geo. Wash. L. Rev*. 293 (1992).

**108.** See *e.g.* Richard Posner, *Overcoming Law* 4 (1995).

**109.** STJ, Resp no. 1.172.603, Órgão Julgador: 2ª Turma, Relator: Humberto Martins, 04.03.2010, STJJ (Braz.).

**110.** Under Brazilian law, a "*ação rescisória*" is a lawsuit that in exceptional circumstances can be filed to challenge an unappealable, final judgment. See art. 485 of the Brazilian Civil Procedure Code.

**111.** TJRN, Ag.Rg. no. 2010.008686-7/0001.00, Relator: Des. Osvaldo Cruz, 02.03.2011 (Braz.).

**112.** TJPR, RI no. 2012.0001633-0/0, Órgão Julgador: Turma Recursal, Relator: Des. Gustavo Tinoco de Almeida, 26.07.2012 (Braz.); TJSP, ED no. 0112359-50.2008.8.26.0053/50000, Órgão Julgador: 5ª Câmara de Direito Público, Relator: Des. Fermino Magnani Filho, 17.09.2012 (Braz.).; and TJSP, Ap. Civ. no. 450.057-4/1-00, Órgão Julgador: 7ª Câmara de Direito Privado, Relator: Des. Élcio Trujillo, 13.09.2006 (Braz.).

**113.** James Gordley, "The State's Private Law and Legal Academia", 56 *Am. J. Comp. L.* 639 (2008) (describing the "symbiotic relationship between law as promulgated by state authority and law as understood by jurists").

# PICKING THE WRONG WINNERS: EVALUATING A LEGAL POLICY BEYOND THE LAW

**Alexandre Pacheco da Silva**[1]
**Victor Nóbrega Luccas**[2]

## Introduction

Legal policies are what the lawmakers understand as the appropriate way to address social problems. Policies are based on an evaluation of the goals to be pursued and of the policy's consequences, as well as on an assessment of the facts and the effectiveness of the proposed remedies. Legal education often deals with the evaluation of policy goals from a legal doctrine point of view, but seldom deeply examines how the knowledge from other fields impacts factual assessment and the evaluation of goals.

It is often said by experts that "Brazil is not for beginners." The phrase means that our country offers unique challenges for analysis in various fields, such as sociology, history, economy, and of course law. Since legal policies draw upon knowledge from all these fields, the study of Brazilian legal policies is a daring intellectual enterprise, that may offer a privileged perspective and interesting discussions on many themes.

In the context of a program for international students in a Brazilian school of law, the abovementioned considerations prompted the creation of a course that could, at the same time, deal with the traditional deficit of legal education and introduce students to very important themes that Brazilian lawyers, sociologists, and economists have to confront. The course is named "Social Representations of Law," and the basic idea behind it is that legal policies are based on some representations of society's problems, given by other fields of knowledge. Understanding these representations is fundamental to comprehend the policy, even in legal terms.

In this brief article, we intend to present an example of what our students do in "Social Representations of Law," namely evaluating a legal policy while taking into consideration representations of society that demand knowledge

beyond the law. The policy to be discussed is the "Cinema Close to You" initiative by the Brazilian National Cinema Agency (Agência Nacional de Cinema – ANCINE), linked to the Federal Government's Ministry of Culture. This policy was chosen for three reasons: (i) it is an attempt to implement a social right, a common and challenging problem in Brazil; (ii) it is a policy which is not often discussed by legal academics, ensuring novelty; (iii) it allows for different types of arguments and criticism that require creativity and an open mind. The ability to devise creative alternatives is an essential skill for lawyers that is often overlooked in legal education.

In section "The 'Cinema Close to You' initiative" we will introduce the "Cinema Close to You" initiative and the problem it was trying to address, namely the small number of movie theatres in Brazil and their concentration in large cities. In the same section, we will present the government's plan to solve the issue and, finally, the outcome of the initiative. In section "Evaluating the legal policy" we will present our claims that: (i) the policy failed to achieve some of its objectives due to mistakes in factual assessment; (ii) the policy is based on a narrow conception of access to movies that must be overcome in order to create interesting alternatives.

As it will become clear on the following pages, we believe that the mistakes made by the Brazilian government may be summarized as "picking the wrong winners:" first, the government inadvertently chose large cities and shopping centers as winners, maintaining the concentration; second, the government bet on building movie theatres, a physical location, whilst the internet (a digital location) could provide alternative means of promoting access to movies. We acknowledge the value of the government's effort, as well as our comfortable position of pointing out mistakes and limitations after the events have taken place. The criticism is still valid, nonetheless.

## The "Cinema Close to You" initiative

### THE MOVIE THEATER DISTRIBUTION PROBLEM IN BRAZIL

During the 1970s, the movie theater distribution in Brazil could be described as vast and decentralized, since there were more cinema screens per inhab-

itant than nowadays, and they were present in large, medium and small cities. In 1975, the country had nearly 3,300 screens, which represented roughly one for every 30,000 Brazilian citizens, 80% of them located in countryside towns.

Throughout the 1980s, there was a significant decrease in the number of cinemas and film offerings to the public. To provide a clear overview of this downturn: whilst in 1979 the country had nearly 3,000 screens, in the summer of 1982 this number fell to 2,000, a decrease of a third of the total in just three years. The decline continued throughout the decade, reaching its worst scenario in 1997, when the country had about 1,000 cinema screens.

The changes in the Brazilian film industry may be associated with a significant reduction of public policies to encourage the sector in the late 1980s and early 1990s.[3] The extinction of traditional instruments of development and industry protection, which marked the industry during the 1970s and 1980s, reduced activities within the film market in all its dimensions: production, distribution, and exhibition. The best example of this phenomenon happened during president Fernando Collor de Mello's mandate. He extinguished the government owned company Empresa Brasileira de Filmes (Embrafilme), which served as the main engine of the film industry in the country.[4] Not only did traditional film market protection instruments in Brazil cease to exist, but also public sources to finance the production and distribution of films in Brazil were drained. As a consequence, Brazilian film companies lacked resources to finance their projects, since they had no private funding options. Due to this scenario, these years are described as a time of collapse for the Brazilian film industry.[5] In the words of Melina Marson,[6] "the Brazilian government neglected the national culture".

Thanks to the country's administrative and economic reorganization during the second half of the 1990s, there was a renewed interest from private companies to invest in the movie theater business across the country, betting on the entertainment industry's growth.[7] However, unlike the decentralized distribution of the 1970s, the investment in the expansion of the number of cinemas in the 1990s prioritized large cities and concentrated on setting up theaters in newly built shopping malls. In twelve years, the number of cinema screens in the country had more than doubled, reaching 2,200 in 2009.

Despite the renewed interest from private companies, there was a perception in the early 2000s that the audiovisual industry would not be able to sustain itself without the direct intervention of the state through public policies to support the sector.[8] The extinction of Embrafilme, the low capacity of Brazilian companies to raise funds with financial institutions or investors, and the low professionalization of the sector were some of the factors that reinforced the perception that public policies were needed to avoid the demise of the Brazilian audiovisual production chain. As a result, the Brazilian National Cinema Agency was created.

Since then, the ANCINE accompanied the development of the film industry. Even with the growth in the number of movie theaters in Brazil, in 2009 the Agency diagnosed that there was still a shortfall in the supply of cinemas for the population, which was more significant in the Northern and Northeastern regions of Brazil, in small and medium cities, and in poor areas of large cities.

In 2009 Brazil had one cinema screen for every 88,000 inhabitants, while Argentina, for example, had one per 38,000 inhabitants and the United States achieved the stunning milestone of 8,000 inhabitants per screen. Considering only the Northern and Northeastern regions in Brazil, the ratio rose to 200,000 inhabitants per cinema screen. In addition, more than half of the screens in 2009 were located in its two largest cities, São Paulo and Rio de Janeiro. In short, the ANCINE found that Brazil had two problems concerning its movie theater distribution: (i) a small number of cinema screens per inhabitant; and (ii) an excessive concentration of movie theaters in the Southeast region, large cities, and shopping malls.

## A PLAN TO SOLVE THE PROBLEM

According to ANCINE, the average growth of 3.79 of the gross domestic product between 2002 and 2011, combined with the expanding middle class in Brazil, increased the demand for culture and consequently the need for public policies to foster cultural production. It is worth noting that the Brazilian Federal Constitution (art. 215) states the existence of a right to culture to be guaranteed to all Brazilians by the state. This scenario offered a great

opportunity to create an incentive program to increase investments in movie theaters in the country and to solve its distribution problem.

A comment on the general strategy of ANCINE for the development of the film industry is relevant in order to understand how the policy to be analyzed fits in a wider framework. The idea is that the most effective way to develop the film industry is by financing and fostering the whole productive chain, comprising production, distribution, and exhibition.[9] It is useless to produce a lot of films if they cannot reach a wide public, which is only possible by expanding the exhibition sector. The other way around, a wide public will generate more income and stimulate film production.

Based on the strategy above, on March 23, 2012, Law No. 12.599 was enacted, establishing the federal initiative "Cinema Close to You," an attempt to cope with the problem of concentration and the deficit in the number of movie theaters in Brazil. The policy focused on expanding the exhibition sector and the consumer base, considering the existence of a repressed demand of the ascending middle class (which also fits in with the general economic strategy of the Worker's Party government, from 2002 until the recent economic crisis). According to art. 9 of the statute, the initiative had four objectives:[10]

- to strengthen the film exhibition industry through incentives to companies operating in the sector;
- to facilitate access to movies in medium-sized cities and poor areas in large cities;
- to enable access to movies for the low-income population through policies aimed at lowering ticket prices; and
- to decentralize the movie theaters' distribution across the country, seeking to boost the development of cinemas in local consumer centers.

In spite of the law being enacted in 2012, the initiative "Cinema Close to You" actually started in 2009 when the National Bank for Economic and Social Development (Banco Nacional de Desenvolvimento Econômico e Social – BNDES) was accredited as a financing agent for the Audiovisual Sector Fund (Fundo Setorial do Audiovisual – FSA).[11] The Operating Agree-

ment signed by BNDES provided that the bank would act as a funding entity for the film exhibition market in Brazil, contributing significantly to the expansion of companies in the sector.

After appointing the main backer of the exhibition market expansion, Provisional Measure 491 was issued in June 2010 defining the program "Cinema Close to You." In 2011, Provisional Measure 491 was replaced with Provisional Measure 545, of equal content, and subsequently converted into Law No. 12.599 of 2012. In this sense, the beginning of the policy took place in 2009, and not in 2012, when Law No. 12.599 was enacted.[12]

The focus of the initiative lies in offering films in movie theaters located in areas inhabited by the poorest sections of the population, as a means of promoting social inclusion. Back in 2009, the perspective of the Federal Government was that the ascension of the lower-class population to the middle class would be the engine for the country's growth, as significant portions of the population would thus be able to acquire certain goods and services.

In short, the initiative seeks to trigger a process of decentralization and expansion of services supply in Brazil's audiovisual industry. To achieve these objectives, the initiative presented three instruments: (i) first, lines of credit and investment by BNDES for the construction and modernization of movie theaters in Brazil; (ii) second, tax incentives for the expansion and modernization of movie theaters; and (iii) third, a project called "Cinema for the City."

The construction of new movie theaters in selected regions would be funded by public entities. Between 2009 and 2012, the National Bank for Economic and Social Development and the Audiovisual Sector Fund provided approximately R$ 160 million[13] in loans and investment contracts for companies with headquarters and management in Brazil. While BNDES finances loans with interest below market interest rates, the ASF supports projects through co-financing, by having a share in the results of economic exploitation of movie theaters.

As for tax incentives, Law No. 12.599 created the Special Taxation System for the Development of Cinema Exhibition Activity in Brazil, also called, in Portuguese, RECINE, suspending the levy of taxes on the purchasing of

machinery, equipment, apparatuses, and building materials to be used in the construction or modernization of movie theaters.

Finally, the "Cinema Close to You" initiative created the program "Cinema for the City" for the Federal Government to invest resources in building cinemas in cities with populations of 20,000 to 100,000 inhabitants. This special program was designed because, according to the ANCINE, there is an inherent difficulty in building cinemas in cities with less than 100,000 inhabitants. The reason is purely economical. Companies in the exhibition market would not likely invest resources in building theaters in such cities due to the low return that the box offices might have. To circumvent this issue, government intervention should be direct, building theaters in partnership with local governments. After construction, the management of the theaters would be left to private companies, which would not be concerned with the return on investment. The local government would be responsible for choosing the private managing companies.

## MAIN OUTCOME OF THE INITIATIVE

Even though the initiative is recent, ANCINE[14] stipulated goals for the years 2012, 2013, and 2014. There were five proposed goals to be achieved by the end of 2014: (i) the opening of 600 movie theaters in the country with resources from the initiative; (ii) reaching the proportion of one cinema screen for every 60,000 inhabitants; (iii) the presence of movie theaters in all municipalities with over 100,000 inhabitants; (iv) a growth of 30% in volume of box office revenue in the country; and (v) the digitalization of half of the country's movie theaters.

Two observations must be made concerning the initiative goals and outcomes. The goals of digitalization and increasing the box office revenue are not clearly related to the diagnostic of the distribution problem, and the Agency does not explain in its official homepage why they were adopted. Hence, they seem to be lateral goals. For this reasons, we will not take these goals into account in our evaluation of the policy. To the contrary, although not expressed in any goal, the "Cinema for the City" program results should also be taken into account, since it was part of the initiative.

The data to evaluate the initiative's outcome may be found in the 2014 Annual Exhibition Market Monitoring Report, which provided an overview of the increase in the number of movie theaters in the country, its distribution between cities and states, and the number of digital projectors in Brazilian cinemas.

A broad conclusion can be drawn from the report. The policy partially succeeded in expanding the number of movie theaters and cinema screens in Brazil, but failed in decentralizing its distribution. The following charts support our conclusion.

**Table 1 – Exhibition sector general data**

| Variable / Year | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|---|
| Total number of screens | 2,110 | 2,206 | 2,352 | 2,517 | 2,678 | 2,833 |
| Total number of movie theaters | 647 | 662 | 686 | 701 | 721 | 746 |
| Number of screens per movie theater | 3.26 | 3.33 | 3.43 | 3.59 | 3.71 | 3.8 |
| Brazilian population | 193,543,969 | 195,497,797 | 197,397,018 | 199,242,462 | 201,032,714 | 202,758,031 |
| Cinema admissions | 112,670,935 | 134,836,791 | 143,208,012 | 146,593,494 | 149,518,269 | 155,572,656 |
| Cinema admissions per capita | 0.582 | 0.69 | 0.725 | 0.736 | 0.744 | 0.767 |
| Inhabitants per screen | 91,727 | 88,621 | 83,927 | 79,159 | 75,068 | 71,570 |
| Cities with movie theaters | 377 | 381 | 392 | 391 | 392 | 398 |
| % of cities with movie theaters | 6.80% | 6.80% | 7.00% | 7.00% | 7.00% | 7.10% |
| Digital screens | ND | ND | ND | 784 | 1.353 | 1.770 |
| 3D screens | 109 | 262 | 467 | 617 | 854 | 1,039 |

*Source: ANCINE – 2014 Annual Market Monitoring Report*

Concerning the expansion objective, goal (i) was not achieved, since, from the beginning of 2012 to the end of 2014, only 481 cinema screens were opened. Goal (ii) was also not achieved, since, in the end of 2014, there were 71,570 inhabitants per screen.

Notwithstanding the failure to fulfill the expansion goals, the advancement seems significant when one compares the figures of 2009 to 2014. The total number of screens grew 34.3%, from 2,110 to 2,833, and the number of inhabitants per screen fell from 91,727 to 71,570 (approximately 22%). On the other hand, the number is still far from the ratio of other countries already mentioned above, such as Argentina and the United States.

**Table 2 – Cinema screens distribution per region, 2009 – 2014**

| Region | Movie Theater Distribution per Year | | | | | | Share in 2014 | Evolution 2009/2014 |
|---|---|---|---|---|---|---|---|---|
| | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | | |
| Midwest | 214 | 198 | 203 | 213 | 239 | 245 | 8.6% | 14.5% |
| Northeast | 243 | 270 | 284 | 307 | 351 | 403 | 14.2% | 65.8% |
| North | 81 | 98 | 113 | 125 | 136 | 156 | 5.5% | 92.6% |
| Southeast | 1,220 | 1,270 | 1,353 | 1,440 | 1,497 | 1,574 | 55.6% | 29% |
| South | 352 | 370 | 399 | 432 | 455 | 455 | 16.1% | 29.3% |
| Total | 2,110 | 2,206 | 2,352 | 2,517 | 2,678 | 2,833 | 100% | 34.3% |

*Source: ANCINE – 2014 Annual Market Monitoring Report*

A more significant growth is observed in the number of cinemas in the North and Northeast regions of the country during the relevant period, as indicated in Table 2. These areas had the highest rates of expansion: in the last six years the Northern region saw a 92.6% increase in the number of movie theaters, whereas in the Northeast the increase was 65.8%. Despite the enormous growth in these regions, the hegemony of the Southeastern region remained intact, with 55.6% of all of the country's cinemas.

## Table 3 – Proportion of cities with movie theaters by number of inhabitants (city size) 2009-2014[15]

| City Size / Year | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|---|
| Less than 20,000 (very small) | 0.2% | 0.2% | - | 0.1% | 0.1% | 0.1% |
| 20,001 to 100,000 (small) | 13.4% | 12.5% | - | 12.7% | 12.0% | 12.0% |
| 100,001 to 500,000 (medium) | 62.7% | 66.9% | 68.2% | 68.8% | 68.3% | 69.7% |
| More than 500,000 (large) | 95.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |

*Source: Prepared by the authors with data from ANCINE – Annual Market Exhibition Reports from 2009 to 2014*

## Table 4 – Total number of cinema screens per city by number of inhabitants (city size) 2009-2014

| | 2009 | | 2010 | | 2011 | | 2012 | | 2013 | | 2014 | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Very Small | 10 | 0.5% | 9 | 0.4% | 7 | 0.3% | 6 | 0.2% | 5 | 0.2% | 5 | 0.2% |
| Small | 226 | 10.7% | 213 | 9.7% | 233 | 9.9% | 220 | 8.7% | 223 | 8.3% | 232 | 8.2% |
| Medium | 586 | 27.8% | 644 | 29.2% | 730 | 31.0% | 823 | 32.7% | 858 | 32.0% | 956 | 33.7% |
| Large | 1,288 | 61.0% | 1,340 | 60.7% | 1,382 | 58.8% | 1,468 | 58.3% | 1,592 | 59.4% | 1,640 | 57.9% |
| Total | 2110 | 100% | 2206 | 100% | 2352 | 100% | 2517 | 100% | 2678 | 100% | 2833 | 100% |

*Source: Prepared by the authors with data from ANCINE – 2014 Annual Market Exhibition Report*

If the objective of expansion was partially successful, the same cannot be said of the goal of decentralization. The data presented in the tables above reinforces the trend towards concentration regarding the movie theater market. Firstly, it should be noted that goal (iii) was also not achieved, since only 69.7% of the cities with more than 100,000 inhabitants had movie theaters by the end of 2014 (Table 3). It is also noteworthy that the percentage of medium-sized cities (between 100,000 and 500,000 inhabitants) with movie theaters grew only 7%, from 62.7% in 2009 to 69.7% in 2014 (Table 3), and that the percentage of cities with movie theaters in the country grew only 0.3%, from 6.8% in 2009 to 7.1% in 2014 (Table 1).

When it comes to small and very small cities (less than 100,000 inhabitants), the number of cinema screens remained almost the same, varying from 236 in 2009 to 237 in 2014 (Table 4). Moreover, the distribution of cinema screens in Brazil according to city size suffered only minor alterations: the medium-sized cities share grew 5.9%, the large-sized cities share decreased 3.1% and the small-sized cities share decreased 2.8% (Table 4). Regarding market share, large cities with over 500,000 inhabitants and medium-sized cities combined have more than 91.6% of the country's movie theaters.

**Table 5 – Share of cinema screens by region, 2009-2014**

| Region / Year | 2009 | | 2010 | | 2011 | | 2012 | | 2013 | | 2014 | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Midwest | 214 | 10.1% | 198 | 9.0% | 203 | 8.6% | 213 | 8.5% | 239 | 8.9% | 245 | 8.6% |
| Northeast | 243 | 11.5% | 270 | 12.2% | 284 | 12.1% | 307 | 12.2% | 351 | 13.1% | 403 | 14.2% |
| North | 81 | 3.8% | 98 | 4.4% | 113 | 4.8% | 125 | 5.0% | 136 | 5.1% | 156 | 5.5% |
| Southeast | 1,220 | 57.8% | 1,270 | 57.6% | 1,353 | 57.5% | 1,440 | 57.2% | 1,497 | 55.9% | 1,574 | 55.6% |
| South | 352 | 16.7% | 370 | 16.8% | 399 | 17.0% | 432 | 17.2% | 455 | 17.0% | 455 | 16.1% |
| Total | 2110 | 100% | 2206 | 100% | 2352 | 100% | 2517 | 100% | 2678 | 100% | 2833 | 100% |

*Source: Prepared by the authors with data from ANCINE – 2014 Annual Market Exhibition Report*

Table 5 shows that the distribution of cinema screens across regions has not changed significantly, in spite of the expressive increase in the number of screens in the Northern and Northeastern regions, shown in Table 2. The share of the Northern region in the total number of cinema screens in the country grew only 1.7% from 2009 to 2014, while the share of the Northeastern region grew 2.7% in the same period.

**Table 6 – Total number of cinema screens by location, 2009 – 2014**

| Location / Year | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | Share | Evolution |
|---|---|---|---|---|---|---|---|---|
| Shopping centers | 1712 | 1822 | 2002 | 2177 | 2343 | 2488 | 87.8% | 45.3% |
| Street | 398 | 384 | 350 | 340 | 345 | 345 | 12.2% | -13.3% |
| Total | 2110 | 2206 | 2352 | 2517 | 2688 | 2833 | 100.0% | |

*Source: ANCINE – 2014 Annual Market Exhibition Report*

Finally, one can see that the growth in the number of movie theaters in the country is directly connected to the construction of shopping malls. In the last six years, there has been a growth of 45.3% in the number of cinema screens in shopping centers. A very different scenario is found when it comes to street cinemas: in the same period, the number of cinema screens in street movie theaters in the country fell by 13.3%, as shown in Table 6.

Based on the data, it seems that the business model of large cinema chains in Brazil has established itself almost entirely in shopping centers. Although the number of screens is expanding, possibly as a result of the public policy,[16] it is clear that the policy has been unable to change the market tendency of where the theaters will be built. Therefore, when considering the location of the movie theaters, the last years have shown a strong process of concentration.

## Evaluating the legal policy

Our evaluation of the "Cinema Close to You" initiative is divided in two parts: (i) the program's effectiveness; and (ii) the existence of creative alternatives to promote access to movies.

### EFFECTIVENESS

As mentioned before, the policy did not achieve its goal of decentralization. We claim this is at least partially due to the fact that the lawmakers did not recognize the multiplex model trend in the cinema exhibition sector. In other

words, the policy failed, at least partially, for a lack of economic knowledge concerning the market.

From the late 1990s (after the resumption of domestic film production) and onwards, the complexity of movie theaters in Brazil underwent significant changes that affected how the investment in the sector is made. The exhibition sector in the country was taken over by foreign companies that operated under the model called "multiplex."[17] This model is characterized by offering a cinema structure integrated with other services like coffee shops, cafes, and restaurants, as well as parking lots. Its financial return depends on the operation of all services offered and not only on the exploitation of box office figures.[18]

The growth of the multiplex model has been reinforced by a change in the consumer's profile. According to Michel and Avellar,[19] Brazilian consumers recently began to search for movie theaters in the multiplex format and, as a consequence, many companies operating in the cinema exhibition market started to concentrate their investments on this model and on certain regions of the country. The change in the Brazilian consumer's profile seems to have followed an international tendency that started in the United States.[20] In other countries, it has been argued that the multiplex model actually helped restore the consumer's interest in cinema.[21] Many academic studies can be found arguing in this direction, as well as trying to measure the multiplex influence in consumer's habits and to explain how and why it increases the demand for movies.[22]

The leader of the film exhibition market in Brazil is the Cinemark group, with 594 theaters across 18 Brazilian states in 2015, almost 20% of the country's total numbers. The company's strategy is to build cinemas only in shopping centers or places with a similar service infrastructure.[23] This is justified because the box office is just one component of its service portfolio, which also comprises food services. In some places, the returns on food services may even exceed those obtained from the box office. The dominance of the multiplex model is so severe in the country that, among the 25 largest companies in the exhibition industry in Brazil, all have adopted the multiplex model.[24]

Notwithstanding its spectacular ascension throughout the country, promoting expansion, the multiplex model produces a concentration tendency. Firstly, because it cannot be easily adapted to small cities (less than 100,000 inhabitants), since it is not economically viable in those venues. Secondly, because the multiplex model is easily adapted to shopping centers, and shopping centers are a business model fit for medium or large cities of greater wealth. This helps to explain the enormous concentration of cinema screens in shopping centers (87.8% in 2014, Table 6) and the small increase in the number of cities with movie theaters from 2009 to 2014 (Table 1), as opposed to the great increase in the total number of cinema screens (Table 1). Finally, it is important to emphasize that shopping centers tend to be built not only in richer cities, but particularly in the richer areas of the cities. So the multiplex model also produces concentration within the cities.

Thus, the multiplex model explains, at least partially, the policy failure to decrease the concentration. It is noteworthy that public policy developers did not notice the complexity of the current market design, where companies have chosen not to invest in smaller or poorer cities because of the difficulty of implementing the multiplex model.

But this is not all. The multiplex model, as a market trend, also allows us to question whether the growth of the number of movie theaters was a result of the policy or a mere consequence of market forces. One can always say that the policy has played some role, but it may be the case that it was minimal. If this is true, the decision of publicly financing the building of movie theaters may be criticized, since private investors could have achieved similar results without the government's aid, and the scarce public resources could be spent elsewhere.

## ALTERNATIVES

When discussing access to movies, we might question what "access to movies" means and if there is only one way to deliver films to certain regions. Public policy developers assume that access is directly related to the availability of theaters in a city, without considering that nowadays the technological development allows us to deliver movies to consumers by alternative means.

Today, according to the Brazilian Institute of Geography and Statistics (IBGE) in its 2013 national survey of households sample (PNAD),[25] four out of ten Brazilian households (42.3%) already have internet access, while in 2008 it was only two out of ten (23.8%). According to a research conducted by the IBGE regarding the usage of media by Brazilian citizens,[26] 67% of the population uses the internet for leisure and entertainment, a scope that encompasses audiovisual works, such as movies and short films. On the other hand, even though internet users tend to utilize the web for leisure, there is a reasonably high disparity in Brazil regarding internet accessibility throughout the territory. A research conducted by the Brazilian Internet Steering Committee[27] reported that, while over 60% of households in the Southeast own a computer, this number drastically drops in regard to poorer regions, such as the North (30%) and Northeast (33%).

Despite the disparities, the growth of internet access and its use by the population cannot be overlooked in the debate about public policies for access to films in Brazil, since the medium offers an alternative to provide access to movies. In fact, it is a mistake to believe that movie theaters are the only way to grant access to movies. Access can occur in various forms, for example: television, personal computers, tablets, and even mobile phones. There are various forms of transmission such as open television signals, closed signals of pay-TV, and the internet. Maybe the public policy would have been more successful in its goal of decentralization if the concept of accessibility to films were broader and followed current technological developments.

It can be argued that video streaming services could provide access to films with similar quality to traditional film projectors without the need to build theaters for the exhibition. Even if the experience is not exactly the same as seeing a movie on the big screen, there are many advantages to streaming: the costs of delivering the movie are much lower and the prices for the consumer are reduced accordingly (compare, for example, the price of a session in a movie theater and the Netflix monthly subscription fee); more people can watch the movie at the same time; the film offerings may be more diverse, etc.

In spite of the streaming advantages, one could observe that the needed infrastructure to provide broadband internet access is more costly than build-

ing movie theatres. But it is worth noting that there is already a public policy to provide broadband internet access, the National Broadband Plan, created by Decree No. 7175 in May 2010. The resources spent building movie theaters could be used to develop a governmental streaming service or to foster the development of low-cost streaming services.

There are many issues that would need to be considered in more depth to assess the feasibility of a policy that would grant access to movies by using the internet. Nevertheless, this is an interesting discussion which is only possible if we expand the concept of movie exhibition and access to movies in ways the lawmaker has not yet considered. A renewed concept of access to movies, combined with the universalization of the access to the internet, may challenge the whole strategy of financing the exhibition sector.

## Conclusions

We have evaluated a legal policy drawing criticism based on economic knowledge and on the devising of creative alternatives to solve the issue, providing a different interpretation of the meaning of access to movies. By doing so, we hope to show that a legal policy may be understood and criticized by analyzing the social representations that are embedded in it.[28] In our case, ANCINE acted based on an economic representation of the film exhibition market that did not take the multiplex business model into consideration. The whole policy was also based on a social representation of what it means to access a movie, which was challenged based on current social practices and technological development.

Such assessment, that goes beyond the law and helps to shape its meaning (since access to movies is an instance of the right to culture set forth in the Brazilian Constitution), is essential and often lacking in legal education. It is precisely the kind of reasoning we encourage our students to make in "Social Representations of Law."

During the course, we also tell the students that our discussions never exhaust the subject or settle the matter. The same is true for the analysis provided here. Other reflections and questions could be raised about possible wrong winners:

(i) Some argue that the multiplex model also has the tendency of decreasing the variety of film offerings to the public, and that it helps to ensure the hegemony of Hollywood blockbusters. Does this affect the right to culture? How? What would be an appropriate legal way to ensure the variety of film offerings? Should we stop financing multiplex movie theaters?
(ii) Should we spend so much money on the film industry since there are other forms of culture? The electronic games industry, for example, according to some statistics, has surpassed the film industry. Should it be considered a form of culture? Should we have a Brazilian National Gaming Agency?
(iii) Should we provide incentives for the exhibition sector with public resources, since they profit from their activity?

The constant debate and thorough assessment of a devised legal policy, carried out by qualified and diverse participants, seems to be the only way to avoid picking the wrong winners.

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# ENDNOTES

**1.** Bachelor degree in Law at FGV DIREITO SP. Master degree in Law and Development at FGV DIREITO SP. Doctorate student at the Department of Technological and Scientific Politics at the University of Campinas (Unicamp). Coordinator of Teaching and Research Group in Innovation at FGV DIREITO SP. Professor of Law at FGV DIREITO SP.

**2.** Bachelor degree in Law at FGV DIREITO SP. Master and Doctoral degree in Philosophy at Law School at São Paulo University. Coordinator of Research Methodology at Center for Educacional Research and Innovation at FGV DIREITO SP. Professor of Law at FGV DIREITO SP.

**3.** Gomes and Santos Júnior, 2014, p. 25.

**4.** Gomes and Santos Júnior (2014) divide the production of Brazilian films in seven cycles by evaluating the participation of the Brazilian government in the development of the industry. According to the authors, there is a direct relationship between the growth of the film industry in Brazil and incentive policies promoted by the Brazilian government. The authors point out that a public policy of encouragement and protection of the film industry was set in the 1930s, when the Brazilian government edited Decree no. 21,240/1932, establishing a mandatory quota of films produced in Brazil to be exhibited in movie theaters. In addition to interventions by law enactment, the Brazilian government also created public companies, such as the Atlântica Empresa Cinematográfica do Brasil in 1941, the Companhia Cinematográfica Vera Cruz in 1949, and the Empresa Brasileira de Filmes (Embrafilme) in 1969, the last government-owned film company set up in the country. During the 1970s, Embrafilme assumed the jobs of coordinating and financing film production and distribution throughout the country. The extinction of the company in the early 1990s generated a void and a profound disorganization in the Brazilian film market.

**5.** Marson, 2006, p. 11.

**6.** Marson, 2006, p. 52.

**7.** The resumption of the Brazilian film industry began with the enactment of Law no. 8313/1991 (Rouanet Law), followed by Law no. 8685/1993 (Audiovisual Law). According to Gomes and Santos Júnior (2014, p. 25) the resurgence of the Brazilian film industry was characterized by a change in the government's role in financing film production. The direct

intervention model, started by the Brazilian government in the 1930s, was replaced by an indirect intervention model, where tax exemptions became the main instrument to promote the film industry's development. The Rouanet Law and the Audiovisual Law can be considered the synthesis of this change.

**8.** Luca, 2010, p. 70.

**9.** Mello, Goldenstein and Ferraz, 2013, p. 294.

**10.** In order to provide further information about the "Cinema Close to You" initiative, ANCINE offers various resources regarding the initiative on their official website http://cinemapertodevocê.acine.gov.br. In addition to a full description of the initiative, the players involved, and the strategic partners, the site offers reports, empirical data, and other documents relevant to the assessment of its achievements and results. Along with the official homepage "Cinema Close to You", ANCINE created the Brazilian Cinema and Audiovisual Observatory, which has the mission of providing data and market research on the national film industry. The Observatory provides a complete dataset on the complexity of movie theaters in the country since 2007. The main document with information on the film exhibition market in Brazil is the Market Monitoring Annual Report. Annually, the Agency publishes an overview of the exhibition market describing the results of its incentive policy and reiterating the reasons for the creation of their incentive to sectorial policies. For more information, see: <http://oca.ancine.gov.br/exibicao.htm>. Accessed on Feb. 04, 2016.

**11.** Mello, Goldenstein and Ferraz, 2013, p. 304.

**12.** Mello, Goldenstein and Ferraz, 2013, p. 304.

**13.** According to Mello, Goldenstein and Ferraz (2013, p. 306), between 2009 and 2012 R$ 124 million were granted to finance film exhibition companies in Brazil. In addition to funding, the bank and the fund have participated in transactions that raised R$ 35 million for companies in this sector in the same period.

**14.** It is possible to find a more in-depth description of the program goals between 2012-2014 on the official homepage of the "Cinema Close to You" program: <http://cinemapertodevoce.ancine.gov.br/objectives and goals->. Accessed on Feb. 24, 2016.

**15.** Some data from 2011 could not be used because the parameter was changed (cities with less than 50,000 inhabitants and cities with 50,001 to 100,000 inhabitants).

**16.** The data shown above is not sufficient to conclude that the expansion is a direct consequence of the policy. One would need to consider other possible factors contributing to the expansion, and verify how the resources of the policy were actually spent.

**17.** Michel and Avellar, 2014, p. 509.

**18.** Autran, 2010, p. 10.

**19.** Michel and Avellar, 2014, p. 509.

**20.** The story of the birth of the multiplex model is controversial and depends upon the disputed definition of "multiplex". Nevertheless, there seems to be a consensus that the model has been created in the United States. For a brief collection of possible origins of the multiplex model: <http://cinelog.org/cinelog/2009/06/27/the-many-births-of-the-multiplex/>. Accessed on Feb. 24, 2016.

**21.** For example, it has been said that the UK film industry was saved by the multiplex model: <http://www.theguardian.com/film/2010/nov/11/multiplex-cinemas-the-point-milton-keynes>. Accessed on Feb. 24, 2016.

**22.** See Sean A. Pager, "Beyond Culture vs. Commerce: Decentralizing Cultural Protection to Promote Diversity Through Trade", *Northwestern Journal of International Law & Business*, vol. 31, 2011; MSU Legal Studies Research Paper no. 12-06; Mark Niles and Naomi Mezey, "Screening the Law: Ideology and Law in American Popular Culture", 28 *Colum. J. L. & Arts* 91, 2005; Allan Collins, Chris Hand, and Andrew Ryder, "The Lure of the Multiplex? The Interplay of Time, Distance, and Cinema Attendance", *Environment and Planning A*, March 2005, vol. 37, no. 3, 483-501; Orietta Dessy and Marco Gambaro, "Demand for Movies in Europe and the Effects of Multiplex Diffusion: A Panel Approach", Feb. 1, 2009, Università degli Studi di Milano Working Paper no. 2009-03. Available at SSRN: <http://ssrn.com/abstract=1176542>. Accessed on Feb. 24, 2016.

**23.** Michel and Avellar, 2014, p. 511.

**24.** Michel and Avellar, 2014, p. 510.

**25.** Available at: <http://ibge.gov.br/home/estatistica/populacao/acessoainternet2013/microdados.shtm>.

**26.** IBGE, "Pesquisa Brasileira de Mídia 2015 – Hábitos de consumo de mídia pela população brasileira". The full report in Portuguese can be found at: <http://www.secom.

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**27.** CGI, "ICT Households 2014: survey on the use of information and communication technologies in Brazilian households". The full report in Portuguese can be found at: <http://www.cgi.br/media/docs/publicacoes/2/TIC_Domicilios_2014_livro_eletronico.pdf>. Accessed on Feb. 24, 2016.

**28.** The analysis provided here has at least some resemblance to the "institutional imagination" approach of Mangabeira Unger. See, for example, Roberto Mangabeira Unger, "Legal Analysis as Institutional Imagination", *The Modern Law Review*, vol. 59, no. 1, p. 1-23, Jan. 1996.

# TAXING MULTINATIONAL ENTERPRISES: BASIC ISSUES OF INTERNATIONAL INCOME TAX HARMONIZATION[1]

**John I. Forry**[2]

## Introduction

Multinational enterprises now devote considerable attention to compliance with and planning for the complex and often contradictory tax regimes in the countries in which they invest and do business. In recent years taxation of multinational enterprises has also received increased attention by national and international governmental bodies. Various groups within the United Nations, the Organization for Economic Cooperation and Development, the European Economic Community, and the United States Congress and Department of the Treasury are continually reviewing and developing guidelines for the taxation of multinational enterprises. Principal among their considerations have been the identification and harmonization of conflicting income tax systems and goals. This article summarizes – without detailed technical analysis – the basic issues and approaches involved in such international income tax harmonization.

## The impact of multiple taxing jurisdictions

### SOURCE VS. RESIDENCE TAXATION AND TAX NEUTRALITY

Income that arises in one country and then flows to another country – business profits, dividends, interest, royalties and so forth – is generally taxed by both countries according to their respective laws. The source country claims the right to tax the income on the grounds that the activities giving rise to the income occurred there, while the recipient's country claims the right to tax the income on the basis of the recipient's residence. If taxation by the two

countries is not coordinated, a heavier tax burden may be imposed on such income than on domestic income, with a consequent decrease in foreign trade and investment. If, for example, a royalty payment having a source in Country A bears a 30% withholding tax in that country and is also subject to a 50% tax in the recipient's country of residence, the aggregate tax burden with respect to the payment will be substantially higher than if the payment originated and was received in the recipient's home country. Alternatively, lack of co-ordination may grant income from foreign trade or investment unintended tax benefits, where, for example, income is free from tax in both the source and residence countries. In either event, taxation induces a distortion of allocation of capital among countries.

Double taxation often arises from rational but competing concepts of tax neutrality in residence and source countries. Most countries seek to effect some form of tax neutrality with respect to foreign trade and investment, so that such trade and investment are neither encouraged nor burdened by their respective tax systems. On the one hand, a country such as the United States may wish to tax each of its citizens, residents and domestic corporations on its worldwide income in order to avoid creating a tax incentive in favor of foreign investment over domestic investment. On the other hand, other countries may wish to tax equally income from similar assets or activities in the same physical locale or source, even though worldwide taxation by another country will reach the same item of income (in order to avoid preferring foreign investors over local investors). Many countries, including the United States, tax on both bases, with nonresidents generally subject only to source taxation.

## SOURCE AND RESIDENCE DEFINITIONS

Even while two countries tax principally on the basis of the source of income, their rules for determining the source may differ so that both tax the same item of income. For example, certain countries regard the source of royalty payments as the residence of the payor, while other countries consider the source to be where the property giving rise to the royalty is used. In addition, an enterprise organized under one country's laws and managed in another

country may risk treatment as a tax resident by both countries. However, in certain cases neither country's source rules may treat a specific item as having a local source, so that the payment may escape tax entirely. Certain countries, for example, have not taxed operations on their continental shelves on the theory that their taxing jurisdiction does not extend beyond the shoreline. Likewise the definition of a local establishment subject to source taxation often differs from country to country. In less likely circumstances, an enterprise may avoid tax residence in a country imposing worldwide taxation, and also may avoid taxation under source rules of countries from which it derives income.

## DOUBLE TAXATION OF CORPORATE EARNINGS

Many domestic tax systems purposely impose double taxation on corporate profits distributed to shareholders – once at the corporate level and once at the shareholder level. Such taxation is traditional within the United States tax system, as well as that of many other countries. This form of double taxation may be mitigated by reducing or eliminating the second level of taxation on dividends distributed to corporate shareholders. Such rules postpone the double taxation of income remaining in corporate solution until dividends are paid to individual shareholders, and facilitate at least intercorporate capital transfers. However, this tax benefit often is not extended to dividends received from a foreign corporation, resulting in an additional tax burden on foreign trade and investment. Even where countries have adopted integrated tax systems for distributions to individual shareholders, nonresident shareholders are often denied the benefit of the refunds or credits which effect the amelioration of the tax burden on corporate earnings.

## DIRECT VS. INDIRECT TAXATION: VALUE ADDED AND SALES TAXES

The economic impact of double taxation or the avoidance of tax varies – at least theoretically – with the kind of tax involved. A tax imposed on net income, such as gross receipts less investment and operation costs, is generally a direct tax – one which the tax payer is unable to pass on to his customer

because he is unable to predict the precise amount of tax at the time of the transaction. For a multinational enterprise engaged in substantially the same types of transactions over several years in substantially the same economic environments, this theoretical assumption is often false since the enterprise can predict its ultimate taxation with a fair degree of accuracy based on prior experience, and adjust its receipts accordingly.

On the other hand, it is generally assumed that an indirect tax – such as a sales tax or a tax on value added at each step of the production of an item by succeeding enterprises – is passed on to the customer and not borne economically by the producers. If both local products and imports are subject to the same local indirect taxes, theoretically both products are economically neutral so far as a local customer is concerned. In the same manner, exported products should be subject to no indirect taxation in the country of production (or such taxes should be refunded at export) and subjected to such taxation only in the country of destination, so that the products will compete equally with local products subject to the same tax in the destination country. This assumption is questionable where, for example, production costs in the country of origin or transportation costs between the countries result in higher costs to the foreign manufacturer, so that he cannot pass on the full burden of indirect taxation in the destination country. The economic impact of multiple taxing jurisdictions, while often involving primarily direct taxes, cannot be so limited.

## TAX INCENTIVES AND DISINCENTIVES

A country which taxes only local source income of its tax residents may provide a tax incentive to foreign trade and investment over domestic commerce to the extent tax rates abroad on the foreign activities are lower than domestic rates. A restrictive definition of tax residence also may permit a multinational enterprise to arrange its operations so that it is not currently taxable on foreign source income. For example, the United States generally has considered only those corporations organized in the United States to be taxable on their worldwide income. Accordingly, the use of foreign subsidiary corporations by United States enterprises generally defers the United States

tax on foreign operations until the income is repatriated. In addition, a country which taxes the worldwide income of its tax residents may nevertheless provide tax incentives or disincentives to foreign trade or investment by eliminating, reducing or increasing its tax on certain types of foreign source income or activities.

International income tax harmonization is complicated further by unilateral tax incentives and disincentives which bear little or no relation to the sound economic performance of multinational enterprises and reflect instead unilateral moral standards or sociological goals. For example, tax penalties and the denial of tax incentives for enterprises participating in certain religious or national boycotts or in certain foreign payoffs, regardless of economic distortion, have been proposed in the United States. Likewise a temporary local employment increase in spite of comparative inefficiency may be sought by discouraging investment abroad by local employers.

Finally, certain countries seek to encourage investment from abroad by providing tax exemption or reduced taxation of such investment. Such benefits may be extended to local branches of foreign enterprises, or only to locally organized subsidiaries of such enterprises. However, the efficiency of such incentives may be impaired in the absence of a similar tax credit or reduction against the home country tax on the worldwide income of the foreign enterprise.

Such local tax exemption may also be employed by a tax haven country simply to attract the organization of local subsidiaries to do business or hold investments in other countries, with license and professional fees being the principal benefit for the haven.

## TRANSFER PRICING

The lack of international tax harmonization may often be manipulated to the advantage of a multinational enterprise through pricing policies of related enterprises. By carefully arranging transactions between such related enterprises, high prices may be charged for goods and services flowing to an entity operating in a high tax country. For example, a subsidiary in a high tax country may be charged for raw materials at a price which greatly exceeds

the market price for the materials or the price charged for the materials to other subsidiaries in lower or no tax jurisdictions. In this case, the subsidiary's high cost of goods sold reduces its taxable income. In other cases, a parent enterprise may lend funds to a subsidiary in a high tax country at high interest rates. The additional interest costs also reduce the subsidiary's taxable income.

