Mark Fenwick · Stefan Wrbka *Editors*

Flexibility in Modern Business Law

A Comparative Assessment

Springer

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The Flexibility of Law and Its Limits in Contemporary Business Regulation

Mark Fenwick and Stefan Wrbka

Contents

1 Introduction

Over the last three decades, the rapid pace of technological change, transformations in the composition of markets and the emergence of global production capacities and service providers have created many new opportunities for business, as well as consumers. Globalization is the new and irreversible economic reality of our age. Clearly these economic changes have contributed to the creation of new pressures on, and expectations of, those fields of law connected to the regulation of business, particularly cross-border business. Lawmakers and regulators have been compelled to respond to the new demands and challenges created by the emergence of a global economy. New expectations of law – in particular, that it be more agile or flexible in regulating the market economy – have prompted law-makers and regulators in multiple jurisdictions to adopt various novel regulatory techniques and legal forms to respond to this challenge.

In many cases, these adaptations in domestic law have entailed compromising traditional legal principles – such as legal certainty – in favor of empowering regulators with greater discretion than has traditionally been permitted in modern legal institutions. These changes raise important, but difficult, questions about the

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balance between fairness and efficiency, as well as the relationship between the public and private good.

From the perspective of companies, the already weighty challenges of doing business in a global economy are compounded by the additional challenge of navigating the resulting mosaic of regulatory regimes. The profile of legal risk for modern business is rendered highly unstable by the fact of transnational operations, but the additional uncertainties created by the fact of diminishing legal certainty and the relentless pace of law reform becomes a further source of legal risk and additional costs. The benefits of these additional risks and costs are often uncertain, further compounding the challenges for business enterprises.

The aim of this book is to bring together scholars from different fields of economic and business law in order to map some of the legal responses to the challenges of economic globalization, focusing in particular on this question of the shifting meaning of flexibility in the context of contemporary business regulation. In this introductory chapter, we would like to provide some background and context to the discussion that follows, as well as an overview of individual chapters.

2 The Demand for Flexibility in Business Regulation

This volume is intended as a contribution to debates on business regulation, focusing on this theme of flexibility. Although the topic of flexibility can be found in much of the literature, one important development in this area was the 1992 publication of *Responsive Regulation* by Ian Ayres and John Braithwaite.[1] In this work, Ayres and Braithwaite attempted to transcend the debate between advocates of state-orchestrated command and control measures and advocates of compliance and more market oriented, de-regulation by proposing a new approach. The central claim of 'responsive regulation' was that regulatory measures – laws and policies broadly defined – are more likely to be effective when the regulator is able to utilize in a flexible manner an "enforcement pyramid" comprising multiple regulatory measures. In particular, a range of enforcement sanctions ranging from persuasion, at the "base" of the pyramid through warnings and civil sanctions up to criminal penalties, at the "top".

According to this individualized approach, regulation of a particular firm should start at the base of the pyramid – i.e. with persuasion, education and warnings – and then, in the event that this approach proves ineffective, escalate to more punitive measures. If the regulated company "knows" that more severe enforcement is conditioned on their rejection of cooperation then a strong incentive is created to cooperate. Equally, regulated entities know that cooperation will result in "softer" sanctions, as the company is moved "down" the pyramid. In this way, regulators

[1] Ayres and Braithwaite (1992).

can deploy their limited resources more efficiently by that having to make recourse to the severest – and often most costly – measures from the start.

This idea of responsive regulation – particularly the model of the enforcement pyramid – has been extremely influential across multiple fields of regulation and jurisdictions. For our purposes, what is interesting about this model is the degree of discretion it affords to the regulator, notably the flexibility in how regulators should approach the issue of sanctions.

Nevertheless, there are several problems with this kind of approach. In the following, we will focus on those that are most relevant for what we are tying to do here. First, responsive regulation presupposes that regulated entities do actually respond to the pressures created by regulators as they move up and down the pyramid. But is this a reasonable assumption? And even if it is correct, corporate actions may be more strongly influenced by other considerations, such as the culture of the organization, prevailing practice within that sector or by the pressures of competition. Greater research would be required on the various motives for non-compliance in particular sectors, and the need for more targeted approaches based on those motives. The important point is that flexibility on the regulatory side needs to be matched by an understanding of the motive of business. An emphasis on regulatory flexibility is contingent on a greater recognition of the business perspective.

A second set of concerns with responsive regulation relate to the capacities of the regulators. Do regulators possess the capacities and resources to make these often-complex decisions regarding the "best" means of enforcement? Whether a responsive approach "works" will depend on issues such as resources of the agency, the size of the regulated entities, the type and complexity of the standard that is being imposed, the degree to which non-compliance is observed and observable, as well as the costs of compliance.

Moreover, the demand for regulatory responsiveness assumes that the regulator has the flexibility to change its regulatory direction. Again, this may be an unrealistic assumption for a number of reasons, including the regulatory culture and the broader political and economic constraints of the institutional environment. The regulator may lack resources or the will to pursue more punitive measures and there may be a fear of a negative business reaction to any such escalation. On the other hand, there may be a political decision from above to adopt a more punitive approach or media pressure to do the same. For all of these reasons, a high degree of flexibility on the part of the regulator may be difficult to achieve.

A third set of concerns relate to the fairness of such any approach premised on flexibility on the part of the regulator. A risk in any system that adopts flexible regulatory responses to the actions of individual firms is that it creates an unacceptable degree of discretion and a corresponding lack of transparency. Concerns about consistency of treatment – i.e. fairness – are thus raised. Although rules and guidelines can potentially ameliorate such concerns, the resulting restrictions may end up depriving regulators of the very flexibility that we were pursuing in the first place.

The final set of concerns that we would highlight relate to the type of legal norms that are applicable in business regulation, particularly in transnational settings. Increasingly, the legal norms that govern business enterprises have a hybrid nature that do not necessarily originate with nation states, but are the result of a complex interaction between official and unofficial entities.[2] The literature on this new transnational business law clearly shows how quasi-private ordering of this kind increasingly acts as an alternative or supplement to traditional norm-making. The resulting competition between a particular type of self-governance, national and international norms adds to the complexity of the contemporary legal landscape for both business enterprises and regulators. At the very least, the proliferation of norms suggests that there is unlikely to be a one-size-fits-all solution and that there is a need for specific analyses of particular fields of law in which the perspective and interests of policy-makers, regulators and business enterprises are all considered. Mapping some of these issues in particular fields of law is the primary intention of this book.

3 Chapters

This books comments on the significance of and challenges for flexibility in today's business world. The discussion is divided into three main parts: flexibility and the role of the lawmaker, flexibility as seen from the regulator's side (in the broadest sense) and flexibility from the perspective of business.

The authors of the first of the three parts of the book approach the flexibility notion from the viewpoint of the legislator – or, more broadly speaking, from the perspective of legal norms. Stefan Wrbka opens the flexibility discussion with comments on the Austrian warranty regime. In this context he focuses on teleological reduction, in particular on its potential and limits to accomplish a 'just' or 'fair' result in applying warranty rules. The author explains that legal flexibility (to react to special scenarios that cannot be explicitly addressed by statutory law) can create a certain amount of tension from the perspective of legal certainty. The important question that is raised by this issue is how to balance the interests of involved stakeholders in crafting a clear legal framework, on the one hand, and the possibility to allow for a more flexible application of underlying rules that would allow paying tribute to the parties' 'special' interests in a concrete case. Wrbka shows that certain warranty scenarios exist where the lawmaker's wish to introduce clearly worded rules might undermine the general interest in remedying an objectively unbalanced distribution of benefits and detriments. In this context one might justifiably argue that the legislator would have opted for a more nuanced approach if he had taken the special circumstances of such a case more seriously. To remedy

[2] See Callies and Zumbansen (2010) for a discussion of hybridity in contemporary transnational business law.

this alleged deficiency one might take recourse to interpretative means, including the – at least in civil law countries – likely most 'controversial' interpretative instrument of teleological reduction (in the case at hand coupled with analogy). In this context, the so-called *lex-lata*-rule as framed by Franz Bydlinski enjoys great significance, because it sets an outer limit to the possible application of teleological reduction of (at first sight) clearly worded statutory rules. In Bydlinski's understanding reducing the scope of legal norms 'teleologically' is permissible unless both the wording of the respective norm *and* the legislative intention behind that norm clearly indicate that such an interpretative move would not be permissible. From the viewpoint of legal certainty and the allocation of legislative competences this solution might look too far-reaching. Nevertheless, as the warranty claim period example discussed by Wrbka shows, Bydlinski's *lex-lata*-rule can have its justification to achieve true legal stability. If – like in the example discussed by Wrbka – special circumstances would make it *generally* impossible to realise the purpose of a legal concept, teleological reduction could be considered permissible. Although legal certainty concerns must not be neglected, allowing teleological reduction in combination with analogy to satisfy the rationale of a norm or a legal concept in dispute should be considered as weighing heavier – unless a *lex-lata*-analysis leads to the result that no room must be given to applying statutory rules more flexibly.

Daniele Mattiangeli and Lisa Katharina Promok add insights from the (again Austrian) company law perspective. The authors discuss recent changes to the Civil Law Company without legal personality (*Gesellschaft bürgerlichen Rechts*), a popular company type in Austria. This popularity derives from the fact that it can be initiated without any special formal requirement. The regulatory framework governing this type of company dates back to the very early days of the Austrian Civil Code (*Allgemeines Bürgerliches Gesetzbuch* or *ABGB*), which was introduced in 1811. However, certain parallels can even been drawn to the Roman Law *societas*, that can be considered as one of the models for the Austrian Civil Law Company. One of the characteristics of the Austrian Civil Law Company – that also derived from the Roman Law *societas* – is its flexibility that allows for its use in different fields, both within and outside of the traditional business world. The basic legal framework of the Austrian Civil Law Company has – until very recently – been left untouched for more than 200 years, which is quite remarkable if one considers that many areas for which this company form has been used have undergone substantial, practical changes. The flexible character of the Austrian Civil Law Company can, as Mattiangeli and Promok point out, arguably be considered as a core reason why the regulatory framework had remained unchanged.

In October 2014, after more than two centuries, the Austrian Civil Law Company regime was finally revised to enhance legal certainty. Several new provisions were added to accommodate new challenges and to reflect the further developments of this company form via case law that led to the obsolescence of several existing provisions. Remarkably though and despite the revision of the framework, the basic concepts that characterise the Austrian Civil Law Company, including its

flexibility, were retained. Hence, the 'new' regime reflects both the wish for improved legal certainty and the long-established and widely appreciated flexible character of this company type.

Mattiangeli and Promok comment on the development of and changes to the Austrian Civil Law Company by also referring to the Roman Law *societas* to highlight certain tensions between legal certainty and legal flexibility that can be found under the new rules. The issues they cover include *inter alia* questions related to the management and proxy, profit and loss distribution, liability, assets, the company name, dissolution and liquidation of the Austrian Civil Law Company. The authors conclude that, in principle, a proper balance was found between legally and linguistically modernizing and structuring the discipline of Austrian Civil Law Company that reflects case law developments on the one hand and maintaining the underlying flexibility and simplicity of the regime on the other. Mattiangeli and Promok further arrive at the conclusion that in the course of modernization the legislator – consciously or subconsciously – maybe 'ironically' took recourse to some additional Roman Law principles. Despite the overall success in striving for the optimal legal framework some shortcomings can be found. In this context a newly introduced, 'incomplete' rule for the dissolution and the exclusion of members of the Austrian Civil Law Company, which only applies to entrepreneurs, should – so the authors – be pointed out.

Sean McGinty takes the legal flexibility debate to Japan. He switches to corporate law an analysis the impact of globalisation on national lawmaking. More precisely, he focuses on two corporate forms – the 'business organization' and the 'Shoutengai Promotion Association' (SPA). While the first term refers to a corporate form that can be used for companies of different sizes and different geographical orientation (local, regional, international) – and thus can be found in a bigger, i.e. cross-border setting – the term SPA describes a corporate form that is typically found in Japanese more traditional shopping streets. To borrow McGinty's words, the SPA concept can be defined as 'a type of business cooperative which allows individual retail and service providers operating within a shopping street to organize themselves as a collective entity'. It refers to a very local form of business that usually does not show any cross-border involvement, at least not when talking about offering products and services to customers. The author discusses the flexibility concept in this context as illustrating the influence of globalisation on legal change. Put as a question, does – and if yes, how does – a changing international business setting lead to legal changes at a national level? The jurisdiction and the two corporate forms McGinty concentrates on – Japan and the Japanese business organization/SPAs – are a very interesting example in this context, because they offer two totally different cases embedded in a traditionally relatively reform-immune legal environment: A vibrant and growing industry, on the one hand, and a traditional, not to say 'old-fashioned' scenario, on the other. The author arrives at the conclusion that international legal developments play an important role for national lawmaking in those scenarios where Japan would lose its international competitiveness if staying legislatively passive. Driven by scholarly discussions and foreign trends Japan has been aiming to converge its legal setting by initiating a

major corporate law reform with far-reaching consequences for Japanese business organizations.

SPAs, however, have not been affected by this legal change, mainly because the Japanese legislator did not find it necessary to alter a long-established legal framework to improve the competitiveness of SPAs. Since SPAs concentrate on the local market, economic globalisation does not show any greater effect on the day-to-day business. The decision to leave the legal setting for SPAs intact might seem logical at first sight (in particular because of the 'only' local nature of SPA business), but is nevertheless remarkable. McGinty points out that globalisation and the growth of the cross-border market has put huge pressure on SPAs as the focus of a large portion of customers has moved towards bigger businesses. Despite this development SPAs have, however, been able to withstand this pressure by engaging in niche markets to satisfy the demand for goods and services that are not the prime target of bigger corporations. These developments have led to a quite unique picture of an even more scattered legal framework for Japanese business organizations on the one hand and SPAs on the other.

Christian Gomille finishes the first part of this book off by dealing with another clash of interests. He focuses on the tension between the novelists' artistic freedom and the novels' protagonists' personality rights. Based on the observation that many authors use real-life people as model for their story characters, Gomille deals with the question of how to balance the authors' interest in commercialising true stories on the one hand and the interests of persons not to share their private lives with the readership or more generally speaking: with the public. Although authors are basically free to create stories, this freedom might find its limitation in cases of insulting privacy rights of individuals. In such a situation exploiting other persons' life stories might have to be considered impermissible.

With respect to Germany Gomille explains that the German *Federal Constitutional Court* (FCC) argues that the labelled 'fictionality' of a novel prevents the traditional private law concept of defamation (which at first sight seems to be the most suitable legal device to answer such a situation) from being applied directly. As a result of this the court has been trying to develop special rules to cover defamation-like scenarios that occur in a novel. By looking at the situation in the United States Gomille argues that the FCC's approach is not entirely convincing. He explains that traditional defamation rules have to be applied in a more flexible way that would allow handling also cases that are labelled as fictional, but turn out to be a copy of a real-life person's story. Gomille states that such storytelling would not differ from a direct denunciation of a person if the novel's character is identifiable. If that is the case – which can most likely be proven by concluding that the readership interprets the circumstances as a reflection of a real-life person's experience (and not as a truly fictional story) – one has to consider such a situation as a case of defamation. The only major difference between the defamed person and the story character is that the story character is given a name that is different from the person's real name.

Hence, one can say that in such a situation the fiction label is used in a misleading way. The consequence of this is that legal instruments, such as the

torts of libel and slander as well as the theories of illegal disclosure of private facts and breach of confidentiality, should be considered as being directly applicable. A comparable legal consequence can arise if the means of personal defamation is not a falsely labelled factual report, but a vexation of an identifiable real-life person that occurs by 'drawing a picture' that does not tell a true story. In such a case the so-called 'abusive criticism rule' could be applicable. This is in the affirmative if the story about the real-life person is told for the sole purpose of vexation. In cases that are not subsumable under any of these scenarios the novel's author could, however, rightfully exercise his artistic freedom.

The second part of this book takes a look at the flexibility notion as seen from the perspective of the regulator and, in doing so, adds several additional ideas. Two authors contribute to this debate.

Steven Van Uytsel and Ying Bi open the discussion with an analysis of leniency policies under the Chinese Antimonopoly Law (CAML), a relatively recent piece of anti-cartel legislation, adopted in 2007. Under the CAML framework the two competent authorities to enforce this anto-monopoly law, the National Development and Reform Commission (NDRC) and State Administration for Industry and Commerce (SAIC), are given competence to craft and implement leniency policies. In this context the two bodies introduced two different concepts, one addressing price related cartels (NDRC) and the other non-proce related cartels (SAIC). Both constructs allow the authorities to apply leniency rules in a comparatively flexible manner. The authors take a look at leniency experiences of other jurisdictions, i.e., the United States, the European Union and Japan and explain what could have been learnt from those older legislative schemes. Van Uytsel and Bi argue that more transparent and clear rules could, in principle, show positive, yet – as the Japanese example shows – nevertheless not absolutely positive effects. The approach taken by the CAML, however, is far from being either transparent or clear, given the fact that both the NDRC and the SAIC possess far-reaching competences to create broad leniency rules. Although one should still expect the Chinese leniency policies to be of practical importance, the authors come to the conclusion that leniency applications will be filed at a very a late point in the process, i.e., when the wrongdoer is almost sure that punishment could otherwise not be prevented.

Claudia Reith concludes this second part of the book by commenting on investor-state arbitration, in particular as seen from the viewpoints of the EU and – to a lesser extent – the US. Investor-state arbitration clauses are an often found constituent of international investment treaties, which are an important tool to facilitate foreign investment to stimulate competition on the supply side and to bring foreign capital into domestic markets. An intrinsic characteristic of investor-state arbitration is its flexibility that allows adaption to special circumstances. Not only due to this flexibility, but also because of the fact that investor-state arbitration leads to an exclusion of the traditional judiciary, investors might feel 'safer' when going abroad. This could be explained with fears on the investors' side to be exposed to allegedly state-friendly courts, that – for whatever reason – are relatively reluctant to rule against national politics. In short, one can say that investor-state arbitration grants investors comprehensive protection, a fact that might prompt

commentators to argue that foreign investors are – compared to the situation that domestic businesses are confronted with – put at an unreasonable advantage. Several developments have fuelled the criticism towards investor-sate arbitration, most notably problems arising from the so-called 'changing hat syndrome' with blurred lines and switching positions between/of counsels to arbitral proceedings and arbitrators or concerns of lacking consistency and coherence of case-law. Possible tensions between transparency and confidentiality add further food for discussion. In the context of investor-state arbitration Reith puts a special focus on the situation in the EU, where the Lisbon Treaty granted the EU broad competences to conclude investment treaties. This decentralized competence might intensify the overall investor-state arbitration debate. It should not be neglected, however, that in times of increasing significance of investment treaties – to date there are, as Reith explains, more than 3,000 investment treaties in place – investor-state arbitration is a phenomenon that cannot be thought away anymore. Despite all the criticism it surely has its justification, because it aims to encourage foreign investment by depoliticising the governing legal framework. In addition, attempts to improve overall transparency have indicated that stakeholders are willing to answer to prime criticism of investor-state arbitration. The flexible character of investor-state arbitration surely makes it easier to respond to shortcomings and remedy defects that would scare states off from concluding investment treaties. Reith calls for patience and concludes that one must not neglect the potential of well-designed investor-state arbitration.

The third part of this book deals with flexibility as seen from the business perspective. It comprises three contributions examining different aspects of the problem.

Mark Fenwick examines how the expansion in the scope of contemporary corporate criminal law – what he characterises as the 'new corporate criminal law' – has greatly expanded the quantity and quality of legal risk facing businesses today. He uses the term corporate criminal law to refer to that body of the criminal law that applies to the corporation *itself*, rather than individual members of the corporation, such as executives, managers, employees or other stakeholders, i.e. the application of criminal law to legal persons. The chapter begins with the suggestion that over recent decades and across multiple jurisdictions there has been a process of "net-widening" whereby the scope of corporate criminal law has greatly expanded and that this legal change has created an unprecedented degree of legal risk for all corporations. And although we shouldn't be naïve in underestimating the power of corporate interests to resist the intrusions of the criminal justice system into their activities, he argues that it is also the case that corporations cannot simply choose to ignore these developments. Formulating an organisational response to this new legal risk is a necessity.

The main focus of the chapter is on the trend to expand the scope of corporate criminal law to cover activities that have been conducted overseas, i.e. the extra-territorial application of corporate criminal law. In particular, the chapter describes how the territorial reach of corporate criminal law has extended further and elements of the criminal law of a particular jurisdiction now apply to any

corporation that issues securities in that jurisdiction or simply conducts part of its business in that jurisdiction, irrespective of where that corporation was established, where the firm's centre of operations are located, or where the alleged wrongdoing took place. This change massively increases the legal risk profile for corporations, as they are now obliged to navigate through an overlapping mosaic of different criminal law norms from an ever-increasing number of jurisdictions.

The chapter ends with a critical examination of how corporations have responded to this expansion in legal risk by adapting adaptive and flexible "compliance" mechanisms. Corporate compliance consists of an organization's policies, procedures, and actions that aim to prevent and detect violations of laws and regulations. The stated aim of such compliance is to manage regulatory risk and to ensure that an organization has systems of internal control that adequately measure and manage the risks that it faces. Compliance is expected to perform various functions connected to this core task, namely to identify the risks that an organization faces and advise on them; to design and implement controls to protect an organization from those risks; to monitor and report on the effectiveness of those controls in the management of an organization's exposure to risks; to resolve compliance difficulties as they occur; and to advise the business on rules and controls. The growth in compliance represents one of the most significant shifts in corporate organization over recent decades. The chapter concludes with some critical comments on this development.

Jarl Jacob adds comments on the regulation of the consumer credit business with a comparative study of the underlying legal regimes in Japan and two EU Member States – Belgium and the UK. By looking at consumer credit regulations his analysis focuses on a rapidly developing aspect of today's business world that demands a flexible yet transparent regulatory framework. This chapter shows that the solution might look different – depending on the prime concerns in the respective jurisdiction. As Jacob explains legislators might face different challenges. In Japan, the lawmaker had to solve problems that occurred from the exploitation of unparalleled consumerist behaviour that led to a greatly increased amount of private debts. Consumer credit businesses had flourished in Japan – not least due to the lax legal framework that was meant to protect credit users. The Japanese legislator tried to answer with a recent amendment of the Money Lending Business Law (MLBL).

Changes to national consumer credit laws in the EU had a different starting point. In a European context, it was the wish to harmonise consumer credit rules beyond state borders to stimulate the competitive consumer credit market, on the one hand, and to ensure a more standardised level of consumer protection throughout the EU, on the other. The central tool in this respect was the fully harmonised 2008 Consumer Credit Directive that forced Member States to implement several parameters that aimed to defragment national rules. The two EU jurisdictions chosen by Jacob – Belgium and the UK – illustrate that (not least because of a certain legislative leeway or more generally speaking: legislative flexibility with respect to issues not covered by the Directive) this endeavour was not fully successful. The author also points out that the MLBL and the 2008 Consumer Credit Directive conceptually differ in their approaches with the first one

introducing more precise and comprehensive rules than the second one, which allows for greater flexibility to accommodate the interests of both businesses and consumers. The MLBL has introduced relatively clear parameters for central issues linked to consumer credits, *inter alia* a definition of creditworthiness. Such a definition is missing both in the 2008 Consumer Credit Directive and the national, European laws analysed by Jacob.

Although the absence of a definition can be explained with the wish to provide a flexible scheme to evaluate the concrete circumstances in a given situation, the author – referring to observations of the consumer credit market after the enactment of the MLBL and the 2008 Consumer Credit Directive – arrives at the conclusion that more detailed rules might prove beneficial also in the EU. This is undoubtedly true if one comments on the frameworks from the viewpoint of lowering the number of people experiencing private debts as a result from the use of credits. Recalling the prime driving factors behind the two laws – reducing the number of consumer credit debt cases as fast as possible in Japan and guaranteeing a certain protective level while standardising the protective framework in the EU –, the different approaches chosen might only be logical.

Nevertheless, Jacob points out that one could – from a consumer perspective – have wished for a more ambitious approach at the EU level that would not have stopped, in principle, at fully harmonising the mandatory information to be given to consumers in the course of concluding and processing consumer credit agreements. Praising the Japanese, relatively aggressive approach towards regulating the consumer credit business sector, Jacob calls for additional measures to be introduced at the EU level, such as a (greater) restriction of interest rate limits or the introduction of a harmonised creditworthiness notion.

The contents of the book are completed by Marcelo Corrales and his analysis of the significance of mutual trust in cloud computing and related business activities. Corrales commences his contribution with a definition of the main characteristics of cloud computing that involve a great amount of complexity, not only in a technical sense, but also in a legal context. Potential users of cloud computing might be scared off by the intricacy of specialist terminology and widely ramified legal constructs that govern the technical settings and are spread over numerous jurisdictions and between service providers.

The legal framework can – at best – be described as lacking transparency. But even if they not deterred, users might remain unaware of possible, legal risks that are found in cloud computing, and suffer a surprise when legal issues arise. To enhance cloud computing and related business forms Corrales examines law and economics and discusses various models introduced by leading authors.

In particular, he discusses Scott Shapiro's deliberations with respect to 'planning agents' and Lawrence Lessig's observations of the architecture of the internet as the prime regulator in online transactions. Combining thoughts introduced by these two Corrales shapes a theoretical framework for cloud computing that he calls 'Plan-like Architectures'. This framework, so Corrales, would remedy the trust deficiency of cloud computing by adding a 'trust perspective' to Service Level Agreements (SLA) (which are an intrinsic legal component of cloud computing models). In this

context the author stresses the importance of objectively trustworthy third party institutions that engage in trust building – both in a technical and a legal sense. By mandating such stakeholders with framework drafting competences, it would be guaranteed that a legal environment can be created that offers a win-win-situation to both providers and users of cloud computing. Cloud providers could benefit from the third party's expertise to craft a framework of trust that users can – justifiably – identify as such. Users would not have to doubt the reliability and legal compliance of cloud computing anymore. The use of third party stakeholders would embody a quite flexible regulatory approach with tailor-made solutions suitable for different scenarios. Following the law and economics doctrine Corrales is convinced that a competitive cloud market would function as the perfect setting to develop concepts of trust, because different kinds of SLA services could compete against each other with the result that the trustworthy ones would succeed in the end.

Acknowledgements The purpose of the book is to bring together, in one edited volume, research from a range of substantive areas of business law that shares a common interest in understanding the multi-layered challenges of contemporary business regulation. The book will be of interest both to lawyers interested in transnational business law, as well as other disciplines interested in understanding economic globalization and its effects.

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Part I
The Perspective of the Lawmaker

The Potential and Limits of Teleological Reduction Shown with the Example of the Austrian Warranty Regime

Stefan Wrbka

Contents

Abstract One of the main purposes of contract law is to regulate the legal obligations between two parties to a contract. From the viewpoint of contractual parties, legal certainty is important to predict the consequences of possible 'unwanted' actions and events that could impair the parties' expectations. Against this background the codification of private law rules, most notably in the form of civil codes is one of the most relevant mechanisms in civil law countries.

One of the biggest demerits of civil codes is that not every thinkable scenario can be sufficiently or explicitly addressed. In various cases appropriate solutions cannot be found merely by basing the decision on the wording of a pertinent provision. Additional means of legal interpretation (i.e., logical-systematic interpretation, historical/subjective-teleological interpretation and objective-teleological interpretation to support literal interpretation) can be of help to clarify the meaning. But even if the wording of a provision seems to be clear and supported by other forms of legal interpretation, one might face a situation that is not absolutely convincing, in particular if it leads to an objectively unjust result. Teleological reduction of said provisions can be one last resort to reach a 'just' result. From the viewpoint of legal certainty the use of teleological reductions might, however, be controversial,

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because allowing for too much flexibility could lead to insufficient clarity and transparency of legal rules.

The present contribution aims to analyse the tension between flexibility and clarity with the example of the Austrian warranty regime that offers interesting perspectives for this discussion. It will comment on debates regarding the phenomenon of planned obsolescence that concern a possible loosening up of written rules for the sake of reaching a higher level of fairness and will conclude with some thoughts on how to solve problems that might occur in this endeavour.

Keywords Legal methodology • Teleological reduction • Warranty law • Austrian private law • Analogy • Legal flexibility • Legal certainty • Planned obsolescence

1 Introduction

Economic globalisation is a trend that has increasingly been gaining importance in the business world and cannot be ignored. Looking at the example of the European Union (hereinafter, *EU*), this is best exemplified with increased efforts to strengthen the Internal Market by harmonising national laws that affect trade within and across borders. One of the older examples for this was the decision to align national warranty rules in the area of business-to-consumer (hereinafter, *B2C*) sales via the Consumer Sales Directive (hereinafter, *CSD*)[1] in 1999. This move was based on the assumption that diverse warranty rules would be counterproductive from the perspective of cross-border transactions.[2] The CSD aimed to answer this hypothesis by harmonising selected aspects of the national B2C warranty regimes, most notably by setting a minimum time standard for claims relating to defects in movables.[3]

The CSD did, however, not regulate every single possible warranty aspect. One of the questions that was left unanswered – at least, it was not explicitly addressed – was the phenomenon of so-called planned obsolescence. This term refers to practices and techniques used by producers and/or sellers to artificially speed up the product aging process and thus to 'persuade' users to purchase new products.[4] As shown later, various projects have been discussed and/or launched in the EU to

[1] Directive 1999/44/EC of the European Parliament and of the Council on certain aspects of the sale of consumer goods and associated guarantees, OJ L 171, 7 July 1999, p. 12.

[2] Recital CSD puts this as follows '[T]he laws of the Member States concerning the sale of consumer goods are somewhat disparate, with the result that national consumer goods markets differ from one another and that competition between sellers may be distorted.'

[3] According to Article 5(1) CSD warranty claim-related prescription periods 'shall not expire within a period of 2 years from the time of delivery.'

[4] For details, see Wrbka (2015).

address planned obsolescence. Although the potential of the warranty regime has been stressed by the European Commission (hereinafter, *Commission*) on this issue,[5] no concrete efforts have been taken yet to utilise the warranty regime, either at the EU level or at the national level. Taking into consideration that the question of culpability can be (basically)[6] disregarded in the context of warranty rights, the exclusion of planned obsolescence from the contemporary warranty debate is – from the buyers' perspective – deeply regrettable. The aim of this contribution is to explain how existing legislation can (with the help of interpretation understood in a broad sense) be used in the attempt to address planned obsolescence. The Austrian warranty regime will be used by way of illustration.

The analysis will start by taking a brief look at the phenomenon of planned obsolescence before turning to the Austrian warranty regime and some of its key features. It will continue with remarks on the Austrian warranty claim prescription period concept, which arguably is the most striking key obstacle for buyers to pursue their planned obsolescence-related warranty claims. Subsequently the contribution will highlight the key features of legal interpretation of Austrian private law. It concludes with an analysis of said period from the viewpoint of legal interpretation and by doing this will touch upon the issues of legal flexibility, certainty and fairness.

2 Planned Obsolescence

The phenomenon of planned obsolescence is nothing new. In the 1920s leading light bulb producers from around the world formed the so-called 'Phoebus cartel' with the aim to limit the durability of light bulbs at a maximum of 1,000 h of operation to force consumers to regularly and (from the perspective of technical possibilities) prematurely purchase replacements.[7] Over the years, the number of obsolescence critical commentators has risen, initially in the US.[8] In the second half

[5] In 2011 Potočnik (on behalf of the Commission) argued as follows: '[The CSD offers to consumers minimum rights against sellers of faulty products, i.e. of products whose quality and performance are not normal in goods of the same type and cannot be reasonably expected by the consumers. These rights include the right to have a faulty product repaired or replaced free of charge or to obtain, under certain conditions, a refund or a price reduction within a period of 2 years from the delivery of the product. Member States may adopt more stringent provisions, i.e. longer guarantee periods, in their national legislations'. For details, see http://www.europarl.europa.eu/sides/getAllAnswers.do?reference=E-2011-001284&language=EN. Accessed 30 June 2015.

[6] Culpability questions could still arise in the context of §§ 928 (deceitfulness and warranty claims) and 933a (compensation and warranty claims) ABGB though. For details see Wrbka (2015), p. 73.

[7] For a discussion of the Phoebus cartel see, e.g., Reuß and Dannoritzer (2013), pp. 13 et seq.

[8] For (mostly obsolescence critical) contributions from the US see, e.g., London (1932), Packard (1957, 1960), Slade (2006), and Bulow (1986).

of the twentieth century the debate finally reached the European continent.[9] While economic and socio-political arguments dominated earlier discussions, the range has broadened and now additionally encompasses environmental, public health-related and cultural concerns.[10]

Both at the domestic and the pan-EU level, the first initiatives have been launched to address the planned obsolescence phenomenon. In Germany and Austria, for example, various workshops organised by legislative key stakeholder groups show that the topic has reached a broader public policy level.[11] To support the quest for a suitable legal response, scholars both from within and outside legal academia have been asked to submit suggestions. Three recent expert opinions shall be mentioned in this context. In 2013, the study group REGIO Stadt-und Regionalentwicklung GmbH issued an opinion mandated by the German parliamentarian representation of the Alliance 90/The Greens party (Bündnis 90/Die Grünen)[12] with interdisciplinary comments on planned obsolescence. In 2015, a consortium of the German Öko-Institut e.V. and the Institute for Agricultural Engineering at the University of Bonn disclosed first results of a study that focused on the environmental impact of planned obsolescence.[13] In the same year, the author of this chapter completed a sectoral legal study on planned obsolescence from an Austrian perspective. The main focus of that review was to examine the relationship between planned obsolescence and the Austrian warranty regime.[14] All three reports explain that existing national legislation exhibit some limited potential to address planned obsolescence. At the same time all three studies suggest that further steps have to be taken to enhance existing legal mechanisms.

More advanced (at least preliminary) results can be found in some other Member States. In Belgium, for example, the Senate has extensively deliberated on possible legal actions. A decision is, however, still pending.[15] The most concrete step

[9] For (mostly obsolescence critical) contributions from Europe see, e.g., Schmidt (1971), Röper (1975, 1976, 1977), Bodenstein and Leuer (1976), Hillmann (1977), Wortmann (1983), Wortmann and Schimikowski (1985), Raffée and Wiedmann (1987), Kürsten (1988), Bellmann (1990), Heckl (2013), Reuß and Dannoritzer (2013), Buschenlange (2013), Schridde (2014), Kreiß (2014), and Brönneke and Wechsler (eds) (2015).

[10] For detailed comments on all of these see opinion of the European Economic and Social Committee on 'Towards more sustainable consumption: industrial product lifetimes and restoring trust through consumer information', OJ C 67, 6 March 2014, p. 23, Recitals 2.7–2.12.

[11] For more recent results see, e.g., the following conference proceedings: Brönneke and Wechsler (eds) (2015) summarising the results of a 2014 workshop organised by the Polytechnic Pforzheim, Germany; Wien (eds) (2013), summarising the results of a 2013 workshop organised by the Chamber of Labour of Vienna, Austria.

[12] For details see ARGE REGIO Stadt-und Regionalentwicklung GmbH (2013).

[13] For details see Öko-Institut e.V. and Institut für Landtechnik – Universität Bonn (2015). This study was mandated by the German Federal Environment Agency (Deutsches Bundesumweltamt).

[14] For details, see Wrbka (2015). This study was mandated by the Chamber of Labour of Vienna.

[15] For a summary of the discussion see, e.g., http://www.senate.be/www/?MIval=/publications/viewPub.html&COLL=S&LEG=5&NR=1251&VOLGNR=1&LANG=fr; http://www.ps.be/Pagetype1/Actus/News/Obsolescence-programmee.aspx. Both accessed 30 June 2015.

(within the EU) was taken in France. At the time of writing, the French legislator was in the process of adopting a revision of the French Consumer Code (Code de la consommation) that would introduce an explicit prohibition of planned obsolescence strategies. The proposed wording of the relevant provision (Article L213-4-1 Code de la consummation) reads as follows: 'Planned obsolescence is defined as any measure with the intent to conceptually reduce the operating life of a good for economic considerations. It is punishable with 2 years of imprisonment and a fine of EUR 300,000.'[16]

At the EU-level, the first projects to address planned obsolescence have been launched in recent years. In this context, one should primarily mention environmental directives, e.g., the Ecodesign Directive,[17] the Energy Label Directive,[18] the Waste Electrical and Electronic Equipment Directive[19] and the Waste Directive.[20] Certain additional programmes have been introduced to evaluate planned obsolescence from the perspective of sustainable use. In this context the Roadmap to a Resource Efficient Europe,[21] the Commission Communication on building the single market for green products[22] and a 3-year-project to 'develop product- and sector-specific rules' to measure the environmental impact and performance of products[23] under the mandate of the Commission can be listed.

Aside from these environmental policy instruments, two other directives should be mentioned, both of which deal with the phenomenon from a different, *rights-enforcing* perspective. The 2005 Unfair Commercial Practices Directive

[16] 'L'obsolescence programmée se définit par tout stratagème par lequel un bien voit sa durée de vie sciemment réduite dès sa conception, limitant ainsi sa durée d'usage pour des raisons de modèle économique. Elle est punie d'une peine de deux ans d'emprisonnement et de 300 000 euros d'amende.' For details, see e.g., http://magazine.ut-capitole.fr/a-peine-votee-deja-enterree – 506206.kjsp; http://www.juristes-environnement.com/article_detail.php?id=1885; https://www.lenergieenquestions.fr/tag/senat/. All accessed 30 June 2015.

[17] Directive 2009/125/EC of the European Parliament and of the Council of establishing a framework for the setting of ecodesign requirements for energy-related products (Text with EEA relevance), OJ L 285, 31 October 2009, p. 10.

[18] Directive 2010/30/EU of the European Parliament and of the Council on the indication by labelling and standard product information of the consumption of energy and other resources by energy-related products, OJ L 153, 18 June 2010, p. 1.

[19] Directive 2002/96/EC of the European Parliament and of the Council waste electrical and electronic equipment, OJ L 37, 13 February 2003, p. 24.

[20] Directive 2008/98/EC of the European Parliament and of the Council on waste and repealing certain Directives, OJ L 312, 22 November 2008, p. 3.

[21] Communication from the Commission, Roadmap to a Resource Efficient Europe, 20 September 2011, COM/2011/0571 final.

[22] Commission Communication, Building the Single Market for Green Products Facilitating better information on the environmental performance of products and organisations, 9 April 2013, COM/2013/0196 final.

[23] For details, see Commission Press Release, Environment: Helping companies and consumers navigate the green maze, 9 April 2013, http://europa.eu/rapid/press-release_IP-13-310_en.htm

(hereinafter, *UCPD*)[24] primarily seeks to bring unfair commercial practices that are used in a B2C-context to an end. Individual rights are covered by the 1999 CSD.

The latter, i.e., the CSD, aimed at aligning national warranty (and goods-associated guarantee) rules. The underlying idea of the directive was that reducing the differences between national warranty regimes would simplify the legal setting in cross-border B2C transactions. To achieve this, several warranty-related issues were addressed and standardised. As already mentioned, the prescription of warranty claims might have been the most notable one. The (partial) revision of the burden of proof is another example.[25] The Commission remains convinced that taken together both the UCPD and the CSD could be used to successfully address the risk of planned obsolescence.[26]

On a different occasion I presented a detailed analysis of the Austrian warranty regime in the context of answering planned obsolescence (as an example of a national equivalent to the CSD).[27] I do not want to go into too much detail in this contribution. What I would like to do in the following though, is to use the example of the Austrian warranty regime to explain the importance that legal interpretation plays in the absence of direct legislative action in utilising existing legislation to enhance rights enforcement.

3 General Remarks on Planned Obsolescence from the Perspective of the Austrian Warranty Regime

Warranty laws are not the only, let alone the most obvious possible instrument that can be applied in attempts to answer planned obsolescence. Regulatory mechanisms (e.g., anti-cartel legislation or environmental protection related tools) as well as instruments to prevent unfair marketing practices are among alternatives that arguably show broader effects. Nevertheless, warranty laws could contribute to remedy planned obsolescence, in particular because they provide prospective victims of obsolescence with the opportunity to pursue their claims directly. If

[24] Directive 2005/29/EC of the European Parliament and of the Council concerning unfair business-to-consumer commercial practices in the internal market and amending Council Directive 84/450/EEC, Directives 97/7/EC, 98/27/EC and 2002/65/EC of the European Parliament and of the Council and Regulation (EC) No 2006/2004 of the European Parliament and of the Council, OJ L 149, 11 June 2005, p. 22. For the relevance of the UCPD in the context of planned obsolescence see Wrbka (2015) with further references.

[25] Pursuant to Article 5(3) CSD the seller has to prove that a product was defect-free at the time of performance if a defect manifest within the first 6 months after performance. It should be noticed that the reversal only relates to the question of time, not to the defectiveness of the product itself. This means that the buyer still needs to prove that a defect exists. For comments on this issue see, e.g., Wrbka (2015), chapter 3.3.

[26] See Wrbka (2015), chapters 2.3.3 and 2.3.4 with further references.

[27] See Wrbka (2015).

one further bears in mind that warranty claims could form part of collective redress actions and that warranty laws apply regardless of any fault on the traders' side,[28] the possible effects of the warranty regime should not be underestimated.

EU law has widely harmonised national warranty laws. However, for a number of different reasons – most notably the minimum harmonisation character and the limited scope of the CSD[29] – national legislators still possess a certain leeway when it comes to the fine-tuning of national warranty regimes.

In my afore-mentioned, planned obsolescence-focused analysis I came to the conclusion that three main issues are key to the success of the current Austrian framework. First, an important factor is the definition of material defects that qualify as warranty relevant defects pursuant to § 922 ABGB. The most important and difficult issue in the present context is to classify a concrete case as a defect in the sense of § 922 and not as an 'ordinary' form of obsolescence that results from usual wear and tear (which would not lead to the application of the warranty rules).[30] To address obsolescence relevant cases, i.e., cases that fall under § 922 (and to distinguish those cases linguistically from ordinary wear and tear) one could use the term 'premature obsolescence'.

Second, the question of the burden of proof, i.e., the question of who has the onus to prove his or her stance correct, plays a decisive role, because the pertinent concept has an impact on the argumentative powers to the parties. The CSD changed the picture in several Members States (including Austria) in this respect and introduced a purchaser-friendlier framework. The Austrian implementation of this – § 924 ABGB – stipulates that the transferee of an allegedly defective good has to prove that the defect was not already existing at the time of transfer of the good from the seller to the buyer, if the defect emerges within 6 months calculated from the transfer of good.[31] § 924 ABGB, however, does not alter the burden of proof rule regarding the question of defectiveness itself. Hence, regarding those defects that emerge within 6 months from the relevant time the basic mechanism is twofold. The buyer needs to prove a defect; the seller needs to prove that the defect did not exist at the relevant time. For defects that emerge later, the traditional burden of proof concept applies. In such cases the onus lies fully on the transferee.

Third (and for the present contribution of key relevance) is the question of the time prescription of possible warranty claims. The ABGB applies a multilayered

[28] Fault on the trader's side can, however, lead to several 'extra' consequences. For details see Wrbka (2015), p. 73.

[29] Note: The CSD focuses solely on B2C issues and even in this respect does not touch upon all possible warranty related questions.

[30] § 922-relevant cases of obsolescence are characterised by a premature ending of the products lifecycle that is not attributable to the purchaser – for details see Wrbka (2015). Note further that the ABGB distinguishes between material defects and legal defects and basically applies different prescription periods to these two categories. I will come back to this issue later in this contribution.

[31] Note: If delivery (understood as obtaining the factual control over a good) and the passing of risk occur at different times, the latter one is the relevant parameter – for details see Wrbka (2015), chapter 3.2 with further references.

system that makes a twofold differentiation. First, it distinguishes between defects in movables and immovables. Second, a further differentiation is made between defects that relate to the substance itself (hereinafter, *material defects*) and defects in rights (hereinafter, *rights-related defects*). § 933(1) ABGB, the pertinent rule in this context, addresses both issues. It reads as follows: 'The warranty right must, if it relates to immovables, be claimed within 3 years, if it relates to movables, within 2 years. The period commences on the day of transfer of the good [note: understood as handing-over to the seller]. In the case of defects in rights, however, the period commences on the day the transferee becomes aware of the defect' (translation mine).[32]

At first sight § 933(1) ABGB seems to introduce a clear framework. The same warranty periods for movables (2 years) and immovables (3 years) apply regardless of whether the defect is a material or a rights-related one.[33] The classification as either a material defect or a rights-related defect should – if one sticks to the wording of § 933(1) – only be decisive for determining the day of commencement of the warranty period. While the day of transfer should be the relevant factor for the category of material defects, the warranty period for rights-related defects should not commence before the day the transferee becomes aware of the defect.[34] The double-tiered division between defects in immovables and defects in movables on the one hand and material and rights-related defects on the other roots deep back to the origins of the Austrian code. The overall system was left untouched by the implementation of the CSD (note: The CSD only led to an extension of the movable defects related warranty period from 6 months to 2 years).