In reverse situations, the income of enterprises in low tax countries may be purposely increased. For example, the enterprise may sell goods to a subsidiary in a lower or no tax country at a lower price, perhaps even at a price resulting in a loss for the selling enterprise. Or it may lend money or provide services to such a subsidiary at no cost. In these cases, taxable income in the high tax country is held down while the subsidiary with which the dealings take place reaps the profits.

## TAX ADMINISTRATION, INFORMATION AND ENFORCEMENT

The multiplicity of rules for the taxation of multinational enterprises is further complicated by the difficulties of administration in the various countries involved. Generally the level of sophistication shown in the administration of a national tax system reflects the relative economic development of the country. Developing countries simply cannot devote the same number and quality of personnel to the administration of their tax systems as do most developed countries. Accordingly many countries lack the information and expertise to administer effectively their tax systems in the same manner as, for example, the Unites States. In certain cases these variations in administration are easily exploited by taxpayers using low or no tax jurisdictions and local secrecy laws. In other cases, however, developing countries have reacted to their administrative problems by imposing a broad range of restrictions on investments from abroad, including high withholding taxes on payments flowing out of the country.

Further difficulties arise from the traditional reluctance of countries to provide local information or enforcement for the fiscal laws of another country. The consequent uncertain manner in which the tax laws of a particular

country will be administered and enforced further distorts the flow of gods and capital among countries.

## Unilateral approaches to tax harmonization

The basic issues above underlie substantially all present and proposed approaches to the income taxation of multinational enterprises. Certain issues present contradictory goals so that one principle may compromise another. This is particularly obvious in choosing between the two basic principles of tax neutrality, or in adopting a tax incentive or disincentive rather than tax neutrality.

### CREDIT OR DEDUCTION FOR FOREIGN TAXES

One basic unilateral approach to international tax harmonization is to grant a deduction from worldwide income or a credit against the home country tax on foreign source income for foreign taxes paid on such income by the multinational enterprise. A deduction provides only partial harmonization, since the home country tax is reduced by only a portion of the foreign taxes. In the case of the foreign tax credit, if the foreign tax rate is lower than the home country rate, only the excess of the home country tax over the foreign tax on the foreign income is payable to the home country. If the foreign tax rate is higher, the home country foregoes tax on the income. However, the credit generally is limited to the amount of home country tax on the foreign income with respect to which the foreign taxes are paid, so the credit does not affect home country tax on domestic income. The home country may require the income and credit limitation of each foreign country to be calculated separately, or may permit high and low taxes of various foreign countries to be combined and so averaged over all foreign source income. The home country may also permit excess foreign tax to be carried over for possible credit in a prior or subsequent year.

Certain countries grant a credit only for foreign taxes imposed directly on the enterprise, such as taxes on foreign branch operations and withholding taxes on investment income. Other countries such as the United States

also allow an indirect credit for taxes paid by a substantially owned foreign corporation to the extent the previously taxed profits are distributed in the form of dividends to the parent corporation. The effect of the foreign tax credit, together with possible carryovers of excess credits to other years, is to subject the enterprise's foreign source income to total income taxes at least equal to the home country tax rate on domestic source income. Accordingly a tax incentive in favor of foreign over domestic investment is avoided.

However, double taxation often arises where an enterprise is required to compute taxable income in the country where foreign activities are carried on in a different manner from the computation in the enterprise's home country. For example, the home country may require deductions for expenses such as start-up costs while the source country requires the capitalization of those expenses, *i.e.* disallows a current deduction for the expenses. This frequently occurs in the conduct of mineral operations. In other cases, the home country may permit the enterprise to consolidate the income and losses from its entire operations while the source country of a particular income item may not allow the use of losses arising outside that country. Similar problems also arise where home and source country rules differ as to the determination of gross income. The home country may require the enterprise to report income on the accrual basis while the source country may allow the enterprise to report income only when it is actually received. In all of these cases, under a system which employs the foreign tax credit to eliminate double taxation of foreign source income and limits the credit in proportion to the amount of the enterprise's foreign source income as computed under the home country's rules, double taxation may continue. For example, where the home country requires deductions which are not allowed in the source country, the home country's foreign tax credit for the income taxed in the source country will be greatly reduced.

A contrary example of the lack of tax credit harmony is the deduction in the home country of a foreign source loss by a multinational enterprise without a carryforward of the loss under foreign law to reduce further foreign income taxes. Hence foreign creditable taxes in both years may remain high although a home country deduction was also taken for the loss. However, in the United States the recapture of tax on such a foreign loss out of future

foreign income by limiting the foreign tax credit on such income has been proposed.

Furthermore, from the viewpoint of a country which provides local tax exemptions or reduced taxation to encourage investment from abroad, the foreign tax credit is often defective in that the benefits of tax incentives accrue to the home country's treasury when the income is repatriated rather than to the multinational enterprise for which they were designed. One possible variation is to grant a home country credit not only for foreign taxes paid directly or indirectly by the enterprise, but for foreign taxes spared by the foreign country as part of its tax incentive program, *i.e*. a tax sparing credit. Another variation is the extension of a home country investment tax credit, or deductible investment allowance or investment reserve, to foreign investment by a multinational enterprise. In this case, as opposed to the tax sparing credit, the home country rather than the foreign country controls directly the amount of tax incentive.

## EXEMPTION METHOD

A second basic unilateral approach is to exempt all foreign source income from home country taxation, or apply reduced home country tax rates to such income. Certain countries use this method particularly where an establishment abroad is subject to foreign taxation, or a foreign subsidiary already subjected to foreign tax on its income remits dividends to the home country enterprise. In these cases, considerable attention is focused on the source of income so that losses or expenses which relate to exempted or reduced rate income are not charged against taxable domestic earnings. Tax neutrality is achieved in that the multinational enterprise is taxed by the foreign country substantially as are enterprises from other countries deriving income from similar assets or activities in the same physical locale or source. However, this method provides a tax incentive to foreign trade and investment over domestic commerce where the tax rates abroad on the foreign activities are lower than home country rates.

## CURRENT TAXATION OF SUBSIDIARY EARNINGS

Toward the opposite extreme, the principle of current worldwide taxation of home country residents on the basis of their respective abilities to pay may be extended so that even the income of a foreign subsidiary when earned is taxable on an accrual basis to its shareholders in their home countries. Various countries such as the United States, Canada and Germany have attempted to curb certain tax avoidance techniques by current taxation of domestic shareholders on certain types of undistributed income of foreign subsidiaries, particularly investment income and income generated by subsidiaries located in tax havens.

For example, if a foreign company is a controlled foreign corporation owned more than 50% in voting power or value by United States persons each owning 10% or more of the voting power, its income from transactions outside its home country with related enterprises and its passive investment income, among other categories, may be taxed currently to those shareholders and the benefit of deferral of taxation of its other income may be offset by such shareholders' gains on disposition of their shares being taxed as ordinary income. Likewise, current taxation to the trust grantor of income of certain foreign trusts created by United States persons has been enacted and current taxation to United States shareholders of all foreign subsidiaries' income has been proposed from time to time.

Taxation on such an accrual basis does not produce tax neutrality as among various investors in the same physical locale or source, since their home country taxation may vary substantially. However, substantial tax neutrality between foreign investment and domestic investment in the home country may be achieved if a foreign tax credit is provided for foreign taxes paid directly or indirectly on the accrued income.

## UNILATERAL REPORTING REQUIREMENTS

Both developed and developing countries may seek information on the income of multinational enterprises by imposing large penalties on nondisclosure of such information. For example, the United States has adopted requirements

that foreign financial institutions and other foreign enterprises must report annually to US tax authorities investments in those enterprises by US persons, principally so the authorities can confirm compliance with US taxation of worldwide income of those US persons – with enforcement of such reporting by levying a 30% withholding payment on distributions of US source income to non-reporting foreign enterprises. Such unilateral requirements and penalties may create significant burdens on multinational enterprises.

## Bilateral and multilateral approaches to tax harmonization

### Inadequacy of unilateral methods

The unilateral relief of double taxation automatically introduces a considerable degree of international income tax harmonization. However, unilateral measures are often inadequate or imperfect in dealing with certain important problems – technical limitations in the relief offered by national laws, the home country cost of bearing the principal tax loss where a foreign tax credit or deduction is used, high source country withholding taxes which lead to the loss of home country foreign tax credits, settlement of transfer pricing disputes, exchange of information and other matters.

The possibilities for reducing aggregate tax liabilities through transfer pricing have made such pricing the single most important issue in the taxation of multinational operations in recent years. The United States, for example, polices the charges imposed between related parties under "arm's-length" principles. Most other countries have adopted similar rules which, in general, require that related enterprises deal with each other as though they were unrelated.

The difficulty with the imposition of arm's-length standards on a unilateral basis is simply that two countries may disagree as to what is a proper arm's-length charge. Where income or deductions are redetermined by the tax authorities of one country, double taxation can occur if the other country does not make an offsetting adjustment. For example, if a parent enterprise in country A sells widgets to its country B subsidiary at $100 each, and the tax

authorities of country A determine that the sale price should have been $200 each (thus increasing A's income by $100 per widget), double taxation results unless country B allows the subsidiary to increase its cost of goods sold to $200 (from the $100 actually paid). Absent agreement between countries A and B, there will be double taxation of the same income and, depending on the tax rates involved, the total tax may equal or exceed the income on the transaction. Ironically it is precisely where country B's tax on the subsidiary is significant, so that tax reduction by shifting profits to the subsidiary is unlikely, that the highest double taxation will result. Most countries are simply unwilling to forego an increase in tax collections because of the failure of another country to make correlative adjustments in respect of their redeterminations of income. Problems of this nature can only be solved through bilateral agreements between taxing jurisdictions.

## BILATERAL TAX TREATIES

To resolve these questions effectively, many countries have entered into bilateral income tax treaties. The United States treaties, and the treaties of the other developed countries, generally follow the Draft Double Taxation Convention on Income and Capital adopted by the Fiscal Committee of the OECD. This model treaty and most other bilateral income tax treaties generally establish rules for:

- the determination of income (including allowable deductions) for branch operations in a country conducted by residents of the other country;
- the kind of activities giving rise to taxation in a country;
- the reduction of withholding taxes on dividends, interest and royalties;
- the establishment of arm's-length pricing rules;
- the taxation of income from personal services;
- the allowance of foreign tax credits or the exemption of income from tax;

- the exchange of information and establishment of dispute settlement and enforcement procedures; and
- non-discrimination protection.

The number of bilateral agreements dealing with these matters is rapidly increasing, and for the near future they will form the basis of further income tax harmonization.

## MULTILATERAL AGREEMENTS

Tax harmonization on a multilateral basis is developing more slowly. The members of the European Economic Community have placed the harmonization of tax systems and rates – including a uniform system of value added taxes and of integrated corporation and shareholder taxation – high on the agenda, as cited above.

An equally important development is now taking place with regard to international tax enforcement. The growing network of bilateral income tax treaties has set the stage for a multilateral exchange of information among countries having tax treaties with each other, and in certain cases information is already being so exchanged. The "Guidelines for Multinational Enterprises" issued by the OECD, cited above, also state with respect to taxation that multinational enterprises should:

- upon request of the taxation authorities of the countries in which they operate, provide, in accordance with the safeguards and relevant procedures of the national laws of these countries, the information necessary to determine correctly the taxes to be assessed in connection with their operations, including relevant information concerning their operations in other countries;
- refrain from making use of the particular facilities available to them, such as transfer pricing which does not conform to an arm's-length standard, for modifying in ways contrary to national laws the tax base on which members of the group are assessed.

While the guidelines are voluntary, they are considered to be appropriate in whole or part by a number of multinational enterprises, and express the growing multinational interest in increased taxpayer information and monitoring of intercompany transactions.

Certain multinational groups have imposed new restrictions on investment and trade from abroad, including tax disincentives, such as those under the Andean Investment Code. However, the expanded activities of the OECD and the UN in international income tax harmonization, cited above, seem likely to encourage individual countries to focus more on the benefits of such harmonization for both national tax revenues and increased investment from abroad.

## MULTILATERAL GUIDELINES

Recently the OECD – among other groups – has embarked on a project to recommend new guidelines for national income taxation of international activities to combat growing perceptions of base erosion of local source country income and profit shifting among related enterprises in different countries. Beginning in 2015, a series of recommendations to modify rules for attributing source of income to a particular country, modify benefits of income tax treaties, require country-by-country reports of worldwide revenues and assets of multinational enterprises, and other changes are being issued for consideration by all countries.

One significant risk of this project is that different countries will adopt different – or no – parts of such recommendations, so that a multinational enterprise will be taxed differently on the same items of income, expense and capital expenditure by two or more countries. Such differing rules – unless reconciled under income tax treaties or mandatory binding arbitration – may result in multiple taxation beyond the scope of foreign tax credits or other unilateral tax harmonization measures. Another risk is that such country-by-country reports will be disclosed beyond tax authorities to other regulators or competitors of multinational enterprises.

## Conclusion

Clearly the accommodation of the basic issues of multiple taxing jurisdictions, tax incentives and disincentives, transfer pricing, and tax administration and enforcement must generate further unilateral, bilateral and multilateral approaches to the income taxation of multinational enterprises. A successful accommodation may also alter the emphasis of such taxation, for a basic goal of most national income taxation of multinational enterprises in recent years has been prevention of tax reduction or avoidance. For example, high withholding taxes attempt to offset administrative difficulties, transfer pricing which shifts profits to a low tax country is penalized by potential double taxation upon redetermination, and the mandatory allocation of expenses to foreign source income reduces the home country foreign tax credit on income taxed at a lower foreign country rate.

However, where foreign tax rates commence to approximate or exceed the particular taxing country's rate, such prevention is less crucial. Furthermore, as export trade and foreign investment by a particular country become more nearly balanced or exceeded by important trade and investment from abroad, a tax rule mandating high export transfer pricing or allocation of substantial expenses to foreign source income conversely reduces the country's tax revenue on such inward trade and investment. Similarly, tax rules which may increase or accelerate the gain on a transaction due to a revaluation between two currencies will also increase or accelerate a tax loss on a devaluation. Accordingly a focus on economic neutrality in income taxation of multinational enterprises, rather than penalties or immediate tax maximization, may ultimately serve the interests of most countries.

# ENDNOTES

1. This paper is adapted and updated from "Taxing Multinational Enterprises: Basic Issues of International Income Tax Harmonization," 10 International Lawyer 623, 1976. Editors' note: For this book, the abstract was excluded.

2. Director of US Law & Policy Program for International Professionals & Professor in Residence, University of San Diego School of Law, A. B. Amherst College, J. D. Harvard Law School.

# EU FRAMEWORK FOR RESERVATION OF TITLE

**Michael Schillig**[1]

## Introduction

In 1993, Professor Robin Morse published a seminal article in the *Journal of Business Law* on "Retention of Title in English Private International Law." The article attempted to identify and discuss the difficulties that retention of title clauses may give rise to in a conflict of laws context and to suggest a framework of analysis which may help to resolve these issues.[3] Since the article has been published, the regulatory landscape in Europe has changed considerably with the Rome I and Rome II Regulations,[4] and most importantly with the EU Insolvency Regulation of 2000 (EUIR),[5] which has been reformed and has recently been recast (EUIR 2015).[6]

The effectiveness of reservation (or retention) of title clauses under any particular legal system depends on the applicable law of contract, on (personal) property law, and on the law of insolvency. The *raison d'être* of these clauses is their enforceability and effectiveness in the debtor's insolvency.[7] In a transnational or cross-border context, proprietary issues and insolvency law issues – and therefore the efficacy of these clauses – will almost always be determined according to a law other than the law under which they have been contractually agreed. This is due to the *lex situs* principle applicable to proprietary issues in international transactions[8] and the principle of *lex fori concursus*, subject to various carve-outs, in international insolvency law, notably pursuant to art. 3 and 4 of the EUIR (art. 3 and 7 EUIR 2015). This is of considerable practical significance: retention of title clauses are used widely in intra-EU trade, and even in an area as integrated economically as the European Union the treatment that these clauses in their various forms receive in different jurisdictions varies considerably.[9] Despite art. 9(1) of Directive 2011/7/EU on combating late payment in commercial transactions,[10] member states do not even have to provide for a simple reservation of title to be

effective under their laws. As Recital 31 of that Directive clarifies,[11] member states' laws merely must give effect to a foreign simple retention of title clause if under the law of the member state, applicable pursuant to private international law, a domestic retention of title clause would be effective.[12] Where a reservation of title clause is extended so as to secure not just the purchase price but all open claims owed by the buyer ("all monies clause'", or the seller's ownership right is meant to be extended into a product newly manufactured by the buyer ("manufacturing clause"), or the security extends so as to attach to the receivables or proceeds obtained by the buyer by virtue of a sub-sale ("proceeds clause") the picture is even more diverse and complex.[13] Where goods cross borders it can easily happen that, in the buyer's or seller's insolvency, the effectiveness of the counterparty's proprietary protection is significantly weakened or, due to a lack of compliance with formal requirements, completely disappears.[14]

This paper seeks to give a flavour of this diversity and the complexity that even simple transactions may give rise to in the insolvency context. It considers both the substantive law and the relevant conflict of laws rules in England and Germany, taking into account the European legal framework. Uncertainties lurk in many corners and overall the situation appears to be unsatisfactory. The paper does not provide any ready solutions; it merely highlights the underlying issues in an attempt to encourage further discussion.

## Simple reservation of title

Under the Sale of Goods Act 1979 (SGA), property in specific or ascertained goods passes from the seller to the buyer at such time as the parties to the contract intend it to be transferred.[15] In the absence of a specific agreement in this respect, property in specific goods[16] passes to the buyer when the contract is made.[17] Property in unascertained goods[18] passes with unconditional appropriation to the contract.[19] The legal basis for retention of title is SGA, sec. 19(1):

> "Where there is a contract for the sale of specific goods or where goods are subsequently appropriated to the contract,

> the seller may, by the terms of the contract or appropriation, reserve the right of disposal of the goods until certain conditions are fulfilled; and in such a case, notwithstanding the delivery of the goods to the buyer […] the property in the goods does not pass to the buyer until the conditions imposed by the seller are fulfilled."

Thus, on the basis of the general principle embodied in SGA, sec. 17 and the specific elaboration in SGA, sec. 19(1), a contract for the sale of goods may provide that property shall pass only when the buyer has paid the price in full. Until then the seller remains the owner of the goods and has the best title to them recognised by law, subject, however, to the terms agreed in the contract between the parties. Extensive rights on the part of the buyer and limitations on the remedies of the seller are not incompatible with the notion of legal ownership. As a consequence, simple retention of title clauses successfully, if temporarily, protect the seller: the seller can reserve legal ownership of goods supplied to the buyer.[20]

In the buyer's insolvency, the seller may repossess the goods if the buyer is in liquidation or administration, however only after having obtained leave of the court,[21] which will normally be granted.[22] The seller must be able to identify the goods as of his manufacture and as unpaid for; he must be able to show to the satisfaction of the insolvency practitioner that the goods he claims can be linked to a specific invoice recorded as unpaid in the buyer's records. Without identification a claim will not be successful. Lack of identification accounts for the rejection of the vast majority of claims and is one of the most hotly contested issues in practice.[23] The administrator may, with leave of the court, dispose of assets subject to a reservation of title clause.[24]

By contrast, in the seller's insolvency, short of paying in full prior to commencement of insolvency proceedings, the buyer will usually depend on the mercy of the insolvency practitioner, even if he has already paid almost the entire sales price. This is because prior to full payment the buyer will not have a proprietary interest in the goods. Because the Sale of Goods Act 1979 is considered to be a complete code for the transfer of property under a contract of sale, goods sold under a contract of sale are considered not to

vest in equity in the buyer.[25] Thus, the seller's liquidator or administrator can either disclaim the contract or decline to procure performance, in which case the buyer may exercise any right he may have to terminate the contract for non-performance. In any case, the contract comes to an end, and the buyer will end up as a general unsecured creditor with a claim for damages.[26]

Under German law, absent a delivery substitute,[27] property passes from seller to the buyer when both parties agree that property shall pass and the goods are delivered, *i.e.* possession transferred, to the buyer.[28] In addition to the contract for sale, German law requires a separate agreement, the so-called "real agreement" in order to effectuate the actual change in the allocation of proprietary rights (disposition), together with the actual physical delivery of the goods.[29] A simple retention of title is the insertion of a condition subsequent of full payment[30] into the real agreement. Where such a condition was not agreed in the contract, its insertion into the real agreement may amount to a breach of contract, but would still be effective in proprietary terms. The seller remains the owner until full payment. He may repossess the goods on the basis of the *rei vindicatio* upon termination of the contract.[31] In the buyer's insolvency the seller under a simple reservation of title clause has a right to separate satisfaction, leaving him completely outside the insolvency process and able to enforce his proprietary interest undisturbed by the insolvency proceedings.[32] In the seller's insolvency, the buyer does not remain unprotected. Even prior to the payment of the last instalment, he holds a "proprietary expectancy" in the goods sold under retention of title, which is a lesser form of proprietary interest similar in kind to ownership.[33] This proprietary expectancy increases in strength with the amount paid towards the purchase price. It may be transferred, used as collateral and is protected in the same way as ownership is. Consequently, in the seller's insolvency the buyer can force the liquidator or administrator to complete the contract if he is in possession of the goods, provided he pays the outstanding purchase price.[34]

On the basis of this treatment of reservation of title clauses under different national substantive laws, we can now formulate a simple hypothetical cross-border scenario with a number of variations:

- A German seller sells and delivers goods to an English buyer,[35] prior to full payment of the purchase price:
  - The buyer goes into administration, and the seller seeks to retrieve the delivered goods;
  - The seller goes into insolvency proceedings; the office holder rejects the contract and seeks to retrieve the goods, whilst the buyer wishes to complete the sale.
- An English seller sells to a German buyer, prior to full payment of the purchase price:
  - The buyer goes into insolvency proceedings, and the seller seeks to retrieve the delivered goods;
  - The seller goes into administration, the administrator rejects the contract and seeks to retrieve the goods, whilst the buyer wishes to complete the sale.

Absent a choice of forum clause, it will usually be the court of the member state where the buyer is domiciled that has international jurisdiction to hear an action based on reservation of title brought by the seller. This follows from art. 4, 63 of the Brussels I Regulation.[36] In *German Graphics*, the Court of Justice held that an action by a seller against an insolvent buyer on the basis of a reservation of title clause is not so closely connected to the insolvency proceedings that this action would be covered by under art. 1(2)(b) of the Brussels I Regulation, excluding proceedings relating to insolvency from its scope of application.[37] Thus, in scenario i.a. (German seller, English buyer in administration) English courts would have jurisdiction; whereas in scenario ii.a. (English seller, German buyer in insolvency) jurisdiction would lie in Germany.[38] In the reverse scenarios (i.b. and ii.b.), where the office holder in the seller's insolvency seeks to retrieve the goods from the buyer who in turn would like to complete the sale, international jurisdiction is determined by art. 4, 63 of Brussels I. Although completion may only be in doubt because of the insolvency official's power, under general principles of insolvency law, to either assume or reject an executory contract, there is no close link to the insolvency proceedings and it would seem to be quite inappropriate to compel the buyer-defendant to appear before a foreign forum. Thus, art.

2 and 60(1) of the Brussels I Regulation would point towards England in scenario i.b. (German seller in insolvency, English buyer) and, respectively, Germany in scenario ii.b. (English seller in administration, German buyer), provided that the buyers have their respective domiciles in these countries.

In each alternative, two questions need to be distinguished: who may initiate and effectuate the realisation of the goods subject to a reservation of title clause; and how are the proceeds so realised to be distributed (realisation and distribution). The starting point in each case is the *lex fori concursus* pursuant to art. 4(1) of the EUIR (art. 7(1) EUIR 2015), which applies in particular to the question as to which assets form part of the insolvency case,[39] subject to the choice of law carve-outs.[40]

Consider scenario i.a. (German seller, English buyer in administration): the English courts have jurisdiction[41] and English insolvency law applies,[42] in particular the English court will have to consider whether to grant the seller leave to repossess assets delivered under retention of title.[43] Art. 7(1) EUIR (art. 10(1) EUIR 2015), providing that the opening of insolvency proceedings does not affect the seller's rights under a reservation of title clause, does not apply because in our scenario the goods are in the member state where insolvency proceedings have been opened (England). As a preliminary question, it must be considered, however, whether there is an effective reservation of title clause. This is to be determined on the basis of the relevant conflicts rule of the *lex fori*, thus on the basis of English private international law. The first issue is how reservation of title is to be classified.[44] A sale encompasses both contractual and proprietary elements. The contractual aspect, whether the retention of title clause has been validly agreed and incorporated into the contract, is contractual in nature and the relevant conflict of laws rules are to be determined on the basis of art. 3 and 4 of the Rome I Regulation. Thus, in the absence of a choice of law clause, the law that governs a contract for a sale of goods is the law of the country where the seller has its habitual residence;[45] in our scenario, German law applies. The proprietary aspects of a sale, in particular whether or not title passes from seller to buyer, is determined by the conflicts rule on property. This is the *lex situs* at the time the transfer took place. A title validly acquired (or retained) under the *lex situs* will remain effective when the goods are transferred to a new *situs*

unless or until that title is overridden by a transaction taking place at the new *situs*, and on that basis the law at the new *situs* regards the original title to be extinguished and a new title as being conferred.[46] In our scenario, the *lex situs* rule refers to German law (where title was retained), including German private international law,[47] which follows *lex situs* referring to German substantive law.[48] Consequently, provided the reservation of title clause is effective under German law, this has not changed with delivery to England.[49] English law recognises the simple reservation of title. Thus, public policy does not intervene and would be prevented from doing so on the basis of art. 4 of Directive 2000/35/EC. Thus, as a consequence, the reservation of title is effective in the buyer's administration in England. However, the administrator may apply to the court to dispose of the goods,[50] or the court may refuse to grant leave to repossess where the goods are required for achieving the purpose of the administration[51] (realisation). In any case, the seller will have a preferential claim to the value of the goods up to the amount of his claim[52] (distribution).

Now consider scenario i.b. (German seller in insolvency, English buyer): the English courts have jurisdiction[53] and, in principle, German insolvency law applies.[54] The nature and extent of the seller's and buyer's proprietary interests is to be determined on the basis of the relevant conflicts rule of the *lex fori*, perhaps modified by the *lex concursus*. Whether the buyer has a proprietary expectancy is to be determined on the basis of the relevant conflicts rule of the English forum: *lex situs* at the time the alleged transfer took place.[55] Since a proprietary expectancy requires real agreement and delivery (as a lesser form of ownership)[56] this would refer to English law (where delivery took place). English law does not recognise the "proprietary expectancy" nor, in the case of a sale of goods, an equitable interest as the functional equivalent. However, this does not matter where art. 7(2) EUIR (art. 10(2) EUIR 2015) applies. If, after the delivery of goods, insolvency proceedings are opened against the seller, the opening of proceedings does not prevent the buyer from acquiring title in the goods provided they were situated in a member state other than the state of the opening of proceedings. This is not a conflicts rule, but a substantive provision of insolvency law, ensuring that the purchaser can acquire title regardless of the opening

of proceedings. The effect is the same as under InsO, §107(1): the buyer may request completion of the transfer of title provided the goods were sold under a reservation of title clause and the buyer has received possession of the goods prior to commencement of insolvency proceedings. The provision refers to the proprietary expectancy acquired by the buyer prior to paying the final instalment.[57] Thus, subject to the prerequisites of art. 7(2) EUIR (art. 10(2) EUIR 2015), our English buyer can obtain title in, and keep, the goods provided he pays the outstanding instalments to the German office holder.

Turning to scenario ii.a. (English seller, German buyer in insolvency): German courts have jurisdiction,[58] and German insolvency law applies.[59] Prior to the payment of the final instalment, the German office holder may assume the contract, pay the outstanding instalments and acquire ownership; or else, reject the contract.[60] In the latter case, retention of title gives a right to separation[61] and a seller has the right to retrieve and repossess the goods outside of the insolvency proceedings on the basis of his standard non-insolvency remedies.[62] Art. 7(1) EUIR (art. 10(1) EUIR 2015), ensuring that the opening of insolvency proceedings against a buyer does not affect the seller's rights under a reservation of title clause, does not apply where at the time of the opening of proceedings the goods where situated in the member state where insolvency proceedings have been opened. As a preliminary issue, there must be an effective reservation of title clause. This is to be determined on the basis of the *lex situs* where the goods are situated,[63] thus German law, including the German conflicts rule that title validly acquired or retained under a previous *lex situs* remains effective where assets have been moved to Germany, although these rights may not be exercised contrary to the German legal order.[64] Given that Germany recognises the simple reservation of title clause, a valid English reservation of title would be effective in the German buyer's insolvency. Consequently, where the German office holder either rejects the contract or accepts it but does not pay the outstanding instalments, the English seller may repossess the goods in the German insolvency.[65]

Finally scenario ii.b. (English seller in administration, German buyer): German courts have jurisdiction,[66] and English insolvency law applies.[67] The question is whether the buyer in Germany has any proprietary interest in the goods; if not the goods are part of the seller's assets and the administrator

may either assume the contract and collect the outstanding proceeds, or claim the assets for the administration without the buyer being able to force completion of the contract. The relevant conflicts rule of the German forum is *lex situs* where the goods are situated, thus German substantive law. Under German law, the buyer under a reservation of title clause obtains a proprietary expectancy upon delivery of the goods and prior to the payment of the entire sales price. Moreover, pursuant to art. 7(2) EUIR (art. 10(2) EUIR 2015) the buyer has the right to complete the transfer of title (by paying the outstanding instalments), may keep the goods and the administrator is prevented from walking away from the contract.

## "All monies clause"

In *Armour v Thyssen Edelstahlwerke AG*[68], the German supplier to a Scottish company of steel relied on the following clause translated from German:

> "All goods delivered by us remain our property (goods remaining in our ownership) until all debts owed to us including any balances existing at relevant times – due to us on any legal grounds – are settled. This also holds good if payments are made for the purpose of settlement of specially designated claims. Debts owed to companies, being members of our [group], are deemed to be such debts."

The clause encompasses not just all debts owed by the buyer to the seller, but also debts owed by the buyer to companies belonging to the same corporate group as the seller. On the basis of SGA, sec. 17 and 19(1), it was held that a condition in the terms of the contract to the effect that the property in the goods did not pass to the buyer until all debts due to the seller by the buyer have been paid was a legitimate retention of title and did not create a right of security.[69] It may be inferred from the decision that it is open to the parties to agree to whatever conditions they desire in restricting the transfer of property, including the payment of debts owed by the buyer to companies associated with the seller.[70]

Under German law, the condition subsequent inserted into the real agreement, similarly, allows for making the transfer of ownership, in principle, dependent upon the payment of additional debts other than the initial purchase price (*Kontokorrentvorbehalt*).[71] However, an extension of the clause so as to encompass claims owed by the buyer to a third party, in particular an affiliate, subsidiary or parent company of the seller (*Konzernvorbehalt*), would be invalid pursuant to BGB, §449(3). Moreover, as soon as the original purchase price has been paid and the reservation of title merely secures debts other than the purchase price, the seller's ownership right is recharacterised in the buyer's insolvency and treated like a security interest proper (pledge).[72] Consequently, the seller no longer has a right of separation, but only a right to preferential satisfaction out of the proceeds of the sale of the collateral.[73] The office holder has the power to realize the value of tangible moveable assets within his possession.[74] This power can be invoked as a defence against the seller's enforcement attempts. Consequently, he can no longer repossess the goods as such, but has a claim to the net proceeds, which must be applied with priority for discharging the amounts owed to the seller that are covered by the all monies clause.

We can now reformulate our scenarios:

- A German seller sells and delivers goods to an English buyer under an all monies clause:
  - After the purchase price, but not all outstanding debts, has been paid the buyer goes into administration, and the seller seeks to retrieve the delivered goods;
  - The seller goes into insolvency proceedings, the office holder rejects the contract and seeks to retrieve the goods, whilst the buyer wishes to complete the sale.
- An English seller sells and delivers goods to a German buyer under an all monies clause:
  - After the purchase price, but not all outstanding debts, has been paid the buyer goes into insolvency proceedings, and the seller seeks to retrieve the delivered goods;

– The seller goes into administration, the administrator rejects the contract and seeks to retrieve the goods, whilst the buyer wishes to complete the sale.

In scenario iii.a. (German seller, English buyer in administration), English courts have jurisdiction[75] and English insolvency law applies.[76] The validity of the reservation of title is to be determined on the basis of German substantive law.[77] Given that English law recognises an all monies clause, such a clause validly agreed under German law retains its effectiveness in the English administration. Now assume that the all monies clause included claims owed to the seller's affiliates (*Konzernvorbehalt*) and that these third-party claims are the only ones remaining unpaid. BGB, §449(3) renders the condition subsequent in the real agreement void to the extent that the condition relates to the payment of third-party claims; not however the contract of sale as such, neither the real agreement (including the simple reservation of title clause and all monies clause).[78] The question is whether BGB, §449(3) is to be characterised as contract law or property law. If the former, the Rome I Regulation would apply with the consequence that the parties could choose English law,[79] subject only to overriding mandatory provisions[80] to which BGB, §449(3) is unlikely to belong. However, given the direct and immediate impact on the reservation of title, it seems to be preferable to characterise BGB, §449(3) as property law, with the consequence that it applies regardless of whether the contract is governed by German law or not. To the extent that the clause makes the transfer of property dependent on the payment of third-party claims it will be void. This does not change when the goods are delivered to the buyer in England. With payment of all outstanding debts other than those owed to affiliates the buyer obtains good title to the goods. This is on the basis of English substantive law.[81] The seller's affiliates will thus be unsecured creditors in the buyer's insolvency.

As for scenario iii.b. (German seller in insolvency, English buyer), the buyer cannot rely on art. 7(2) EUIR (art. 10(2) EUIR 2015) since this provision only applies to a simple reservation of title clause.[82] Extended reservation of title clauses, including an all monies clause, would come under art. 5(1) EUIR (art. 8(1) EUIR 2015), insulating rights *in rem* of creditors from the

effect of an opening of insolvency proceedings. However, our English buyer cannot rely on art. 5(1) EUIR (art. 8(1) EUIR 2015). This is because, according to the principles set out in scenario i.b. above, the buyer does not have a proprietary expectancy and, thus, no right *in rem*. German insolvency law applies.[83] However, InsO, §107(1) also requires a proprietary expectancy, in the absence of which InsO, §103 gives the German office holder the choice to either assume or reject the contract. The English buyer cannot compel the office holder to complete the transfer. Consequently, the German office holder may retrieve the goods from the buyer.

Scenario iv.a. (English seller, German buyer in insolvency) is to be resolved in the same way as scenario ii.a. above. The difference is, however, that with payment of the initial purchase price, the seller merely has a right to preferential satisfaction (not a right to separation). The outcome may be different where the all monies clause is extended so as to also secure claims of the seller's affiliates (*Konzernvorbehalt*). Under the *lex situs* at the time of the transaction (English law), this would be effective. However, when moving the goods to Germany art. 43(2) EGBGB applies: German law does not recognise the extension of an all monies clause so as to cover the claims of affiliates of the seller (*Konzernvorbehalt*); seeking to enforce an all debts clause in respect of such claim would be contrary to the German legal order. As a consequence, in respect of the affiliates' outstanding claims they will be unsecured creditors in the buyer's insolvency.

In scenario iv.b. (English seller in administration, German buyer), art. 7(2) EUIR (art. 10(2) EUIR 2015) does not apply because we have an all monies clause as an extended reservation of title. However, given that the buyer has a proprietary expectancy,[84] art. 5(1) EUIR (art. 8(1) EUIR 2015) comes to the buyer's rescue. The buyer may exercise his right *in rem* as if the insolvency proceeding has not been opened. Thus, the seller's administrator cannot reject the contract and reclaim the goods for the administration; instead the buyer may compel the administrator to complete the transfer of property. Moreover, where in case of an all monies clause securing also the claims of the seller's affiliates (*Konzernvorbehalt*) the buyer has paid all outstanding debts other than the affiliates' prior to commencement of proceedings he will have acquired good title already and may, thus, keep the goods. Payment of

the amount outstanding on debts other than affiliates' claims constitutes a new and overriding transaction under the law of the new *situs* which includes BGB, §449(3).

## Manufacturing clause

In *Clough Mills* Robert Goff LJ (as he then was) considered, *obiter*, the effects of a manufacturing clause, seeking to extend the seller's retained ownership right to a new product manufactured by the buyer out of the delivered goods. Goff LJ's view was that, where the seller's material is lawfully used by the buyer to create new goods, whether or not the buyer incorporates other material of his own, the property in the new goods would generally vest in the buyer. But there was no reason not to give effect to an agreement between the parties that the property in the new goods shall vest in the seller. On this analysis, under a manufacturing clause property in the new goods would *ipso facto* vest in the seller when they come into existence, and the seller would thereafter retain its ownership in them. However, it has to be taken into account that the buyer may have paid part of the price for the material, that he may have borne (parts of) the cost of manufacture of the new goods, and may also have provided other materials for incorporation into those goods. As long as the seller is bound to account to the buyer for any surplus he may obtain under the contract no injustice need arise. The problem is that upon termination of the contract the ownership of the seller in the new goods would be retained uninhibited by any terms of the contract which would cease to apply. It was impossible to believe that the parties could have intended that the seller would gain the windfall of the full value of the new product, without any duty to account to the buyer for any surplus above the outstanding balance. Therefore, the manufacturing clause in this case had to be read as giving rise to an equitable charge on the new goods in favour of the seller.[85] Consequently, it is probably fair to say that under English law a manufacturing clause will almost always be treated as creating a mortgage or charge that will be unenforceable for lack of registration if the buyer is a company incorporated under the Companies Act 2006.[86] However, as was indicated in *Clough Mill* and other cases, the parties may agree that

the new thing should belong, from the moment of its creation, to the seller rather than the buyer.[87] The limitation on parties' freedom of contract in this respect appears to derive from a desire to prevent a (presumably) unintended windfall gain on the part of the seller.[88]

German law has considerably less problems with manufacturing clauses. Pursuant to BGB, §950, the manufacturer of a new movable corporeal thing will be the owner of that thing. In principle, therefore, the buyer would, by operation of law, become the owner of newly manufactured goods; the reservation of title in the raw material would be extinguished. However, although BGB, §950 is deemed to be mandatory, the Federal Court of Justice accepts that parties may define amongst themselves who the manufacturer is.[89] A manufacturing clause is then simply a stipulation in the contract to the effect that the buyer will manufacture any new goods from the delivered material on behalf of the seller who will be the manufacturer and consequently acquire ownership in the new product *ipso iure* pursuant to BGB, § 950. The buyer's initial proprietary expectancy comes to an end.[90] However, the manufacturing clause may be interpreted as containing a clause to the effect that the seller transfers *brevi manu*[91] to the buyer ownership in the new product subject to the condition subsequent of full payment. Where the manufacturing clauses of more than one supplier collide, the sellers acquire co-ownership in the new product proportionate to the value of the goods that they contributed.[92] Similarly, seller and buyer may agree to become co-owners in the new product in proportion to the value of their respective contributions.[93] In the buyer's insolvency the seller's interest in the new products is recharacterised and will not give rise to a right to separation; instead it will be treated as a security interest proper (pledge) giving only a right to preferential satisfaction.[94]

A further modification of our scenarios is in order:

- A German seller sells and delivers goods to an English buyer under a manufacturing clause:
  - Before payment of the purchase price, and after the delivered goods have been turned into a new product, the buyer goes into administration, and the seller seeks to invoke an interest in the new product;

  - The seller goes into insolvency proceedings, the office holder rejects the contract and seeks to seize the new products, whilst the buyer wishes to complete the sale.
- An English seller sells to a German buyer under a manufacturing clause:
  - Before payment of the purchase price, and after the delivered goods have been turned into a new product, the buyer goes into insolvency, and the seller seeks to invoke an interest in the new product;
  - The seller goes into administration, the administrator rejects the contract and seeks to seize the new products, whilst the buyer wishes to complete the sale.

In scenario v.a. (German seller, English buyer in administration), English courts have jurisdiction, and English insolvency law applies. The preliminary question whether the seller has a proprietary interest in the new product has to be determined under the *lex situs* of the English forum. The manufacturing took place in England and constitutes an overriding transaction at the new *situs*, regardless of whether the manufacturing clause had been validly agreed under German law. Under English law the manufacturing clause is likely to be recharacterised as a registrable charge which, for lack of registration, will be unenforceable vis-à-vis the administrator and other creditors.[95] Thus, the seller will likely be an unsecured creditor in the buyer's administration.

In scenario v.b. (German seller in insolvency, English buyer), the English courts have jurisdiction as regards the office holder's action to seize the new products, whilst German insolvency law applies. The question is whether the buyer has a proprietary interest in the new product. The relevant conflicts rule of the English forum is *lex situs* at the time the alleged transaction took place. The manufacturing of the new product in England constitutes an overriding transaction at the new *situs*, rendering the manufacturing clause ineffective. The buyer would obtain good title in the new product, which would not be available in the seller's insolvency. Art. 5(1) EUIR (art. 8(1) EUIR 2015) does not apply because the asset does not "belong to the debtor."[96]

In scenario vi.a. (English seller, German buyer in insolvency), the German courts have jurisdiction and German insolvency law applies. Whether

the seller has a proprietary interest in the newly manufactured products is to be determined on the basis of the *lex situs*.[97] The new product was manufactured in Germany. Under German law, the manufacturing clause would be effective and make the seller the owner of the new product. However, in the German buyer's insolvency, recharacterisation takes place and the English seller would merely have a right to preferential satisfaction in respect of the new product.

Finally scenario vi.b. (English seller in administration, German buyer): the German courts have jurisdiction, whilst English insolvency law would apply. The first question is whether the seller has obtained property in the new goods, in which case they may be retained by the administrator and used for the purpose of the administration. The relevant conflicts rule of the German forum is *lex situs* pursuant to EGBGB, art. 43(1). This points to German law where manufacturing took place. Under German law, the seller would be the owner of a new product in accordance with the manufacturing clause, and the product would be available for the purposes of the administration. The question then is whether the buyer in Germany has a proprietary interest in the goods and can force completion of the sale. The applicable German law confers on the buyer a proprietary expectancy in the new product at the completion of manufacture.[98] However, this may offend the anti-deprivation principle under English insolvency law. Pursuant to the anti-deprivation principle, the debtor may not contract at any time, either before or after the commencement of insolvency proceedings, for its property to be removed or disposed of or dealt with otherwise than in accordance with the statute.[99] Traditionally, a distinction has been made between interests that were granted as limited so as to come to an end, automatically or by way of termination, when the company goes into insolvency proceedings; and absolute interests where a party is given the right to recapture the asset upon the debtor's insolvency. Only the latter was considered to offend against the anti-deprivation rule; in the former type of cases the interest never was the outright property of the company.[100] Following the Supreme Court's decision in Belmont,[101] each transaction has to be assessed on its own merits in order to distinguish between a commercial rearrangement of rights to reflect the economic consequences of insolvency and an attempt to preempt the distri-

bution of assets in a bankrupt estate.[102] Whether on that basis a proprietary expectancy on the part of the buyer would offend the anti-deprivation principle is not entirely clear. In any case, art. 5(1) EUIR (art. 8(1) EUIR 2015) would apply, resulting in the buyer being able to compel the administrator to complete the transaction.

## Proceeds clause

In all retention of title transactions, the buyer is likely to have an express or an implied power to sell the original or the processed goods in the ordinary course of business. Thus, the seller will loose his retained legal ownership at the latest with a sub-sale by the buyer (and the sub-buyer's acquisition of ownership). The question is whether a "retention of title" clause may be extended so as to cover the proceeds or debt receivables (owed to the buyer by the sub-buyer) emanating from a sub-sale.

In the *Romalpa* case it was held that the buyers were fiduciaries and as such were under a duty to account to the sellers for the products and their proceeds. The sellers were in equity entitled to trace these proceeds and to recover them.[103] Subsequent cases were less generous and distinguished *Romalpa* on the basis that the "proceeds clause" itself has only contractual effect and does not create a fiduciary relationship out of which equitable proprietary rights may arise.[104] In *Tatung (UK) Ltd v Galex Telesure Ltd*[105] it was clear for the judge on the wording[106] that the sellers' interest in the proceeds was agreed to be defeasible upon payment of the debts owed to the sellers and, consequently, was an interest by way of security amounting to a charge on the buyers' property, rather than an absolute interest. Similarly, in *Compaq Computer Ltd v Abercorn Group Ltd & Co.*[107] it was held that since the beneficial interest in the proceeds of sale was determinable on the payment of debts, the rights and obligations of the parties were in reality and in substance characteristic of those of the parties to a charge and not of those in a trustee/beneficiary or other fiduciary relationship.[108] It also does not seem to help when the proceeds clause is structured as an outright assignment of future claims. In *E. Pfeiffer Weinkellerei-Weineinkauf G.m.b.H. & Co. v Arbuthnot Factors Ltd*[109] the judge found that a clause, translated from Ger-

man,[110] constituted an agreement by the buyer to assign to the seller future choses in action, namely future debts owed by sub-purchasers to the buyer, but only up to the amount of any outstanding indebtedness on the part of the buyer to the seller. In so far as debts came into existence falling within that agreement, the agreement created an equitable assignment of the debts. However, the agreement was plainly by way of security, and the assignments under it were capable of being redeemed through payment by the buyer of the outstanding indebtedness. Consequently, the provision created a charge over the buyer's book debts, which being unregistered was rendered void as against the buyer's other creditors.[111] Thus, irrespective of whether the "proceeds clause" expressly gives the seller absolute ownership of the proceeds, requires the buyer to account as the seller's bailee or agent and to keep the money in a separate account, the courts almost invariably concluded that the seller's interest is a registrable charge.[112] This result seems to rest on the fact that the seller's interest in the proceeds is determinable upon payment of the debt by the buyer.

German law has little difficulty with this type of clause. A reservation of title (simple, all monies, and/or manufacturing clause) may be combined with an authorisation by the seller of the buyer to dispose of the goods in the ordinary course of business.[113] This is further combined with an (anticipatory) assignment, pursuant to BGB, §398, of the future claims that the buyer may obtain against sub-buyers arising from the sale of goods delivered under retention of title or manufactured under a manufacturing clause. Such an assignment is perfectly valid and has retroactive effect as long as the future claims are ascertainable when they come into existence upon the sub-sale.[114] As long as the buyer operates in the ordinary course of business he collects the proceeds on behalf of the seller without disclosing the assignments to the sub-buyers. Where the buyer is in financial distress, the seller may withdraw the authorisation and collect himself, finally disclosing the assignment. The receivables owed to the buyer by the sub-buyers are the property of the seller as soon as they come into existence. However, in the buyer's insolvency, the seller's ownership right in the receivables is recharacterised and treated as a security interest proper (pledge of receivables), giving a right to preferential satisfaction only.[115]

And the final modification of our hypothetical:

- A German seller sells and delivers goods to an English buyer under a proceeds clause:
  - Before payment of the purchase price, and after the delivered goods have been sold on to sub-buyers, the buyer goes into administration, and the seller seeks to collect from the sub-buyers;
  - The seller goes into insolvency proceedings, the office holder rejects the contract and seeks to collect from the sub-buyers, whilst the buyer wishes to complete the sale.
- An English seller sells to a German buyer under a proceeds clause:
  - Before payment of the purchase price, and after the delivered goods have been sold on to sub-buyers, the buyer goes into insolvency, and the seller seeks to collect from the sub-buyers;
  - The seller goes into administration, the administrator rejects the contract and seeks to collect from the sub-buyers, whilst the buyer wishes to complete the sale.

In vii.a. (German seller, English buyer in administration), jurisdiction of the courts for enforcing the claim against the sub-buyers depends on where the sub-buyers are situated; whereas English insolvency law applies. The preliminary question is whether the claims assigned belong to the buyer and can be used for the purposes of administration, or belong to the seller. This seems to depend on the relevant conflicts rule of the forum and thus on where the sub-buyers are situated. Let us assume that sub-buyer 1 is domiciled in England. In determining whether the administrator or the seller has a right to collect from sub-buyer 1, the conflicts rule of the *lex fori* applies. This is the *lex situs* of the asset at the time of the relevant transaction. The asset in question is the debt owed by sub-buyer 1, which came into existence with the sub-sale. Some of the private international law aspects of an assignment of receivables are governed by art. 14 of the Rome I Regulation. For the relationship between assignee (seller) and assignor (buyer), art. 14(1) Rome I Regulation refers to the law that governs the contract between assignor and assignee, which is the initial contract of sale. In the absence of a choice of

law, this would be German law.[116] Under German law, the assignment for the benefit of the seller would be effective. Pursuant to art. 14(2) Rome I Regulation, the relationship with the third-party debtor (sub-buyer) is governed by the law that applies to the receivable. This is likely to be English law. In any case, the administrator does not simply step into the shoes of the debtor (buyer); rather he may invoke greater rights than the buyer himself would have had by arguing that the assignment is void for lack of registration. The conflicts rule that deals with the third-party effects of an assignment is not actually regulated by art. 14 Rome I, and different approaches have been advocated in this respect.[117] The actual question is, however, whether the clause amounted to a charge on book debts created by the buyer company and subject to registration pursuant to Companies Act 2006, sec. 859A. This provision applies to all charges created by companies registered in England, in particularly a charge on book debts owed by an English company. Whether a charge is registrable is a matter for English law to determine.[118] Consequently, in our scenario the administrator is likely to prevail over the seller.

Now assume that sub-buyer 2 is domiciled in Germany (or another member state other than the UK). In that scenario, the outcome may be modified by art. 5(1) EUIR (art. 8(1) EUIR). Art. 5 EUIR (art. 8 EUIR 2015) applies to rights *in rem* in intangible assets so that the ownership of, or a security right in, a debt receivable may be a right *in rem* within the meaning of art. 5 EUIR (art. 8 EUIR 2015). Further, provided the right exists, it must be situated, at the time of the opening of proceedings, within the territory of a member state other than the state where proceedings have been opened. Pursuant to art. 2(g) third indent EUIR (art. 2(9)(viii) EUIR 2015) this will be the case where sub-buyer 2 has its centre of main interest in Germany (or another member state other than the UK). Whether the right *in rem* exists is to be determined on the basis of the relevant conflicts rule of the forum,[119] which will usually refer to the *lex situs*. But what is the *lex situs*? Can we simply assume that it is German substantive law, perhaps in line with art. 2(g) third indent EUIR (art. 2(9)(viii) EUIR 2015)? Or would it be the law that under German conflicts rules governs the assigned debt? In Germany, art. 14(2) of the Rome I Regulation is extended so as to apply to the relationship between assignee and third parties, including a liquidator invoking overriding rights;[120]

accordingly, decisive would be the law that governs the assigned claim. In the absence of a choice of law, this would be English law.[121] As a consequence, there would be no right *in rem* and the result would be as above.

If we assume that the right *in rem* would be effective (*i.e.* if German substantive law were to apply), the consequence of the applicability of art. 5(1) EUIR (art. 8(1) EUIR 2015) is that the seller could exercise this right so as if the insolvency proceedings had not been opened. He may collect the proceeds from the sub-buyer without any insolvency related restrictions.[122] Others would like to subject the right *in rem* to the restrictions of the insolvency law under the *lex fori concursus*, or the *lex sitae concursus*. The difference is that under the latter two approaches the seller would have to return any overvalue to the administrator in the main proceedings, not however under the former approach.[123]

In scenario vii.b. (German seller in insolvency, English buyer), the issue is whether either the German office holder can collect from the sub-buyer and keep the proceeds, or the buyer can obtain release of the assigned receivables. German insolvency law applies. The question is whether the buyer has a proprietary interest in the receivables. This may depend on whether the proceeds clause was drafted so as to contain an automatic retransfer upon payment (proprietary expectancy in respect of the assigned receivables) or as merely granting a right to have the receivables released upon payment (personal claim). InsO, §107(1) protects the buyer's initial proprietary expectancy regarding the goods in the seller's insolvency. Since the initially existing proprietary expectancy in the goods has come to an end with the sub-sale, InsO, §107(1) does not apply. Therefore, we need to distinguish: with sub-buyer 1 being situated in England, the buyer may be able to rely on art. 5(1) EUIR (art. 8(1) EUIR 2015). Whether one follows the approach that would apply art. 14(2) Rome I Regulation by way of analogy (the law that governs the receivable) or favours the law of the debtor,[124] the applicable substantive law is likely to be English law. The assignment as part of a proceeds clause would be ineffective and the buyer would be the owner of the claim against sub-buyer 1. With sub-buyer 2 being situated in Germany, in application of art. 14(2) Rome I Regulation, what matters is the law that governs the receivable. Absent a choice of law this would be English law,

and the outcome would be the same. However, if buyer and sub-buyer had subjected their contract to German law, this choice would also govern the third-party effect of the assignment. Under German law, the assignment would be effective. If the assignment was subject to the resolutive condition of full payment, the buyer's proprietary expectancy would be protected pursuant to art. 5(1) EUIR (art. 8(1) EUIR 2015) and the German office holder would be prevented from destroying the buyer's legal position. Otherwise (right to release the receivables upon payment), the buyer would merely have a personal claim in the seller's insolvency.

Now viii.a. (English seller, German buyer in insolvency): German insolvency law applies. If we assume that sub-buyer 1 is situated in England, art. 5(1) EUIR (art. 8(1) EUIR 2015) may apply. Whether a proprietary right exists is to be determined on the basis of art. 14(2) Rome I Regulation, the law that governs the receivable, as the relevant German conflicts rule. Absent a choice of law, this would be German law: the buyer as seller under the contract from which the receivable emanates is situated in Germany.[125] Consequently, the assignment would be effective and, pursuant to art. 5(1) EUIR (art. 8(1) EUIR 2015) the English seller could collect from the sub-buyer without interference by the insolvency proceedings. Where buyer and sub-buyer had subjected their contract to English law, the outcome would be the same. The assignment would be effective in equity. Since the buyer is a German company, the registration requirement of Companies Act 2006, sec. 859A does not apply. With sub-buyer 2 being situated in Germany, art. 5(1) EUIR (art. 8(1) EUIR 2015) is inapplicable. The question is whether the seller has a proprietary interest in the receivable emanating from the sub-sale. This is to be determined on the basis of art. 14(2) Rome I Regulation as the relevant conflicts rule of the German forum. The same considerations would apply as above with one exception: the receivable would now be subject to the German insolvency proceeding. This means that the German office holder may realize the value of the receivable, by collecting from the sub-buyer or selling the receivable.[126] Any net proceeds so realized are to be paid over to the seller, up to the amount of his outstanding claim.

And finally, viii.b. (English seller in administration, German buyer): English insolvency law applies. The question is whether the assigned receiv-

ables belong to the seller, and if so whether the administrator can collect from the sub-buyers and keep the proceeds, or whether the buyer can obtain their release out of the administration proceedings. Regardless of whether English law or German law governs the sub-sale, the assignment is likely to be effective because the registration requirement of Companies Act 2006, sec. 859A does not apply to the German buyer. Thus, the question is whether the buyer retains a proprietary interest in the assigned receivables. If sub-buyer 1 is situated in England, art. 5(1) EUIR (art. 8(1) EUIR 2015) will not apply. It seems that, where the assignment is governed by English law (due to a choice of law clause) and is subject to an automatic retransfer, the buyer will have an effective proprietary interest in the receivables. Indeed, an automatic retransfer is unlikely to offend against the anti-deprivation principle.[127] If sub-buyer 2 is situated in Germany, art. 5(1) EUIR (art. 8(1) EUIR 2015) may apply. If German law applies to the claim, and the assignment is subject to a resolutive condition of full payment, the buyer obtains a proprietary expectancy as a right *in rem*. Presumably, pursuant to art. 5(1) EUIR (art. 8(1) EUIR 2015), he can pay the remainder of the initial sales price to the administrator, obtain ownership of the receivables and collect from the sub-buyer.

## Conclusion

This little survey, taking into account only two member states and a limited number of potentially problematic scenarios, has revealed considerable complexity and uncertainty in this area of law. Outcomes seem to be somewhat random and frequently lack any clear rationale. This renders transactional planning more difficult and is likely to impede trade. Short of a comprehensive harmonisation of security interests and title-based financing techniques in the EU, which is unlikely to happen in the foreseeable future, greater clarity may be achieved through the streamlining of the EU's private international law framework, including international insolvency law. In this respect, the recent recasting of the EUIR seems like a missed opportunity.

## ENDNOTES

**1.** The Dickson Poon School of Law, King's College, London.

**2.** On 23 June 2016, in a non-binding referendum, the UK population has voted with a 52% majority to leave the European Union. At the time of writing, the government is intent on implementing this decision by initiating the withdrawal process pursuant to art. 50 TEU in early 2017. What form the UK's exit and its relationship with the EU thereafter will take remains as yet unclear. With the exit becoming effective, the EU Regulations discussed in this article would no longer apply in the UK, unless they are reenacted through national law. However, for now, and until the end of the withdrawal process, these instruments remain in force.

**3.** CGJ Morse, "Retention of Title in English Private International Law" (1993) *Journal of Business Law* 168.

**4.** Regulation (EC) No 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations (Rome I) OJ EU 4.7.2008 L177/6; Regulation (EC) No 864/2007 of the European Parliament and of the Council of 11 July 2007 on the law applicable to non-contractual obligations (Rome II) OJ EU 31.7.2007 L 199/40.

**5.** Council Regulation (EC) no. 1346/2000 of 29 May 2000 on insolvency proceedings OJ 30.6.2000 L160/1.

**6.** Regulation (EU) No 848/2015 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings (recast) OJ EU 5.6.2015 L141/19. Most of the provisions of the EUIR 2015 will apply from 26 June 2017; EUIR 2015, art. 92.

**7.** J Milo, "Retention of Title in European Business Transactions" (2003) 43 *Washburn Law Journal* 121, 131.

**8.** *Ibid*. 121.

**9.** *Ibid*. 131-134.

**10.** Directive 2000/35/EC of the European Parliament and of the Council of 29 June 2000 on combating late payment in commercial transactions, OJ L 200, 8.8.2000, p. 35-38: "Member states shall provide in conformity with the applicable national provisions designated by private international law that the seller retains title to goods until they are fully paid for if

a retention of title clause has been expressly agreed between the buyer and the seller before the delivery of the goods."

**11.** "It is desirable to ensure that creditors are in a position to exercise a retention of title on a non-discriminatory basis throughout the Community, if the retention of title clause is valid under the applicable national provisions designated by private international law."

**12.** ECJ, 26/10/2006, C-302/05 *Commission v Italy* ECR 2006, I-10597.

**13.** J Milo, "Retention of Title in European Business Transactions" (2003) 43 *Washburn Law Journal* 121, 131-134.

**14.** *Ibid*. 128.

**15.** SGA, sec. 17.

**16.** "Specific goods" are goods identified and agreed on at the time the contract of sale is made; SGA, sec. 61(1).

**17.** SGA, sec. 18 Rule 1.

**18.** Unascertained goods are those that are not identified at the time of the contract but depend on some subsequent agreed act of appropriation carried out by one or both of the parties, upon which the goods become ascertained; E McKendrick, *Goode on Commercial Law* (London: Penguin Books, 4th ed. 2010) 229-230.

**19.** SGA, sec. 18 Rule 5.

**20.** *Clough Mill Ltd v Martin* [1985] 1 WLR 111, 116-121 per Robert Goff LJ.

**21.** Insolvency Act 1986, sec. 130(2) (winding up by the court); Insolvency Act 1986, Schedule B1 para 42, 43 (administration).

**22.** *Re Atlantic Computer Systems Plc* [1992] Ch. 505, 542-544.

**23.** S Wheeler, *Reservation of Title Clauses: Impact and Implications*, Oxford: Clarendon Press 1991, p. 28.

**24.** Insolvency Act 1986, Schedule B1 para 72(1), 111(1).

**25.** E McKendrick, *Goode on Commercial Law*, London: Penguin Books, 4th ed. 2010, p. 237, 239-240.

**26.** *Ibid*. 238.

**27.** These are the mere agreement between transferor and transferee where the latter is already in possession of the goods; BGB, §929 sentence 2 (*traditio brevi manu*); where the transferor-owner is in possession of the goods, delivery may be substituted by an agreement according to which the transferor-owner, as possessor, converts himself into a mere holder on behalf of the transferee who, henceforth, will be the possessor; BGB, §930 (*constitutum possessorium*); where the goods are in the possession of a third party, the transferor may assign his claim to repossess the goods against the third party to the transferee; BGB, §931 (*traditio longa manu*).

**28.** BGB, §929 sentence 1.

**29.** On the "principle of separation" (contract and real agreement as two distinct agreements) and the principle of abstraction (contract and real agreement are independent in terms of their validity) as fundamental principles permeating the entire German Civil Code (BGB), see H Brox, *Allgemeiner Teil des BGB*, Cologne: Carl Heymans Verlag, 26th ed. 2002, p. 59-68.

**30.** BGB, §§158(1), 449(1).

**31.** BGB, §§985, 449(2).

**32.** InsO, §47. L Häsemeyer, *Insolvenzrecht*, Cologne: Carl Heymanns Verlag, 4th ed. 2007, p. 283.

**33.** K Larenz and M Wolff, *Allgemeiner Teil des Bürgerlichen Rechts*, Munich: CH Beck, 9th ed. 2004, p. 275-277.

**34.** InsO, §107(1).

**35.** This denotes, depending on the relevant rule that determines international jurisdiction, that the seller and/or buyer have their habitual residence, domicile, principal place of business or centre of main interests in the respective jurisdiction.

**36.** Regulation (EU) no. 1215/2012 of the European Parliament and of the Council of 12 December 2012 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters (recast), OJ EU 20.12.2012 L351/1.

**37.** Case C-292/08 *German Graphics Graphische Maschinen GmbH* [2009] ECR I-08421 para 38.

**38.** Presumably, the *German Graphics* principle does not apply to a petition to obtain leave of the court in order to repossess assets subject to the statutory moratorium in administration

(scenario i.a.). In such a case there would seem to be a close link between the request and the insolvency proceeding; after all, the moratorium exists only because of the opening of proceedings and is a direct consequence of it. This would point towards the jurisdiction of the English courts in scenario i.a., now on the basis of Art 3(1) of the EUIR (Art 3(1) EUIR 2015), provided the buyer has its centre of main interests in England (Seminal: Case C-341/04 *Eurofood IFSC* [2006] ECR I-3831; Case C-396/09 *Interedil Srl* [2011] ECR I-9915; Case C-1/04 *Staubitz-Schreiber* [2006] ECR I-701). In scenario ii.a. the English seller would enforce his ownership right, provided it is effective, outside of, and undisturbed by, the insolvency proceedings concerning the German buyer. Presumably, this would be an application of *German Graphics*, and there is no close link with the insolvency proceedings; although this is not entirely clear.

**39.** Art 4(2)(b) EUIR; art. 7(2)(b) EUIR 2015.

**40.** In particular, art. 5, 7 EUIR; art. 8, 10 EUIR 2015.

**41.** Art. 4, 63 Brussels I Regulation.

**42.** Art. 3(1), 4 EUIR, art. 3(1), 7 EUIR 2015.

**43.** Insolvency Act 1986, Schedule B1 para 43(3)(b).

**44.** CGJ Morse, "Retention of Title in English Private International Law" (1993) *Journal of Business Law* 168, 170-171.

**45.** Art 4(1)(a) Rome I Regulation.

**46.** CGJ Morse, "Retention of Title in English Private International Law" (1993) *Journal of Business Law* 168, 171. The *lex situs* principle is subject to exceptions: goods in transit or of uncertain *situs*, public policy or mandatory provisions of the forum; *ibid* 172.

**47.** *Ibid*.

**48.** EGBGB, art. 43(1).

**49.** EGBGB, art. 43(2).

**50.** Insolvency Act 1986, Schedule B1 para 72(1).

**51.** Insolvency Act 1986, Schedule B1 para 43(3)(b); *Re Atlantic Computer Systems Plc* [1992] Ch. 505, 542-544.

**52.** Insolvency Act 1986, Schedule B1 para 72(3).

**53.** Art. 4, 63 Brussels I Regulation.

**54.** Art. 3(1), 4(1)(2)(b) EUIR; art. 3(1), 7(1)(2)(b) EUIR 2015.

**55.** CGJ Morse, "Retention of Title in English Private International Law" (1993) *Journal of Business Law* 168, 170-171.

**56.** K Larenz and M Wolff, *Allgemeiner Teil des Bürgerlichen Rechts*, Munich: CH Beck, 9th ed. 2004, p. 276.

**57.** U Foerste, *Insolvenzrecht*, Munich: CH Beck, 6th ed. 2014, p. 126-127.

**58.** Art. 4, 63 Brussels I Regulation.

**59.** Art. 3(1), 4(1)(2)(b) EUIR; art. 3(1), 7(1)(2)(b) EUIR 2015.

**60.** InsO, §§103(1), 107(2).

**61.** BGB, §985; InsO, §47.

**62.** U Foerste, *Insolvenzrecht*, Munich: CH Beck, 6th ed. 2014, p. 126.

**63.** EGBGB, art. 43(1).

**64.** EGBGB, art. 43(2).

**65.** BGB, §985; InsO, §47.

**66.** Art. 4, 63 Brussels I Regulation.

**67.** Art. 3(1), 4(1)(2)(b) EUIR; art. 3(1), 7(1)(2)(b) EUIR 2015.

**68.** [1991] 2 AC 339.

**69.** *Armour v Thyssen Edelstahlwerke AG* [1991] 2 AC 339, 352-353 per Lord Keith of Kinkel.

**70.** A Hicks, "Retention of title – latest developments" (1992) *Journal of Business Law* 398, 405.

**71.** Palandt, *Bürgerliches Gesetzbuch*, Munich: CH Beck, 67th ed. 2008, §449 para 19. In standard contract terms vis-à-vis consumers, an all monies clause will be invalid; BGB, §307(2) No 2. An all monies clause in standard contract terms between commercial parties may also be invalid where it results in an extensive security for the seller; BGB, §307(1).

**72.** U Foerste, *Insolvenzrecht*, Munich: CH Beck, 6th ed. 2014, 185; L Häsemeyer, *Insolvenzrecht*, Cologne: Carl Heymanns Verlag, 4th ed. 2007, p. 419.

**73.** InsO, §§49, 50.

**74.** InsO, §§165, 166.

**75.** Art. 4, 63 Brussels I Regulation.

**76.** Art. 3(1), 4(1)(2)(b) EUIR; art. 3(1), 7(1)(2)(b) EUIR 2015.

**77.** The conflicts rule of the forum (*lex situs* at the time of the retention of title) refers to German law, including the German conflicts rule. Accordingly, an all monies clause validly agreed under German law remains effective when the goods are removed to England, EGBGB, §§43(1) and (2).

**78.** Palandt, *Bürgerliches Gesetzbuch*, Munich: CH Beck, 67th ed. 2008, §449 para 22.

**79.** Rome I Regulation, art. 3(1).

**80.** Rome I Regulation, art. 9(1).

**81.** SGA, sec. 17, 19. *Lex situs* of the forum refers to German law; *renvoi* results in the application of English substantive law. EGBGB, §43(2) does not apply. We have a new overriding transaction at the new *situs*.

**82.** S Smid, *Praxishandbuch Insolvenzrecht*, Berlin: DeGruyter, 5th ed. 2007, p. 611.

**83.** Art. 3(1), 4 EUIR, art. 3(1), 7 EUIR 2015.

**84.** See above scenario ii.b.

**85.** *Clough Mill Ltd v Martin* [1985] 1 W.L.R. 111, 119 per Robert Goff LJ.

**86.** Companies Act 2006, sec. 859A, 859H.

**87.** L Gullifer, *Goode on Legal Problems of Credit and Security*, London: Sweet & Maxwell, 5th ed. 2013, p. para 1-35.

**88.** S Worthington, *Proprietary Interests in Commercial Transactions*, Clarendon Press, Oxford, 1996, p. 32. Such a gain, if it exists at all, could be avoided through the parties explicitly agreeing on co-ownership in proportion to the value of the respective contributions by seller, buyer and third parties to the finished product. If the practical problem of defining *ex ante* the value of the seller's contribution in relation to the value of the finished product

with any accuracy could be overcome, it is hard to see why an explicit agreement should not be effective. A proprietary interest in the form of co-ownership in the product would *ipso iure* be vested in the seller; there would be no room for a charge granted by the buyer.

**89.** BGHZ 20, 159, 163-164.

**90.** BGB, §950(2).

**91.** BGB, §929 sentence 2.

**92.** BGB, §§947, 948

**93.** BGHZ 46, 117.

**94.** U Foerste, *Insolvenzrecht*, Munich: CH Beck, 6th ed. 2014, p. 186.

**95.** CGJ Morse, "Retention of Title in English Private International Law" (1993) *Journal of Business Law* 168, 177.

**96.** Art 7(2) EUIR (Art 10(2) EUIR 2015) does not apply to manufacturing clauses.

**97.** EGBGB, art. 43(1).

**98.** The is achieved through including in (or reading into) the manufacturing clause an anticipatory real agreement effectuating a *traditio brevi manu* under the suspensive condition of full payment; BGB, §929 sentence 2, 158(1).

**99.** *Ex parte Jay* (1880) LR 14 ChD per James LJ 25: "[A] simple stipulation that, upon a man's becoming bankrupt, that which was his property up to the date of bankruptcy should go over to somebody else and be taken away from his creditors is void as being a violation of the policy of the bankruptcy law"; *ex parte Mackay* (1873) LR 8 Ch App 643, 647 per James LJ: "A man is not allowed by stipulation with a creditor to provide for a different distribution of his effects in the event of bankruptcy from that which the law provides."

**100.** R Goode, *Principles of Corporate Insolvency Law*, London: Sweet & Maxwell, 2011, p. 220-221 (para 7-05); R Calnan, *Proprietary Rights and Insolvency*, Oxford: Oxford University Press, 2010, para 1.20-1.22.

**101.** *Belmont Park Investments PTY Ltd v BNY Corporate Trustee Services Ltd and Lehman Brothers Special Financing Inc* [2011] UKSC 38.

**102.** *Lomas v Rixson* [2012] EWCA Civ 419 para [86], [91].

**103.** *Aluminium Industrie Vaassen BV v Romalpa Aluminium Ltd* [1976] 1 WLR 676, 689 per Riskill LJ.

**104.** L. Gullifer (ed.), *Goode on Legal Problems of Credit and Security*, London: Sweet & Maxwell, 5th ed. 2013, para 1-34.

**105.** (1989) 5 BCC 325.

**106.** "[T]he buyer shall be at liberty to sell the goods in the ordinary course of business in the name of the buyer and as principal and not as agent for the [seller] notwithstanding the fact that title to the goods has not then passed to the buyer but the benefit of any such contract of sale and the proceeds of any such sale shall belong to the [seller] absolutely."

**107.** [1991] BCC 484: "In so far as the [buyer] may sell or otherwise dispose of the Compaq products or receive any moneys from any third party in respect of the Compaq products, he shall strictly account to Compaq for the full proceeds thereof (or such moneys as the dealer shall receive) as the seller's bailee or agent and shall keep a separate account of all such proceeds or moneys for such purpose."

**108.** *Compaq Computer Ltd v Abercorn Group Ltd & Co*. [1991] BCC 484, 495.

**109.** [1988] 1 W.L.R. 150.

**110.** "The buyer is only allowed to dispose of the goods or to sell them in business operations carried out in due order and as long as there is no delay in payment. All claims that he gets from the sale or due to another legal reason regarding our goods, with all rights including his profit amounting to his obligations towards us, will be passed on to us. On demand the buyer is obliged to notify the assignment of the claim to give us in written [sic] all necessary information concerning the assertion of our claims and to deliver us all necessary documents."

**111.** *E. Pfeiffer Weinkellerei-Weineinkauf G.m.b.H. & Co. v Arbuthnot Factors Ltd* [1988] 1 W.L.R. 150, 159.

**112.** S Worthington, *Proprietary Interests in Commercial Transactions*, Clarendon Press, Oxford 1996, p. 39.

**113.** BGB, §185(1).

**114.** Palandt, *Bürgerliches Gesetzbuch*, Munich: CH Beck, 67th ed. 2008, §398 para 11-13.

**115.** U Foerste, *Insolvenzrecht*, Munich: CH Beck, 6th ed. 2014, p. 186.

**116.** Rome I Regulation, art. 3(1), 4(1)(a).

**117.** T Hartley, "Choice of Law Regarding the Voluntary Assignment of Contractual Obligations under the Rome I Regulation" (2011) 60 *International and Comparative Law Quarterly* 29, 46-56.

**118.** CGJ Morse, "Retention of Title in English Private International Law" (1993) *Journal of Business Law* 168, 177.

**119.** R Goode, *Principles of Corporate Insolvency Law*, London: Sweet & Maxwell, 2011, p. 768 (para 15-88).

**120.** J Dalhuisen, *Dalhuisen on Transnational, Comparative, Commercial, Financial and Trade Law*, Volume 2: Contract and Movable Property Law, Oxford: Hart, 3rd ed. 2013, p. 504-505.

**121.** Rome I Regulation, art. 3(1), 4(1)(a) (the buyer as seller under the sub-sale being domiciled in England).

**122.** R Goode, *Principles of Corporate Insolvency Law*, London: Sweet & Maxwell, 2011, p. 769 (para 15-89). This is subject to the opening of secondary proceedings in the member state where the assets are situated, as well as the possible avoidance of the transaction which is governed by the *lex fori concursus*.

**123.** INSOL Europe, *Revision of the European Insolvency Regulation*, Nottingham: INSOL Europe, 2012, p. 51-52.

**124.** J Dalhuisen, *Dalhuisen on Transnational, Comparative, Commercial, Financial and Trade Law*, Volume 2: Contract and Movable Property Law, Oxford: Hart, 3rd ed. 2013, p. 506-507.

**125.** Rome I Regulation, art. 4(1)(a).

**126.** U Foerste, *Insolvenzrecht*, Munich: CH Beck, 6th ed. 2014, p. 201.

**127.** R Goode, *Principles of Corporate Insolvency Law*, London: Sweet & Maxwell, 2011, p. 221 (para 7-05).

# THE USE OF PUBLIC PROCUREMENT AS A NON-TARIFF BARRIER: RELATIONS BETWEEN THE EU AND THE BRICS IN THE CONTEXT OF THE NEW EU TRADE AND INVESTMENT STRATEGY

**Nuno Cunha Rodrigues**[1]

## Introduction

Since the Doha round, despite the partial success of the Bali package, the legal framework of international trade remains stagnated and consequently the traditional multilateral approach towards the liberalization of world trade has been weakened. As so, until recently, both developing and developed countries have been pursuing two different approaches with respect to their trade policies.

A set of countries focus on a "global integration" strategy revolving around unilateral liberalization of trade, promotion of inward foreign direct investment (FDI) and encouragement of the participation of local firms in international supply networks and supply chain trade.[2] Some of these countries – particularly developed ones – have also pursued deep reciprocal trade agreements with large trading partners, including the European Union (EU) and the United States of America (USA) as an instrument to anchor domestic policy reforms, to open markets, and to improve the governance of trade policy-related institutions. By celebrating those agreements, thereby pursuing a negotiation agenda which has a plurilateral and bilateral dimension, those countries try to create a negotiation framework that can also contribute to the resolution of longstanding trade barriers.[3]

The EU – and other developed countries – follow this strategy, pursuing the use of deep agreements, also called new generation Preferential Trade Agreements (PTAs), which include detailed and comprehensive procurement chapters, including market access to utilities procurement, leading to the creation of new market opportunities as well as mobilizing the fragmentation of

international trade regulation.[4] Some of these recent PTAs – such as the CETA (Comprehensive Economic and Trade Agreement), the TPP (Trans-Pacific Partnership) or the future TTIP (Transatlantic Trade and Investment Partnership) – can be considered deep rather than shallow agreements[5], as they involve a wide range of issues beyond tariffs – including domestic regulations (or behind-the-border measures) –, such as services, investment, intellectual property protection, competition policy, and public procurement rules.

On the other hand, a group of developing countries put great emphasis on the continued usage of trade policy as an instrument for promoting import substitution and the consequent domestic industrialization, thus limiting the extent of commitments in trade agreements to "shallow integration". Countries in this category include a number of large economies such as the BRICS (Brazil, Russia, India, China and South Africa) and several others. For these countries, public procurement still accounts as an economic policy instrument that can impact international trade. In reality, countries have an interest in the instrumental use of public procurement, regardless of the different degrees of development.[6]

In PTAs, most developed countries look upon the internationalization of public markets as a mean to ensure the opening of the domestic markets of other countries, primarily in reciprocation to their arrangement with the developing countries, which is often far from reality. This is primarily because, on one hand, developing countries often don't have companies that are capable of competing with companies from developed countries, especially in the instance of providing goods and services in public markets, and hence they are not interested in following the reciprocity principle.[7] On the other hand, developed countries often use more or less implicit strategies of discrimination involving the closure of national markets to foreign companies.[8]

Still, it is vital to examine whether the adoption of discrimination mechanisms should be considered and assessed in the context of the participation of states in regional organizations, especially in light of the emergence of regional economic blocs (such as the EU, Mercosur, APEC or NAFTA), as well as in an international context – particularly with regard to the World Trade Organization (WTO) and the Government Procurement Agreement (GPA).

One must remember that the GPA is based on the principle of non-discrimination – prohibition of conducting discriminatory policies through public procurement – as, starting from the classic assumptions of international economy, it was understood that only global liberalization of public procurement would extract benefits for the welfare of nations worldwide.

The idea of equality and reciprocity between states, identified in the GPA, has compelled many developing countries to not be a part of this agreement. Nevertheless, these countries sometimes see the opening of public procurement at the global level as a necessary tool since this – although jeopardizing the protection of the domestic industry against international competitors and, hence, supposedly damaging national welfare – is imposed under the (necessary) international support they receive. This support may include granting loans to developing countries, whose availability will depend on the opening of public procurement markets to foreign companies ("tied-loans" or "tied-aid") or in the context of the enforcement of domestic markets opening rules by international organizations – such as, for example, the rules defined by the World Bank's funding.

Although art. V of the GPA provides that developing countries can negotiate, during a limited period, the exclusion of the national treatment rules for certain entities, products or services, the reservations by developing countries play a major role in hampering their participation in GPA. As a matter of fact, gradual liberalization of worldwide public markets has faced some obstacles, which leads to the conclusion that this process is far from being complete.

As mentioned before, the difficulties are particularly evident in the context of the WTO. Despite notable progress in abolishing the so-called tariff obstacles, it is also becoming clear that public markets, considered as a non-tariff obstacle, continue to be viewed as a last resource instrument which some states, particularly those who have not joined the GPA and have significant economic growth, use to protect domestic industries.

This is, incidentally, one of the reasons why the GPA is a plurilateral agreement and not a multilateral one. As so, it still allows WTO state-members who have not joined the GPA to keep public procurement as a non-tariff obstacle. Nevertheless it is well known that being a part of the GPA can be a

vehicle for achieving export market gains or as an insurance policy against the possibility of being excluded from participation in other GPA parties procurement markets, through possible protectionist or "buy national" measures.[9-10]

Still, presently, the use of public markets as a non-tariff obstacle can take many forms, the most notable of which is the setting of margins of price preference for certain goods and services.[11] In this case, certain percentages are predetermined by law and they automatically increase the price of goods and services proposed by foreign entities in domestic public procurement procedures. As a result, in a situation where a national company competes with a foreign company in a pre-contractual procedure and the application of a preference price margin is 20%, the foreign company is obliged to present a price which is 20% lower if it wants to succeed in the procedure. Hence, price preference, when used by states, is truly a non-tariff barrier to trade (NTB) with respect to public procurement,[12] although it is known that preferential procurement policies sometimes completely fail to achieve their objective of displacing foreign trade with national supply.[13]

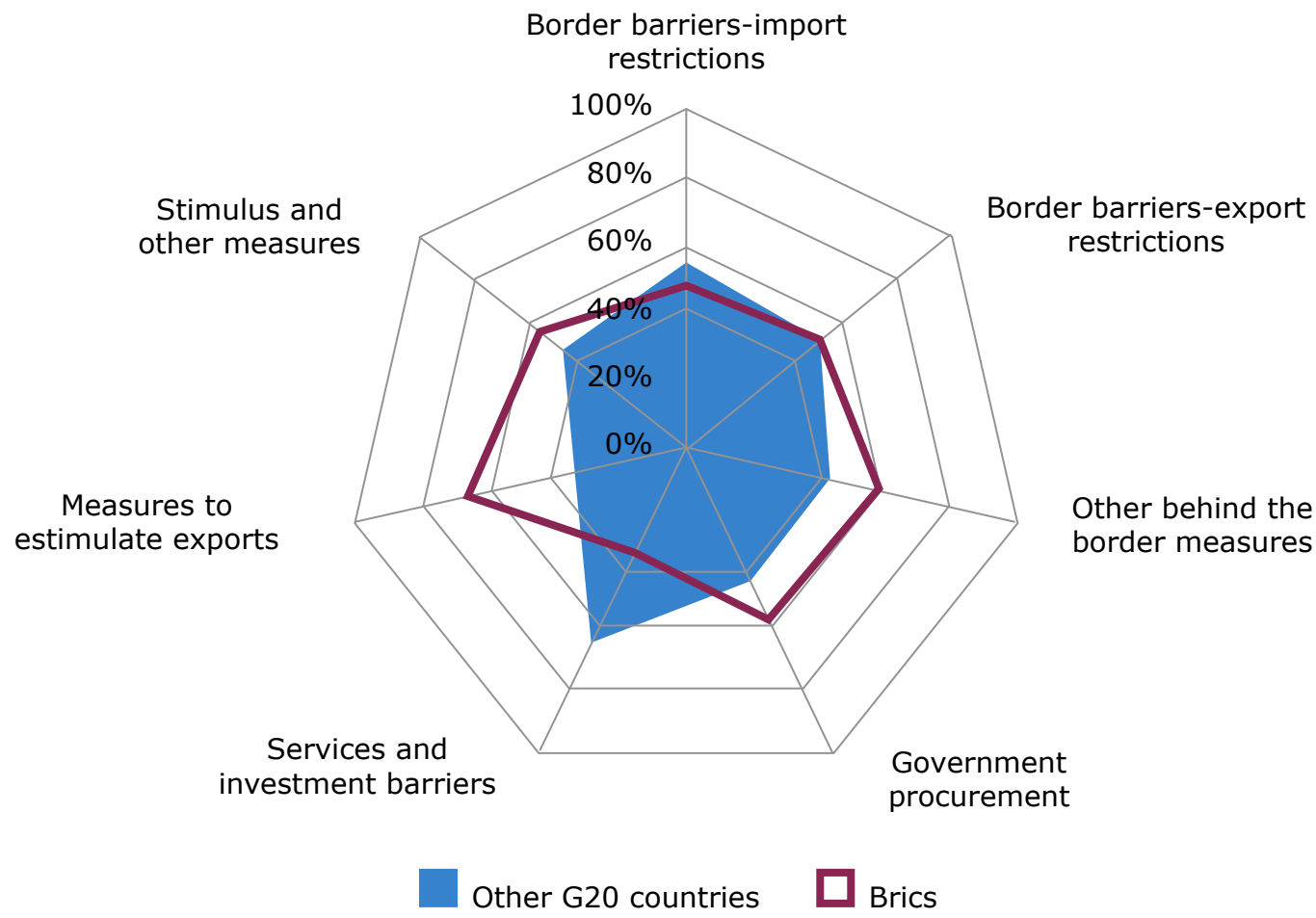
Consequently, several countries (such as the BRICS) are now tilting towards "buy national" rules or "local preference" for public procurement along with regulation of investment in strategic sectors, export support and other areas. A study made for the European Parliament has estimated that in the G20, between 2013 and 2014, 46 new behind-the-border measures were introduced and 13 among those were related to government procurement.[14] This practice led to the possible emergence of beggar-thy-neighbor policies through which states seek to retaliate by closing domestic markets to companies from other states, generating situations of mutual non-cooperation.[15]

## The use of public procurement as a NTB by the BRICS

The EU has been monitoring trade-restrictive measures in the recent past, since they have the capacity to unduly disrupt or restrict trade in one way or another. These measures are divided into: (i) border measures, (ii) behind-the-border measures, (iii) stimulus packages, and (iv) export support measures. Within behind-the-border measures, one can consider two major subgroups

of measures: (a) government procurement measures and (b) service and investment restricting measures.

What the European Commission noticed is that the use of government procurement measures as "behind-the border measures" has recently raised substantially and it has been used namely by the BRICS, as the following diagram can demonstrate:[16]




Source: Policy Department based on data provided by the European Commission apud B. Barone and R. Bendini, "Protectionism in the G20", European Parliament, 2015, p. 16. Available at: http://www.europarl.europa.eu/RegData/etudes/STUD/2015/549028/EXPO_STU(2015)549028_EN.pdf. Accessed in Nov. 2018.

Different measures have been introduced by the BRICS, using public procurement as a NTB,[17] with the common aim of protecting national goods and services against foreign suppliers. In fact, the BRICS don't want to create explicit obstacles to trade because they may violate international trade laws in the field of the WTO – which would happen if they used tariff barriers

– and so they resort to the last instruments they are still able to use such as public procurement rules, knowing that they are not part of international agreements in this field such as the GPA. This is still happening now with all the BRICS, as explained next.

## RUSSIA

In the past the Russian government has considered different protectionist measures aimed at ensuring that the priority in government contracts was given to domestic suppliers of goods and services. For example, in the mid-1990s there was an unsuccessful attempt to require that Russian high-level officials use domestically produced cars for their official transportation needs. This attempt failed because of the unreliability of Russian cars and the bureaucrats' unwillingness to lose the comfort of better foreign car models. In 2008, Russia decided to grant contract price preferences of 15% to bidders that comply with the local content requirement (*i.e.* that supply goods originating in Russia, Belarus or Kazakhstan) through the approval of Instruction No. 427 of 5 December 2008 by the Ministry of Economic Development. This legitimizes the preference for goods produced in Russia, enabling the national producers to win bidding with a price which is up to 15% higher than that of a foreign producer.[18]

## BRAZIL

Brazil has also adopted measures further distorting the conditions for participation in public tenders by establishing preferential margins for certain national products in tendering procedures – modifying, in 20 July 2010, the Brazilian law on public procurement and turning it, *de facto*, into a "buy Brazilian" law – and developing the "Brasil Maior" plan. This plan, announced on 2 August 2011 by president Dilma Rousseff, consists in a package of measures aimed at fostering industrial production in 19 strategic sectors of the country's economy. The plan includes trade protection measures such as tax allowances and preferences in allocating government procurement contracts and allows Brazil to create, from 2010 onwards, public procure-

ment discriminatory schemes in relation to foreign countries and companies. These discriminatory schemes didn't happen in the past and were highly discussed in Brazil, since many were afraid of trade retaliation from foreign countries after the measures were approved.[19]

As part of the package, the government announced that the 25% price preference for domestic products would apply to purchases in the area of health, defence, communications, and high-tech equipment. The plan also foresees other trade-related measures aimed at supporting industrialization of the economy. After this, the initial temporary measure was converted into Law 12.349/10 on 15 December 2010, that allows measures to fix margins ranging from 8% to 25%, covering a whole range of sectors of products and services produced entirely or partially in Brazil.

In line with the "Plano Brasil Maior" and earlier application of procurement thresholds to the ICT sector, the Decree No. 7.546 of 2 August 2011 establishes specific measures regarding public procurement in the ICT field, whereby purchases can be restricted to equipment and services developed and produced in Brazil and the 25% preference margin applies to domestic bidders. Several decrees have been approved establishing preference margins for certain national products in tendering procedures from 8% to 25%.

So, different rules created forms of explicit discrimination against foreign entities through public procurement[20] that are clearly more protectionist than the previous one that established that, in case of a tie between bidders in identical conditions during the public tender process, preference would be given, successively, to goods and services that are produced or rendered by Brazilian companies of national capital; produced in the country; produced or rendered by Brazilian companies, and produced or provided by companies that invest in research and technology development in Brazil.