Although the legislator has left the differentiated commencement date regulation with respect to material defects and rights-related defects untouched, both academics and the judiciary have arrived at the conclusion that certain cases of material defects should be treated in a similar way to rights-related defects in the sense that the period should commence at a later point than the point of transfer of the good. One of these situations refers to cases in which the parties to a contract agree on certain specifications of the good that cannot be proven right or wrong at the time of transfer of the good. The underlying reason for this is the fact that depending on the actual day of detectability the 2-/3-year-period might not make

[32] Note further that § 933(2) ABGB introduces a special rule for defects relating to animals. For the purpose of this contribution, it can, however, be let pass without comment.

[33] Prior to the implementation of the CSD the warranty period for movables was only 6 months long. Due to Article 5(1) CSD that introduced a minimum warranty period of 2 years the Austrian legislator had to align its system. The 3-year period of defects in immovables was left untouched.

[34] The special commencement solution for the latter group of defects, i.e., for rights-related defects was neither influenced by the CSD nor any other EU legislation, but rests on the assumption that rights-related defects usually are not visible at the time of transfer of the good. Hence, for the sake of 'general fairness' the Austrian legislator considered it necessary to link the commencement to a more reasonable event – the day of manifestation of the rights-related defect. For details on the commencement of the warranty period in the case of rights-related defects see, e.g., Wrbka (2015), chapter 3.4.

much sense in such cases if calculated from the day of transfer. Case law thus created a class of exceptions. If a hidden defect relates to an (explicitly) agreed specification that cannot be checked at the time of transfer of the good, then one has to assume that the warranty period commences with the (positive or negative) detectability.[35] From a dogmatic point of view this is explained with a tacit agreement pursuant to § 863 ABGB. The parties to the contract are considered as having mutually agreed on a shift of the commencement day towards the detectability of the (in)correctness of the (explicitly) agreed feature. This view has been generally shared by academia.[36]

Some commentators do, however, not stop at this point. Scholars including Heinrich Mayrhofer,[37] Rudolf Reischauer,[38] Peter Bydlinski,[39] Heinz Krejci,[40] Gabriele Kandut[41] and Elisabeth Böhler[42] have been arguing that – for the sake of maintaining the meaningfulness of the warranty regime – additional scenarios of material defects are thinkable in which a comparable solution should apply. The starting point for their argumentation is the idea that warranty rules aim to ensure a fair contractual balance understood as maintaining (principally)[43] subjective equivalence between performance and counter-performance in legal transactions in which one party promises the other party a good in exchange for money (in the case of a sales contract, or more generally speaking: for value).[44] In the aforementioned case of (explicitly) agreed specifications this goal is realised with the help of contractual interpretation. In that case, one should, in principle, assume that the parties are aware of the comparably late detectability and as a consequence thereof mutually agree on a commencement date later than the day of contractual performance.

Finding a way to maintain the equivalence between performance and counter-performance is obviously more difficult in those cases of hidden material defects in which the defect does not relate to an (explicitly) agreed specification. In these cases it is difficult to arrive at a mutual deviation from the statutory commencement rule via contractual interpretation. The million-dollar question in such cases is to be

[35] For case-law examples see, e.g., RIS-Justiz RS0018909 u RS0018623, insb OGH 2 Ob 535/90; OGH 7 Ob 506/91; OGH 5 Ob 504/96 (OGH 5 Ob 505/96); OGH 1 Ob 41/03 s; OGH 7 Ob 32/04 p; OGH 1 Ob 138/05 h; OGH 5 Ob 53/12 y; Kurschel (1989), pp. 97 et seq.

[36] See, e.g., Wrbka (2015), chapter 3.4 with further references.

[37] Mayrhofer and Ehrenzweig (1986), p. 451.

[38] Reischauer (2000), § 933 Recital 3a, (2002), p. 154.

[39] Krejci (1994), p. 143.

[40] Bydlinski P (1986), p. 237, (2005), p. 690, (2014c), § 933 Recital 12.

[41] Kandut (1992), p. 244.

[42] Böhler (2000), pp. 50 et seq.

[43] See, however, Bydlinski (2014b), § 922 Recital 6, where Peter Bydlinski touches also upon the idea of maintaining/restoring objective equivalence.

[44] In this sense, e.g., the second sentence of § 922(1) ABGB; OGH 4 Ob 583/80; Bydlinski P (1993), p. 565, (2014b), § 922 Recital 6, Dullinger (2014), Recital 3/67, and Koziol and Welser (2007), p. 65.

seen in the choice between acknowledging greater legal flexibility for the sake of serving the transferee's interest in easier rights enforcement (hereinafter, the *softer approach*) and upholding legal certainty by – with the exception of the (explicitly) agreed specification concept – sticking to the wording of § 933(1) ABGB (hereinafter, the *stricter approach*).

The just listed authors support the first view and argue that a solution comparable to the afore-mentioned shift of the commencement date would be permissible in these cases, if sticking to the statutory rule would mean that transferees in similar situations would generally be deprived of pursuing their interests with the help of warranty instruments. This argumentation rests on the idea to treasure the subjective equivalence concept to the highest possible extent to guarantee a fair balance between the two performances. The supporters of the softer approach advocate a solution that (in its result) is similar to the case law-developed rule of linking the commencement day to the detectability of the defectiveness of the product. From a dogmatic point of view they usually arrive at this solution via a teleological reduction of the material defect rule of § 933(1) ABGB in combination with an analogous application of the rights-related defect solution.[45]

Case-law and several contributors from academia have, however, favoured the stricter approach and consider a derogation from § 933(1) ABGB permissible only in the case of hidden, material defects that relate to specifications that the parties (explicitly) agree on. The Austrian Supreme Court has repeatedly expressed its view that the detectability of a hidden, material defect is irrelevant if the defect only relates to specifications that have not been (explicitly) agreed on by the parties. In such cases one would have to strictly follow the wording of § 933(1) ABGB and link the commencement date to the transfer of the good.[46]

In the following chapters I will focus on the softer approach. In particular, I will aim to answer the question whether statutory interpretation could justify a derogation from the wording of § 933(1) ABGB in cases in which the hidden, material defect does not relate to (explicitly) agreed specifications.

[45] For details see, e.g., Wrbka (2015), chapter 4.4.4 with further references.

[46] For the extensive case-law on this topic see, e.g., OGH 1 Ob 169/58; OGH 7 Ob 103/72 (OGH 7 Ob 104/72); OGH 1 Ob 800/76; OGH 3 Ob 92/76; OGH 6 Ob 595/77; OGH 1 Ob782/79; OGH 1 Ob 615/80; OGH 5 Ob 552/81 (OGH 5 Ob 553/81); OGH 7 Ob 822/81; OGH 5 Ob 57/82; OGH 7 Ob 604/82; OGH 2 Ob 553/83 (OGH 2 Ob 554/83); OGH 5 Ob 2/83; OGH 6 Ob 665/84; OGH 8 Ob 579/86; OGH 7 Ob 592/86 (OGH 7 Ob 593/86); OGH 3 Ob 535/87; OGH 7 Ob 727/87; OGH 8 Ob 677/88; OGH 1 Ob 536/90; OGH 2 Ob 535/90; OGH 7 Ob 669/90; OGH 7 Ob 603/91; OGH 1 Ob 545/92; OGH 7 Ob 1585/94; OGH 1 Ob 573/95; OGH 1 Ob 2005/96 a; OGH 5 Ob 504/96 (OGH 5 Ob 505/96); OGH 7 Ob 2129/96 f. OGH 8 Ob 2350/96p; OGH 1 Ob 231/ 98 x; OGH 1 Ob 122/99 v; OGH 3 Ob 150/02 h; OGH 3 Ob 150/04 m; OGH 8 Ob 33/04 t; OGH 6 Ob 94/09f; OGH 5 Ob 53/12 y; OGH 8 Ob 59/12 b. For commentators who agree with this case-law see, e.g., Kurschel (1989), pp. 97 et seq.; OGH 10. 10. 1990, 2 Ob 535/90, ecolex 1991, 84 (*Wilhelm*), Welser I (1999), p. 33, and Welser and Jud (2000), p. 143, (2001), § 933 ABGB.

4 Key Features of Interpretation, Teleological Reduction and Analogy in Austrian Private Law

The discussion of the consequences of hidden, material defects that do not relate to explicitly agreed specifications of a good mainly revolves around the question of how to interpret pertinent legal rules. From a more dogmatic point of view one could say that the 'correct' interpretation of statutory law (note: the party agreement underlying the respective legal transaction does – due to silence on the issue of planned obsolescence and hidden defects in general – not help us any further) is the key to determining the most appropriate solution. In this chapter I would like to briefly summarize some key elements of legal interpretation in its widest sense, which includes teleological reduction and analogy.

With respect to Austrian private law, one commonly differentiates between four categories of interpretation of statutory law: (1) literal or grammatical interpretation ('Wortlaut-', 'Wortsinn-' or 'grammatische Interpretation'; hereinafter, *literal interpretation*),[47] (2) logical-systematic interpretation ('logisch-sytematische Interpretation'),[48] (3) historical or subjective-teleological interpretation ('historische' or 'subjektiv-teleologische Interpretation'; hereinafter, *subjective-teleological interpretation*)[49] and (4) objective-teleological interpretation ('objektiv-teleologische Interpretation').[50,51]

For the analysis at hand I would like to emphasise two issues that arise – or at least: can arise – when interpreting statutory law. First, a situation might occur where the application of the four interpretative means lead to different results. Here the question is how to balance the tools and their respective outcome. Do the four mechanisms stand next to each other, i.e., possess (in principle) the same power of persuasion or do some overrule the others, i.e., do we need to take a cascade approach? Although statutory law itself does not clearly answer this question, it is nowadays widely believed that preference has to be given to a 'comprehensive consideration' (*Gesamtbetrachtung*) of the concrete situation by carefully weighing

[47] Literal interpretation takes a linguistic approach towards legal norms.

[48] Logical-systematic interpretation tries to clarify the meaning of a provision by putting it into a bigger context, i.e., by assessing the interplay between the rule at question and related norms.

[49] Under the framework of subjective-teleological interpretation one examines the concrete intention of the legislator in a historic context.

[50] The main emphasis of the objective-teleological interpretation is put on the ratio of the norm in the current context.

[51] While there is consensus regarding the legal basis for the first three categories (§ 6 ABGB), some authors include the fourth category in the same framework, while others discuss it in the context of § 7 ABGB. For the first one see, e.g., Schauer (2013a), § 6 ABGB; for the second one see, e.g., Bydlinski P (2014a), § 7 Recital 6. For details on legal interpretation see, e.g., Kerschner (2014), pp. 35 et seq., Bydlinski F (1991, 2012), pp. 26 et seq., and Kehrer (2013); for Switzerland, e.g., Kramer (2013), pp. 55 et seq.; for Germany, e.g., Larenz and Canaris (2008), pp. 133 et seq. and Zippelius (2012), pp. 35 et seq..

the arguments of all four mechanisms against each other if they would point into different directions.[52] Hence, if the application of the four interpretative tools leads to different answers, one would have to go with the strongest or most convincing argumentation. Put differently, none of the four interpretative techniques enjoys absolute priority, but it is rather the interplay between them that leads to the correct solution.[53] I will come back to this issue briefly later.

Second, situations might occur in which a concrete case cannot be easily subsumed under any provision, because the facts at hand fall outside the 'yard of the term' (*Begriffshof*; hereinafter, *Begriffshof*)[54] of the provisions. The question arises whether the regulative incompleteness should be closed to answer to the (at first sight) unregulated situation or not. Hence, the decisive issue (to be answered with the help of the afore-mentioned interpretative tools) in this context is to be seen in the clarification of whether the gap is planned ('planned incompleteness') or not ('unplanned incompleteness'). While planned gaps do not necessitate any further steps, unplanned gaps need to be closed. This issue is addressed by § 7 ABGB which deals *inter alia* with the concept of legal analogy that is used to fill said, unplanned gaps (*planwidrige Unvollständigkeit*[55] or *planwidrige Lücke*[56]).[57] If one arrives at the conclusion that the (at first sight) unregulated facts on the one hand and the situations explicitly covered by a provision on the other are close or similar enough, one would have to extend the application of the norm to include the (at first sight) unregulated situation.

Likewise, one could face a situation in which the problem does not lie in a too narrow yard of a term that needs to be extended by ways of analogy but in a too broad nucleus of a term (*Begriffskern*) that comprises cases that – from a linguistic point of view – undoubtedly would have to be subsumed under the provision at hand.[58] Here the problem lies in the fact that a certain situation is explicitly covered by the wording of a norm, although a closer interpretation of the norm put in context with the case at hand reveals that it should not apply in the concrete case. To achieve this, the respective norm or more precisely speaking: the *Begriffshof* would be 'teleologically reduced' to exempt the case at hand from the application of the

[52] In this sense, e.g., Schauer (2013a), § 6 Recital 25.

[53] Schauer (2013a), § 6 Recital 25.

[54] For this term see, e.g., Kerschner (2014), p. 49.

[55] Bydlinski P (2014a), § 7 Recital 2, Posch (2012b), § 7 Recital 2, and Schauer (2013b), § 7 Recital 4.

[56] Barth et al. (2014), § 7.

[57] Depending on the legal basis that is used in an attempt to apply legal norms analogously one can differentiate between individual analogy (*Einzelanalogie*; one can further find the German expressions *Gesetzesanalogie* or *Rechtssatzanalogie*) and comprehensive analogy (*Gesamtanalogie*; in the literature also the term *Rechtsanalogie* is used to refer to this category). For details on these two see, e.g., Posch (2012b), § 7 Recital 8 and Schauer (2013b), § 7 Recitals 14–16.

[58] For this term see, e.g., Kerschner (2014), p. 49.

provision whose wording (explicitly) covers the case.[59] One could also say that teleological reduction can be used in situations in which there is good reason to argue that the – at first sight – seemingly conclusive scope of a legal norm is actually too broad or 'excessive' (*überschießend*).[60]

Teleological reductions might, however, only be an intermediate step towards finding an appropriate answer. Once a legal norm is – in a concrete case – teleologically reduced, one could face the problem that no other norm is (at least at first sight) applicable. If one arrives at the additional conclusion that this gap (caused by teleological reduction) is unwanted, teleological reduction might lead to the afore-mentioned necessity of resorting to analogy to subsume facts under the correct legal consequence. In legal academia this combined procedure is commonly referred to as 'teleological reduction coupled with analogy' (*teleologische Reduktion gekoppelt mit Analogie*).[61]

Especially the concept of teleological reduction, in particular its scope and permissibility, are not undisputed. Where shall the limit be set? Regardless of whether commentators follow a narrower or broader approach, they basically agree that teleological reduction can (to a certain extent) be applied. Ferdinand Kerschner takes a rather strict approach and argues that teleological reduction is (only) permissible under exceptional circumstances, namely merely in those cases in which a *clear* 'legislative plan' shall be realised.[62] (Purely) judge-made law would and should not be permissible, because it would mean an arrogation of (legislative) competences that are restricted to the legislator (*gesetzesübersteigendes Richterrecht*).[63] If there is no *clear* indication that the legislator actually wanted to exempt certain facts from the regulation of a given norm, teleological reduction should thus not be permissible.

To answer the question of the permissibility of teleological reduction (and analogy) Franz Bydlinski crafted the '*lex-lata*-boundary' concept (*Lex-lata-Grenze*; hereinafter, *lex-lata-rule*),[64] which addresses the permissibility issue from a slightly different angle and which seems to enjoy the biggest support.[65] The underlying idea behind the *lex-lata*-rule lies in the assumption that the principle of legal certainty must be treasured to the highest possible extent.[66] Franz Bydlinski focuses on the question whether *both* the wording of the provision at question and

[59] Several authors argue that teleological reduction is another way of actually filling a gap which is seen in the absence of an explicit exemption clause in a provision – see, e.g., Kerschner (2014), p. 50.

[60] See, e.g., Schauer (2013b), § 7 Recital 18 with reference to Bydlinski F (1991), p. 480.

[61] Kramer (2013), p. 226–227.

[62] Kerschner (2014), p. 49.

[63] Kerschner (2014), p. 49.

[64] See, e.g., Bydlinski F (1991), pp. 541 et seq. (2012), pp. 108–113, Bydlinski P (2013), 1/55; OGH 4 Ob 542/91 JBl 1992, p. 106, Kerschner (2012), and Sailer (2012).

[65] On the *lex-lata*-rule see, e.g., Bydlinski F (1997), p. 620, (1991), pp. 568 et seq,, (2000), § 6 Recital 25; see further Sailer (2012), pp. 137 f. and Rüffler (2002), pp. 69 et seq.

[66] Posch (2012b), § 7 Recital 20 with reference to case-law (SZ 67/62).

the legislative plan are clear enough to prohibit teleological reduction/analogy. If that were the case, then any attempt to teleologically reduce/analogously apply a norm would – under normal circumstances[67] – have to be considered as an impermissible change of statutory law *de lege ferenda*[68] that infringes the competences of the legislator.

It is crucial to apply the 'clearness' factor correctly in the context of the *lex-lata*-rule. If one (via the application of any of the above-mentioned four interpretative mechanisms[69]) arrives at the conclusion that *either* the wording of the norm *or* the legislative plan (or even both) is/are not clear enough, then teleological reduction/analogy would be considered permissible (for the sake of finding of justice *de lege lata*).[70] In the following chapter I will comment on the Austrian warranty regime in the context of planned obsolescence from the viewpoint of teleological reduction by discussing the phenomenon of planned obsolescence, an issue that – as indicated earlier – is enjoying increasing 'popularity' within different academic fields (including legal academia).[71]

5 Teleological Reduction Explained with the Example of Planned Obsolescence in the Context of the Austrian Warranty Regime

From the viewpoint of legal interpretation, planned obsolescence as seen from the perspective of the warranty regime is a very interesting topic. It combines older dogmatic ideas, i.e., the long-running debate on hidden defects in the context of the warranty regime, with the rather more recently discussed issue of planned obsolescence. I already defined the term 'premature obsolescence' that could be used to differentiate (possibly) warranty relevant cases of wear and tear from 'ordinary' forms of wear and tear, i.e., wear and tear that could not be subsumed under the warranty-relevant 'defect' term. As I will explain briefly in this chapter, the planned

[67] See, e.g., Bydlinski P (2013), 1/55 and the literature in FN 63.

[68] This refers to public policy considerations.

[69] i.e., the literal/grammatical, the logical-systematic, the historical/subjective-teleological or the objective-teleological interpretation.

[70] This refers to legal doctrine considerations. Peter Bydlinski adds that avoiding massive value judgement contradictions should be considered as a good reason for questioning the scope of a provision (even if the wording and the legislative plan seem to be clear) – for details see Bydlinski P (2014a), § 7 Recital 2 with reference to case law and comments (OGH ObA 288/95 DRdA 1996, 498 *Knöfler*; OGH Ob 149/07a RdW 2008, 86; 10 Ob 45/13k; Kehrer (2013), p. 98. One could, however, also argue that the massive value judgement argument falls under the pillar of objective-teleological interpretation and hence would not have to be additionally and explicitly mentioned.

[71] For legal literature see, in particular, Wrbka (2015) (Austria), Wortmann (1983), Wortmann and Schimikowski (1985), Gildeggen (2015), and Brönneke (2015); (all from Germany). For non-legal literature on planned obsolescence see the examples in Wrbka (2015), FN 4.

obsolescence debate could create some new food for thought to the discussion of hidden defects under the warranty law framework.

Before turning to an assessment of the potential of teleological reduction to answer planned obsolescence with the help of the warranty regime, let us briefly recall some ideas that characterise the warranty concept in general. The warranty rules touch upon some issues that Franz Bydlinski in his analysis of Austrian private law principles considered as key concepts. Both the idea of restoring equivalency in legal relationships and achieving substantive justice characterise also the warranty regime and should be mentioned in this context.[72] Warranty rules aim to guarantee that parties to a contract with which one party promises to dedicate a good to a different party for value (note: In the context of this analysis I focus on sales contracts as the most relevant form of contracts falling under the possible application of warranty rules) receive the opportunity to remedy an imbalance in performance. Restoring a just balance (as agreed upon by the parties), i.e., the key rationale behind the warranty regime, thus reflects both the wish to balance an imbalanced situation and to serve the call for ensuring contractual fairness. In the case of hidden defects these ideas – if followed absolutely – could, however, cause some tension with the concept of legal certainty. The earlier explained opposing views on how to answer to hidden defects in the context of the warranty regime illustrate this tension. Case-law and those commentators who share the seller-friendlier approach favour legal certainty over the balance function, whereas those who ask for a buyer-friendlier application of the warranty rules mainly base their view on the argument to treat defect-caused imbalances between performances and counter-performances in a way similar to rights-related defects or hidden defects in the case of explicitly agreed specifications.

I do not intend to go into too much detail regarding the reasonableness of the arguments of either side, i.e., the pros and cons of a buyer-friendlier interpretation of the warranty period commencement rules.[73] Nevertheless, I believe that it is helpful to briefly highlight some of the key concerns of the seller-friendlier approach before evaluating the possible permissibility of the buyer-friendlier view.

In the case-law affirming literature and legislative materials primarily three arguments are used to put a stop to attempts to apply teleological reduction to the warranty period rule on material defects. First, the wish for legal certainty would outweigh possible concerns that the warranty period commencement rule could cause an unfair result for buyers in the case of hidden material defects.[74] This, so, e.g., as argued by Irene Kurschel, is explained by the view that fairness arguments brought in the context of a 'hidden defect' warranty claim would usually be of only

[72] For details see Bydlinski F (1996), pp. 158 et seq.

[73] For details on this issue, see Wrbka (2015).

[74] See, e.g., Wilhelm's claim that a buyer-friendlier interpretation of the warranty rules would lead to 'legal disputes with a totally unknown outcome' (*Streitereien mit ganz offenem Ausgang*) – see OGH 10. 10. 1990, 2 Ob 535/90, ecolex 1991, 84 (*Wilhelm*). For a similar claim see Welser and Jud (2001), § 924 Recital 5, where the authors argue that the commencement of the warranty period must not be influenced by 'subjective conditions' (*subjektive Gegebenheiten*).

individual nature (*Einzelfallgerechtigkeit*) and that under no circumstance individual justice should enjoy more weight than the wish for general legal certainty and simplification.[75]

Second, the legislative materials seem – at least at first sight – to point into a clear direction. The explanatory notes on the draft of the warranty law amendment act (*Gewährleistungsänderungsgesetz*; hereinafter, *GewRÄG*),[76] for example, explain that in the case of hidden, material defects the basic commencement rule, i.e., the rule that the warranty period for material defects commences on the day of transfer of the good, should be left untouched (unless the parties have agreed on a certain specific of the good to which the defect at hand relates). The explanatory notes argue that the extension of the national warranty period for movables from 6 months to 2 years (that was necessary in the course of implementing the CSD) should lead to a considerable and sufficient improvement of the situation for defect-struck transferees.[77]

Third, case-law supporters add that the wording of § 933(1) ABGB would be too precise to allow for a deviation from the enshrined commencement date. According to their view § 933(1) unambiguously stipulates that the period for material defects should not commence later than with the contractual performance by the transferor.[78]

Putting § 933(1) ABGB and the three key arguments of the case-law affirming view into the context of the methodological approach towards the application of statutory private law, one will see that the central question revolves around the permissibility of teleological reduction in combination with analogy. This approach can be considered the most obvious – if not the only – possible way to narrow down the scope of the material defect-warranty rule and to subsume the premature obsolescence situation under a different solution (that follows the 'detectability approach' taken, in principle, by both the rights-related § 933(1) solution and the 'agreed specification' scenario). Interestingly enough, the three just outlined arguments that are used to argue *against* the permissibility of teleological reduction in combination with analogy reflect the ideas behind the earlier-mentioned *lex-lata*-rule. Case-law supporting commentators try to convince the readership that both the

[75] Kurschel (1989), p. 100. Böhler, who belongs to the case-law critical group of scholars, stresses the importance of legal certainty for the involved stakeholders, but at the same time argues that there are justified limits to legal certainty – hidden defects can fall under this qualified limit if the concrete case is an expression of a general problem – see Böhler (2000), p. 54 and the argumentation later in this contribution.

[76] Gewährleistungsrechts-Änderungsgesetz BGBl I 2001/48.

[77] Explanatory notes on the GewRÄG draft, Recital 20 (ErläutRV 422 BlgNR 21. GP 20). Böhler, again, agrees on this point, but does not consider this argument as being convincing enough to base the case-law supported stricter understanding – for details see Böhler (2000), pp. 50 et seq.

[78] Kurschel (1989), p. 100 and Welser I (1999), p. 33, where the author argues that any attempts to argue against a linguistically correct interpretation would subvert the clear meaning of § 933 (1) ABGB; OGH 10. 10. 1990, 2 Ob 535/90, ecolex 1991, 84 (*Wilhelm*). For similar case-law arguments see, esp., RIS-Justiz RS0018623; RIS-Justiz RS0018834; RIS-Justiz RS0018937; RIS-Justiz RS0018982.

wording of § 933(1) ABGB and the legislative intention are too clear to allow for a buyer-friendlier rule in the case of hidden defects that do not relate to explicitly agreed specifications. The decisive question is whether their argument is really convincing.

Looking at the linguistic pillar of the *lex-lata*-rule one has to admit that the wording of the warranty period commencement rule indeed does not offer a chance for interpretation. The second and third sentences of § 933(1), which read as follows: 'The period commences on the day of transfer of the good. In the case of defects in rights, however, the period commences on the day the transferee becomes aware of the defect' are indeed unambiguous. Pursuant to this rule the commencement of the material defect warranty period is linked to the day of contractual performance.

According to the *lex-lata*-rule, one must, however, go one step further. An unambiguous wording alone would not prohibit a teleological reduction and/or analogy if the legislative intention did not clearly affirm the chosen wording. The decisive question in the case at hand is whether the legislator really intended to exclude the possibility to pursue hidden defects with warranty claims if the defect cannot be detected 'on time'. Undeniably, the explanatory notes indicate that hidden defects *basically* should not lead to any alteration with respect to the commencement date of the warranty period.[79] However, it must be doubted that the legislator was aware of the phenomenon of planned obsolescence at the time of creating the warranty rules and affirming them with the GewRÄG in 2001. The available materials do not indicate that the planned obsolescence debate had already reached the legislative stage at that time. It rather seems that – in line with the afore-mentioned 'individual justice' v, legal certainty debate – the legislator intended to declare that the warranty period commencement rule for material defects of § 933(1) must not be changed to remedy a one-time 'outlier' or 'subjective' hidden defect (unless it relates to an agreed specification). Objective, serial hidden defects were neither explicitly addressed in the legislative materials in the context of the warranty period nor is there any clear indication that the legislator wanted to exclude the possibility to apply a more flexible regime to this group of hidden defects. Why is this fact important to stress?

On a different occasion I explained in detail that most cases of planned obsolescence are necessarily characterised by a general, objective delay in detectability of the defect and not limited to one case only. Put differently, planned obsolescence related defects that can potentially be of relevance from the warranty regime perspective – at a different occasion I referred to them as a serial expression of 'qualitative obsolescence'[80] cases – do not occur only once or on an individual

[79] Explanatory notes on the GewRÄG draft, recital 20 (ErläutRV 422 BlgNR 21. GP 20).

[80] See, Wrbka (2015), pp. 20–21. The second planned obsolescence group could be addressed as 'psychic obsolescence' (*psychische Obsoleszenz*). The latter refers to expressions of planned obsolescence that do not relate to defects, but to situations in which the use of a product ends because of purely psychic reasons. A person who purchases a new product (although the present

basis, but must be considered as a generic or general phenomenon, because all products of the particular type are hit by the defect (i.e., by premature wear and tear).

Should one really assume that the legislator would favour legal certainty over the correction of the imbalance also in cases of general hiddenness? Looking at the differentiating concept of the commencement of the warranty period under Austrian law one should rather assume that the legislator would prefer a concept that treasures the correct balance between performance and counter-performance if the imbalance were a general or necessary consequence. This is exemplified with two considerations. First, the legislator introduced a two-tiered concept with respect to the commencement of the warranty period. In the case of a rights-related defect the warranty period should not follow the general commencement period, but start with the detectability of the defect.[81] The reason why the legislator opted for a different solution for rights-related defects is generally be seen in the fact that in the case of rights-related defects it is usually impossible to detect the defect already at the time of contractual performance. Fairness and the wish to maintain a just balance between performance and counter-performance would ask for an adjusted commencement rule.[82]

Similar considerations can be found in the context of the afore-mentioned agreed specifications solution. Here too (this time, however, in combination with considerations related to contractual interpretation), some commentators emphasise that in several cases agreed specifications can generally neither be proven correct nor wrong at the time of contractual performance. Hence, a detectability rule that resembles the approach taken for rights-related defects and hidden defects that relate to explicitly agreed characteristics should be applied.

Recalling these reflections, one should exercise great care when evaluating the legislative idea behind the warranty commencement framework. The legal certainty argument is undeniably very important and arguably weighs stronger than individual justice considerations. However, one must not conclude that the legislator wanted to unconditionally exclude the opportunity to apply warranty rules if – like in the case of planned obsolescence – it would *basically or generally* be impossible to react 'on time'. On the contrary, the outlined considerations allow for taking a different approach in certain cases of special circumstances and the example of the case-law developed rule for hidden defects relating to agreed specifications show that it sometimes is advisable to deviate from the standard rule of § 933(1) ABGB. The phenomenon of planned obsolescence, in the context of the warranty regime understood as a special form of premature wear and tear (undetectable but already latent at the point of contractual performance), arguably –

product would still function) merely because he or she is convinced by the product marketing that the new product would be better can be used as a classic example.

[81] For a definition of the term 'detecability' in this context and other warranty contexts see Wrbka (2015), pp. 45–46.

[82] See, e.g., Böhler (2000), p. 53.

in particular because of its 'generality' or general relevance – allows for a special treatment approach. Dogmatically this can be achieved via a teleological reduction of the scope of the material-defect warranty commencement rule of § 933(1) in combination with an analogous application of the detectability rule (as known from the rights-related defect concept or the 'agreed specification' rule).

6 Conclusion

Language is limited. Even the most unambiguous terms can be subject to interpretation. Law is a good example of this. To understand the meaning and scope of law, it is not enough to concentrate on a linguistic interpretation of rules. Legal interpretation shows various facets that ask for a more comprehensive and complex analysis of possible applicable norms. In certain scenarios, legal interpretation can lead to the result that the scope of a legal norm must be cut back, because the wording is too broad. If this leads to a legislative gap, i.e., if the case at hand would not clearly fall under a different rule, and if this gap would be considered as 'unplanned' or 'unwanted', teleological reduction would have to be followed by an analogous application of a suitable rule.

Legal certainty asks for a cautious or modest use of teleological reduction, in particular, to safeguard the predictability of legal rules. To strike a balance between legal certainty and legal flexibility the predominantly applied *lex-lata*-rule rule aims to set an absolute limit to the permissibility of teleological reduction. If both the wording of a norm *and* the legislative intention behind the norm clearly show that teleological reduction should not be applied, flexibility considerations should be left standing. This is a consequence of the principle of separation of powers that reserves legislative powers to the legislator and limits the competence of the judiciary to create legal rules.[83]

The example of planned obsolescence in the context of the Austrian warranty regime shows that the 'natural rationale of a law' (translation mine)[84] is an important parameter to interpret the legislative plan behind legal norms. Possible tensions between legal certainty and legal flexibility can be resolved by taking a closer look at the rationale of legal rules. If – like in the case of planned obsolescence – special circumstances would make it *generally* impossible to realise the purpose of legal concepts although the pertinent legal norms aim at regulating the problem at hand, teleological reduction could and should be considered permissible. From the viewpoint of legal certainty this might lead to lowering the level of objective determinability (in our case understood as being able to clearly determine the end of the warranty period already at the time of contractual performance). Although this concern must not be neglected, allowing teleological reduction in

[83] Posch (2012a), § 6 Recital 20.

[84] Posch (2012a), § 6 Recital 22.

combination with analogy to satisfy the rationale of a norm or legal concept in dispute should be considered as weighing heavier than possible certainty concerns unless a *lex-lata*-analysis leads to the result that no room must be given to apply statutory rules flexibly in a concrete case.[85]

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[85] In the case at hand, this was explained with the necessity to satisfy the rationale behind the warranty regime in terms of maintaining a proper balance between performance and counter-performance. Via a *lex-lata*-analysis we arrived at the conclusion that – despite the clear wording of § 933(1) ABGB, a teleological reduction in combination with analogy is permissible and in the concrete case actually preferable. As the legislator did not clearly rule against such an approach, the current, strict case-law offers an unsatisfying result in this respect.

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The Austrian Civil Law Company as an Example of a Successful Company

Daniele Mattiangeli and Lisa Katharina Promok

Contents

Abstract The Austrian *Gesellschaft bürgerlichen Rechts*, is a Civil Law Company without legal personality and its regulations can be found in the 27th chapter of the ABGB (the Austrian Civil Code). Up until October 2014, the Civil Law Company has been the oldest unchanged company in Austrian law and has existed since 1811. At the end of October 2014, however, the entire discipline of Civil Law companies has been reformed in order to increase legal certainty. It is remarkable that the reform has not changed the legal nature of the Civil Law Company, even though a number of new provisions were added.

Keywords Corporate law • Company law • Civil law • Association • Corporation • Austrian Civil Code • ABGB

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1 Introduction

Since October 2014, the entire Austrian discipline of Civil Law Companies has been reformed and newly structured. The regulations can be found in the 27th Chapter of the ABGB (the Austrian Civil Code). This reform mostly has a clarification function and aims at increasing legal certainty, because previous provisions were partly outdated, and in some regards, jurisdiction and jurisprudence have further developed and moved away from the provision's original wording. The result was a substantial legal uncertainty regarding a number of important questions and the reform aimed at clarifying these points.[1]

On the other hand, the codification of some institutions of the general company law has also been adopted. These institutions have been accepted so far, but had not at all been regulated explicitly, and only in parts. Examples are the so-called *actio pro socio*, the duty to protect interests and equal treatment, a modern and transparent asset structuring, the rule of "*socii mei socius meus socius non est*" (D. 17,2,20),[2] and a better regulation of shareholder succession as well as the transformation into an "Offene Gesellschaft" or a "Kommanditgesellschaft" (both Austrian company forms).

According to Articles 1175 and following of the Austrian Civil Code (ABGB), a Civil Law Company is established by a contractual association of at least two persons, who share a common objective with their activity, and as long as the associates do not choose another company form, for example a limited liability company or a stock corporation. An *affectio societatis* has to be provided in the contract, which is the will to pursue a common purpose. Regarding the contract a certain form is not provided. Every allowed purpose is possible, as well as any activity, which is not prohibited by law.[3]

It is the basic form of partnership and descends directly from the classic *societas* of Roman Law, as a consensual contract between two or more persons without legal personality, such as the *societas omnium bonorum* or the general *societas universorum quae ex questu veniunt*. Up until the October 2014 reforms, the Civil Law Company has been the oldest, still valid and mostly unchanged company in Austrian law, having existed since 1811.

Thanks to its adaptability, the Civil Law Company is widespread in a number of different fields, because it can be adjusted to the respective needs of the associates in a flexible way.

It can also be established in an inexpensive way and without great effort, and everyday life business can also be arranged in a non-bureaucratic manner. The Civil Law Company has adopted the flexibility, which is typical for the Roman Law *societas*.

[1] Slezak et al. (2012), p. 5.

[2] D. 17.2.20, Ulpian 33 ad Edictum: „nam socii mei socius meus socius non est". We can translate this rule as follow: My business partner's business partner is not my business partner. That means that a third Person, Partner of my Business partner won't be automatically my business partner.

[3] Further definitions on the government bill, 270 of the supplements, XXV. GP, p. 1.

This might be the very reason why the original Austrian Civil Code version has survived so well, up until today. It is remarkable that the Civil Law Company has not even changed its legal nature even after the 2014 reform, compared with its original form. Another remarkable fact is, that the new reform has clearly adopted and codified one or another fundaments of Roman Law, such as the *actio pro socio*, or the irrelevance of legal relations of an associate opposite third parties outside of the company, as well as the co-ownership nature of assets, even more obviously than the original version as established 200 years ago.

The Company Agreement can, in principle be concluded without specific formal requirements; therefore it can be done verbally or conclusively. However, it is generally recommended to draft the contract in written form as this provides greater certainty. Most of the relevant legal provisions are dispositive. This means that the agreement may include different provisions. The European Economic Interest Grouping, legal entities of public law, legal entities of private law, a limited partnership, underage persons, natural persons, general commercial partnerships, private foundations or trustees can be members of a Civil Law Company. Merely persons with restricted legal capacity, registered companies, communities of heirs, Civil Law Companies, non-profit associations and silent partnerships are not able to act as a member of a Civil Law Company according to Article 1175 ABGB.[4]

A Civil Law Company has no legal personality (such as would be the normal case with the classic Roman *societas*), therefore it will not be registered in the commercial register.

The company assets still remain in co-ownership between the associates and do not constitute a so-called "Gesamthandeigentum", a form of common corporate property. The Company cannot own itself, nor can it possess things. Instead, the associates are co-owners of the things that constitute the company assets. The Austrian Civil Law Company still remains outside the Category of "Gesamthandsgesellschaft", which include for example an OG ("Offene Gesellschaft"), who can possess goods and acquire property. The Austrian Civil Law Company is therefore a genuine example of a very easily created contractual company between a small number of persons that don't want to build a legal person or to have legally independent corporate assets.

[4] Fritz and Perktold (2015), p. 20.

§ 1175 ABGB (1) Schließen sich zwei oder mehrere Personen durch einen Vertrag zusammen, um durch eine bestimmte Tätigkeit einen gemeinsamen Zweck zu verfolgen, so bilden sie eine Gesellschaft. Sofern sie keine andere Gesellschaftsform wählen, bilden sie eine Gesellschaft bürgerlichen Rechts im Sinn dieses Hauptstücks.

(2) Die Gesellschaft bürgerlichen Rechts ist nicht rechtsfähig.

(3) Sie kann jeden erlaubten Zweck verfolgen und jede erlaubte Tätigkeit zum Gegenstand haben.

(4) Die Bestimmungen dieses Hauptstücks sind auch auf andere Gesellschaften anzuwenden, soweit für diese keine besonderen Vorschriften bestehen und die Anwendung dieser Bestimmungen auch unter Berücksichtigung der für die jeweilige Gesellschaft geltenden Grundsätze angemessen ist.

If the Civil Law Company runs an enterprise whose annual revenue transgresses a certain threshold value (more than 700,000 EUR sales revenue in two consecutive years, or more than one million EUR sales revenue during one business year), it has to be transformed into another company form, a so-called "Offene Gesellschaft" or a "Kommanditgesellschaft", and thus needs to be registered at the commercial register.

This Chapter will examine the 2014 reforms of the law focusing on the flexibility of this unusual corporate reform and the attempt to reconcile the language of the law with the operation of Corporate Civil Law Companies as they have developed over the last 200 years, both in practice, but also in case law.

2 Transitional Law

All provisions of the GesbR reform came into force on January 1, 2015. Companies established at this time follow automatically the reformed rules. In addition, the reformed rules are applicable to existing companies, but subject to the following restrictions: The new requirements may not be applied retroactively to circumstances that occurred before the date of entry into force of the reforms. Such circumstances are e.g. acts of representation or setting the reason for termination. As the legislator uses the term "circumstance", it is shown that the establishment of a company is not meant with this term. In accordance with Article 1503(5)(1) ABGB it is not a matter of the fact when the company has been established. Pursuant to Article 1503(5)(2) ABGB the date of establishment has an important role to play. To companies established before January 1, 2015 the listed paragraphs in section two are applicable from July 1, 2016. Regarding this rule sufficient time for adopting the new provisions should be given to the partners. The regulation can only be applied by July 1, 2015 if all partners agree to those amendments. In case of contradiction by a single partner and the wish to maintain the rules previously in force does prevent the application of the new regulations. In the event of an opting-out the entire system is applicable after January 1, 2022.[5]

3 Management and Proxy

As far as management is concerned private autonomous freedom of design is applied to the company.[6] The current dispositive legislative proposal, unlike the overall management by majority vote in the previously applicable law, provides for

[5] Bydlinski and Fritz (2015), pp. 9 et seq. For Details see Article 1503 ABGB.

[6] See Article 1181 ABGB.

ordinary transactions the solitary management with a right to object to the other shareholders.[7]

In case of any doubt, all associates are entitled to act as managers and as proxies. In such a case, the following provisions apply, as long as the company agreement does not provide different provisions.

Unless something different has been agreed upon in the company agreement, the principle of "Einzelgeschäftsführung" (solitary management) applies since the reforms came into effect on January 1, 2015 for common business. This means that each managing associate can act individually (without the participation of others) in situations that refer to common operations. However, each associate is allowed a veto right. If a managing associate exercises their right to veto, the proposed action must be omitted.

Common operations of a business generally include all actions that do not exceed a normal operational frame.

Uncommon or special operations require a resolution by all associates (this is the so-called "*Einstimmigkeitsprinzip*"). Uncommon operations are operations that go beyond common operations of the business.

The power of proxy of associates who represent the company externally merely extends to the management power. However, the agreement can provide for a different provision. On principle, an external representation is – even after the 2014 reforms – still not possible for the entire company, because there is no legal personality for Civil Law Companies.

Even the many other provisions of internal law, as the rules for business content and provisions how to make contributions, the funding obligation, the reimbursement of expenses of the shareholders to the shareholder resolutions, the controlling rights of the shareholders and the profit distribution were left open as far as it was possible, to the proven solutions of case law and doctrine well that is well-elaborated in the provisions of the *UGB*.

4 *Innengesellschaft* vs. *Außengesellschaft*

As a company isn't immediately visible from the outside a distinction needs to be drawn between *Innengesellschaft* and *Außengesellschaft*. Pursuant to Article 1176 ABGB partners may limit the company on their relation with each other, the so-called *Innengesellschaft* (undisclosed partnership) or they could occur commonly in legal communication, in what would represent an *Außengesellschaft* (outside company). In case the object of the company is operating a business or if the members act under the companies name (see Article 1177 ABGB), it shall be presumed that the partners wanted to arrange an outside company. Unless an outside company is excluded by contract, this circumstance is binding on third

[7] See Article 1190 (1) ABGB. Bydlinski and Fritz (2015), p. 5.

parties only, if they were neither aware nor should have been aware about the existence of an undisclosed partnership. Rules concerning the outside company, e.g. acts of representation and joint liability, will not come to fruition in undisclosed partnership.[8]

5 Profit and Loss Distribution

As a general rule, the profit and loss distribution can be freely agreed upon in the company agreement.

If there is no such provision in the company agreement, the profit and loss of the business year is allocated to the associates according to their capital shares. If associates are not obliged to contribute in an equal way, this also has to be considered when distributing profit.

For Civil Law Companies that have been established before January 1, 2015, transitional provisions as laid down in the Civil Law Company Reform Act (*GesbR-Reformgesetz*), dated January 1 2015, will apply. The transitional provisions concern, among other things, regulations regarding management as well as the profit and loss distribution. If one associate declares that he or she would like to keep the previous legal system (the one before the Reform Act) towards the other associates and upon expiry of June 30, 2016, this is possible until December 31, 2021. From January 1, 2022 onwards, the new provisions also apply to Civil Law Companies that have been established before January 1, 2015.

If no associate issues such a declaration, the new legal position will apply to this company as well from January 1, 2016 onwards.

If a company agreement provides for provisions that differ from the current legal situation anyway, nothing changes for the company (e.g. regarding the power of management).

Civil Law Companies that have been established after the Reform Act (January 1, 2015) are already subject to the new provisions.

6 Actio pro socio (Article 1188 ABGB)

In the new version of this discipline, the rule of *action pro socio* is this time explicitly codified. Under the title "Enforcement of Company Claims", the Roman *actio pro socio* is basically adopted as means to claim own rights opposite other associated in internal relations. The action pro Socio empowers a member, irrespective of the existence or the extent of the management authority, to assert

[8] GesbR reform law, ministerial proposal, 17173, 2014, p. 2; Bydlinski and Fritz (2015), pp. 3 et seq.

claims in the name of the *GesbR* against another member from the company statutes. This issue is primarily concerned with the entitlement of one member for the assertion of claims against co-partners. The partner has to bring in an action in its own name against the company. The plaintiff, who has pledged himself to perform services for the Civil Law Company, is now able to force the other co-partners to provide the services that they have earlier agreed to. The action pro socio based on § 1188 is the best and most directly effective way, like in the Roman Law before, in order to regulate disputes between the associates and to resolve even "internal" problems with one or other associates. This action can fit for different purposes inside the company in order to re-balance the economic and legal relations between associates.

Up to now the action pro socio wasn't expressly required by law but was a recognized principle in well-settled case law.[9]

7 Liability

Pursuant to Article 1199 ABGB the associates are subject to a personal and unlimited liability concerning their personal assets, unless otherwise agreed by the associates. Legal transactions, which are contracted by one member in its own name for the companies account, oblige an entitlement only towards third parties. Whereas the Austrian Corporate Code (UGB) declares in Article 128, that members bear unlimited liability in respect of the company's obligations. One of the most important changes of the *GesbR* reform law is the clarification of the company and member's liability structure.[10]

8 Trade Law and Tax Law

With regard to trade and tax law, the Company does not have its own legal personality. Each associate has to supply a certificate of competence and trade license, independently from the statute of the company.