## CHINA

Although the EU continues to encourage China to join the GPA as soon as possible and to bring its legislation in line with the GPA, "Buy local" clauses exist in China since 2003 as established under the Government Procurement Law (GPL). Art. 10 of the GPL provides for a domestic preference exception

for products that cannot be obtained in China or cannot be obtained in China under reasonable business conditions or for products that are to be used out of China. This "Buy Chinese" policy was strengthened in 2007 through two implementing decrees limiting the possibility to procure foreign goods only when domestic products are "unreasonably" more expensive or of lower quality. Moreover, in spring 2009 China emphasized to its procuring entities that they should tightly enforce the existing "Buy Chinese" provisions in its public procurement legislation by further eliminating the possibility to buy foreign products, even if they are of better quality or less expensive. As the European Commission recognizes, a key factor still contributing to difficulties for foreign companies in engaging in government and public procurement in China is the inconsistent interpretation of the term "domestic goods".[21]

## INDIA

In India, EU companies are still facing important market access barriers in the IT and electronics goods sectors. In fact, on 10 February 2012 India approved a proposal to provide preference to domestically manufactured electronic products in the procurement of those electronic products which have security implications for the country and in government procurement for its own use.[22] India maintains that it is not bound by any WTO commitments (notably the GPA to which India is not a party), although India is expected to soon announce the value addition criteria in its government procurement scheme.[23]

## SOUTH AFRICA

Lastly, South Africa published, on 8 June 2011, new Preferential Procurement Regulations that also created a "Buy local" clause.[24-25]

Remarkably, these laws from the BRICS are not an exception, and similar measures have been recently taken by other countries such as Algeria, Argentina, Australia, Canada, Ecuador, Egypt, Indonesia, Kazakhstan, Nigeria, Paraguay, Tunisia, Turkey, Ukraine, and Vietnam.[26]

## THE REACTION OF THE EUROPEAN UNION TO THE USE OF PUBLIC PROCUREMENT AS A NTB

It appears that several BRICS countries are particularly appealing to foreign companies as they have achieved significant economic growth rates until now and need to build public infrastructures throughout their territory (such as roads, sanitation or school equipment).[27] Additionally, since many of them have hosted sporting events (such as the Olympic Games or the World Football Cup in the case of Brazil) there is an added need for building infrastructures associated with them.

Furthermore, on account of the fact that some countries in Europe are facing economic depression – such as Ireland, Portugal, Spain, Italy, Cyprus, and Greece[28] – and reduced public spending – which led to a corresponding reduction in the amount spent on public procurement – it seems only natural that many European companies from those countries see the BRICS – considered to be strategic economic partners of the EU[29] – as a business opportunity, namely because some of them share a common history, such as Portugal and Brazil.

Besides that, public procurement is an area of significant untapped potential for EU exporters since EU companies are world leaders in areas such as transport equipment, public works and utilities, but they face discriminatory practices in almost all their trading partners, which effectively close off exporting opportunities.

It is at this stage that the significance of preference margins established, for example, in Brazil by the recent changes to Law No. 8.666 of 21 June 1993 becomes more apparent. Such rules are considered as a NTB to the entry of foreign companies in those countries where they can be identified. A significant number of European companies have complained about this explicit discrimination mechanism and the insurmountable obstacle that has reduced the possibility, for European companies, of tendering to public contracts in those countries. The EU has recognized this and has reported it in several documents.[30] However, until now, the EU has been reluctant in adopting trade reciprocity and consequent retaliation policies (in this case,

with regard to the BRICS) that also address the above mentioned negative reputational effects associated with the use of beggar-thy-neighbor policies.[31]

The truth is that the EU has traditionally been an open economy and an advocate of free trade, which means, for procurement, a low degree of protectionism. Nevertheless, tenders that contain products originating in third countries outside the EU were and are subject to special rules provided for in art. 85 and 86 of Directive 2014/25/EU.[32] Under those articles, similar to previous art. 58 of Directive 2004/17/EC,[33] tenders that cover products originating in third countries with whom the EU has not concluded a bilateral or a multilateral agreement, and that ensure comparable and effective access for Community companies to the markets of those third countries, may be rejected where the proportion of products originating in third countries, as determined by the Community Customs Code, "exceeds 50% of the total value of the products constituting the tender."[34]

Recently, however, we have seen a change in the external trade policy of the EU – and the use of the so-called policy of reciprocity – and in particular, in the field of public procurement.[35] Many of the protective measures recently adopted by the BRICS were pointed by the EU.[36] Although in the past the EU usually acted as a litigator before the WTO, namely against Brazil, there are increasing signs that the EU will embrace a new attitude in international trade, especially when faced with protectionist measures taken by third countries. The probability of this change becomes more obvious due to annual reports on international trade, several proposals of regulations that appeared in the recent years, claims submitted to the WTO, and public statements issued by the European Commission.[37]

Accordingly, on October 2015 the EU issued a communication titled "Trade for all – Towards a more responsible trade and investment policy" which raised a new strategy for international trade.[38] The communication announces a range of initiatives under the headings of effectiveness, transparency, values, and the EU's programme of negotiations.[39] In the end, the EU proposes to expand the EU trade policy from traditional tariff discussions, taking a holistic approach that covers vital issues like public procurement, competition, subsidies, and sanitary and phytosanitary barriers. This change, which is unquestionably motivated by the freezing of multilateralism in inter-

national trade and caused by the blocking of the Doha's round negotiations, has led the EU, on the one hand, to negotiate bilateral agreements (PTAs) where public procurement is one of the main topics and, on the other hand, to create legal instruments in order to ensure reciprocity with states that still use public procurement as a NTB.[40] Through these bilateral agreements, the EU aims at overlooking the reluctance of developing countries in accessing the GPA – guaranteeing both the opening of new public procurement markets and producing what can be termed as a "California effect" in the field of public procurement.[41]

The initiative to create legal instruments has a clear intention of ensuring reciprocity with countries such as the BRICS, where the use of public procurement as a NTB is established, and thereby bolstering EU's stance with respect to the public markets worldwide. We refer, in particular, to one proposal and a recent new regulation:

> Proposal for a European Parliament and Council Regulation on access of goods and services from third countries to the internal procurement market of the EU and establishing the procedures supporting negotiations on access of goods and EU services to markets procurement of third countries ("EU reciprocity initiative" – first version dated March 2012, amended in January 2016);[42]
>
> Regulation of the European Parliament and the Council on the exercise of EU rights for the application of and compliance with international trade rules.[43]

The proposal ("EU reciprocity initiative") and the new regulation represent, at the same time, a change and a sign in European trade policy in this area. Until recently, the EU sought to ensure the opening of international public markets through the accession of countries to the GPA or by entering into bilateral agreements (PTAs) that can be considered, more and more, as deep trade agreements. As a matter of fact, since the number of states that

have joined the GPA is still insufficient, the EU entered into a small number of bilateral agreements with other states.[44] Nonetheless, as seen previously, there are still a significant number of third countries which continue to exercise protectionist policies in relation to the instrumentalization of public markets.

The wider problem remains. Taking into account states that are not yet part of the GPA or have not entered into any bilateral agreement, the EU does not have any legal instrument that allows it to react against protectionist policies through the use of public markets in different countries. So, the proposal aims to fill any existing legal gap that results from the EU's lack of a legal instrument that enables it to ensure reciprocity and, in the end, to retaliate against other countries that assert non-tariff obstacles through public procurement, due to a growing number of countries with rising business opportunities, related to public procurement, such as the BRICS, that have adopted legal protectionist measures for public procurement. The above-mentioned proposal aspires to fill this gap, achieving reciprocity by creating an autonomous instrument that would both enhance the EU's position in negotiations on market access and preserve a competitive procurement regime in the EU.[45]

Despite this, since the proposal does not aim at according preference to European companies but rather at creating mechanisms that enable the EU to have the same degree of openness of public markets, in the EU, as those that exist in third countries, it cannot be considered as a "Buy national" – or "Buy European" – regulation similar to those recently adopted, namely by the BRICS. Furthermore, the proposal was not designed to affect countries that are already part of the GPA – where the non-discrimination principle and the most favored nation clause (MFN) are already established – but rather to affect countries that are not part of the GPA, such as the BRICS or other countries, even if some of them have already the status of observer at the GPA.[46]

In the end, the proposal intends to harmonize the treatment of goods and services from third countries not covered by the EU's international commitments relating to public procurement. It will further provide the European Commission with the ability to assess the existence of a substantial lack of reciprocity, analyze the extent to which public procurement legislation of a country can ensure transparency in line with international standards in the

field of public procurement – GPA – thereby preventing any discrimination in relation to goods, services, and economic sector operators from the EU. If there is a lack of reciprocity, then the European Commission may take appropriate restrictive measures that involve, according to the 2016 version, the application of a penalty on the price of goods or services from the country concerned, the so-called "price adjustment measures" (*i.e.* the establishment of preference margins on reciprocal terms).

Nevertheless, the 2016 proposal has some ambiguities that can be considered as a problem because there is room for some member states to use discretion in their application, namely with the exceptions defined in art. 12 that can be invoked when the application of "price adjustment measures" "would lead to a disproportionate increase in the price or costs of the contract".

In the end, the proposal aims at creating a legal framework that allows the EU to retaliate against a third country – providing the EU different levels of sanctions – that is not part of the GPA in case it creates protectionist measures through the use of public procurement rules, having in account that these measures are not submitted to art. 23 of the DSU that contains a broad prohibition against unilateral retaliatory measures since the third country is, as said, not part of the GPA. On the other hand, the new regulation No. 2015/1843 repeals the Council Regulation No. 3286/94 that approved the first Trade Barriers Regulation (TBR), which came into effect on 1 January 1995.

The main goal of the TBR was (and still is) to maintain third country markets open for EU exporters by giving the right to EU enterprises, industries or their associations, as well as the EU member states, to lodge a complaint with the European Commission, that will then investigate and determine whether there was any evidence of a violation of international trade rules which resulted in either adverse trade effects or injury. The new regulation codifies the previous one – that had been substantially amended several times – and defines the procedure to ensure the effective exercise of the rights of the Union under international trade rules without prejudice to other measures which may be taken pursuant to art. 207 of the TFEU.[47] Like the previous TBR, the new one covers a wide range of obstacles to trade or trade barriers – defined as "any trade practice adopted or maintained by a

third country in respect of which international trade rules establish a right of action" –, providing an illustrative list of some of the trade obstacles.

It should be noted that the TBR doesn't replace or undermine the application of WTO rules to the European Union. On the opposite, it can be said that the TBR is complementary to the application of the WTO rules because it should be invoked previously to their application. As such, it complies with art. 23 of the DSU that contains a broad prohibition against unilateral retaliatory measures.[48]

The new TBR aims at ensuring that the EU can effectively enforce commercial rights, despite not having a common legislative framework, in order to ensure the standing of their rights under international trade agreements. One must note that this regulation doesn't represent the use of a conditional MFN clause and is not intended to be used against international trade law rules.

The proposal and the new regulation do not aim at escaping the WTO rules or creating some kind of conditional MFN principle – through which third parties must bargain and provide equal compensation in order to benefit from MFN status – nor, in the end, at creating some kind of unilateral trade policies that can be used by the European Commission. On the opposite, the proposal and the new regulation aim at filling a gap, allowing the EU to play a role concerning the use of public procurement as a NTB by states that are note part of the GPA – knowing that the proposal clearly states that it will be applicable to countries that are not part of the GPA. The disputes between the GPA parties will continue to be solved under the WTO Dispute Settlement Mechanism and the resolution of disputes regarding the process of awarding particular contracts using domestic bid challenge systems. In fact, the regulation doesn't give free license to the European Commission to retaliate against a third country.

First, because "obstacles to trade" have to be verified, which means any trade practice adopted or maintained by a third country in respect of which international trade rules establish a right of action that exists when international trade rules either prohibit a practice outright, or give another party affected by the practice a right to seek elimination of the effect of the practice in question.

Secondly, and according to art. 11, 4 of the regulation, the European Commission has to examine the impact of such adverse effects on the economy of the Union or of a region of the Union, or on a sector of economic activity therein.[49]

Thirdly, because the regulation says that the Commission, in examining evidence of adverse trade effects, shall have regard to the provisions, principles or practices which govern the right of action under relevant international rules.

Under this regulation, the Commission may adopt the following types of commercial policy measures:[50]

- suspension or withdrawal of any concession resulting from commercial policy negotiations;
- raising of existing customs duties or the introduction of any other charge on imports;
- introduction of quantitative restrictions or any other measures modifying import or export conditions or otherwise affecting trade with the third country concerned.

These measures trigger the so-called "cross-retaliation" (the suspension of concessions or other obligations if different from that to which the infringement is detected) which is generally possible in accordance with WTO rules.[51] It should be noted that "cross-retaliation" cannot be applicable to public procurement according to WTO rules,[52-53] and that, according to the GPA, if a party fails to meet its commitments, the other parties may only suspend concessions or other obligations with regard to public markets.

Correspondingly, the new regulation also aims at eventually adopting commercial policy measures in the field of public procurement, so that the EU is able to effectively fulfill their legal rights with regard to public contracts covered by the EU's international obligations. In fact, without retaliation, injuring parties have low compliance incentives and high compliance costs with any trade sanctions granted against it, so one major benefit of retaliation is that it solves the enforceability problem with trade sanctions.[54]

Notwithstanding the above, at a first glance the proposal and the new regulation could come across as confusing, which is not the case. On the one hand, the proposal concerning the access of goods and services from third countries to the internal market of EU public procurement aims at increasing the power of influence of the EU in negotiating access for products conditions, service providers and public procurement markets in third countries, thus unintentionally focusing on giving access third countries to public markets inside the EU which do not benefit from any commitments on market access under international agreements covering public procurement, in particular the GPA.

On the other hand, the new regulation concerning the exercise by the EU of rights for the application and compliance with international trade rules examines in a horizontal manner the fulfillment of these agreements and provides a framework of rules that will enforce such provisions related to international trade and bilateral agreements concluded by the EU.[55] Hence, while both documents have different levels of application, it is still not clear if the first will be approved, although there are ongoing legislative procedures.

Until January 2016, the proposal "EU reciprocity initiative" appeared to have been frozen by the European Commission, after amendments adopted by the European Parliament at its first reading on 15 January 2014,[56] possibly because of the division that it produced between the Commission[57] and member states (with France in favor and Germany being the principal opponent) adding to the fear that it could result in protectionism, undermining competition and casting a negative light on the worldwide reputation of the EU as a trade partner.[58]

Still, in January 2016, a new version of the "EU reciprocity initiative" was approved by the European Commission.[59] The 2016 revised proposal, when compared with the previous one, limits possible restrictive measures to price penalties ("price adjustment measures"); eliminates the possibility for contracting authorities to decide autonomously on the prohibition to foreign bidders; establishes a presumption that tenders submitted by companies originating on the targeted third country will be targeted by the price penalty, unless they can demonstrate that less of 50% of the total.

In an interesting development of the previous proposal, the new one states that price adjustment measures will not be applicable to bidders and

products originating from developing countries subject to GSP+ treatment (general scheme of preferences), in line with EU trade and development policy towards these countries.

The 2016 proposal on "EU reciprocity initiative", along with the new regulation and several other pointers given by the European Commission (such as the annual trade reports, the new PTAs that are being negotiated – such as the TTIP – or were concluded – such as CETA, with Canada[60] – and the new trade strategy, issued in October 2015) offers a strong indication that the EU will not stop due to the multilateralism freezing caused by the Doha round and the subsequent Bali package and that bilateral relations will continue while it awaits further developments of multilateralism in international trade. Furthermore, the possible approval of the TTIP and the recent TPP stands, for the BRICS, as a new opportunity for reinforcing the need to open their markets – specially the public markets – by reviewing their priorities and reevaluating losses and gains.[61]

It is clear that the GPA has, among its objectives, to bring about the liberalization and expansion of world trade, facilitate integrity and predictability in government procurement systems, and foster the efficient and effective management of public resources. In this regard, the GPA helps to bring about legal certainty, transparency, and good governance in the government procurement markets covered by it, providing a boost to competition and improved value for public money.[62]

By accessing the GPA (or by celebrating bilateral treaties with the EU), the BRICS could reinforce welfare, enhance internal reforms, and strengthen anti-corruption efforts in their economies. In fact, closed and non-transparent markets can facilitate and perpetuate corruption in national systems. Opening public procurement markets not only through the EU reciprocity initiative but also through the participation in international agreements would have a positive effect in the transparency of the internal public procurement markets.

So, the implementation of good governance policies in developing countries necessarily involves the transparency and credibility of public procurement markets which entails, *inter alia*, to expunge or reduce corrupt practices. By accessing the GPA and allowing greater openness to public procurement

markets, the problems of corruption in public procurement markets that occurred in some of the BRICS (namely the recent "Lava Jato" case in Brazil[63]) may be alleviated. This was positively recognized for the first time in the preamble to the revised GPA (2014), which mentions "the importance of transparent measures regarding government procurement, of carrying out procurements in a transparent and impartial manner, and of avoiding conflicts of interest and corrupt practices, in accordance with applicable international instruments, such as the United Nations Convention Against Corruption."

One can say that the GPA goes hand in hand with other international legal instruments such as the UN Convention against Corruption, the UNCITRAL model on public procurement, some relevant guidelines by the World Bank and the OECD about preventing corruption, in particular the OECD Convention on combating bribery of foreign public officials in international business transactions. The latter Convention represented a significant advance in the global awareness of the impact of corruption and the damage that this means for developed and developing countries, facilitating access to public procurement in states that joined it.[64] The EU has also made a contribution to fight corruption in foreign countries by creating a blacklisting system, which excludes from access to public contracts tenderers who have been convicted of corruption.[65]

Knowing that developed countries are witnessing an increase in the prosecution of corruption and that, in developing countries, this development is a prerequisite for economic growth, it is easily understood that the accession to the GPA (or other bilateral agreements) may represent, for the BRICS, not just an opportunity to increase international trade, but also, internally, to reduce corrupt practices related to procurement. GPA membership can also be seen, in the BRICS, as an international "stamp of approval" that might encourage inbound foreign direct investment (FDI) in those countries.

In the end, one can say that the EU is no longer an angel in the field of international trade and that the principle of reciprocity will have to be taken into account whenever dealing with third countries, considering the public markets and the need to ensure their openness, especially with the BRICS. As the European Commissioner responsible for the Internal Market and Services, Michel Barnier, said in 2012, the EU should no longer be naïve

and should aim at fairness and reciprocity in world trade.[66] This was clearly mentioned in the new EU trade strategy, which stated that while the EU has progressively integrated and opened its markets, EU companies still encounter discrimination and restrictions abroad.[67]

That being said, the European Commission recognizes that it is, therefore, essential to ensure a level playing field in market access which can be achieved partly through PTAs and negotiations on the accession of new countries to the GPA. This new EU strategy shifts the EU international trade approach from one based on the traditional tariff discussions to one that takes a holistic approach, covering vital issues like public procurement.

It is now evident that, in the future, the EU will look carefully at the "Buy national" legislation from third countries and will try to force the openness of those public markets by applying the principle of reciprocity through bilateral mechanisms – negotiating PTAs or forcing the accession to the GPA – or by de-freezing and approving the proposal on market access and consequently obtaining an instrument to retaliate against those countries.

In the event the EU obtains that legal instrument, it could easily trigger true trade wars in the field of public procurement with other states, notably when they breach the principle of reciprocity. In a way it could also be deduced that if the proposal is adopted it could, as well, initiate a trade war – based on discrimination through public procurement – between the EU and some of the BRICS. Such triggers could result in multiple scenarios. First, it could initiate reciprocal closing of public procurement to companies both from the BRICS and the EU. Secondly, if new legal instruments were to be adopted by the EU they could to be used to add pressure to the ongoing negotiations between the EU and some of the BRICS – such as Brazil and India – so that in the end, both can sign a bilateral agreement (PTA) similar to others signed by the EU.[68]

Finally, the possible accession of China to the GPA[69] and the ongoing negotiations for the accession of Indonesia and Russia[70] could result in the affirmation of the GPA as an effective global agreement between states that are different geographically and face various levels of economic development – and not only among Western countries – representing a first step towards the possible multilateralization of the GPA, desired by some advocates of

liberalization of international trade and feared by others, afraid of the negative impact that such openness can produce in domestic markets and the lack of alternatives to the use of NTB to protect internal public markets.

## Conclusions

For many countries that are not a part of the GPA, namely the BRICS, public procurement, by using different strategies such as price preferences schemes, can still be seen as a protectionist tool (NTB). Until recently, the EU did not have legal instruments that could present it with the option of retaliating against countries that use public procurement as a NTB. Yet, there are strong indications that this will change in the future.

The EU recognizes that more determination at the political level as well as an intensified and active implementation of the EU Market Access Strategy remain crucial for the EU's efforts to remove barriers and that the combined use of different tools, considering the specific context of each barrier and the prospects of its resolution, promises the best results.[71]

The new TBR Regulation laying down Union procedures in the field of the common commercial policy in order to ensure the exercise of the Union's rights under international trade rules, in particular those established under the auspices of the WTO, the 2016 proposal on access of goods and services from third countries to the internal procurement market of the EU ("EU reciprocity initiative"), the annual trade reports issued by the European Commission, the new PTAs that are being negotiated – such as the TTIP – or were concluded – such as CETA, with Canada –, and the new EU trade strategy, issued in October 2015, which shifts the EU international trade approach from one based on the traditional tariff discussions to one that takes a holistic approach covering vital issues such as public procurement – reinforce the change.

These are strong signs given to third countries, particularly the BRICS, that will influence the way they conduct their international trade strategy in the future, especially concerning the openness of their public markets with respect to EU, through the celebration of PTAs considered to be deep agreements, the possible accession to the GPA or the multilateralization of this agreement.

# ENDNOTES

**1.** PhD in Law. Professor at the Law School of the University of Lisbon, Portugal. Holder of a Jean Monnet module in International and European Public Procurement Law granted by the European Commission.

**2.** See B. Hoekman, "Supply Chains, Mega-Regionals and Multilateralism: A Road Map for the WTO", London: CEPR Press, 2014, p. 25. Available at: http://www.voxeu.org/sites/default/files/file/WTO_Roadmap.pdf. Accessed in Sep. 2016.

**3.** About the use of this strategy by the EU in the recent past, see Report from the Commission to the European Council Trade and Investment Barriers Report 2015, Brussels, 17.3.2015, COM (2015) 127 final, p. 2.

**4.** See R. Williams, "Access to utilities procurement markets of non-EU countries", in P.P.L.R. 2010, 2, NA40.

**5.** About the distinction between "deep" and "shallow" agreements, see WTO, "World Trade Report: The WTO and preferential trade agreements: From co-existence to coherence", 2011. Available at: https://www.wto.org/english/res_e/booksp_e/anrep_e/world_trade_report11_e.pdf. Accessed in Sep. 2016.

Two distinct dimensions of deep integration are the "extensive" and the "intensive" margin. The extensive margin refers to an increase in the policy areas covered by an agreement, while the intensive margin refers to the institutional depth of the agreement. The extensive and intensive dimensions of deep agreements may be related, as an extension of the coverage of an agreement may require the creation of common institutions for its proper functioning.

The following graphic provides examples of the distinction between deep and shallow integration (see *op. cit.*, p. 110):

| Shallow versus deep integration | | | |
|---|---|---|---|
| Integration level | Type of PTA | Features | Example |
| SHALLOW INTEGRATION ↓ DEEP INTEGRATION | Free trade agreement (FTA) | Members liberalize internal trade but retain their independent external tariffs | US-Israel FTA |
| | FTA+ | An FTA that in addition harmonizes some beyond the border standards (e.g. environmental standards) | NAFTA |
| | Customs Union (CU) | Members liberalize trade within the union and adopt common external tariffs against the rest of the world | SACU |
| | Common Market | Establishment of the free movement of all factors of production within the PTA including labour and capital | EU |
| | Monetary Union | Establishment of a common currency and completely integrated monetary and exchange rate policy | Euro Area |
| | Fiscal Union | Establishment of a common fiscal policy | US |

*Note*: The depth of integration of PTAs might overlap across types of agreements in certain circumstances.

**6.** See F. Trionfetti, "Home-bias government procurement and international trade", in *Public Procurement, the Continuing Revolution*, Hague: Kluwer Law International, 2003, p. 223, and S. Evenett and B. Hoekman, "Government procurement: market access, transparency and multilateral trade rules", *European Journal of Political Economy*, vol. 21, I, 2005, p. 163.

**7.** See J. Linarelli, "The WTO Transparency Agenda in Public Procurement, the Continuing Revolution", Hague, Kluwer Law International, 2003, p. 237, saying that "the *quid pro quo* existing in developed countries in unlikely to exist in developing countries where producers may not have a comparative advantage in supplying goods and services to public buyers in other countries."

**8.** One should not confuse these strategies with pursuing, through public procurement, secondary policies, also called horizontal or side policies. With these latter policies, public entities are pushed to, through the use of public procurement, achieve purposes other than just the mere procurement of goods and services – and the inherent "value for money" – as those connected to the pursuit of environmental policies – by encouraging the purchase of environmentally friendly goods and services ("green public procurement") – or social policies (*e.g.* by creating forms of positive discrimination like those that promote the acquisition of goods and services provided by companies employing disabled persons). About these

policies see S. Arrowsmith and P. Kyunzlik (org.), *Social and Environmental Policies in EC Procurement Law*, Cambridge: Cambridge University Press, 2009.

**9.** Even in developing countries in areas such as Africa, the potential benefits outweigh the potential costs of participation in the GPA. See N. C. Niggli and K. Osei-Lah, "Infrastructure provision and Africa's trade and development prospects: potential role and relevance of the WTO agreement on government procurement (GPA)", WTO, 30 Oct. 2014.

**10.** The estimate for the total value of additional market access commitments that would result from GPA accession by the full range of WTO members is in the range of US$ 380-970 billion annually. Describing these numbers and analyzing the commercial benefits that could flow to BRICS based suppliers from legally enforceable market access rights in the GPA Parties' procurement markets see R. D. Anderson; A. C. Muller; K. Osei-Lah; P. Pelletier, "Assessing the value of future accessions to the WTO Agreement on Government Procurement: some new data sources, provisional estimates, and an evaluative framework for WTO members considering accession", in P.P.L.R. 2012, 4, p. 115.

**11.** Concerning the cost of procurement and welfare implications of price preferences, see A. Mattoo, "The Government Procurement agreement: implications of economic theory", WTO, Staff Working Paper TISD-96-03, Oct. 1996, p. 10. Available at: https://www.wto.org/english/res_e/…/tisd-96-03.doc. Accessed in Sep. 2016.

**12.** Similar to what happens with the use of tariff barriers, here domestic firms can charge higher prices and maintain inefficient operations, whereas foreign competition would force them to become more efficient or exit. However, as said by A. Reich, *International Public Procurement Law: the Evolution of International Regimes on Public Purchasing*, Hague, Kluwer Law International, 1999, p. 13-14: "in the case of margins of preference, the 'increase' in the foreign price is imputed – no additional levy is actually paid by the foreign supplier or the consumer of the foreign goods, and there are no tax revenues for the government. The product is simply evaluated as more expensive than it really is".

**13.** As explained by S. Arrowsmith, J. Linarelli and D. Wallace Jr., *Regulating Public Procurement – national and international perspectives*, Hague, Kluwer Law International, 2000, p. 242: "in the situation in which government demand is less than domestic output, the economic outcome is that the preference policy merely raises the price of the products or services purchased by the government, which purchases from domestic market whilst private purchasers shift their demand towards imports."

**14.** See B. Barone and R. Bendini, "Protectionism in the G20", European Parliament, 2015, p. 12. Available at: http://www.europarl.europa.eu/RegData/etudes/STUD/2015/549028/EXPO_STU(2015)549028_EN.pdf. Accessed in Sep. 2016.

**15.** Those beggar-thy-neighbor policies, when used, are associated with a negative reputational effect to states that follow them and are often necessary in order to achieve a consensus among world states, a phenomenon for which game theory is able to give a better understanding.

**16.** B. Barone and R. Bendini, "Protectionism in the G20", European Parliament, 2015, p. 16. Available at: http://www.europarl.europa.eu/RegData/etudes/STUD/2015/549028/EXPO_STU(2015)549028_EN.pdf. Accessed in Sep. 2016.

**17.** Concerning BRICS trade strategy, see S. Evenett, "The BRICS Trade Strategy: Time for a Rethink – The 17th GTA Report", Centre for Economic Policy Research. Available at: http://www.voxeu.org/sites/default/files/BRICS_Trade_Strategy_GTA17.pdf. Accessed in Sep. 2016.

**18.** See European Commission, 11th report on potentially trade-restrictive measures, 2014, p. 139. Available at: http://trade.ec.europa.eu/doclib/docs/2014/november/tradoc_152872.pdf. Accessed in Sep. 2016.

**19.** See European Commission, 11th report on potentially trade-restrictive measures, 2014, p. 130. Available at: http://trade.ec.europa.eu/doclib/docs/2014/november/tradoc_152872.pdf. Accessed in Sep. 2016.

**20.** One should look carefully at Brazilian Law no. 8.666 of 21 June 1993 and its amendments. Art. 3 of that law states that any bid is subject to the classic principles of administrative law in Brazil such as the principles of legality, impersonality, morality, equality or advertising. However, paragraph 2 of art. 3 contains provisions that clearly aim at discriminating between foreign and Brazilian companies. It provides that, during the public tender process, in case of a tie between bidders in identical conditions preference will be given, successively, to goods and services "produced or rendered by Brazilian companies" or "produced or provided by company investing in research and technology development in the country". Further, the same law regulates the establishment of preference margins, in accordance with the changes introduced in 2010 by Law no. 12.349.

**21.** See European Commission, 11th report on potentially trade-restrictive measures, 2014, p. 132. About the possible accession of China to the GPA, see; J. Linarelli, "China and the WTO

Agreement on Government Procurement", in P.P.L.R. 1996, 2, CS54; R. D. Anderson, "China's accession to the WTO Agreement on Government Procurement: procedural considerations, potential benefits and challenges, and implementation of the ongoing re-negotiation of the Agreement", in P.P.L.R. 2008, 4, p. 161; and J. H. Grier, "What are the prospects for concluding work on China's GPA accession in 2015?", in P.P.L.R. 2015, 6, p. 221.

**22.** See European Commission, 11th report on potentially trade-restrictive measures, 2014, p. 135. See http://pib.nic.in/newsite/PrintRelease.aspx?relid=80075. Accessed in Sep. 2016.

**23.** See Report from the Commission to the European Council Trade and Investment Barriers Report 2015, Brussels, 17.3.2015, COM (2015) 127 final, p. 6-7.

**24.** See European Commission, 11th report on potentially trade-restrictive measures, 2014, p. 141.

**25.** One should also consider the example of the USA which, despite being a part of the GPA, approved the American Economic Recovery and Reinvestment Act (ARRA), that was converted into law by president Obama on 17 Feb. 2009. See European Commission, 11th report on potentially trade-restrictive measures, 2014, p. 143. This legislation includes two new "Buy America(n)" provisions that:

"prohibit funds appropriated by this Act to be used for a project for the construction, alteration, maintenance, or repair of a public building or public work unless all of the iron, steel and manufactured goods used in the project are produced in the United States";

"prohibit funds appropriated by this Act to be used for the procurement by the Department of Homeland Security of a detailed list of textiles items (*e.g.* clothing, tents, cotton and natural fibers, etc.) unless the item is grown, processed in the United States."

However, this provision does not apply in a case where the head of the federal department or agency involves finds that, *inter alia*, it is inconsistent with United States obligations under international agreements. See K. Dawar, "The Proposed 'Buy European' Procurement Regulation: An Analysis", in Simon Evenett (org.), *Débâcle: The 11th GTA Report on Protectionism*, Centre for Economic Policy Research (CEPR), June 2012, p. 94. Available at: http://www.globaltradealert.org/sites/default/files/GTA11_0.pdf. Accessed in Sep. 2016.

The EU continues to be concerned about "Buy American" restrictions governing US public procurement. Such restrictions still cover a large proportion of public purchasing in the US by reserving a significant part of public procurement to local goods and services and excluding foreign companies from procurement. It is clear that significant progress in this area is an

important pre-requisite for a successful conclusion of the TTIP negotiations. In particular, it will be crucial to secure better EU access to sub-federal procurement in the US. See Report from the Commission to the European Council Trade and Investment Barriers Report 2015, Brussels, 17.3.2015, COM (2015) 127 final, p. 8.

**26.** See European Commission, 11th report on potentially trade-restrictive measures, 2014, p. 128. The European Commission has recognized that Turkey is the closest emerging economy to the EU and a key regional player but the trade and investment relationship is sub-optimal and that a modernized customs union should release the untapped economic potential of areas like services, agriculture and government procurement. See European Commission, 11th report on potentially trade-restrictive measures, 2014, p. 34.

**27.** According to the World Bank, the growth of real GDP for the OECD in 2016 will be 2.4% and for the BRICS 5.5%. See Forecast Table for 2015, World Bank. Available at: http://www.worldbank.org/en/publication/global-economic-prospects/summary-table. Accessed in Sep. 2016.

There are no precise numbers concerning the dimension of public procurement markets at the BRICS. Some estimate that the accession of the BRICS countries to the GPA would, by itself, add in the range of US $290-741 billion annually to the value of the market access commitments that would result from GPA. See R. D. Anderson; A. C. Muller; K. Osei-Lah and P. Pelletier, "Assessing the value of future accessions to the WTO Agreement on Government Procurement: some new data sources, provisional estimates, and an evaluative framework for WTO members considering accession", in P.P.L.R. 2012, 4, p. 115.

Others consider that the size of the contestable markets in these countries ranges between €9.3-€27.8 bn in Brazil (2006); €17.2-€51.5 bn in China (2004); €6.1-€18.4 bn in India (2007) and €8.7-€26 bn in Russia (2007). See Anirudh Shingal, "Estimating market access in non-GPA countries: a suggested methodology", Paper for the Fourteenth Annual Conference of the ETSG, 13-15 Sep. 2012. Available at: http://www.etsg.org/ETSG2012/Programme/Papers/148REMOVED.pdf. Accessed in Sep. 2016.

**28.** See Eurostat, Real GDP growth rate, 2015. Available at: http://ec.europa.eu/eurostat/tgm/table.do?tab=table&init=1&language=en&pcode=tec00115&plugin=1. Accessed in Sep. 2016.

**29.** See Report from the Commission to the European Council Trade and Investment Barriers Report 2015, Brussels, 17.3.2015, COM (2015) 127 final, p. 2.

**30.** See, *inter alia*, European Commission, *Trade and investment Barriers Report* 2012, 70, p. 12 and 14.

**31.** This idea is aligned with theories that depart from game theory, for which the main reason why states keep commitments, even those that produce a lower level of returns than expected, is because they fear that any evidence of unreliability will damage their current cooperative relationships and lead other states to reduce their willingness to enter into future agreements. In the past, those theories arguing that reputational concerns help ensure that states maintain their agreements were put in question because: (1) states have different levels of reliability in connection with different agreements, and (2) there is considerable evidence that states possess multiple or segmented reputations. See G. W. Downs and M. A. Jones, "Reputation, Compliance, and International Law", *Journal of Legal Studies*, vol. XXXI, Jan. 2002, p. S95.

**32.** See considering 135 of Directive 2014/24/EU, which states that: "Having regard to current discussions on horizontal provisions governing relations with third countries in the context of public procurement the Commission should closely monitor global trade conditions and assess the Union's competitive position." According to art. 17 of the proposal on regulation "EU reciprocity initiative" (Jan. 2016 – COM (2016) 34 final 2012/0060 (COD)), art. 85 and 86 shall be deleted with effect from the entry into force of this regulation.

**33.** Art. 20 of the proposal repealed those articles saying that art. 58 and 59 of Directive 2004/17/EC shall be repealed with effect from the entry into force of this regulation.

**34.** Concerning the situation of access of European Union suppliers to the procurement markets of third countries in the fields covered by Directive 2004/17, see R. Williams, "Access to utilities procurement markets of non-EU countries", in P.P.L.R. 2010, 2, NA39-44.

**35.** Concerning the evolution of the policy of reciprocity in the field of public procurement until 1995, see S. Arrowsmith, "Third country access to EC public procurement: an analysis of the legal framework", in P.P.L.R. 1995, 1, p. 1.

**36.** For example, on 19 Dec. 2013 the EU requested consultations with Brazil with respect to certain measures concerning taxation, charges in several sectors and tax advantages for exporters. See https://www.wto.org/english/tratop_e/dispu_e/cases_e/ds472_e.htm. Accessed in Sep. 2016.

**37.** One should also consider other signs given by the EU such as the decision of not considering, since 1 Jan. 2014, Brazil as a part of the generalized system of preferences.

**38.** Available at: http://trade.ec.europa.eu/doclib/docs/2015/october/tradoc_153846.pdf. Accessed in Sep. 2016.

**39.** It states various claims to that aim at a program of negotiations to shape globalization namely by re-energizing multilateral negotiations and by designing an open approach to bilateral and regional agreements, including TTIP; requesting a mandate for PTA negotiations with Australia, New Zealand, Philippines and Indonesia; ensuring EPAs are implemented effectively and modernizing existing agreements with Turkey, Mexico and Chile and the Customs Union with Turkey.

**40.** Concerning the growing enthusiasm for the conclusion of bilateral treaties that has emerged within the EU, which is motivated by the relative swiftness in the progress of liberalization possible on the bilateral or regional level, less achievable in multilateral procedures and describing several bilateral agreements closed by the EU until 2005, see J. S. Schnitzer, "The external sphere of public procurement law: bi-regional trade relations from the perspective of the European Community", in P.P.L.R. 2005, 2, p. 63.

**41.** In the past, some said that globalization would lead to a "race to the bottom" caused by interdependence and the need to decrease production costs. However, that increased interdependence has led, in some cases, and in an opposite way, to a strengthening, rather than a weakening, of protective standards. This phenomenon was called the "California effect" after the American state that has often played a frontrunner's role in raising regulatory standards in the United States. The California effect takes place when a country (or a coalition of countries) exports or imposes its own (stricter) standards upon one or more of its partners through the use of market access. This process takes place in a number of steps. First, a country with strict standards can deny market access to products that do not conform or are not produced according to its standards. See S. Princen, "The California Effect in EC's external relations", paper, 1999, p. 1. Available at: http://aei.pitt.edu/2367/. Accessed in Sep. 2016. Departing from this "California effect" idea, one could consider that the EU is looking to produce a "European Union effect", trying to raise the transparency and integrity of public procurement systems in countries that aren't members of the GPA.

**42.** COM (2016) 34 final 2012/0060 (COD). Describing the first version of the proposal, see R. Williams, "Commission proposals in relation to third country access", in P.P.L.R. 2012, 4, NA169-173.

**43.** Regulation no. 2015/1843 laying down Union procedures in the field of the common commercial policy in order to ensure the exercise of the Union's rights under international

trade rules, in particular those established under the auspices of the World Trade Organization, published at the OJEU, 16.10.2015, L 272/1. Available at: http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2015.272.01.0001.01.ENG&toc=OJ:L:2015:272:TOC.

**44.** See annex to the proposal that includes a list of international agreements that the Union has concluded in the field of public procurement including market access commitments, namely with Mexico; Swiss Confederation; Chile; Former Yugoslav Republic of Macedonia; Montenegro; Albania; and South Korea.

**45.** Describing the agency's three-stage approach to reciprocity, see K. Dawar, "The Proposed 'Buy European' Procurement Regulation: An Analysis", in Simon Evenett (org.), *Débâcle: The 11th GTA Report on Protectionism*, Centre for Economic Policy Research (CEPR), June 2012, p. 90-92. Available at: http://www.globaltradealert.org/sites/default/files/GTA11_0.pdf. Accessed in Sep. 2016.

**46.** See K. Dawar, "The Proposed 'Buy European' Procurement Regulation: An Analysis", *ibidem*, p. 94: "this proposal sends warning signals to acceding and observer-status GPA parties, most notably China, that if the EU does not like the results of its accession agreement in terms of market coverage, it could seek to remedy this situation outside of the Agreement."

**47.** The TBR procedure establishes that, if following the initiation of the TBR procedure, the third country takes satisfactory steps to eliminate the obstacle to trade, no action by the EU is required. If after the end of the examination procedure, or at any time before, the third country is willing to negotiate a settlement with the Commission, the proceedings would be temporarily suspended to allow negotiations to take place. If an agreement was reached the procedure could be either formally suspended or terminated. One after this, and if it has not been possible to reach a satisfactory solution and the investigation supports the claims of the complaint, the case might be brought under the WTO dispute settlement procedure or another appropriate international mechanism. Since the dispute settlement procedure involves exclusively governments and public entities like the EU the TBR is an instrument, which effectively provides industry with an indirect access to the rights deriving from the WTO Agreements. The experience with the previous TBR during 20 years (1995-2015) was quite positive, solving several market access problems for EU producers wishing to export to third countries. See Memo – Trade Barriers Regulation (TBR) – Brussels, 5 Oct. 2009. Available at: http://trade.ec.europa.eu/doclib/docs/2009/october/tradoc_144995.pdf (accessed in Sep. 2016), providing three examples of success:

Colombian tax law discriminates against imported motor vehicles. Colombia's value-added tax (VAT) system was designed in such way as to discriminate against certain foreign cars and to unfairly protect local manufacturers. Following a TBR complaint, the Commission raised the issue with the Colombian authorities who agreed to eliminate the tax discrimination. Thanks to the TBR, EU car exporters secured a level playing field vis-à-vis their competitors established in Colombia.

Lack of transparency and discrimination in the Turkish pharmaceuticals market. Turkey maintained a number of regulations affecting the sale of imported pharmaceutical products. In 2003, following a complaint under the TBR and a Commission investigation, the Turkish authorities modified their system in order not to penalize imported products.

Lack of protection of wines with geographical indication "Bordeaux" and "Médoc" in Canada. Canada refused to protect Bordeaux and Médoc as geographical indications ("GIs"). The Commission negotiated an agreement with Canada which led to these terms being protected as GIs.

**48.** See M. Matsushita, T.J. Shoenbaum & P.C. Mavroidis, *The World Trade Organization – Law, practice and policy*, Oxford, Oxford University Press, 2006, 2nd ed., p. 138.

**49.** The regulation explicitly states that "adverse trade effects may arise, *inter alia*, in situations in which trade flows concerning a product or service are prevented, impeded or diverted as a result of any obstacle to trade, or from situations in which obstacles to trade have materially affected the supply or inputs, for example parts and components or raw materials, to Union enterprises. Where a threat of adverse trade effects is alleged, the Commission shall also examine whether it is clearly foreseeable that a particular situation is likely to develop into actual adverse trade effects."

**50.** See art. 13, number 3 of the regulation.

**51.** The proposal provides that, where the Union has to resort to commercial policy measures not covered by the regulation, in particular with regard to trade in services or the commercial aspects of intellectual property rights, the Commission may submit proposals for legislative acts based on art. 207 TFEU or use other applicable procedures.

**52.** Concerning the interpretation of art. III:8(a) of the GATT 1994, see reports of the Appellate Body, *Canada – Certain Measures Affecting the Renewable Energy Generation Sector / Canada – Measures Relating to the Feed in Tariff Program*, WT/DS412/AB/R and WT/DS426/AB/R, 6 May 2013, p. 96-101. Available at: https://docs.wto.org/dol2fe/

Pages/FE_Search/FE_S_S006.aspx?Query=(@Symbol=%20wt/ds412/ab/r*%20not%20rw*)&Language=ENGLISH&Context=FomerScriptedSearch&languageUIChanged=true#.

Both the Panel and the Appellate Body found, albeit for different reasons, that the measures at issue did not fall within the scope of the derogation under art. III:8(a).The Appellate Body found that, to qualify for this derogation, the product of foreign origin allegedly being discriminated against must be in a competitive relationship with the product purchased by the government. In these disputes, the product being procured by the Government of Ontario was electricity, whereas the foreign product suffering from discrimination due to the Minimum Required Domestic Content Levels under the measures at issue was electricity generation equipment. These two products were not in a competitive relationship. Thus, the Appellate Body found that the discrimination relating to foreign generation equipment was not covered by the derogation. The Appellate Body reversed the Panel's intermediate finding that the measures at issue were laws, regulations, or requirements governing the procurement by governmental agencies of electricity within the meaning of GATT art. III:8(a), and declared moot and of no legal effect the Panel's other intermediate findings.

**53.** Analyzing, between 1995 and 2008, the ten formal Dispute Settlement Understanding (DSU) cases that reached the stage in which the respondent Member's failure to comply with WTO obligations compels DSU arbitrators to authorize the complaining Member to retaliate and apply countermeasures, see C. P. Bown and M. Rutta, "The Economics of Permissible WTO Retaliation", WTO, 2008. Available at: https://www.wto.org/english/res_e/reser_e/ersd200804_e.pdf.

**54.** Discussing the pros and cons of retaliation in international trade, see B. H. Liebman and K. M. Tomlin, "Safeguards and Retaliatory Threats", *Journal of Law & Economics*, Oakland University 51, May 2008, p. 351.

**55.** As the EU says in the communication "Trade for All – Towards a more responsible trade and investment policy", p. 6: "while the EU has progressively integrated and opened its markets, EU companies still encounter discrimination and restrictions abroad. It is therefore essential to ensure a level playing field in market access, and this can be achieved partly through PTAs and negotiations on the accession of new countries to the WTO Government Procurement Agreement (GPA)."

**56.** See (COM(2012)0124 – C7-0084/2012 – 2012/0060(COD)) and information available at http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex:52012SC0058. Accessed in Sep. 2016.

**57.** About the policy options that surround this proposal, see Commission staff working document executive summary of the impact assessment, Brussels, 21.3.2012, SWD(2012) 58 final. Available at: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52012SC0058&from=EN. Accessed in Sep. 2016.

**58.** Nevertheless, and according to the Commission Work Programme for 2015, the proposal would be amended in line with the priorities of the current Commission. See http://ec.europa.eu/growth/single-market/public-procurement/international/index_en.htm. Accessed in Sep. 2016.

**59.** COM (2016) 34 final 2012/0060 (COD).

**60.** The comprehensive economic and trade agreement (CETA) with Canada is considered by the European Commission as the EU's most comprehensive PTA to date, namely because it includes unprecedented commitments from Canada on public procurement and geographical indications. See European Commission, 11th report on potentially trade-restrictive measures, 2014, p. 30.

**61.** See Carlos A. Primo Braga, "TTIP and Brazil: Much ado about nothing?", in M. Sait Akman, Simon J. Evenett and Patrick Low (org.), *Catalyst? TTIP's impact on the Rest*, 2015, p. 75, available at http://www.voxeu.org/sites/default/files/file/TTIP_23march.pdf (accessed in Sep. 2016), saying that in the case of Brazil the costs of isolation in the world because of the difficulties of Mercosur should be reexamined with care.

**62.** See R. Anderson, "The WTO Agreement on Government Procurement: an Emerging Tool of Global Integration and Good Governance, in Law in transition online", EBRD, Oct. 2010, p. 1-6. Available at: http://www.ebrd.com/downloads/research/news/lit102e.pdf. Accessed in Sep. 2016; R. D. Anderson, W. E. Kovacic and A. C. Müller, "Ensuring Integrity and Competition in Public Procurement Markets: a Dual Challenge for Good Governance", Ch. 22, p. 681-788, in Arrowsmith and Anderson (ed.), *The WTO Regime on Government Procurement: Challenge and Reform*, Cambridge: Cambridge University Press, 2011.

**63.** Supporting the need of Brazil to access the GPA, see http://www.direitodoestado.com.br/colunistas/thiago-marrara/corrupcao-em-licitacoes-chegou-a-hora-de-aderir-ao-tratado-da-omc-sobre-contratacoes-publicas. Accessed in Sep. 2016.

**64.** Available at: http://www.oecd.org/dataoecd/4/18/38028044.pdf. Accessed in Sep. 2016. See also Sope Williams and Ama Eyo, "Fighting corruption in public procurement through the OECD: a review of recent initiatives", in P.P.L.R., 3, 2009, NA103-113; and Robert

D. Anderson, "Current developments on public procurement in the WTO", in P.P.L.R., 2006, 15, p. 167.

**65.** Analyzing EU policies to fight corruption, see Martine Boersma, "Catching the 'Big Fish'? A Critical Analysis of the Current International and Regional Anti-Corruption Treaties", Maastricht Faculty of Law Working Paper, 2008-9. Concerning the connection between corruption and public procurement, see also Sope Williams, "The mandatory Exclusions for Corruption in the New EC Procurement Directives, no. 31", *European Law Review*, 2006, p. 38; Tina Soreide, "Corruption in public procurement", paper, 2004, p. 2; and T. M. C. Asser Institute, "Prevention of and administrative action against organised crime: a comparative study of the registration of legal persons and criminal audits in eight EU member states", 1997, p. 39-80. Concerning the fight against corruption in international trade, see Council Framework Decision 2003/568/JHA of 22 July.

**66.** See press release issued on March 21, 2012 (ref.IP/12/268).

**67.** See European Commission, "Trade for all – Towards a more responsible trade and investment policy", Oct. 2015. Available at: http://trade.ec.europa.eu/doclib/docs/2015/october/tradoc_153846.pdf. Accessed in Sep. 2016.

**68.** Saying that, in the case of Brazil, there is no trade logic of an agreement with the EU without an agreement with the US in the case of a successful TTIP, see V. Thorstensen and L. Ferraz, "The impacts of TTIP and TPP on Brazil", FGV, Jan. 2014, p. 8. Available at: http://ccgi.fgv.br/sites/ccgi.fgv.br/files/file/Publicacoes/TTIP%20e%20TPP%20(ENG)%2016.01,14.pdf. Accessed in Sep. 2016.

**69.** China started negotiations to GPA accession in 2007. Since then, it has submitted six offers of the procurement that it proposes to open under the GPA but until now, negotiations were not closed.

**70.** Concerning GPA accession, China has already made substantial progress and is still expected to accede even though the process has taken much longer than expected and a conclusion is not imminent. Russia is firmly committed to commence its accession to the GPA in late 2016. Brazil, India and South Africa have no known intention, until now, to accede, although India has a status of observer of the GPA.

**71.** See Report from the Commission to the European Council Trade and Investment Barriers Report 2015, Brussels, 17.3.2015, COM (2015) 127 final, p. 12.

# JURISDICTION AND GOVERNING LAW IN INTERNATIONAL BUSINESS CONTRACTS UNDER TURKISH LAW

**Zeynep Derya Tarman**[1]

## Introduction

The increasing globalization of markets has resulted in cross-border contracts becoming a common feature of practice for most lawyers. Those lawyers lacking specific experience in cross-border transactions may face difficulty with a number of rather complicated issues not arising when dealing with contractual matters solely within Turkish borders. Rules governing contracts between companies from the same country (or domestic contracts) are contained in the national law of the parties. The relevant courts having jurisdiction in the event of a dispute under a domestic contract will be those determined by the national law of parties, where no alternative dispute resolution has been selected by the parties. When the contract is international, however, the situation becomes much more complicated.[2]

This paper aims to provide a pointed overview of the legal issues arising in the field of international business contracts with a Turkish party. Discussion on the legal issues follows the trend of those mainly occurring under Turkish law in practice. Two main issues arising with respect to cross-border contracts are the applicable law and jurisdiction. These issues arise due to the lack of an adequate legal framework for cross-border transactions. Presently, no law addressing cross-border contracts has priority over domestic legal systems applicable when a contract is international, nor is there a recognised common judicial system for international trade as an alternative to domestic courts.

The importance of including jurisdiction and governing law clauses in contracts relating to international business transactions cannot be understated. Many in the business community hold the opinion that when they choose the jurisdiction they are simultaneously choosing the substantive law of

that country as the law applicable to a contract; and vice versa, by choosing the applicable law they are also determining the jurisdiction of the courts of the country whose law they have chosen. These assumptions are based mainly on the failure to appreciate the difference between these two issues. Therefore, there is a clear need to distinguish between the issues regarding the applicable law and those concerning jurisdiction.

An international contract can be determined by its legal connections to more than one country. As a matter of practice, first it must be ascertained how many and which countries' courts can potentially grant standing for an international dispute action, or whether an alternative dispute resolution could be applicable. For the purpose of this paper, the rules on international jurisdiction of the Turkish courts will be elaborated on. Further discussion addresses the Turkish conflict of law rules applicable to the substantive issues of contractual relationships.

## THE METHODS FOR SOLVING DISPUTES

Essentially, the dispute resolution clause should identify the means and location for determining disputes arising under contract. Sometimes a dispute resolution clause may be omitted or difficulties in interpretation result in preliminary actions to resolve the means and location for the substantive contractual dispute determination. Such preliminary actions can result in lengthy and costly proceedings, and therefore it is important to ensure that an effective jurisdiction clause is included in a contract at the outset.

Parties to international commercial contracts may choose different methods for the resolution of disputes arising from contractual relations. The parties may prefer litigation and file lawsuits to national courts, or select alternative dispute resolution methods, including arbitration and/or mediation. A gradually increasing trend shows parties seeking arbitration, rather than referring to litigation, for settlement of commercial disputes, particularly in respect to international transactions involving parties from different jurisdictions.[3] Arbitration offers a number of advantages over litigation on matters relating to international contracts. Notably, the enforceability of awards under the 1958 New York Convention on the Recognition and Enforcement

of Foreign Arbitral Awards;[4] the finality of decisions; the ability to choose the arbitrators; and the privacy of proceedings.

Where ordinary jurisdiction is preferred, possible disputes will be decided by state courts having jurisdiction on the matter or chosen by the parties. In this event, the court should firstly analyze whether it has the competence to hear the substantive lawsuit.[5] International jurisdiction is a term referring to whether the courts of a state are competent on lawsuits involving a foreign element.[6]

## TURKISH JURISDICTION RULES

In Turkish law, the Private International Law and International Civil Procedure Code (hereafter: PIL Code)[7] constitutes the principal source of law on international civil procedure. The PIL Code has determined the limits within which the Turkish courts may exercise international jurisdiction (art. 40-47).

### 1. Choice of Court Agreements (art. 47 PIL Code)

Turkish law entitles parties to a dispute to designate a foreign court with a choice of court agreement (jurisdiction agreement or jurisdiction clause). In cases where the jurisdiction of Turkish courts is determined pursuant to the principle of exclusive jurisdiction, however, a foreign court may not be granted jurisdiction by agreement of the parties; an agreement on jurisdiction contrary to the principle of exclusive jurisdiction does not have any legal consequence in Turkish law.[8] An agreement on jurisdiction can only be made where a dispute is not within the scope of exclusive jurisdiction conditions listed in the PIL Code.[9] Art. 47(2) states that the jurisdiction of the courts determined in art. 44, 45, 46 may not be set aside by an agreement by the parties. Art. 44 governs lawsuits related to employment contracts and employment relationships. A further restriction in art. 45 concerns lawsuits related to consumer contracts, and art. 46 concerns lawsuits related to insurance contracts. Arguably, within these competencies, an exclusive jurisdiction has been established.[10]

According to the provision regulating agreements on jurisdiction (art. 47 PIL Code), parties may agree on the settlement of disputes before foreign courts only if the dispute involves a foreign element arising from the contractual obligations between them.[11] Any agreement conferring jurisdiction must be evidenced in writing. In the event of a sales contract, parties are free to determine the competence of a foreign court. However, for disputes arising from matrimony matters, or civil law matters, no jurisdiction agreement can be made between parties.[12]

Questions may arise as to the substantive validity of a choice of court agreement, and this should be decided in accordance with the law of the state of the court or courts designated in the agreement, including the conflict of law rules of that state. An agreement which gives competence to a foreign court must be valid according to the law of that foreign state. The foreign court is competent only when the agreement meets the validity requirements under the law of that state.[13] Therefore, it is advisable at the stage of contract drafting to make sure that the choice of court agreement is valid under the law of the state of the court designated in the agreement. Under Turkish law a choice of court agreement is valid if the subject matter of the dispute is not within the scope of the exclusive jurisdiction of the Turkish courts. In business contracts this is usually not the case.

A further issue surrounds the effect of jurisdiction agreements designating a foreign court on the competence of the Turkish courts. According to art. 47, where a valid choice of foreign court agreement exists, the dispute can be settled before the Turkish courts only when the foreign court considers itself as not having jurisdiction over the dispute, or the defendant does not make an objection on jurisdiction before the Turkish courts.[14] In the past, Turkish courts decided it is possible to bring suit before a Turkish court despite the agreement on jurisdiction.[15] Notwithstanding this, it was later determined by a General Assembly decision that these prior decisions were incorrect.[16] Under current law, where a valid jurisdiction agreement confers jurisdiction to a foreign court, the Turkish court shall decline jurisdiction in favour of that court.[17]

If a foreign court is granted competence by means of a jurisdiction agreement, the issue whether the decision of the competent court shall be rec-

ognised and enforceable is not considered relevant in the determination of the validity of the jurisdiction agreement. The recognition and enforcement capacity of the foreign court cannot be challenged as a validity requirement.[18] When a foreign court decision's recognition and enforcement is rejected in Turkey, notwithstanding the presence of a jurisdiction agreement, the Turkish court is available for applications.[19]

If there is no jurisdiction clause in a contract, the courts competent to settle a dispute arising from the contract will be determined by the national rules of the states involved. This can cause uncertainty and lead to additional costs and delay. Since the courts will determine their competence according to their own national jurisdiction rules, the absence of a jurisdiction clause in the agreement can result in parallel litigation proceedings in different countries.

Where parties fail to include a jurisdiction clause into their contracts, the competent courts must be determined by the jurisdiction rules of each state. Whether a Turkish court has competence to hear a dispute arising from an international contract is determined by the jurisdiction rules in accordance with the PIL Code.

## 2. Jurisdiction Rules

Art. 40 of the PIL Code states the general rule designating the international jurisdiction of the Turkish courts. According to art. 40, international jurisdiction rules will be determined according to the domestic jurisdiction rules principally outlined in the Code of Civil Procedure (CCP[20]). Art. 40 states that if a court is competent under the domestic rules of jurisdiction, this court also has international jurisdiction.[21]

### *a) General Jurisdiction Rule*

According to art. 6 CCP, the domicile of the defendant is the general competent court which means that this court is the competent court for all related lawsuits, although there may also be other competent courts, authorized by alternative (special) jurisdiction rules. The court of the domicile of the defendant is a court which also has international jurisdiction. The appli-

cable procedural provisions in the assessment of the domicile are determined by the principle of *lex fori*.[22] The *lex fori* principle refers to the rules of the state in which the lawsuit is brought before the court.

In Turkish law, the domicile of the defendant is determined according to art. 19 of the Civil Code.[23] Accordingly, the domicile of a real person is the place where he/she intends to stay permanently. A person may not have more than one domicile at the same time (art. 19 (2) Civil Code). The place where a person whose previous domicile is not known or who does not yet have a domicile in Turkey, although he/she left his/her domicile abroad, where he/she resides at the moment is regarded as his/her domicile (art. 20 Civil Code). The domicile of the legal persons is determined according to art. 51 of the Civil Code, according to which the place of administration is the domicile. Art. 8 (1) of the CCP states that the court of the current habitual residence of the officers, employees and students will be the competent court if the reason for their residence will last a long time. Furthermore, art. 9 (1) CCP states that the court at the place where the habitual residence of the defendant is present has general jurisdiction for the individuals who do not have a domicile in Turkey.

According to art. 9 CCP, when a defendant does not have a domicile or habitual residence in Turkey, lawsuits arising from law of property rights may be brought before the court at the location of the property. Such an action, however, may only be initiated in Turkey if the disputed property is located in Turkey.[24] The competent court should be situated in the region or district where the property, which is the subject matter of the dispute, is located; any other court does not have jurisdiction.[25] If the defendant does not have a domicile or habitual residence in Turkey, the court where the property is located constitutes the only competent court. In other words, if the property constituting the subject matter of the dispute is not located in Turkey, and if the defendant does not have a domicile or habitual residence in Turkey, the jurisdiction of a Turkish court does not arise and the lawsuit cannot be brought before a Turkish court.[26]

*b) Special Jurisdiction Rule for Actions Arising from Contractual Obligations*

In addition to the defendant's domicile, there are alternative grounds of jurisdiction based on a close connection between the court and the action. These courts also have international jurisdiction due to the reference made by art. 40 PIL Code. In principle, alternatively competent courts do not hamper the competence of the courts of general competence.[27] It is an option for the applicant to choose between the courts of general competence or an alternatively competent court.

In terms of contractual relationships, according to art. 10 CCP, the place of performance of the contract also has jurisdiction. The crucial issue here is the determination of the place of performance.[28] The jurisdiction rules do not provide a definition for the place of performance. According to the doctrine, it has been argued that the place of performance should be determined through *lex fori* rules.[29] In contrast, other scholars argue that the place of performance cannot be determined through *lex fori* rules; it should be determined through the material law that should be applied to the case, which will be assessed through the rules on conflicts of laws.[30] If the applicable law is Turkish law, then the place of performance will be determined through the Code of Obligations.[31] If the parties to the contract have chosen a place of performance, the court of the place of performance becomes the alternatively competent court, though this does not amount to a jurisdiction agreement within the meaning of art. 47 PIL Code.[32] For example, when a Turkish party and a French party have concluded a sales contract with the place of performance in Izmir and, say, the Turkish party initiates a lawsuit against the French party. According to the general jurisdiction rule stated in art. 6 CCP, such lawsuit can be filed at the domicile of the defendant. In our example, however, the defendant does not have a domicile in Turkey. Alternatively, the courts in Izmir, the place of performance, will have jurisdiction to hear the case notwithstanding the domicile of the respondent being in France.

### 3. Objection to International Jurisdiction

In Turkish international civil procedure, the Turkish courts are governed according to the *lex fori* principle.[33] The domestic rules on local jurisdiction are resorted to as rules of international jurisdiction too. Thus, procedural objections on grounds that a court is incompetent to hear the case are subject to the provisions in the CCP.

The absence of international jurisdiction of Turkish courts may be asserted only as a primary objection, as with absence of local jurisdiction (art. 19 (2) CCP). If the court considers that it does not have international jurisdiction upon objection, it rejects the case on lack of competence grounds. If such objection fails to appear in the initial rebuttal petition, the court will not consider the respondent's claim regarding jurisdiction at a later stage or *ex officio*. If the defendant does not assert his/her primary objection concerning the absence of international jurisdiction, he/she is considered to have consented to the international jurisdiction of the court and the suit is heard before the Turkish court.[34]

This rule is also applied in cases where the defendant is domiciled abroad and is unfamiliar with Turkish law.[35] One could take the example of a contract between a German party and a Turkish party containing a jurisdiction clause referring to the competence of the courts in Berlin. In our example, the Turkish party may opt to file a lawsuit against the German party in a Turkish court notwithstanding the valid jurisdiction clause under German law. Under these circumstances, the German party must assert objection concerning the absence of international jurisdiction within two weeks in accordance with art. 19 CCP, otherwise the Turkish court will assert jurisdiction and hear the case.

According to art. 19 (2) CCP, the party who files the objection must state the competent court as the basis of the claim. Otherwise, the objection will not be considered. Art. 19 (3) indicates that the court shall also declare the jurisdiction after the party's objection. Distinct from the domestic rules applicable where there is an objection to jurisdiction, under international civil procedure law rules the parties are not required to indicate the court that has legal authority. Moreover, the court also need not determine jurisdiction.

This rule derives from the understanding that every state has their own sovereignty rights. It should also be highlighted that if there is no objection to the jurisdiction of the court, that court gains jurisdiction and continues with the proceedings. As a matter of fact, Turkish Civil Procedure Law provides that when there is no objection to the jurisdiction, the court will automatically gain jurisdiction over the case (art. 19 (4)).

## ARBITRATION IN TURKEY

The Turkish International Arbitration Law[36] is based on the UNCITRAL Model Law and the international arbitration sections of the Swiss Federal Private International Law of 1987.[37] Therefore, it contains regulations generally accepted in the arena of international arbitration. In this regard, parties have equal rights and competence in arbitral proceedings and both parties must be given the opportunity to submit their claims and defences in full.[38] Party autonomy is encouraged and the intervention of the state courts in arbitral proceedings is limited to specific circumstances. Moreover, the rules of domestic and international arbitration have been harmonised through implementation of the new CCP, which came into effect on 1 October 2011. From this point of view, the existence of arbitration rules in Turkey at an international level is positive for foreign contract parties.

Under Turkish law, there is no restriction preventing the Turkish state or its state entities from entering into arbitration agreements with other parties as long as the matter is arbitrable. They may then become a party to an international arbitration proceeding. Reluctance by the parties to refer to national courts of the state due to concern that they will not be treated impartially make arbitration an attractive alternative particularly for state-investor disputes. Moreover, in 1999, the Turkish Constitution was amended to make concession contracts arbitrable.[39] This change removed the administrative courts' exclusive jurisdiction, and parties were permitted to conclude private law contracts containing arbitration clauses. This was particularly important for the advancement of privatization projects and Built-Operate-Transfer (BOT) contracts.

The recognition and enforcement of foreign arbitral awards is regulated separately under the PIL Code. Art. 1(2) PIL Code states that the provisions of international conventions to which the Turkish Republic is a party are reserved. If an issue falls within the scope of an international convention, the international convention takes the precedence of provisions of the national law. Turkey is a party to the Washington Convention on the Settlement of Investment Disputes between States and Nationals of Other States (1965),[40] to the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards (1958),[41] and to the Geneva Convention on International Commercial Arbitration (1961).[42] These conventions constitute a major part of Turkish arbitration legislation.

In the event the parties choose arbitration as an alternative dispute resolution method, it is crucial to precisely express that intention to resolve any related dispute by arbitration within a contract and avoid any contradictory statements. Under Turkish law, where a valid arbitration agreement is present, the Turkish courts shall decline jurisdiction in favor of arbitration upon objection by a party seeking to enforce the arbitration agreement.

## Applicable law in contractual obligations

All national legal systems have rules regarding the determination of the law applicable to issues involving a foreign element, *i.e.* that are not merely domestic. These rules (called conflict of law rules) make it possible to apply domestic laws to international matters, particularly where the domestic law appears to be more appropriate to govern these situations. When a dispute is brought before a national court, there is no doubt that such court must apply its own conflict of law rules. Therefore, when a court must determine the applicable law with respect to a contract, it will base its decision on its own system of private international law. However, the conflict of law rules of each country are different from one country to another. The variance in conflict of law rules creates uncertainty and has the propensity to produce contradictory results. If courts of different countries apply different conflict of law rules to the same situation, they may come to different conclusions. For example, if one country has a rule stating the law of the place of con-

clusion of the contract shall apply, while another country's rule states the law of the place of performance of the contract shall apply, the final results may be quite different.

In the following part of this paper, the Turkish conflict of law rules applicable to contractual relationships will be explained. In addition to art. 24 PIL Code, contractual obligations in the PIL Code are governed by special articles dealing with contracts of a special nature. If the contract is not in the scope of the specific categories of contracts listed in art. 25-29 PIL Code, the general rule – art. 24 PIL Code – will be applicable. For instance, art. 24 applies to sales, service, construction, joint venture or share purchase contracts.

## GENERAL RULE (ART. 24)

Art. 24 PIL Code provides a general rule on the law applicable to conflicts arising from contracts. The first three clauses of art. 24 give the parties the freedom to choose the law to be applied. The fourth and last paragraphs of the article regulate cases where the parties have not chosen an applicable law in their contract, and accordingly, the most closely connected law will govern their contractual relationship.

### 1. Choice of law principle

Art. 24 accepts the basic principle that parties may choose the law governing their contractual relationship. This freedom is a reflection of the well accepted freedom of contract principle in international private law.[43] The autonomy of the parties regarding the choice of law applicable to their contracts is quite wide; the choice of the applicable law may be expressed or implied. The implied choice is only possible if demonstrated with reasonable certainty by the contract and the circumstances of the case, such as the choice of a jurisdiction clause, language, currency, place of conclusion, place of performance, common domicile of the parties, etc. Furthermore, the choice may cover the contract wholly as well as partly, and it may occur or be altered at

any time. However, a choice of law after the conclusion of the contract may not adversely affect third party rights.[44]

The law chosen by the parties need not be closely related to the contract at hand, *i.e.* parties from Germany and Turkey contracting for the sale of goods shipped from France to Turkey are permitted to select Chinese, Brazilian or Russian law to govern their contract. Although the parties' freedom in this regard is quite broad, they must choose the law of a particular state as applicable law. Codes and rules of law such as Unidroit Principles on International Commercial Contracts (PICC)[45] or Principles of European Contract Law (PECL)[46] are not considered a valid choice of law under the PIL Code.[47]

The freedom to choose the applicable law ensures that the parties have predictability, legal certainty, safety and simplicity.[48] In other words, by choosing the applicable law in advance, parties are able to know how the contract will be regulated when a dispute arises. In this way they warrant that the law of the chosen country will be applied regardless of the forum of the case, and in the end of the day there will be no surprises. If a law has been chosen, the generally accepted rule is that the substantive provisions of that law will apply and not those of its private international law (art. 2(4) PIL Code).

Under Turkish law, the parties that choose the law of a particular jurisdiction are subject to the chosen legal system in totality, including international conventions the relevant state is party to. Therefore, the choice of German or Turkish law regarding contracts for the sale of goods results in the application of the Convention on the International Sale of Goods (CISG).[49] While the CISG provides uniform substantial rules on sales contracts to which 84 countries – including Turkey and Germany – are a party, however, the convention has a number of gaps which are filled by the domestic rules of the applicable law. It is advisable to insert a choice of governing law clause into contracts, also including cases where this convention applies. If the parties prefer to exclude the application of this convention, art. 6 CISG allows contractual parties to opt out of the convention.[50]

### 2. Objective connecting factor

Art. 24 also determines which law applies if there is no agreement between the parties. In the absence of a choice of law, the applicable law shall be the law of the country to which the contract is most closely connected. It is presumed that the contract is most closely connected to the country in which the party who is to affect the characteristic performance of the contract has, at the time of its conclusion, his/her habitual residence. This connection is determined according to the characteristic performance of the contract that is not defined in the PIL Code but by doctrine.[51] According to the doctrine, the characteristic obligation is the obligation that distinguishes the contract from others and gives it a legally essential nature. Pursuant to art. 24(4), the applicable law is determined by reference to the country where the party required to carry out the characteristic performance has his/her habitual residence. In contracts that are entered into on account of commercial or professional activities, the law of the place of business of the party responsible for the characteristic performance of the contract is deemed to be the most closely connected law. If there is no place of business, then the law of the place of domicile will apply. If a party has more than one place of business, then the applicable law will be the place of business that is most closely connected to the performance of the contract. In case of a sales contract between a Turkish seller and German buyer, the applicable law is determined by the obligation of the seller. In other words, Turkish law will be applicable in cases where a choice of law clause is absent.

Art. 1(2) PIL Code states that where Turkey is a party to international conventions, convention provisions are reserved if Turkish law is also applicable in the relevant area of law. Therefore, it must be determined whether the case at hand falls within the scope of an international convention. For example, in the case of contracts for the sale of goods, CISG takes precedence over provisions of Turkish law. Conversely, the issues not covered by CISG will be subject to Turkish domestic law.

### 3. Escape clause

An escape mechanism is available if it is clear from all the circumstances of the case that the contract is manifestly more closely connected to a country other than the country to which the allocation of the characteristic performance refers. This rule introduces a certain degree of flexibility in resolving conflict of laws and attempts to achieve an equitable solution in situations where the application of an objective conflict of laws rule does not lead to just results.[52] The escape clause is only applicable in the absence of a choice of law clause in the contract. If the parties have expressly selected the applicable law, the Turkish judge must respect the will of the parties and apply the relevant law.

## SPECIFIC CATEGORIES OF CONTRACTS

Art. 24 of the PIL Code addresses contracts generally, whereas the articles of the PIL Code discussed below provide specific instructions regarding contracts concerning immovable property, intellectual property, employment and consumer contracts.

### 1. Contracts related to immovable property (art. 25)

A contract concerning a right *in rem* in or a tenancy of immovable property is subject to the law of the country where the property is situated (*lex rei sitae*). It is a generally accepted universal rule that all contracts concerning real property are subject to the law of the country in which the real property is located. Contracts giving the right to claim a right *in rem* in real properties – such as the purchase and sale of property, the exchange of property, promising the donation of property, the division of an estate etc. – fall within the scope of this article. Contracts giving a right to use property or to benefit therefrom, such as renting the property or leasing a revenue-generating asset, are subject to the law of the country in which the property is located.[53]

### 2. Consumer contracts (art. 26)

Another special category consists of consumer contracts defined in art. 26 PIL Code as contracts the object of which is the supply of goods or services to a person (the consumer) who acts with a purpose unrelated to his/her trade or profession, or a contract for the provision of credit for that object. The parties may choose the applicable law, but such a choice cannot deprive the consumer of the protection afforded to him/her by mandatory rules of the law of the country where the consumer has his/her habitual residence. In consumer contracts, the parties are permitted a limited choice of law that is beneficial to the consumer.[54] The provisions of the chosen law that provide the consumer with less protection than the law of his habitual residence will not be applicable, *i.e*. the law of his/her habitual residence provides the minimum standards in the context of consumer protection.

If no choice of law has been made, a consumer contract is to be governed by the law of the country where the consumer has his/her habitual residence. Only consumer contracts which are entered into under the specific circumstances stated in art. 26(2) PIL Code are under the protective umbrella of this provision.

### 3. Individual employment contracts (art. 27)

Besides consumers, employees are also regarded as weaker parties in a contractual relationship, and therefore individual employment contracts are safeguarded by special conflict rules.[55] In terms of employment contracts, parties are entitled to a limited choice of law in favour of the employee. Parties are afforded the opportunity to choose any country's law regardless of its relevance to the particular contract. Although parties may choose the applicable law according to the general rule of art. 24 PIL Code, such a choice of law may not deprive the employee of the protection afforded to him/her by the mandatory provisions of the law that governs in the absence of a choice of law. In the absence of a choice of law, the law of the country in which the employee habitually carries out his/her work in the course of performing the contract, even if he/she is temporarily employed in another country (art.

27(2)), will be applicable. If it is impossible to determine the applicable law pursuant to this rule, the contract is to be governed by the law of the country where the employer's place of business is situated (art. 27(3)). The application of the law – determined by virtue of the objective connecting factor – may be declined if it appears from the circumstances as a whole that the contract is more closely connected to another country (art. 27(4)).

### 4. Contracts related to intellectual property rights (art. 28)

In terms of contracts regarding intellectual property rights, parties are entitled to a choice of law. The freedom to choose the law applicable to contracts regarding intellectual property rights embodied under art. 28(1) has an exception in art. 28(3) PIL Code. Subparagraph (3) states that contracts between an employer and an employee regarding rights to intellectual property which the employee has created in the course of his/her employment shall be governed by the law applicable to the employment contract.

In the absence of a choice of law, the law governing the contract will be the law of the state in which the party who transfers the intellectual property or the use thereof has his/her place of business at the time of the conclusion of the contract. If there is no such place then the place of habitual residence is to be taken into consideration. Art. 28(2) permits an escape clause authorizing the application of the law more closely connected to the contract, where the presence of such a law is clear from all the circumstances of the case.

### 5. Contracts related to the carriage of goods (art. 29)

Art. 29(1) PIL Code accepts the principle of freedom of choice as to contracts for the carriage of goods. The text of art. 29 does not state whether it is required that the applicable law is explicitly determined in the contract. Nonetheless, by analogy it can be assumed that art. 24 PIL Code, allowing an implicit choice, can be applied to contracts for the carriage of goods.[56] Art. 29(2) lays down principles for determining the applicable law in the absence of a choice by requiring a combination of connecting factors. If the country where the carrier has his/her principal place of business at the time

the contract is concluded is also the country in which the place of loading or the place of discharge or the principal place of business of the consignor is situated, it is presumed that the contract is most closely connected to that country. Where these requirements are met, the law of the country where the carrier has his/her principal place of business, at the time the contract is concluded, will apply. In applying this paragraph to single-voyage charter-parties and other contracts, the main purpose of which is the carriage of goods, they shall be treated as contracts for the carriage of goods. Art. 29(3) provides a route to escape the application of the law designated by the objective allocations if the contract is manifestly more closely connected to another country.

## Conclusion

When striking deals and drafting contracts, little importance is typically given to the governing law and jurisdiction provisions which form part of the boilerplate clauses in the end of the contract. It is important, however, that these clauses receive as much attention as the substantive provisions of the contract. Failure by parties to agree or to include suitable governing law and jurisdiction clauses may lead to lengthy and potentially expensive disputes over the governing law and dispute resolution procedures to be applied to a given contract.

All national legal systems have rules regarding the determination of the competent court and the law applicable to issues that involve a foreign element. These rules (called international jurisdiction rules and conflict of law rules) differ from one country to another. When no express choice of governing law is provided in the contract and a dispute occurs, a court will decide which law to apply in accordance with the relevant conflict of law principles in that jurisdiction. The variance in these rules may create uncertainty and produce contradictory results. Therefore, governing law and jurisdiction clauses are important and should always be included in international contracts.

Under Turkish law principles, parties are free to agree on the competence of the forum and the applicable law. Parties may choose the law governing

their contractual relationship, excepting contracts related to immoveable property – where the choice of law is not permitted – and consumer contracts and employment contracts, which necessitate a limited choice of law in favour of the weaker party in the relationship. Further restriction on the parties' choice of law can apply at the state level, particularly in Turkey where the parties' choice of law shall only be valid under the PIL Code where that choice is the rules of a recognised state.

## ENDNOTES

**1.** Assoc. Prof. Dr. jur. Koc University Law School, Istanbul/Turkey, Department of Private International Law. Email: ztarman@ku.edu.tr.

**2.** Ekşi Nuray, *Milletlerarası Ticaret Hukuku* (International Business Law), Istanbul 2015, p. 135.

**3.** Cemal Şanlı, Emre Esen, Inci Ataman Figanmeşe, *Milletlerarası Özel Hukuk* (International Private Law), Istanbul 2015, p. 571.

**4.** Available at: http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/NYConvention.html.

**5.** Ekşi, p. 135.

**6.** Şanlı, Esen, Figanmeşe, p. 353; Ergin Nomer, *Devletler Hususi Hukuku* (International Private Law), Istanbul 2015, p. 417.

**7.** Law no. 5718 published in the Official Gazette (OG) dated 12 Dec. 2007 and numbered 26728. For the English text of the Code, see Gülören Tekinalp and Ayşe Odman Boztosun, "The 2007 Turkish Code on Private International Law and International Civil Procedure", in P. Sarcevic *et al*. (ed.), *Yearbook of Private International Law*, vol. 9, Berne: Staempfli, p. 583-604.

**8.** Şanlı, Esen, Figanmeşe, p. 396; Aysel Çelikel & Bahadır Erdem, *Milletlerarası Özel Hukuk* (International Private Law), Istanbul 2012, p. 563.

**9.** Ekşi, p. 153.

**10.** Şanlı, Esen, Figanmeşe, p. 397; Nomer, p. 483.

**11.** Şanlı, Esen, Figanmeşe, p. 393; Ekşi, p. 151; Çelikel, Erdem, p. 563.

**12.** Nomer, p. 484.

**13.** Şanlı, Esen, Figanmeşe, p. 404.

**14.** Çelikel, Erdem, p. 568.

**15.** YHGK 15 June 1988, E. 1988/11-246, K. 1998/476 (www.kazancı.com); Ekşi, p. 155.

**16.** YHGK 6 May 1998, E. 1998/12-287, K. 1998/325 (www.kazancı.com).

**17.** Şanlı, Esen, Figanmeşe, p. 404; Çelikel, Erdem, p. 568.

**18.** Nomer, p. 488.

**19.** Şanlı, Esen, Figanmeşe, p. 408

**20.** Law no. 6100 published in the Official Gazette dated 4 Feb. 2011 and numbered 27836.

**21.** Şanlı, Esen, Figanmeşe, p. 355.

**22.** Çelikel, Erdem, p. 508; Şanlı, Esen, Figanmeşe, p. 362.

**23.** Law no. 4721 published in the Official Gazette dated 8 Dec. 2001 and numbered 24607.

**24.** Çelikel, Erdem, p. 516.

**25.** Çelikel, Erdem, p. 517.

**26.** Şanlı, Esen, Figanmeşe, p. 368; Nomer, p. 459.

**27.** Şanlı, Esen, Figanmeşe, p. 365; Çelikel, Erdem, p. 513.

**28.** Nomer, p. 460.

**29.** Çelikel, Erdem, p. 514.

**30.** Şanlı, Esen, Figanmeşe, p. 367; Nomer, p. 460.

**31.** Law no. 6098 published in the Official Gazette dated 4 Feb. 2011 and numbered 27836.

**32.** Nomer, p. 461.

**33.** Şanlı, Esen, Figanmeşe, p. 327; Çelikel, Erdem, p. 433.

**34.** Nomer, p. 476.

**35.** Şanlı, Esen, Figanmeşe, p. 391.

**36.** Law no. 4686 published in the Official Gazette dated 5 July 2001 and numbered 24453.

**37.** Ziya Akıncı, *Milletlerarası Tahkim*, 2007, p. 56; Turgut Kalpsüz, *Milletlerarası Tahkim Kanununda ICC Tahkim Kuralları ile IPL'den Esinlenen Hükümler*, ICC Türkiye 2003, p. 17-18.

**38.** Provided that the respondent was given the proper opportunity to present its case, an arbitral award which is based on the respondent's default will be valid and enforceable by Turkish courts according to art. 11/C/4 of the International Arbitration Law.

**39.** The demand to establish a code of international arbitration became apparent in disputes arising from the concession agreements and contracts regarding public services concluded for the assurance of the necessary services and investments to construct big infrastructure facilities such as bridges, reservoirs, sewage and water treatment services which can only be executed by external financing. The major drawback of the concession agreements and contracts was the Council of State's (*Danıştay)* authority of preliminary examination. Since conflicts concerning concession agreements and contracts were subject to administrative jurisdiction, the Council of State has been granted the right to eliminate the issues concerning international arbitration within concession agreements and contracts during the preliminary examination. And this elimination was an obstacle for the foreign investors to make investments in Turkey. To put an end to this conflict created by the Council of State, many laws were amended starting with the Constitution. Turgut Kalpsüz, *Türkiye'de Milletlerarası Tahkim*, 2007, p. 5.

**40.** Law no. 3460 of 27 May 1988, published in the Official Gazette dated 2 June 1988 and numbered 19830.

**41.** Law no. 3731 of 8 May 1991, published in the Official Gazette dated 21 May 1991 and numbered 20877.

**42.** Law no. 3730 of 8 May 1991, published in the Official Gazette dated 21 May 1991 and numbered 20877.

**43.** Şanlı, Esen, Figanmeşe, p. 253; Nomer, p. 312.

**44.** Şanlı, Esen, Figanmeşe, p. 256.

**45.** Available at: http://www.unidroit.org/english/principles/contracts/principles2010/integralversionprinciples2010-e.pdf.

**46.** Available at: http://www.transnational.deusto.es/emttl/documentos/Principles%20of%20European%20Contract%20Law.pdf.

**47.** Şanlı, Esen, Figanmeşe, p. 257; Nomer, p. 315.

**48.** Nomer, p. 316.

**49.** Available at: http://www.uncitral.org/uncitral/en/uncitral_texts/sale_goods/1980CISG.html.

**50.** Şanlı, Esen, Figanmeşe, p. 263.

**51.** Nomer, p. 326; Şanlı, Esen, Figanmeşe, p. 271.

**52.** Şanlı, Esen, Figanmeşe, p. 274.

**53.** Nomer, p. 331; Şanlı, Esen, Figanmeşe, p. 275.

**54.** Şanlı, Esen, Figanmeşe, p. 276.

**55.** Çelikel, Erdem, p. 363; Şanlı, Esen, Figanmeşe, p. 278.

**56.** Şanlı, Esen, Figanmeşe, p. 263.

# INSTITUTIONAL ARBITRAGE: CHINA'S ECONOMIC POWER PROJECTION AND INTERNATIONAL CAPITAL MARKETS[1]

**Weitseng Chen**[2]

## Introduction

China's aggressive participation in global capital markets dominates today's headlines, leaving informed observers with mixed feelings. Not only are there landmark transactions, such as the Agriculture Bank of China recording the biggest initial public offering (IPO) in financial history at the time, but statistics tell the larger story: China has become the world's biggest IPO market despite the global downturn, and Chinese company listings on global exchanges set a record in 2010, with 129 IPOs, up from 77 in 2009.[3] Moreover, since January 2008, Chinese firms have disclosed 1,414 overseas acquisitions, valued at about $235 billion; of those deals, 198, valued at about $40.6 billion, occurred in 2012.[4] In the US alone, 2012 is also a record year for Chinese outbound direct investment, with completed deals worth $6.5 billion, a 17% increase from the previous record of $5.5 billion in 2010.[5]

At the same time, the substantial Chinese presence in the market has fueled international controversies about alleged accounting frauds, national security consequences of Chinese companies acquiring foreign assets, and disputes between Chinese and foreign regulators. China's sovereign wealth fund and mighty state-owned enterprises have also challenged the conventional thinking of corporate governance and global regulatory structure.

How can we interpret this phenomenon from a theoretical perspective? In particular, how has China been able to offset its institutional weaknesses at home while achieving such impressive results without moving further toward the existing models of Western countries? Political scientists label this economic supremacy as "Chinese state capitalism",[6] while economists emphasize the strength of "latecomer advantage."[7] Resonating the two schools

of thought from an institutional perspective in law and development, this paper uses international capital market practices to illustrate how the Chinese developmental state compensates for its domestic institutional deficits by leveraging institutions across various jurisdictions, and thereby pursues its development strategy at an unprecedented speed. I call this approach "institutional arbitrage."[8]

In finance, arbitrage is a speculative practice that takes advantage of price differences between multiple markets, pursuing an almost guaranteed profit by buying low at one market and selling high at the other. The flip side of price and profit is risk. In theory, arbitrage is risk-free as it is an exchange where the profits are known beforehand; in practice, however, arbitrage may incur enormous risks simply because the betting is carried out not in a perfect market, but in a real world where unforeseen variables, drastic changes of market conditions, or the complexity of different rules across markets often catch the arbitrageur off guard.

This paper uses arbitrage as a metaphor to describe an approach adopted by the Chinese state and companies of making up for flawed institutions at home, thereby borrowing time and acquiring managerial expertise for reforms while accessing foreign capital to achieve development goals. Like arbitrage, however, this strategy is not risk-free, either for Chinese firms or the global capital markets, in that the risks from the domestic institutional weakness are not dissolved but rather diffused globally.

I will begin with a brief discussion about Chinese state capitalism and its interaction with international capital markets, followed by an analysis of institutional arbitrage, its impacts on global regulatory regimes, and a number of identified patterns before concluding.

## Chinese state capitalism and international capital markets

Scholars of law and development stress that institutions matter, but how they matter and which institutions matter most remain hotly contested questions.[9] In the Asian context particularly, activist developmental states usually undermine conventional assumptions regarding legal regulations. The classic

liberal model emphasizes government constraint rather than empowerment, whereas public-private capitalistic coalitions in East Asia require a government that is both constrained and, more importantly, empowered.[10]

## WHY IS CHINESE STATE CAPITALISM UNIQUE?

State capitalism is hardly new in Asia, but Chinese state capitalism is unique and is distinguished by two characteristics. First, it relies on foreign investment, with a high degree of dependence on international capital markets.[11] Second, it is directly led by state-owned enterprises (SOEs) and state-controlled firms.[12] Since 2007 when the sovereign wealth fund China Investment Corporation (CIC) was incorporated, big SOEs have been receiving further financial support from the CIC to expand globally and invest actively in international financial institutions and the natural resources sector.[13] These two characteristics sharply contrast the Chinese model with its predecessors in East Asia.

Compared to its Chinese counterpart, state capitalism in Japan, Korea and Taiwan relies more on domestic capital and is largely led by private enterprises, with guidance and strong support from developmental state institutions.[14] A recent cross-country study of state capitalism also indicates more complex and dynamic patterns of corporate structure – a hybrid of majority and minority shareholding in various forms of business entities – that Chinese state capitalism has developed and relied upon compared to those of its counterparts in the old days.[15] In the following sections, I look at how Chinese state capitalism has been adapted to global capital markets regulations while continuing to adapt domestically through institutional designs.

## HOW DOES CHINESE STATE CAPITALISM SHAPE MARKET INSTITUTIONS AT HOME AND WORLDWIDE?

The Chinese government has adopted an approach of "institutional bypass" domestically.[16] This involves creating favorable rules and institutions that attract inward foreign investments and encouraging big SOEs and state-controlled firms to go abroad,[17] thereby circumventing institutional weakness or

barriers pertaining to the SOEs, banking system, and corporate governance.[18] For instance, China's domestic capital markets have so far not proven effective in either providing sizable amounts of capital to firms or in disciplining the management of listed companies.[19] The problems of corporate governance in China have also been well-documented, including concentration of state ownership, lack of independence among board directors, false financial disclosures, insider trading, and limited private enforcement through litigation.[20] The institutional bypass approach confers an instant advantage and provides big SOEs a shortcut to foreign capital, albeit with foregoing structural problems at home.