Equally, each associate is subject to income taxation regarding his or her respective share of profits and the company is not taxed as an independent entity.

[9] Fritz and Perktold (2015), pp. 106–107.

[10] Fritz and Perktold (2015), p. 185.

9 Assets

Article 1178 ABGB defines the company assets as the property that is dedicated to it, the other company-related proprietary rights, the company-related contractual relationships, assets and liabilities and the company-related intellectual property rights. Due to the lack of legal personality, transferred movable objects by one member are partly owned by all members (see Articles 1178 (1) and 1180). However, the company is collectively liable for intangible objects. As part of the reform it had been considered whether to take account of the anchoring of the total hand property (so called *Gesamthandeigentum*). As far as physical objects are concerned the reform still retained the principle of co-ownership of non-material shares.[11] In the end it seems that the Austrian Civil Law Company still remains outside the assets-category of the *Gesamthandsgesellschaft*, because it is still impossible and – as it used to be in Roman Law – to acquire property in the name of the company, which is a typical possibility of a company based on principles of the total hand property (*Gesamthandeigentum*), e.g. the OG in Germany, as we can read in Article 124 HGB.[12] Such companies ("*Offene Gesellschaft*") could acquire real property and can sue or be a defendant in the front of the court.[13] This situation would be impossible for the Austrian Civil Law company.

10 Commercial Register/Conversion

A Civil Law Company cannot be registered with the commercial register, due to a lack of legal personality. If several people run the Civil Law Company, and if the accounting threshold has not been exceeded (the amount was previously mentioned: it is more than 700,000 EUR sales revenue in two consecutive years, or more than one million EUR sales revenue during one business year), then the company has to be registered as a different company form, the so-called "Offene Gesellschaft" (*OG*) or "Kommanditgesellschaft" (*KG*). The fifth chapter is all about the Conversion of the *GesbR* into an *OG* or *KG*. There are certain advantages set for this process. An analogue application for this clause is not provided for by statute. This refers to better publicity and legal certainty regarding to the legal structure of *OG* and *KG*. The legislator enables to facilitate the change of the legal form from *GesbR* to *OG* or *KG*, but not vice versa.

[11] Bydlinski and Fritz (2015), pp. 4 et seq.

[12] Schmidt (1997), p. 190.

[13] § 124 HGB: Die offene Handelsgesellschaft kann unter ihrer Firma Rechte erwerben und Verbindlichkeiten eingehen, Eigentum und andere dingliche Rechte an Grundstücken erwerben, vor Gericht klagen und verklagt warden.

11 Company Name

A Civil Law Company may act under a specific name. The name has to indicate that the company is a civil law company, if the associates appear under a common name.

This means that a contracting party, towards which the company name has been mentioned, has to be aware that he/she is concluding a contract with a Civil Law Company. Possible names are, for example: "Gesellschaft bürgerlichen Rechts", "GesbR", as an abbreviation of the before mentioned or "Arbeitsgemeinschaft", which are all German titles for the Civil Law Company. The name can be entirely fictional and, in consequence, does not have to include the name of any or all of the associates.

12 Dissolution

The sixth chapter of the *ABGB* deals with the dissolution of the *GesbR*. In Article 1208 ABGB reasons for dissolution are listed, which namely are: due to expiration, decision, bankruptcy proceeding on the property of one member or the non-opening of such proceedings from the absence of finances to cover costs; termination and due to death of one member. No major overall differences are found when compared to *UGB* regulations. The existing set of *ABGB* rules followed the certain *UGB* models; except in case of dissolution against the assets when insolvency proceeding is initiated.

In such a case, dissolution is impossible due to the GesbR's insufficient assets to cover costs, because for lack of legal personality a GesbR cannot face insolvency.[14]

13 Liquidation

The seventh chapter follows UGB models, more precisely Article 145 up to 158 UGB. Article 1216b (4) ABGB takes the lack of transparency concerning commercial register into account. This article contains the obligation of all partners to inform their contracting partners, creditors, and debtors.

[14] **§ 1208 ABGB:** Die Gesellschaft wird aufgelöst:

1.	durch den Ablauf der Zeit, für die sie eingegangen ist;
2.	durch Beschluss der Gesellschafter;
3.	durch die rechtskräftige Eröffnung des Konkursverfahrens über das Vermögen eines Gesellschafters, durch die Abänderung der Bezeichnung Sanierungsverfahren in Konkursverfahren oder durch die rechtskräftige Nichteröffnung oder Aufhebung des Insolvenzverfahrens mangels kostendeckenden Vermögens;
4.	durch Kündigung oder durch gerichtliche Entscheidung;
5.	durch den Tod eines Gesellschafters, sofern sich aus dem Gesellschaftsvertrag nichts anderes ergibt.

Moreover an announcement in accordance with the local custom of dissolution and liquidators is required. According to Article 1216e ABGB the company's contractual rights and obligations remain despite the liquidation, as far as it is necessary for the liquidation. Company-related legal relationships with third parties are only affected by the liquidation, insofar far as this has been agreed. Partners are free to reach another agreement instead of liquidation.[15]

14 Conclusion

To summarize, this reform is a reform that on the one hand modernizes and structures the discipline of Civil Law Companies, and definitely adopts – whether it be consciously or subconsciously – some Roman Law principles. Article 1175 up to 1216e of the ABGB were restructured and language was updated, taking into account new legislative standards. The update was urgently necessary since there was a huge difference between the outdated wording of the law and the prevailing practice within the jurisdiction. It was not necessary to re-invent the wheel as the simplicity and the flexibility of the *GesbR* needed to be maintained in order to preserve the distinctive character of the Civil Law Company. The *GesbR* will also remain without legal personality in the future. A Civil Law Company can be furthermore formed without any formal requirements, also by an oral agreement. In the Company's name concluded contracts empower the members as contracting partners.

Transferred movable objects by one member are still partly owned by all members and the company is collectively liable for intangible objects.

A simple, more effective solution might have been preferable. The wide scope of the Civil Law Company undoubtedly causes difficulties. As far as the dissolution and the exclusion of a member are concerned a proper arrangement would have

[15] **§ 1216e ABGB:** (1) Das nach Berücksichtigung der Schulden verbleibende Gesellschaftsvermögen ist nach dem Verhältnis der Beteiligung der Gesellschafter unter Berücksichtigung ihrer Guthaben und Verbindlichkeiten aus dem Gesellschaftsverhältnis unter die Gesellschafter zu verteilen.

(2) Das während der Liquidation entbehrliche Geld wird vorläufig verteilt. Zur Deckung noch nicht fälliger oder streitiger Verbindlichkeiten sowie zur Sicherung der den Gesellschaftern bei der Schlussverteilung zukommenden Beträge ist das Erforderliche zurückzubehalten. § 1196 Abs. 1 ist während der Liquidation nicht anzuwenden.

(3) Entsteht über die Verteilung des Gesellschaftsvermögens Streit unter den Gesellschaftern, so haben die Liquidatoren die Verteilung bis zur Entscheidung des Streites auszusetzen.

(4) Reicht das Gesellschaftsvermögen zur Deckung der Guthaben von Gesellschaftern aus dem Gesellschaftsverhältnis nicht aus, so sind die übrigen Gesellschafter ihnen gegenüber verpflichtet, für den Betrag im Verhältnis ihrer Verbindlichkeiten aus dem Gesellschaftsverhältnis aufzukommen. Kann von einem Gesellschafter der auf ihn entfallende Betrag nicht erlangt werden, so wird der Ausfall auf die übrigen Gesellschafter wie ein Verlust verteilt.

Bydlinski and Fritz (2015), pp. 9 et seq.

been advantageous, especially because non-entrepreneurs can also form a Civil Law Company. The newly built article for termination is only applied to entrepreneurs. However, explicit rules concerning the conversion were also applied. Members can be forced to pay additional contributions by a majority vote of the members even if this case is not stipulated in the partnership agreement. Moreover, the unanimous vote of all partners will be needed in question of exceptional transactions, as distinguished from ordinary transactions (any partner may decide, if no other member raises an objection. We can see that in the end, the changes consist in the codification of what doctrine and jurisprudence have taught and written about for decades, for example the concept of *actio pro socio*. New amendments only exist within the transformation of the ABGB civil law company into an OG (Offene Gesellschaft) and KG (Kommanditgesellschaft). Also new is the fact that the new discipline is based on some principles of the OG.

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From the Boardroom to the Corner Store: Globalization, Law and Economic Organization

Sean McGinty

Contents

Abstract In addition to the economic and social changes it brings, globalization is also a driver of legal change. In the field of corporate law its relationship with legal change is usually approached through the competing lenses of convergence and path dependence. This creates a narrative in which globalization, through various processes, forces national laws to converge on economically efficient sets of rules, with some variation being attributed to historically determined idiosyncrasies within individual countries. This chapter raises the point that this narrative is in large part determined by the nature of the interaction of large corporations with globalization; they are embedded in cross border markets which expose them, and the laws which regulate them, to forces driving legal convergence. This, however, is not a typical scenario for economic organizations in general, with many being challenged by globalization in ways which they institutionally have difficulty adapting to. This chapter explores the differing path of legal change in relation to globalization which organizations in such a situation face by comparing legal change in Japanese corporate law to that in the law governing Shoutengai Promotion Associations – a form of organization for retail merchants in Japan which is in such a dilemma.

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1 Introduction

Often missing from our discussions of the influence of economic globalization on legal rules is the fact that in addition to increasing the mobility of capital, products, services, people and ideas across borders it is also a fundamentally disruptive process which creates both economic winners and losers. Some ways of organizing economic activity, and the rules related thereto, are better able to reap the benefits of globalization than others, which may be either marginalized or completely overwhelmed by the changes it introduces to local markets. Legal scholarship and theorizing on the relationship between globalization and legal change in recent years has generally focused on the former, and in particular on corporate law. This chapter seeks to broaden our understanding of the process by drawing a comparison with the latter – an economic organization which belongs among those which globalization has largely left behind.

The concept of globalization and its relationship to legal change has predominantly manifested itself in the corporate law literature within the framework of a debate on convergence.[1] This debate largely concerns the question of to what degree diverse sets of rules that exist in domestic corporate law regimes around the world are becoming more similar. It has been given a degree of relevance thanks to the work of some economists suggesting that certain rules, particularly those enhancing the rights of shareholders against directors, will give countries economic benefits.[2] Forces such as regulatory competition, the modelling effect of successful economies and the efforts of international bodies like the World Bank which actively promote the adoption of specific sets of rules act to promote this process of convergence.

Holding this back are the countervailing forces of path dependence, driven by various historically determined arrangements of institutions and power relations which exist in a given country.[3] These may influence the direction of legal change in a number of ways. Incumbent economic interests which benefit from existing distributional effects of rules may use their influence to block changes which threaten this position, even where adoption of such rules may be beneficial to society. More benignly, a lack of complementariness with existing rules may also

[1] See generally Gilson (2001), Hansmann and Kraakman (2001).

[2] Particularly La Porta et al. (1998).

[3] The case for path dependence in corporate law is most fully made out in Bebchuk and Roe (1999).

prevent the adoption of rules which are widely accepted elsewhere simply because they do not or cannot work well in the specific institutional mix that exists. Changing one law may be simple, changing the entire set of related institutions necessary for that law to work properly, in contrast, may be more trouble than it is worth.

The duality of convergence and path dependence provides us with a relatively simple narrative framework for understanding the relationship between globalization and legal change in the context of corporate law. It is a march towards greater standardization of economically efficient rules across jurisdictions driven by international forces which occasionally run into roadblocks created by the peculiarities thrown up by historical happenstance in local contexts.

This chapter raises the question of to what extent this theoretical framework for understanding the impact of globalization on legal change is useful with respect to economic organizations other than large business corporations. This question arises in light of three perhaps obvious but often overlooked observations. The first is that the corporate law literature in which these theories have been explored focuses almost exclusively on large, listed corporations. Second is that these large corporations form both a very small minority of the total number of corporations[4] and that the business corporation itself is but one (albeit an important one) among many types of legally defined entities which economic organizations take.[5] Finally, the nature of the interaction of these large corporations with the forces of globalization is, despite the enormous amount of theoretical attention they receive, largely atypical – most economic organizations do not experience the same degree of international integration and may be affected by globalization in different ways. If we wish to expand our view of how globalization affects the laws of economic organizations[6] beyond this narrow focus on large corporations, this paper argues that the narrative of legal change and globalization is not determined solely by the clash between global forces of convergence encountering local forces of resistance, but is also fundamentally moulded by the character of the underlying economic organization itself and the way in which globalization affects it. The business corporation by its legal design allows it, as an organization, to avail itself of international opportunities for expansion and diversification in product, capital

[4] The number of companies listed on the Tokyo Stock Exchange as of 1 May, 2015 was 3,491. In comparison the total overall number of business corporations (kabushiki Kaisha) was 2,839,291 as of 2012. Statistical Handbook of Japan, available online at http://www.stat.go.jp/english/data/handbook/c0117.htm. Accessed 1 May 2015.

[5] Japanese law provides dozens of different forms of incorporated entities which serve a variety of private and public functions. For a comprehensive discussion of these see Mikami (2002).

[6] This chapter uses North's broad definition of organizations as "groups of individuals bound by some common purpose to achieve objectives" with the added caveat that they should be defined by law – thus including incorporated entities while not including purely voluntary forms of association. Organizations with an economic purpose include an array of legal entities such as corporations and cooperatives. The term "economic organization" is here used to distinguish these from other forms of organization with non-economic purposes such as political parties, universities or churches. North (1990), pp. 4–5.

and labor markets across the globe which globalization presents. In doing so it exposes itself, and the domestic law upon which it is based, to new actors with new ideas or demands for change. Thus, perhaps unsurprisingly, a large part of the literature on corporate law change in recent years has focused on the clashes between actors like activist hedge funds with domestic corporate laws and domestic actors with differing views.[7]

To illustrate the point and the degree to which corporate law reform is in this regard presents us with an atypical view of the influence of globalization on legal change, this chapter contrasts the narrative of corporate law change in Japan with that of an economic organization that, while similarly structured as a legal entity, operates within a domestic institutional and market setting which defines its interaction with globalization in a drastically different way – the Shoutegai Promotion Association (SPA).[8] SPA are an incorporated entity which allows small merchants who operate on the nation's many shopping streets (shoutengai) to organize themselves as a collective entity with the twin goals of allowing members to engage in cooperative economic activity and improving the physical environment of their shoutengai.

Unlike the business corporation, SPA are confined – both by the Act and by their very nature – to a geographically defined area which in practice rarely amounts to more than a few square blocks. This holds equally true for the vast majority of their membership, which are typically family run businesses operated at a very small scale. This means that globalization has a very different impact on them, which in effect puts them in a 'worst of both worlds' dilemma. On the one hand, globalization – among other forces – has brought about changes to the retail market which pose new competitive challenges to them. On the other hand, being geographically confined, they cannot offset these challenges by availing themselves of the opportunities for global expansion to international markets which globalization provides. Unsurprisingly, many SPAs find themselves stuck in a downward spiral of economic decline which they have little means of averting.

More relevantly for this chapter, convergence and path dependence fail to provide us with a useful means for understanding legal change in an organization whose economic relationship with globalization is defined in this way. The various forces of convergence driven by the interaction between changing actors, markets and ideas which impacts change in corporate law have no channel through which to affect the law in such contexts. Path dependence likewise loses much of its useful explanatory power in the absence of such forces to act as a foil. This chapter therefore suggests that an understanding of how legal rules relate to globalization requires not just an understanding of the forces of convergence and path dependence, but also a consideration of the degree to which the underlying economic organization subject to those legal rules interacts with these forces. While corporate law scholarship paints of picture of globalization unleashing dynamic and contested

[7] See for example Buchanan et al. (2012).

[8] Incorporated under the Shoutengai Promotion Association Act, Act No. 141 of 17 May 1962.

waves of legal innovation, SPA provide us with a much different picture in which globalization disrupts existing institutional balances without providing avenues for such potentially beneficial legal change to take place. While SPA may themselves be an atypical form of economic organization, the general point this chapter raises is that these more locally embedded organizations may become stuck in this worst of both worlds dilemma and our understanding of the relationship between globalization and legal change should take account of why this occurs. The chapter proceeds as follows. Section 2 reviews the notions of convergence and path dependence as they relate to corporate law and sets out the narrative of change in Japanese corporate law in relation to this. Section 3 then looks at the SPA, contrasting the narrative of change there with that of corporate law and exploring how this can be explained by the nature of its interaction with globalization. Conclusions follow.

2 The Conventional Narrative of Corporate Law: Markets, Actors, Ideas and Rules

2.1 Convergence, Globalization and Corporate Law

The debate on convergence in corporate law has been inextricably linked with the notion of shareholder primacy as the underlying principle guiding corporate governance and corporate law. In its strongest form this was put forth at the turn of this century by Hansmann and Kraakman,[9] who described it in terms of historical inevitability. Diverse sets of corporate law rules, they argued, would despite some variation converge on a standard model in which shareholders were alone as the "parties to whom corporate managers should be accountable."[10] While the general proposition that the convergence of corporate law represents an "end of history" in its development has not been widely accepted, the work does provide a useful framework for considering the influence of globalization on corporate law reform. They cite three specific factors as driving convergence, all of which are connected to globalization.

The first of these is the perceived failure of alternative models upon which to base corporate law. Alternative models centred on the interests of other stakeholders such as management, labor or the state simply lost their normative appeal while consensus was forming around the logic of the shareholder model. While subsequent events and literature have called into question the validity of the claim of consensus support for shareholder primacy as an evolutionary end goal,[11] the relevant point in terms of globalization's influence on legal change is the notion that

[9] Hansmann and Kraakman (2001).

[10] Hansmann and Kraakman (2001), p. 441.

[11] See for example Puchniak (2007) for such a critique.

there is an international competition of ideas which encompasses academics, policymakers and others with a stake in the law reform process. Communication among these can influence the normative ideals and narratives that take place within the confines of domestic legal reform.

The second force is that of competitive pressure towards convergence. If one accepts the functional superiority of a given model for structuring economic activity – such as that presented by shareholder primacy in corporate law and governance – then the globalization of capital and product markets will tend to create demands for adoption of the better functioning model. This is partly a function of the competitiveness of individual companies in a jurisdiction, which may be punished by markets in the form for example of higher costs of equity capital if they are subject to less well functioning rules.

A third force is the rise of an international class of shareholders. The increase in share ownership among wider segments of society in the developed world combined with the increasing influence of large institutional shareholders has created a coherent interest group with the ability to push a pro-shareholder legislative agenda. The cross border nature of their diversified investments in turn means that these actors can, and do, bring influence to the law making process in countries in which they invest, particularly where those countries are eager to attract such investment.

These three forces – which can be broadly defined in terms of the emergence of new actors (international shareholders), new ideas (the normative appeal of shareholder primacy) and new competitive pressures (via markets) – at the global level provide one narrative framework for understanding the relationship between globalization and corporate law change. More recent works, while offering differing taxonomies of the forces for convergence and greater detail, generally cover similar ground. Mathias Siems, for example, draws a distinction between convergence through pressure and convergence through congruence.[12] The former includes lobbying by various actors (companies and their stakeholders, international organizations, states and other interest groups), while the latter is linked to broader processes of internationalization of social, political and economic circumstances which impact law. Despite the differences in categorization, these share the common view that these forces are driving corporate laws across jurisdictions to becoming more similar.

Path dependence provides us with a theoretical explanation for why rules may remain different even in the presence of these forces pushing towards convergence. Bebchuck and Roe[13] note that the path of development of corporate law rules can be heavily constrained by the ownership structure – dispersed or concentrated – which companies in a jurisdiction adopted at some point in the past. This past decision – made for whatever reason – provides two reasons why convergence may not occur. The first is that a given ownership structure created in the past may dictate that what constitutes an efficient set of rules elsewhere may not work efficiently in that

[12] Siems (2014), pp. 230–232.

[13] Bebchuck and Roe (1999).

context owing to a variety of reasons – from the costs of adapting to the new rule to a lack of complementarities with existing institutions. The second reason is interest group based and concerns the fact that individuals who benefit from the existing structures and rules may, given their power as incumbents, be able to block legal change that otherwise may have worked well.

The nature of these two competing, yet also complimentary, theories lends itself to viewing legal change as a binary duel between global forces for convergence, on the one hand, and local institutions and interests, on the other. The following subsections lay out the basic narrative of change in Japanese corporate law with this framework in mind.

2.2 *Japan's Traditional Approach to Corporate Governance*

The narrative of change in Japanese corporate law and its relationship to globalization since the 1990s can be described within this framework set out by the convergence literature. Corporate law in Japan had until that time presented itself as something of a puzzle that demanded explanation.[14] On the one hand, the law itself had been heavily influenced by American reform during the post-war occupation period and was structured, as with most corporate laws around the world, in a way that prioritized shareholder interests above those of others. On the other hand, however, corporate governance practice at the time largely sidelined shareholder interests while putting those of other stakeholders, and particularly those of employees, ahead. A number of factors contributed to this situation which we can briefly review here.

One of these was the fact that the effectiveness of the shareholder right of "exit" – to simply sell their shares if they are unsatisfied with management – was undermined by a system of cross-shareholdings among friendly firms which had been established in the early post-war period.[15] In a market in which shares and voting rights can be freely traded, the management of a company theoretically has an incentive to maximize shareholder value in the fear that failure to do so may make it a target of a hostile takeover bid. In Japan, however, cross-shareholdings in listed firms tied up nearly half the outstanding shares,[16] thus preventing the existence of an external market for corporate control that might have better aligned management incentives with the interests of other shareholders. This largely insulated management from market threats to their position – while shareholders could

[14] See for example Shishido (2000) which discusses the difference between Japanese corporate law on the books and in practice as it existed at that time.

[15] Morck and Nakamura (2007), p. 369.

[16] From 1987 to 1993 cross shareholdings constituted between 45 and 46 % of shareholdings. Miyajima and Kuroki (2007), p. 81.

always sell their shares and voting rights, there would be nobody in a position to buy enough of them to mount a proxy battle against management.

Another factor was the composition and function of the board of directors. In a shareholder primacy model, the board's function is to act as an outside monitoring body which oversees management on behalf of shareholders rather than a part of the everyday management of the company itself. This notion developed over time in American corporate governance[17] and by the 1990s had come to be the widely accepted view on the board's proper role and various supporting practices like the use of audit, nomination and compensation committees and of having independent outsiders forming the majority of directors became standard. In Japan, however, the board of directors retained a strong managerial function which was reflected in its composition and structure and closely tied to the overall employment hierarchy within companies. The boards were quite large relative to those found in the United States, with several dozen members not being uncommon. These were almost entirely drawn from the ranks of senior employees and individual directors tended to represent the interests of their own divisions within the company, which they often also served as the heads of.[18] Instead of committees, Japanese boards at the time tended, owing to their size, to develop smaller groups of core members who made the most important decisions.[19] A separate board of corporate auditors, tasked with overseeing the board on behalf of shareholders also existed but in practice was criticized for failing to perform a useful role, in part owing to the fact that the auditors largely owed their relatively weak position outside the board of directors.[20] A system of lifetime employment which both guaranteed lifetime income and closely tied the interests of employees to companies[21] tended to support this system as directors and auditors, coming from it, tended to identify the employees of the firm rather than the shareholders as the main interest group in whose interest they owed a duty to.[22]

A further factor was the relatively low importance of equity finance to Japanese corporations, which instead relied mainly on credit as a source of outside capital. Whereas companies in a system of corporate finance which relies primarily on equity have a much greater incentive to adopt governance practices which appeal to shareholders, the ready availability of bank lending obviated the need for such in Japan. As a result banks are viewed as having played a much more important role in providing external monitoring of corporate management than that played by shareholders. Main banks, which provided not just loans but other services to their client corporations, arguably had greater access to information, capacity and incentive to

[17] Gordon (2007) discusses the historical development of the monitoring board and independent directors in American corporations.

[18] Abe (2002), pp. 3–5.

[19] Abe (2002), pp. 3–5.

[20] See for example criticism of the system in Lee and Allen (2013).

[21] Pejovic (2014) discusses the lifetime employment system in Japan and its significance.

[22] Shishido (2000) refers to this as the company community concept.

carry out monitoring activities than individual shareholders and thus may have been well suited to this role.[23]

Consistent with this differing approach to corporate governance, many of the rights afforded to shareholders under corporate law were underutilized. Derivative actions, which gave shareholders the ability to sue directors on behalf of the company for breaches of their duties and were the main mechanism through which shareholders could obtain legal redress against management misdeeds were almost never used prior to 1990.[24] Shareholders meetings, intended to be one of the main organs of the corporation in company law which gave shareholders some voice in important decisions including the appointment of directors were reduced to little more than heavily orchestrated formalities lasting a few minutes each year.[25]

2.3 Globalization and Change in Japanese Corporate Law

In the 1990s this system began to undergo significant changes, which continue at the present, upon which the forces of convergence and path dependence outlined above had a major influence. The initial spark which provided an impetus for these changes was the collapse of the Japanese asset bubble in the early 1990s. This ushered in the "lost decade" of low economic growth which created serious problems for corporate finance, as the devaluation in assets, coupled with low growth, created the huge problem of non-performing loans for the Japanese banking sector. This accelerated a trend begun before the crisis for larger companies to make greater reliance on capital markets rather than bank loans as a source of finance and, with its financial "big bang" in the late 1990s, the government largely liberalized the regulatory framework which had encouraged reliance on bank loans in the first place with the specific purpose of creating a market based system of finance.[26]

Concurrent with this, corporate governance reform came to be seen as an important part of reform by both individual companies and policy makers. This was, in part, a natural consequence of changes occurring in the financial system – a corporate governance system which allowed management to largely ignore shareholder interests would be incompatible in an environment in which they needed to make greater reliance on investments by those same shareholders. At the same time that Japan was going through its lost decade the American economy was going through a period of success relative to other developed economies. As Hansmann

[23] On the main bank system see generally Aoki and Patrick (1994).

[24] Puchniak and Nakahigashi (2012) discuss changes in derivative litigation which, while almost never used prior to 1990 has increased significantly since then.

[25] In 1997, for example, the average meeting length was approximately 30 min and at 87.5 % of them no questions were asked. The need to limit Sokaiya racketeers was a major reason for the rigid control placed over meetings. West (1999), pp. 800–801.

[26] On the liberalization of the finance system see Horiuchi (2000).

and Kraakman note,[27] this gave it appeal as a potential model for reform in other countries, including Japan. The shareholder primacy model promised the ability for companies to gain better returns on their assets in part by encouraging a greater willingness to take more risks, something which a system centred on bank financing tended to discourage.[28]

A number of other changes have occurred which have complemented these forces. The financial crisis of the 1990s led to the partial unwinding of the system of cross shareholdings among friendly firms.[29] In part this was the result of deliberate policy measures aimed at reducing such holdings and in part may also be attributable to the costs associated with holding onto shares which were depreciating in value.[30] While prior to the mid-1990s shareholdings in Japan had been overwhelmingly held by domestic investors – foreign shareholdings generally amounting to no more than 5 % of outstanding shares of firms listed on the Tokyo Stock Exchange and going as low as 2.8 % in 1978 – from about 1995 this began to change radically.[31] Foreign shareholdings surpassed 10 % that year and steadily increased with some variation year by year after that, surpassing the 30 % threshold in 2013.

The change in the make up of shareholders themselves has had some effect on the demand for legal change. Unlike stable cross-shareholders, these foreign shareholders, many of them large institutional investors, came to their investments with different sets of expectations molded in their home jurisdictions (which often times was the United States). Some[32] were quite active in pushing for both the reform of corporate governance at individual firms in which they invested and also in promoting broader legal reforms in the direction of more shareholder friendly models. In addition to themselves, the emergence of a large class of international investors has brought secondary actors into the market such as corporate governance specialists and proxy advisory services which have also taken an active part in lobbying for more shareholder friendly corporate law reforms.[33]

The direction has not been entirely one way; Japanese corporations and investors have also become more active in international markets. While this trend precedes the 1990s the scale has increased significantly in recent years. Foreign direct

[27] Hansmann and Kraakman (2001).

[28] This argument was put forward in Gibson (2000).

[29] Miyajima and Kuroki (2007), p. 81. The ratio of stable shareholdings fell from 45.2 % in 1993 to 27.1 % in 2002.

[30] Kanda (2000), pp. 282–83.

[31] Based on the Tokyo Stock Exchanges 2013 Shareownership Survey, available online at http://www.jpx.co.jp/english/markets/statistics-equities/examination/01.html. Accessed 1 May 2015.

[32] For a case study of one, see Jacoby (2007).

[33] The largest of these, Institutional Shareholder Services (ISS) now has a Tokyo office and issues proxy recommendations for firms listed on the Tokyo Stock Exchange. They were also among those to submit public comments on the Interim Proposal Concerning Revision of the Companies Act in 2012, which led to the most recent amendments.

investment by Japanese firms more than quadrupled between 1996 and 2013[34] in part driven by firms shifting manufacturing processes overseas. Japanese companies have also become active in foreign capital markets, with cross listing on foreign stock exchanges being a particularly notable way in which domestic rules may be affected, as companies must subject themselves to a set of listing rules crafted in a different institutional environment to do so, thus gaining knowledge and experience with new sets of practices.[35]

To sum up, the above described process brought to the arena of corporate law reform three major changes. First was a new set of actors – particularly foreign shareholders, while banks faded in significance. Second was the fact that the corporate entities subject to corporate law were (of course to varying degrees) operating in both new markets and in old ones which had undergone significant changes. Finally, the ascendency of the American economy and the perceived benefits of its shareholder primacy model suggested a path down which reform might beneficially lead.

With these factors in mind, we turn to the question of how the legal rules actually responded to this changed environment. Gilson and Milhaupt in 2005[36] described the strategy for corporate law reform as an "enabling" one, and the subsequent path of change since then generally backs up this view. Throughout the period from 1993 to 2002 there were a series of changes which could in their view be characterized as: "[A]dvancing one of two goals: expanding the choice set of Japanese managers by enhancing organizational flexibility and increasing corporate finance options, or improving the monitoring capabilities of the board and other corporate organs."[37]

These included such things as reducing the cost of shareholder derivative suits, deregulating the repurchase of shares (enabling greater flexibility in remuneration packages through stock options) and streamlining the process for mergers. The most ambitious, however, was the 2002 reform to the Commercial Code which created the companies with committees system. This reform, which was partially inspired by changes implemented at Sony in the late 1990s which in turn was based on American practice, sought to fundamentally restructure the board of directors so as to clearly delineate its function as a monitoring rather than managerial body. Companies with committees are required to establish nomination, compensation and audit committees on their boards and the majority of the directors on these must be outsiders. They are also required to create the position of executive officers separate from the board and specifically tasked with the managerial function

[34] Japan External Trade Organization, Japan's Outward and Inward Foreign Direct Investment, available online at http://www.jetro.go.jp/en/reports/statistics/. Accessed 1 May 2015.

[35] Sony, whose internal reforms in the late 1990s were influential on the 2002 Commercial Code reform, had been among the first Japanese companies to cross list on the New York Stock Exchange. See generally Sano (2001) available online at http://www.oecd.org/dataoecd/6/36/1873238.pdf. Accessed 1 May 2015.

[36] Gilson and Milhaupt (2005).

[37] Gilson and Milhaupt (2005), p. 350.

previously played by executive directors. Such companies also do away with the much-criticized board of auditors system.

This reform was enabling in the sense that it was created as an optional form for companies to adopt rather than a mandatory one. This is in part attributable to opposition to making the reforms mandatory by domestic groups, most notably Keidanren, the Japanese business association, which favored reforms that would allow firms the ability to maintain their existing institutional arrangements.[38] Companies were thus free to choose either the companies with committees system or to retain their conventional form with the board of auditors and no committees or executive officers (though they could create these voluntarily if they chose). In fact, only a small number of companies actually made the switch to the company with committees system, amounting to roughly 2.2 % of firms listed on the Tokyo Stock Exchange as of 2013.[39]

The lack of popularity of the company with committees system became a focal point of reform in the most recent round of amendments to the Companies Act.[40] This led to the creation of a third option for companies to choose – the so-called Companies with supervisory and audit committees. This may be seen as something of a compromise between the existing choices, which roughly represented the differing monitoring (company with committees) and managerial (company with auditors) views on the function of the board of directors. This new system, like the company with committees system, does away with the board of auditors, but it only allows for the appointment of a single committee on the board. Members of this committee are intended to serve in a monitoring role and must be outsiders elected separately from the other directors. At the same time, however, other directors are explicitly given a managerial function. Another issue addressed by these amendments was the question of whether or not to require all firms to appoint at least one outside director. In the end rather than mandating them the rule ultimately adopted was also an enabling one, adopting a "comply or explain" rule with regard to the requirement.

The reforms which have been briefly outlined here can be seen as an outcome of a push and pull struggle between forces for convergence, mainly international, and resistance by domestic actors like Keidanren which seek to limit the degree to which certain changes are imposed. The theoretical framework provided by convergence and path dependence does therefore provide some explanatory power in describing the narrative of change in corporate law and the competing forces working thereon. In the next section we examine the SPA, where a significantly different narrative of globalization and legal change has played out.

[38] Gilson and Milhaupt (2005), p. 354. Keidanren's comments on various proposed legal reforms are available in English on their website at https://www.keidanren.or.jp/en/policy/index03.html. Accessed 30 April 2015.

[39] Tokyo Stock Exchange, TSE-Listed Companies White Paper on Corporate Governance 2013, p. 26.

[40] Passed by the Diet in 2014 but not yet having come into force at the time of writing.

3 The Narrative from the Downside: Globalization and Change in SPA Law

Whereas the dichotomy of convergence and path dependence provides us with a useful lens for considering how globalization has affected corporate law in Japan, in this section we turn to the peculiar world of SPA, an organization whose interaction with globalization provides us with a significantly different narrative. Since it is safe to assume that SPA are a bit less familiar than business corporations, we may here pause to say a bit about what they are and what they are intended to do. SPA are a means for merchants within shoutengai – shopping streets – to organize themselves collectively. Shoutengai themselves emerged in the early twentieth century as a response by small merchants to competitive threats posed to them by department stores which were starting to appear.[41] The idea was to allow these merchants, while maintaining their independence as shop-owners, to create a collective entity that would offer consumers the same convenience as department stores by gathering multiple businesses offering a variety of products in a single street. Organization would also allow them to share various costs of mutually beneficial activities – such as advertising, transport, warehousing and the maintenance of common facilities like arcade roofs –and, importantly, give them increased political power.

Originally they organized themselves either as voluntary, unincorporated associations or, beginning in the 1930s, as business cooperatives. In 1962 the Central Government enacted the SPA Act which for the first time created a legal entity specifically designed for shoutengai[42] and as of 2009 2378 shoutengai had incorporated under the Act.[43] The Act creates an incorporated entity which is structured similarly to a business corporation. A board of directors is elected by the general assembly of the members, who must each make a cash contribution to the SPA when joining. As with the relationship between shareholders and directors in a corporation, the nature of the SPA also gives rise to potential agency problems between the directors and the membership, which the act deals with largely by replicating various corporate law rules such as the fiduciary duty/duty of care, imposing various information disclosure requirements and providing judicial remedies to membership for breach of these rules.

In other ways, however, the rules provided by the SPA differ in ways that reflect its special purpose. Whereas shares in a corporation can be freely bought and sold to almost anyone, members in an SPA must meet membership qualifications which

[41] On the history of shoutengai see generally McGinty (2015 forthcoming), Hama (2005), Arata (2012).

[42] On the background surrounding the introduction of the SPA Act see Hama (2008).

[43] *Shoutengai Jitai Chousa Houkokusho* (Report on the Survey of the Condition of *Shoutengai*) (Small and Medium Enterprises Agency, 2010), p. 9. The majority of shoutengai, roughly three quarters, remain as unincorporated associations, while a smaller number are organized as business cooperatives.

largely confine it to local merchants operating in the shoutengai. The Act also ties the SPA to a geographically defined area in which the physical shoutengai actually exists.[44] This typically will amount to no more than a couple of city blocks. The activities which an SPA can engage in are also somewhat restricted to an enumerated list in Article 13 of the SPA Act. These activities can be financed through both membership dues or by special levies imposed on members.[45] For larger projects, such as the construction of arcade roofs above pedestrian only streets, the high costs require outside financing which is usually provided by various government funds established at the local, prefectural or national level.[46] Subsidies for smaller activities are also provided by some municipal governments.

Economic globalization has had a significantly different impact on SPA than it has on business corporations. This has primarily manifested itself indirectly through changes in the retail market in which they operate and its regulatory framework. In particular, American pressure for trade liberalization and the removal of structural barriers thereto in Japan beginning in the 1980s led to significant deregulation with respect to large retailers.[47] Since as early as 1937[48] shoutengai had been given a certain amount of regulatory protection from larger retailers by a series of Acts which gave them an effective veto right in the approval process for the opening of large retailers in their neighborhoods. Reforms to this legislation in the 1990s largely eliminated this right and the number of large retailers has increased considerably since then. Pressures have also been brought to bear on the nebulous thread of distribution chains between producers and retailers which generally tended to favor smaller retailers located in shoutengai.[49]

In addition to the increased competition which they face, shoutengai have also been presented with internal problems which threaten their viability as business entities. The most pressing of these is the lack of successors for aging shopkeepers to hand their businesses down to.[50] A large proportion of the shops on shoutengai are family owned businesses handed down from generation to generation, but for a large number the current generation has nobody to take over when they retire. The

[44] Article 6 of the SPA Act sets out the rules delineating the district of an SPA. It must be an area in a city or ward of a city in which 30 or more retail or service providers operate in close proximity to one another.

[45] Article 20 of the SPA Act requires members to make an equity contribution on joining, while Article 22 allows the SPA to impose levies for expenses on members and Article 23 allows the imposition of usage fees.

[46] When the Osaka Nipponbashi Suji Shoutengai replaced its arcade roof, more than 90 % of the 1.26 billion Yen cost of the project came from city, prefectural and central government sources while only about 8 % was covered by the SPA itself. Yamada et al. (2012), p. 309.

[47] On the regulatory changes which occurred in that period, see generally Upham (2001).

[48] With the introduction of the Department Store Act no. 76 of 14 August 1937. See Grier (2001), p. 4.

[49] Discussed in Itoh (2000).

[50] This was the number one problem cited by shoutengai in *Shoutengai Jitai Chousa Houkokusho* (Report on the Survey of the Condition of *Shoutengai*) (Small and Medium Enterprises Agency, 2010).

result is the slow death of many shoutengai as individual shopkeepers retire and close up their shops, but continue to reside in the shopbuilding rather than moving on to allow new businesses to move in.

As with corporate law, the SPA Act has seen a series of major revisions in recent years but fitting the relationship between these changes and globalization into the convergence/path dependence framework is a bit like trying to fit a square peg into a round hole. Space considerations prevent a full recounting of these amendments,[51] but the main ones, carried out in 2005 and 2006, were generally focused on increasing the accountability of directors to the membership through such mechanisms as increased disclosure requirements and stiffer penalties for violations of rules. Mirroring the enabling approach taken to corporate law they also introduced a new governance system for large SPA which required the appointment of an outside auditor. Small SPA could voluntarily choose this system and the threshold for it to become a mandatory requirement – set by ordinance as SPA with over 1000 members – was so high that virtually no SPA would be required to implement it.

As the author has argued elsewhere,[52] these reforms largely fail to address actual problems which SPA and shoutengai in general are dealing with and are instead importations of legal ideas generated elsewhere, mostly in the field of corporate law. There is, in other words, a lack of innovation – the experimentation with new rules to address actual problems – in the field of SPA law reform. This is likely in part attributable to the fact that as organizations of declining economic importance SPA do not provide much incentive for actors to invest in the process through lobbying, litigation, research and other activities which may influence legal change. We may also, however, consider here the degree to which the local nature of SPA and their interaction with globalization has also played a role in determining this outcome.

As discussed above, change in Japanese corporate law has been influenced by globalization primarily (though not necessarily exclusively) through the increased interaction of corporations in different markets, the introduction of new actors such as international institutional investors, and the impact of new ideas from abroad such as the proper role for directors and how legal rules might change to reflect that. The cumulative effect of these forces, and their interaction with more purely local ones, has been to turn corporate law into a hotly contested arena for change in which a certain amount of innovation has occurred.

In the field of SPA law, however, none of these forces are at work. To begin with, the nature of the shoutengai and its individual businesses precludes the type of expansion to other markets which the corporation can avail itself of in an era of globalization. Shoutengai are geographically tied to the local markets for products, capital and labor in the cities in which they exist. While they cannot escape these markets, they also have no means of excluding other organizations which lack this

[51] On these, see McGinty (2015 forthcoming).

[52] McGinty (2015 forthcoming).

handicap from entering and competing against them in the same market – particularly in the form of large scale retailers. Not only does this put them at a competitive disadvantage, but it also limits their exposure to and knowledge of rules and norms which operate in other markets.

A second point is that the actors which constitute the stakeholders of a shoutengai – primarily the shopkeepers themselves but also including city and prefectural governments – are likewise drawn from a very narrow and local field. While small numbers of chain stores and other "outsider" types of businesses do operate on shoutengai many of these have corporate policies against participation in SPA,[53] while the smaller businesses which do participate tend to be family based and slowly dying out in part due to their unwillingness or inability to attract outsiders.[54] Thus the pool of actors with an interest in legal change is largely homogenous, local and shrinking.

Finally we can note the question of ideas and their transmission across borders. Legal change in corporate law in Japan has been heavily influenced by ideas originating elsewhere – such as the use of committees on boards of directors and the very notion of the monitoring board itself. Various mechanisms of communication may enable the diffusion of knowledge of the effectiveness of certain rules or norms which are viewed as beneficial, with the example of the American shareholder primacy model articulated by Hansmann and Kraakman being one example. The voluminous comparative corporate law literature which has been produced in recent years testifies to the degree to which this cross border diffusion of ideas about corporate law is both accessible and influential. With SPA, however, there is no similar debate occurring. This is despite the fact that legal models for addressing some of the problems faced by shoutengai are being developed in other jurisdictions. The most notable of these are Business Improvement Districts (BIDs)[55] which have been used by somewhat similar shopping streets in the United States to improve their fortunes and have come to be regarded as something of a model for legal reform. Despite the availability of this comparative model, outside of brief mentions in a few architectural journals a discussion of BIDs has been absent in regard to reform of SPAs. This isn't to suggest that BIDs or other models would necessarily solve the problems of shoutengai, but the absence of debate is striking.

While far from being the only factors determining the narrative of legal change in SPA law, the lack of these interactions with the forces through which globalization affects legal change does give it a significantly different character than that presented by Japanese corporate law. It also demonstrates the limitations of using

[53] A survey of shoutengai by the Tokyo government indicates such policies are among the main reasons certain businesses operating on shoutengai refrain from joining their SPA. *Tokyo To Shoutengai Jitai Chosa Hôkokusho* (Report on the Survey of the Condition of Shoutengai in Tokyo) Tokyo City Department of Industry and Labor (2010), p. 37.

[54] *Shoutengai Jitai Chousa Houkokusho* (Report on the Survey of the Condition of *Shoutengai*) (Small and Medium Enterprises Agency, 2010) notes that the lack of successors to existing business is cited as the top concern by far of shoutengai.

[55] On BIDs, see generally Briffault (1999).

the convergence/path dependence framework as a basis for considering how globalization is affecting legal change in contexts outside the narrow confines of the large corporation. With SPA the nature of the organization itself and its relationship with globalization has given it very little room for interaction with the forces that give that framework meaning in the corporate law context.

4 Conclusion

This chapter has compared the relationship between globalization and legal change in the context of two sharply contrasting forms of economic organization in Japan. On the one hand the increased interaction between large corporations and international markets, investors and ideas has been particularly influential in shaping the course of corporate law reform in Japan. This has furthermore lent the process towards being described as a conflict between forces of convergence and path dependence and has had an effect on the substantive content of the new rules introduced. On the other hand the SPA provides us with a picture of a form of economic organization which the forces of globalization and convergence largely has no interest in. The parochial nature of the SPA themselves result in this feeling being, in a sense, mutual. While the development of SPA law is by no means exclusively explained by the lack of interaction with the forces of globalization, their absence is nonetheless notable. Globalization has brought new competitive pressures to SPA but has largely excluded them from interaction with the forces for convergence which have given reform in corporate law its unique character.

More generally the point which this chapter has sought to make is that an understanding of how globalization affects the laws of economic organizations outside the world of large corporations cannot be understood within the theoretical framework developed therein. While not going so far as to propose a comprehensive theory of globalization and legal change, it does raise the point so often overlooked that the relationship between the two is as much defined by those organizations marginalized or ignored by its processes as those who gain from them.