Furthermore, the fact that Chinese state capitalism is led by the SOEs has given rise to a corporate governance regime that allows state intervention. Many international lawyers involved in SOE global securities offerings report not to a board of directors but to a decision-making party committee, the members of which are usually appointed under political consideration.[21] This institutional design lets the government guide SOEs and extract immense revenues from them. In 2010, 121 SOEs directly overseen by the State-Owned Assets Supervision and Administration Commission posted a combined profit of 1.13 trillion yuan (US$ 182 billion) and handed over about 60 billion yuan (US$ 9,639 million) to the government.[22] The state can, in turn, reallocate resources within the public-private coalition in a strategic manner by, for example, establishing and expanding the sovereign wealth fund, which has played a crucial role in global capital markets.[23]

Unsurprisingly, the immense scale of Chinese state capitalism has long-term implications for international capital markets. Along with increasing their economic power, the Chinese government and SOEs are leveraging their market status to better position themselves in globalized capital markets, and gradually are changing their attitude toward existing regulations and practices and becoming more visionary in a bid to reshape the rules of the game.

Thanks to the globalization of capital markets, China is able to adopt an "institutional arbitrage" approach to compensate for its own institutional deficits at home by reaping comparative institutional advantages worldwide, across different jurisdictions and varying regulatory regimes. Other developing countries and firms may adopt the same approach, but they barely bring

about as great an impact as China has. Size matters; for example, Chinese high-yield offerings have dominated global bond issuances the past few years as numerous PRC issuers from various industry sectors have taken turns executing deals. Furthermore, Beijing's policy to internationalize renminbi (RMB) as a rival to the US dollar has gradually and systematically changed the configuration and practices of international capital markets, as manifested by the boom of RMB-denominated bonds beginning in 2010 and the establishment of offshore settlement centers for RMB business recently in Hong Kong, Singapore, Macau, London, Taiwan, and potentially Luxemburg in the near future. In just 10 years, China and its SOEs have transformed themselves with unprecedented speed from students learning and adapting to existing capital market practices, to savvy players enjoying being part of the establishment, to finally game-changers.

## China's institutional arbitrage in international capital markets

### Institutional arbitrage and Chinese state capitalism

Chinese state capitalism represents a coalition consisting of the developmental state and its affiliates in the market, namely SOEs and state-controlled companies. Contrasting with the orthodox view of institutions as humanly devised constraints that structure human interactions,[24] I emphasize institutions as resources that China and its firms strategically utilize for solving problems of cooperation, risk distribution, and implementation of development strategies.[25]

Whereas traditional arbitrage is about individual market players taking advantage of information asymmetry and price differences between multiple markets, institutional arbitrage focuses on the way in which the developmental state and its affiliates leverage the complexity and differences between multiple systems of regulation across countries to pursue their development goals and/or carry out long-term strategies. Consequently, risks and costs caused by institutional deficiencies may cross borders and

flow into less-regulated markets, as exemplified by current global market practices examined below.

## PUTTING NEW WINE IN OLD BOTTLES: PLATFORMS FOR INSTITUTIONAL ARBITRAGE

China's institutional deficits relating to capital markets and corporate governance have barely disadvantaged Chinese firms in the global capital and financial arena; yet this would not have been possible but for a crucial regulatory platform structured by Rule 144A and Regulation S under the US Securities Act of 1933, as amended (the "Securities Act"). Rule 144A and Regulation S are two exemptions granted by the US Securities Exchange Commission (SEC) in 1990 to exempt securities issuers from full compliance with the Securities Act, thereby allowing these issuers to access the global and American capital markets without going through a time-consuming registration process.[26] Without these two exemptions, the past decade would not have seen a skyrocketing number of global securities offerings by Chinese firms.

In contrast, Chinese law only has to play a very limited role in PRC firms' international capital market transactions.[27] First of all, the governing law of each transaction is made not by the PRC but by foreign jurisdictions, usually New York State. Second, PRC firms' financial advisors and US lawyers are mainly concerned about potential liability should their clients fail to comply with US securities laws; hence PRC laws are less of a focus in the execution of exempted transactions. Third, as far as PRC laws are concerned, Chinese issuers often will not hesitate to represent no compliance issue under PRC law in order to fulfill the requirement by the exemptions that allow foreign issuers to follow their home state regulations regarding corporate governance, disclosure and accounting standards, instead of those of the host state. As a result, the two exemptions greatly relieve the compliance burdens for PRC firms and their professional advisors and similarly reduce their potential liability.

Prior to the adoption of Rule 144A, foreign borrowers wishing to raise large-scale capital in the US were forced to use the New York market by structuring their cross-border offerings as domestic US securities offerings,

which required a lengthy and expensive registration process.[28] This is now not the case, as Rule 144A provides an exemption for foreign issuers intending to sell their securities in the US if their securities are sold only to qualified institutional buyers, such as banks and savings associations. Thanks to Rule 144A, US institutional investors have also gained a quick channel to foreign investment opportunities and hence can benefit from higher rates of return globally.[29] Similarly, regulation S provides issuers an exemption from registration if the offer and sale of securities are made outside the US and no "directed selling efforts" are made in the United States. This way, American companies can foster their fundraising overseas without compromising the protection of US investors.[30] To be eligible for the exemptions, issuers can only sell securities through private placements, instead of public offerings that still require registrations with the SEC.

Regardless of the importance of the exemptions for Chinese issuers, Chinese firms were not part of the equation when the two exemptions were created. Most Chinese SOEs and private enterprises were still struggling to survive in the late 1980s when the amendments were under consideration. The original purpose of Regulation S and Rule 144A was mainly to benefit European and American firms that wanted more efficient capital flows across the Atlantic Ocean.[31] To protect American investors, US securities laws are meant to apply to any onshore or offshore transaction that employs US jurisdictional means, requiring the registration with the SEC of any offer or sale of securities involving the use of interstate commerce unless specifically exempted.[32] Given the strong presence of American investors worldwide, the extraterritorial reach of the Securities Act has defined global capital market practices and potentially imposes huge compliance costs on any foreign company making its securities available for American investors.

A decade later after the two exemptions were created in 1990, Chinese firms injected a new dynamic into this regulatory structure that had benefited European and American companies, whose corporate governance and regulatory regime at home are very different from their Chinese counterparts. With the exemptions, private placements are mainly governed by market practices standards rather than any formal system of securities regulation.[33] To take advantage of the foregoing exemptions, most global IPO schemes

structured by Chinese issuers have adopted a commonly referenced "global offering structure." As any foreign issuer relying upon the exemption from registration can sell securities only by private placements, this structure consists of a public offering in the issuer's home market, plus a series of private placements in reliance on Rule 144A and/or Regulation S. While the former part of this structure makes the shares to be registered and circulated in the home state, the latter part enables issuers to sell their shares globally and access to the US capital market with much less stringent regulations.

The IPOs of China's "big four" banks between 2005 and 2010 are cases in point. All four banks adopted the "global offering structure," which constituted public offerings of shares in Hong Kong and/or Shanghai and private placements of shares internationally as allowed by Regulation S and Rule 144A. In fact, shares sold through private placements in all four IPOs are nearly ten times greater than those sold through public offering.[34] Only a tiny portion of shares were sold and distributed through channels that fit the conventional IPO definition. This has become the common practice today.[35]

Private placements serve equally well the other forms of international securities offerings that constitute most of capital market activity by Chinese firms today. Offerings of convertible bonds, high-yield bonds, RMB-denominated bonds, global depository receipts or straight debt in the greater China markets are always structured, if not entirely, as exempted deals per Rule 144A and Regulation S, including global notes issued by the PRC government that has been active as a private issuer with the assistance of investment banks and consulting firms.[36] Private placements have not earned much attention from academic observers in part because the placements are perceived as a postscript to normal regulations.[37] In practice, they have become the dominating mechanism for Chinese firms and the Chinese government to gain access to US capital.

## REGULATORY LEVERAGE AMONG INTERNATIONAL STOCK EXCHANGES

Unlike public offerings, foreign issuers do not have to publicly list their securities before selling them through private placements, which are not subject to any formal system of securities regulation. However, this approach may not

be beneficial for issuers from emerging markets because investors generally perceive such issuers to be less creditworthy. Investors usually prefer securities that are listed so as to rely on reputable stock exchanges that formally address their concerns by listing rules that require greater transparency and accountability from issuers. In theory, by subjecting themselves through a listing to a thorough legal regime, foreign firms legally bond themselves and their insiders to responsive corporate governance and protection of investors' rights, which increases the value of their securities.[38] Chinese firms and their advisors are aware of the legal bonding effect but always investigate respective listing and disclosure requirements of various global stock exchanges before making private placements in the hope of gaining both listing status and minimally intrusive obligations post-listing.[39]

Today, the Luxembourg Stock Exchange and Singapore Exchange are the two most convenient venues for Chinese firms, places where they often go to reap the benefits of the legal bonding effect. Both stock exchanges have created alternative listing platforms geared toward foreign issuers selling securities through private placements.[40] Not only is the review of disclosure documents by respective regulators minimal, it takes just one month to complete the listing process.[41] At the same time, although they still prefer listed securities, US investors have become increasingly indifferent to where a company is listed, and large mutual funds have changed their charters to allow their fund managers to invest in non-U.S. stocks such that they can obtain more investment opportunities in emerging markets.[42]

Furthermore, the current US regime also offers choices to those who have chosen public access in the past, but now prefer a different approach (*e.g.* private access) or other markets (*e.g.* Hong Kong), aiming to create an incentive to foreign issuers to initially register their securities with the SEC.[43] One pronounced post-financial crisis phenomenon is the increasing number of delistings and deregistrations by Chinese firms that had listed their securities in the US but have chosen to migrate back to Asia where abundant capital is available.[44] This has coincided with the SEC's recent increased scrutiny of Chinese firms, especially those that have obtained listing status in the US through reverse mergers.[45] A substantial number of Chinese firms have completed, or are in the process of, delisting and deregistering their

securities from US stock exchanges and have made plans for relisting in Hong Kong or Shanghai.

## RISK MANAGEMENT BY THE STATE

To defend its companies from exposure to market risk and potential liability as a result of global securities offerings, the Chinese government will intervene and alter market practices if necessary. Such policies usually would not discourage international investors who have mainly been driven by potentially high profits that may offset remote risks or transaction costs caused by such protective measure. One prominent example is that Chinese regulators, contradicting international practice, forbid foreign issuers of debt securities to require any onshore PRC company to provide guarantees or pledges for offshore issuers.[46] It is worth noting that the foreign issuers in question usually are Chinese-owned parent holding companies incorporated overseas only for financing purposes, and the onshore PRC companies are usually their subsidiaries that conduct actual business operations and own valuable corporate assets in China. Consequently, because the Chinese borrower's guarantees are substantially outlawed, international creditors who purchase Chinese debt securities issued overseas are not sufficiently protected in a fashion commensurate with international market practices that treat foreign and domestic creditors equally. In short, foreign creditors are made subordinated to onshore PRC subsidiaries' creditors, such as state-owned banks or local companies.

This rule is essentially a firewall set by the Chinese government between international and domestic capital markets in favor of PRC companies and creditors. It has changed capital market practices regarding Chinese debt securities in that Chinese companies pay very high interest while giving their foreign lenders limited rights in the event the companies fail. Generally, this firewall effectively protects Chinese firms and domestic creditors without discouraging keen international investors who are willing to take the risk in exchange for potentially high profits.[47] Sometimes this doesn't work out well for investors when the risk is materialized. In a bankruptcy case filed in Hong Kong court in 2009 by Asia Aluminum Holdings Ltd, PRC creditors

were given priority and US investment bank Merrill Lynch and institutional investors received less than one cent for every dollar the company owed them in the form of high-yield bonds.[48]

## CHINESE LATECOMER ADVANTAGE

Chinese firms that successfully leverage the complexity of different regulatory systems are also benefited by their latecomer advantage in the market. Compared to their European and American counterparts, who called for the adoption of Regulation S and Rule 144A in the 1980s, Chinese firms have been able to access an array of institutional resources from the moment they entered this competitive market.[49]

First, internationalized legal services have greatly eliminated the high compliance costs that used to burden foreign issuers and led to the adoption of Rule 144A and Regulation S in 1990. Today, top-notch lawyers and bankers from international law firms and investment banks are local and provide seamless services through regional offices for their Chinese clients.[50] It is not uncommon that the working language within American law firms and banks based in Beijing, Shanghai or Hong Kong is Mandarin, because many of their lawyers and bankers are trained in China or elsewhere. Difficult legal compliance issues – except perhaps in fees paid to Wall Street lawyers – no longer exist.[51] Their professional expertise and skills put Beijing and SOEs in the driver's seat for a strategic piece of the Chinese economy.[52]

Second, the economic system today is buoyed by financial innovations that produce many benefits, such as reduced risk, enhanced transactional efficiency, expanded scope of services and better utilized professional knowledge. Hedging mechanisms – such as credit default swaps, securitization, and future and options contracts – spread risk, minimize potential liability, and protect against loss from financial volatility. Chinese firms have greatly benefited from these financial innovations, international accounting and financial rules, new deal structures, and pricing methodology, which increasingly make their securities acceptable worldwide because the inherent risks resulting from the quality of their corporate governance and emerging market status can be defused by distributing widely.

Furthermore, the Internet, smartphones, digital databases, and other telecommunication technologies have transformed time differences and geographic distances, turning them from transaction costs into operational efficiencies. Lawyers and bankers from different time zones can coordinate to provide their Chinese clients far more efficient services globally, 24 hours a day, 7 days a week. The once cumbersome clearing and settlement system has been digitalized too; with SWIFT codes, the proceeds of offerings can swiftly be wired to Chinese issuers around the world. Book-entries have replaced physical certificates issued by foreign issuers, and investors' titles to securities purchased appear on their accounts as quickly as issuers instruct the transfers on the other side of the globe. No longer is distance or geography a barrier to China deal-making.

## Impacts of institutional arbitrage on international capital markets

### Global regulatory competition

China's institutional arbitrage in the international capital markets may shed light on a policy debate about issuer-choice under US securities laws – whether foreign issuers should be allowed to choose foreign securities regulation when accessing US capital markets. Proponents assert that providing exemptions under US securities laws is an incentive for foreign issuers to reach US investors and for the SEC to make its regulations more cost-efficient.[53] Meanwhile, critics of issuer-choice warn that it would encourage regulatory competition between various jurisdictions, and eventually, lead to a destructive "race to the bottom," in which issuers migrate to a least demanding regulatory regime with the lowest level of investor protections, causing the overall quality of global securities regulation to deteriorate.[54]

In the current global capital markets, Chinese firms often gravitate to light-touch regulation systems, such as platforms offered by the Luxembourg Stock Exchange or the Singapore Exchange for private placement issuers. The Hong Kong Exchange where an increasing number of PRC firms have

listed their shares is in the process of changing listing rules to make listings easier too.[55] The issuer-choice theory assumes that good governance of an issuer will be reflected by a higher price of the securities to be offered because the price system is a mechanism for communicating information; hence the issuer as well as home regulators have incentives to pursue good corporate governance instead of engaging in regulatory competition to lower a regulatory standard.[56] Empirical studies of European capital markets and companies generally support this assumption and find no compelling evidence of a race to the bottom; the gap distinguishing US and European disclosure standards has in fact become narrower over time.[57] This assumption, however, does not seem to apply to behavior of Chinese firms. Other factors, such as an issuer's monopolistic market status, often outweigh the quality of corporate governance as major pricing factors for Chinese securities.[58]

Chinese firms particularly disfavor certain foreign regulations that might challenge their overseas operations in certain areas, especially those that have been labeled as Chinese state capitalism. For example, the SEC has required Chinese firms that list their shares in the US to disclose detailed information pertaining to not just companies themselves but also their beneficial shareholders, subsidiaries and affiliates.[59] In its comments on the 2006 annual report of China National Offshore Oil Cooperation (CNOOC), one of the major PRC national oil companies, the SEC asked for details of CNOOC's current, past and anticipated activities associated with Iran, Syria and Sudan, including through affiliates and other direct and indirect arrangements.[60] This strikes a nerve with Chinese regulators and firms because such information might trigger enforcement of trade sanctions decisions made by the Office of Foreign Assets Control (OFAC).

In general, the threat of enforcement actions against foreign issuers, including the Foreign Corruption Practices Act (FCPA), has proven to be quite real recently. The Dodd-Frank Wall Street Reform and Consumer Protection Act (2010) has also strengthened the enforcement by setting up a securities whistleblower program, creating monetary awards as much as thirty percent of the monetary sanctions so collected to whistleblowers providing information that leads to successful enforcement actions against various corporate frauds.[61] According to the SEC report, China has been one of the largest

sources of whistleblower tips received overseas, ranked number one in 2011 and fourth in 2012.[62] When regulatory regimes like those of the US are laden with increasing moral obligations, Chinese firms and regulators may opt for a classical *laissez-faire* regulatory regime elsewhere.[63]

Furthermore, at a time when global capital markets are more volatile than before, Chinese firms are particularly attracted to light-touch regulations.[64] To capture investment windows that have become much shorter, especially exacerbated after the 2008 global financial crisis, issuers need to avoid any delay in the registration process. Today, once an investment window is identified, a Chinese high-yield bonds issuer is able to mobilize their lawyers and financial advisors to complete an offering within two to three months through private placements in reliance on Regulation S and/or Rule 144A exemptions. This is in contrast to the years prior to the financial crisis when it used to take a significantly longer period to execute a similar private placement transaction, not to mention the six months or longer required to register a public offering. However, a quick execution may further compromise due diligence and disclosure standards, which have been lowered for private placement transactions.

## DISTRIBUTION OF REGULATORY DEFICIENCY

Through institutional arbitrage, Chinese firms can piggyback on foreign institutions and regulatory systems to access capital before resolving institutional deficits at home; consequently, risk can go across borders to be distributed to investors worldwide. At the same time, financial innovations that defuse risk, such as securitization and credit default swaps, may paradoxically tempt market players to take more risk because of the improved capability to bear risk.

Since 2009 there has been an outbreak of corporate scandals surrounding Chinese companies listed overseas. In Canada in 2011, Sino-Forest Corporation, a once well-regarded Chinese timber company listed in Toronto, was accused of a massive accounting fraud. This was followed by an investors class-action claim against the company, as well as its big-name underwriters and auditors. Sino-Forest has filed bankruptcy in March 2012.[65]

In the US since late 2010, alleged financial frauds and accounting issues have been revealed at a number of Chinese companies. Nasdaq and NYSE halted trading in the shares of at least 21 Chinese companies in 2010 alone and delisted five of them from the exchanges.[66] As of September 2012, 67 China-based public companies have had their auditors resign.[67]

Likewise, on the Singapore Exchange, since early in 2008, there have been nineteen corporate scandals involving Chinese companies.[68] In Hong Kong, at least six disputes were reported in the first four months of 2012 and the Hong Kong Financial Reporting Council has announced that 13 Chinese firms require close monitoring.[69]

## POLITICAL AND REGULATORY CLASHES

Wary of regulatory deficiencies surrounding China-based companies, regulators of the US and elsewhere have started tightening enforcement on all fronts. As evidenced by the CNOOC annual report incident in 2007, the SEC, through its review of annual reports and other company disclosures, has strengthened its scrutiny of Chinese firms as well as their shareholders, subsidiaries and affiliates.[70] Various compliance issues now routinely scrutinized include FCPA or economic sanctions enforced by OFAC against terrorists or other targeted foreign countries such as Iran where Chinese oil companies have a presence.

In response, Chinese regulators fiercely defend the current practices of institutional arbitrage on the grounds of national sovereignty. For example, the China Securities Regulatory Commission (CSRC) has rejected a continuing request by the Public Company Accounting Oversight Board (PCAOB), a watchdog agency created by the Sarbanes–Oxley Act (2002) to oversee the auditors of public companies.[71] PCAOB wants to directly inspect Chinese auditing firms involving U.S.-listed companies in the wake of increasing accusations of accounting irregularities at a number of Chinese companies.[72]

Recently the tension between Chinese and foreign regulators has increased. The CSRC, for instance, has ruled out the possibility of allowing SEC staff to conduct on-site reviews of the records and books of Chinese rating agencies applying for the status of Nationally Recognized Statistical

Rating Organizations (NRSROs) under the Securities Exchange Act of 1934. The CSRC insists that the SEC should entrust the CSRC to implement the SEC's oversight of Chinese agencies.[73] Consequently, when the SEC denied an NRSRO application by Dagong Global Credit Rating Co., China's largest rating agency that works closely with China's Commerce Ministry on ratings projects in connection with SOEs, the decision aroused strong criticism of the SEC for intruding on national sovereignty and discriminating against Chinese applicants.[74]

The most recent dispute is the SEC's proceeding against five big international accounting firms that have a strong presence in China. In December 2012, the SEC brought an administrative proceeding against Deloitte Touche Tohmatsu Certified Public Accountants Ltd., Ernst & Young Hua Ming LLP, KPMG Huazhen, PricewaterhouseCoopers Zhong Tian CPAs Ltd., and BDO China Dahua CPA Co., Ltd, alleging they failed to submit documents sought in the SEC's investigations and thus violated the Securities Exchange Act and the Sarbanes-Oxley Act.[75] The five firms refused to comply with the SEC's order for fear of violating PRC secrecy laws.[76]

Disputes have also arisen in the context of the national security review of foreign investment by recipient nations of Chinese foreign investment. Early in 2012, Huawei, the world's second largest telecom equipment supplier based in China, was barred by the Australian government from a A$ 42 bn tender to build a national broadband network. The Australian government expressed concern about the alleged links between Huawei and the Chinese military.[77]

Similar tensions between China and the US were manifested in a lawsuit against president Barack Obama by Ralls, a company owned by two Chinese executives, in October 2012.[78] Ralls believes the president violated constitutional protections on property ownership and has challenged the decision of the Committee on Foreign Investment in the US (CFIUS) to determine the negative effect on the US national security that would be brought about by Rolls' acquisition plan. The committee's decision prompted the president to issue an order blocking Rolls' investment in wind farms within or in the vicinity of restricted air space in Oregon because of national security concerns.[79] The then PRC vice-premier Wang Qishan subsequently chastised

US cabinet members for performing "political background checks", adding that Americans were not asked about politics when investing abroad.[80]

## Patterns of institutional arbitrage

Institutional arbitrage is different from mere forum shopping, although the latter conveys a similar but narrower sense of calculations. While forum shopping mainly refers to a choice of jurisdiction that maximizes the benefits of plaintiff or defendant in dispute, institutional arbitrage goes beyond to entail more dynamic arrangements across multiple jurisdictions and/or systems of regulation to maximize one's institutional advantages (or minimize disadvantages).

The globalized and complex capital markets make institutional arbitrage even more commercially and legally viable. For instance, it is not uncommon to see an offering made by a Chinese company incorporated in Hong Kong, with major operations in mainland China and Taiwan through its subsidiaries listed in Singapore, that is to issue bonds to be listed on the Luxembourg Stock Exchange in reliance upon the exemptions under the US Securities Act of 1933, with the New York State law as the governing law. As multiple jurisdictions and systems of regulation are often involved in one single transaction, there is plenty of room for the market players, such as the state, to leverage the complexity of cross-border regulations for their benefits. Institutional arbitrage is based on a function of various factors, including compliance and transaction costs, commercial or institutional strengths and weaknesses, targeted markets, development strategies, business alliances with certain market players, or any other political economy consideration.

A few patterns of institutional arbitrage can be identified.[81] First, the Chinese state seeks to compensate for its institutional deficits at home by encouraging SOEs and state-controlled companies to bypass institutional obstacles (*e.g.* immature domestic capital markets) and policies (*e.g.* the capital account control) in accessing international capital markets. In numerous transactions, the state and its affiliates have appeared to be willing to pay a premium to learn and to sacrifice higher valuations for foreign expertise in order to strengthen its corporate sector.[82] Although they have been willing to

conform to international regulatory standards, especially in the early years, Chinese firms act strategically, usually choosing the least intrusive regulations that would not undermine their public-private coalition. As Carl Walter and Fraser Howie indicated in their research, after China Life Insurance Company's IPO in 2003 on the New York Stock Exchange was investigated for financial irregularities, its fellow SOEs from the "national champion" team opted for Hong Kong as the venue of choice, while many overseas returnees are moving back directly to Shanghai where things are "a bit easier to manage," as one SOE chairman put it.[83]

Second, the Chinese government and companies may ignore or defect from current international market practices and regulations. This pattern has been evident in recent disputes between Chinese and US regulators. In regard to the SEC's proceeding against the top five accounting firms in December 2012, it was reported that Chinese officials warned the accounting firms about releasing information about Chinese SOEs and private companies to outside parties, considering it a possible violation of Chinese secrecy laws.[84]

Third, the state may defend international standards by preserving core competencies centered on home institutions and rules. The party-state maintains its strong presence in the corporate governance structure of SOEs, despite the fact that many of these firms have become seasoned players in global capital markets.[85] The other example of this is the legal firewall between global and domestic capital markets erected by Chinese regulators to protect PRC firms and their creditors from foreign creditors' claims. The regulators refuse to follow international practices that treat overseas and domestic creditors equally and disallow overseas creditors to protect their credits by asking for pledges or guarantees against issuing companies' assets under their effective control in China (as discussed in section "China's institutional arbitrage in international capital markets"). In this regard, China has made advantageous use of market enthusiasm for investment opportunities in China and leveraged a favorable regulatory environment for PRC firms.

Furthermore, Chinese firms may seek better evaluation and greater access to international capital markets by symbolically adapting to international regulations. As discussed previously, although a listing status is not legally needed for private placements, Chinese issuers bond themselves with a

reputable foreign stock exchange by obtaining a nominal listing status that requires minimal obligations.[86] Regulatory competition between international stock exchanges may facilitate such regulatory leverage by Chinese issuers.

Ultimately, the Chinese government and Chinese firms may change, or reform existing practices as prescribed by various countries' regulatory regimes and market standards. This intention to change comes at a time when architects of Chinese state capitalism are altering their attitude towards international regulation, becoming more visionary and setting their own agenda. The resulting institutional changes may be accomplished by "layering" – not by eliminating existing institutions but by creating new alternatives that may or may not be fundamentally different from the existing ones. The internationalization of renminbi (RMB) in global capital markets is a case in point and is at the top of China's agenda. This change of status for RMB will very likely provide new momentum for critical institutional changes in global capital markets in the near future.

The recent boom in "dim sum" bonds, the RMB-denominated bonds traded outside China, illustrates these institutional changes by layering. Perceiving the internationalization of RMB as a critical long-term development strategy, the Chinese government has allowed such bonds to be issued in 2007 and the market took off significantly in 2010 following further deregulation.[87] As a result, the dim sum bonds market has rapidly changed practices across the board – from the character of clearing and settlement institutions (*i.e.* a shift from American to Chinese banks and institutions) to the credentials of banking and legal professionals (*i.e.* greater knowledge of PRC and HK regulations and more fluency in Mandarin) and to the creation of new RMB-denominated financial products and trading markets (*i.e.* a stronger demand by RMB holders for investment opportunities). To achieve these breakthroughs that may fundamentally reshape the US dollar-denominated capital world, China has simply replicated an existing capital market model and created an alternative platform with a Chinese currency touch.[88]

## Conclusion

An institutional perspective on development issues has become increasingly prominent in the field of development theory and practice, leading to a proliferation of research exploring not just why but how institutions matter. Meanwhile, the rise of China has posed even more challenges to conventional development thinking, as captured in the fashionable term "Beijing Consensus."[89] While the current literature tends to focus on the institutional evolution taking place within jurisdictional boundaries, with the state as a major supplier of institutional reforms, Chinese state capitalism shifts such discussion to a global level among multiple jurisdictions, with its developmental state and affiliates as consumers of good institutions worldwide.

In light of the widely recognized relationship between economic growth and good institutions regarding financing, banking and corporate governance,[90] how has the Chinese system been able to compensate for its institutional weaknesses at home without having to move closer to the existing models and practices of developed countries? This paper uses the concept "institutional arbitrage" to explain China's strategy and its impressive performance in international capital markets for the past decade. Institutional arbitrage allows the Chinese government and its firms to compensate for its domestic institutional deficits by piggybacking on foreign institutions, regulatory regimes and managerial expertise to tap foreign capital and facilitate domestic institutional reforms. The Chinese developmental state in turn extracts revenues from SOEs and reallocates resources strategically within the state capitalism system, and thereby further projects the state's economic power and institutional changes worldwide.

China's institutional arbitrage model poses various challenges to conventional thinking. Bernard Black once argued that big individual companies may partially escape weak home-country institutions by listing shares overseas, but it is much harder for an entire country to piggyback on foreign institutions due to the complexity of securities regulation and law enforcement.[91] However, the Chinese experience shows that it is the very complexity of regulations that makes China's institutional arbitrage possible. The connection between Chinese firms and the developmental state adds a new

dimension that challenges the traditional thinking that treats the firm and the government separately.

While this paper has shown patterns of institutional arbitrage, the consequence of it all remains to be observed. Economic historians point to the invention of bond markets as a key to understanding why the United Kingdom replaced France in the 19th century as the world's strongest power as the French in general did not appreciate the logic and power of bond markets then.[92] Does China's institutional arbitrage in capital markets illustrate a parallel? For certain, Chinese firms as a whole have quickly transformed themselves from inexperienced conformists to sophisticated players and finally to game-changers, all within a decade. With the proliferation of their overseas activities that may lead to more clashes between Chinese and foreign regulators, the future is rocky at best.

# ENDNOTES

**1.** This article originally appeared at 26 *Columbia Journal of Asian Law* 347 (2013). Editors' note: For this book, the abstract was excluded.

**2.** Assistant Professor and Deputy Director of the Center for Asian Legal Studies, National University of Singapore Faculty of Law. J.S.D. (2007), Yale Law School; Hewlett Fellow (2008), The Center on Democracy, Development, and the Rule of Law, Stanford University. Email: weitseng.chen@nus.edu.sg. Thanks to Robert Bianchi, Gilles Cuniberti, Michael Dowdle, Arif A. Jamal, Jedidiah Kroncke, Ji Li, Gregory Noble, Jiwei Qian, Victor Ramraj, Arad Reisberg, Kevin Smith, Kevin Tan, Yingmao Tang, Gregory Feihong Wang, my former colleagues at Davis Polk & Wardwell, and all participants of the seminars at Peking University Law School, Tokyo University, Taiwan University College of Law and Keio University Law School for helpful discussions and comments.

**3.** Gillian Zhang, Zero2IPO Research Center, "324 Chinese IPOs Raised US$ 53.8B in Jan-Nov 2011 with 154 VC/PE-backed IPOs Down 20.0% YoY" (Jan. 6, 2012, 4:21 PM), http://www.pedaily.cn/Item.aspx?id=218355; Samuel Shen & Jacqueline Wong, "China's IPO Market the World's Biggest Despite Slump", Reuters (Jan. 4, 2012, 1:48 PM), http://www.reuters.com/article/2012/01/04/us-china-ipo-idUSTRE8030IP20120104.

**4.** Simon Hall *et al*., "China Push in Canada Is Biggest Foreign Buy", *Wall St. J*. (July 24, 2012), http://online.wsj.com/article/SB10000872396390443437504577544470741886332.html.

**5.** Thilo Hanemann, "Chinese FDI in the United States: Q4 2012 Update", Rhodium Group (Jan 16, 2013), http://rhg.com/notes/chinese-fdi-in-the-united-states-q4-2012-update.

**6.** See *e.g*. *The Economist*, "The Rise of State Capitalism" (Jan. 21, 2012); Philip C. C. Huang, "Profit-Making State Firms and China's Development Experience: 'State Capitalism' or 'Socialist Market Economy'?", 38 *Modern China* 591 (2012).

**7.** For a representative discussion, Lin Yifu (林毅夫) *et al*., Zhong Guo de Qi Ji: Fa Zhan Zhan Lüe yu Jing Ji Gai Ge (中国的奇迹发展战略与经济改革) [The Chinese Miracle: Development Strategy and Economic Reform] (Shanghai Renmin, 2nd ed., 2002); Justin Yifu Lin, "Development 3.0", *The Straits Times* (June 27, 2012), http://www.straitstimes.com/microsites/global-perspectives/story/justin-yifu-lin-development-30.

**8.** "Institutional arbitrage" was initially constructed by strategic business management literature that aims to analyze the situation where a firm exploits the differences between the institutional environments of two countries, usually the home country and a host country where the firm invests in, to maximize its profits and advantages. Ajai S. Gaur & Jane W. Lu, "Ownership Strategies and Survival of Foreign Subsidiaries: Impacts of Institutional Distance and Experience", 33 *J. Mgmt*. 84 (2007); Max Boisot & Marshall W. Meyer, "Which Way through the Open Door? Reflections on the Internationalization of Chinese Firms", 4(3) *Mgmt. & Org. Rev*. 349 (2008).

**9.** For an excellent symposium discussion about the challenges for current law and development thinking, see *e.g*. Tom Ginsburg, *The Future of Law and Development*; Katharina Pistor, *There Is No Single Field of Law and Development*; Mariana Mota Prado, *Should We Adopt a "What Works" Approach in Law and Development?*; D. Daniel Sokol, "Law and Development – The Way Forward or Just Stuck in the Same Place?" *in Symposium: The Future of Law and Development*, *Nw. U. L. Rev. Colloquy*, vol. 104, at 164 (2009), http://colloquy.law.northwestern.edu/.

**10.** Tom Ginsburg, "Does Law Matter for Economic Development? Evidence from East Asia", 34 *Law & Soc'y Rev*. 829, 836-37 (2000) (discussing how the accounts of public-private coalitions in East Asia challenge the conventional theory about the role of law).

**11.** See *e.g*. Barry Naughton, *The Chinese Economy: Transitions and Growth*, at 401-06 (2007) (discussing the predominance of foreign investment in China); Yasheng Hunag, *Selling China: Foreign Direct Investment During the Reform Era*, at 6-14 (2005) (discussing China's substantial reliance on foreign direct investment).

**12.** SOEs dominated the 2010 list of China's top 500 companies, with 329 SOEs earning more than 80 percent of the total revenue. "SOEs Dominates Top 500 List", *People's Daily Online* (Sept. 06, 2010), http://english.people.com.cn/90001/90778/90862/7130352.html; Also Yasheng Huang, *Capitalism with Chinese Characteristics*, at 278-81(2008) (discussing state-led capitalism in China compared with other East Asian countries).

**13.** Jianfei Zhao, "Overseas Acquisitions: A Chorus Without a Conductor", *Caijing* (Feb 25, 2009), http://english.caijing.com.cn/2009-02-25/1 10074133.html. For a general discussion, for example, Mariana Pargendler, "State Ownership and Corporate Governance", 80 *Fordham L. Rev*. 2917 (2012); Souvik Saha, "CFIUS Now Made in China: Dueling National Security Review Frameworks as a Countermeasure to Economic Espionage in the Age of Globalization", 33 *NW. J. Int'l L. & Bus*. 199 (2012).

**14.** Huang, *supra* note 10, at 280 (noting the insignificant role of foreign direct investment in the successful export production model of the East Asian economies except for Singapore).

**15.** Aldo Musacchio & Sérgio G. Lazzarini, "Leviathan in Business: Varieties of State Capitalism and Their Implications for Economic Performance", working paper (May 30, 2012), available at SSRN: http://ssrn.com/abstract=2070942.

**16.** For a general discussion of institutional bypass, Mariana Mota Prado, "Institutional Bypass: An Alternative for Development Reform" (University of Toronto, working paper, Apr. 19, 2011), available at http://ssrn.com/abstract=1815442.

**17.** Historically the Chinese government is very cautious about foreign listings because greater concentration of foreign control over Chinese companies may affect central planning of economy, such as money supply in the economy. However, exceptions have been made for big SOEs since the early 1990s when the Deng Xiaoping/Zhu Rongi administration decided to take advantage of limitless capitals available overseas. Since then, Beijing has encouraged its "national champion" SOEs to pursue overseas listings by providing favorable credit and tax policies and by actively assisting in the investment process. By contrast, private firms that intend to pursue overseas listings have to circumvent a handful of legal restrictions by, for instance, reverse merger, overseas holding company structure, joint venture structure, or variable interest equity (VIE) structure. Such legal restrictions on foreign listings can be seen in the Notice on Issues Concerning Overseas Listing Application of Enterprises (1999) ("1999 Notice") and the Provisions on the Merger and Acquisition of Domestic Enterprises by Foreign Investors (2006), both of which set high thresholds and tough preconditions for Chinese firms pursuing overseas listings. However, the Chinese regulators have lifted some of such restrictions recently. In December 2012, the China Securities Regulatory Commission abolished and replaced the 1999 Notice with the Regulatory Guidance on Application Documents and Examination Procedures of Issuing Shares Abroad and Overseas Listing by Company Limited by Shares (effective on 1 Jan 2013). For a general discussion, see I. A. Tokley & Tina Ravn, *Company and Securities Law in China*, 85 (1998); Carl E. Walter & Fraser J. T. Howie, *Red Capitalism: The Fragile Financial Foundation of China's Extraordinary Rise* (2011).

**18.** See *e.g.* Naughton, *supra* note 9, at 406-13 (discussing a generally favorable regime for foreign investments in China); Yasheng Huang, "One Country, Two Systems: Foreign-invested Enterprises and Domestic Firms in China", 14 *China Econ. Rev.* 404 (2003); Weit seng Chen, "WTO: Time's Up for Chinese Banks-China's Banking Reform and Non-Performing Loan Disposal", 7 *Chi J. Int'l L.* 239 (2006).

**19.** See *e.g.* Lay-Hong Tan & Jiangyu Wang, "Modeling an Effective Corporate Governance System for China's Listed State-Owned Enterprises: Issues and Challenges in a Transitional Economy", *J. Corp. L. Stud.*, vol. 7, no. 1, Apr. 2007, at 143 (discussing the issues of China's corporate governance regime and overall institutional weakness regarding the domestic capital markets); Satyananda J. Gabriel, *Chinese Capitalism and the Modernist Vision*, at 147 (2006) (noting that Chinese firms usually raise money only once through domestic stock markets in the form of an IPO and rarely dip back into the stock market for additional funding through secondary offerings).

**20.** See *e.g.* Donald C. Clarke, "Law Without Order in Chinese Corporate Governance Institutions", 30 *Nw. J. Int'l L. & Bus.* 131 (2010); Yong Kang *et al.*, "The Rand Corporation, Chinese Corporate Governance: History and Institutional Framework" (2008). Available at: http://www.rand.org/pubs/technical_reports/TR618.html.

**21.** Katharina Pistor has used the concept of "human resource management" to illustrate how the CCP has been able to implement a relatively coherent policy through its control of the human resource of SOEs without greatly compromising market efficiency. See Katharina Pistor, "The Governance of China's Finance", in *Capitalizing China* (Joseph P. H. Fan & Randall Morck ed., 2012) (discussing the pros and cons of the CCP's human resource management within SOEs as an alternative corporate governance model in China).

**22.** Since 2011 China has begun collecting profits from more SOEs (approximately 1,631 SOEs, up from about 120 previously), with a higher proportion of their profits to be paid to the state. "More State Companies' Profit for Social Welfare", *People's Daily Online* (Feb. 23, 2011, 8:28 AM), http://english.people.com.cn/90001/90778/7296669.html; "Why China collects earnings from more SOEs?", *People's Daily Online* (Nov. 4, 2010, 11:59 PM). Available at: http://english.people.com.cn/90001/90778/90862/7188893.html.

**23.** For a description, Larry Cata Backer, "Sovereign Investing in Times of Crisis: Global Regulation of Sovereign Wealth Funds, State-Owned Enterprises, and the Chinese Experience", 19 *Transnat'l L. & Contemp. Probs.* 3 (2010); Scott B. MacDonald & Jonathan Lemco, *Asia's Rise in the 21st Century*, at 103 (2011) (noting the background and formation of the China Investment Corporation in 2007); "China's Sovereign Wealth Fund Received $30 Billion New Capital Last Year", *Bloomberg News* (Mar. 4, 2012, 3:24 PM). Available at: http://www.bloomberg.com/news/2012-03-04/china-s-sovereign-wealth-fund-received-30-billion-new-capital-last-year.html.

**24.** Douglass C. North, "The New Institutional Economics and Third World Development", in *The New Institutional Economics and Third World Development* (John Harriss *et al*. ed., 1995) at 23.

**25.** This view resonates with a developing literature of international business that focuses on how market players view institutions as resources for solving problems of economic coordination based on firm-specific resources. See *e.g*. Gregory Jackson & Richard Deeg, *Comparing Capitalism: Understanding Institutional Diversity and Its Implications for International Business*, 39 J. Inte'l Bus. Stud. 540 (2008); W.P. Wan, *Country Resource Environments, Firm Capabilities and Corporate Diversification Strategies*, 42 J. Mgmt. Stud. 161 (2005).

**26.** 17 CFR § 230.144A (2012). Rules 901 through 905 of the Securities Act form the body of Regulation S. See 17 CFR §§ 230.901-.905 (2012).

**27.** It is worth noting that various domestic regulations still put strict restrictions on foreign listing applications made by Chinese companies, especially private firms. Nevertheless, once a foreign listing approval has been granted, like most international offerings, home state laws play a very limited role during the execution of a global transaction. See *supra* note 15.

**28.** Geoffrey Fuller, *The Law and Practice of International Capital Markets*, at 92-98 (2007) (discussing the international capital market practices prior to the adoption of Rule 144A and Regulation S).

**29.** Kellye Y. Testy, "Comity and Cooperation: Securities Regulation in a Global Marketplace", 45 *Ala. L. Rev*. 927, 930-32 (1994) (noting that US companies may benefit from the adoption of Rule 144A given the rock-bottom interest rates and sluggish corporate earnings growth found domestically at the time).

**30.** US borrowers have become one of the largest borrowers in the international bond markets since late 1980s. Prior to the adoption of Regulation S, offshore transactions were governed by Securities Act Release No. 4708 and a sprawling body of no-action letters issued by SEC's staff as most companies were compelled to seek an individualized determination by the SEC that their particular offerings would not be deemed to occur in the US. See Securities Act Release No. 33-6779, *supra* note 26; Testy, *supra* note 24, at 939.

**31.** See generally Securities Act Release No. 33-6779, 41 SEC-Docket 126 (June 10, 1988); Kellye Y. Testy, "The Capital Markets in Transition: A Response to New SEC Rule 144A", 66 *Indiana Law Journal* 233 (1990).

**32.** Section 5 of the Securities Act serves as the focal point for the Securities Act's registration requirement for offers and sales of securities. "Interstate commerce" is defined widely to include trade or commerce in securities between the US and any foreign country. The registration process results in the creation of an information disclosure document known as the registration statement, or prospectus, to be delivered to investors. See 15 USC § 77e (2012), 15 USC § 77(a)(7) (2012).

**33.** See Howell E. Jackson & Eric J. Pan, "Regulatory Competition in International Securities Markets: Evidence from Europe in 1999-Part I", 56 *Bus. Law*. 653, 655 and 684-85 (2000-2001).

**34.** Shares sold through private placement represent approximately 95% of all H shares offered in the IPOs of all the big four banks, as indicated in respective prospectuses.

**35.** In Hong Kong market, it is not uncommon that issuers would have sold their shares entirely though private placements but for the minimum public float requirement by the Listing Rules of the Hong Kong Exchange.

**36.** For example, in 2004 PRC issued global notes in the amount of US$ 500 million and global bonds in the amount of  1 billion in reliance on Regulation S and Rule 144A, with Goldman Sachs, JP Morgan, Morgan Stanley, Merrill Lynch, UBS, Deutsche Bank and PNB Paribas as underwriters. Also, Eric J. Pan, "Challenge of International Cooperation and Institutional Design in Financial Supervision: Beyond Transgovernmental Networks", 11 *Chi. J. Int'l L.* 243, 249-250 (2010) (discussing the necessity of shifting the focus of the international regulatory framework to reflect governments' engagement in private markets today).

**37.** See Alan R. Palmiter, "Toward Disclosure Choice in Securities Offerings", 1999 *Colum. Bus. L. Rev.* 1, 31-32 (1999) (noting the rationale of the private placement exemptions that wealthy investors, whether individuals or institutions, can absorb greater risk and replicate the protection of full-blown registration).