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The Novelist's Artistic Freedom v. His Protagonist's Rights of Personality: A Comparison Between German and U.S.-American Law

Christian Gomille

Contents

Abstract Novelists and authors of short stories often model their story characters upon real-life persons. Though it is, in principle, permissible to do so, the living model's right of personality needs to be respected. The balancing of the freedom of expression with the right of personality usually is conducted within the general legal framework on defamation.

Due to a novel's general fictionality, however, the general provisions on defamation do not easily apply to such issues. Hence, the German *Federal Constitutional Court* (FCC) tried to create specific defamation rules relating to fictional literary works. Comparing the German to the American legal situation, the article critically reviews the FCC's case law on this issue.

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1 Introduction

Suppose that I try to start a new a career as a novelist. For my debut, persons that I have met by participating at a particular academic conference might serve as an inspiration. So, I might create a protagonist and other characters that have similar names to the participants of the conference, who look like participants of the conference and who, anyway more or less, behave like participants of the conference. In the fictional reality underlying my novel, of course, I will make those characters experience a certain number of adventures, and thereby they will act sometimes heroically, sometimes ridiculously or sometimes simply pitiably.

I am sure that the participants of this conference wouldn't feel comfortable if I seriously conducted my alternative career plan in such a way. If I nevertheless did so, this would certainly be a case of very bad behavior by my part. But would it legally matter? Providing an answer to that question will be my task in this chapter, which first considers the German opinion on such issues but then moves on to discuss the American point of view.

2 The Factual Background: *Esra, Mephisto* and *Esco Brooks*

First of all I will give you three cases to exemplify the crucial points, two cases from Germany and one case from the United States.

From the recent past, the most important German case dealing with the conflict between artistic freedom and personal rights undoubtedly is the so called *Esra* case.[1] *Esra* is the female protagonist of a novel written by the German author *Maxim Biller*. The novel's story is about the failed love affair between *Adam* and *Esra*, including more or less detailed descriptions of sexual acts between both characters. Shortly after the publication, *Maxim Biller's* former girlfriend *Ayse Romey* filed defamation claim in order to prohibit the further dissemination of the book. She argued that the allegedly fictional character *Esra* actually was a portrayal of herself. In the overall result, *Ayse Romey's* claim was successful due to the disregard of her general right to respect.

Until the German *Federal Constitutional Court's* decision on *Esra*, *Mephisto*[2] was the leading case relating to the issue discussed in this chapter. *Mephisto* is a novel written by *Klaus Mann* and was first published in the Netherlands in 1936. *Klaus Mann* tells the story of *Henrik Höfken*, a young and outstandingly talented actor, and

[1] BVerfGE 119, 1.

[2] BVerfGE 30, 173.

the career he made during the Nazi-regime. The novel is inspired by the biography of *Gustav Gründgens*, a German actor and former general manager of the Prussian State Theatre and, moreover, *Klaus Mann's* personal friend and brother-in-law. After *Gustav Gründgens'* death, a German publishing house announced the publication of *Mephisto* in 1963. A few weeks later, *Gustav Gründgens'* sole heir successfully filed a defamation claim against the publisher. The German *Federal Constitutional Court* identified *Henrik Höfken* to be a literary version of *Gustav Gründgens*. The Court found that *Gustav Gründgens* was described in an all too negative manner and hence affirmed the prohibition to publish, to disseminate or to reproduce this novel.[3]

Similar conflicts have occurred in U.S. litigation too. The case *Middlebrooks v. Curtis Publishers*,[4] for example, refers to the short story *Moonshine Light, Moonshine Bright* by *William Price Fox*. The teenager *Esco Brooks* is one of the story's main characters and he reminded the plaintiff, Mr. *Larry Middlebrooks*, of himself. Unfortunately, the *Esco Brooks* depicted in the story was a rather ridiculous person, and so Mr. *Middlebrooks* took libel action against the publishing company. However, he did not succeed. After the courts in charge of the case, Mr. *Middlebrooks'* personal reputation wasn't affected by the description of the fictional character *Esco Brooks*. There was too much dissimilarity as to age, employment situation and other characteristics of the real and the fictitious persons.

What we can see from these examples, is that the modeling of a story's character upon a real-life-person potentially is subject to defamation claims. The likelihood of success of such claims depends on a balancing of the allegedly affected personal rights with the author's artistic freedom.[5] This general approach applies in German, as well as in American law.

3 Literary Art and the General Legal Framework on Defamation

The conflict between freedom of expression and personal rights certainly characterizes any defamation case. Before focusing our attention on balancing our concrete situation, we should take a short look at the general rulings on libel and slander as provided by German and American private law.

3.1 Defamation Under German Law

Under German law, the torts of libel and slander are settled in Sections 823, 824 of the Civil Code. Following the interpretation given by the *Federal Court of Justice*

[3] BVerfGE 30, 173, 198 et seq.

[4] Middlebrooks v. Curtis Pub. Co., 413 F.2d 141 (C.A.S.C. 1969).

[5] Rixecker (2012), Recital 180.

as well as by the *Federal Constitutional Court*, the affected one's right of personality precedes if the other one untruthfully states or disseminates a fact.[6] No one should be allowed to put another person into a false light.[7] Moreover, abusive criticism is prohibited.[8] However, the scope of this latter group of cases is quite narrow. Abusive criticism can actually be considered only under condition that vexation is the statement's sole purpose.[9]

To the contrary, anyone can principally legally state and disseminate true facts about other people.[10] Of course, the extent of this principle has to be adjusted to the affected person's legitimate informational self-determination.[11] For this reason, the limit of what is legally permissible is exceeded in case of revelations so intimate and unwarranted as to outrage the community's notions of decency.[12] The same goes for cases involving breach of confidence,[13] may the obligation to secrecy arise from a contractual or from another legal relationship.

[6] BVerfGE 54, 208, 219; 61, 1, 8; 85, 1, 15; 90, 1, 15; 90, 241, 247; 97, 391, 403; BVerfG, NJW 1991, 1475, 1476; 1993, 1845; 1999, 3326, 3327; 2000, 199, 200; 2000, 2413, 2414; 2000, 3485; 2004, 354, 355; 2004, 592; 2007, 2686, 2687; BGHZ 176, 175, 189; BGH, NJW 1989, 774; 1989, 2941, 2942; 1997, 1148, 1149; 1999, 2736; 2008, 2110, 2112; 2013, 790; Rixecker (2012), Recital 149, Soehring and Hoene (2013), § 18 recital 2, and Wenzel et al. (2003), recital 6.14.

[7] Larenz and Canaris (1994), § 80 II. 1. a).

[8] BVerfGE 82, 272, 283 f.; 93, 266, 294; BVerfG, NJW 1993, 1462; 2003, 961, 962; 2003, 3760; 2012, 1643, 1644; 2012, 3712, 3713; BGH, NJW 2008, 2110, 2115; 2009, 1872, 1874; 2009, 3580, 3581; Rixecker (2012), Recital 156, Steffen (2006), recital 190, Soehring and Hoene (2013), § 20 recital 9, and Wenzel et al. (2013), recital 5.97.

[9] BVerfGE 85, 1, 16; 93, 266, 294; BVerfG, NJW 1991, 1475, 1477; 1993, 1462; 1994, 2413, 2414; 2003, 3760; 2005, 3274; 2009, 749, 750; 2009, 3016, 3061; 2012, 1643, 1644; 2012, 3712, 3713; 2013, 3021; 2014, 3357, 3358; BGH, NJW 2009, 1872, 1874; 2009, 3580, 3581; 2013, 3021; 2015, 773, 774f.; Teichmann (2014), recital 70, Rixecker (2012), Recital 156, Beater (2007), recital 1617, Soehring and Hoene (2013), § 20 recital 9a, Wenzel et al. (2003), recital 5.98, and Hager (1996), p. 207.

[10] BVerfGE 97, 391, 403; 99, 185, 196; BVerfG, WM 2009, 1706, 1708; BGH, NJW 2013, 790; 2015, 776, 777; GRUR 2013, 200, 201; 2014, 904, 906; Bamberger (2015), recital 179, Rixecker (2012), Recital 149, Hager (1999), recital C 146, Larenz and Canaris (1994), § 80 II. 2.), and Soehring and Hoene (2013), § 19 recital 1.

[11] Beater (2007), recital 1448.

[12] BVerfGE 34, 238, 145f.; 54, 148, 154; 99, 185, 196f.; BVerfG, NJW 1996, 2669, 2670; 2000, 2189; 2001, 1921, 1924; 2002, 3767, 3768; 2003, 1109, 1110; 2012, 756, 757; 2012, 1500, 1501; GRUR 2011, 255, 257; BGHZ 73, 120, 124; 98, 32, 36f.; BGH, NJW 2010, 1454, 1455; Beater (2007), recital 1450, Soehring and Hoene (2013), § 19 recital 4, and Wenzel et al. (2003), recital 5.35.

[13] BVerfGE 66, 116, 142; BGHZ 73, 120, 123; 171, 180, 184f.; Larenz and Canaris (1994), § 80 II. 4. a).

If these conditions are met, the plaintiff will usually attempt and obtain injunctive relief.[14] Upon proof that the defendant acted at least negligently, she is entitled to recover damages.[15]

3.2 *Defamation Under American Law*

Under American law, defamatory statements aren't granted any protection either. Within the American legal framework, defamation refers to both libel and slander[16] and the relevant rules are provided by common law and additional constitutional considerations.[17] It is widely recognized that there is no constitutional value in false statements of fact.[18] Consequently, defamation is generally defined as a false statement of fact about a person that causes that person reputational harm.[19] One thus discovers that untruthful statements principally infringe on another's personal rights both under German and under American defamation law.

American defamation law, however, provides only much narrower remedies in favor of the affected person. Firstly, American defamation claimants principally are not entitled to injunctive relief; their remedies rather are solely monetary.[20] Secondly, a defendant's mere negligence often does not justify the application for damages. Ever since *New York Times v. Sullivan*, the plaintiff being a public figure

[14] Beater (2007), recital 1914, Soehring and Hoene (2013), § 30 recital 1, and Wenzel et al. (2003), recital 12.5.

[15] Beater (2007), recital 1967, Soehring and Hoene (2013), § 32 recital 1, and Wenzel et al. (2003), recital 14.21.

[16] Trevino (2012), p. 51, Moore (2014), p. 41, and Kern (2014), p. 258.

[17] Kern (2014), p. 258.

[18] Gertz v. Robert Welch, Inc., 418 U.S. (1974), 323, 340; Time, Inc. v. Firestone, 424 U.S. (1976), 448, 482; Virginia State Bd. of Pharmacy v. Virginia Citizens Consumer Council, Inc., 425 U.S. (1976), 748, 777; Herbert v. Lando, 441 U.S. (1979), 153, 171; Keeton v. Hustler Magazine, Inc., 465 U.S. (1984), 770, 776; Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc., 472 U.S. (1985), 749, 767; Milkovich v. Lorain Journal Co., 497 U.S. (1990), 1, 18; Nike, Inc. v. Kasky, 539 U.S. (2003), 654, 664; Finan (1988), p. 813, Post (1990), p. 621, and Strauss (1991), p. 339.

[19] Post (1990), p. 611, Boggs (2012), p. 926, Moore (2014), p. 41, see also Assaf (2012), p. 615, and Naprawa (2013), p. 511.

[20] Ardia (2013), p. 1; however, there are several other torts than libel and slander that give rise to temporary injunctions (Hill 1976, p. 1291: breach of a confidential relationship).

is prohibited from recovering damages unless she proves that the false statement was made with actual malice[21] – that is to say: with actual knowledge that the stated fact was false, or with reckless disregard of whether it was false or not.[22] The plaintiff being a private person still needs to show a defendant's fault that amounts at least to negligence.[23]

Furthermore, defamation only refers to untruthful statements. Publishing and disseminating true facts about another person thus is not subject to defamation but rather to the theory of breach of confidence or to the theory of illegal disclosure of private facts.[24] Finally, abusive criticism infringing on the affected party's personal reputation is accepted only in very few cases. For instance, the right against abusive criticism is one of the personal rights particularly granted to artists.[25]

3.3 Literary Art and the General Provisions on Defamation

Several problems arise from the application of those general defamation rules to matters of literary art. What is crucial in this context is the general fictionality of literature.

[21] New York Times C. v. Sullivan, 376 U.S. (1964), 254, 279f.; Gertz v. Robert Welch, Inc., 418 U.S. (1974), 323, 334; Wolston v. Reader's Digest Ass'n, Inc., 443 U.S. (1979), 157, 163; Connick v. Myers, 461 U.S. (1983), 138, 162; Bose Corp. v. Consumers Union of U.S., Inc., 466 U.S. (1984), 485, 490; Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc., 472 U.S. (1985), 749, 751; Lorain Journal Co. v. Milkovich, 474 U.S. (1985), 953 f.; Anderson v. Liberty Lobby, Inc., 477 U.S. (1986), 242, 244; Hustler Magazine, Inc. v. Falwell, 485 U.S. (1988), 46, 56; Harte-Hanks Communications, Inc. v. Connaughton, 491 U.S. (1989), 657, 686; Milkovich v. Lorain Journal Co., 497 U.S. (1990), 1, 14; Hernandez v. New York, 500 U.S. (1991), 352, 367; Masson v. New Yorker Magazine, Inc., 501 U.S. (1991), 496 f.; Cohen v. Cowles Media Co., 501 U.S. (1991), 663, 674; U.S. v. Alvarez, 132 U.S. (2012) 2537, 2553; White (1991), p. 1114, Sullivan (2010), p. 149, and Kendrick (2014), p. 1258.

[22] New York Times C. v. Sullivan, 376 U.S. (1964), 254, 280; Old Dominion Branch No. 496, Nat. Ass'n of Letter Carriers, AFL-CIO v. Austin, 418 U.S.(1974), 264, 280; Cox Broadcasting Corp. v. Cohn, 420 U.S. (1975), 469, 490; Wolston v. Reader's Digest Ass'n, Inc., 443 U.S. (1979), 157, 160; Bose Corp. v. Consumers Union of U.S., Inc., 466 U.S. (1984), 485, 502; Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc., 472 U.S. (1985), 749, 755; Philadelphia Newspapers, Inc. v. Hepps, 475 U.S. (1986), 767, 773; Hustler Magazine, Inc. v. Falwell, 485 U.S. (1988), 46, 52; Harte-Hanks Communications, Inc. v. Connaughton, 491 U.S. (1989), 657, 659; Milkovich v. Lorain Journal Co., 497 U.S. (1990), 1, 14; Masson v. New Yorker Magazine, Inc., 501 U.S. (1991), 496, 510; U.S. v. Alvarez, 132 U.S. (2012), 2537, 2545; Bluebond (2014), p. 704.

[23] Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc., 472 U.S. (1985), 749, 766; Philadelphia Newspapers, Inc. v. Hepps, 475 U.S. (1986), 767, 784; Weeks (2014), p. 80, Bluebond (2014), p. 704, and Sasaki (2014), p. 792.

[24] Time Inc. v. Hill, 385 U.S. (1967), 374, 383; Sidis v. F-R Pub. Corporation, 113 F.2d 806, 809 (C.A.2, 1940); Garner v. Triangle Publications, 97 F.Supp. 546, 549 (D.C.N.Y. 1951); Travers v. Paton, 261 F.Supp. 110, 115 (D.C.Conn. 1966); Hill (1976), p. 1291, Grunfeld (1992), p. 498, and Barbas (2012), p. 1015.

[25] Kwall (1985), p. 9 [fn. 35] and Swack (1998), p. 402.

3.3.1 Falsehood and Fictionality

In contrast to the genres of biographies or documentations, fictional stories do not match with the category of false or untruthful statements.[26] The reason for this is quite evident: Seen from an objective perspective, factual matters described in novels and short stories may typically be untrue.[27] In keeping with the readership's expectation and understanding, however, the author does not intent to deliver any factual report to anyone by means of his or her story.[28] If fictional stories hence do not even purport to express literal truth, they consequently cannot put any person into a false light. And for this reason, the objective falsehood of fictional stories does not legally matter.

Let's clarify this by the example of *Frank Schätzing's* science-fiction novel *The Swarm – A Novel of the Deep*. This book tells the story of the clash between mankind and an unidentified intelligent life form living in the world's oceans. The author *Frank Schätzing* put an enormous effort in researching his story's scientific basis and *Gerhard Bohrmann* – a geologist previously employed at the *Helmholtz Centre for Ocean Research* in *Kiel* – was his main scientific consultant. To give thanks for *Gerhard Bohrmanns* great support, *Frank Schätzing* created a story character of the same name and the same profession and let him experience a certain number of thrilling adventures, such as a fight against mutant sharks.

All these adventures certainly didn't have anything to do with *Gerhard Bohrmann's* real life experiences. One hence could say that *Frank Schätzing* put *Gerhard Bohrmann* into a false light and consequently caused serious harm on *Gerhard Bohrmann's* personal reputation. However, this solution of the *Schätzing-Bohrmann*-situation intuitively lacks persuasiveness. Any experience made by the story character named *Gerhard Bohrmann* is presented in an obviously fictional context. In other words: *Frank Schätzing* didn't ever purport that *The Swarm* described real life experiences of the real life *Gerhard Bohrmann*. The real life *Gerhard Bohrmann* thus wasn't only not put in a false light in *The Swarm*, but rather he wasn't put in any light at all.

[26] Wilson (1981), p. 28.

[27] Wilson (1981), p. 28, Schauer (1985), p. 235, and Prechtel (1994), p. 193.

[28] BVerfGE 119, 1, 28; OLG Stuttgart NJW 1976, 628, 629; OLG Hamburg NJW 2009, 1510, 1512 f.; OLG München BeckRS 2013, 7462; Klass (2014), recital 134, Silver (1978), p. 1077, Wilson (1981), p. 28, Prechtel (1994), p. 193 f., Savare (2004), p. 154, Gilbert (2004), p. 859, and consenting Katzenmeier (2012), recital 211; see also Leopold v. Levin, 45 Ill.2d 434, 445 (1970); Here, the motion picture, play and novel, while 'suggested' by the crime of the plaintiff, were evidently fictional and dramatized materials and they were not represented to be otherwise. They were substantially creative works of fiction and would not be subject to the 'knowing or reckless falsity' or actual malice standards discussed in Time, Inc. v. Hill, where the court considered an untrue but supposedly factual magazine account; apparently differing LG Frankfurt/Main ZUM 2009, 308, 322; Arnot (2007), p. 1862.

3.3.2 Fictionality and Disclosure of Private Facts

For the same reason, neither the theory of illegal disclosure of facts belonging to a person's private sphere nor the theory of breaking confidentiality applies to fictional matters. Both theories require that the disseminated fact is deemed to be true.[29] Obviously, this condition is not met if the author himself claims the story and its elements to be fictional: what is fictional cannot be disclosed nor can it be subject to confidentiality.

3.3.3 Fictionality and Abusive Criticism

Abusive criticism of another person by means of literary art is principally possible. In a fictional context, however, such a case is not at hand unless two conditions are met: Firstly, a significant proportion of the readership must interpret the story as an allegory or a parable about the living person behind the story character. Moreover, the story needs to be told for the sole purpose of vexation. It is yet clear that both requirements can only be satisfied if the readership connects the allegory to the living model.[30]

4 The Creation of Specific Defamation Rules Relating to Literary Art in the German *Federal Constitutional Court's* Case Law

4.1 Prerequisite: The Recognizable Real-Life Person

The recognizability of the real-life model behind a story character is therefore a prerequisite for any harmful effect that the story might have on the real life person's general right to respect.[31] Therefore, when the German *Federal Constitutional*

[29] Hill (1976), p. 1291, Scheller (2015), p. 579, and Meltz (2015), p. 3452.

[30] BVerfGE 30, 173, 195; 119, 1, 24 f.

[31] This is consented under German and under U.S-American Law as well: KG NJW-RR 2004, 1415; OLG Hamburg NJW-RR 2007, 1268; OLG München NJW-RR 2009, 477, 479; Rixecker (2012), Recital 183, von Becker (2003) p. 676; idem, NJW 2007, 662, 663; idem, ZUM 2008, 265, 267; Wanckel (2006), p. 579, Hahn (2008) p. 100, and Gostomzyk (2008), p. 739; Schwarz/Hansen, ZGE 2 (2010), 19, 36; Loschelder (2013), p. 18; see also BVerfG ZUM-RD 2008, 113; GRUR-RR 2008, 206, 207; BGH GRUR 2009, 83, 85; OLG Frankfurt/Main ZUM 2009, 952, 955; Geisler v. Petrocelli, 616 F.2d 636, 640 (C.A.N.Y., 1980); Ruzicka v. Conde Nast Publications, Inc., 999 F.2d 1319, 1322 (C.A.8 [Minn.], 1993); Kirch v. Liberty Media Corp., 449 F.3d 388, 399; (C.A.2 [N.Y.], 2006); Clare v. Farrell, 70 F.Supp. 276, 277 f. (D.C.MINN. 1947); Dworkin v. Hustler Magazine, Inc., 668 F.Supp. 1408, 1417 (C.D.Cal., 1987); Naantaanbuu v. Abernathy, 746 F.Supp. 378, 380 (S.D.N.Y., 1990); Mitchell v. Globe Intern. Pub., Inc., 773 F.Supp. 1235,

Court creates specific defamation rules relating to literary art, it firstly develops some criteria with which the real-life person shall be identifiable.

The starting consideration is more or less evident: even a clearly fictional story cannot fundamentally avoid that a real-life person having inspired the author may be identifiable to the reader. Otherwise, neither the autobiographical novel nor the biographical novel could exist as a literary genre. After weighing the interests of the conflicting parties, the German *Federal Constitutional Court* presents the following definition: recognizability is given if a more or less large circle of acquaintances that are familiar with the circumstances feel compelled to make the identification.[32] This normally presupposes that there is a large accumulation of identifying factors.[33]

Having developed this definition, the German *Federal Constitutional Court* applied it to the *Esra* case and concluded that *Ayse Romey* was identifiable as the real-life person behind the story character *Esra*. The fact that both *Ayse* and *Esra* were winners of the 1989 Federal Film Prize Award was one of the key factors giving rise to this conclusion.[34] In the prior *Mephisto* case, the story character *Henrik Höfken* is described to have made the same career in the fine arts sector during the Third Reich as the real actor *Gustav Gründgens* did. Because of this corresponding identifying factor, *Gustav Gründgens* was considered to be represented by *Henrik Höfken*.[35] In *Moon Shine Light, Moon Shine Bright*, by contrast, the *United States Court of Appeals for the Fourth Circuit* discovered important dissimilarities as to the characters' ages as well as to their employment situation. Due to these dissimilarities, the fictional *Esco Brooks* could not be considered as a portrayal of the real-life *Larry Middlebrooks*.[36]

1238 f. (W.D.Ark. 1991); Netzer v. Continuity Graphic Associates, Inc., 963 F.Supp. 1308, 1324 (S.D.N.Y., 1997); Polsby v. Spruill, 1997 WL 680550 (D.D.C., 1997), *8; Muzikowski v. Paramount Pictures Corp., 2001 WL 1519419 (N.D.Ill., 2001), *2; D.F. ex rel. Finkle v. Board of Educ. of Syosset Cent. School Dist., 386 F.Supp.2d 119, 130 (E.D.N.Y., 2005); Duncan v. Universal Music Group Inc., 2012 WL 1965398 (E.D.N.Y., 2012), *4; Seale v. Warner Bros. Entertainment, 2014 WL 1219008 (W.D.Tex., 2014), *2; Hill (1976), p. 1299, Wilson (1981), p. 32 f., Silver (1978), p. 1084, and Carlson (1983), p. 391; Rich and Brilliant (1986), p. 6; Anderson (1986), p. 383 f.; in different contexts see also Chau v. Lewis, 771 F.3d 118, 129 (C.A.2 [N.Y.], 2014); Biro v. Conde Nast, 883 F.Supp.2d 441, 456 (S.D.N.Y., 2012); Harris v. Queens County Dist. Attorney's Office, 2012 WL 6630034 (E.D.N.Y., 2012), *9.

[32] BVerfGE 119, 1, 26; see also OLG Karlsruhe NJW-RR 2012, 820, 821; Söder (2015), recital 75.

[33] BVerfGE 119, 1, 26; see also OLG Karlsruhe NJW-RR 2012, 820, 821; Söder (2015), recital 75.

[34] BVerfGE 119, 1, 26.

[35] BVerfGE 30, 173, 198.

[36] Middlebrooks v. Curtis Pub. Co., 413 F.2d 141, 143 (C.A.S.C. 1969).

4.2 *Serious Impairment on the Real-Life Model's Personal Reputation*

The artistic freedom, however, covers the novelist's right to create a story character upon a real-life person.[37] From that, it follows that recognizability – as such – doesn't yet infringe on the real-life model's personal reputation.[38] In order to adjust for this, the German *Federal Constitutional Court* and its proponents moreover require the story or some of its elements to seriously impair the real-life model's right of personality.[39] The given impairment must be so serious that the author's artistic freedom has to take second place.[40] This second requirement might *prima facie* seem appropriate. However, it isn't clear at all how the necessary seriousness should be measured or otherwise determined. Stating that the seriousness of the impairment depended on the severity of the impairment[41] even the *Federal Constitutional Court* itself seemed to be at something of a loss with regard to this issue. The question as to whether or not an impairment is serious enough to infringe on another one's personal reputation, finally, has to be weighed up individually, taking into account the particular circumstances of the case.[42]

Since the *Federal Constitutional Court's* "impairment-requirement" remains way too abstract, let's take a look at several cases in order to get an impression of how the conflicting interests are concretely weighed up.

4.2.1 The *Esra* Case: Illegal Disclosure of Private Facts

As noted above, the real *Ayse Romey* was considered to be represented by the female protagonist in *Esra*. Due to the realistic and detailed account of events originating from the immediate experiences of the author, the German *Federal Constitutional Court* further concluded that the novel seriously affected on *Ayse Romey's* personality rights.[43] According to the Court, this serious impairment occurred particularly through the exact account of some of the most intimate details of a woman who was clearly recognizable as having really been an intimate partner

[37] BVerfGE 30, 173, 190; 119, 1, 28; OLG München NJW-RR 2009, 477, 478; LG Leipzig ZUM 2008, 617, 618; Klass (2014), recital 134, Obergfell ZUM 2007 p. 913, and Loschelder (2013), p. 19.

[38] BGH NJW 2005, 2844, 2846; 2008, 2587, 2588; 2009, 751, 753; Klass (2014), recital 135, Katzenmeier (2012), recital 211; Söder (2015), recital 144.

[39] BVerfGE 119, 1, 28; BGH NJW 2005, 2844, 2847; 2008, 2587, 2588; Klass (2014), recital 262, Katzenmeier (2012), recital 211, and Söder (2015), recital 116.

[40] BVerfGE 119, 1, 27.

[41] BVerfGE 119, 1, 27.

[42] BVerfGE 30, 173, 195; 119, 1, 29; Klass (2014), recital 262; Katzenmeier (2012), recital 211; Schwarz/Hansen (2010), p. 45; Reber (2010), p. 25.

[43] BVerfGE 119, 1, 34.

of the author.[44] This amounted to a violation of *Ayse Romey's* intimate sphere.[45] In arguing so, however, the *Federal Constitutional Court* simply applies the general rules either on the illegal disclosure of private facts or on the breach of a confidential relationship. That is to say, any specific legal framework relating to the conflict between the author's artistic freedom and his protagonist's rights of personality actually isn't clear.

However, the solution given by the *Federal Constitutional Court* is methodically problematic. The theory of illegal public disclosure of private facts requires that the facts disclosed are allegedly true.[46] Vice versa, this theory does not apply to fictional matters. Therefore, the *Federal Constitutional Court's* solution is consistent only under the following condition: that the intimate scenes in the novel must not be interpreted as matters of fiction, but rather as a factual report of *Ayse Romey's* true and real intimate affairs.[47] The *Federal Constitutional Court's* order, nonetheless, lacks any explicit rationale for this interpretation being made in the *Esra* case. Apparently, the Court considers sufficient the mere fact that the real-life person behind the story character is recognizable.

In arguing so, the *Federal Constitutional Court* obviously disregards the general fictionality of literary works, such as novels and short stories.[48] Remember the example of *Gerhard Bohrmann* and his fight against mutant sharks in *The Swarm*. In this case, the real *Gerhard Bohrmann* was clearly identifiable. Nevertheless, any of the readership understood very well that the story character's fight against mutant sharks was pure fiction. Therefore it must be concluded that despite the contrary practice of the *Federal Constitutional Court*, the mere recognizability of the portrayed real-life person cannot turn a fictitious story into a factual report.

4.2.2 The *Mephisto* Case I: Falsehood

Vice versa, the same error already occurred some 36 years before, when the German *Federal Constitutional Court* decided upon the *Mephisto* case. Comparing the biographies of the fictitious *Henrik Höfken* and the real *Gustav Gründgens*, the *Federal Constitutional Court* found out that some of the events described in the novel had never happened in reality. *Henrik Höfken*, for example, was in an

[44] BVerfGE 119, 1, 34.

[45] BVerfGE 119, 1, 34.

[46] Haynes v. Alfred A. Knopf, Inc., 8 F.3d 1222, 1230 (C.A.7 [Ill.], 1993); Tyne ex rel. Tyne v. Time Warner Entertainment Co., L.P., 204 F.Supp.2d 1338, 1344 (M.D.Fla., 2002).

[47] BVerfGE 119, 1, 40 (differing opinion of Judges Hohmann-Dennhardt and Gaier).

[48] Ironically, the *Federal Constitutional Court* underlines the fictionality of literary art at the same time: „In this connection, a literary work which is identifiable as a novel should therefore initially be seen as work of fiction that does not purport tob e factual. Ifo ne did not assume that a literary text was intended to be fictional, one would ignore the special qualities of a novel as a work of art and thus the requirements of artistic freedom." (BVerfGE 119, 1, 28). The Court's order hence is somewhat self-contradictory.

intimate relationship with a chorus girl of African origin that he handed over to the Gestapo after the Nazis came to power. *Gustav Gründgens*, however, never had been in an at least comparable relationship. Therefore, the *Federal Constitutional Court* concluded that *Mephisto* contained false facts about the life of *Gustav Gründgens*. Moreover, those false facts had an extremely negative connotation. Due to this circumstance, *Gustav Gründgens'* (postmortem) personal rights were affected seriously enough to prohibit the publication and the further dissemination of the novel.[49]

Also in this situation, the *Federal Constitutional Court* legally treats any incident described in the book as if it was a description of purportedly literal truth. The only justification the Court gives for this conclusion is that the *Gustav Gründgens* was clearly recognizable to be the living model behind the story character *Henrik Höfken*. This reasoning disregards the character of literary art.

4.2.3 The *Mephisto* Case II: Abusive Criticism

The Federal Constitutional Court's Reasoning

However, the *Federal Constitutional Court* gave a second reason why the story of *Mephisto* should seriously harm on *Gustav Gründgens'* personal reputation: The story character *Henrik Höfken* was portrayed in a very negative light. Since *Henrik Höfken* was only representative of the real *Gustav Gründgens*, the novel was nothing more than an abusive criticism of *Gustav Gründgens* and written for the sole purpose of vexation.[50] After the Court, this allegedly abusive criticism caused a serious impairment of *Gustav Gründgens'* personal rights too.

A Comparison with the General Rules on Defamation

Unfortunately, the *Federal Constitutional Court* is once again adopting a problematic stance. To show this, a comparison between the Court's reasoning and the general provisions on defamation shall preliminarily be performed. Let us keep in mind that due to the needs of free speech public figures principally have to withstand any negative criticism. Within this legal context, even heavy and polemic wording is appropriate except upon proof that the criticism is made for the sole purpose of vexation. For the sole purpose of vexation, however, a criticism is only made if the criticism lacks any serious concern.[51]

[49] BVerfGE 30, 173, 198.

[50] BVerfGE 30, 173, 199.

[51] BVerfGE 82, 272, 284; 85, 1, 16; 93, 266, 294; BVerfG NJW 1991, 95, 96; 1991, 1475, 1477; 1993, 1462; 1993, 1845, 1846; 1994, 2413, 2414; 1999, 204, 206; 2001, 3613, 3614; 2003, 961, 962; 2003, 1109, 1110; 2003, 3760; 2004, 590, 591; 2004, 590, 591; 2005, 3274; 2006,

One now might presume that *Klaus Mann* didn't criticize *Gustav Gründgens* by means of a fictional novel, but rather by means of a piece of fact-based literature, such as a newspaper article or a biography. *Klaus Mann's* criticism of *Gustav Gründgens* being presented in such a forum would be legally assessed under the general provisions on defamation as developed in the free speech context. Then, it has to be taken into account that *Gustav Gründgens* cooperated to a certain extent with the Nazi regime in order to promote his career in the fine arts sector. Against this backdrop, it would not be an exaggeration to say that *Gustav Gründgens* was at least an ambiguous figure. From that it further follows that any harsh criticism of *Gustav Gründgens* picking up on his role and his comportment during the Third Reich undoubtedly was granted protection under Art. 5 subsection 1 of the German Basic Law.

This leads to the following conclusion: if one applies this general provision from the free speech context to the *Mephisto* case, any inappropriate abusive criticism obviously is not to be found. If one instead applies the German *Federal Constitutional Court's* specific legal regime relating to literary art, the substantially identical criticism will be prohibited.

Evaluation of this Inconsistency

The comparison heretofore performed gives rise to a certain legal inconsistency. However, the showing of this inconsistency does not yet prove that the German *Federal Constitutional Court's* solution of the *Mephisto* case is wrong. Rather, the Court would be right, if the author of fictional stories was granted less freedom of expression than the author of fact-based articles or books.

But this is not the case. Pursuant to Art. 5 subsection 3 of the German Basic Law, artistic freedom is guaranteed principally without any restrictions.[52] More precisely: artistic freedom is only restricted by direct constitutional barriers.[53] By contrast, free speech as well as the freedom of the press find their limits in the provisions of general laws, in provisions for the protection of young persons, and in the right to personal honor (Art. 5 subsection 2 of the German Basic Law). Therefore, the scope of artistic freedom at least is not narrower than the scope of

3769, 3771; 2008, 2424, 2425; 2009, 749, 750; 2009, 3016, 3017; 2012, 1643, 1644; 2012, 3712, 3713; 2014, 3357, 3358; NJW-RR 2000, 1712; 2001, 411, 412; 2004, 1710, 1712; 2007, 840, 841; 2010, 204, 206; GRUR 2008, 81, 83; ZUM 2013, 793, 794; Beater (2007), recital 1618, Soehring and Hoene (2013), § 20 recital 9a, Wenzel et al. (2003), recital 5.101, and Hager (1996), p. 207.

[52] BVerfGE 30, 172, 191; 67, 213, 228; Bethge (2014), recital 195, Odendahl (2014), recital 44, Wittreck (2013), recital 53, Kloepfer (2010), § 62 recital 52, and Soehring and Hoene (2013), § 20 recital 13.

[53] BVerfGE 30, 173, 193; 67, 213, 228; 83, 130, 39; BVerfG NJW 2001, 598, 599; Kempen (2015), recital 176, Bethge (2014), recital 198, Odendahl (2014), recital 44, Wittreck (2013), recital 54, Kloepfer (2010), § 62 recital 53, Soehring and Hoene (2013), § 20 recital 15, and Bismark (1985), p. 251.

free speech. From that, it further follows that there is no justification provided as to why a criticism presented by means of literary art should be subject to stricter criteria than the substantially identical criticism presented by means of a newspaper article, a documentary or any other fact-based contribution.

5 The American Solution and Its Transferability to German Law

One hence can state that the *Federal Constitutional Court* has failed to create an internally consistent defamation regime for fictional literary works. Turning to the American attempts in resolving the conflict discussed in this chapter, however, one discovers a very pragmatic and, at least in the outcome, convincing approach.

5.1 Fact and Fiction Under American Defamation Law

Under American law, novels and short stories are subject to the general provisions on defamation if a significant proportion of the recipients understand the purportedly fictional "matter to be essentially a factual presentation of truths" about the real-life model behind the story.[54] Therefore, the proper distinction between matters of fact and matters of fiction is the core problem in dealing with the conflict between the author's artistic freedom and his novelist's rights of personality.[55]

In order to concretize the necessary distinction between fictional and factual matters, some say that a reasonably aware reader must feel compelled to understand the purportedly fictional matter as a matter of fact.[56] Others argue to rely on the writer's statement and the critics' opinions.[57] Finally, some other scholars focus on whether the story prompted a conviction in the reader.[58] A conviction would occur if the alleged defamatory statement inspired a belief in its audience.[59] Notwithstanding the difference in the wordings, all those proposals have one aspect in common: due to artistic freedom, relatively high thresholds must be overcome

[54] Hill (1976), p. 1311.

[55] Wilson (1981), p. 44.

[56] People on Complaint of Maggio v. Charles Scribner's Sons, 205 Misc., 818, 823 (N.Y.Mag.Ct. 1954); Wheeler v. Dell Pub. Co., 300 F.2d 372, 376 (C.A.Ill. 1962); Middlebrooks v. Curtis Pub. Co., 413 F.2d 141, 143 (C.A.S.C. 1969); see also Masson v. New Yorker Magazine, Inc., 501 U.S. 496, 512 f. (1991); Wright v. R. K. O. Radio Pictures, 55 F.Supp. 639, 641 (D.C. MASS. 1944); Landau v. Columbia Broadcasting System, 205 Misc. 357, 362 (N.Y. Sup. 1954).

[57] Wilson (1981), p. 44.

[58] Smirlock (1983), p. 521; see also Savare (2004), p. 162 f.

[59] Smirlock (1983), p. 521.

unless a novel can be understood as a factual presentation in the aforementioned sense.[60] If these standards are applied to *Esra*, *Mephisto* and *Moonshine Light, Moonshine Bright*, none of those are factual. Despite some references to events that had occurred in the real world, the readership would certainly understand that all three stories are pieces of fictional literary art. Merely in literary genres characterized by blurring lines between fact and fiction, such as the so called docu-fiction or faction, one might come to a different conclusion.

5.2 *Defamatory Statements in a Non-factual Context*

Let us now slightly modify the example of *Frank Schätzing* and *Gerhard Bohrmann*. It may be supposed that *Frank Schätzing* did not present *Gerhard Bohrmann* in a polite way, but rather exposed him to ridicule. The readership still understands *Gerhard Bohrmann's* adventures with the mutant sharks as matters fiction. That's why a typical defamation case is not given in this situation.

Nevertheless, the author is not necessarily insulated from any accusation of defamation in such cases. At least some scholars argue that such subterfuge should not be protected and that those who pervert the fiction label in order to defame others intentionally should be punished.[61] Substantially, one herein finds an argument against the author circumventing the law.

5.3 *The Transfer to German Law*

The results found in the American context may now be transferred to German Law.

5.3.1 The First Step: The Identifiable Real-Life Person

The first step consists in considering if the real-life person behind the story character is identifiable. For this purpose, the German *Federal Constitutional Court's* acquaintances-standard can be applied without any problems. If any living model isn't identifiable under that standard, there isn't any potentially affected

[60] However, there is a certain number of American court decisions that contain the same error as the German Federal Constitutional Court's decisions. One example is Bindrim v. Mitchell (92 Cal. App.3d 61 [Cal.App.2.Dist. 1979]). Despite any dissimilarities, the 2nd District Court of Appeal of California held that the real-life person behind the story's protagonist was recognizable. From this recognizability, the court further follows, that any event described in the book and relating to the alleged real-life model were purportedly literal truth and thus were subject to the proof of the truth.

[61] Savare (2004), p. 161.

person. From that, it further follows that there aren't any specific defamation rules to be applied in such cases.

5.3.2 The Second Step: The Factual Report Labeled as Fiction

If identifiability is given, one will proceed to the next step. There it will be questioned whether the incidents described in a fictional-labeled story actually are purportedly true. The answer is only in the affirmative if a significant proportion of the readership is convinced of the statement's literal truth.[62] If this is the case, there isn't actually any fictionality to be dealt with and the general provisions on defamation apply. That means that the affected real-life person is entitled to remedies if the stated fact is false or if it is subject to confidentiality. This type of cases hence isn't resolved on the basis of any specific defamation rules either.

5.3.3 The Remaining Cases: Parables and Allegories

The remaining cases are characterized by the reader clearly identifying the real-life person behind the story's protagonist as well as clearly recognizing that the story is a product of the author's fantasy. No legal calamities will arise from the very most number of such cases. However, that doesn't mean that the author is granted absolute immunity from any accusation of defamation. As we have noted above, at least some American scholars stick with defamation if the author uses matters of fiction in order to insult the real-life person behind the story character.

The equivalent in German defamation law most likely is the abusive criticism rule. This rule applies to fictional matters if a significant proportion of the readership interpret the story as a parable or an allegory about the real-life person behind the story character. Such an allegory being discreditable and made for the sole purpose of vexation is not granted any protection under Art. 5 of the German Basic Law and hence seriously infringes on the real-life model's personal reputation.[63] The control question in this context is whether or not the author could legally conduct the same criticism by means of a biography, a documentation or a newspaper article.

Thus, we can state that also this last type of cases actually is governed by the general provisions on defamation. That further means that there are no specific defamation rules on fictitious literary work at all.

[62] See Smirlock (1983), p. 541.

[63] Hill (1976), p. 1310.

6 Summary

Summarizing the core results, I will now conclude the chapter. A novelist principally is allowed to model a story character upon a real-life person. Notwithstanding that, the living model's right of personality has to be considered. Due to a novel's fictionality, the torts of libel and slander do not easily apply to such cases. The German *Federal Constitutional Court* hence tried and – it has been suggested – failed to create a specific defamation regime for fictional literary works. A comparison between German and American law on these issues shows that there actually is no need for any specific legal framework related to the conflict of the author's artistic freedom and his protagonist's rights of personality. Subject to the following conditions, such conflicts can be governed by the general rules on defamation:

> The real-life person behind the story character must be identifiable. If a significant proportion of the readership interprets the story as factual report about the real-life person, there is actually no fiction at hand. Rather, fiction is only used as a misleading label. Hence, the torts of libel and slander as well as the theories of illegal disclosure of private facts and breach of confidentiality directly apply. If a significant proportion of the readership does not interpret the story as factual report, but as a parable or an allegory about the real-life person, the abusive criticism rule is potentially applicable. This is in the affirmative if the story about the real-life person is told for the sole purpose of vexation. In any other case the living model's right of personality takes second place behind the author's artistic freedom.

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Part II
The Perspective of the Regulator

Delayed Leniency Applications: The Unfortunate But Predictable Outcome of the Flexible Leniency Policies Under the Chinese Antimonopoly Law

Steven Van Uytsel and Ying Bi

Contents

Abstract Leniency has become important for the enforcement of competition law against illegal cartels. When the Chinese Anti-Monopoly Law was drafted, the possibility to give lenient treatment to an infringer coming forward with information on the illegal cartel was inscribed in Article 46. In their elaboration of this general leniency provision, NDRC and SAIC created two leniency policies, one of price related and one for non-price related cartels. These leniency policies empowered the enforcement agencies to take decisions almost as they like.

Flexible leniency policies, as experience in the United States and the European Union has shown, do not always lead to a favourable outcome in terms of detecting cartels independent from investigations from enforcement agencies. The European experience suggests that a flexible leniency policy will still trigger leniency applications, but that they will always follow the investigations by another enforcement

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agency. The Japanese experience has taught that this outcome may even not be achieved by a clear and transparent leniency policy. Despite that outcome, the Japanese experience shows that the leniency applications will follow almost directly the foreign investigations. Combining these experiences, the chapter suggests that the Chinese leniency policies will be used. However, due to the uncertainty, the leniency applications will be delayed until it is almost certain that the firm will be punished.

Keywords Leniency • Anti-cartel enforcement • Immunity and reduction • Delayed application • NDRC • SAIC

1 Introduction

Over recent years, leniency policies have become the new religion of anti-cartel enforcement agencies.[1] Since the United States (US) made successful progress with the enforcement of their competition laws against international cartels due to a leniency policy,[2] several other states followed the US policy. Not only established competition law regimes decided to adopt a leniency policy, also countries that newly engaged with this field of law opted for the possibility to create such a policy.[3] One such state is China. China adopted its competition law in 2007 under the title, Anti-Monopoly Law of the People's Republic of China (CAML).[4] Article 46 Paragraph 2 of the CAML provides the possibility of lenient treatment and gives the competence to the enforcement agencies in charge of the anti-cartel legislation, National Development and Reform Commission (NDRC)[5] or State Administration for Industry and Commerce (SAIC)[6] respectively, the task of working out a leniency policy.

Three years after the adoption of the CAML, NDRC and SAIC implemented Article 46 Paragraph 2 CAML and devised two sets of leniency policies: Article 14 of Procedural Rules on Administrative Enforcement of Anti-price Monopoly (NDRC's Leniency Policy)[7] and Article 11, 12 and 13 of the Procedural Rules for Prohibition by Administrative Authority for Industry and Commerce against

[1] See Beaton-Wells and Tran (2015) and Beaton-Wells (2014).

[2] See Griffin (2003).

[3] See for an overview of countries with a leniency policy ICN (2009), pp. 17–20.

[4] Anti-Monopoly Law of the People's Republic of China, adopted at the 29th Meeting of the Standing Committee of the National (30 August 2007). For a text in Chinese and English, see Harris et al. (2011), pp. 373–394.

[5] See Harris et al. (2011), p. 273.

[6] See Harris et al. (2011), p. 277.

[7] NDRC (2010b). For a text in Chinese and English, see Harris et al. (2011), pp. 461–469.

Monopoly Agreements (SAIC's Leniency Policy).[8] The NDRC's Leniency Policy would apply to price-related cartels,[9] while the SAIC's Leniency Policy would apply to non-price related cartels.[10] Both leniency policies are characterized by a lot of flexibility. An applicant for leniency under either the policy of the NDRC or SAIC is unable to predict whether they will be treated leniently and, if so, how leniently. Both the NDRC and SAIC have conceptualized their respective leniency policies in such a way that they have both retained a significant degree of flexibility.

Flexibility inside leniency policies may offer the enforcement agencies a way to increase the degree of fairness in their decisions based upon how and to what extent the illegal cartel activity was reported. The open and general terms allow an appreciation margin in favor of firms that are more cooperative or provide better information. It could also allow for depreciating the applications of firms that have obviously taken a leading role in the cartel formation. To achieve these fairness objectives, NDRC's and SAIC's Leniency Policies still have to be effectively implemented. This chapter will assess whether such an implementation is feasible, especially given the high degree of flexibility, and suggest how the NDRC and SAIC might address the identified shortcomings. To assess the impact, this Chapter will rely on leniency policies in the US, the European Union (EU) and Japan. Each of these jurisdictions has experimented with flexibility in its leniency policy. Most of them have retracted from that experiment, though.

The Chapter is structured as follows. Section 2 will introduce the different forms of flexibility that have been part of the leniency policies of the US, the EU and Japan. To explain this, a short overview will be given to various leniency policies that have been in place in the US, the EU and Japan and that have had a different kinds and degrees of flexibility. These policies will be compared with the Chinese Leniency Policies in Sect. 3. To understand the Chinese Leniency Policies, the relevant articles in the CAML related to leniency will be explained before the implementation of the leniency provisions by the NDRC and SAIC. Section 4 highlights the enforcement results of the flexible leniency policies in the US, the EU and Japan, in order to make a prediction of the Chinese Leniency Policies. The predictions will be tested with data available on the use of the Chinese Leniency Policies. Before concluding in Sect. 6 that the Chinese Leniency can be improved, Sect. 5 will formulate possible changes to the Chinese Leniency Policies.

[8] SAIC (2010). For a text in English, see Linklaters (2010).

[9] See Xue and Yang (2013), p. 86.

[10] See Xue and Yang (2013), p. 86 and Yang (2013), p. 377.

2 Leniency Policies and Flexibility

2.1 Flexibility Within Leniency Policies

2.1.1 Examples of Flexibility in Leniency Policies in the United States, the European Union and Japan

The use of leniency policies in the enforcement of competition law dates back to 1978, the year in which the US adopted its first Corporate Leniency Policy (the 1978 Corporate Leniency Policy).[11] This leniency policy was only able to attract 17 applications in a period of 15 years. Only 10 applications qualified for immunity. Most of the successful applications, 6 in total, were after 1987, the year in which the United States adopted its leniency policy for individuals.[12] The relatively low application rate led the enforcement agencies to adjust the leniency policy in 1993 (the 1993 Corporate Leniency Policy).[13]

The European Union adopted its first leniency policy in 1996: the Commission Notice on Immunity from Fines and Reduction of Fines in Cartel Cases (the 1996 Leniency Notice).[14] The 1996 Leniency Notice was heavily criticized, due to which an amendment followed in 2002 (the 2002 Leniency Notice).[15] This amendment had as its main purpose the elimination of the discretionary powers of the Commission. To further clarify general norms, a last change occurred in 2006 (the 2006 Leniency Notice).[16]

Japan, in part inspired by the claims of success of the respective leniency policies in the above-mentioned jurisdictions, included rules on leniency (the Japanese Leniency Program) in the Japanese Antimonopoly Law (AML) in 2005.[17] The amendment to the AML took effect in 2006. A small correction to the Japanese Leniency Program, relating to the number of eligible applicants and joint applications, was implemented in 2009.[18]

Each of the leniency policies introduced above has a degree of flexibility for the actors involved in the implementation of the policies. These actors are the firms engaging in illegal cartel activity and the competition enforcement agencies. In the implementation of the leniency policies, each of these actors can enjoy a degree of flexibility. Firms have a choice to engage with a leniency policy. If a decision is made in favor of applying for leniency, the firm has to decide on the timing of the

[11] See Department of Justice (1978).

[12] See Kobayashi (2001), pp. 728–731. The leniency policy for individuals was revised in 1994. See Department of Justice (1994).

[13] See Department of Justice (1993).

[14] See European Commission (1996).

[15] See European Commission (2002).

[16] See European Commission (2006).

[17] See Article 7-2 AML.

[18] See Article 7-2 (13) AML; See for a summary discussing the changes, JFTC (2009).

application, the kind of the application, and the degree of cooperation. Competition enforcement agencies have been given the power to decide on the acceptability of a leniency application, the value of the information, the degree of leniency, and criminal referral.

2.1.2 Leniency Policies and Flexibility for Firms

Firms, confronted with the participation in an illegal cartel, have the option to apply for leniency. It may be odd to characterize this as flexibility in the law. However, it is a necessary flexibility. A firm cannot be forced to apply for leniency when it internally detects the participation in cartel activity. A firm can only apply for leniency when it has been able to assess its ability to apply for leniency.[19] This is a complex and potentially lengthy process in which the board needs to confirm whether there is sufficient information. This may be problematic given the efforts of the employees to hide the documentation on the cartel activity. It has been well documented that employees go to great lengths to keep the cartel activity secret. The strategies followed can include, but are not limited to, the use of private email accounts, unregistered mobile phones, destroy paper trails, meet at hotel lobbies or airport lounges, or covering up costs related to cartel meetings as other expenses. In such circumstances, the board will need the assistance of its employees, be it current or former, to successfully collect a sufficient amount of information. At this point, a "misalignment in terms of incentives between the board (acting on behalf of the company) and the employees"[20] might occur. Various reasons, rational or irrational, could make employees let their personal interest prevail. This may lead to the destruction, concealment or falsification of documents, something that in most jurisdictions can jeopardize the leniency application.

Having taken the hurdle of gathering information, the 2006 Leniency Notice and the 1993 Corporate Leniency offer firms the flexibility to choose between different application tracks. On the one hand, firms would have the possibility to apply for leniency by proving the existence of an infringement.[21] On the other hand, the firm could apply for leniency by providing information enabling a dawn raid.[22] The idea behind this flexibility is to allow any of the cartel members to apply for leniency. If all applicants had to prove the infringement, it would be possible that a cartel participant, not at the core of the organization, lacks sufficient information and thus would not be able to defect the cartel. In other words, this kind of stipulation would be potentially beneficial for the cartel participants that are not operating the cartel. Other jurisdictions, such as Japan and the US, do not offer this kind of flexibility, but require the submission of available information.[23] The enforcement agency

[19] For a detailed description, see Stephan and Nikpay (2014), pp. 16–19.

[20] Stephan and Nikpay (2014), p. 19.

[21] See Department of Justice (1993), par. A and B.

[22] See European Commission (2006), par. 8.

[23] See Van Uytsel (2008), pp. F31–F36.

would then further guide the applicant in the construction of the cartel story, with the risk that sufficient evidence for a conviction will not be collected.

The 2006 Leniency Notice and the Japanese Leniency Program offer the cartel participants the flexibility to apply for immunity or for reduction.[24] Immunity is usually limited to the first successful leniency applicant, while reduction is available for subsequent successful leniency applicants. This flexibility in the law allows firms to defect the cartel even if they are not the first applicant. Coming forward in a subsequent leniency applicant may be easier in one jurisdiction compared to another. In Europe, for example, a subsequent leniency applicant has to provide information with significant added value to the Commission.[25] In Japan, to the contrary, the subsequent leniency applicant has to submit information of which they are aware.[26] Only the fourth and the fifth applicant have to submit information that the JFCT has not been able to ascertain.[27]

Once a leniency application has been submitted, the flexibility for the firm becomes limited. The firm will have to comply with a fixed set of conditions in order to maintain its position in the leniency queue.[28] These conditions can vary from jurisdiction to jurisdiction, but the often-returning conditions are the following: terminating the illegal activity, refraining from disclosing the leniency application, continuously cooperating with the enforcement agency and not falsifying the information. In principle, the firm has control over the process of complying with these conditions. However, the firm is composed out of individual employees. These employees may, for one reason or another, not be willing to cooperate with the leniency application.[29]

2.1.3 Leniency Policies and Flexibility for Enforcement Agencies

The early leniency policy of the US gave also flexibility to the enforcement agency, the Antitrust Division of the Department of Justice. The 1978 Corporate Leniency Policy allowed firms to apply for immunity in return for unknown information on the illegal cartel. The firm had also to comply with conditions, such as to provide the information with candor and completeness, terminate the participation in the carte, continue to assist the Antitrust Division of the Department of Justice in their investigation, and to offer restitution to any injured parties, if possible. Firms that coerced others to participate in the cartel or that were the originator or leader were

[24] See European Commission (2006), section II and III; Article 7-2 (10), (11), and (12) AML.

[25] See European Commission (2006), par. 24.

[26] See Article 7-2 (11); JFTC (2005).

[27] See Article 7-2(11) (iii) of the AML.

[28] See Department of Justice (1993), par. A (2), (3), (4), (5), (6) and par. B (2), (3), (4), (5), (6), (7), European Commission (2006) par. 12, 13, and 24; Article 7-2 (10) (ii), (11), (12), (16), (17) AML, and JFTC (2005), Section 8.

[29] See Stephan and Nikpay (2014), pp. 16–19.

not eligible. Despite full compliance with these conditions, a firm could not be sure whether it would obtain immunity. The Antitrust Division was not obliged to grant immunity automatically. To the contrary, the Antitrust Division could second-guess the leniency application. The second-guessing was the result of a reasonable expectation clause in the 1978 Leniency Policy. If the Antitrust Division had a reasonable expectation that it could have discovered the illegal cartel even without self-reporting of the firm, immunity would not be granted.[30] With the reform in 1993, the possibility of second-guessing the leniency application was abolished.[31] This kind of flexibility never existed in Europe or Japan.[32]

The EU Commission adopted a different kind of flexibility. The 1996 Leniency Notice gave the Commission the competence to make a choice between immunity and reduction to the first successful leniency applicant. If immunity was considered too generous, the Commission could give a reduction ranging from 75 to 99 % of a potential fine.[33] Equally, the subsequent leniency applicants were not certain of the percentage of reduction of their fine. Also for the subsequent successful leniency applicants, the Commission had to make a choice from a fixed range of percentages. The decision on the final degree of reduction was contingent on the Commission's appreciation of the evidence. The value of the evidence was determined as a function of its contribution to revealing the existence and the depth of an illegal cartel. The value was further affected by the other information already gathered by the Commission or acquired during the whole investigation process. The assessment process was internal to the Commission. This kind of flexibility never existed in the United States or Japan.[34]

An appreciation of information was not only important in determining the degree of leniency in Europe, it also played in the eligibility criteria for a leniency applicant. The 1996 Leniency Notice stipulated that the first applicant could only be eligible if they had "*decisive* evidence of the cartel's existence"[35] or "information, document or other evidence which *materially* contribute to establishing the existence of the infringement."[36] The former kind of evidence had to be submitted by the first leniency applicant before or after the Commission has started its investigation. The latter kind of evidence was required from leniency applicants subsequent to the first leniency applicant. The Commission changed the formulation in 2002 and left out the words 'decisive' and 'materially contribute'. Instead, the 2002 Leniency Notice started to require information and evidence that in the "*Commission's view* may enable it to carry out a targeted inspection in relation to the alleged cartel or to find an infringement of Article [101] TFEU in order to obtain

[30] See generally, Kobayashi (2001), pp. 728–731 and Van Uytsel (2014), p. 197.

[31] See Leslie (2011), p. 175.

[32] See Van Uytsel (2008), pp. F31–F36.

[33] See European Commission (1996), par. B.

[34] See Van Uytsel (2008), pp. F31–F36.

[35] European Commission (1996), par. B (b) (emphasis added).

[36] European Commission (1996), par. D (2) (emphasis added).

immunity."[37] To be granted a reduction, the firms had to submit information and evidence that had "*significant added value* with respect to the evidence already in the Commission's possession."[38] Significant added value evidence is of course again a concept that attributes a certain degree of flexibility to the Commission to appreciate the information it receives in a leniency application. The concepts of the 2002 Leniency Notice have been kept in the 2006 Leniency Notice. The 2006 Leniency Notice clarifies, however, these concepts to a greater extent.[39] The informational requirements are far less complicated in the US[40] and Japan.[41]

Despite its contentious nature, information and evidence necessary to successfully obtain leniency has not been the only concept open for interpretation. The 1993 Corporate Leniency Policy excludes the leader or the originator.[42] Similarly, the 1996 Leniency Notice excludes an instigator or a firm with a determining role in the illegal activity.[43] Both concepts have disappeared in the 2002 Leniency Notice and do not return in the 2006 Leniency Notice.[44] Instead, the "coercer" was included as category of firms not eligible to apply.[45] The Japanese Leniency Program excludes the coercer from the list of eligible applicants for leniency.[46] Other concepts of this kind include the 'a truly corporate act' in the 1978 and 1993 Corporate Leniency Policy.[47] These policies also stipulate that reporting has to be done "with candor."[48] Finally, the EU Leniency Notice refers to 'prompt' when it requires the termination of the participation in the cartel.[49]

Peculiar to Japan is the complexity of its enforcement structure and this gives a great deal of flexibility to the JFTC. The Japanese AML provides both an

[37] European Commission (2002), par. 8 (emphasis added). A similar formulation is to be found in the 1993 Leniency Policy. The United States has also some provisions in its leniency policy that allow the Antitrust Division some flexibility in the appreciation of the information and evidence submitted. The 1993 Leniency Policy allows applicants to report the illegal cartel even if the Antitrust Division has information on the cartel. The condition is, however, that the information in the hands of the Antitrust Division is likely not to result in a sustainable conviction. This element gives the same flexibility to the Antitrust Division as the Commission. Information needs to be assessed.

[38] European Commission (2002), par. 21 (emphasis added).

[39] See European Commission (2006), par. 8 in combination with 9 and 24 in combination with 25.

[40] See Joshua (2007), p. 519 and Ceres et al. (2006), p. 4 (indicating that a good cartel story has to be given and that the Antitrust Division then guides the applicant to fill the gaps in the story). See also supra note 37 and the explanation on assessment of information.

[41] For a detailed description, see Van Uytsel (2015a), pp. 78–80 n. 85, 96, 98, and 100.

[42] See Kobayashi (2001), pp. 729; on the contentious nature of these concepts, see Beaton-Wells (2013), pp. 184–186.

[43] See European Commission (1996), par. B (e).

[44] See European Commission (2002) and European Commission (2006).

[45] See European Commission (2006), par. 13.

[46] See Article 7-2(17) (iii) AML.

[47] See Kobayashi (2001), p. 729.

[48] Kobayashi (2001), p. 729.

[49] See European Commission (2006), par. 12 (a).

administrative surcharge and criminal sanction as a remedy for a cartel infringement. The Japanese Leniency Program only applies to the former. However, in order for the criminal sanctions to apply, the JFTC has to refer the infringing firms to the prosecutor. The JFTC has flexibility in this respect. Firms can be excluded from the referral to the prosecutor's office. The Ministry of Justice has indicated that the JFTC should do so for the first successful leniency applicant. In other words, the JFTC should make use of its flexibility to extend the immunity for the administrative surcharge to the criminal sanctions.[50] This problem does neither occur in the US not in the EU.[51]

3 Chinese Leniency Policies and Flexibility

3.1 Beyond Hardcore Cartels

The possibility to create a leniency policy in China is part of Article 46 CAML. Article 46 CAML regulates in first order the sanctions for illegal monopoly agreements. Paragraph 1 of Article 46 CAML provides that, besides a cease-and-desist order, the enforcement agencies have to confiscate the illegal gains and impose a fine of 1 % up to 10 % of the sales revenue in the previous year. If the monopoly agreement was not performed, and thus no illegal gains exist, a fine up to 500.000 yuan shall be imposed. The Article 46 CAML does also regulate, in a general way, the lenient treatment. Paragraph 2 of Article 46 CAML stipulates that "[i]f an undertaking voluntarily reports the relevant circumstances of the monopoly agreement..., the anti-monopoly enforcement authority shall impose a reduced punishment or waive punishment of such undertaking."[52]

Including the lenient treatment in the same article dealing with the sanctions, it is possible to conclude that the lenient treatment is applicable to both confiscation and the additional fine. As Article 46 CAML does not deal with any other form of sanction, it is reasonable to expect that a possible lenient treatment will not extend to criminal penalties that may arise while committing an anti-monopoly infringement[53] or private damages actions.[54]

Another factor regulating the scope of Article 46 CAML is the explicit use of the wording 'monopoly agreements'. Monopoly agreements are defined in Chapter II CAML. Article 13 CAML includes monopoly agreements that are in western competition law literature usually referred to as hardcore horizontal agreements[55]

[50] See Van Uytsel (2015b), pp. 89–90 and Van Uytsel (2012), pp. 19–20.

[51] See Van Uytsel (2008), pp. F31–F36.

[52] See Article 46 CAML.

[53] See Article 52 CAML.

[54] See Article 49 CAML.

[55] See Article 13 (1), (2), and (3) CAML.

and horizontal cooperation agreements.[56] Article 14 CAML defines monopoly agreements as to include what is known to western competition lawyers as vertical price fixing agreements.[57] Both articles have a provision stipulating that the list is not exhaustive and can be extended by the responsible enforcement agencies.[58] Since there is no explicit limitation in Article 46 CAML to either of the agreements mentioned in Article 13 CAML or 14 CAML, both the sanctions and the lenient treatment would appear to apply to all monopoly agreements.[59]

Article 46 CAML does not provide any detail as what the lenient treatment could or should mean. NDRC and SAIC have elaborated detailed rules containing the conditions and procedures for leniency applications. NDRC's Leniency Policy has been outlined in the Rules on Administrative Enforcement Procedures for Anti-Price Monopoly.[60] SAIC has led down its leniency policy in the Procedural Rules for Prohibition by Administrative Authority for Industry and Commerce against Monopoly Agreements.[61]

3.2 The Leniency Policies of the NDRC and SAIC

3.2.1 NDRC and Its Leniency Policy

NDRC's Leniency Policy provides that the first applicant may be granted immunity from punishment.[62] The subsequent applicant, the second one, can be offered at least a 50 % reduction.[63] Once these two slots have been occupied, an unlimited number of subsequent applicants can obtain a maximum of 50 % reduction.[64] The rules do not indicate how an applicant can assure his position in the queue of applications and when this position can be confirmed to the applicant.

The text of NDRC's Leniency Policy is silent on when the application for leniency needs to occur. It is for sure that there is no explicit prohibition on an application for leniency once an investigation has started.[65] The general silence on when the application needs to happen and the absence of a prohibition to apply after an investigation has started could create the presumption that a firm is eligible to

[56] See Article 13 (4) CAML.

[57] See Article 14 (1) and (2) CAML.

[58] See Article 13 (6) CAML and 14 (3) CAML.

[59] See Foster (2015), pp. 98–103 and Harris et al. (2011), p. 291. See infra Sect. 4.3 (indicating that leniency is not always extended to the confiscation).

[60] NDRC (2010b).

[61] SAIC (2010).

[62] See NDRC (2010b), Article 14.

[63] See NDRC (2010b), Article 14.

[64] See NDRC (2010b), Article 14.

[65] See NDRC (2010b), Article 14.

apply for leniency before and after an investigation. The only requirement that the firm needs to fulfil is to provide information that constitutes material evidence.[66]

Material evidence is something that each applicant needs to submit.[67] Material evidence is evidence that can ascertain the existence of the monopoly agreement.[68] The rules are silent on whether different applicants could submit the same evidence or whether each applicant has to provide new evidence. It is also not stipulated that the information cannot be false. However, it is easy to infer that false information cannot constitute material evidence.

Unlike many other leniency policies, NDRC's Leniency Policy does not expand on the need to fulfil certain conditions.[69] It is not clear whether the leniency applicant has to terminate their illegal behavior. The rules do not stipulate whether the leniency applicant has to continue cooperation with NDRC. The rules are also silent on whether the leniency applicant has to keep their submission secret to third parties. In order to obtain immunity, there is no condition that the applicant cannot have been the organizer of the illegal behavior.[70]

3.2.2 SAIC and Its Leniency Policy

SAIC has a slightly different conceptualization of its leniency policy. Leniency is divided into two categories: immunity and reduction.[71] Immunity is available for the first applicant who, after confessing, fully cooperates with the investigation.[72] There is some discussion on whether the first applicant may or should be given leniency. The majority indicates that the literal interpretation of the text requires that SAIC should give automatic immunity.[73] Subsequent applicants may receive a reduction, but the level of reduction is not specified.[74] SAIC enjoys discretion in this regard.[75] The only guidance given is that the degree of any lenient treatment depends on the time sequence of the application, the importance of the evidence provided, the relevance of the information and the cooperation with the investigation.[76]

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[66] This chapter uses the wording *material evidence*. This is the translation found in the official translation of the law given by the Ministry of Commerce, see MOFCOM (2008). The majority of the literature refers to *important evidence*. For the purposes of this chapter, the two concepts are interchangeable and have the same meaning.

[67] See NDRC (2010b), Article 14.

[68] See NDRC (2010b), Article 14.

[69] See Harris et al. (2011), p. 292.

[70] See Oded (2013), p. 156.

[71] See SAIC (2010), Article 11.

[72] See SAIC (2010), Article 12.

[73] Harris et al. (2011), p. 293 and Xue and Yang (2013), p. 88.

[74] See SAIC (2010), Article 12.

[75] See Harris et al. (2011), p. 293.

[76] See SAIC (2010), Article 11.

Just like the NDRC's Leniency Policy, SAIC's Leniency Policy does not explicitly require a submission of the application before an investigation.[77] Neither is it explicitly prohibited to submit a leniency application *after* an investigation has started. Therefore, a similar conclusion can be drawn as to the NDRC's Leniency Policy. Firms, able to submit material evidence, can submit this evidence at any time, even after an investigation has started.

Again, in order to receive lenient treatment, the leniency applicant has to submit material evidence. The evidence becomes important when it facilitates the initiation of an investigation or it can contribute to the finding of an agreement.[78] Such evidence can include the parties to the agreement, the products included in the agreement, the form and the content of the agreement, and details about the implementation of the agreement.[79]

The leniency applicant under SAIC's Leniency Policy cannot be the organizer of the anticompetitive agreement.[80] There seems to be an understanding that the organizer includes both the originator and the leader.[81] In other words, SAIC would neither provide leniency to the firm establishing the illegal agreement nor to the firm who was responsible for operating the agreement.

Just like NDRC's Leniency Policy, SAIC's Leniency Policy does not expand on the need to fulfil certain conditions. It is not clear on whether the leniency applicant has to terminate their illegal behavior, even though the leniency policy stipulates that a firm voluntarily terminating the participation in the cartel can be treated leniently. As such, this lenient treatment seems to be available for firms that have not applied for leniency.[82] The rules are also silent on whether the leniency applicant has to maintain secrecy regarding their submission to third parties.

3.3 The Chinese Leniency Policies Riddled with Flexibility

3.3.1 Flexibility Regarding the Timing of Application

The Chinese Leniency Policies are silent on the existence of the possibility to obtain leniency after an investigation has started. It is not explicitly provided to firms, but it is also not explicitly forbidden. Both leniency policies provide the possibility to obtain leniency in return for material evidence. The interpretation of material evidence will be the biggest hurdle for granting leniency after an investigation has started.

[77] See SAIC (2010), Articles 11–13.

[78] See SAIC (2010), Article 11.

[79] See SAIC (2010).

[80] See SAIC (2009), Article 20.

[81] See Harris et al. (2011), p. 293 and Xue and Yang (2013), p. 88.

[82] See SAIC (2010), Article 10.

SAIC's Leniency Policy is the most detailed in providing guidelines regarding material evidence. Evidence will be considered important if it can initiate an investigation or find an agreement. It is obvious that the former excludes a post-investigation lenient treatment. However, the latter does not exclude it and it could be possible that evidence for finding an agreement may also be provided in a post-investigation stage.[83]

3.3.2 Flexibility in Granting Immunity

Immunity under NDRC's Leniency Policy is not automatic. NDRC *may* grant the first successful applicant immunity, and retains thus a high degree of flexibility. This flexibility does not seem to be linked to predictable guidelines. It is also not clear whether reduction can be given if no immunity is granted. In the worst case, the first successful applicant may result in the payment of a fine. This uncertainty creates an incentive to keep quiet until NDRC has discovered the cartel or another cartel member has, for whatever reason, used the leniency policy.[84] SAIC does not have this kind of flexibility. SAIC will offer, according to the general understanding in the literature, automatic immunity to the first successful leniency applicant.[85]

3.3.3 Flexibility in Granting Reductions

Besides immunity, NDRC's and SAIC's Leniency Policy provide the possibility to grant a reduction of the fine. NDRC's approach towards subsequent leniency applicants is different than SAIC's approach. NDRC determines broadly the level of reduction for subsequent leniency applicants, while SAIC has chosen not to fix the level of reduction and to keep full discretion to determine the level on a case-by-case basis. Moreover, it is unclear whether subsequent leniency applicants will enjoy lenient treatment by the NDRC or SAIC. Both leniency policies stipulate that subsequent leniency applicants may enjoy leniency treatment.

3.3.4 Flexibility to Interpret Information

Article 46 AML stipulates that leniency can be obtained in return for material evidence. This requirement has been repeated by NDRC and SAIC in their respective leniency policies. NDRC does not further qualify what it could mean, while

[83] See SAIC (2010), Article 11.

[84] See MLex Staff (2014), p. 2 (indicating that international lawyers are cautious to advice on applying for leniency in China).

[85] See Harris et al. (2011), p. 293 and Xue and Yang (2013), p. 88. But see Oded (2013), p. 157 (urging for caution as no official statement has been made by SAIC).

SAIC indicates that it should be information that could lead to an investigation or a finding of an agreement.

Material evidence can be conceptualized from different perspectives. Evidence can be material evidence because it is unknown to the enforcement agency. Information can be material evidence in a more abstract way. The information may have the capacity of being material evidence due to its contribution in detecting the cartel. Similarly, information may be abstractly important in terms of evidence necessary to lead to a conviction. Importance can also manifest itself in a comparative way. Information evidencing a cartel can be more important than other information, due to which one leniency applicant may have better information than the other. Deciding importance in a comparative way can only be done at the moment the enforcement agency has closed their investigation and is about to formulate its decision. A very liberal take on importance could be construed by looking at the whole process of cartel detection and conviction. Any kind of information that contributes in one way or another to this process might be regarded as material evidence.

SAIC has included guidelines in relation to the interpretation of material evidence. Evidence becomes important if it contributes to initiating an investigation or the finding of an agreement. It is obvious that both requirements reflect the EU 2006 Leniency Notice, but there are substantial differences. For initiating the investigation, SAIC does not explicitly require the absence of sufficient information to start an investigation or the investigation does not have to be targeted. In relation to finding an agreement, SAIC does explicitly ask for new information. SAIC does also not explicitly distinguish between the evidence necessary for initiating an investigation or finding an agreement.[86]

3.3.5 Flexibility to Change the Order of Applications

Linked to the problem of the interpretation of material evidence is the order in which the leniency applicants approach the enforcement agencies. Neither NDRC nor SAIC have enumerated provisions on how to determine the order of application.[87] The absence of any rule on the order of application and a vague requirement to submit material evidence could lead to the consequence that the central issue in

[86] SAIC's silence on all these aspects does open different possibilities for the implementation of the leniency policy. By not explicitly excluding a standard that is less severe than in the EU Leniency Notice, SAIC could substantially lessen the requirements for the leniency applicants. Unless there is evidence in that direction, the opposite may be true as well and SAIC may be following the rules set out in Europe. In the latter case, SAIC itself must not have sufficient information or the provided evidence must allow for a targeted investigation. In terms of finding an agreement, SAIC may decide that the information must be unknown. Further, if the European approach is followed, the information required for initiating an investigation would be less demanding than if they were finding an agreement.

[87] Harris et al. (2011), p. 292 and Xue and Yang (2013), p. 88.

determining eligibility for leniency is not who was the first firm to apply but who was the first firm to submit material evidence. Considering the hastiness under which the initial step has to be taken, firms risk submitting incomplete leniency applications and so face an unfavorable outcome. This unfavorable outcome could manifest itself in two different ways. First, it is possible for NDRC or SAIC to reject the leniency application because of incompleteness. Second, if the incompleteness is not of such a kind to reject the application, a subsequent leniency application with more important information could substitute the first application. In other words, the second applicant may supersede the first application.

3.3.6 Flexibility in Interpreting Other Concepts

The more conditions that are attached to a leniency policy the more chance there is that the interpretation of these conditions can damage the predictability of the leniency application process. Besides the condition of SAIC's Leniency Policy that the leniency applicant should not be the originator of the cartel, there are no other conditions attached to neither of the leniency policies. Concretely speaking, the leniency policies do not require the leniency applicant to terminate its participation in the illegal activity. It is also not explicitly required, except for the immunity applicant under SAIC's Leniency Policy, that the leniency applicants continuously cooperate with the enforcement agencies.

3.3.7 Uncertainty Regarding the Applicable Leniency Policies

The CAML has two different leniency policies administered by two different enforcement agencies. The existence of two enforcement agencies in relation to cartels has widely been commented on, especially in terms of its desirability.[88] It is not the purpose of this paper to delve deeply into this debate, but just to point out the problems of this double enforcement structure to the good functioning of the leniency policies in China. Even though there is a well-established understanding that NDRC and SAIC have a different field of competence, price and non-price related cartels respectively,[89] it is possible to conceive of circumstances in which it is not so easy to determine which of the agencies has competence over the cartel.[90]

Cartel agreements are rarely just agreements on the price alone.[91] Very often cartels are complex and have besides price fixing agreements, also agreements on restricting output or market allocation agreements. Price fixing agreements are

[88] See, e.g., Zhang and Zhang (2012), p. 66 (focusing on the coordination costs), Hao (2013), pp. 15–34 (giving a general overview), Wang (2014), and Emch (2014).

[89] See Wang and Su (2012), pp. 68–6 and Van den Bergh and Faure (2011), pp. 57–58.

[90] See Van den Bergh and Faure (2011), p. 58 and Huang and Zhang (2011), p. 51.

[91] See Zhang and Zhang (2013), pp. 123–126.

obviously a competence of NDRC, which can be deducted from the fact that it determines what a price agreement can be in its Anti-Price Monopoly Rules.[92] Output restrictions and market allocations, however, belong to SAIC's competence. SAIC has made this clear by defining these types of agreements in its Rules on the Prohibition of Monopoly Agreements.[93]

The CAML does not contain rules to determine which agency will have competence over complex cartels, i.e. cartels in which both price and non-price related agreements are to be found.[94] The CAML has a structure to coordinate between the agencies. This structure is the Antimonopoly Commission, which task it is to coordinate the enforcement.[95] Despite this structure, the silence of the CAML on how to deal with a conflict of jurisdiction opens various perspectives. Both NDRC and SAIC could claim competence over the cartel. A concurrent claim would mean that a cartel could be punished twice, once for the price related aspect and once for the non-price related aspect. For the leniency policy, this would mean that a cartel member has to submit two different leniency applications at the same time. Another possibility would be that a decision has to be taken on which aspect of the cartel is prevailing. The dominant aspect would then determine the competent agency and also the applicable leniency policy. Problems will arise if an agency retrospectively overrules the decision of what the prevailing aspect of the cartel is. A firm can lose its position in the leniency queue if it did not also apply for leniency at the other agency. Still another possibility would be that the agency taking first initiative will become the competent agency. In this case, it does not really matter to which agency the firm submits its leniency application, even though a rational firm would select the agency where the expected benefit is the biggest.

4 Flexible Leniency Policies and Their Consequences

4.1 Flexibility in Leniency Policies

Based upon the leniency policies in the US, EU and Japan, a broad categorization of the possible flexibilities has been described above. On the one hand, we have flexibilities that are within the control of the firms. On the other hand, we have flexibilities that are managed by the enforcement agencies. The flexibilities described are about choices to be made. Some of the choices are business related matters; other choices are law related issues. The business related choice is the one in which the firm has to make a decision whether to apply for leniency or not. The business decision to apply for leniency will be influenced by the legal issues. These

[92] See NDRC (2010a), Article 3. For an English version, see Harris et al. (2011), pp. 450–460.
[93] SAIC (2010), Article 4.
[94] See Emch (2014), p. 233. See also Eichner (2012), p. 612 and Zhang and Zhang (2012), p. 66.
[95] See Lin and Qiao (2015), p. 135.

legal issues relate to the conceptualization of the respective leniency policies. The conceptualization has two different dimensions: the structure of the leniency policy and the use of open concepts.

Understanding the structure of the leniency policy is necessary to make the business decision regarding the kind of leniency the firm can apply for. The firm has to ascertain whether there is only immunity for a sanction available or also a reduction for a sanction. If both are available, the choice will be determined by the other requirements that the leniency policy prescribes, by the existence of another leniency applicant, or by the start of an investigation. If there is no other leniency applicant, the firm has often the choice to obtain immunity through different procedures. Again, this choice will be determined by the other requirements of the leniency policy or by the start of an investigation.

The other requirements of the leniency policy often contain flexible rules. Flexible rules have two components. These are rules that "grant discretion with or without standards for its exercise, or vague concepts...."[96] The enforcement agencies can derive from a rule the discretional powers to decide in one way or another or be given the competence to interpret vague concepts in one way or another. As the definition shows, the discretional power may be intertwined with vague concepts. If the law itself or general principles do not provide standards to guide the discretional power or the interpretation of the vague concepts, the rule would be open-ended. An open-ended rule "do[es] not determine [its] respective outcome."[97] The rules are inherently flexible and this leads to a tension "between flexibility on the one hand and legal certainty on the other."[98]

There is a rich literature on rule-inherent and the tension between flexibility and legal certainty, especially regarding the admissibility of such rules.[99] Rather than focusing on the theoretical and philosophical aspects of that debate, this paper will indicate what the consequences are when flexible rules are created. The evidence from the US, the EU and Japan will be highlighted. Based upon that evidence, some predictions will be made as to the probable impact of the Chinese leniency policies.

4.2 Leniency Policies, Flexibility for Enforcement Agencies and Its Consequences

The flexibility enforcement agencies have in the use of leniency policies has been negatively evaluated.[100] The evidence for the negative evaluation has been taken

[96] Atiyah and Summers (1978), p. 71; See also Summers (1992), pp. 245–246 and Wolff (2011), pp. 551 and 566.

[97] Wollf (2011), p. 551.

[98] Wollf (2011), p. 552.

[99] See Wollf (2011), pp. 553–561 (summarizing the discussion and provided a wealth on sources).

[100] ICN (2009).

from the poor performance of the 1978 Leniency Policy and the 1996 Leniency Notice. The benchmark for evaluating the former has been the total number of leniency application during a period of 15 years. The benchmark for assessing the latter has been its inability to attract leniency application exogenous from US cartel or from leniency applications in the same industrial sector.

There is a prevailing opinion that the 1978 Leniency Policy was not successful. The benchmark for this statement is that the 1978 Leniency Policy was not able to attract a significant number of leniency applications. Over a period of 15 years, the 1978 Leniency Policy was only able to induce 17 leniency applications between 1978 and 1993. Out of the 17 leniency applications, 6 firms saw their application denied. The ten remaining firms qualified for amnesty, thus a full waiver of the fines. It has been said that the number of firms qualifying for amnesty would have been smaller than 10 if it were not that the Antitrust Division implemented the Leniency Policy for Individuals in 1987. At the end, only 4 firms were granted amnesty before 1987 and all remaining 6 after 1987.[101]

The 1996 Leniency Notice was able to attract more than 17 leniency applications, even though the Commission had a substantial amount of flexibility in operating the leniency policy. Despite the higher number of leniency applications, the 1996 Leniency Notice is generally regarded as a failure. The failure is attributed to the inability of the 1996 Leniency Notice to incentivize firms to defect a cartel. Two observations warrant this conclusion.[102] First, Andreas Stephan has pointed out that the majority of the leniency applications in the EU were preceded by or simultaneous with an investigation in the US.[103] No less than 23 out of 34 cases in the EU were the result of a leniency application under the 1996 Leniency Notice. The 23 cases resulting out of a leniency application could be divided into 15 cases in which the US had conducted a prior or simultaneous investigation and 8 cases in which only the Commission conducted an investigation. Second, Stephan pointed out that the 8 EU only investigations were most likely not the result of the existence of the EU leniency policy. Various reasons are mentioned for this conclusion. Several cartels had already failed for a few years before the Commission started its investigation, indicating that the reporting occurred well after the cartel had already died. In another cartel, a firm that was forced to be a member of the cartel, and thus did not want to be part of the cartel from the beginning, applied for leniency. Still another cartel defector was a minor player within the cartel. It is also indicated that several cartels were linked with each other on the basis of identical cartel participants.[104]

The main flexibility in Japan is related to criminal enforcement. A leniency applicant can still face criminal charges on the condition that the JFTC refers the leniency applicant to the prosecutor's office. Unless the firm considering applying

[101] See Kobayashi (2001), pp. 729–730.

[102] See Stephan (2005), pp. 8–9.

[103] See Stephan (2005), p. 9.

[104] See Stephan (2005), pp. 9–14.

for leniency knows the JFTC will not refer his case to a prosecutor's office, the firm may not be willing to apply for leniency. To address the uncertainty, the Ministry of Justice has issued a notice stating that the first leniency applicant will not be referred to the Prosecutor's Office. The JFTC has sided with that notice. In four cases in which it referred leniency applicants to the Prosecutor's Office, the first leniency applicant did not face criminal charges. The flexibility of the JFTC has thus been used in favor of the leniency policy and mitigated the negative effects of criminal enforcement that hangs as a sword of Damocles over the leniency applicant's head.[105]

The literature seems to be unanimous in its conclusion on the 1978 Leniency Policy and the 1996 Leniency Notice. Too much flexibility for the enforcement agencies was the primary factor for the failure of the respective leniency policies.

When writing on how the US leniency policy has improved since 1993, Christopher Leslie clearly indicated where the problems were in the 1978 Leniency Policy:

> In 1993, the Antitrust Division of the U.S. Department of Justice significantly revised its Corporate Leniency Policy and made it easier for confessing firms to qualify for amnesty. For example, the Division *limited the discretion that it had possessed under its former policy* as to whether to grant amnesty to a confessing firm. Under the revised program, firms that met certain criteria – for example, being the first to confess, not being the ringleader of the cartel, and confessing before government investigators had already developed their case against the cartel – could automatically receive amnesty.[106]

The changes brought by the 1993 Leniency Policy were considered to be successful. Bruce Kobayashi, writing in 2001, indicated the drastic increase in the number of applications to an average of 2 per month.[107] This number is more or less confirmed by Leslie, who, by referring to James Griffin, speaks of an average of 3 per month.[108]

Stephan summarized the critique on the 1996 Leniency Notice as follows:

> The main criticisms of the notice were that it lacked clarity and certainty. Its lack of clarity was mainly due to its subjective working; in particular in stating that an 'instigator' or firm with a 'determining role' could not be granted full or very substantial immunity, and that leniency would only be granted if the applicant was the 'first to adduce decisive evidence of the cartel's existence'. There was no guidance as to when these conditions were satisfied. Secondly, there was an inherent lack of certainty as to how a firm would be treated once it had approached the Commission; full or very substantial immunity was only available if the Commission had not already opened an investigation into the cartel, or already had enough evidence to prove its existence. . . .There were also two further problems. First, leniency applicants were unsure of the level of leniency granted to them before the Commission delivered its final decision, several years later. Secondly, they were required to 'put an end to [their] involvement in the illegal activity no later than the time at which [they disclosed] the cartel'."[109]

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[105] Van Uytsel (2015b), pp. 89–90.

[106] Leslie (2011), p. 175 (emphasis added, footnotes omitted).

[107] See Kobayashi (2001), p. 731.

[108] See Leslie (2011), p. 175; See also Griffin (2003).

[109] Stephan (2005), p. 21.

Several of the above mentioned problems were settled in the 2002 Leniency Notice. The 'decisive evidence' requirement was removed. 'Instigator' and 'determining role' was replaced by 'coercer', which is generally seen as a clearer concept[110] but still not without problems.[111] Nevertheless, this did not mean that all flexibility disappeared. The 2002 Leniency Notice inscribed flexibility in relation to the information and evidence that had to be submitted to the Commission. This information and evidence must in the *Commission's view* enable it to carry out a targeted investigation.[112] To avoid a subjective assessment of the Commission and to ascertain the fulfilment of that requirement, the 2006 Leniency Notice introduced the possibility of an initial application in hypothetical terms.[113]

The above may suggest that reducing the flexibility of the enforcement agencies will create a more successful leniency policy. Empirical research has indicated that this is not necessarily the case. Japan has been able to create a clear and transparent leniency policy without much flexibility detrimental to the leniency applicant. Judging Japan based upon the benchmarks of Stephan's example, i.e. the ability to detect country specific cartels or to attract the first leniency application, a very similar conclusion could be drawn. In a different study, I have argued that there are only a limited number of leniency applications that are truly independent. From the 67 grants of immunity, thus firms that submitted a leniency application before the JFTC started its investigation; only 22 were independent from any foreign cartel or a web of cartels within one industry.[114] If we would also look at the timing of the leniency application and relate that to the last cartel activities, thus making a statement on whether the leniency policy was the cause of the application, it is well possible that the number would further reduce. With these considerations in mind, it would be wrong to conclude that, if the degree of flexibility were reduced, a leniency policy would produce a better result. A more reliable benchmark may be the number of leniency applications, because this would be a sign of trust in the application and assessment process.

4.3 The Use of Leniency Policies in China

The Chinese Leniency Policies are permeated with a high degree of flexibility. Based upon the empirical research in relation to the 1978 Leniency Policy and the 1996 Leniency Notice, the two leniency policies that provided the most flexibility

[110] See Stephan (2005), p. 20.
[111] See Beaton-Wells (2013), pp. 184–186.
[112] See Stephan (2005), p. 20.
[113] See Stephan (2005), p. 20.
[114] Van Uytsel (2015b), pp. 93–99.

to the enforcement agencies, it could be predicted that the Chinese Leniency Policies will not render the expected results.

The empirical research on flexible leniency policies does not make it possible to predict exactly what kind of result will be brought about by such leniency policy. The 1978 Leniency Policy did attract few applications in general. The 1996 Leniency Notice did not necessarily have few applications. The problem with the 1996 Leniency Notice was the quality of the cases revealed by the leniency policy. Most of the leniency applications were follow-on application or applications of cartels that had already broken down.

The fact that since 1996 globalization has taken on different dimensions, with more countries being member of the WTO, there is a tendency of an increased flow of goods and services across borders. The presence of firms is no longer limited to a single country or a neighboring region. Firms are more active worldwide. This has also consequences if these firms engage in illegal activity, such as the formation of cartels. A cartel will have the same worldwide effects as the trade of goods and services. It is more likely than before that the cartels have an international dimension. A cartel detected in one country will trigger suspicion of enforcement agencies elsewhere. To avoid penalties in the other countries, leniency applications will be submitted. Based upon the European experience, this will be done even in an environment of legal uncertainty.

Out of all decisions taken by NDRC and SAIC,[115] only 7 decisions have been taken based upon a leniency application submitted solely to NDRC.[116] The earliest reporting of the use of the NDRC's Leniency Policy is in 2012, after the Price Bureau of Guangdong Province became aware that the prices of sea sand were fixed increasing the prices of concrete and consequently the cost of construction projects. It is reported that the investigations into the cartel encountered difficulties and that therefore six firms were targeted and that the leniency policy was given as an incentive to provide the necessary evidence. One of the organizers of the Sea Sand Association cartel, Guangdong Baohai Sand and Stone Co. Ltd., received a 50 % reduction in its punishment.[117] The other two organizers received a maximum fine, while other participants only received a warning. This cartel involved only Chinese firms.

The LCD cartel is often discussed within the framework of leniency applied by NDRC. However being correct in the use of leniency, the whole decision is based upon the Price Law, which is not covered by the NDRC's leniency policy. The Price Law allows for a mitigation of the fines, and thus an application of a kind of leniency.[118] After being investigated in various other jurisdictions,[119] AU

[115] USCBC (2015), pp. 18–33 (giving an overview of all decisions by NDRC and SAIC until May 2015).

[116] Hong (2015).

[117] See Xue and Yang (2013), p. 92. See also Editorial Board (2012).

[118] See Xue and Yang (2013), p. 93 (the Price Law was applied because the investigation started before the CAML came into effect).

[119] See Chen (2013), pp. 2–3.