**38.** John C. Jr. Coffee, "Racing Toward The Top? The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance", 102 *Colum. L. Rev.* 1757, 1780-83 (2002); "The Future of History: The Prospects For Global Convergence in Corporate Governance and Its Implication", 93 *Nw. U. L. Rev.* 673-76 (1999) (both discussing that foreign issuers may increase their share value by migrating to US markets and agreeing to comply with higher governance systems, disclosure standards and accounting rules that prevail in

the US); Rene Stulz, "Globalization, Corporate Finance, and The Cost of Capital", *Journal of Applied Corporate Finance*, vol. 12, no. 3, at 8, 15 (1999) (suggesting that globalization reduces capital costs and foreign companies can make fund raising less expensive by seeking additional listing on exchanges and committing to higher disclosure standards).

**39.** Stulz also suggests a "thin" version of such legal bonding effect, indicating that the mere accouchement that a foreign company intends to list on a stricter exchange tends to be interpreted by the market as good news. Stulz, *supra* note 32 at 15.

**40.** London and Japan are two other alternative venues but have appeared less popular than they once were. Erica Fung, "Regulatory Competition in International Capital Markets: Evidence from China in 2004-2005", 3 *NYU J. L. & Bus*. 243, 292-96 (2006) (discussing why London and Japan, together with Singapore, are attractive to Chinese firms).

**41.** For example, the Luxembourg Stock Exchange created Euro MTF (Multilateral Trading Facility) in 2005 to provide an easy listing procedure that falls out of the scope of a European "regulated" market under European Directives 2004-39-EC.

**42.** Fung, *supra* note 34, at 296-97.

**43.** The SEC has adopted new rules in 2007 to make it easier for foreign companies to terminate their registration of securities and reporting obligations. See "Termination of a Foreign Private Issuer's Registration of a Class of Securities Under Section 12(g) and Duty To File Reports Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934", Release No. 34-55540; 17 CFR §§ 200, 232, 240, and 249 (2012).

**44.** Interviews with US lawyers and practitioners based in Hong Kong. Also see "More Chinese Firms Seek Delisting from US Market", *China Daily* (July 4, 2012). Available at: http://www.chinadaily.com.cn/bizchina/2012-07/04/content_15547675.htm; and "23 Chinese Companies Delisted in US Since Last Year", *China Times* (Aug 14, 2012). Available at: http://www.wantchinatimes.com/news-subclass-cnt.aspx?id=20120814000039&cid=1102.

**45.** "SEC Approves New Rules to Toughen Listing Standards for Reverse Merger Companies" (Nov. 9, 2011), available at http://www.sec.gov/news/press/2011/2011-235.htm; Jamila Trindle, "SEC Tightens Rules for 'Reverse Merger' Listings", *Wall St. J.* (Nov. 10, 2011, 4:17 AM). Available at: http://online.wsj.com/article/SB10001424052970204358004577028381460208046.html.

**46.** It requires an approval from the State Administration of Foreign Exchange (SAFE) for a PRC company to provide a guarantee in favor of any foreign company. Recently SAFE

issued the "Circular on Relevant Issues Concerning Foreign Exchange Administration Relating to Encouraging and Guiding a Healthy Development of Private Investment" (国家外汇管理局关于鼓励和引导民间投资健康发展有关外汇管理问题的通知) (June 15, 2012) to slightly relax this restriction on a case-by-case basis, but this has not changed market practices as SAFE gives its approval only to strategic SOEs.

**47.** Foreign investors in fact are informed of such risks, which Chinese issuers always disclose as a risk factor in their prospectuses.

**48.** Tom Kohn & Andrea Tan, "Asia Aluminum Needs 'Urgent Action' from Investors", *Bloomberg* (June 15, 2009), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aBvJJh4WwYl0; "Investors Lose Battle For Asia Aluminum", *Intellasia East Asia News* (June 29, 2009, 7:01AM), http://www.intellasia.net/investors-lose-battle-for-asia-aluminum-102364.

**49.** See *e.g.* Walter & Howie, *supra* note 15, at 156-64 (suggesting the crucial role of Goldman Sachs in China Telecom's US$ 4.2 billion IPO in 1997 and stating "The New China of the 21st century is a creation of the Goldman Sachs and Linklaters & Paines of the world").

**50.** Unlike in the 1980s, most major American and British law firms have branch offices in Hong Kong, Shanghai and Beijing today, as do most reputable accounting firms and international investment banks.

**51.** Also, see Fung, *supra* note 34, at 264 (noting a remark made by a financial/legal advisor in China that the frequently complained financial disclosure standards under the Sarbanes-Oxley Act of 2002 are not difficult to meet and that foreign issuers often exaggerate the burden).

**52.** Walter & Howie, *supra* note 15, at 161-164.

**53.** See *e.g.* Roberta Romano, "Empowering Investors: A Market Approach to Securities Regulation", 107 *Yale L. J.* 2359 (1998); Stephen J. Choi & Andrew T. Guzman, "Portable Reciprocity: Rethinking the International Reach of Securities Regulations", 71 *S. Cal. L. Rev.* 903 (1998).

**54.** See *e.g.* Merritt B. Fox, "Retaining Mandatory Securities Disclosure: Why Issuer Choice is Not Investor Empowerment", 85 *Va. L. Rev.* 1335 (1999).

**55.** Among 1,358 companies listed in the Main Board of Hong Kong Exchanges and Clearing Limited (HKEx) as of Oct. 31, 2012, 640 are mainland Chinese firms and 622 are HK companies, with the remaining 96 companies from worldwide. (Data source, HKEx,

Oct. 31, 2012). See also Paul J. Davies, "HK Moves to Make Foreign Listings Easier", *Fin. Times* (Nov. 25, 2012, 10:40 PM), http://www.ft.com/intl/cms/s/0/eb4d88cc-3549-11e2-bf77-00144feabdc0.html.

**56.** Amir N. Licht, "Regulatory Arbitrage for Real: International Securities Regulation in a World of Interacting Securities Market", 38 *Va. J. Int'l L.* 563, 565 and 609 (1998) (noting that conventional finance theory argues that the impact the law has on listed companies is quick to be reflected in stock prices as the price system is a "mechanism for communicating information," and hence better laws mean higher stock prices and vice versa).

**57.** Howell E. Jackson & Eric J. Pan, "Regulatory Competition in International Securities Markets: Evidence from Europe-Part II", 3 *Va. L. & Bus. Rev.* 207 (2008); Jackson & Pan, *supra* note 28.

**58.** In fact, it is reported that the Chinese high-yield issuers have largely avoided corporate governance risk premium commonly born by their Indonesian counterparts. HSBC, *The View: Asia's Bond Markets*, at 7 (Feb. 8, 2011) (on file with the author).

**59.** The SEC may impose substantial pressure on foreign private issuers to make comprehensive disclosure by commenting on their annual reports in Form 20-F.

**60.** CNOOC correspondence dated 12 Feb 2007, in response to the SEC comment letter dated 11 Jan 2007, available at the SEC filing archive: http://www.sec.gov/Archives/edgar/data/1095595/000114554907000225/filename1.txt. The SEC's requirement ended up with additional disclosure in CNOOC's annual report in the following year, albeit with CNOOC's fierce push-back.

**61.** Section 922 of the Dodd-Frank Wall Street Reform and Consumer Protection Act amended the Securities Exchange Act of 1934 by, among other things, adding Section 21F entitled "Securities Whistleblower Incentives and Protection." Pub. L. no. 111-203, § 922(a), 124 Stat 1841 (2010).

**62.** US Securities and Exchange Commission, Annual Reports on the Dodd-Frank Whistleblower Program Fiscal Year 2011 and 2012. Available at: http://www.sec.gov/whistleblower.

**63.** Andrew Brady Spalding, "The Irony of International Business Law: US Progressivism and China's New Laissez-Faire", 59 UCLA *L. Rev.* 354 (2011).

**64.** The overall regulatory environment would also cause a firm migration from one country to another. China's largest state-owned banks have begun moving big chunks of their European business to Luxembourg to escape tougher regulation in the City of London. Daniel Schäfer, "Chinese Banks Flee London's Tough Rules", *Fin. Times* (Oct. 28, 2012, 9:27 PM). Available at: http://www.ft.com/intl/cms/s/0/3cabad56-2105-11e2-9720-00144feabdc0.html#axzz2FU38Z8LI.

**65.** For a description, Madhavi Acharya-Tom Yew, "Sino-Forest Investigation: OSC Accuses Ernst & Young of 'Failure to Perform Sufficient Audit'" (Dec. 3, 2012). Available at: http://www.thestar.com/business/article/1296809--osc-accuses-ernst-young-of-failure-to-perform-sufficient-audit-on-sino-forest.

**66.** Robert Cookson, "China Foreign Listings Dogged by Scandal", *Fin. Times* (June 5, 2011, 11:37 PM). Available at: http://www.ft.com/intl/cms/s/0/9b70a976-8f8a-11e0-954d-00144feab49a.html#axzz2FpkoJosz.

**67.** Many of these companies are small Chinese companies that obtained US listing status through reverse mergers. Michael Cohn, "PCAOB Makes Tentative Progress on Chinese Audit Firm Inspections", *Accounting Today* (Sept. 24, 2012). Available at: http://www.accountingtoday.com/news/pcaob-china-audit-firm-inspections-64051-1.html.

**68.** For a general discussion, see *e.g.* Qian Meijun, "Why S-chip Fraud Cases Keep Cropping Up" (press release, RMI of National University of Singapore, Feb. 17, 2012). Available at: http://*www.rmi.nus.edu.sg*.

**69.** Fox Hu, "Investor Distrust of Chinese Listings Hits IPOs Prices", *Bloomberg* (Apr. 19, 2012, 6:00 AM). Available at: http://www.bloomberg.com/news/2012-04-18/investor-distrust-of-chinese-listings-hits-ipos-prices.html

**70.** *Supra* note 58.

**71.** "SEC and CSRC Wrestle over Cross-Border Financial Supervision", *Caijing* (Jan, 08, 2013, 15:45PM). Available at: http://english.caijing.com.cn/2013-01-08/112419091.html.

**72.** PCAOB seeks to inspect these China-based audit firms because they are registered with the PCAOB and audit approximately one fourth of the Chinese firms that have obtained listing status in the US through reverse mergers. Cohn, *supra* note 57.

**73.** Securities Exchange Act of 1934 Release No. 62968, Admin. Proc. File no. 3-13860 (Sept. 22, 2010) (stating that it did not appear possible for the Chinese applicant to comply with

the recordkeeping, production, and examination requirements of the US securities laws); Neil Gough, "Rating Agency Dagong's Profile on the Rise", *South China Morning Post* (Aug. 15, 2011). Available at: http://gochina.scmp.com/beijing/news/rating-agency-dagongs-profile-rise.

**74.** Joy C. Shaw, "Dagong Fires Back at SEC", *Wall St. J.* (Sept. 27, 2010). Available at: http://online.wsj.com/article/SB10001424052748704082104575515470951666514.html

**75.** SEC Release No. 34-68335 (Dec. 3, 2012). Available at: http://www.sec.gov/litigation/admin/adminarchive/adminarc2012.shtml.

**76.** Michael Rapoport & Ben Dummett, "US Sues Big Firms over China Audits", *Wall St. J.* (Dec. 3, 2012, 9:08 PM). Available at: http://online.wsj.com/article/SB10001424127887324355904578157252180759338.html.

As far as the PRC secrecy laws are concerned, two legislations have been cited and discussed. First, The Law of PRC on Guarding State Secrets (1988) which broadly defines "state secrets" as "matters that have a vital bearing on state security and national interests and, as specified by legal procedure, are entrusted to a limited number of people for a given period of time." This law provides seven categories of state secrets, including a catch-all provision to cover "other matters that are classified as state secrets by the state secret-guarding department." Second, the Provisions on Strengthening Confidentiality and Archives Administration of Overseas Issuance and Listing of Securities enacted by the CSRC, the State Secrecy Bureau and the State Archives Bureau in 2009. The provisions provide that if work papers created in China by securities services institutions during the process of overseas issuance of securities involve state secrets, national security or other vital interests, they shall not be exported out of China via any method without the authorities' approval.

**77.** The Financial Times Editorial, "Huawei's Woes-Beijing's Export Ambitions Held Back by Cyber Crime Fears", *Fin. Times* (Mar. 28, 2012, 7:28 PM). Available at: http://www.ft.com/intl/cms/s/0/cfb969b4-78e8-11e1-88c5-00144feab49a.html.

**78.** CFIUS, Statement from the Treasury Department on the President's Decision Regarding Ralls Corporation (Sept. 28, 2012). Available at: http://www.treasury.gov/press-center/press-releases/Pages/tg1724.aspx.

**79.** Ralls was seeking to acquire the ownership of four wind farm project companies and place wind turbines made by its Chinese affiliate in Oregon near restricted Navy airspace. Sara Forden, "Chinese-Owned Company Sues Obama over Wind Farm Project", *Bloomberg* (Oct.

02, 2012, 11:45 PM). Available at: http://www.bloomberg.com/news/2012-10-02/obama-bars-chinese-owned-company-from-building-wind-farm.html.

**80.** Richard McGregor, "Beijing Attacks US Investor Checks", *Fin. Times* (Dec. 21, 2012), at 2.

**81.** I borrowed the patterns examined in the context of international business studies and collectively discussed by Gregory Jackson and Richard Deeg. Jackson & Deeg, *supra* note 21.

**82.** For instance, the Chinese government granted substantial discounts to Bank of America and Royal Bank of Scotland for their share purchases in IPOs of China Construction Bank and Bank of China, respectively.

**83.** Walter & Howie, *supra* note 15, at 193.

**84.** Stanley Lubman, "Unpacking the Law Around the Chinese Reverse Takeover Mess", *Wall St. J.* (Jan. 24, 2012). Available at: http://blogs.wsj.com/chinarealtime/2012/01/24/unpacking-the-law-around-the-chinese-reverse-takeover-mess/.

**85.** See Pistor, *supra* note 19 (arguing that the dominant form of governance in China is a network of financial party cadres and that this regime has been strengthened over the past decade in response to perceived threats to the stability of China's financial and political system).

**86.** Likewise, many Chinese firms voluntarily follow US disclosure practices when executing private placements of their securities for commercial reasons – to approach US investors easily and to keep the option for US market open.

**87.** Michael Schuman, "Is the Chinese Yuan Becoming a Rival to the Dollar?", *Time* (Feb. 15, 2011). Available at: http://business.time.com/2011/02/15/is-the-chinese-yuan-becoming-a-rival-to-the-dollar/.

**88.** China has repeated this approach and created its first domestic high-yield bond market in June 2012, opening a new funding channel that by some estimates will see as much as $50 billion in capital flow to cash-starved small and medium-sized private firms within a few years. "China Opens Its First Junk Bond Market", *N.Y. Times* (June 8, 2012), http://www.nytimes.com/2012/06/09/business/global/china-opens-its-first-junk-bond-market.html?_r=0.

**89.** See *e.g.* Joshua Cooper Ramo, "The Beijing Consensus", The Foreign Policy Centre, (2004), available at http://fpc.org.uk/publications/; Yasheng Huang, "Debating China's Economic Growth: The Beijing Consensus or The Washington Consensus", *Academy of Management Perspectives*, vol. 24 (2), at 31 (2010); John Ohnesorge, "'Beijing Consensus' Anyone?", in

*Symposium: The Future of Law and Development, Part V*, *Nw. U. L. Rev. Colloquy*, vol. 104, at 257 (2009). Available at: http://colloquy.law.northwestern.edu/.

**90.** See *e.g.* Henry Hansmann & Reinier Kraakman, "The End of History for Corporate Law", 89 *Geo. L. J.* 439 (2001), and the widely cited and debated "LLSV" literature, such as Rafael La Porta *et al.*, "Law and Finance", 106 *J. Pol. Econ.* 1113 (1998).

**91.** Bernard S. Black, "The Legal and Institutional Preconditions for Strong Securities Markets", 48 *UCLA L. Rev.* 781, 816-831 (2001).

**92.** Fernand Braudel, *The Wheels of Commerce – Civilization and Capitalism: 15th-18th Century*, vol. II (1992), at 385, 389, 400, and 525-28 (discussing the advantage of England over France in terms of credit system, fiscal institutions, and the usage of government bonds); Niall Ferguson, *The Ascent of Money: A Financial History of the World*, at 70-92 (2009) (discussing the advantage of the British financial system in the 19th century that is based on bond markets over the French one based on conventional taxation).

# LAW AND POLITICS TO FORMULATE THE NEXT EUROPEAN UTOPIA[1]

**José M. de Areilza**[2]

> "Our words make our worlds. To choose our words is to choose a form of life. To choose our words is to choose a world. To oppose words is to oppose a form of life and a world. To change words is to change a form of life and a world."
>
> Philip Allott, *Eunomia*, 1990

## Introduction

This short essay is a "tale of two cities," which describes two European ideals, based on law and politics, very different from each other. By creating this narrative it aims to be useful for understanding European integration as a whole, presenting a critique and relaunching it in our time. Each of the two cities represents an approach to the future of European integration, as bearers of a Utopian component, an ideal that gives meaning to "Europeanism" at very different historical moments.

The arrival at the first city, formulated by Jean Monnet and Europe's other "founding fathers," took place at the beginning of the 20th century. The initial steps were taken under exceptional circumstances in the wake of World War II and under the threat of a new world war, a context that strongly moulded the European project.

The task at hand cannot be accomplished taking the same road again and treading it in the same way, but rather charting a new path and proposing another way of traveling together that leads to the second city, as a metaphor for a pro-European vision adapted to our own time.

## The first city: a Europe that rescues its states

### A DINNER IN PARIS

On 13 October 1955 the Action Committee for the United States of Europe began to operate in Paris under the direction of Jean Monnet. The association had its headquarters at 83 Foch Avenue, in the apartment the French politician shared with his brother-in-law. Monnet would spend many hours around the long table in the dining room, piled with stacks of papers, accompanied by his former collaborators from the ECSC, Max Kohnstamm and Jacques Valmont, and supported by a team of secretaries overseen by the able Madame Miguez.

The Committee was the old cognac merchant's personal response to the failure of the European Defence Community (the Pleven Plan, actually the umpteenth Monnet Plan), wrecked in De Gaulle's France in late August 1954 by a disappointing vote in the National Assembly. Following this political setback, Monnet had decided not to serve again as president of the High Authority of the ECSC. Now, having stepped down, he decided to work independently to relaunch integration.

The Committee, funded primarily by his American friends, proposed to create a favourable political environment in the parties and trade unions of the ECSC's six member states in order to establish two new European Communities, one for atomic energy and the other for a common market. At the same time, the committee studied and drafted improvements to these projects in order to link them to the Community that was already in existence. The idea of launching two further Communities had been devised by minister Paul Henri Spaak in what was termed the "Benelux Memorandum." In fact, the Belgian politician had all but reproduced the plan prepared by Jean Monnet and Pierre Uri before withdrawing from the High Authority of the ECSC.

Spaak had sent Monnet the final version of the memorandum accompanied by a hand-written note that said "this is your baby."[3] Spaak now headed the intergovernmental working group that was to develop and implement the document, approved by the ministers of foreign affairs, with certain reservations, at the Messina Conference on 1 June 1955. Antoine Pinay had

spoken on behalf of France to express his opposition to reindustrialising Germany beyond coal and steel. Adenauer's representative, meanwhile, was not entirely convinced of the idea of jointly managing nuclear power for peaceful purposes – Euratom. The Soviets, meanwhile, had conveyed to the Messina forum their firm opposition to any further progress in the efforts to promote European unity.

Monnet continued to believe that both the German problem and the reconstruction of the European economy should be resolved through the Continent's economic and political integration. To make the process work, states were to transfer real decision-making capacities to common institutions rooted in a supranational principle and that wielded authority superior to that of national governments. The idea was to follow the model of the ECSC, the first tangible result of the Schuman Declaration of 1950, which Monnet also drafted.

Monnet's ability to bring together groups of people capable of formulating and promoting projects governing the relationships between states was already legendary on both sides of the Atlantic. Over the preceding twenty-five years he had developed an extraordinary skill at accessing the circles of power in Washington, where, in the upper echelons, everyone knew everyone else. In fact, Monnet was more in synchrony with the Americans than with many Europeans. The two Americans who had helped him most to bring the ECSC to fruition, the Secretary of State, Dean Acheson, and the High Commissioner for Germany, John McCloy, once back on Wall Street, continued to support him through various philanthropic and foreign-policy organisations.

Ever since his youth, when both geography and his region's economy had pushed him towards the Atlantic and the Anglo-Saxon world, Monnet had developed a special relationship with the US. Over time, the relationship was to prove to be his primary source of power. He admired the vitality of American society, its unlimited confidence in individual projects, its openness to change and its ability to carry out its own social and economic transformations.[4] In his business life he gave short shrift to ideologies or nationalities and preferred to focus on what each individual could contribute to his plans, based on long-term objectives and ideas. Monnet had a sense of

urgency and historic need. He had always been an internationalist, and this took precedence over his Europeanism, while he only acted in the public sphere at times of war or in post-war situations, in exceptional times when new solutions were required that were, perhaps, unthinkable during periods of stability.

John Foster Dulles, Secretary of State under the Eisenhower administration, was an old friend of Jean Monnet's. Their relationship dated back to the Versailles Conference in 1919, during which both had served on the Reparations Commission along with John Keynes. Dulles and Monnet were born in the same year: 1888. After their first meeting they worked on various financial projects in the public and private sectors, Dulles with the New York law firm Sullivan and Cromwell, and Monnet with the consultants Murnane & Monnet, which Dulles himself had helped to establish. Despite the former's austere and Calvinist temperament and the latter's penchant for the good life, they got along very well. After World War II the Republican lawyer had been a senator for a few months and then served at the State Department, where he was entrusted with negotiating the peace treaty with Japan. He had not formed part of the Democratic administration's resolute support for the Schuman Plan and the first European Community, the ECSC. But in his book *War or Peace*, published in 1950, Dulles argued that the enlightened interest of the US lay in strongly pressing the Europeans to move towards unity, in the context of a Cold War of whose ultimate consequences no-one could be sure. He had also supported the recently-failed European Defence Community, endorsing all the theses of the Truman Doctrine regarding the need to contain Soviet expansion, starting with Europe.

On the eve of the Atlantic Council's meeting of 17 December 1955, held in Paris, Secretary of State Foster Dulles was able to speak privately to Jean Monnet.[5] The Frenchman's main concern involved the UK's attempts to scuttle the plans for the two new communities, Euratom and the Common Market, which London had spurned even before they had taken shape. The British government proposed merging cooperation and integration initiatives into the Eurostat-OECD, the Council of Europe or the Western European Union – in fact, any formula that eschewed the supranational principle and its implications for the integration process.

Dulles fully supported Monnet's idea of expanding the Community through new projects in six countries (a few days later he would ask president Eisenhower to take the issue up with Britain's Eden and Macmillan so that they would refrain from boycotting the initiative). He advised the Frenchman to give priority to – and to shore up – the Common Market first and only then to address Britain's demands for a free-trade area with the European bloc. The American insisted that the creation of a market was the essential strategic project. Monnet, in his view, was placing too much a stress on Euratom and should avoid devoting his capacity for persuasion to what was a secondary cause. The Frenchman thanked the American for his help, and on the way to dinner with his collaborators made a mental note of making sure that bottles of his family cognac should be sent to offices of Eisenhower and Foster Dulles before Christmas Day.

After dinner they spoke about how far European integration might one day be taken. Dulles was more optimistic than his Democratic predecessor, Secretary of State Dean Acheson, another long-time friend of Monnet's, who in March of 1950 had remarked in a speech, with his usual brilliance, that "in Europe neither the people nor their rulers are prepared for a Federation." After all, Dulles argued, the objective of a Federation had been made explicit in the Schuman Declaration, and was accepted by the six founding countries. Monnet was sincere and pragmatic: what concerned him at the time was to ensure peace through a new economic interdependence based on shared prosperity. The problem was not what political model Europe should have, about which a calculated ambiguity was advisable, but rather how to overcome the resistance of European states, particularly France, when it came to pooling and organising sufficient human and material resources at the European level, thereby solving problems too great for each individual state to confront, and all in a situation in which Europe's organisation was subject to profound American and Soviet influences.[6] Paul Reuter, Monnet's chief jurist and one of the authors of the ECSC Treaty, told Dulles that integration was distinct from cooperation and not comparable to classic federalism, which was based on other solidarities and balances between different levels of government. European solidarity could not be taken for granted and had to be built, step by step, upon a foundation of facts. Federal checks and balances did not make

much sense given the urgency of building the Communities, which called for the centralisation of powers "characteristic of the modern economy" in their spheres of action, in line with the finest tradition of French interventionism.

Reuter continued to set forth his theses: integration implied the exercise of functions previously reserved to the state and national representatives in Community bodies were to make decisions with simple majorities, alongside others possessing decision-making powers who were not representatives of any state. The resulting law was to be of direct application, without the intermediation of national governments, and all should be subject to a highly developed legal system, guaranteed by a Court of Justice. Thus, the ideas of "integration" and "Community" were original and could not be easily classified politically. The term "supranational" could even result in a "premature federal stain." In the words of the French jurist, there was no other path than "faltering invention."[7]

## ARRIVING AT THE FIRST CITY

Almost 60 years after the talks in Paris between Monnet and his American friends, the achievements of integration are such that none can doubt that it has been a historic success. The Utopia formulated by Monnet's generation was far beyond expectations. It is true that integration has not been linear, as it has been rocked by economic determinism, based on the neo-functional analyses used to explain the European Communities during their inception. The road has proved to be far more complex and uncertain. The role of national governments and supranational institutions like the Commission and the Court of Justice has been highly significant, as has the impact of historic and economic changes on the Continent – the end of the Cold War, an ageing population, global market pressures and so on.

Overall, European integration during this long stage has been an exercise in successful pragmatism. Despite the anxiety generated by the Eurozone crisis, today the Union's political value is still very great. It is the most advanced example of regional economic integration and a paradigm in the development of institutions capable of managing problems common to an entire network of states in the context of globalisation.

It could be argued that in the end of the 20th century Europe had brought into being the utopia inspired by the ideals of shared peace and prosperity which Jean Monnet and the other founding fathers entertained in the 1950s. Reconciliation between former enemies came about in the market and through common policies, supported by a community of law, based on such fundamental values as non-discrimination on the grounds of nationality. Checks and balances between the Community's institutions functioned as curbs on the new European power, as well as between the level of European government and the national democracies. Brussels' institutions have established effective limits on economic protectionism and extreme nationalism.

Ultimately, member states were rescued from themselves by a new European legal and economic discipline that they themselves had desired. In the late 1980s historian Alan Milward thoroughly investigated the historical origins of the Communities and explained to what extent the founding of Europe involved a rare convergence of national interests and cosmopolitan ideals. Integration was approached as a "European rescue of the nation-state," *i.e*. a project accepted by governments in the interest of their people, in need of economic reconstruction through a market on a European scale, while they developed their social states in the national sphere.[8] The Communities saved nation-states from obsolescence.

## POLITICAL FATIGUE

When the 21st century began, a very successful Union, from a historical point of view, had consolidated, but it was devoid of any Utopian aspirations. It began to be taken for granted, merely part of the landscape. The old ideals of shared peace and prosperity had been achieved and were no longer a cause for motivation. Thus the Union was a victim of its own success: weary and on the defensive, it was unable to find the resources with which to reinvent itself as a project and to relaunch integration on a new basis in the pursuit of a worthy Utopia. A disconnection between the past and the future is not something unique to European integration. Every dynamic process ends up losing steam and every creative project exhausts its possibilities. And, in politics, the corollary is that all power becomes increasingly oligarchic.

The three core projects of the century's first decade illustrate how integration has come to lack the dynamism and ambition of yesteryear.

The single currency was launched but its *raison d'etat* was justified in political terms that were neither unified nor convincing, a failing mirrored by the institutions developed to make it sustainable, as revealed by the financial and economic crisis.

The negotiation process for a European Constitution between 2002 and 2004 failed, aggravating public mistrust and sapping the political power of a Union that was beginning to feel drained.

Union enlargement in 2004 and 2007, which almost doubled the number of member states, did not have the desired effect of relaunching the European project but instead simply generated fear and misgiving.

The pending step of integration, the strengthening of the Union's external dimension, was inadequately dealt with, despite official speeches that proclaimed that the Lisbon Treaty of 2007 was the great leap forward. The Union is still not an entity that effectively defends its own interests in a globalised world undergoing an accelerated transformation.

One of the obstacles to the European project's reinvention is the mindset that Joseph Weiler has called "political messianism." On the way to the first city, part of the legitimation of European integration was a sense of mission and of historical destiny. In an exceptional situation such as that faced by post-War Europe, it was the road to the Promised Land. The European dream generated an idealism and the feeling of an epic feat among certain governmental elites. The result was a tendency to overlook deficiencies in the Communities' democratic credentials, an issue the Union has only partially addressed. Once the first city had been reached, messianism was no longer the way forward. But the sense of a "historic mission" resurfaced as empty rhetoric in some of the efforts to articulate what Europeanism should consist of today.[9]

The project's realisation and exhaustion have occurred without the Union making a qualitative political change to establish itself as a democracy outside the state, and without a single *demos*, which is no small task. It is true that since the Maastricht Treaty's ratification in 1992 a necessary debate began about how to justify, from a democratic perspective, the increased exercise

of power in Brussels. In fact, one of the ways to view European integration since then is to conclude that it has reached what Kalypso Nicolaidis calls its "Tocqueville moment."[10] Following in the footsteps of the enlightened Frenchman, we Europeans have begun to ask ourselves the tough questions addressed by all democracies: in our case, how to overhaul a supranational project carried out by a select few – the economic and political integration born in 1950 – and aimed primarily at rescuing states from themselves.

The Union faces this "Tocqueville moment" of staking a claim to legitimacy as a new power following the faltering of the social contracts based on the welfare state, the profound mutation undergone by the continent due to the disappearance of one of its blocs and the acceleration of economic globalisation. Brussels and Europe's national capitals have made decisions – such as setting up the single currency and promoting the Union's eastward expansion – that have transformed its very nature and made it even more necessary to fortify its political process. But not enough steps have been taken to achieve a Union that is truly "owned" by its citizens. National and European elites, excessively shielded by the opacity with which they operate in the Union's various institutions, have failed to successfully engage in a democratic debate on the Union itself.

As explained by Francisco Rubio Llorente, the European integration project has been typically justified as a function of national power: "in question is not so much the emergence of a new and free power, as the creation of a limit on already existing powers. This creation needs to be justified, or legitimated, but this is a new need: not the need to democratically legitimise a new power, but rather to legitimise the existence of a set of limits on democracy."[11] In our time, a paradigm shift has become necessary and the task ahead is to legitimise, as such, a new European power.

## A STRANGE GOVERNANCE

The financial and economic crisis of 2008 found the Union undergoing another crisis, of a political nature, which became manifest through growing citizen indifference and criticism of the institutions in Brussels, which had yet to advance any compelling formulation of a new European Utopia.

It has become a commonplace that this period exposed a glaring lack of leadership and vision with regard to the European integration process. Less attention has been focused on the fact that the common currency has survived the worst ravages of the powerful financial markets, having survived and succeeded for important reasons of a political, and not just economic, nature. Despite four years of mutual hesitation and mistrust, the world markets have maintained their confidence in Europe's single currency, even in the depths of recession. No government in the Eurozone has decided to abandon ship, despite the vessel's manufacturing flaws, and neither have we veered towards a euro restricted to fewer states. And with varying degrees of success, the redesigning of the economic and monetary union, to make it more solid and credible, is underway.

However, the exceptional nature of these years, during which the common currency has been on the verge of disappearing, has led to the intensified elitism that characterised the first stage of European integration as well as to the traditional tendency of justifying integration on the basis of results. The process's elitist nature has intensified as the euro crisis has encouraged leaders to seek refuge in the policies of their national capitals.

Germany has acquired a new degree of prominence. During the crisis years it has all but imposed its own social contract upon the Eurozone's other members, based on austerity, sacrifices, savings, and a clear distrust of the financial markets and of transferring new competencies to the Union. It should be noted that Berlin has not acted with an imperial mindset, but rather with an inward-looking intent. Germany's categorical imperative has been "to resolve the crisis playing by the rules," which has given rise to a dangerous abstraction, overlooking the context of each country, upon which Germany's constitutional identity has been projected. Germany feels that the design of the common currency threatens its sovereignty, which it seeks to defend. Today's most sovereign member state, Germany, would prefer to be left alone than to lead, but by example and by projecting its way of doing things on the single currency's new rule book.

In this situation, integration is all too often understood as a legal and financial discipline imposed not at the European level but by certain member states on others. A sharp division has been drawn between creditor and debtor

countries, giving rise to tensions and grievances between them, while the institutions and the "community of law" have been weakened at the European level along with the normal functioning of democracy at the national level. This is due to the fact that during the early years of the crisis it was assumed that the rescued countries were the problem, along with Italy and Spain, which turned out to be an error of diagnosis. The root of the euro crisis has not been the debt of certain countries, but rather the monetary union's flawed design. Its central institutions lack the instruments necessary to ensure stability, the correction of imbalances, and survival in the event of a crisis.[12]

During the euro crisis the Parliament lacked a leading role, its political deliberations were not centralized, and the Commission lost the capacity of initiative in both the European Council and the Euro group, where Germany's position was decisive. The counterweight to Berlin was the ECB, more than any other institution. Despite all this, pro-European positions have prevailed in all Eurozone capitals due to a deep conviction that integration is the future. But to have weathered the storm is not enough, nor is the wariness exhibited by creditor states, especially those governing them, a new category of leaders reluctantly wielding power in Brussels.

The transfer of new powers and resources to the Union, without which the single currency will not be viable, has become more necessary and, at the same time, more difficult.[13] Restoring the euro is proving to be an uphill battle, but the main problem is not a lack of leadership. Neither is the solution as simple as implementing the appropriate economic policies. Rather, the problem has deeper roots, related to the need of renewing and restoring the vision of a European Utopia.

The good news is that through a peculiar form of governance, with measures that have not always been well coordinated at the European and national levels, valuable time has been bought during which it has been possible to undertake new political and economic reforms. In this regard it is essential to know where we want to go. The common currency crisis has accelerated and at the same time complicated the political debate that is essential to relaunching integration. The Utopia of perpetual peace between Europeans – after which the Communities were created – is now taken for granted. When anti-European populism leads to sustained grumbling it is

time to remember that nothing is won forever and that to lay the foundations to construct a new ideal makes the pursuit of unity attractive once again.

The second stage on the road cannot simply be a continuation of the preceding one. Unlike the post-war era, the challenge is no longer to make nation-states become member states of a Union, rather it is to establish and flesh out the role of the new European power – legitimate, limited and effective – and make it fully compatible with national democracies which, in turn, will gain the beneficial effects of a European legal and economic discipline.

## The second city: a Europe rescued by politics

Europe is now also the problem, as much as its member states. It is necessary to legitimise a new power that cannot be justified merely on the basis of its transformation of nation-states into open and prosperous member states. The time has come to evolve towards a reinforced European political community, though limited in its material expansion and compatible with national democracies. The states that make up the Union face the problem of meeting the challenges posed by today's world, in which none of them can effectively defend their interests on their own. Sovereignty, the compulsion to have the last word, is blind to a country's future. There is a European society with common traits that suffices to justify this paradigm shift.

The journey to the second city requires the formulation of a new European Utopia that provides a *modus operandi* similar to that which characterised the first plan, drawn up during an exceptional era. Elitism, a sense of historical destiny, excessive technocracy, and the preeminence of diplomatic negotiations – again, elements very much present in the redesign of the euro – are counterproductive when it comes to reinventing integration. Of course, the political dimension, materialised in institutional forms, still calls for prestigious figures that are seldom or never suspected of acting on the basis of national biases. The first requirement would appear to be personal prestige. That is the founders' reconciled Europe. But neither the Union nor the Eurozone can relive their past nor aspire to survive as projects essentially based on a certain kind of enlightened despotism.

In order for the EU to regain momentum it is necessary for it to become a public forum through which to formulate a new ideal, a distinct European narrative mobilised in favour of integration. As stated by Javier Gomá, ideals are essential: they establish a target and, by virtue of their attraction, they propel the moral progress of societies.[14] Even when they fall short, the pursuit of well-defined goals at least ensures that significant progress has been made.

With a view to generating this new Utopian impulse, 21st-century Europeanism should be based on three axioms. The first is to make progress in European integration compatible with the member states' national projects, *i.e.* to demonstrate that progress towards integration is compatible with the demand for political and economic modernisation. The second is to make decision-making subject to democratic processes within a Union with enhanced democratic credentials. The third is to respond to the desire harboured by most Europeans of making the Union a global player in the face of the accelerated transformation of the surrounding world.

## A EUROPEAN PROJECT COMPATIBLE WITH NATIONAL DEMOCRACIES

During the German election campaign of September 2013 some moderate voices called for European integration not to dominate public debate or to be a ubiquitous issue, in an effort to dispel the idea that everything, both good and bad, should emanate from Brussels. In essence what they were asking for was that democracy at the national level retain its full force, even taking into account the European context. The president of the German Constitutional Court explained this in vivid terms when he recognised that his worst nightmare was to wake up one day and realise that his Parliament no longer made decisions because everything was to be voted on at the Community level.

In this regard we must learn from German democracy and its political, legal and economic debate on the mutations produced by the euro's redesign. At the same time, worthy of criticism is the German tendency to impose a unilateral vision on the development of the Union, instead of articulating a convincing proposal for the group of member states and their citizens, as too

often the Germans' approach generates imbalances and ends up suppressing the European debate.

The executive in Berlin, however, is right about insisting on assigning maximum importance to discussing what new policies ought to be transferred to the European level. It is essential to thoroughly address how much integration citizens want, thereby getting all participants to accept the new rules of economic governance, which, renovated, must be sustained both in new national social contracts and in a European pact.

In the founding fathers' original plans, a high degree of economic integration was compatible with the preservation of national identities. Therefore, it was necessary to justify each new Community power, to create legal and political mechanisms to regulate this progressive centralisation and to develop democratic life at the European level. Little by little, however, Europeans developed a mentality according to which any and every new Community action was good news, as if we were riding a bicycle on which we had to keep pedalling to not fall over. Only with the ratification of the Maastricht Treaty in 1992 were the first democratic debates held to justify the continuous transfer of powers to Brussels.

A certain determinism is exerting its influence on the current situation. Simplistic solutions to the problems of the single currency tend to be based on calls for our leaders to centralise in Brussels – almost overnight – all kinds of different powers and resources in order to bolster economic and monetary integration. Yet, while continuing to act with the diligence the situation requires, the classic democratic question of how much integration each state really wants cannot be sidestepped. Instead of uniting people, as Jean Monnet believed the European dream should, the common currency has sparked serious hostility, and it is essential for its reconstruction to reflect a widely shared and thoroughly debated vision of the European project.

Moreover, the centralisation of new powers to strengthen economic governance should not lead to an unlimited amassing of authority in the EU's hands. A "union of general competences," should it come to pass, would not enjoy legitimacy in the peoples' eyes. Thus, mechanisms should be established to make it possible to renationalise some policies when this represents a desirable European decision. The idea of a Union with wide-ranging and

flexible power, but with limits, would make it possible to maintain the full compatibility between national and European democracies. Only the implementation of a model of "equilibrium of enumerated powers" would ensure that the stress between centre and periphery would be beneficial to both levels of government. The effect would be to "get off the bicycle," as Fidel Sendagorta once proposed, to regain the voters' confidence and to address the demands of the citizens without relinquishing vigorous democracy at either the national or European levels.[15]

At the national level more importance should be assigned to political and economic reform, not through the imposition of European institutions but rather through national capitals taking better advantage of the opportunities offered by the Union. Spain should learn from German democracy. Even though the Union has an impact on almost all of Spain's economic and social life, the latter contributes little to the formulation of a vision for Europe. In Spain, the desire for "more Europe" sometimes reveals that what it wants is for others to govern it. This childish longing has recently been accompanied by a certain scepticism – just as counterproductive – of a Union that is unable to solve all of its problems, starting with its complex and unstable state, based on a system of *comunidades autónomas*.[16]

In this regard, constitutional reform in Spain, a pending task that is yet to be undertaken, would have to be based on its status as a member state of the Union, a legal and political reality that offers valuable guidance. An overhaul of Spain's territorial model would be more feasible if it were to be based on how the state's will is applied to European issues, how the internal market's integrity is preserved and how Community law is more effectively and coherently applied.

If we want a new Europeanism to take root, it is also essential for member states to contribute to foster integration, going beyond the defence of their short-term interests, which the economic crisis has brought to the fore. One of these proposals should be the political development of the concept of European citizenship, originally a Spanish initiative but today stalled at an embryonic stage. This complementary status of member state nationality is based on a cosmopolitan ideal that could inject both reason and moderation into our territorial debate, as its essence entails belonging

simultaneously and harmoniously to different collective identities, making European integration fully compatible with a commitment to the projects of the Union's various nation-states.

## DEMOCRACY FOR THE UNION

The second vector of this new Europeanism would require shedding any nostalgia for the integration that has already been accomplished, acting decisively to transform European governance today. It is not enough to move forward once again towards a "Europe of results." The transfer of new powers to the EU can only be justified by improving its system of government in democratic terms, based on the acceptance of a new social contract between Europeans to resolve the tensions and political and economic imbalances that have been responsible for so much uncertainty in the European project. Renovation would involve allowing further transfers of powers essential for redesigning the euro in exchange for the democratic and political reinforcement of Community institutions.[17]

Brussels' institutions must govern in a more visible and public way, and not just formulate policies. The objective should be to improve the quality of democratic debate in Europe, with greater transparency, intelligibility, accountability and, progressively, competition between different European visions of the common good.

The fostering of a vigorous democracy at the European level should lead to discussions at the Community level about the kind of Europe we want. Fritz Scharpf has observed that to a great extent the present Union is rooted in a liberal political model and not a republican one (in reference to Community political philosophy). Its priority is the protection of individual economic rights and it aims to establish limits on the exercise of European power by means of an institutional system based on multiple vetoes, thereby enshrining a pluralist model rather than one based on a pan-European majority.[18] Given the current ground rules and the lack of a clear electoral mandate, Scharpf argues, the Union cannot promote the common good nor can it solve many problems that its states are unable to tackle on their own. This analysis is particularly accurate in tracing the general outlines of the European political

model, but it incorporates a vision that is too demanding as it regards the necessary degree of common identity. Ultimately, it proposes a state-based model applied at the European level.[19]

The Union can only lay claim to the status of a "democracy outside the state" by recognising the absence of a *demos*, and by not seeking to improvise a sense of common identification comparable to that felt in a unitary state. Therefore, the effort of creative imagination in the field of politics must be greater in order to respect preexisting national identities and, at the same time, to go further in the creation of a *polis* in the European sphere that reflects both the diversity and common features of European society. The most pressing question remains how the Union can one day constitute an advanced democracy, enjoying legitimacy and incorporating, at the European level, all the democratic traits of Western political systems, without having to necessarily evolve towards a European state.

It must be recognised that the size of the European political community makes it difficult to achieve this democratic quality. At present the Union is structurally remote from Europe's more than 500 million citizens. There is no example worldwide of a democracy enjoying mechanisms that ensure deliberation, transparency, accountability, and the efficient management of public affairs with such a large and diverse population. At the European level it is difficult to fully honour the required standards of representation and citizen participation, and it is a daunting task to generate public opinion about the issue. We face a certain structural impediment that hinders the establishment of an advanced democracy.

At the same time, there are reforms which should be tackled now that the urgent demands of the euro crisis are over. The European institutional system does not yet allow a debate on electoral mandates or responsible government. It would be advisable for the Commission's possible development models to include its transformation into a European Cabinet, in which the positions of Commission and European Council president would be fused. The Cabinet should be capable of acting as a European government and of putting into practice a platform generated in the European elections, as well as of dissolving the assembly and holding elections, or being compelled by Parliament to go home. The European Parliament, meanwhile, is part of the

solution, but it also tends to claim a degree of representativeness greater than it really has. The reorganisation of the assembly at Strasbourg, with formulas such as half of its deputies being elected in European elections and the other half being national deputies appointed by their Parliaments to serve as European representatives would improve the European debate and enhance accountability. Rather than a step backwards, this could be a way of reconnecting and harmonising national and European democracy.

The making of political decisions at the European level has become more difficult as a result of the aggravation of the technocratic nature of policy at all levels due to the impact of globalisation. The process of global economic integration has augmented the power wielded by interest groups of experts who understand each other because they speak the same highly technical language.