Optronics submitted a leniency application to NDRC for fixing the prices of LCD panels sold in China. This resulted in fines for the Korean and Taiwanese firms involved in the cartel.[120] AU Optronics was able to obtain immunity as the first firm reporting the cartel.[121] The lenient treatment did not extend to the confiscation of the illegal gains.[122]

Following the use of the leniency policy in the LCD cartel was the use of the NDRC's leniency policy in two resale price maintenance cases,[123] thus vertical price fixing.[124] The first case involved milk powder and was run by five foreign firms, one Hong Kong-based firm and one Chinese firm.[125] During the investigation, three firms admitted to the allegations of organizing a 'vertical monopoly' and started to cooperate with the NDRC under its leniency policy. All three firms, Wyeth, Meiji and Beignmate, were granted immunity. The second case involved eyeglasses and contact lenses and was operated by six foreign firms and one Chinese firm.[126] These firms imposed minimum resale prices on their retailers. Hoya Corp. and Weicon Corp. informed NDRC about this practice and were granted immunity from the fine.[127] None of these cases were subject to foreign investigations. However, leniency was applied for when the investigation was ongoing.

In the local insurance market in the province of Zhejiang, the insurers' local association organized a cartel in relation to car insurance policies.[128] Twenty-three insurance firms participated in the cartel. This did not include any of the foreign American and Japanese insurance firms. NDRC started to investigate the fixing of the commissions levels after which the People's Insurance Company of China, China Life and Ping An admitted the price-fixing activities. The People's Insurance Company of China was granted immunity for reporting as first firm. China life received 90 % reduction as the second firm coming forward and Ping An was granted 45 % reduction. No other insurance firms benefited from fine reductions,

[120] The firms involved were the Korean firms Samsung and LG on the one hand, and the Taiwanese firms AU Optronics, Chunghwa Picture Tubes, Chimei InnoLux and HannStar on the other hand.

[121] See Xue and Yang (2013), p. 93. See also Orrick (2013).

[122] See Zhong Lun Law Firm (2013), p. 3 Annex 1.

[123] See Xu (2015) (discussing the milk powder case) and USCBC (2015), p. 23 (giving an overview on the eyeglasses case).

[124] Recently, NDRC has taken decision on vertical price fixing in relation to FAW-Audi and Mercedes-Benz. However, these decisions seem not to be based upon a leniency application.

[125] The firms active in the vertical milk powder price cartel are: Biostine, Mead Johnson, Dumex, Abotts Lab, FrieslandCampina, Wyeth, Fonterra, Beignmate and Meiji.

[126] The firms active in the vertical eyeglass cartel are: Essilor International SA of France, Germany's Car Zeiss AG, the Japanese firms Hoya Corp. and Nikon Corp.; and Bausch + Lomb owned by Canada's Valeant Pharmaceuticals International Inc and the Chinese firm Shanghai Weicon Optics Co.

[127] See Staff Reporter (2014).

[128] See Modrall and Hu (2014), p. 3.

"apparently because they did not voluntarily report the conclusion of the illegal agreements or did not provide evidence the NDRC regarded as important."[129] This cartel was local and did not get investigation abroad.

In the aftermath of worldwide investigations into the cartel formation in the car parts industry, NDRC started to investigate the market as well.[130] During the investigation, Hitachi reported the cartel to NDRC,[131] after which all other suppliers submitted leniency applications. The investigation resulted in the decision that there was price fixing for 13 types of car components supplied by Hitachi Automotive Systems, Denso, Yazaki, Furukawa Electric, Sumitomo Electric, Aisan, Mitsubishi Electric and Mitsuba. Hitachi received immunity, Denso was granted 60 % reduction, three other suppliers were each given 40 % reduction and the other three suppliers got 20 % each.[132] The other international cartel in de automotive sector was the car bearings cartel, led by Nachi-Fujikoshi, NSK, NTN, and JTekt. All firms submitted leniency applications. Nachi-Fujikoshi submitted first and received immunity. NSK was second and got 60 % reduction. NTN and Jtekt benefited from a reduction of 40 % and 20 % respectively.[133]

More recently, an international cartel among capacitor makers has reported voluntarily to the NDRC at the same time it reported to the Antitrust Division in the US, the Commission in the EU, the JFTC, the Korean Fair Trade Commission and the Taiwan Fair Trade Commission.[134] It is to be seen what the result will be of the investigation. Based upon a statement of Lu Yanchun, the deputy director general of the NDRC'S Price Supervision and Antimonopoly Bureau, applying will give a benefit to the firm.[135] This creates expectations for the capacitor makers. The benefit will depend on how early and how much a firm reports. Immunity seems to be limited to firms coming forward before an investigation has been opened or during the initial probe of the NDRC when there is no evidence gathered.[136]

Since the inception of the Chinese Leniency Policies, only NDRC's Leniency Policy has been used.[137] Seven decisions have been taken based upon that policy and this over a period of 4 years. In terms of absolute numbers, this is a great success. However, none of the firms decided to use the leniency policy voluntarily. The domestic cartels, horizontal and vertical, were incentivized to use the leniency policy due to the start of an investigation by the NDRC. It could be said that the foreign cartels reported due to the investigations of foreign enforcement agencies. However, also in these cases the NDRC seems to have started investigations before

[129] Modrall and Hu (2014), p. 4.
[130] See Modrall and Hu (2014), p. 2.
[131] See MLex Staff (2014).
[132] See Modrall and Hu (2014), pp. 2–3.
[133] See Modrall and Hu (2014), p. 3.
[134] See Gibson Dunn (2014), pp. 1–2.
[135] Cf. MLex Staff (2014).
[136] See MLex Staff (2014).
[137] See Hong (2015), pp. 92–104.

the firms even thought of reporting. It should be further noted that two of the seven mentioned leniency applications would not be eligible for a leniency application in many other jurisdictions. Vertical price maintenance is something that can be detected without having to rely on leniency.

There are some interesting elements to mention. NDRC accepts leniency after investigations have begun. Some sources seem even to indicate that NDRC is using the leniency as an incentive to facilitate their investigation.[138] Immunity is not necessarily limited to only one firm in vertical price fixing cases.[139] The last cases indicate that an endless number of leniency applicants can be eligible for lenient treatment. This, of course, casts doubts on whether there is a high standard to fulfil in order to provide material evidence. From the third applicant onwards, the maximum reduction is 50 %. There is no indication that the amount of reduction is being determined based upon the order of reporting. The level of reduction seems to be dependent upon elements not mentioned in any of the leniency policies, such as early withdrawal from the cartel. There also is no fixed line in the amount of reduction. The reduction in the car parts cartel, with all foreign firms, was lower than in the insurance cartel, with all domestic firms.

5 Reducing Flexibility in the Chinese Leniency Policies

The omnipresence of flexibility in the Chinese Leniency Policies is, based upon the experience in the US and the EU, most likely a cause of why firms, especially in international cartels, only come forward with information once there is a strong suspicion that NDRC is already conducting an investigation into their industry. It is thus important for the Chinese Leniency Policies to reduce the flexibility of the enforcement agencies.[140]

The first flexibility that should be addressed is the timing of the leniency application. NDRC and SAIC have not stipulated when a leniency application needs to be made in order to obtain immunity or receive a reduction. Both NDRC and SAIC are young enforcement agencies. With a limited number of human resources, still building up experience in the field, excluding enforcement tools that could facilitate the decision making process would seem contra-productive. Hence, if NDRC or SAIC would decide that post-investigation leniency is not available, these agencies would negatively affect the policies' effectiveness. The more information they can obtain from the firms, the smoother their decision making process will be and that within the boundaries of their resources. On top of that, all the extra information will give these agencies know-how on and insights

[138] See Editorial Board (2012); But see Deng and Zhang (2014).

[139] See Hong (2015).

[140] See, e.g., Hong (2015), Lou (2010), and Zhang (2008) (mainly focusing on the expansion of Article 46 CAML).

in the fabric of a cartel. This familiarization process will facilitate the later adaption of rules and investigation procedures. This kind of welfare economics argument could be further consolidated by referring to the political economy surrounding competition law.[141] In a business environment in which economics and politics are intertwined,[142] openly betraying your business partners may not be an option. Applying for leniency before an investigation started may not work in these circumstances. The possibility of applying for leniency in a post-investigation stage may be a necessity for China. NDRC seems to have embraced leniency applications submitted once an investigation has started.[143] Nevertheless, more clarity could be provided in the rules creating the leniency policies.

The second flexibility that needs to be rectified is the absence of automatic immunity in NDRC's Leniency Policy. NDRC has various options. NDRC could adjust its rules and insert more certainty on obtaining immunity. This may be a time consuming procedure and complicated. Another option would be to build up a practice in which they show that the first successful applicant receives automatic immunity. The cases described above seem to go in the latter's direction.[144] Of course, this is going to require open communication of NDRC on how the leniency rules will be applied. One possibility is to publish the NDRC's decision and not just a press release. Without a clear stance on how NDRC will grant immunity, applicants may be reluctant to come forward with information. SAIC, from its side, will have to confirm in practice the majority view in the literature that their immunity is automatic.

Related to the immunity issue is the third flexibility on granting of lenient treatment to subsequent applicants. NDRC and SAIC may freely choose to grant reduction to subsequent applicants. Based upon NDRC's enforcement practice above, it could be stated that subsequent applicants are more or less certain of a reduction. However, circumstances may be different in some cases inducing NDRC to decide otherwise. If the enforcement agencies consider it necessary to have subsequent leniency applications, more certainty has to be created. Another flexibility NDRC and SAIC enjoy in relation to subsequent applicants is the level of reduction. The flexibility differs slightly between the leniency policy of NDRC and SAIC. NDRC has a sliding scale of reduction ranging from 99 to 50 % reduction for the second applicant and less than 50 % reduction for any other applicant. NDRC has thus discretion to determine the ultimate level of reduction it will grant. SAIC does not have the reduction determined in terms of a sliding scale. SAIC has full flexibility to determine the reduction between 1 and 99 %. In order to keep the leniency policy effective, NDRC and SAIC have to be careful in choosing the right level of reduction. Too high levels of reduction will disincentivize firms to apply for immunity. Too much variation without the necessary explanation will undermine

[141] See Williams (2013), pp. 88–118.

[142] See Zhang (2014), pp. 689–697 and Williams (2013), pp. 98–99.

[143] See supra Sect. 4.3.

[144] See supra Sect. 4.3.

the trustworthiness of the leniency policies. The practice described above reveals that NDRC has given various levels of reduction without explaining necessarily why the level of reduction is different. This may trigger critique, especially if foreign firms are involved.[145] In the short run, transparency may solve much of the problem. Adopting concrete guidelines on how the level of reduction will be determined may reduce the problem even more.[146] Fixing the levels of reduction will exclude any kind of perception of arbitrariness.

Even if the blurred language on the possibility of obtaining a certain degree of leniency were to disappear, the fourth flexibility of how to interpret material evidence remains. In regard to this concept, many questions arise. At what point in time does the enforcement agency decide the importance of the evidence? If it is done at the moment of taking the final decision, it could be a backdoor for the second guessing form of discretion. Is it possible that a firm can provide more material evidence than another? If such a possibility exists, does that mean that a second applicant can still become the first one based upon the value of its evidence? Could a good cartel story already be material evidence? Or is more required? To offer a solution to these questions, several perspectives can be taken into account. To increase the detection of new cartels, material evidence could mean the submission of unknown information. To attract more information, material evidence could just be a good cartel story. To get useful information, a higher standard than just a good cartel story could be required, such as proving the existence of a cartel. Material evidence could also be explained in comparison to other information, already in the possession of the enforcement agencies or submitted by other cartel participants.

In order to be effective, the above interpretations have to be viewed from the perspective of the whole framework of the current leniency policy. Since the current leniency policies do not require leniency applicants to further cooperation (except the immunity applicant under SAIC's Leniency Policy) with the agencies, only a high standard of proof would prevent the risk of ending up with information that is not sufficient to lead to a final conviction. Including an obligation to continuously cooperate with the enforcement agencies may be a requisite to overcome that problem.[147] Even if the leniency policies would include a continuous

[145] See, e.g., Modrall and Hu (2014).

[146] SAIC has tried to limit the flexibility by stating that the time of application, the importance of the evidence, the relevance of the information and the cooperation during the investigation are factors to be taken into consideration when the level of reduction has to be determined. However, these guidelines still do not reveal much about the final degree of leniency.

[147] The condition of continuous cooperation has also not been incorporated in the text of the leniency policies. Continuous cooperation may be a helpful condition to construe material evidence in a liberal way. If material evidence is being regarded as any kind of evidence that can contribute to the discovery of a cartel and, eventually, the conviction, it may be necessary for the enforcement agency to further rely on the leniency applicants. The enforcement agency can guide the leniency applicant through the process of supplementing its original information with other information relevant for the discovery and conviction of the cartel. Even though continuous cooperation is a condition not explicitly expressed in the rules determining the leniency policies, it

cooperation obligation, enforcement agencies should still avoid a system in which information has to be compared. Such a comparative perspective undermines the certainty required for a leniency policy. Fairness arguments could also be put forward not to choose this interpretation. The more active firms in the cartel will be most likely the one to provide more detailed information on the cartel than the followers in the cartel. If a comparative perspective is adopted, enforcement agencies might also consider excluding, besides the originator of the cartel, the leader of the cartel from the leniency policy. However, seen the difficulty to apply this kind of concepts,[148] a more cautious approach would be not to follow this perspective. To give certainty to the leniency applicant, no matter which interpretation will be followed, more trust could be created if NDRC and SAIC accept the possibility of a hypothetical application or something alike. Such a possibility would allow the leniency applicant to confirm that the information is sufficient to obtain leniency.[149]

Overcoming the problem of what kind of information is required to obtain leniency is overshadowed by the fifth complexity of having two leniency policies that exist parallel to each other. Despite the decision that NDRC will be responsible for price related infringements and SAIC for non-price related infringements, firms could combine price and non-price related infringements. In such a scheme of concurrent jurisdictional claims over the infringement, the question is to whom the potential leniency applicant should address its application. A one-stop leniency shop could be set up in order not to jeopardize any of the leniency policies.[150] This would require NDRC and SAIC to synchronize many aspects of their respective leniency policies.

As this seems difficult, there are two pragmatic ways of dealing with claims of concurrent jurisdiction. First, the firms could submit two different leniency applications and leave the decision on who will take jurisdiction to the enforcement agencies. Second, the agency which receives a leniency application will exclude the other agency of taking jurisdiction over the case. A study on the price and non-price

would be possible to construct this obligation out of the 'material evidence' condition. Material evidence could be regarded as any kind of information that contributes to the discovery and conviction of a cartel. However, information provided to the enforcement agencies could lose their status of important if the leniency applicant refrains from continuous operation with either of the enforcement agencies. In doing so, firms can come forward with a good cartel story and further be guided by the enforcement agency in supplementing that story with more relevant information. Willfully refusing to cooperate could then render the good cartel story unimportant. Other cartel participants that have in the meanwhile applied could than overtake the first position and still be granted immunity. However, this is not an uncertainty in the head of the firm anymore. The firm has control over its efforts to further cooperate.

[148] See Beaton-Wells (2013), pp. 184–186.

[149] See Eichner (2012), p. 615.

[150] See, e.g., Eichner (2012), pp. 614–615.

related infringement cases has revealed that, when cases arise in which concurrent jurisdictional claims can arise, the agency that has taken the first investigation steps takes jurisdiction. The other agency has refrained from taking action.[151]

If there is a practice developing of excluding the other agency from asserting jurisdiction by starting the investigation first, a sixth flexibility needs to be addressed. None of the leniency policies address the situation of how an applicant should be considered to be the first applicant. To prevent a situation in which a first applicant loses his position due to incomplete information, a marker system should be created. A marker system allows a firm to notify the enforcement agency that it is going to come forward with information regarding a cartel and requests being granted a marker because more time is needed to collect all information. Upon this notification, the enforcement agency usually grants marker and informs the firm of a period in during which it has time to collect the information. At the end of the period granted, the firm needs to proffer the collected and arranged evidence and information.[152]

6 Conclusion

Leniency policies have often included flexible rules or attributed flexible competences to the enforcement agencies. Early examples of such leniency policies were the 1978 Leniency Policy of the US and the 1996 Leniency Notice of the EU. Both policies have been heavily criticized. Too much flexibility would be the cause of ineffective leniency policies. In the case of the US 1978 Leniency Policy the low number of leniency applications was referred to as proof for the failure. The low number of leniency applications that were first submitted to the EU Commission, and had thus no investigation or leniency submission in the US, had to proof the failure in the EU.

Despite these experiences, NDRC and SAIC, when devising their respective leniency policies, have incorporated a number of flexibilities. The flexibility relates to the timing of the leniency application, the granting of immunity, the level of

[151] See Wang (2014). See also Emch (2014), pp. 223–229 and 238 (arguing that both NDRC and SAIC have expanded their scope, thus enforcing beyond their respective competences without the other agency taking an initiative to investigate the same case. This suggests that there is a principle of 'first come, first serve'. The author mentions that this is also the principle advocated by the NDRC and SAIC officials at conferences).

[152] In order to remedy this situation, NDRC and SAIC should implement a marker system. A formal procedure could be followed and the rules could be changed to incorporate the marker system. However, with a few practical changes, NDRC and SAIC could achieve a similar result. Each of the enforcement agencies could install a single fax number. The order of application would be determined based upon the receipt of the fax. In order not to trump the order of the incoming faxes, NDRC and SAIC should conceptualize the material evidence conditional in a very liberal way. The submission of information that could reveal a cartel, in short 'a good cartel story,' should be sufficient in order to make this operational.

reduction, the order of application, the required evidence and the competent enforcement agency. Given the experience in the US and the EU, doubt could be casted as to the effectiveness of the Chinese Leniency Policies. Based upon the enforcement practice, the ineffectiveness of at least the NDRC's Leniency Policy seems not to go in the direction of the 1978 Leniency Policy. With 7 decisions based upon leniency applications, the NDRC's Leniency Policy has done relatively well. SAIC has not been able to attract any application, but that may have been due to circumstances beyond the leniency policy.

This is not to say that there is no problem at all with the NDRC's Leniency Policy. Almost all of the leniency applications, even the ones seeking immunity, have been submitted when it was obvious that the NDRC was taking investigative steps into their industry. It has even been said that NDRC is offering leniency as an incentive in order to further their investigations. This is not only noticeable in domestic, but also in international, cartels. All in all, the result is the same: delayed leniency applications. Based upon previous experience elsewhere, suggestions have been made to make the leniency policies more certain and transparent. If these changes create more trust, it is likely that, and this will become apparent in international cartels, firms will come forward much earlier with information. However, even if there is more trust in the Chinese Leniency Policy, it could still be predicted that, and this based upon the Japanese experience, the use of the Chinese Leniency Policy will not necessarily precede leniency applications in other jurisdictions.

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Investor-State Arbitration: A Tale of Endless Obstacles?

Claudia Reith

Contents

Abstract Investment treaties play a crucial role in attracting foreign investments, which are necessary to boost the steadily weak economies of many states. These treaties protect foreign investors and grant them – besides broad substantive protection – the right to bring claims against the host state before an arbitral tribunal. Due to the fact that investor-state arbitration insulates the foreign investor from domestic courts, which may be inefficient or hostile towards claims against the host state, it has become the generally recognized method for resolving disputes between foreign investors and states. Nonetheless, in recent years investor-state arbitration has been increasingly criticized for various reasons. The contribution will outline the major concerns associated with investor-state arbitration. Issues such as the "*changing hat syndrome*" between arbitrators and counsel as well as the lack of consistency and coherence in case-law are discussed. Further, the tension between confidentiality and transparency in investor-state arbitration is addressed. A special focus will be given to the situation in the European Union (EU): The

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Lisbon Treaty has transferred the competence to conclude investment treaties to the EU and has therewith caused many uncertainties. However, this contribution will not only put emphasis on the shortcomings of the current system, but will also have a look at possible ways forward by proposing a set of measures, which might have the effect of improving investor-state arbitration.

Keywords Investment arbitration • Investment law • Foreign direct investment • Confidentiality • Transparency • Consistency • European Union • Lisbon Treaty • Dual role of arbitrators and counsel • Appeal mechanism

1 Introduction

Every second week in 2014, an investment treaty was concluded between states, amounting to a total of 3,268 investment treaties.[1] Although the number of concluded investment treaties per year has steadily fallen since its peak at the millennium, they constitute the most important legal basis for conducting foreign investments. Their main objective is to mitigate political risks associated with foreign investments, such as expropriation, breach of contract etc., as well as attracting foreign investments.[2] Besides the material standards, which offer foreign investors far-reaching protection, investment treaties also contain dispute resolution clauses.[3] An OECD study has found that more than 90 % of all investment treaties offer investor-state arbitration as a possible dispute resolution form.[4] These clauses entitle private investors to directly commence arbitral proceedings against the host state without the need of having previously exhausted all national remedies.[5] Investor-state arbitration has been developed in order to overcome the shortcomings of the traditional dispute settlement mechanisms, such as the recourse to the national courts of the host state or the reliance on diplomatic protection.[6]

[1] UNCTAD (2015), p. 1, http://unctad.org/en/PublicationsLibrary/webdiaepcb2015d1_en.pdf. The term investment treaties refers to bilateral investment treaties as well as to other treaties containing chapters on foreign investments such as Chapter 11 of the North American Free Trade Agreement, https://www.nafta-sec-alena.org/Home/Legal-Texts/North-American-Free-Trade-Agreement. All accessed 12 May 2015.

[2] Cf. UNCTAD (2003), p. 3, http://unctad.org/en/Docs/iteiit20054_en.pdf. Accessed 12 May 2015; see also Schill (2011), p. 249.

[3] Schill (2011), p. 252.

[4] See Pohl et al. (2012), p. 11, http://www.oecd.org/daf/inv/investment-policy/WP-2012_2.pdf. Accessed 12 May 2015.

[5] Delaney and Magraw (2008), p. 723.

[6] Greenberg et al. (2011), paras 10.11 et seq.

From the viewpoint of the foreign investor both options have not been satisfactory, because the investor might have little trust in a foreign court system and does not have the right to diplomatic protection. Rather, the exercise of diplomatic protection usually lies in the discretion of the investor's home state.[7] Since it is important to create a favourable investment climate, including the possibility for the foreign investor to turn to independent and impartial authorities in case of a dispute, investor-state arbitration has been established. Commenting on this trend, an arbitral tribunal came to the conclusion that "*Nowadays*, *arbitration is the generally accepted avenue for resolving disputes between investors and states*."[8]

However, what was once considered as the ideal solution has turned out not to be entirely flawless. Although the first bilateral investment treaty was already concluded in 1959 between Germany and Pakistan, investor-state arbitration was rarely used until the end of the 1990s.[9] This has changed significantly over the last two decades, where the number of investor-state arbitration has exploded, amounting to 608 known investor-state arbitrations at the end of 2014.[10] With the increase of the proceedings and the awareness of the public of this kind of dispute settlement mechanism also its shortcomings became apparent. In response to this criticism some states have abandoned investor-state arbitration. For example, Venezuela, Bolivia and Ecuador announced their withdrawal from the International Convention on the Settlement of Investment Disputes between States and Nationals of other States (ICSID) and South Africa decided to phase out a number of investment treaties with European states.[11] The Australian government also stated that it would no longer include investor-state dispute resolution provisions in its investment agreements.[12] However, Australia's Foreign Affairs, Defence and Trade Legislation Committee, has recently said that the respective law, which prohibits the use of investor-state arbitration, should be refused.[13] This opinion is not binding for the parliament, but can be decisive for the on-going discussions in Australia. Some critics go so far as to claim that investor-state arbitration constitutes a threat to the principle of democracy and the rule of rule.[14] In this vein, arbitral tribunals were

[7] Barcelona Traction Light and Power Company Limited (Belgium v. Spain), Judgement, 1970 I. C.J., pp. 3 et seq. (5 February 1970); Dolzer and Bloch (2005), para 113.

[8] Plama Consortium Limited v. Republic of Bulgarien, ICSID Case No. ARB/03/24, Decision on Jurisdiction, (8 February 2005), 20 ICSID Review – Foreign Investment Law Journal, pp. 266 et seq. (2005).

[9] Dolzer and Stevens (1995), p. 1 and Schill (2011), p. 248 footnote 1.

[10] UNCTAD (2015), p. 5, http://unctad.org/en/PublicationsLibrary/webdiaepcb2015d1_en.pdf. Accessed 12 May 2015.

[11] Ripinsky (2012), http://www.iisd.org/itn/2012/04/13/venezuelas-withdrawal-from-icsid-what-it-does-and-does-not-achieve/#_ftn1. Accessed 12 May 2015.

[12] Tienhaara and Ranald (2011), http://www.iisd.org/itn/2011/07/12/australias-rejection-of-investor-state-dispute-settlement-four-potential-contributing-factors/. Accessed 12 May 2015.

[13] McKinnon (2015), p. 57, http://www.debevoise.com/~/media/files/insights/publications/2015/01/arbitration_quarterly_january2015.pdf. Accessed 12 May 2015.

[14] Fritz (2015), p. 5, http://www.tni.org/sites/www.tni.org/files/download/iias_report_feb_2015.pdf. Accessed 12 May 2015; Schill (2011), p. 247.

accused of being "*justice behind closed doors*" and acting as "*shadow governments*".[15] Whether investor-state arbitration is sufficiently flexible to cope with the challenges or whether it is a tale of endless obstacles and therefore outdated is addressed in this chapter.

2 Shortcomings of the Current System

Investor-state arbitration has come under attack for various reasons. It has been questioned whether investor-state arbitration is the adequate forum for resolving disputes dealing with regulatory measures adopted by parliaments and incredibly high amounts in dispute.[16] Authors have expressed their discomfort with the dual role of counsel and arbitrator in investor-state arbitration, which has been considered to be contrary to the principle of separation of powers and the rule of law.[17] Further, conflicting decisions and the lack of an appeal mechanism has given rise to concerns such as the fact that investor-state arbitration can still be conducted confidentially.[18] Before proposing a set of measures, which might contribute to eliminate or at least to reduce the imperfections of the current regime, the *status quo* will be outlined by explaining the most important shortcomings.

2.1 Changing Hat Syndrome

Coming from a legal tradition that puts great emphasis on the separation of powers and the independence of judges,[19] it is hard to imagine that a system exists, which allows (a) persons to act as an arbitrator one day and as a litigant the next day, and (b) disputing parties to appoint "*their*" arbitrators, who decide the case. This might seem incredible from the perspective of traditional rule of law values, but is a matter of fact in the world of investor-state arbitration.

The first point of criticism refers to the fact that a circle of people is alternatively, or even concurrently, acting as both counsel and arbitrator.[20] This approach is highly questionable when one bears in mind that arbitral decisions have a certain

[15] Kaufmann-Kohler (2005), p. 1, www.transnational-dispute-management.com/article.asp?key=608. Accessed 16 June 2015.

[16] Cf. Teitelbaum (2010), p. 54.

[17] See e.g. Perry (2012), p. 2.

[18] See e.g. Bottini (2014), p. 1, www.transnational-dispute-management.com/article.asp?key=2075. Accessed 19 June 2015; Tams (2007), p. 223.

[19] Articles 87 and 94 Austrian Constitution, https://www.ris.bka.gv.at/GeltendeFassung.wxe?Abfrage=Bundesnormen&Gesetzesnummer=10000138. Accessed 12 May 2015.

[20] Eberhardt (2012), pp. 34 et seq., http://www.tni.org/sites/www.tni.org/files/download/profitingfrominjustice.pdf. Accessed 12 May 2015.

extent of precedential value.[21] The mixing of roles may cause the perception that the arbitrators' independence and impartiality is suffering. If, however, it appears that the decision-making persons are not completely independent and impartial the entire system falls into disrepute. In fact, in investor-state arbitration not a single rule exists, which prohibits arbitrators from simultaneously serving as counsel.[22] Most arbitration rules provide for the challenge of an arbitrator, if there are justifiable doubts as to his/her impartiality and independence, but do not explicitly forbid an arbitrator from having a dual role.[23]

The second concern is related to the appointment procedure.[24] Usually in investor-state arbitration three arbitrators are appointed, each disputing party selects one and the party-appointed arbitrators or the arbitral institution selects the presiding arbitrator.[25] Practically, counsel are appointing an arbitrator, who may in future – quasi in return – appoint that person as an arbitrator, who previously acted as counsel.[26] This practice increases the probability of cross-appointments, which do not foster the rule of law.[27] Further, it is highly doubtful whether an arbitrator appointed by a disputing party can be truly impartial and independent.[28] The mixing of roles as well as the appointment procedures, which are currently in place, are detrimental to increase the legitimacy of investor-state arbitration. Trust and confidence in the system can only be established by leaving these practices behind.

2.2 Secret Trade Courts

In the past, arbitral tribunals were described as "*secret trade courts*", because the proceedings were held in private and not even the final award was published, unless both parties consented.[29] In other words: Investor-state arbitration was hidden from

[21] Schill (2011), p. 267 and Kaufmann-Kohler (2007), p. 357.

[22] Bernasconi-Osterwalder and Rosert (2014), p. 13, http://www.iisd.org/pdf/2014/investment_treaty_arbitration.pdf. Accessed 12 May 2015.

[23] For an overview see Bernasconi-Osterwalder and Rosert (2014), p. 13, http://www.iisd.org/pdf/2014/investment_treaty_arbitration.pdf. Accessed 12 May 2015.

[24] Bernasconi-Osterwalder and Rosert (2014), p. 13, http://www.iisd.org/pdf/2014/investment_treaty_arbitration.pdf. Accessed 12 May 2015.

[25] Blackaby et al. (2009), paras 4.30, 4.36; for further concerns regarding the appointment procedure see Bernasconi-Osterwalder and Rosert (2014), p. 12, http://www.iisd.org/pdf/2014/investment_treaty_arbitration.pdf. Accessed 12 May 2015.

[26] Buergenthal (2006), p. 5, www.transnational-dispute-management.com/article.asp?key=820. Accessed 16 June 2015.

[27] Buergenthal (2006), p. 5, www.transnational-dispute-management.com/article.asp?key=820. Accessed 16 June 2015 and Bernasconi-Osterwalder et al. (2010), p. 4, https://www.iisd.org/sites/default/files/pdf/2011/dci_2010_arbitrator_independence.pdf. Accessed 12 May 2015.

[28] Bernasconi-Osterwalder and Rosert (2014), p. 12, http://www.iisd.org/pdf/2014/investment_treaty_arbitration.pdf. Accessed 12 May 2015.

[29] New York Times (2004), http://www.nytimes.com/2004/09/27/opinion/27mon3.html?_r=0. Accessed 12 May 2015.

the public eye. This can be attributed to the fact that investor-state arbitration borrowed its main elements from commercial arbitration.[30] As such, many proceedings were conducted pursuant to arbitration rules, which were initially created for commercial arbitration, where privacy and confidentiality are two main features.[31] Confidentiality describes the obligation that neither the fact that proceedings have been initiated nor any other information regarding the dispute is shared with third persons.[32] Privacy, on the other hand, means that the hearings are not public and persons not involved in the arbitration can not follow the hearings.[33] Until the 1990s commercial arbitrations were conducted by strictly adhering to the principles of confidentiality and privacy, because it was argued that these two features are inherent to arbitration even without an explicit legal basis.[34] However, even with regard to commercial arbitration the existence and the scope of application of confidentiality and privacy have been increasingly questioned.[35]

Although commercial and investment arbitration are both forms of alternative dispute resolution they exhibit much more differences than similarities and this fact must be taken into due consideration when addressing the pressing demand for transparency in investor-state arbitration.[36] One of the main differences refers to the fact that an investment tribunal is not deciding upon an issue arising from a commercial contract, rather it decides upon rights and duties having their origin in public international law.[37] Further, investor-state arbitration inevitably involves a state entity as a disputing party, which gives rise to public interest.[38]

In this regard it must be noted that investor-state arbitration often concerns sensitive public policy issues such as water supply or sewage disposal and therefore has a dimension, which affects the general public.[39] This position is also supported by case-law. The arbitral tribunal in the case *Suez v. Argentina* held that "[..] the present case potentially involves matters of public interest. This case will consider

[30] Dimsey (2008), p. 35 and Schill (2011), p. 259.

[31] Around 36 % (222 claims) of the known investor-state arbitrations were filed under arbitration rules, which were traditionally designed for commercial arbitration. UNCTAD (2014a), p. 4, http://unctad.org/en/PublicationsLibrary/webdiaepcb2014d3_en.pdf; UNCTAD (2015), p. 7, http://unctad.org/en/PublicationsLibrary/webdiaepcb2015d1_en.pdf. All accessed 12 May 2015.

[32] Mistelis (2005), p. 213.

[33] Mistelis (2005), p. 221.

[34] Kouris (2005), p. 127 and Bagner (2001), p. 243.

[35] Reith (2015a), pp. 66 et seq.

[36] Schill (2011), p. 263.

[37] Greenberg et al. (2011), para 10.1.

[38] Cf. Greenberg et al. (2011), para 10.1.

[39] UNCITRAL Secretariat, Note Settlement of commercial disputes: Preparation of rules of uniform law on transparency in treaty-based investor-State dispute settlement, para 9, U.N. Doc. A/CN.9/WG.II/WP.160/Add.1, (5 August 2010); Blackaby (2003), pp. 358 et seq. and Delaney and Magraw (2008), pp. 723 et seq.

the legality under international law, not domestic private law, of various actions and measures taken by governments. The international responsibility of a state, the Argentine Republic, is also at stake, as opposed to the liability of a corporation arising out of private law. While these factors are certainly matters of public interest, they are present in virtually all cases of investment treaty arbitration under ICSID jurisdiction."[40]

Moreover, if the state loses the arbitration – which occurred in 25 % of the overall concluded cases – the awarded damages and the costs of the proceedings are paid with public money.[41] In 2014, the Permanent Court of Arbitration, awarded three claimants in related cases US$ 50.02 billion in damages and ordered the respondent (Russia) to pay the full costs of the arbitration plus US$ 60 million to cover 75 % of claimants' legal fees.[42] In light of these considerations, one could no longer deny that investor-state arbitration has direct implications on the civil society.[43]

Not only the specific features of investor-state arbitration require transparency, but also from a legal point of view states are obliged to make information available to the public.[44] On the national level, states have to obey their access to information acts, which have already served as a legal foundation for requesting information regarding investor-state arbitration.[45] But even if no such act exists, respective obligations can be derived from international commitments: the right to access to information – understood as an independent right – is internationally recognized by the General Comment No. 34 to Article 19 International Covenant on Civil and Political Rights as well as the case-law developed by the European Court of Human Rights in the context of Article 10 European Convention on Human Rights and the Inter-American Court of Human Rights under Article 13 American Convention on Human Rights.[46] Hence, the need for transparent investor-state arbitration is not only a policy aim, but from a legal perspective it is long overdue.[47]

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[40] Aguas Argentinas S.A., Suez, Sociedad General de Aguas de Barcelona S.A. and Vivendi Universal S.A. v. Argentine Republic, ICSID Case No. ARB/03/19, Order in Response to a Petition for Transparency and Participation as *Amicus Curiae*, (19 May 2005), 21 ICSID Review – Foreign Investment Law Journal, pp. 342 et seq (2006).

[41] UNCTAD (2015), p. 1, http://unctad.org/en/PublicationsLibrary/webdiaepcb2015d1_en.pdf. Accessed 12 May 2015.

[42] UNCTAD (2015), p. 8 footnote 20, http://unctad.org/en/PublicationsLibrary/webdiaepcb2015d1_en.pdf. Accessed 12 May 2015.

[43] Cf. Blackaby (2003), p. 356.

[44] Orellana (2011), pp. 61 et seq.

[45] See Orellana (2011), pp. 61 et seq., http://www.right2info.org/access-to-information-laws. Accessed 12 May 2015; UNCITRAL Secretariat, Note on Comments received from Mexico on transparency in treaty-based investor-State arbitration, p. 7, U.N. Doc. A/CN.9/WG.II/LIII/CRP.2, (1 October 2010).

[46] Human Rights Committee General comment No. 34, 102nd Sess., June 11-July 29, 2011, para 19, U.N. Doc. CCPR/C/GC/34; Társaság a Szabadságjogokért v. Hungary, Eur. Ct. H.R. case no. 37374/05, paras 26 et seq. (2009); Claude-Reyes et al. v. Chile, Inter-Am. Ct. H.R. case no. 151, para 77 (2006).

[47] Cf. Reith (2015a), pp. 61 et seq.

Although the response to the demand of transparent investor-state arbitration has taken quite a while, considerable progress has been made in the last years. Among the challenges investor-state arbitration faces the objective of transparency has been pursued most vigorously. Several efforts have been undertaken to make investor-state arbitration more transparent. Even if the development with regard to transparency is not yet completed, it serves as a role model how the system's other imperfections could be remedied in the future. Given the demonstration character of the recent developments, it seems to be justified to explain them in greater detail in a separate section below.

2.3 *Lack of Consistency and Coherence*

Predictability plays a vital role with regard to the rule of law. The lack of predictability might entail a "*legitimacy crisis*".[48] Certainly, one might argue that arbitral tribunals appointed for the resolution of a certain dispute are less responsible to contribute to the development of law, but should rather provide a suitable solution for the concrete case.[49] There are various criteria, which favour the phenomena of conflicting decisions. First, arbitral tribunals might come to different conclusions although the underlying treaty is the same or the facts of the disputes are similar.[50] For example in the cases *Lauder v. Argentina and CMS v. Argentina* the appointed arbitral tribunals came to different solutions: In the first matter Mr. Lauder commenced arbitral proceedings at the London Court of International Arbitration (LCIA) against the Czech Republic based on the bilateral investment treaty (BIT) concluded between the U.S.A. and the Czech Republic.[51] His company, in contrast, initiated proceedings against the Czech Republic at the Arbitration Institute of the Stockholm Chamber of Commerce (SCC) relying on the Dutch-Czech BIT.[52] Whereas Mr. Lauder's claim was not successful, his company prevailed: The arbitral tribunal constituted under the LCIA found that there was no sufficient connection between the breach and the damage.[53] On the contrary, the arbitral tribunal constituted under the SCC decided that certain standards, such as the fair and equitable treatment and the constant protection and security had been violated.[54]

[48] Franck (2005), p. 1521.

[49] Schill (2011), p. 260.

[50] Franck (2005), p. 1521.

[51] Lauder v. Czech Republic, Final Award, (3 September 2001), http://www.italaw.com/sites/default/files/case-documents/ita0451.pdf. Accessed 12 May 2015.

[52] CME Czech Republic v. Czech Republic, Final Award, (14 September 2003), http://www.italaw.com/documents/CME-2003-Final_001.pdf. Accessed 12 May 2015.

[53] Lauder v. Czech Republic, Final Award, para 309, (3 September 2001), http://www.italaw.com/sites/default/files/case-documents/ita0451.pdf. Accessed 12 May 2015.

[54] CME Czech Republic v. Czech Republic, Partial Award, para 624, (13 September 2001), http://www.italaw.com/sites/default/files/case-documents/ita0178.pdf. Accessed 12 May 2015.

Besides arbitral tribunals which interpret facts and law differently, other factors – such as confidentiality, the relatively low usage of consolidation, the lack of an appeal mechanism and the absence of a system of precedent – constitute a breeding ground for conflicting decisions. The lack of transparency has caused – to some extent – the lack of consistency and coherence in case-law: if decisions are not made public or are only selectively published, future arbitral tribunals cannot rely on prior rendered awards.[55] In this regard, practice has considerably improved in the last years and more recently lots of awards rendered in investor-state arbitration are published and can therefore serve as a basis for future decisions. However, even if the arbitral awards are available, arbitrators are not obliged to consider them, because investor-state arbitration is not familiar with a system of precedent.[56] Accordingly, prior rendered decisions do not bind arbitral tribunals. In other words: Although arbitral tribunals are free to strengthen their reasoning by referring to other case-law, they are not obliged to consider it, even if they are aware of factually and legally comparable cases.[57]

In general, one of the advantages of arbitration is finality meaning that a once rendered award is final and binding and not subject to an appeal mechanism.[58] However, with regard to strengthening consistency and coherence of case-law the finality principle must be seen from another perspective: An award can only be scrutinized on very limited grounds. In the context of ICSID, an annulment procedure was established, which provides for some kind of review, but it does not allow re-examining the matter again.[59] Arbitral awards rendered outside the ICSID regime can either be annulled by national courts according to their national arbitration acts or recognition and enforcement may be refused pursuant to the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards.[60] However, all these restricted possibilities cannot be equated with a national appeal system. Hence, no superior authority exists, which could ensure the consistency of case-law. Moreover, parallel proceedings, such as the two *Lauder* cases, and the lack of willingness to consolidate similar cases may result in diverging awards.[61]

2.4 Investor-Friendly Standards

The concern of inconsistency explained above can also be attributed to the fact that the standards contained in the investment treaties are drafted in very general terms

[55] Cf. Dimsey (2008), p. 39.

[56] Kaufmann-Kohler (2007), p. 368.

[57] See Schreuer and Weininger (2008), p. 1196.

[58] Greenberg et al. (2011), paras 1.83 et seq.

[59] Article 52 ICSID Convention, I.L.M. 1965, pp. 524–544; Reed et al. (2011), pp. 162 et seq.

[60] Article V New York Convention, U.N.T.S. 1959, pp. 3–82.

[61] Cf. Spoorenberrg and Viñuales (2009), p. 100.

and therefore leave a considerable margin of interpretation to the arbitral tribunal.[62] A typical example for a traditional clause providing for a fair and equitable treatment of the foreign investor reads as follows: "1. Each Contracting Party shall accord to investments by investors of the other Contracting Party fair and equitable treatment and full protection and security."[63] The exact meaning needs to be defined by the arbitral tribunal. Admittedly, this problem is less procedural than material in nature, but finally it redounds on the arbitrators when they fill the empty phrases with different substance. The vagueness of the current clauses gives scope for interpretation and this in turn might lead to different outcomes, which cause inconsistency.

Moreover, it has been alleged that the broad standards are interpreted to the foreign investors' benefit and that investor-state arbitration generally tends to be investor-friendly.[64] Pleas in action have been diverse.[65] However, repeatedly measures protecting the environment or the health have been challenged.[66] Hence, it is said that investor-state arbitration unreasonably restricts the policy discretion of the states and favours a small circle of economic players at the cost of the general public. In this line it has been argued that foreign investors exploit or even abuse the rights, they have been granted in the investment treaties and that investor-state arbitration stops states from taking necessary measures, because states would fear being confronted with new claims. In other words: Investor-state arbitration leads to a regulatory chill.[67]

3 Set of Measures

The answer to the *changing hat syndrome* lies in the following statement of Judge Buergenthal: "[. . .] arbitrators and counsel should be required to decide to be one or the other, and be held to the choice they have made, at least for a specific period of time. That is necessary, in my opinion, in order to ensure that an arbitrator will not be tempted, consciously or unconsciously, to seek to obtain a result in an arbitral decision that might advance the interests of a client in a case he or she is handling as

[62] Schill (2011), p. 255.

[63] Article 3 BIT between Austrian and Guatemala 2006, http://investmentpolicyhub.unctad.org/Download/TreatyFile/3316. Accessed 12 May 2015.

[64] Weininger and Naish (2014), http://www.lexology.com/library/detail.aspx?g=2f28b3cd-ff72-4829-9a54-3536b0561c24. Accessed 12 May 2015.

[65] For a list see Blackaby (2003), pp. 358 et seq.

[66] See e.g. Methanex Corporation v. U.S.A, Statement of Claim, 3 December 1999, http://www.naftaclaims.com/disputes/usa/Methanex/MethanexStatementOfClaim.pdf. Accessed 12 May 2015.

[67] Schreuer (2012), p. 2.

counsel. ICSID is particularly vulnerable to this problem because the interpretation and application of the same or similar legal instruments – the Bilateral Investment Treaties, for example – are regularly at issue in different cases before it."[68]

Judge Buergenthal here pleads for a strict separation of arbitrators and counsel in investor-state arbitration. This leads to the question whether there should be an explicit rule stipulating the incompatibility of both professions at the same time. One might argue that the language of the current rules and guidelines offer sufficient flexibility to address this concern, because they require the independence and impartiality of arbitrators.[69] However, the hope that rules will be interpreted in one way or the other is fraught with uncertainty and constitutes a halfway solution. Hence, a more straightforward model is the introduction of a respective rule – most importantly in the framework of ICSID and the UNCITRAL Arbitration Rules. One could follow the example adopted by the Court of Arbitration for Sport (CAS), which reads as follows: "[. . .] CAS arbitrators and mediators may not act as counsel for a party before the CAS."[70] A similar rule is urgently needed in investor-state arbitration and can be introduced by amending the respective arbitration rules.

The current appointment procedure should be replaced as follows: First, a list of full-time arbitrators is required, who are willing to act as arbitrators for, at least, some years. Given the fact that the amount of disputes per year is limited, the number of appointed arbitrators would need to be restricted. The ICSID or UNCITRAL Secretariat or the permanent body, which is proposed below in the context of coping with the consistency problem, could administer this list. The registered claims could be allocated to the arbitrators for instance according to the first letter of claimant's name. Hence, nobody would know in advance, who sits in the panel. Certainly, the argument may be raised that the traditional appointment procedure is a key feature of arbitration and ensures that arbitrators are appointed, who have the expertise for the particular case. However, this argument fails: only persons specialized in investment law come into question of being registered. Again the permanent body, which is explained in greater detail below, could be responsible for selecting the arbitrators for the list.

If disputing parties are not appointing a particular arbitrator in the hope that he/she decides in their favour, the parties cannot be against the fact that they do not have any longer any influence on the appointment procedure. Such a list would not only address the concerns regarding the appointment procedure, but also the criticism concerning the "*double hat syndrome*", because only full-time arbitrators

[68] Buergenthal (2006), p. 5.

[69] Bernasconi-Osterwalder et al. (2010), p. 42, https://www.iisd.org/sites/default/files/pdf/2011/dci_2010_arbitrator_independence.pdf. Accessed 12 May 2015.

[70] Section 18 Statutes of the Bodies Working for the Settlement of Sports-Related Disputes, http://www.tas-cas.org/fileadmin/user_upload/Code20201320corrections20finales20_en_.pdf. Accessed 12 May 2015.

would be listed. Moreover, this approach would also minimize the risk of procedural delays and increase the efficiency of the proceedings, which seems to be of importance when considering the fact that ICSID arbitration takes an average of 3.6 years.[71]

Inconsistency, for whatever reasons, creates uncertainty and impairs the predictability as well as the stability of investor-state arbitration. Possible solutions range from the creation of an appellate body to the introduction of a system of precedent in investor-state arbitration or proceedings, which allow for some kind of preliminary rulings similar to the model of preliminary rulings established in the EU pursuant to Art 267 Treaty on the Functioning of the European Union (TFEU).[72] Several years ago, the creation of an appeal mechanism was proposed in the context of ICSID.[73] However, this idea was not further pursued.[74] Another solution may be the establishment of and adherence to precedents.[75] To realize precedent "[A]wards should, for reasons of legitimate expectation and legal certainty and consistency, not deviate from established jurisprudence, except if there are significant new arguments and only with careful and detailed reasoning."[76]

Given the fact that the establishment of precedents does not require any institutional reform and is therefore independent from the states' consent, it appears that – compared to the other approaches – this solution is the most achievable strategy for ensuring consistency and coherence. However, it also has its restraints: First, it rests with the arbitrators whether they are relying on a line of cases. Second, non-compliance with prior rendered awards entails no consequences. Third, investor-state arbitration is decentralized with having arbitral institutions, arbitral tribunals and seats of arbitration all over the world.[77] Fourth, although arbitral awards are increasingly published, many are still kept confidential.[78] These facts may hamper the comprehensive introduction of precedent in investor-state arbitration. Though the reliance on prior rendered awards might be an interim solution to achieve coherence, in the long-term it must be supplemented by the establishment of a permanent body, most preferably under the auspices of ICSID, which allows either for an appeal or a preliminary ruling and observes the development of consistent case-law. In my view a system of preliminary rulings would be favourable, because it would not infringe the highly valued principle of finality. It

[71] Sinclair et al. (2009), p. 1, http://www.goldreserveinc.com/documents/ICSID%20arbitration%20%20How%20long%20does%20it%20take.pdf. Accessed 12 May 2015.

[72] Kaufmann-Kohler (2004), p. 289 et seq. and Schreuer and Weininger (2008), pp. 1200 et seq.

[73] ICSID Secretariat (2004), paras 20 et seq., https://icsid.worldbank.org/apps/ICSIDWEB/resources/Documents/Possible%20Improvements%20of%20the%20Framework%20of%20ICSID%20Arbitration.pdf. Accessed 12 May 2015.

[74] Schreuer (2012), p. 6.

[75] Kaufmann-Kohler (2008), p. 146.

[76] Wälde (2008), p. 113.

[77] Cf. Kaufmann-Kohler (2008), p. 147.

[78] See Wälde (2008), p. 113.

would allow arbitral tribunals to suspend the ongoing proceedings and submit the matter in question to the permanent body, if the issue is of particular importance, the tribunal wants to deviate from established case-law, or established case-law is missing at all.[79]

When creating such a permanent body several issues need to be considered. The persons in question should be highly renowned, independent, impartial, representing different continents, cultures and economies. Therefore, other employment, such as acting as counsel or arbitrator should be incompatible with the task of delivering preliminary rulings. The persons should at least serve several years in the permanent body and should receive a fixed remuneration.[80] Moreover, the number of persons in the permanent body must be restricted in terms of delivering preliminary rulings in a reasonable time frame, which could be 3–4 months. It should be noted that – once established – the permanent body could also undertake other tasks such as deciding upon arbitrators' challenges, because it has already been considered problematic that colleagues sitting in the same panel or persons appointed by business representatives decide upon this issue.[81]

Bearing in mind that such a permanent body requires a complete new international convention or an amendment of the already existing legal frameworks, it will take some time to develop. Nonetheless, the deficiencies require action. In this regard the states need to be reminded that they are not an end in themselves, and are urged to pull together to show progress.

The list of arbitrators, proposed above, could also help to limit the scope of the material standards in the investment treaties, because permanent arbitrators supposedly feel less obliged to interpret clauses to the foreign investors' benefit, if they are not appointed by them. Further, a rebalance between the rights and duties of the foreign investors and states could be achieved by a clearer drafting of the standards.[82] If the standards are more narrowly formulated, the arbitrators' scope of interpretation is restricted respectively. Accordingly, the ball is passed to those responsible for negotiating and concluding the investment treaties – the states. With the current language it is hard for the foreign investors as well as for the states to predict how the arbitral tribunal will eventually interpret the standards, which results in uncertainty for both. Besides providing a clearer wording in future investment treaties, it will be equally necessary to draft precise exceptions to the general rules, which allow the states to take measures aiming to protect generally recognized values, such as the public health, the environment etc. It will be vital to grant the states sufficient discretion to adopt necessary measures without having to

[79] Cf. Schreuer and Weininger (2008), p. 1204.

[80] Cf. Basedow (2014), http://www.faz.net/aktuell/wirtschaft/wirtschaftspolitik/freihandelsabkommen-das-problem-mit-den-geheimgerichten-13173663-p5.html. Accessed 12 May 2015.

[81] Bernasconi-Osterwalder and Rosert (2014), p. 12, http://www.iisd.org/pdf/2014/investment_treaty_arbitration.pdf. Accessed 12 May 2015.

[82] Weininger and Naish (2014), http://www.lexology.com/library/detail.aspx?g=2f28b3cd-ff72-4829-9a54-3536b0561c24. Accessed 12 May 2015.

pay damages to the foreign investors. These rules are typically referred to as sustainable development provisions and have been in fact increasingly incorporated in investment treaties in recent years.[83]

The proposed measures are certainly not an answer to all of the questions concerning investor-state arbitration. Furthermore, the effectiveness of the measures will heavily depend on whether foreign investors, who can choose between a range of arbitral institutions and rules, do not circumvent the established measures in one regulatory framework by simply picking another. Hence, the set of measures should be accompanied by a restriction of the investors' choice in order to ensure that the efforts are not in vain. If these suggestions are considered, investor-state arbitration could emerge strengthened rather than weakened from the reform process, which is necessary for its long-term survival. Further, some allegations – e.g. arbitrators tend to decide in favour of foreign investors – are not fact-based but rather of polemic nature. In this regard, it should be noted that less than one third of the overall concluded cases was decided in favour of foreign investors.[84]

4 The Transparency Initiative: A Role Model

As mentioned above, the need for transparent investor-state arbitration has been recognized for a number of years. The initiatives in this context prove that there is not only the willingness to adjust the system to the current needs, but there is also sufficient ability and flexibility to address the concerns surrounding investor-state arbitration. Since the undertaken efforts are unique and might provide some guidance on how the other shortcomings could be removed, it is worth having a closer look at them.

Transparent investor-state arbitration can be realized by different paths: one approach is the amendment of the arbitration rules by incorporating respective provisions, which provide for transparent investor-state arbitration.[85] In this regard it should be noted that the ICSID and UNCITRAL Arbitration Rules are the most often used rules in investor-state arbitration. In around 90 % of all cases one of these rules was applied.[86]

The International Centre for the Settlement of Investment Disputes has been established in the 1960s under the auspices of the World Bank.[87] The ICSID

[83] UNCTAD (2015), p. 3, http://unctad.org/en/PublicationsLibrary/webdiaepcb2015d1_en.pdf. Accessed 12 May 2015.

[84] UNCTAD (2015), p. 8, http://unctad.org/en/PublicationsLibrary/webdiaepcb2015d1_en.pdf. Accessed 12 May 2015.

[85] Harrison (2011), p. 3.

[86] UNCTAD (2014a), p. 4, http://unctad.org/en/PublicationsLibrary/webdiaepcb2014d3_en.pdf; UNCTAD (2015), p. 7, http://unctad.org/en/PublicationsLibrary/webdiaepcb2015d1_en.pdf. Accessed 12 May 2015.

[87] Greenberg et al. (2011), paras 1.35 et seq.

Convention entered into force in 1966 and has 151 contracting states.[88] Since ICSID is the only specialized institution for investor-state arbitration, it was also very early in picking up the issue of transparency. Although investor-state arbitration under ICSID has never been completely confidential,[89] the revised ICSID Arbitration Rules, which entered into force in 2006, have been a turning point in providing greater transparency. First, Rule 37 para 2 ICSID Arbitration Rules 2006 entitles the arbitral tribunal to accept *amicus curiae* submissions regardless of the consent of the disputing parties. Generally, *amicus curiae* submissions are reports from experts, very often submitted by non-governmental organizations, which are drafted independently from the disputing parties' position and without getting paid for them.[90] *Amicus curiae* submissions are seen as an element of public participation in investor-state arbitration. It is argued that such submissions reflect the position of the general public and that therefore a public dimension finds its way into investor-state arbitration.[91] Further, the Centre is now obliged to immediately include in its publications excerpts of the legal reasoning of the tribunal, though it is not allowed to publish the award without the consent of the parties.[92] Thirdly, the arbitral tribunal may conduct hearings open to the public, unless either party objects.[93] Before 2006 the arbitral tribunal had to obtain the parties' consent, if it wished to hold open hearings.[94]

Following the ICSID example the issue of transparency was also discussed at the level of the United Nations Commission on International Trade Law (UNCITRAL), although the UNCITRAL Arbitration Rules have not been particularly designed for investor-state arbitration, but rather for commercial disputes.[95] In 2010 the UNCITRAL Commission entrusted the Working Group II (Arbitration and Conciliation) with the drafting of a transparency standard in investor-state arbitration.[96] The Working Group submitted the draft rules to UNCITRAL in 2013, which

[88] https://icsid.worldbank.org/apps/ICSIDWEB/about/Pages/Database-of-Member-States.aspx?tab=FtoJ&rdo=BOTH. Accessed 12 May 2015.

[89] See e.g. Rule 48 para 4 ICSID Arbitration Rules, which allows the Centre to include in its publication excerpts of the legal rules applied by the Tribunal, even if it was prohibited from publishing the award without the consent of the parties. Further, the Secretary General has to publish some information about the operation of the Centre, including the registration of arbitration claims, https://icsid.worldbank.org/ICSID/StaticFiles/basicdoc/CRR_English-final.pdf. Accessed 12 May 2015.

[90] Mistelis (2005), pp. 218, 231.

[91] Delaney and Magraw (2008), p. 777 and Blackaby (2003), p. 363.

[92] Rule 48 para 4 ICSID Arbitration Rules 2006.

[93] Rule 32 para 3 ICSID Arbitration Rules 2006.

[94] Cf. Kaufmann-Kohler (2005), p. 3 and Knahr (2007), p. 341.

[95] Cf. Tuck (2007), p. 913.

[96] Cf. Rep. of the U.N. Comm. on Int'l Trade Law, 43rd Sess., June 21-July 9, 2008, U.N. Doc. A/65/17, para 87.

finalized and adopted them.[97] The *UNCITRAL Rules on Transparency in Treaty-based Investor State Arbitration* (UNCITRAL Transparency Rules) make the cornerstones of investor-state arbitration transparent by *inter alia* providing for the publication of certain information at the very outset of the proceedings.[98] Further, under the UNCITRAL Transparency Rules key documents, such as the statement of claim, are automatically published and the arbitral tribunal is entitled to accept submissions by third persons (*amicus curiae submissions*) and non-disputing parties to the treaty.[99] Another novelty constitutes the fact that hearings shall be public according to Article 6 UNCITRAL Transparency Rules.[100] Moreover, the UNCITRAL Transparency Rules provide for very narrow exceptions to the rules and in addition, a repository has been established, which ensures the publication of certain information.[101] Hence, the UNCITRAL Transparency Rules, if applicable, secure transparency from the commencement of the proceedings until the closure. If a dispute arises out of an investment treaty concluded before the date of their entry into force (1st April 2014), the UNCITRAL Transparency Rules only apply, if the disputing or contracting parties agree to their application (opt-in approach).[102] In order to provide the contracting parties with an instrument to express their consent to apply the UNCITRAL Transparency Rules, the corresponding *Convention on Transparency in treaty-based investor-State arbitration* (UNCITRAL Transparency Convention) has been established, which is open for signature since 17th March 2015 and has been signed by 16 states.[103] In relation to investment treaties concluded on or after 1st April 2014, the UNCITRAL Transparency Rules apply automatically, when the investor-state arbitration is initiated under the UNCTRAL Arbitration Rules, except the parties have decided otherwise (opt-out approach).[104] Further, it is remarkable that the UNCITRAL Transparency Rules are not only available, if the arbitration is conducted under the UNCITRAL Arbitration Rules, but they can also be applied in connection with other arbitration rules.[105]

Besides modifying the arbitration rules or establishing a completely new regulatory framework, another approach to ensure transparent investor-state arbitration constitutes the incorporation of specific rules into the investment treaties. Usually, investment treaties stipulate that their provisions modify or supplement the

[97] Rep. of the Working Group II, 57th Sess., Oct. 1–5, 2013, U.N. Doc. A/CN.9/760; Rep. of the Working Group II, 58th Sess., Feb. 4–8, 2013, U.N. Doc. A/CN.9/765; Rep. of the U.N. Comm. on Int'l Trade Law, 46th Sess., July 8–26, 2013, U.N. Doc. A/68/17, para 128.

[98] Article 2 UNCITRAL Transparency Rules, http://www.uncitral.org/pdf/english/texts/arbitration/rules-on-transparency/Rules-on-Transparency-E.pdf. Accessed 12 May 2015.

[99] Articles 3–5 UNCITRAL Transparency Rules.

[100] See Reith (2015b), p. 131.

[101] Reith (2015b), pp. 138 et seq.

[102] Article 1 para 2 UNCITRAL Transparency Rules.

[103] http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/2014Transparency_Convention_status.html. Accessed 28 October 2015.

[104] Article 1 para 1 UNCITRAL Transparency Rules.

[105] Article 1 para 9 UNCITRAL Transparency Rules.

arbitration rules.[106] The Central American Free Trade Agreement (CAFTA), for example, contains a provision entitled "*Transparency of Arbitral Proceedings*".[107] This provision *inter alia* obliges the respondent to make important documents available to the public and prescribes open hearings. A similar standard has been achieved through interpretative statements by the Free Trade Commission and joint statements by the contracting parties in the context of the North American Free Trade Agreement (NAFTA).[108]

Despite having in mind that not all rules and frameworks described above provide for the same extent of transparency, one has to admit that at different levels a lot has been done to raise the veil of confidentiality in investor-state arbitration. Now the remaining shortcomings have a turn. Hopefully, they will be tackled with the same engagement.

5 Investor-State Arbitration in the Context of the EU

5.1 The Shift of Competence

Until the Lisbon Treaty, which entered into force on 1st December 2009, the EU was not empowered to negotiate and conclude investment treaties, rather this competence rested with the member states.[109] Due to the lack of competence, the EU had not concluded a single investment treaty, whereas in contrast its member states have made large use of this instrument and are contracting partners in more than 1,400 such treaties.[110] However, due to the increasing significance of foreign direct investments the European Parliament urged for a common investment policy at the European level.[111]

This aim was realized with the long awaited entry into force of the Lisbon Treaty, which assigned the exclusive competence in the area of the common commercial policy including foreign direct investments to the EU.[112] The transfer of competence was needed, because the so-far established investment protection by the member states differs significantly and the EU intended to create an extended

[106] See e.g. Article 1120 para 1 NAFTA; Article 10.15 para 5 Central American Free Trade Agreement https://ustr.gov/sites/default/files/uploads/agreements/cafta/asset_upload_file328_4718.pdf. Accessed 12 May 2015.

[107] Article 10.21 CAFTA; Singh (2004), pp. 335 et seq.

[108] See Reith (2015a), pp. 185 et seq.

[109] For the legal situation before 2009 see Maydell (2008), pp. 73 et seq.

[110] Burgstaller (2012), p. 207; http://trade.ec.europa.eu/doclib/docs/2015/january/tradoc_153046.pdf. Accessed 12 May 2015.

[111] European Parliament (2010), p. 9, http://www.europarl.europa.eu/committees/en/studiesdownload.html?languageDocument=EN&file=33990. Accessed 12 May 2015.

[112] Article 207 in connection with Article 3 para 1 lit e Treaty on the Functioning of the European Union, OJ C 326, 26.10.2012, pp. 1–390.

and consistent investment protection.[113] Although the reasons for a shift of competence were indeed legitimate, it initially caused great uncertainty among the investment community.[114] From the viewpoint of a foreign investor it was, for example, not clear against whom – the EU or the member state – a potential claim can be filed. Hence, at the first glance the new competence left many issues inadequately clarified without any apparent added value. However, a second look reveals the possibilities of the amendment, in particular to adjust the investor-state arbitration system to current requirements. In this regard, one has to bear in mind that in the long run the EU will replace the member states as contracting party of investment agreements and will thus be in the position to form the future shape of investor-state arbitration. Whether the EU has shown sufficient willingness and flexibility to close the loophole caused by the shift of competence and has concurrently addressed the concerns underlying investor-state arbitration is discussed below.

5.2 *The EU's Position on Investor-State Arbitration*

One of the first reactions to its new competence was the communication from the European Commission (Commission) in July 2010 titled "*Towards a comprehensive European international investment policy*". In this communication the Commission acknowledged the importance of investor-state arbitration and stated that also future investment treaties concluded by the EU should contain such a mechanism.[115] Concurrently, the Commission was aware of the shortcomings of the system and mainly referred to the lack of transparency in investor-state arbitration.[116] The Commission emphasized that transparent proceedings could be realized by publishing the request for arbitration, pleadings and the award, by making proceedings open to the public as a well as by allowing *amicus curiae* submissions.[117] The Council of the EU and the European Parliament shared this position.[118]

[113] European Commission (2010), p. 5, http://trade.ec.europa.eu/doclib/docs/2010/july/tradoc_146307.pdf. Accessed 12 May 2015.

[114] Cf. Maes (2010), p. 12.

[115] European Commission (2010) 343 final, p. 11, http://trade.ec.europa.eu/doclib/docs/2010/july/tradoc_146307.pdf . Accessed 12 May 2015.

[116] European Commission (2010), p. 11, http://trade.ec.europa.eu/doclib/docs/2010/july/tradoc_146307.pdf. Accessed 12 May 2015.

[117] European Commission (2010), p. 11.

[118] Council of the European Union (2010), paras 4, 18, http://italaw.com/documents/CouncilofEUConclusions.pdf; European Parliament (2011), http://www.europarl.europa.eu/sides/getDoc.do?type=TA&language=EN&reference=P7-TA-2011-141; European Parliament (2010), pp. 45 et seq., http://www.europarl.europa.eu/committees/en/studiesdownload.html?languageDocument=EN&file=33990. All accessed 12 May 2015.

In autumn 2014, the EU and Canada finished their negotiations on the Comprehensive Economic and Trade Agreement (CETA), which offers investor-state arbitration as a possible dispute resolution mechanism and provides for the application of the recently adopted UNCITRAL Transparency Rules.[119] Further, the Commission brought forward a proposal for ratifying the UNCITRAL Transparency Convention.[120]

The steps taken by the EU are a clear commitment to investor-state arbitration as the main venue for resolving disputes arising out of foreign investments and prove that clauses providing for investor-state arbitration will be an integral component of future investment treaties. However, some issues have been disregarded by the EU. One of the main unresolved questions concerns the compatibility of the investor-state system with the autonomy of the European legal system.[121] In this context it has been stated that, in some cases, arbitral tribunals will apply European law without, however, having the opportunity to turn to the European Court of Justice to request a preliminary ruling, which should ensure the consistent interpretation of European law.[122] It remains to be seen how the EU tackles this problem.[123]

5.3 The Current Legal Framework

One of the crucial questions, which arose after the EU took over the competence in foreign direct investments, was the fate of the remaining investment treaties concluded by the member states. With the adoption of the Regulation (EU) No 1219/2012 the EU has restored, at least partly, a stable and predictable environment for foreign investors.[124] In essence, the Regulation stipulates that investment treaties, which were concluded by the member states and entered into force before 2009, remain valid until they will be replaced by an investment treaty concluded by the EU and the third country.[125] Whereas the member states have to merely notify the Commission of all investment treaties concluded before 2009, they have to seek the Commission's authorization for amending or concluding respective contracts

[119] Comprehensive Economic and Trade Agreement, http://www.international.gc.ca/trade-agreements-accords-commerciaux/agr-acc/ceta-aecg/text-texte/10.aspx?lang=eng. Accessed 12 May 2015.

[120] European Commission (2015), http://eur-lex.europa.eu/resource.html?uri=cellar:d11c207e-a7b8-11e4-8e01-01aa75ed71a1.0005.01/DOC_1&format=PDF. Accessed 12 May 2015.

[121] Burgstaller (2012), pp. 216 et seq. and Lavranos (2011), pp. 1 et seq.

[122] Burgstaller (2012), pp. 216 et seq.

[123] For possible solutions see Lavranos (2011), pp. 13 et seq.

[124] Regulation (EU) No 1219/2012 of the European Parliament and of the Council of 12 December 2012 establishing transitional arrangements for bilateral investment agreements between Member States and third countries, OJ L 351, 20.12.2012, pp. 40–46.

[125] Recital 7, Article 3 Regulation (EU) No 1219/2012.

thereafter.[126] Moreover, the member states are under a duty to inform the Commission of every initiated dispute resolution procedure and must cooperate with the Commission in terms of the defence, which can include the Commission's participation in the proceedings.[127] What form the Commission's participation in the proceedings will take, is not clear yet.[128] It appears that the only possibility to involve the Commission in the proceedings is to recognize it as *amicus curiae*, because for another form of participation the legal foundation is simply lacking.

Another step towards the implementation of a comprehensive investment policy was the adoption of the Regulation (EU) No 912/2014, which allocates the financial responsibility resulting from investor-state arbitration between the EU and its member states.[129] Although the Regulation entered into force in September 2014, its application is limited to arbitral proceedings resulting from an investment treaty the EU or the EU and its member states are parties to.[130] Accordingly, the Regulation *de facto* currently only applies to proceedings arising from the Energy Charta Treaty. The Regulation lays down the criteria, which should be taken into account when it comes to the allocation of the financial responsibility, whereby the term financial responsibility includes the awarded compensation as well as the costs resulting from the arbitration.[131] The basic principle is that the entity, whose treatment has given rise to the claim, has to bear the costs, except the treatment was implemented by a member state in order to comply with EU law.[132] Besides the apportionment of the financial burden, the Regulation also sets forth rules for the conduct of disputes. Again the important connecting factor is the question where the treatment stems from: If the dispute arose in connection with a member state's treatment, the Regulation stipulates a close cooperation between the state and the EU.[133] Therefore, the Regulation contains reciprocal information obligations including the duty to exchange relevant documents.[134] In accordance with the criteria allocating the financial burden, the entity, whose treatment has given rise to the claim, acts as respondent in the proceedings.[135] However, the EU always acts as respondent, if the member state declares pursuant to Article 9 para 1 lit b Regulation No 912/2014 that it does not intend to be respondent or the Commission decides that the EU acts as

[126] Recital 8, Articles 2, 5 and 9 Regulation (EU) No 1219/2012.

[127] Article 13 lit b Regulation (EU) No 1219/2012.

[128] Cf. Kendra and Kozyreff (2013), p. 255.

[129] Regulation (EU) No 912/2014 of the European Parliament and of the Council of 23 July 2014 establishing a framework for managing financial responsibility linked to investor-to-state dispute settlement tribunals established by international agreements to which the European Union is party, OJ L 257, 28.8.2014, pp. 121–134.

[130] Article 1 Regulation (EU) No 912/2014.

[131] Article 2 lit g, Article 3 Regulation (EU) No 912/2014.

[132] Article 3 para 1 Regulation (EU) No 912/2014.

[133] Articles 5–8 Regulation (EU) No 912/2014.

[134] Articles 10 et seq. Regulation (EU) No 912/2014.

[135] Article 4 Regulation (EU) No 912/2014.

respondent provided that the circumstances in Article 9 para 2 Regulation No 912/2014 are fulfilled. Furthermore, the Regulation contains certain rules for concluding settlement agreements and the payment of awards and settlements.[136]

Although the shift of competence within the EU caused great uncertainty in the beginning, the EU has proven to be flexible in designing rules, which ensure a smooth transition from the investment treaties concluded by the member states to the next generation of investment treaties, which will be negotiated and signed by the EU. The regulations were urgently needed in terms of the currently ongoing negotiations on potential investment treaties with China, India, Japan, Morocco, Myanmar, Singapore, Thailand, the U.S.A. and Vietnam in order to provide future contracting parties a stable regulatory framework.[137] Given the fact that more than half of the total known arbitration claims have been submitted by European investors, the retention of investor-state arbitration – though in an updated version – seems to be a sensible solution.[138]

6 Conclusion

Bearing in mind that the majority of the more than 3,000 investment treaties, which are currently in place, provides for investor-state arbitration we will not easily get rid of the system, in spite of its many imperfections. Also, the steps taken by the EU after the Lisbon Treaty entered into force suggest that investor-state arbitration will be maintained. In the discussion the fact is sometimes overlooked that investor-state arbitration was introduced for good reasons. It was established to depoliticize disputes, which could otherwise affect diplomatic relations between states or even result in a military conflict.[139] Additionally, it opens individuals an access to legal proceedings and ensures legal protection. Hence, it is neither desirable nor feasible to reject investor-state arbitration in its entirety. The transparency initiative has shown that the system is sufficiently flexible to break out of the vicious circle of flaws, uncertainties and complaints. Certainly, further progress needs to be made in order to take the wind of the critics' sails, which will be a great challenge considering the fragmented nature of investment law. However, rather than adding fuel to the heated debate, one should now keep a clear head. The problems have been identified and possible solutions are proposed.[140] It is only the implementation that is lagging behind.

[136] Articles 13 et seq. Regulation (EU) No 912/2014.

[137] European Commission (2015), http://trade.ec.europa.eu/doclib/docs/2006/december/tradoc_118238.pdf. Accessed 12 May 2015.

[138] European Commission (2015), http://trade.ec.europa.eu/doclib/docs/2015/january/tradoc_153046.pdf. Accessed 12 May 2015.

[139] Schreuer (2014), http://derstandard.at/1395364339465/Jurist-Frueher-fuehrte-das-zu-Krieg. Accessed 12 May 2015.

[140] See e.g., UNCTAD (2014b), http://unctad.org/en/PublicationsLibrary/webdiaepcb2014d6_en.pdf. Accessed 12 May 2015.

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Part III
The Perspective of Business

The New Corporate Criminal Law and Transnational Legal Risk

Mark Fenwick

Contents

Abstract This chapter examines the transnational character of the 'new corporate criminal law' and identifies some of the consequences for any business that operates across borders, notably the expansion of transnational legal risk. A response to this expansion in legal risk has been the growth of adaptive and flexible "compliance" mechanisms within organizational governance. From the perspective of regulators, the new corporate criminal law also creates new sources of risk and the chapter will suggest that the increased importance of transnational regulatory networks between regulators is an adaptation to the new legal reality. The chapter concludes by suggesting that one important consequence of this expansion in new scope of legal risk is a transformation in the normative character of criminal law, as it applies to corporations.

Keywords Corporate crime • Legal risk • Regulatory networks • Transnational law • White-collar crime

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1 Introduction

This chapter examines the transnational character of contemporary corporate criminal law and identifies some of the consequence for any business that operates across borders, notably the expansion of transnational legal risk. A response to this expansion in new legal risk has been the growth of adaptive and flexible "compliance" mechanisms within organizational governance. From the perspective of regulators, the new corporate criminal law also creates new risks and the chapter suggests that the increased importance of transnational regulatory networks between regulators is, in large part, an adaptation to this new reality.

By way of a preliminary definition, *corporate criminal law* refers to the body of law that imposes criminal liability on the corporation *itself* rather than individual members of the corporation, such as directors, officers, managers or employees. Corporate criminal law has greatly expanded over the last three decades, particularly in the fields of market regulation, anti-corruption, anti-money laundering and securities law. A salient feature of the widening of the corporate criminal law "net" is the extension in the territorial reach of substantive corporate criminal law provisions to include acts that have occurred beyond the national boundaries of the concerned jurisdiction. A company established in a jurisdiction that engages in corporate corruption overseas, for example, is criminally liable in the home jurisdiction for certain offences.

More recently, however, the territorial reach of corporate criminal law has extended further and the criminal law of a particular jurisdiction is applied to any corporation that issues securities or simply conducts part of its business in a jurisdiction, irrespective of where that corporation was established, where the firm's center of operations are located, or where the alleged wrongdoing took place. A company established and with its center of operations in the US, for example, but issues shares on a UK-based stock exchange or conducts business in the UK, for example, may be exposed to criminal liability in the UK for conduct occurring in either the UK, the companies home jurisdiction (i.e. the US) or any third country.

The real complexities arise, however, when multiple jurisdictions extend the reach of their corporate criminal law in this way. The legal requirements of different legal systems may vary significantly or, at least, significant uncertainties may remain as to the precise degree of any overlap in substantive norms. Criminal law retains a strong national character and precise harmonization between substantive norms of jurisdictions is unlikely, even in those cases where there is a shared legal tradition, a broad consensus around the nature of the underlying problem and an international treaty in place. Companies thus find themselves obliged to comply with the disparate normative requirements of multiple jurisdictions and enforcement agencies are obliged to conduct investigations transnationally and manage the resulting jurisdictional conflicts.

The combined effect of these changes is that the profile of legal risk for companies is greatly expanded. Moreover, this new risk profile has a highly

complex and unstable character that requires a greater investment in the management of legal risk. This chapter will introduce the idea of a corporate criminal law (Sect. 2); the process of "net-widening" in corporate criminal law that has occurred over recent decades (Sect. 3); the emergence of the new transnational legal risk that this net-widening has created (Sect. 4); and the response of both regulators (Sect. 5) and companies (Sect. 6).

2 Corporate Criminal Liability

The idea of a corporate criminal law is not new; in its modern form, its origins can be traced to English law in the early decades of the nineteenth century.[1] The historical position of modern legal systems was that although individual members of a corporation could be criminally liable for offences committed in the course of their occupation, the corporation *itself* could not be liable.[2] Criminal liability lay with members of the corporation – directors, managers or employees – but not with the corporation itself. As such, the corporation fell outside the domain of criminal responsibility. From the perspective of the criminal law, a corporation was an incorporeal entity that lacked the necessary degree of fault or blameworthiness that is a necessary condition for the imposition of criminal liability.

For example, William Blackstone, in his *Commentaries on the Laws of England*, regarded it as self-evident that criminal liability was confined to natural persons and that any other approach would constitute an anthropomorphic error, in that a corporation is incapable of acting with the requisite fault necessary for the criminal law.[3] He characterized the corporation as an impoverished legal subject and identified on a number of practical difficulties that would arise in applying criminal law and procedure to corporations. In particular, a corporation cannot appear in court "in person" to offer a defense (resulting in a trial *in absentia*), a corporation cannot swear an oath, nor can a corporation be arrested, imprisoned or executed. For Blackstone, at least, it was obvious that corporations could not be subjected to the discipline of the criminal law.

The origins of modern corporate criminal liability rules can be traced back to the early decades of the nineteenth century when, in the context of rapid industrialization, corporations acquired a greater social presence as the scope and impact of their activities expanded dramatically.[4] In response to this socio-economic transformation, English law gradually extended the application of the criminal law to juristic

[1] For the history of corporate criminal liability, see Wells (2001).

[2] The so-called principle of *societies delinquere non potest*. For early English cases, see, *The Case Suttons Hospital* (1612) holding that a corporation is "incapable of an act understanding and it has no will to exercise".

[3] Blackstone (1979), p. 464.

[4] Wells (2001), chp. 2.

persons, such as municipalities and then corporations. This change was initially a result of judicial rather than legislative action, and involved cases of criminal omission resulting in public nuisance. The scope of this new form of criminal liability gradually expanded, however, to include acts as well as omissions and finally crimes requiring intent and not just absolute liability offences.

A similar story can be told about the emergence and development of corporate criminal liability in a US context.[5] The early US history of corporate criminal liability culminated in 1909 with the US Supreme Court decision in *New York Central & Hudson River Railroad v. United States*, in which constitutional concerns about Federal anti-trust legislation that explicitly imposed criminal liability on corporations were set aside in favor of the more pragmatic view that corporate criminal liability represented the "only means" to "control" corporations.[6]

By the early-decades of the twentieth century, the idea of corporate criminal liability was well established in the main jurisdiction of the common law world. The differences between jurisdictions were to be found in the liability standard. Some jurisdictions – US Federal law, for example – adopted a vicarious liability standard in which a company is liable for that criminal act of *any* employee that is committed in the course of his or her employment and with the intention of benefiting, at least in part, the company.[7] This broad standard lowers the threshold for securing a conviction, but exposes the company to the risk of a conviction for the actions of a single "rogue" employee.

In contrast, other common law jurisdictions – English law, for example – focused on the criminal acts of senior managers within the company (the so-called "directing mind" standard) in determining liability. This approach focuses on the question of whether the particular offence was committed by senior figures within the company who can legitimately be identified with the company itself.[8]

Nevertheless, for much of its history, corporate criminal law was marginalized from the mainstream of criminal justice, even in those jurisdictions that embraced the doctrine of criminal liability for corporations. In practice, criminal prosecution of corporate suspects remained something of an exception. Moreover, most civilian rejected the idea of corporate criminal law, preferring instead to focus on the personal liability of managers.[9] This approach reflected the view that the liability of legal persons is properly dealt with as part of public administrative law rather than the criminal law. Many countries in Europe (such as Germany, Italy and Spain) began to confront the growing power of business enterprises by introducing systems of administrative regulation, similar to "public welfare" offences in the United States or regulatory offences in the UK. These infractions are enforced by

[5] See, generally, Bernard (1984).

[6] *New York Central & Hudson River Railroad v. US*, (*1909*) 212 U.S. 481.

[7] See Khanna (1996).

[8] See Gobert (1994).

[9] For a discussion of the principles underling the traditional continental European approach, see Leigh (1977).

administrative agencies and have neither the status of criminal sanction and are thought to be morally neutral and lacking the element of condemnation associated with criminal liability.

The consequence was that corporate criminal liability occupied a marginal position both in the imagination and practice of modern criminal justice.[10] As with white-collar offenders, more generally, the early history of corporate criminal law is a familiar tale of economically powerful elites being insulated from the gaze of criminal justice.

3 The New Corporate Criminal Law

Over the last three decades, however, this situation has changed and corporate criminal law has acquired a new significance in the "mix" of regulatory strategies for responding to corporate wrongdoing. Across multiple jurisdictions, a process of "net-widening" has occurred that has significantly expanded the scope of corporate criminal law. Although we should not be naive in underestimating the capacity of the business community to limit the degree of intrusion into their activities, an effect of this new emphasis on corporate criminal law is that business enterprises can no longer afford to ignore corporate criminal law and they are now obliged to incorporate it into their decision-making processes, policies and practices, and organizational structure. This section will briefly introduce this process of net-widening.

Firstly, many civilian jurisdictions that did not previously have provision for corporate criminal liability have now introduced it.[11] The administrative law approach to corporate wrong doing has gradually been supplemented by the introduction of corporate criminal liability. In a European context, this seems to have largely been the result of pressure from regional and international organizations that identified a regulatory gap, which – it was believed corporate criminal responsibility could fill. In Asia, there has been a similar trend to adopt corporate criminal liability. Chinese law has extensive provision for so-called "unit crime". Under Japanese law, juridical persons may also be criminally punished if a dual punishment provision (so-called "*ryobatsu-kitei*") exists which provides that juridical persons can be punished together with the individual offender that actually committed the violation regarding the business of the juridical persons.[12]

The most notable exception to this trend to adopt corporate criminal liability is Germany.[13] In German law, the criminal law only applies to natural persons, and

[10] On this controversy and marginalization generally, see Hamdani and Klement (2008), Khanna (1996), and Laufer (1994).

[11] See Heine (1998).

[12] On Japan, see Kyoto (1996).

[13] See Beck (2010).

most German commentators reject the possibility of a company committing a crime on the grounds that a company lacks the capacity to be guilty. Nevertheless – in keeping with the traditional approach of the civil law – a company can be held liable, under Germany's *Administrative Offences Act*. If a person commits an unlawful act with managerial responsibility and the offences involved violations of the company's policies, or the company was enriched or intended to be enriched, the company can be held liable. Although lacking condemnatory force of criminal law, this type of scheme can be regarded as the functional equivalent of corporate criminal liability, insofar as it impacts upon corporate practice.

The second piece of evidence for net-widening has been the expansion in the scope of corporate criminal law and the creation of multiple new categories of criminal offence.[14] Even a cursory list of the main fields of contemporary corporate criminal law highlights the breadth of the law in this area; anti-corruption law, anti-money laundering law, fraud law (including investment fraud, securities fraud, government fraud, mortgage fraud, consumer fraud and false advertising), competition law, tax law (including off-shore tax evasion), accounting standards law, marketing law, export controls and sanctions law, labor law, health and safety law, and environmental law. Moreover, these are just the general fields of law; there are also many industry specific laws that impact upon corporations operating in particular sectors of the economy. These are all areas that have significantly expanded over the last three decades.

Paralleling this expansion in the number of criminal offences has been a corresponding tendency to weaken the *mens rea* requirements for corporate crimes. The emergence and expansion of strict liability (i.e. "no-fault" or public welfare) offences is the most obvious example of this transformation. It is no coincidence that many strict liability offences are concerned with corporate activities, such as pollution and health and safety where there is a clear public interest at stake in halting the proscribed acts. And yet, there has also been a more general trend on the part of legislators to move from relatively "high level" *mens rea* requirements, such as intent or knowledge, to relatively low-level requirements, such as recklessness and negligence. As with strict liability, this general trend has also been particularly important in the context of corporate regulation.

The final element in the widening of the criminal justice "net" is a more aggressive attitude towards enforcement. Enforcement actions have increased substantially, particularly over the past decade. There is a great deal of discussion of a "new era" of enforcement in multiple fields of corporate criminal law, notably anti-corruption law, anti-money laundering law, securities law and competition law.[15] There has also been a corresponding increase in the size of sanctions. Sentencing guidelines for organizations have been upwardly adjusted and enforcement agencies are more aggressive in pursuing larger penalties.

[14] On this trend, see Larkin (2013).

[15] On the new era of enforcement, see Orland (2006).

There are many factors driving this, notably public anxiety over corporate wrong doing. Another factor has been the proliferation of new economic understandings of crime that seem particularly pertinent in understanding corporate wrongdoing. Corporations are perceived to be amoral calculators, particularly receptive to the message – notably the threat – communicated by a well-designed and calibrated system of criminal sanctions. As such, an economic account of crime provides a strong normative justification for a greater role for the criminal justice system in the regulation of corporate wrongdoing. Policy makers seem to have arrived at the conclusion that effective control of the economy is, at least in part, contingent on a more rigorous subordination of corporations to the discipline of the criminal law.

Against this background, the primary purpose of corporate criminal liability seems to have crystallized; imposing criminal liability on business enterprises offers the tantalizing possibility of the *ex ante* prevention of corporate wrongdoing by creating a strong incentive for *all* the stakeholders within a company to monitor for wrongdoing and to correct any wrongdoing that is uncovered. If all the stakeholders within the company are exposed to the risks of a criminal conviction (i.e. if corporate assets – financial and reputation – are placed at risk), then all the stakeholders will seek to ensure that wrongdoing does not occur. Corporate criminal liability can motivate companies to minimize their liability exposure by assuming the task of policing their agents themselves.[16]

Moreover, companies are particularly well placed to perform this monitoring function. At least, they are better placed than the state or any third parties negatively affected by corporate wrongdoing. A company can introduce internal controls and *ex ante* measures for detecting agents contemplating wrongdoing. In addition, a company can react to wrongdoing by investigating the extent of the problem, disciplining wrongdoers, reporting them to the authorities and implementing measures to ensure that there is no reoccurrence. In this way, corporate criminal liability can make a distinctive contribute to a net reduction in corporate wrongdoing at least cost to society.

It is worth emphasizing the difference between corporate and individual criminal liability on this point. When an individual is punished or threatened with punishment, the goal of that punishment or threat is to inhibit rather than to mobilize. The message that the law communicates is to refrain from committing the offence. At least, that is the basis of all traditional deterrence-based justification for punishment, be it general or specific. In contrast, in the context of *corporate* criminal law the threat is – as Fisse has perceptively observed – "catalytic" as well as inhibitory. The message conveyed is "refrain from committing that offence and take such steps as are necessary organizationally to guard against repetition".[17] This recognition of the "catalytic" possibilities of corporate criminal liability distinguishes the new corporate criminal law from both criminal law as applied to natural persons and earlier iterations of corporate criminal law. Within the framework of economic

[16] See Fisse (1983).

[17] Fisse (1983), p. 1160.

understandings of wrongdoing, the identification of this "catalytic" function provides corporate criminal law with a unique role and function that adds distinct value to the "mix" of liability strategies. At least, that became the conventional wisdom and was accepted by policy makers in almost every jurisdiction.

4 Transnational Legal Risk

A particularly salient feature of the widening corporate criminal law "net" is the extension in the territorial reach of substantive criminal law to include acts that have occurred, and actors that operate, beyond the national boundaries of the concerned jurisdiction. The new corporate criminal law consists of a complex and unstable mosaic of overlapping norms that emerges when multiple jurisdictions extend the scope and reach of corporate criminal law in this way. The transnational reach of the new corporate criminal law creates an unprecedented degree of legal risk for firms – particularly any firm that conducts part of its business activities overseas – as well as creating new challenges for enforcement agencies charged with the responsibility of enforcing this law.

The most obvious manifestation of this extension in the transnational reach of corporate criminal law is the broad provision for the extra-territorial application of criminal law.[18] In its most basic sense, this simply refers to the fact that the substantive norms of a particular jurisdiction are applied to corporate conduct that has occurred overseas. More recently, however, the territorial reach of corporate criminal law has extended further and the criminal law of a particular jurisdiction is also applied to any corporation that issues securities or simply conducts part of its business in that jurisdiction, irrespective of where that corporation was established, where the firm's center of operations are located, or where the alleged wrongdoing took place. A company that has been established and has its center of operations in one jurisdiction, but issues shares in a UK-based stock exchange, for example, may be exposed to criminal liability in the UK for conduct occurring in either the UK, the companies home jurisdiction or a third country.

Consider the example of anti-corruption law. Contemporary efforts to engage with transnational corporate corruption can be traced back to the United States in the mid-1970s when, in the context of diminishing public trust with corporate and other power elites triggered by the Vietnam War, the civil rights movement and Watergate, the Carter administration enacted the *Foreign and Corrupt Practices Act* (*FCPA*). The *FCPA* criminalized the payment of bribes to foreign government by any company issuing securities in US-securities markets, irrespective of where the bribe actually took place.[19]

[18] See Slaughter and Zaring (1997).

[19] For the "story" of the *FCPA*, see Koehler (2012a).

The real complexities arise, however, when multiple jurisdictions extend the reach of their corporate criminal law in this way. The legal requirements of different legal systems may vary significantly or, at least, significant uncertainties may remain as to the precise extent of any overlap. Criminal law retains a strong national character and precise harmonization between substantive norms of jurisdictions is unlikely, even in those cases where there is a shared legal tradition, a broad consensus around the nature of the underlying problem and an international treaty in place. Companies find themselves obliged to comply with the disparate normative requirements of multiple jurisdictions and enforcement agencies are obliged to conduct investigations transnationally and manage the resulting jurisdictional conflicts.

Again consider the example of corporate corruption. In retrospect, the enactment of the *FCPA* can be seen as a foundational moment in the history of the new corporate criminal law, both in terms of the substance of the law and the attention that it attracted to the issue of transnational corporate wrongdoing. A series of international treaties followed, e.g. *The OECD Anti-Bribery Convention*, 1997 and *The UN Convention Against Corruption*, 2004.[20] More recently, a number of other important jurisdictions have expanded the scope of their domestic criminal laws, including Brazil, China, India and the UK, and a more aggressive attitude towards enforcement has been adopted.[21] However, important differences between the different schemes – on issues such as facilitation payments, for example – still remain and create new complications for corporations.