Since the 1970s we have witnessed the rising power of "sub-national" agents within the Union. As explained, many European policies are decided by individuals with sector-based loyalties who are neither motivated nor guided by any notion of European or national interests. Globalisation has accentuated this narrow, technocratic and fragmented view of the terms of European public debate. Supranational and intergovernmental viewpoints are not enough when it comes to understanding the EU's current and future development. In many EU negotiations the decisive agents involved pay little more than lip service to European or national loyalties, and what they really seek is to advance specific projects entailing specialised technical considerations. This "infranationality" prevails in Brussels, as it does in the capitals of all Western countries, and makes it possible to resolve, with some degree of effectiveness, certain transnational problems related to the extensive regulation of internal markets and foreign trade.

But these communities are both opaque and unaccountable, thus generating the impression that both Europeanisation and globalisation severely undermine the power of states while failing to transfer power to democratic institutions and political processes above the national level. It is as if power had disappeared, lost amidst the inner workings of committees and agencies which, like black holes, absorb political visions, powers, and aspirations. In addition, its fragmented debates, focusing on concrete problems, typically

involve complex issues reserved for genuine experts. The solution is not to wield national legitimacy as a counterweight to the communities of experts at the European level or to curb their tendency to present highly political decisions in technical language. Rather, the necessary contribution of the hundreds of committees should form part of a system of checks and balances, which combine representative institutions capable of working with other organs not based on the majority principle. Both models of exercising power should be subject to effective accountability. To better regulate these processes and make them more transparent, and for them to offer more equitable access to stakeholders, neither federal nor constitutional reform is necessary.

No political reform would be complete without reinforcing the status of the Union's citizens, so that members of European society share a series of substantive rights and duties derived from a vision of civic values guiding Europe's institutions. This would give rise to a more clearly expressed identity and European loyalty that would reinforce and strengthen that felt towards states and regions. Europe's citizens, by definition, would be people of different nationalities and the Union would not succumb to the temptation of trying to evolve towards an unnecessary and counterproductive objective of statehood.

European identity should serve to guide the exercise of power at the European level, but without seeking to replace national or regional identities, which European legal and economic discipline should help to refine and update. Neither does it make any sense to define who we are as Europeans in terms of opposition to other identities, whether the US or Muslim societies, to mention two recent temptations, as it would be a mistake to foster outbreaks of Continental nationalism.

In order to strengthen European citizenship, ways to enrich it could be considered by fulfilling what was expressed in the Treaty on the Functioning of the EU: "The citizens of the Union hold the rights and are subject to the duties set out in the Treaties." For now, however, the treaties do not establish any real duties.[20] We should devise different ways to strengthen their sense of belonging among Europe's citizens. An initiative in this regard could be the creation of a European system of volunteers, going beyond the small steps that have been taken so far.

The aim would be to instil in the minds of Europe's next generation, who believe that the advantages of belonging to the Union are unrenounceable, a sense of duty so that they devote some time during their lives to the service of others in projects of a European scope. To this end the Union could create a system to certify and recognise, as "European service," the thousands of volunteer activities already underway in the 28 member states, and those of European origin being carried out all over the world. To grant this recognition the Union could request that European voluntary service be performed by teams made up of citizens from different countries, so that they might learn to work together in the service of their societies. The Union could also make a concerted effort to ensure that European voluntary service should acquire prestige and include a practical aspect through its acceptance, evaluation and promotion by schools, universities and employers.

The democratisation of institutions and the support of citizens should help to avoid the distraction of producing constitutions, declarations of rights and reflections based on a statist mentality in which we ask ourselves to what extent the Union should evolve towards a European federation. The essential hurdle to the project's unity, sovereignty, cannot be tackled directly through a constitutional amendment but rather indirectly, through economic stimuli, which may fail, as in the case of monetary integration, and by legitimising a new European public space through politics.

Each federal experience is different and the common features of federalism are few. Thus, there is no ideal paradigm or type of federation.[21] The Union already possesses some federal features of its own, and they are limited. First of all, its law, applied by European and national judges whose decisions prevail over national law. Also, its decision-making, largely based on the majority principle, both in the European Parliament and in the Council of Ministers. One can also speak of federalism with regards to its flexible distribution of competencies. Almost all the powers of the Union and its member states are shared, their actual extension being negotiated, day by day, by representatives of the states and the Union, as in any contemporary system of cooperative federalism.

The Union, however, is not and should not aspire to be a state-type federation, as it lacks social legitimacy and its citizens' direct loyalty. Some

have proposed the formulation of a "two-speed Europe." The nucleus of such an effort would be dedicated to the economic governance of the common currency. Political tensions, however, between the two concentric circles and the threat to the integrity of the internal market and Community law, shared by all – the two networks that create interdependence and European unity – would prevent this project from working.[22]

The Union has already emerged as a legal federation based upon a political confederation. The Community model defines this organisational novelty and European policy: an institutional and legal architecture created over the course of 60 years, with a dynamic combination of supranational and intergovernmental political elements under the growing influence of more technocratic decision-making, which we have called "infranational." It is true that the redesigning of the single currency calls for new elements typical of an economic federation: banking supervision, fiscal union, and mechanisms to ensure financial stability. But the Union of tomorrow must counterbalance this centralisation with improved representation and accountability mechanisms, as well as with decentralisation in areas in which European action is no longer demanded by the public.

## A EUROPEAN GLOBAL PLAYER

A third vector of the Europeanism of the future involves addressing the challenge, recognised for some time now, of making the EU a truly global player. One of the serious shortcomings of early Europeanism was its desire to make Europe an island of perpetual peace, which failed to observe its neighbours and understand globalisation trends which exert competitive pressures on its welfare states.

Once again, the idea of dressing the Union as a superpower in anything that is not tailor-made must be ruled out. José I. Torreblanca has called for a Union which acts as an introvert rather than an extrovert, perceiving that if we fail to undertake this transformation in a multipolar world we run the risk of European irrelevance. Most of the problems to be faced by European society in the coming years will involve solutions designed and negotiated beyond our borders and we cannot allow others to make these decisions for

us. The sum of just half of all European efforts – still uncoordinated today – in the fields of economic governance, diplomacy, security and defence, would be enough to achieve this goal.[23]

European external action is usually analysed on the basis of an assessment of European capabilities, an evaluation that emphasises its lack of resources and institutions with a political will. This combines with the unilateral and insufficient actions carried out by some states, incapable of resolving their problems, jealous of their power as international players and nostalgic about their past, when they were world powers. The Union, however, has some important resources in terms of both foreign policy and external action, though it must incorporate more and better national actors and processes into these tasks.[24]

In this way, a European process that coordinates and includes national stakeholders and better legitimises European decision-making is necessary. We need to democratise the EU's external action and not only its common policies, overcoming its technical language, elitism, fragmentation and lack of coordination.

The EU's most troubling shortcoming is its lack of foreign policy support through its security and defence policy, an area in which capacities and political will are clearly lacking. Its biggest advantage is the fact that public opinion demands more European external action. The potential of a Union not inspired by a state model to gain prominence as a global actor in the world is very great and, little by little, this decision-making should generate a sufficient European identity.

* * *

The alternative to the renewal of the Utopian component of European integration is an increasingly debilitated Union marred by mounting inequality between its states and greater public indifference towards its institutions and legislation. The community of law and the internal market, which have required so much effort to establish, may yield their preeminence to a set of intergovernmental agreements, prominent in the redesigning of the euro,

difficult to apply and, at the same time, very demanding with the reforms that debtor states are to undertake in response to European mandates.

Considering the divisions and tensions that in the medium term would lead to a frayed Union, it is necessary to recoup the central idea of integration as an ethical project whose primary purpose is to unite people. The path towards a new Utopia must be different from the first journey. Now the Union must be reformed by placing emphasis on the material restriction of its powers, on politics and democracy at the European level, and on taking steps to make the Union an effective global actor. Based on these three axioms, it is possible to generate a new European ideal.

We should still learn, at the same time, from the organisational capacity and audacious long-term thinking of Jean Monnet. But the debate on how to pursue a new Union must be capable of engaging and inspiring not just the national and European elites, but also its citizens, transforming the European *polis*.

The task of building and propagating the new Europeanism is now up to a new generation, for whom membership in the Union is as natural as the digital world, sunsets and the changing of the seasons. The European challenge of our time was well summed up by Goethe: “now you must prove yourself worthy of what you have inherited from your parents.”

# ENDNOTES

**1.** This paper is based on the last chapter of the book *Power and Law in the European Union*, Civitas, 2014, and expands further some of the themes presented there.

**2.** Professor of Law & Jean Monnet Chair at ESADE, Secretary General of Aspen Institute España.

**3.** C. P. Hackett *et al*., "Monnet and the Americans", Jean Monnet Council, Washington, 1995.

**4.** J. Monnet, "Memorias", Encuentro IUEE-CEU, Madrid, 2010, p. 45-46.

**5.** C. P. Hackett *et al*., "Monnet and the Americans", *op. cit*.

**6.** Paul Reuter, *Organizaciones europeas*, Bosch, Barcelona, 1968, p. 13.

**7.** *Ibid*., p. 29-30.

**8.** Alan Milward, *The European Rescue of the Nation-State*, Routledge, Oxford, 1989.

**9.** Joseph Weiler, *Europe in Crisis*, *op. cit*., p. 256.

**10.** K. Nicolaidis, "UE: un moment tocquevillien", *Politique Étrangère*, vol. 3, no. 3, 2005.

**11.** F. Rubio Llorente, "El futuro político de Europa: espacio, fines y método", *Claves de Razón Práctica*, no. 89, 1999, p. 2-9.

**12.** J. I. Torreblanca & J. M. de Areilza, "Spain's Salvation in the Euro", *The New Political Geography of Europe*, ECFR, London, 2013, p. 71-77.

**13.** *Ibid*.

**14.** J. Gomá, "Ingenuidad aprendida", *Galaxia Gutemberg*, 2011.

**15.** F. Sendagorta, "Bajarse de la bicicleta", *ABC*, 11 Sept. 2005, p. 61.

**16.** Spain's *comunidades autónomas* (autonomous communities) are regional government divisions granted considerable power and authority under the country's 1978 Constitution. The costs and complications associated with maintaining this tier of government have been great and highly controversial.

**17.** J. I. Torreblanca & J. M. de Areilza, "Spain's Salvation in the Euro", *op. cit*.

**18.** F. W. Scharpf, "Legitimacy Intermediation in the Multilevel European Polity", *op. cit.*

**19.** Joseph Weiler, "Europe in Crisis", *op. cit.*, p. 256.

**20.** Joseph Weiler, "To Be a European Citizen: Eros and Civilization", *The Constitution of Europe*, *op. cit.*, p. 324-358.

**21.** K. Nicolaidis & R. Howse, *The Federal Vision: Legitimacy and Levels of Governance in the United States and the European Union*, Oxford University Press, 2001.

**22.** Jean-Claude Piris has formulated a non-federal, more realistic alternative to establish these "two speeds". But, ultimately, it fails to go beyond providing creative legal solutions to the challenge of strengthening the Eurozone with its own institutions and regulations. See Jean-Claude Piris, *The Future of Europe: Towards a Two-Speed Europe?*, Cambridge University Press, 2012.

**23.** J. I. Torreblanca, "La fragmentación del poder europeo", *op. cit.*

**24.** Emilio Lamo de Espinosa *et al.*, "Europa después de Europa", Academia Europea de Artes y Ciencias, Madrid, 2010.

# THE VALLETTA SUMMIT ON MIGRATION

**Cristina Barettini**[1]

More efficient international protection by the European Union and better chances for stability and economic development in African countries.

All through the year 2015, and more and more during the last months, the European Union has been called to cope with an unprecedented number of incoming migrants, arriving from the African coast both by sea and by land; this tremendously increased flow is likely to continue. Moreover, as opposed to past situations, the great majority of these migrants are asylum seekers, and therefore have an undisputable right by International law (Geneva Convention) and international customary law, as well as by EU law (Treaty on the Functioning of the European Union – TFEU), to be granted refuge.

This emergency situation is creating an enormous burden of practical and financial difficulties to EU member states, especially the ones which are geographically most exposed to the inflow, as well as a dramatic humanitarian crisis for all parties involved, since hundreds of migrants perish on the way, and the fortunate ones who do reach European soil mostly have a terrible journey of deprivation and suffering behind them. The EU is then faced with the problem of a fair resettlement of refugees in the 28 EU member states, on the basis of the principle of solidarity stated by the TFEU, which in its turn arises strong tensions among member states.

Following numerous tragic shipwrecks in the Mediterranean during the initial months of the year, in its special summit on 23 April 2015 the European Council decided to mobilise all efforts at its disposal to prevent further loss of lives at sea and to tackle the root causes of the migration crisis, in cooperation with the countries of origin and transit. Council members committed the EU to reinforce its political cooperation with African partners

at all levels in order to fight illegal migration and combat the smuggling and trafficking of human beings. They also called for a summit to discuss migration issues with the African countries concerned, which Malta, being the seat of the European Asylum Support Office (EASO), offered to host in Valletta in November 2015.

The European Council of 25 and 26 June 2015 focused on three key dimensions of the migration crisis to be advanced in parallel: relocation/resettlement, return/readmission/reintegration, and cooperation with countries of origin and transit. In September 2015, the European Commission put forward a comprehensive package of proposals intended to help address the refugee crisis faced by EU member states and neighbouring countries, including tackling the root causes making people seek refuge in Europe.

In its meeting of 15 October 2015, the European Council declared the intention to achieve concrete operational measures at the forthcoming Valletta Summit with African Heads of State or Government, focusing, in a fair and balanced manner, on effective return and readmission, dismantling of criminal networks and the prevention of illegal migration, accompanied by real efforts to tackle root causes and to support the African socio-economic development together with a commitment concerning continued chances for legal migration. It also expressed the intention to explore possibilities for developing safe and sustainable reception capacities in the affected regions and providing lasting prospects and adequate procedures for refugees and their families, including access to education and jobs, until return to their country of origin is possible.

The Summit on Migration was held in Valletta, Malta, on 11-12 November 2015, chaired by the president of the European Council, Donald Tusk: it brought together European and African Heads of State or Government, in an effort to strengthen cooperation in the area of migration and address the challenges and opportunities of migration. A large number of international and regional organisations, such as the African Union Commission, the ECOWAS Commission, the UN, UNHCR, IOM, and the IFRC, were also invited to participate in the Summit.

The president of the EU Parliament, Martin Schulz, welcomed the Summit as an “opportunity to address every step in the long Odyssey of the

refugees and come to a joint and sustainable strategy for dealing with the refugee crisis,"[2] stressing the need for cooperation among EU member states, since "the refugee crisis is a global challenge nation-states are not equipped to deal with on their own, even less so if every government only focuses on the few miles the refugees make in their respective countries." Mr. Schulz expressed the EU Parliament's ambition to move beyond a purely sector approach, towards a true EU immigration law promoting legal channels for migration and mobility from African countries, within an overall strategy aimed not at fighting migrants, but at fighting the root causes of migration: poverty and conflict.

Building on existing cooperation processes between Europe and Africa, the Valletta Summit focused on five specific areas: addressing the root causes of migration by working to help create peace, stability and economic development in the countries of origin and transit; promoting legal channels for migration and mobility from and between African countries; exploring ways to reinforce the protection of refugees and other displaced persons; seeking for further support to the rule of law and border management authorities in order to tackle smuggling of migrants and trafficking of human beings; strengthening cooperation in order to facilitate the return and sustainable reintegration of irregular migrants, both from EU member states and associated countries and from African countries of transit and destination.

The Valletta Summit adopted a Political Declaration and an Action Plan concerning the above areas, and launched for their implementation an EU Trust Fund, with a minimum of 1.8 billion euro, which comes on top of EU and member states' development assistance to African countries worth 20 billion euro every year.[3]

## Valletta summit political declaration

In their final Political Declaration, Valletta Summit participants express deep concern for the sharp increase in flows of refugees, asylum seekers and irregular migrants and the connected suffering, abuse and exploitation, particularly of children and women, and unacceptable loss of life in the desert or at sea, stating that the EU's first priority in this context is to save

lives and do everything necessary to rescue and protect the migrants whose lives are at risk, on the basis of the EU principles of solidarity, partnership and shared responsibility.

The Political Declaration recognises a strong interdependence between Africa and Europe regarding the common challenges impacting migration: promoting democracy and human rights; eradicating poverty; supporting socio-economic development, including rural development; mitigating and adapting to the effects of climate change, as well as regarding the issue of stability and finally the issue of security, which is currently threatened by terrorism, arms trade and armed conflicts. Participating States commit themselves to addressing these challenges in a concerted manner, notably through early warning, conflict prevention and conflict resolution. Recognising the benefits of well-managed migration and mobility between and within Europe and Africa, they consider a comprehensive approach necessary for boosting sustainable economic, social and environmental development and ensuring that human beings can fulfil their potential to live in dignity and equality, stressing the common responsibility to address the opportunities and challenges of migration and mobility which must be shared in a fair manner among countries of origin, transit and destination.

The states intend to address the root causes of irregular migration and forced displacement resulting from state fragility and insecurity, as well as from demographic, economic and environmental trends, by a common response focused on promoting peace, good governance, rule of law and respect for human rights; reducing poverty; supporting inclusive economic growth through investment opportunities and the creation of decent jobs, as well as improving the delivery of basic services such as education, health and security.

On the other hand, the states are determined to advance legal migration and mobility possibilities and to strengthen the fight against irregular migration, by giving preference to voluntary return and reaffirming that all returns must be carried out in full respect of human rights and human dignity, and to intensify international protection and step up assistance, including its humanitarian dimension.[4] Access to regular mechanisms for protection, such as resettlement, should be reinforced.

The signatories are determined to scale up their joint efforts in preventing and opposing migrant smuggling, eradicating trafficking of human beings and combating those who exploit vulnerable people, both in Europe and in Africa, by intensifying the fight against organised criminal networks, including their links to terrorism, through effective border management, enhanced cooperation and the implementation of the relevant legal and institutional frameworks.

The Valletta Declaration ends with a practical commitment to undertaking concrete actions in response to the challenges of migration, in the first place by launching a number of priority initiatives before the end of 2016, and allocating appropriate resources to the implementation of such concrete actions.[5]

## Valletta summit action plan

The Valletta Summit Action Plan is built around five priority domains, with sixteen priority initiatives to be launched before the end of 2016.

The first priority domain is about addressing root causes of irregular migration and forced displacement, by investing in development and poverty eradication through mainstreaming migration in EU development cooperation; boosting socio-economic development, particularly by creating job opportunities, especially for young women and men; supporting resilience, in particular to the benefit of the most vulnerable and of communities hosting protracted refugee populations, including through rural development, food and nutrition security, health, education and social protection; enhancing sustainable livelihoods and self-reliance opportunities for displaced persons, as well as for host communities. Also included in the first priority domain is the development of the benefits of migration, by promoting cheaper, safer, legally-compliant and faster transfers of remittances and facilitating productive domestic investments, as well as by promoting diaspora engagement in countries of origin. Lastly, this domain covers taking action with regard to conflicts, human rights violations and abuse generating internal displacement, irregular migration and refugee flows; preventing new conflicts; supporting

state building, rule of law and good governance and reinforcing state capacity to ensure security and fight terrorist threats.[6]

A second priority domain is about promoting regular channels for migration and mobility from and between European and African countries, including the promotion of the mobility of students, researchers and entrepreneurs and supporting the implementation of comprehensive strategies on migration and mobility, as well as engaging in visa facilitation.[7]

A further priority domain is about reinforcing the protection of refugees and other displaced persons; upholding the human rights of all migrants, refugees and asylum-seekers; supporting the integration of long term refugees and displaced persons in host communities and strengthening capacities of countries of first asylum, transit and destination, as well as enhancing humanitarian assistance in countries most affected by forced displacement.[8]

The fourth priority domain looks at the prevention of and fight against irregular migration, migrant smuggling and trafficking of human beings, by implementing appropriate legislative and institutional frameworks and providing protection, support and/or assistance to stranded/vulnerable migrants, refugees and victims of trafficking. Member states are encouraged to gather intelligence on smuggling of migrants and trafficking of human beings, with the support of Interpol, Europol and other appropriate agencies. Communication networks between EU and African countries will be further developed. Additional actions foresee fighting corruption and developing alternative income generation opportunities in countries where migrant smuggling and services for migrants are important economic factors, and providing credible information on legal migration opportunities and dangers of engaging in irregular migration, as well as giving a realistic view of living conditions in European countries.[9]

The final priority domain concentrates on strengthening cooperation in order to facilitate the return and sustainable reintegration of irregular migrants, both from EU member states and associated countries and from African countries of transit and destination, paying special attention to unaccompanied minors by taking into account the principle of the best interest of the child; and exploring return pilot projects between the EU, associated countries, and African countries.[10]

## EU EMERGENCY TRUST FUND FOR STABILITY AND ADDRESSING ROOT CAUSES OF IRREGULAR MIGRATION AND DISPLACED PERSONS IN AFRICA

On the occasion of the Valletta Summit, European Commission president Jean-Claude Juncker, together with European Heads of State, launched an important instrument to effectively implement the Action Plan: the "EU Emergency Trust Fund for stability and addressing root causes of irregular migration and displaced persons in Africa."

Made up of €1.8 billion from the European Union financing instruments as well as contributions from EU member states and other donors,[11] the Emergency Trust Fund[12] is a complementary tool to existing EU development cooperation aimed at assisting the most fragile and vulnerable countries across Africa; it will benefit the major African migration routes to Europe, *i.e.* the Sahel region and Lake Chad area, the Horn of Africa and North of Africa,[13] as well as neighbouring countries with a view to addressing regional migration flows and related cross-border challenges.

The Trust Fund is designed to foster stability in these regions and to contribute to better migration management. More specifically, it aims at addressing the root causes of destabilisation, forced displacement and irregular migration, by promoting economic and equal opportunities, security and development. It will finance projects establishing economic programmes to create employment opportunities, especially for youth and women, with a focus on vocational training and the creation of micro and small enterprises; actions should contribute in particular to supporting the reintegration of returnees into their communities. Also, the Trust Fund will apply to projects supporting basic services for local populations such as food and nutrition security, health, education and social protection, as well as environmental sustainability; projects improving migration management, including containing and preventing irregular migration, effective return and readmission, international protection and asylum, legal migration and mobility, and enhancing synergies between migration and development; and projects aimed at improvements in overall governance, in particular by promoting conflict

prevention and enforcing the rule of law through capacity building in support of security and development.

One of the principles of the Trust Fund is to engage in political dialogue with African partners in order to design strategic and efficient interventions. As such, national and local authorities will be consulted, in advance, on priorities and projects submitted to the Strategic Board and the Operational Committee of the Fund, in order to ensure local ownership.

## The EU commission implements its first package of actions

On 16 December 2015, the European Commission announced a total of 16 actions, worth almost €300 million, to address the root causes of irregular migration and displacement, and to increase the positive impact of migration on the economic and social development in countries of origin, transit and destination of migratory flows. This includes a package of ten actions for an amount of €253 million in the Horn of Africa, decided by the first Operational Committee meeting of the EU Emergency Trust Fund for Africa, set-up at record speed to respond to the challenges of instability, irregular migration and forced displacement,[14] as well as six actions financed under the development cooperation instrument "Global Public Goods and Challenges Programme," through its thematic component on "Migration and Asylum."

The ten actions under the EU Emergency Trust Fund for Africa will be implemented jointly by the European Commission and EU member states, in full partnership with African countries.[15] They are foreseen to start in early 2016, focusing on building the capacities of the countries of the Horn of Africa to manage migration and, in particular, to fight against the trafficking of human beings and smuggling of migrants; creating employment opportunities and better livelihoods in particular areas of Ethiopia which are the origin of migratory flows; facilitating the return to stable areas of Somalia by Somali refugees hosted in the region and in Europe; improving the reintegration of South Sudanese refugees in host communities of Uganda or creating favourable conditions for their return; and supporting the implementation of the peace agreement in South Sudan and the return

of internally displaced persons to their areas of origin. All these actions and future packages of projects will benefit from evidence generated by a new research facility which will ensure that evidence is collected, disseminated and used amongst African partners, donors and the broader international community in order to further inform policy and decision-making.

The ten regional and national actions under the EU Emergency Trust Fund for Africa are:

1. Better Migration Management (€40 million): a project aimed at better managing migration in the countries of the Horn of Africa through the provision of capacity building and basic equipment to government institutions, specifically in relation to investigating and prosecuting cases of trafficking and smuggling, improving border management, generating and using statistical data. The project will also help in the development and harmonization of policies and legislative frameworks, notably on trafficking and smuggling; the provision of protection to victims of trafficking and smuggling; and the set-up of awareness-raising campaigns about the perils of irregular migration and options for legal migration and mobility.
2. Research facility (€4.1 million): a project seeking to fill evidence-gaps through research with a view to informing project design and implementation; disseminating research results to African partners, donors and the broader international community to further inform their policy- and decision-making; and strengthening the capacity of partner governments and regional organisations to use evidence-based approaches in order to better manage migration and more effectively prevent violent conflict.
3. Stemming Irregular Migration in Northern and Central Ethiopia (€20 million): a project addressing the root causes of irregular migration in the regions of Tigray, Ahmara, Oromia and SNNPR, in particular in urban centres and urban towns, by enhancing the living conditions of potential migrants and returnees. This will be pursued by prioritising the creation of economic opportunities and job skills for vulnerable groups, mainly women and the youth, through technical vocational training, access to micro-financing and actions related to employment generation. A direct

effect of these actions will also be the creation of conducive conditions for the effective return and reintegration of Ethiopians hosted in other countries.

4. Resilience Building in Ethiopia (€47 million): a second project addressing the root causes of irregular migration and displacement in the regions of Afar, Amhara, Oromia, SNNPR and Somalia, specifically in remote and drought-prone areas. Interventions will strengthen economic opportunities and resilience of the most vulnerable communities, through measures aimed at increasing livelihoods and employment, as well as better access to basic services such as health, water, hygiene and sanitation.
5. Enhancing Somalia's responsiveness to the management and integration of mixed migration flows (€50 million): the scope is to support the voluntary return of Somalis hosted in Kenya, as well as other parts of the region and Europe, or fleeing conflict in Yemen, into stable regions of Somalia. The project aims at creating a favourable environment for return and reintegration, including through economic and social development, increased access to basic services, economic opportunities, and improved peaceful coexistence of both returnees and return communities.
6. Provision of basic health in South Sudan – Health Pooled Fund 2 (€20 million): a project aimed at supporting the implementation of the peace agreement in South Sudan, in particular the development of social services, by increasing access to, utilisation of and quality of health services (including maternal and child health, nutrition and availability of essential drugs) countrywide. Additionally, it will strengthen local administrative core systems to increase the efficacy of health services, and engage with local communities to integrate these interventions into existing community structures.
7. Improvement of the delivery of basic education in South Sudan through improved management and teachers' training (€45.6 million): a second project designed to support the implementation of the peace agreement in South Sudan, in particular the development of social services, by increasing equal access to primary education, improving rates of retention and completion, and increasing the skills and knowledge of teachers. Additionally, it will strengthen the capacity of authorities to improve

teacher management policies and practices, hence making public systems more resilient to emergencies and crises.

8. Support to stabilisation through improved resources, economic and financial management in South Sudan (€12 million): this project aims at supporting the implementation of the peace agreement in South Sudan with a view to economic and financial management, by strengthening a culture of accountability for lower levels of government, as well as helping local institutions to manage public finances and human resources more transparently and responsibly. The project will also support the creation, reinforcement and functioning of key institutions for a responsible public financial management, such as the National Revenue Authority, hence tackling mismanagement of public resources as a key root cause of the conflict.
9. Support programme to the refugee settlements and host communities in Northern Uganda (€10 million): in response to the recent influx of forced migration due to violent conflict in South Sudan, this project aims at addressing the developmental needs of South Sudanese refugees and host communities in targeted areas of Northern Uganda through actions designed to support improved livelihoods, economic opportunities, food security, intercommunity dialogue and conflict prevention, as well as education. Through this approach, the project will equip these populations with the necessary tools for their integration in host communities or return to South Sudan.
10. Strengthening social cohesion and stability in slum populations in Uganda (€4.3 million): in a context of rapid and unplanned urbanisation and increased competition for scarce resources, this project aims to increase social cohesion and peace-building amongst refugees and host communities, in particular by providing economic opportunities and basic services to both communities alike, enhancing the space for refugees to participate in the social and economic life of local communities, and creating platforms for dialogue between civil society and public authorities.

In addition to the first batch of projects to be financed under the EU Emergency Trust Fund for Africa, the EU is going to implement another six

actions (with a total budget of €41.6 million) focused on improving migration management in developing countries and on maximising the positive impact of migration on the development of partner countries:

I. Pilot action on voluntary return and sustainable, community-based reintegration (€15 million): the overall objective of this action is to promote sustainable voluntary return and reintegration by building national capacities to enhance and facilitate a sustainable return and reintegration process.
II. Call for proposals for the implementation of the Rome Programme (Rabat process) (€15 million): the objective of the call for proposals will be to finance actions focused on promoting effective governance of migration and mobility flows in all their dimensions.
III. Global action to improve the recruitment framework of labour migration (€8 million): the overall objective of this action is to improve the recruitment framework of labour migration, in particular to allow governments, social partners and other stakeholders to effectively govern and manage recruitment within the overall labour migration process.
IV. Addressing mixed migration flows in East Africa (€1 million, added to an already approved initiative of €5 million): this action aims at increasing the budget of the current project "Addressing mixed migration flows in Eastern Africa." The overall objective is to support countries in Eastern Africa / Horn of Africa in facing the challenge of complex population movements including asylum seekers, economic migrants and other migrants.
V. Guidelines on mainstreaming migration into Development Policy (€2 million): the main objective of the action is to contribute to effective mainstreaming of migration into all issues of the EU Development Policy. In particular, the initiative aims at working out practical and concrete guidelines for mainstreaming migration into the development policy within the context of EU development funding in all relevant policy sectors and to test the guidelines in practice in selected partner countries.
VI. In addition, a set of support measures (€605,380) will contribute to activities concerning preparation, follow up, monitoring, evaluation and

auditing related to the implementation of the "Migration and Asylum" component of the "Global Public Goods and Challenges Programme." These measures will specifically help to provide support to EU delegations, headquarter services as well as beneficiary countries for designing and delivering evidence based, high quality, value for the money projects and to engage in effective policy and political dialogue.

## The EU council conclusions on migration and the EU commission's communication on the implementation of the priority actions

Both the EU Council held on 17 December 2015 and the EU Council held on 18 February 2016 brought relevant follow up to the Valletta Summit on Migration.

The December 2015 EU Council Conclusions, though acknowledging the EU strategy aimed at stemming the unprecedented migratory flows Europe is facing, highlights the need to speed up its insufficient implementation and to regain control over the external borders of the European Union. EU institutions and member states are called to urgently address the shortcomings at the external borders of the Schengen area, notably by ensuring systematic security checks with relevant databases, and to prevent document fraud; to address deficiencies in the functioning of hotspots and rapidly agree on a precise date for further hotspots to become operational; to ensure that Frontex[16] and EASO[17] have the necessary expertise and equipment; to ensure systematic and complete identification, registration and fingerprinting, and take measures to tackle refusal of registration and stem irregular secondary flows; to implement relocation; to take concrete measures encouraging the actual return and readmission of people not authorised to stay; and to provide support to member states concerned regarding return operations; to enhance measures for fighting smuggling and trafficking of human beings.

In particular, the December 2015 EU Council Conclusions stress the urgent need to ensure implementation and operational follow up to the High Level Conference on the Eastern Mediterranean – Western Balkans route, as well as to the Valletta Summit, particularly in regards to returns and read-

mission, and to the EU-Turkey Statement of 29 November 2015 with the connected EU-Turkey Action Plan; the Conclusions also request all parties involved to continue implementing the agreed resettlement scheme and closely monitoring flows along migration routes so as to be able to rapidly react to developments.

In its Communication to the European Parliament and the Council "on the State of Play of Implementation of the Priority Actions under the European Agenda on Migration," of 10 February 2016,[18] the EU Commission mentions the Valletta Summit on Migration and the Emergency Trust Fund for Africa, lamenting that while EU funding levels are approaching €1.9 billion, the target that national funding would match the EU financing is "far from met, national contributions amounting to under €82 million." At this date, the EU Commission states, projects have already been agreed on for a total amount of more than €350 million,[19] covering areas including job creation, better management of migration and strengthened security; additionally, the EU has maintained support to refugees and internally displaced people in Libya. On a diplomatic level, the High Representative/Vice-President and the Commission have also started actions to include migration and security in the political bilateral priorities with African countries.

The following EU Council, held on 18 February 2016, further expresses concern on the migration crisis facing the EU, underlining the objective to rapidly stem the flows, protect external borders, reduce illegal migration and safeguard the integrity of the Schengen area. Its Conclusions again refer to the implementation of the Valletta Summit decisions and the subsequent EU Commission's actions, by stating[20] that "regarding relations with relevant third countries, the comprehensive and tailor-made packages of incentives that are currently being developed for specific countries to ensure effective returns and readmission require the full support of the EU and the member states" and that "implementation and operational follow-up to the Valletta Summit, in particular the agreed upon list of 16 priority actions, should continue and be stepped up." The EU Council's intent is to be "reforming the EU's existing framework so as to ensure a humane and efficient asylum policy," the further orientations of which have to be fixed through a comprehensive debate at the next European Council.

## THE VALLETTA SUMMIT IMPACT ON THE MIGRATION CRISIS: ATTEMPTS OF CRITICAL EVALUATION

The outcomes of the Valletta Summit were not greeted with overall satisfaction by stakeholders. "While there are some positive steps in the area of legal migration for work, study and research, as well as a commitment to strengthen search and rescue, it is clear that the European States' main objective remains to deter the migratory flows. No meaningful commitment is there for safe and legal channels for refugees,"[21] states Michael Diedring, Secretary General of ECRE.[22] Mr. Diedring expresses particular concern about the emphasis placed on border control and readmission, and even more about the bilateral level between European and African States, which "bears significant risks of refoulement, detention and ill treatment in countries of origin and transit."

Several organisations are disturbed by the increasing attention placed on return and readmission in EU development cooperation: "The EU-Africa migrant plan raises worrying questions," commented Irin News[23] from Valletta on 12 November 2015.[24] Some concern had already been expressed just before the Valletta Summit by the "African and European Civil Society Joint Statement"[25] of 9 November 2015, based on consultations with an array of African and European civil society platforms and organisations conducted by the International Catholic Migration Commission (ICMC) Europe, the Norwegian Refugee Council (NRC) and Caritas Senegal, coordinator of the Migration and Development Civil Society (MADE) network in Africa, as well as by Amnesty International in its article "EU-Africa Summit in Valletta must not dress up border control as cooperation"[26] of 10 November 2015 and by Human Rights Watch in its 9 November 2015 article "EU/AU: Put Rights at Heart of Migration Efforts – Border Control Goals at Summit Shouldn't Undermine Access to Protection."[27]

In his article "A missed opportunity in Valletta"[28] of 1 December 2015, Bob van Dillen discusses his main concerns about the outcomes of the Valletta Summit, particularly the fact that "the Valletta 'European response' to the migration crisis was based on self-interest, rather than shared concerns and urgency" and was "a dual effort of promoting the return of migrants and pre-

venting them from coming." Mr. van Dillen argues that the financial resources provided by the EU Commission for the Emergency Trust Fund were not met by any substantial figures from the EU member states, and wonders whether the Trust Fund will "result in effective protection of migrant rights and tackle the root causes of poverty and inequality, or rather facilitate the deportation of irregular migrants back to Africa and enforce border control in Africa preventing migrants from their departure to Europe." Furthermore, he accuses the Valletta Political Declaration and the Action Plan of being vague in their language, and scarcely innovative; from lacking implementation of past similar programmes he draws the suspicion that the Valletta Action Plan will also fail to be properly implemented. He also accuses the Action Plan of containing absurd provisions[29] and of missing to take action on several civil society demands,[30] and considers the choice of not significantly involving civil society observers a dangerous mistake.

Certainly, migration challenges have risen to a dramatic level for the EU and are putting unprecedented pressure on EU institutions and member states. The solidarity principle on which the EU is based, requiring member states to work together towards offering some solution to the migration issue, is set at high risk by the fear of being overwhelmed and by the economic crisis, luring member states with the temptation of halting or even reversing the European integration process. This emergency, combined with partially dissatisfactory results achieved up to now, strongly calls the EU and its member states to revise their vision and their strategy.

However, the great effort put into implementing a large number of actions foreseen by the EU Emergency Trust Fund for Africa within only one month from the Valletta Summit, and the intensive attention devoted to the Valletta Action Plan by the EU Council and the EU Commission at the very start of 2016 appear to prove a definite political will to achieve the envisaged goals.

Given the long-run objective of successfully addressing the root causes of migration by working to help create peace, stability and economic development in the countries of origin, which undisputedly needs to be the final goal, a serious commitment to the short-run that aims at promoting legal channels for migration and mobility from and between African countries, at reinforcing protection of refugees and other displaced persons, at seeking

further support to the rule of law and border management authorities in order to tackle the smuggling of migrants and trafficking of human beings, and at facilitating the return and sustainable reintegration of irregular migrants, as the Valletta Summit outcomes promise, does seem to spark some glimmer of hope for the near future.

# ENDNOTES

**1.** Turin University.

**2.** Available at: http://www.europarl.europa.eu/the-president/en/press/press_release_speeches/speeches/speeches-2015/speeches-2015-november/ht.

**3.** Available at: http://www.consilium.europa.eu/en/meetings/international-summit/2015/11/11-12.

**4.** It is officially acknowledged that protection must be granted to all those entitled to it in accordance with international and regional instruments.

**5.** Resources will be drawn from all existing instruments, along with the newly set up EU Emergency Trust Fund for stability and addressing root causes of irregular migration and displaced persons in Africa.

**6.** Relevant priority initiatives to be launched before the end of 2016 include projects to enhance employment opportunities and revenue-generating activities in regions of origin and transit of migrants; projects linking relief, rehabilitation and development in the peripheral and most vulnerable areas; supporting the African Institute on Remittances; facilitating responsible private investment in African agriculture and boosting intra-African trade.

**7.** Relevant priority initiatives to be launched before the end of 2016 concern doubling the number of scholarships for students and academic staff through the EU supported Erasmus+ programme in 2016 compared to 2014; launching pilot projects to pool offers for legal migration (*e.g.* for work, study, research, and vocational training) by some EU member states or associated countries to selected African countries; organising workshops on visa facilitation.

**8.** Regional Development and Protection Programmes in the Horn of Africa and North Africa should be up and running by mid-2016. In 2016 trainings will be carried out and the quality of the asylum process will be improved, in close cooperation with UNHCR and with the support of EASO, in countries of origin, transit and destination; projects to improve resilience, safety and self-reliance of refugees in camps and host communities in countries most affected by forced displacement will be developed in close coordination with host countries and international organisations.

**9.** Priority initiatives to be launched by end 2016 include establishing or upgrading national and regional anti-smuggling and anti-trafficking legislation, policies and action plans in countries and regions of origin and transit of migration; identifying single national contact points for anti-smuggling and trafficking activities; projects on strengthening institutional capacities to fight against the smuggling of migrants and trafficking in human beings networks, both in origin and transit countries, and raising awareness on this problem among the populations concerned; setting up a joint investigation team in Niger against migrant smuggling and trafficking in human beings networks, as a pilot project to be potentially replicated in other countries.

**10.** The commitment by the end of 2016 is to strengthen the capacity of countries of origin to respond to readmission applications, including missions by immigration officials from African countries to European countries in order to verify and identify nationalities of irregular migrants; and to launch projects in countries of origin to support the reintegration of returnees into their communities.

**11.** At the date of announcement, 25 EU member states and two non-EU donors (Norway and Switzerland) had announced a total contribution of around € 81.3 million.

**12.** The Trust Fund Board is chaired by the European Commission and composed of representatives of member states and other contributing donors.

**13.** Sahel region and Lake Chad area: Burkina Faso, Cameroon, Chad, the Gambia, Mali, Mauritania, Niger, Nigeria and Senegal. The Horn of Africa: Djibouti, Eritrea, Ethiopia, Kenya, Somalia, South Sudan, Sudan, Tanzania and Uganda. The North of Africa: Morocco, Algeria, Tunisia, Libya and Egypt.

**14.** EU Commissioner for International Cooperation and Development, Neven Mimica, commented: "The adoption of the five-pillar action plan at the Valletta Summit on migration was a major first step towards a renewed partnership with African countries to address migration, mobility and forced displacement through a concrete action. Today we are taking the second step, showing that the real work has started. The fast-tracked approval of today's new projects proves that this is not business as usual."

**15.** The first project under the EU Emergency Trust Fund for Africa, worth €20 million, was signed on 18 December 2015, only one month after the Valletta Summit on Migration, at a ceremony in Brussels attended by the EU Commissioner for International Cooperation

and Development, Neven Mimica, and the Director General for Development Cooperation, Ministry of Foreign Affairs and International Cooperation, Giampaolo Cantini.

**16.** Frontex, the European Agency for the Management of Operational Cooperation at the External Borders of the member states of the European Union, was set up in 2004 to reinforce and streamline cooperation between national border authorities.

**17.** The European Asylum Support Office (EASO), established on 19 May 2010, is a Regulatory Agency of the European Union. Based in Malta; it focuses on three main tasks: 1) developing practical cooperation among EU member states on asylum, by facilitating the exchange of information on countries of origin, providing EU States with support for translation and interpretation, training asylum officials and assisting in the relocation of beneficiaries of international protection; 2) supporting EU member states under particular pressure, mainly through the establishment of an early warning system; coordinating teams of experts to assist them in managing asylum applications and in putting in place appropriate reception facilities; 3) contributing to the implementation of the Common European Asylum System by collecting and exchanging information on the best practices, drawing up an annual report on the asylum situation in the EU and adopting technical documents, such as guidelines and operating manuals, on the implementation of the EU's asylum instruments.

**18.** COM(2016) 85 final.

**19.** Further examples of projects mentioned by the EU Commission include: Mali – 3 projects worth €43.5 million to support local authorities and the vulnerable population in the North of Mali and to create jobs in the rest of the country; Niger – two projects worth €32 million to be implemented in Niger's Agadez region to help the authorities manage migratory flows and promote sustainable alternatives to irregular migration; Senegal – a project worth €8 million to assist the most vulnerable people in the country by improving living conditions and resilience of local populations.

**20.** Available at: http://www.consilium.europa.eu/en/press/press-releases/2016/02/18-euco-conclusions-migration.

**21.** Available at: http://www.ecre.org/component/content/article/70-weekly-bulletin-articles/1274-the-valletta-summit-eu-and-africa-commit-to-prevent-irregular-migration-but-support-legal-mobility.html.

**22.** The European Council on Refugees and Exiles (ECRE) is a pan-European alliance of 90 NGOs protecting and advancing the rights of refugees, asylum seekers and displaced

persons. Its mission is "to promote the establishment of fair and humane European asylum policies and practices in accordance with international human rights law".

**23.** A project of the United Nations Office for the Coordination of Humanitarian Affairs (OCHA) until 1 January 2015, Integrated Regional Information Networks (IRIN) acts as a news agency focusing on humanitarian stories in regions that are often forgotten, under-reported, misunderstood or ignored.

**24.** Available at: http://www.irinnews.org/node/255734.

**25.** Available at: http://madenetwork.org/sites/default/files/PDF/African%20and%20Europe%20CS%20statement%20for%20the%20Valetta%20Summit_final.pdf.

**26.** Available at: http://www.amnesty.eu/en/news/press-releases/all/eu-africa-summit-in-valletta-must-not-dress-up-border-control-as-co-operation-0941.

**27.** Available at: https://www.hrw.org/news/2015/11/09/eu/au-put-rights-heart-migration-efforts.

**28.** Available at: http://madenetwork.org/latest-news/missed-opportunity-valletta?hp#sthash.cXjpNWcf.dpuf.

**29.** "The Action Plan does allow African migration officials to come to Europe for the verification of nationality – a rather absurd situation if this happens to be one of the many notoriously corrupt African dictatorships, who might be keen to facilitate the return (and imprisonment, or worse!) of political opponents, religious or human rights activists."

**30.** "Whereas civil society had expected substantial increase in resettlement, humanitarian visas, extended family reunifications, sponsorship programs and educational scholarships, European member states did not want to provide legal opportunities for African nationals, apart from a doubling of Erasmus scholarships for students. Valletta also did not take any action on other civil society demands, including the lifting of carrier sanctions as a means to ensure safe migration and counter people smugglers, to facilitate the important role of migrants and the diaspora in development, and to stop using development assistance for the first year's reception of asylum seekers."