A final complication arises from the fact that corporate criminal law is constantly changing. New laws are being made and older laws revised. The profile of legal risk for companies is rendered highly unstable and the uncertainties created by the fact of the relentless pace of criminal law reform itself becomes an additional source of legal risk. The instability of contemporary corporate criminal law – the fact that, at any moment, the law somewhere is being revised or reviewed – also has a transnational aspect.

The belief that universal principles – either formal or substantive – can provide a foundation for modern law is no longer credible. Rather, the basis of contemporary corporate criminal law is social "facts" – understood as contingent constructions of a particular social problem – and the political demands that surround those "facts". Crucially, both these "facts" (i.e. the contingent understanding of a particular problem) and the attendant political demands for action are constantly changing as perceptions of transnational corporate wrongdoing evolve.

In the context of political modernity, it has always been the case that the validity of law is a temporary state of affairs, subject to the countervailing wishes of the people as articulated through the legislature. Nevertheless, under contemporary conditions there is acceleration in the temporal instability of the validity of law. Social facts and their associated political demands are constantly changing (driven

[20] For developments at the level of public international law, see Spahn (2012, 2013).

[21] For an overview of developments, see Jordan (2012).

by a 24 h news cycle and social media) and the profile of legal risk acquires a new instability.

More specifically, a process of cycling seems to characterize contemporary law making in which a political demand based on a new understanding of the relevant social facts creates new hope and forms the basis of a new round of law reform.[22] When these new reforms are found not to deliver the desired or expected effects, the resulting disappointment triggers a fresh critique and the emergence of new political demands for reform and the cycle starts all over again. Within this cycling process, high profile scandals – which may not be representative of the realities of a particular social problem – can have a disproportionate and distorting effect on understanding of an issue and the law reform process. The process of law reform becomes highly situational and incident-driven, creating a legal environment characterized by a much greater degree of temporal instability in the validity of law.

The extension in the transnational reach of corporate criminal law occurring in multiple jurisdictions and fields of law has created a new legal environment that is characterized by a complex and constantly fluctuating mosaic of overlapping substantive and procedural norms. In this sense, it is legitimate to regard the new corporate criminal law as an instance of transnational law. Having introduced the main features of this nascent normative order, some of its causes and consequences will be discussed further.

The background to this extension in the transnational reach of corporate criminal law has been the emergence of new expectations of criminal justice in an era of economic globalization. Recent academic discussion on transnational law in a commercial context suggests that contemporary developments in the evolution of law need to be understood as adaptations to the new realities of a global economy.[23] This new economic order is characterized by the declining significance of territorial borders and the emergence of a transnational economic system that no longer primarily operates on a national basis. A central claim of the recent socio-legal literature on commercial transnational law is that many contemporary legal developments can be understood as adaptations to functional imperatives demanded of this global economic system.

Crucially, corporate wrongdoing has, in many cases, also taken on a transnational character or, at least, that is now an influential perception. The "reality" of contemporary corporate wrong is that it occurs "across" national frontiers and involves transnational corporate actors. At least, this attribution structures much state action in this field. This transformation in the perceived character of contemporary corporate wrongdoing has resulted in new demands being made of the criminal law. In this sense, the criminal justice system is increasingly expected to contribute to the regulation of pressing transnational social problems – such as corruption, money laundering, or environmental harm – that are perceived as a threat to important collective transnational interests.

[22] On this process of "cycling", see Komesar (1997, 2001).

[23] See Callies and Zumbansen (2010).

The new expectations placed on criminal justice reflect perceived limits with the various alternative regulatory strategies and forms of legal liability. For example, the high transaction costs associated with coordinating state action limit options in international law. Any treaties that are concluded tend to be limited to imposing general obligations on state parties to criminalize various undesirable conduct. Moreover, a traditional territorial based approach to the criminal law is not seen as viable for dealing with the realities of transnational wrongdoing. The principle of comity and respect for the sovereignty of a foreign state's criminal justice system has been displaced and the reach of criminal law has been extended to cover corporate actions that occur overseas.

From the perspective of business enterprises, the new corporate criminal law and procedure has serious implications. Identifying and complying with the disparate, and possibly competing, obligations of multiple jurisdictions is not always easy and companies are faced with significant costs and uncertainties arising from the need to become familiar with the overlapping requirements of an elaborate mosaic of legal norms that comprise the new corporate criminal law. The technical and organizational challenge of managing this new legal risk has become a crucial and unavoidable task for all business enterprises, regardless of size, that conduct even a small part of their business operations overseas. Responding to this new transnational legal risk has triggered a massive expansion in corporate compliance, which will be considered in more detail in Sect. 6 below.

Equally, the extended transnational reach of the new corporate criminal law introduces significant new challenges and complexities for those agencies responsible for enforcement. Various problems arise as a result of this widening of the corporate criminal law "net" beyond national boundaries. Modern nation-states do not possess the means, authority or resources to police these norms effectively. In large part this is simply because of the prohibitive administrative costs associated with investigating corporate actions in a transnational setting. In an era of austerity in public finances, it is often not practicable for regulatory agencies to fulfill the new expectations that have arisen in the context of transnational corporate misconduct. This is particularly so when one considers the complex character of corporate wrongdoing and the sophisticated efforts that are made to cover it up by well-resourced and highly motivated corporations.

5 Regulatory Adaptations to New Legal Risk: Networks

An institutional adaptation to the regulatory dilemmas created by the extended transnational reach of the new corporate criminal law is the emergence of so-called transnational regulatory "networks".[24] As a consequence of the transnational character of contemporary corporate wrongdoing and criminal law, administrative and

[24] See Fenwick et al. (2014).

other regulatory agencies responsible for enforcement are obliged to cooperate with one another in the investigation and prosecution of corporate crime. This has resulted in routinized, purposive interaction between officials from government agencies of different countries that share a common sphere of expertise and authority. Over time, this interaction has become, to some degree, formalized leading to the emergence and growth of so-called regulatory "networks".

Scholars from a range of intellectual and disciplinary backgrounds have examined transnational regulatory networks; for example those influenced by Keohane and Nye's work in political science[25]; Luhmann's systems theory[26]; and Foucault's work on governmentality.[27] Moreover, the extensive literature associated with Kingsbury and Stewart has also extensively discussed this issue from the perspective of administrative law.[28] This isn't the occasion for a comprehensive review of this diverse literature; rather this section points to some general features of such networks.

Although examples of transnational regulatory networks can be found from the early decades of the twentieth century (in the field of drug control or anti-trusts, for example[29]), such networks have developed rapidly in the last three decades and their recent growth suggests that they are particularly well suited to the conditions associated with late modernity, specifically globalization.

Transnational regulatory networks are flexible and adaptable institutional forms that can perform diverse functions, in part as a result of the relative autonomy that they are able to maintain from external interference. They can contribute to the reduction in the potential for conflicts (jurisdictional or otherwise) by providing a forum for dialogue. More positively, they can facilitate inter-agency cooperation (e.g. investigation, enforcement, notification, consultation and information exchange) and coordination (e.g. procedures such as mutual recognition, simultaneous examination and elaboration of common standards).

In particular, the administrative costs associated with investigation and enforcement in cases involving a cross-border dimension can be greatly reduced by tapping into the local knowledge, expertise and fact-finding powers of partner agencies in other jurisdictions. The "systematization" of such cooperation can further reduce costs in repeat situations. Networks can also function as information hubs, gathering information from different legal or other social systems, repackaging that information and then disseminating it throughout the network. Finally, networks can enhance the power and effectiveness of regulators by developing and promoting a degree of regulatory uniformity (i.e. common understandings, practices,

[25] See, for example, Slaughter (2004).

[26] See, for example, Callies and Zumbansen (2010) and Kjaer (2010).

[27] See Braithwaite and Drahos (2000), Burris et al. (2005), and Drahos (2010).

[28] See, for example, Cassese (2005) and Kingsbury et al. (2005). For a more recent collection of essays, see Anthony et al. (eds) (2011).

[29] For example, the 1936 *Convention for the Suppression of the Illicit Traffic in Dangerous Drugs* facilitated the creation of new national agencies to coordinate international efforts at drug control.

knowledge and standards) from the "bottom up" without the delays and inefficiencies associated with centralized or negotiated harmonization. As such, these institutionalized organizational couplings can reduce the complexity of the regulatory environment, stabilize expectations, enhance trust, and activate resources produced by other agencies elsewhere within the network.

A distinctive feature of this institutional form is the resulting disaggregation of state sovereignty. Governmental units communicate with each other directly through policy networks and not just through conventional channels of communication (e.g., foreign ministries) or via formal international organizations. Although uneven and fragile, the emerging transnational web of regulatory relationships has seen the development of the sovereign state toward forms of statehood that may be less sovereign, from the perspective of classical accounts, but which, in the context of late modernity, may be better suited to achieving regulatory objectives.

Regulatory networks have typically arisen as a result of policy failure or other structural deficiencies with existing institutional forms, notably public international law and domestic-oriented regulatory models. To many observers, public international law and the system of liberal inter-governmental cooperation on which it is based have often been inflexible, and ineffective at meeting the complex policy challenges of late modernity. Even at their most successful, multilateral organizations created within the framework of international law have been clumsy and are often times constrained by procedural requirements that make decisive action impractical. Regulatory networks dispense with the formal equality and time-consuming costs associated with traditional international agreements and organizations, on the one hand, whilst facilitating a transnational approach to problem solving, on the other.

This type of cooperation is based on relatively loosely structured, horizontal ties developed over time through repeat interaction amongst multiple players rather than via centrally coordinated ex ante agreement. Such cooperation is most commonly structured – when it is formally structured at all - by informal or non-legally binding agreements (e.g. MOUs), and involves regular peer-to-peer cooperation between participating agencies that is based on trust and not directly controlled by the head of the executive or the foreign ministry of respective governments. The "central" hub of such networks that may emerge are often relatively weak, at least initially, and performs a coordination function.

Relatively developed examples of such networks, include cooperation between securities regulators (within the framework of the *International Organization of Securities Commissions*) or competition regulators (the *International Competition Network*). Across many fields of regulation, transnational networks exert a powerful influence by reducing complexity, stabilize expectations & facilitate mutual trust.

This last point is particularly important given the inter-connected nature of contemporary global society and its problems. Domestic agencies can't hope to function effectively or cost efficiently in isolation. Scholars and institutions have embraced the concept of "global public goods" to describe the general interest duties that require coordinated international action, because states do not have to

individual capacities to cope with them.[30] These "common concerns of mankind" include issues such as climate change or the fight against corruption that are impossible to combat at national level. More and more issues perceived as of this nature. As such, they highlight the issue of state failure and the limits of the sovereign state.

As such, networks do not emerge out of nowhere. As Peter Craig has observed networks require an "institutional orchestrator", that functions as the initial impetus behind the establishment of a particular network and influences the initial form (i.e. structure, policy direction, spheres of activity, etc.) that it takes.[31] The particular actor that takes on this role varies from network to work depending on various factors – most obviously institutional capacities and power – and reflects the heterogeneity that characterizes this area.

Furthermore, the rise of this type of network has been permitted and fueled by a perception that many contemporary regulatory issues are increasingly technocratic, in the sense that they entail the development and application of expert knowledge.[32] Faith in agency expertise has justified deference to agencies and a concomitant expansion of their powers, both at a national level, but also transnationally. Moreover, political deference to agency actions at the transnational level appears justified by a sense that they relate to issues that are narrowly technical rather than broadly political. As such, they are questions that are best managed by technocrats, rather than political elites or bureaucrats specializing in international relations.

In a knowledge society – a society in which knowledge is the most productive factor in society – information gathering has become central and ex ante judgments of "objective" public interest are increasingly made under conditions of cognitive uncertainty and with a greater degree of deference to purported expertise. In this context, regulatory networks result in the formation of "epistemic communities" whose shared, inter-subjective understanding of a particular issue can then be deployed in order to structure public debate and facilitate political consensus in harmonizing broader policy principles.[33] In circumstances where such consensus does not occur, the existence of networks can, at a minimum, ensure that divergence is informed by (reasoned) dialogue and an awareness of alternative points of view. Administrative systems are thus continuously engaged in a constant reformulation of the public interest based on a reflexive process of continued learning. As knowledge becomes more and more specialized and fragmented and there is less common shared knowledge, and, perhaps even the absence of a common reality, global epistemic communities become increasingly important.

The modern, Hobbesian account in which social order is produced within a self-governing and geographically contained political community by a combination of public deliberation and "top down" control has been displaced by a radically

[30] See Kaul and Conceicao (eds) (2010).

[31] See Craig (2011), p. 107.

[32] See Vermeule (2006).

[33] For an account of regulatory networks that places particular emphasis on epistemic communities, see Braithwaite and Drahos (2000).

fractured vision of a globalized society in which networks of "heterarchical" relationships generate collective global order as a secondary effect of routinized cooperative activities.[34] The production of order is thus radically de-centered and is produced via networks of individuals and organizational relations that are different to reconcile with the traditional state centered narratives of order that have dominated political science and sociology.

The value of the network concept in describing contemporary patterns of global regulation thus resides in that fact that it can provide a powerful alternative narrative as to how order emerges. The complementarity and interdependence of the various nodes within a network and the synergy effects generate new options that are only available in and through the network itself, and are not the result of actors negotiating with one another. A network is constructed not based on the implementation of a pre-formulated plan, but continually invents itself by innovative recombination of individual elements.

Nevertheless, critics of this development have argued that since transnational regulatory networks create order in the "shadow" of conventional modern institutional forms they often result in a reduction in transparency and political accountability. This is a familiar critique of globalization, namely the argument that the post-Westphalian order challenges core modern understandings of democracy and control, and as such circumvent the normal rules of representative democracy by allowing policy to be developed without the approval of an elected legislature.

Critics suggest that the effect of these various deficiencies is an accountability deficit that seriously compromises regulatory networks. First, a lack of representation may result in the interests of member bodies being promoted over those of non-members. Since networks are often dominated by experts they exclude a broad range of views, and that – in consequence – they fail to accommodate in an adequate manner, the full range of public concerns. To the extent that national regulators favor the interests of their own states, the resulting standards may be distorted by self-interest and are not in the best interests of the global community. Particularly when networks are closed societies, they may reinforce existing power relations, particularly inequalities between the developed and developing world. This may adversely affect both the perception of the standards and the actual quality of the standards.

Moreover, transnational regulatory networks do not normally have a mechanism for reviewing any particular standard, outside of the network itself, which also may affect both the perception of legitimacy and the quality of the standards proposed. There is the suggestion that this lack of accountability of global actors at one remove from national administrative law where conceptions of accountability and transparency are relatively advanced. Equally, international law does not have equivalent conceptions that serve to constrain power "above" the state.

Defenders of networks have responded to this type of critique by arguing that networks derive a certain kind (albeit a distinctive kind) of legitimacy since their

[34] See Ladeur (1997).

expert knowledge is believed to provide them with the cognitive resources necessary to contribute to the integration of society. The application of technical expertise to solve technical problems is designed to be objective standards and since transnational regulatory networks bring highly developed expertise to address global problems, the solutions they offer should be less ideologically motivated than those provided by other actors. While states are motivated to develop policies that are self-serving, transnational regulatory networks are motivated by a desire to develop policies that represent the current understanding of best practices. And, while state actors may rely on coercive power to enforce their views, transnational networks rely more on soft power, meaning persuasion, and the possibility – if a particular approach is seen as undesirable – of withdrawing from the network.

In spite of these misgivings, it seems undeniable that such networks do constitute an increasingly important form of contemporary governance and understanding the operation and function of these regulatory networks is a significant task in mapping the institutional framework of the new corporate criminal law.

6 Business Adaptations to New Legal Risk: Social Enforcement

Section 4 introduced the suggestion that the emergence of a new corporate criminal law occurring across multiple jurisdictions can be interpreted as an attempt to provide behavioral incentives to establish meaningful social enforcement inside business organizations. A central aim of the expansion of corporate criminal liability is to create, foster, and harness the self-regulatory capacities of a corporation in order to ensure that regulated entities actively cooperate in the co-production of compliance.

Social enforcement aims at ensuring that meaningful self-regulatory capacities become firmly embedded in the structure and culture of an organization. In this context, a culture of compliance can be characterized by a generalized awareness of relevant legal obligations, incentive structures that encourage compliance with those obligations and institutionalized control mechanisms for monitoring corporate conduct and implementing corrective action in the event of non-compliance.

Social enforcement can be regarded as constituting an "organizing logic" or "embedded principle" structuring policy developments in this area. An embedded principle is a principle that gives disparate practices a unity or coherence, and a shared underlying purpose or rationale. Such a principle defines the goal or set of policy goals in a particular field of law and policy. Other examples of such principles in the context of criminal law would include retribution or rehabilitation, or, in the context of civil law, corrective justice. In each case, the principle orients appropriate policy choices, dictates preferable institutional forms and practice, and provides criteria for defining success.

A key organizing principle of the new corporate criminal law is to provide corporations with incentives to engage in social enforcement and this principle allows us to make sense of a range of legal developments across multiple jurisdictions. This is not to suggest that other principles more traditionally associated with criminal justice, such as punishment or deterrence, are irrelevant in the context of the new corporate criminal law. Modern legal systems have a complex character in the sense that they can simultaneously embed multiple, possibly competing, principles. Nevertheless, the contemporary emphasis on social enforcement gives the new corporate criminal law its distinctive character and that it offers a better interpretive and explanatory fit with a wide range of recent developments than more traditional justifications for imposing criminal liability.

Policy makers have responded to the regulatory dilemmas associated with enforcing transnational corporate criminal law by seeking to strengthen the business enterprise's own responsibility for managing the task of compliance. In this way, the new corporate criminal law transfers much of the responsibility, functions and administrative costs associated with "policing" compliance from the state to private actors. This approach can be justified on the grounds that the corporation is best placed to monitor for, and, when necessary, correct wrongdoing at least cost to society. Public enforcement – in the form of indictment, trial and possible conviction – is regarded as a measure of last resort to be employed in the event of a breakdown or failure in social enforcement.

The emergence of social enforcement is part of a more general contemporary trend to identify a surrogate regulator to achieve policy goals and to minimize the direct enforcement role of state. In other contexts this approach has been characterized as "self-regulation" or "meta-regulation".[35] It entails a form of regulation that is "indirect" or "at-a-distance", in the sense that the state focuses its risk management efforts on facilitating and stimulating the risk management and enforcement mechanisms of individual business enterprises. The rise of "indirect" regulation of this type reflects a broader shift in the understanding of the role of government and the nature of regulation, particularly in the context of regulating business enterprises. It represents an attractive alternative precisely because it has the capacity to deal with complex and diverse organizations that may be impervious to traditional control-based strategies.

Social enforcement connects with the broader issue of how to manage entrepreneurial freedom and responsibility in a globally interconnected economy. Corporations are the primary agents and site of economic growth and a certain degree of risk-taking is economically and socially desirable. However, certain dangers attach to any economy oriented around the systemic production of risk, creating a greater necessity for risk management. Such risk management presumes a high degree of specialized "know-how" on the part of regulators and the capacity to manage new kinds of risk is often beyond the means of the nation state. Incentivizing firms to manage their own risk in a responsible fashion is the most practical alternative

[35] See Braithwaite and Drahos (2000).

available. In this way, entrepreneurial freedom and the responsibility for managing the consequences of decisions made in the exercise of that freedom are closely linked. The alternative would be for the state to prohibit innovative processes, but that is not an attractive policy option in the context of a global economy that is increasingly driven by innovation and risk-taking.

Policy makers have therefore adopted various measures to stimulate social enforcement. The most important mechanism for offering clear behavioral incentives to implement meaningful social enforcement are the broad provision for corporate criminal liability combined with an expansive range of criminal offences. As such, the "catalytic" rationale for corporate criminal liability introduced in Sect. 4 and "net-widening" introduced in Sect. 3 are central to any social enforcement model. By placing all stakeholders of a business enterprise at risk of the negative – possibly catastrophic – effects of a criminal conviction, corporate criminal liability creates a strong incentive for all stakeholders within the firm to monitor one another for wrongdoing and to correct any wrongdoing that is uncovered. If all stakeholders are exposed to the risks attached to wrongdoing then they have a strong and obvious incentive to ensure compliance. As such, corporate criminal liability motivates companies to minimize their liability exposure by assuming the task of policing their agents.

Corporations have adapted to the legal risks associated with the "catalytic" message of the new corporate criminal law by the widespread adoption of compliance mechanisms.[36] Corporate compliance consists of an organization's policies, procedures, and actions that aim to prevent and detect violations of laws and regulations. The stated aim of such compliance is to manage regulatory risk and to ensure that an organization has systems of internal control that adequately measure and manage the risks that it faces. Compliance is expected to perform various functions connected to this central task, namely to identify the risks that an organization faces and advise on them; to design and implement controls to protect an organization from those risks; to monitor and report on the effectiveness of those controls in the management of an organization's exposure to risks; to resolve compliance difficulties as they occur; and to advise the business on rules and controls.

Corporate compliance can be understood as the institutional means adopted by firms to achieve the policy goal of social enforcement. Stand-alone compliance departments developed in the early 1960s, initially in the US. Prior to that time, the legal department would have responsibility for compliance functions. The legal risks associated with the new corporate criminal law, as well as the proliferation of regulation more generally, has triggered an expanded role for the discourse and practice of compliance in contemporary business enterprises. Moreover, a host of

[36] See Kaplan (2013). See also the *Financial Times* (2014/4/24) in which the rising significance of compliance is introduced with the anecdote that in the 1980s the compliance officer of a well-known City of London firm was charged with "looking after the boss's wine cellar". Now, compliance "is one of the hottest areas of financial recruitment, according to headhunters. The age of the compliance officer is upon us".

qualifications are available, from bodies such as the International Compliance Association and the Chartered Institute for Securities & Investment. This new emphasis on compliance is particularly significant in those medium and larger enterprises that operate transnationally and are exposed to a correspondingly higher degree of legal risk.

The legal system increasingly offers incentives to implement effective compliance programs. All of these other mechanisms seek to offer "rewards" for implementing compliance structures in the event that wrongdoing does occur, i.e. in the event of a breakdown in social enforcement companies will be "rewarded" for having had compliance in place at the time any offending occurred. Modern corporate criminal law recognizes that perfect compliance is impossible and that demanding perfection may be counter-productive. Such an expectation has a "chilling effect" on a firm's willingness to invest in what will often be regarded as a non-revenue generating activity.

There are a number of examples of legal measures designed to "reward" compliance. Firstly, compliance can function as a justification, that is to say, a full defense against criminal liability. A company that can show it had adequate compliance procedures in place at the time an offence occurred is not criminally liable. The UK Bribery Act, for example, offers a full defense against liability for the payment of bribes, if – at the time the offence occurred – the corporation had "adequate" compliance mechanisms in place. Secondly, compliance can provide mitigation at the sentencing phase.[37] The US Sentencing Guidelines for Organizations include compliance as a key factor in the reduction of sentence. Finally, compliance can provide a company with leverage in any settlement negotiations that take place prior to indictment. Pre-indictment diversion, in the deferred prosecution agreements, is increasingly common so the advantages to a corporation of having adequate procedures can be important at that stage.[38] In each of these different ways, therefore, the legal system offers clear and additional incentives for a corporation to implement compliance processes and procedures aimed at social enforcement.

I will conclude with some critical reflections on social enforcement as a model for regulating corporate wrongdoing. A core presumption of a social enforcement model of the new corporate criminal law – and economic accounts of crime, more generally – is that the criminal law can alter behavioral incentives in meaningful and predictable ways by sending a clear message backed with a threat.

This model raises a number of potential sources of concern. In particular, there are various pragmatic concerns; do we have enough evidence to suggest that the new corporate criminal law does communicate the "right kind of message" to firms and that firms have both the will and capacity to respond to this message in the

[37] See Koehler (2012b) for a comparative analysis of the compliance defense in different jurisdictions.

[38] On the rise of the deferred prosecution agreement in the context of corporate criminal procedure, see Garrett (2014).

"right kind of way" by implementing substantive, as opposed to shallow and ineffective compliance programs? These concerns about the clarity of the message and the will or capacity of business to implement meaningful compliance are examined in turn.

The extension in the territorial reach of corporate criminal law and the resulting mosaic of norms means that the law is in a state of constant normative flux. Under circumstances of complexity and uncertainty, the capacity of law to deliver a stable message and influence behavior in a predictable fashion may be fatally undermined. The extension in the territorial reach of corporate criminal law and the resulting mosaic of norms means that the capacity of law to stabilize normative expectations and influence behavior in a predictable fashion may be fatally undermined.

Moreover, even if the message is clear, there seems to be an obvious danger that contemporary corporate cultures of compliance become a formalistic exercise in image management – "fig leaf" compliance or "box-ticking" – in which companies position themselves to defend itself against any enforcement action that arises, rather than implement meaningful measures aimed at genuine social enforcement. A lingering suspicion that the goal of the relevant stakeholders is no longer one of systematic social enforcement or substantive compliance. Rather, the extended reach of corporate criminal law has triggered an elaborate game in which the business side seeks to construct a plausible narrative of adequate compliance in the event of an investigation.

A final and competing danger is that a company wishes to implement meaningful compliance, but simply lacks the capacities to do so. After all, compliance is not revenue generating and has the potential to distract business enterprises from core activities and, in a worst case, to contribute to corporate failure.

The crucial issue raised by a social enforcement model seems to be whether and, if so, how, this new entrepreneurial responsibility for compliance can be built into the legal system in a meaningful way without jeopardising corporate growth and having a negative effect on economic development. Ascertaining whether the additional costs associated with the expansion of the new corporate criminal law are justified – presumably by identifying empirically verifiable, counter-veiling benefits and not just costly and empty compliance – represents an important issue, not least because the costs of getting the regulatory framework wrong are potentially so serious. In the absence of clear evidence of these empirical benefits, there seem to be good reasons to be skeptical.

Aside from the pragmatic concerns, there are also concerns of principle. Even if we assume that the social enforcement does work, can that justify the various derogations from various due process values that seem to be central to a social enforcement model? Assume the catalytic message of the criminal law is received in the "correct" way and acted upon, and the various stakeholders within a company are incentivized to monitor and meaningful compliance systems are institutionalized. A key question nevertheless remains: is it an appropriate job for the criminal law to seek to incentivize monitoring by exposing a bystander (i.e. the company and individual stakeholders within the company) to the risk of harm for their failure to prevent another person from committing a criminal offence? Law communicates

with A in order to stop B. A is exposed to legal risk in order to incentivize monitoring of B. Even if we accept law's capacity to alter incentives directly, this process of "deputation" seems problematic. Most obviously, it seems to involve a departure from traditional criminal justice values.

7 Conclusion

This chapter examined the transnational character of the 'new corporate criminal law' and identified some of the consequences for any business that operates across borders, notably the expansion of transnational legal risk. A response to this expansion in legal risk has been the growth of adaptive and flexible "compliance" mechanisms within organizational governance. From the perspective of regulators, the new corporate criminal law also creates new sources of risk and the chapter will suggest that the increased importance of transnational regulatory networks between regulators is an adaptation to the new legal reality.

Transnationally applicable norms entail a significant extension in the criminal justice "net" and are a response to a perception that contemporary corporate wrongdoing involves cross-border actors and activities. Both regulatory networks and social enforcement aim at reducing the effects of asymmetries in information and institutional capacities that exist between enforcement agencies and business enterprises in enforcing transnationally applicable norms.

In many ways this is a familiar narrative of the challenges of globalization and the limited capacities of nation states to delimit a role in the context of world where the significance of territorial borders is rapidly diminishing. Nevertheless, mapping the distinctive path that the new corporate criminal law has taken in adapting to the challenges of globalization represents an important task, not least because of the new legal risks and responsibilities that are created both for business enterprises and the public authorities. This chapter represents a preliminary attempt at identifying the distinctive features, as well as the underlying normative and empirical assumptions of contemporary corporate criminal law and procedure, and can serve as an important first step in clarifying future directions of policy and research.

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Consumer Credit Law in the European Union and Japan: A Comparative Study

Jarl Jacob

Contents

Abstract In recent years, the possibility for consumers to engage in consumer loans have been rising exponentially. This brings with itself an increased possibility of consumers with debt problems and possible personal bankruptcies. This paper examines two pieces of legislation, from two very different regions, the European Union and Japan, designed to deal with these, and other problems.

The Japanese Money Lending Business Law, designed to combat the problem of people shouldering multiple debts, personal bankruptcies, and increasingly aggressive debt collection, can be said to have been successful. The amount of bankruptcies and people with multiple debt has dropped, and the interest rate on consumer credit was made clear within the law. It is not an unmitigated success, however, since the new restrictions on creditworthiness render a large part of the population unable to engage in consumer loans in the first place.

The European Union's Consumer Credit Directive has, next to the objective of added consumer protection, the objective to harmonize consumer credit across the internal market. While it raises the bar for consumer protection rigidly, the harmonization of the internal market for consumer credit remains lackluster.

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While both pieces of legislation have slightly different aims, the Japanese law can be said to have come to closest to fulfilling them, when compared to the European Directive. A harmonized interest rate or a standard concerning the creditworthiness of the consumer, as can be found in the Money Lending Business Law, might be worth considering in the European Union as well.

Keywords Consumer credit law • Comparative study • Money Lending Business Law • Consumer Credit Directive

1 Introduction

Together with the enormous amount of technological changes and advances, the possibilities for consumers to engage in consumer credits have risen exponentially over the last few decades. Whether it is by credit card, store credit, straight up loans from consumer credit companies, this increase in options for credit calls for a sufficient legal framework to regulate the business surrounding consumer credit. This poses the challenge to the legislator to regulate all of these methods so that there is an adequate degree of consumer protection, whilst ensuring that the economic function of these credits is not damaged. This chapter will examine two pieces of legislation from very different backgrounds. Japan had been battling with a greatly increased amount of people shouldering multiple debts, increased amounts of personal bankruptcies and increasingly aggressive debt collection behavior. Their newly amended Money Lending Business Law[1] was enacted to combat this.[2] The counterpart to this law in the European Union however, Directive 2008/48/EC on Consumer Credit, was born from the wish to harmonize the European consumer credit market and promote cross-border use of credit facilities by European Consumers.[3] This difference triggers the question of how these two

[1] Money Lending Business Act, Law number: Act No. 32 of 1983 available translated to English at http://www.japaneselawtranslation.go.jp/law/detail/?printID=&ft=1&re=02&dn=1&x=0&y=0&co=01&ky=%E8%B2%B8%E9%87%91%E6%A5%AD%E6%B3%95&page=4&vm=02. Accessed 22 July 2015.

[2] Q&A on the new MLBL on the Financial Agency Website, Question 3: Q: Why was a law like this created? A: In recent years, the amount of persons with multiple debts who were burdened by such an amount of loans that they couldn't pay them back anymore kept on rising and created a serious social problem (Multiple Debt Problem). With the objective of solving this Multiple Debt Problem in mind, we felt it was necessary to drastically reform the current legislation, and as a result of this, the new MLBL was created. For details see Japan Financial Agency Website (2015b).

[3] This is clear from preamble (2) and (4). The results from the studies only make reference to the working of the internal market for consumer credits and how this is disturbed by a lack of harmonized legislation.

pieces of legislation deal with consumer credit and the surrounding legal challenges.

This chapter will examine both pieces of legislation and to which extent they protect consumers. Through this examination this chapter will try to come to a conclusion as to which of these legislative pieces is best suited to protect the consumer concluding a credit agreement. Since comparing the Japanese legislation to the European legislation without taking into account the inherent differences between the country of Japan and the region of the European Union would be to no avail, this chapter will use the national legislation of Belgium and the United Kingdom concerning consumer credit[4] to examine how the Member States have implemented the Directive. This will allow for a more nuanced image of the differences between Japan and the EU, and give an image of the differences between the EU Member States themselves. Lastly, in its concluding part, the chapter will try to give recommendations that lead to the strengthening of the respective pieces of legislation in the area of consumer protection.

2 Japan's Money Lending Business Law: Extreme Criminal Penalties?

2.1 Background and Previous Legislation

In the past decades, Japan has seen a tremendous increase of people struggling with loan problems, most if not all of these are stemming from engaging in consumer loans.[5] The number of personal bankruptcies has been steadily rising ever since the 1980s, reaching a peak of 242,357 total personal bankruptcies, of which 221,741 are attributed to money lending, in 2003.[6] Only in 2004 did this extreme number of bankruptcies start going down at a steady pace,[7] eventually lowering to 100.510 total personal bankruptcies in 2011.[8] From the data available from the Supreme Court, it can be calculated that in the decade spanning from 2001 to 2011, 1,804,669

[4] The Law of June 13th 2010 to the modification of the law of June 12th 1991 on Consumer Credit and the Consumer Credit act 1974 respectively.

[5] Q&A on the new MLBL on the Financial Agency Website, Question 3. For details see Japan Financial Agency Website (2015b).

[6] Supreme Court of Japan, Judicial Statistics 2003, Subdivision 99: Number of newly received bankruptcy cases.

[7] Supreme Court of Japan, Judicial Statistics 2004, Subdivision 102: Number of newly received bankruptcy cases.

[8] Supreme Court of Japan, Judicial Statistics 2011, Subdivision 105: Number of newly received bankruptcy cases.

Japanese citizens have had to declare personal bankruptcy.[9] This corresponds to roughly 1.3 % of the total Japanese population.[10]

How is it possible that such a large number of people had troubles with (multiple) debts? The answer to this can be found in the previous law regulating the business surrounding consumer loans. The main culprit can be found in the combination of the old Money Lending Business Law (henceforth MLBL), the Act Regulating the Receipt of Contributions, Receipt of Deposits and Interest rates (henceforth Contributions Act) and the Interest Rate Restriction Act (henceforth IRRA). Under the previous IRRA, interest rates were capped at a ceiling of 20 %, and were only regulated between the ranges of 15 and 20 %. Any interest that was charged over the appropriate level set forth in the previous IRRA rendered the consumer credit contract null and void. Pursuant to Article 43 of the old MLBL however, if the consumer was paying this interest willingly, or if the interest charged was not in violation of the interest rate restriction set forth in the Contributions Act (which was set at 29.2 %). Any interest charged above this rate was subject to a criminal sanction of up to 5 years in prison, a fine of 10 million yen (or both), although the contract would still be valid. This meant that as long as the consumer was paying back his interest willingly, there were no sanctions present at all for those money lending businesses that charged an interest higher than the 20 % set forth in the IRRA but lower than the 29.2 % of the Contributions Act.[11] This meant that in practice – no matter how large or small your loan was – you'd be paying an interest rate between 20 and 29.2 %. This practice eventually got labelled "Grey Zone Interest" and had the consequence that people were paying off their debts at a significantly faster pace than they thought they were. This is because in reality the amount of interest that was levied on the loan could never exceed 20 %, so any interest that the customer was paying that went over this 20 % as put forth in the IRRA was going directly to repaying their debt.

On January 13 2006, the Supreme Court of Japan reached a verdict in the case of X vs Y which made it significantly easier for people and their lawyers or judicial scriveners to sue for the money overpaid to the consumer credit companies.[12] The following passage in the judgment is of particular importance:

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[9] Supreme Court of Japan, Judicial Statistics 2001, Subdivision 99: Number of newly received bankruptcy cases; Supreme Court of Japan, Judicial Statistics 2002, Subdivision 99: Number of newly received bankruptcy cases; Supreme Court of Japan, Judicial Statistics 2003, Subdivision 99: Number of newly received bankruptcy cases; Supreme Court of Japan, Judicial Statistics 2004, Subdivision 102: Number of newly received bankruptcy cases; Supreme Court of Japan, Judicial Statistics 2005, Subdivision 102: Number of newly received bankruptcy cases; Supreme court of Japan, Judicial Statistics 2010, Subdivision 105: Number of newly received bankruptcy cases; Supreme Court of Japan, Judicial Statistics 2011, Subdivision 105: Number of newly received bankruptcy cases.

[10] As of 26 October 2011 the Japanese population was at 128,057,352, data taken from the Japan Census Bureau Website (2010).

[11] Nagashima and Tsunematsu (2007).

[12] Judgment on the legitimacy of Article 15(2) of the Ordinance for Enforcement of the Money Lending Business Control and Regulation Act, 2004 (Ju) No. 1518, Minshu Vol. 60, No. 1

> 2. (...) Based on this, the phrase "money voluntarily paid as interest by the debtor" contained in Article 43(1) of the Act could be construed that the debtor has paid money of his own free will, being aware that it would be appropriated to the payment of interest under the interest contract, and it also may be construed that in order for the debtor to be regarded as making such a payment voluntarily, the debtor is not necessarily required to have been aware that the amount of payment exceeds the upper limit of interest or that the contract is null and void with respect to the part of interest in excess (See 1987 (O) No. 1531, judgment of the Second Petty Bench of the Supreme Court of January 22, 1990, Minshu Vol. 44, No. 1, 332). However, if the debtor has been effectively forced to pay the amount of money that exceeds the upper limit of interest, he cannot be deemed to have paid the part of interest in excess at his own free will, and therefore it should be construed that the requirement for applying Article 43(1) of the Act is not satisfied.

This led to a movement of both lawyers and judicial scriveners appealing to people to retrieve the amount of money they overpaid back from the money lenders. Advertisements appeared everywhere, including public transport, offering services to people who thought they might have overpaid when repaying their consumer loans. This movement was a huge success, and a significant amount of people sued those companies. The number of cases and demands for payback was so staggering that one of the four biggest players on the consumer loan market, Takefuji, had to declare bankruptcy in 2010 because they could no longer pay back their former customers.[13]

To put an end to the loans at exorbitant interest rates, lessen the social unrest and troubles caused by the large amount of people burdened with multiple debts, and get rid of the Grey Zone Interest, the Japanese legislature decided to overhaul the MLBL and reform the IRRA and the Contributions Act.[14] There seems little doubt that such a reform was necessary, since the law was passed unanimously in the Diet.[15]

2.2 The Amended Money Lending Business Law

In this part a few of the peculiarities of the Amended MLBL will be highlighted, specifically those that were designed to counter the rising trend of people facing multiple debts. Since the MLBL, but also the IRRA was amended, to achieve this purpose, the IRRA and the interaction between these two pieces of legislation will be described as well. As stated above, the Amended MLBL was passed in the Diet on December 13, 2006 and was subsequently enforced in steps in 2007, although some of the regulations set forth were enforced in a step-by-step fashion from 2007 to 2010. In the list of definitions, the MLBL sets forth the types of credit that it

(Supreme Court 2006/01/13) official translation available at http://www.courts.go.jp/english/judgments/text/2006.01.13-2004.-Ju-.No..1518.html. Accessed 22 July 2015.

[13] Uranaka and Fuse (2010).

[14] Q&A on the new MLBL on the Financial Agency Website. For details see Japan Financial Agency Website (2015b).

[15] "This law was passed unanimously in the diet in December 2006" – see Japan Financial Agency Website (2015a).

governs. Article 2 states that "the term "the Money Lending Business" as used in this Act means the business of loaning money or acting as an intermediary for the lending or borrowing of money (including acting as an intermediary for delivering money through discounts of negotiable instruments, mortgage by sale, or any other method similar thereto, or for providing or receiving money through such method; hereinafter collectively referred to as a "Loan(s)") on a regular basis; provided, however, that the following Loans shall be excluded: loans made by the state or by local public entities; loans made by persons governed by special provisions of other Acts for making Loans on a regular basis; loans made by persons engaged in the business of buying and selling, transporting, or storing goods, or who act as intermediaries in the buying and selling of goods, in the course of their transactions; loans made by employers to their workers." This results in a rather broad definition of those loans being governed by the MLBL.

2.2.1 Creditworthiness of the Consumer

Article 13 of the MLBL sets forth one of the regulations that are meant to restrict the wide range of people being granted loans. The Article states that "A Money Lender shall, in concluding a Contract for a Loan, investigate matters concerning the repayment capacity of the Customer, etc., such as income or profits or other financial resources, credit, the status of borrowings, repayment plans, and any other matters." Concretely, this Article sets forth specific conditions as to when a Money Lender is supposed to engage in a specific background check of the customer wanting to engage in a loan with them. If these conditions are met, the Money Lender is to "demand withholding records or other documents or Electronic Records containing or in which are recorded the matters that disclose the income or profits or other financial resources of an individual customer who is a person seeking funds".[16] The conditions for this more thorough background check are set out in Paragraph 3.1 and 3.2 of the Article in Question and come down to the following: If the amount of the new loan the customer wants to engage in with a money lender, added to the amount of loans the customer already has outstanding with said money lender exceeds ¥500,000 or, if the amount of the new loan the customer wants to engage in with a money lender, added to the amount of loans the customer already has outstanding with money lenders other than the money lender in question exceeds ¥1,000,000, the Money Lender is expected to demand the records mentioned above and determine whether the customer has sufficient repayment capacity.[17] Pursuant to these paragraphs, Money Lending Businesses are forbidden to engage in what the legal text defines as "Excessive Loan Contracts for an Individual Customer".[18]

[16] Article 13(3) Money Lending Business Law.

[17] Article 13 (3.1) and (3.2) Money Lending Business Law.

[18] Article 13.2 (1) Money Lending Business Law.

What exactly constitutes an excessive loan however, and when is a customer deemed to not have sufficient repayment capacity? The law states that, as a basic rule, if the total amount of loans a customer is about to engage in, exceeds one third of his yearly income (as is apparent from the documents the Money Lender is supposed to demand) they are deemed to not have the necessary financial capabilities to pay back their loans, and thus the Money Lender is forbidden from granting them any loans that go over this threshold.[19] Aside from the MLBL, the applicable Cabinet Office Ordinance gives additional information as to what constitutes the income mentioned in Article 13.2 Paragraph 2. Aside from the customer's yearly salary, if applicable the following should also be part of the calculation: the customer's pension, special civil servant pension, and income from real property.[20] A rather important exception to this rule, which is set down in the same Paragraph needs to be mentioned here. As already highlighted above, these regulations concerning the repayment capacity of the customer have been set in place to prevent consumers from dropping in the pitfall of multiple debt problems. Therefore, it has been set forth in the Cabinet Office Ordinance that, in case that there is no risk of people getting into multiple debts, it is fine if the amount of the loan exceeds one third of their yearly income. Specific criteria are written down, which include amongst others the purchase of stocks and bonds and the purchase of real estate.[21]

This Article significantly improves the situation compared to how it was in the previous law, since in the previous MLBL, while there was a regulation that obligated Money Lenders to investigate the repayment capacity of their customers, there were no specifications, nor were there any sanctions, criminal or administrative.[22] The Amended MLBL provides that those Money Lenders, who have failed to engage in the necessary investigations or have otherwise gone against the provisions set forth in Article 13, are subject to a prison sentence with work of up to 1 year, a fine of up to 3 million yen, or both.

2.2.2 Interest Rate Restrictions

As noted earlier, together with the MLBL, the IRRA and the Contributions Act were also amended; this to make sure that the Grey Zone Interest phenomenon would disappear. The Grey Zone Interest being one of the main reasons the multiple debt problem got so out of hand in the first place, this seemed like a very important step towards resolving said problem. Therefore, Article 12-8 of the MLBL states that "A Money Lender shall not conclude a contract for interest wherein the amount of interest (Including Payment regarded as interest (...)) exceeds the amount defined in Article 1 of the Interest Rate Restriction Act". The corresponding Article

[19] Article 13.2(2) Money Lending Business Law.

[20] Ueyanagi and Ōmori (2008), p. 114.

[21] Ueyanagi and Ōmori (2008), p. 115.

[22] Ueyanagi and Ōmori (2008), p. 107.

of the IRRA states the following ceilings and regulations concerning interest rates on loans: If the amount of the loan is lower than ¥100,000 the interest rate ceiling is 20 %, if the amount of the loan is between ¥100,000 and ¥1,000,000, the interest rate ceiling is 18 %, and if the amount of the loan is above ¥1,000,000 the interest rate ceiling is 15 %. Any interest above these percentiles is deemed to be invalid and illegal.[23] The penalties concerning the exceeding of interest rate restrictions are set forth in Article 5 of the Act Regulating the Receipt of Contributions, Receipt of Deposits and Interest Rates[24] which stipulates that "when a person lending money on a regular basis forms a contract to receive annual interest rates that exceed 20 % he or she shall be punished by imprisonment with work for not more than 5 years or a fine of not more than 10 million yen or both."[25]

This is a significant improvement over the previous MLBL with its Grey Zone Interest phenomenon and its little to no enforcing of the interest regulations as long as they were below 29.2 %. It is clear that these strong criminal penalties set forth in the Contributions Act will also deter, at least to some extent, the number of loan sharks that have been rampant in the Japanese loan market. On the other hand, one could say that people might have to resort to loans from the said loan sharks to a greater extent now because they are not able to acquire loans with normal consumer loan companies due to the stricter regulations that are enforced upon these companies. However, the wide variety of government schemes such as Rehabilitation for individuals with small-scale debts and the availability of free council concerning debt problems or problems with making ends meet at places such as the local city hall should alleviate this problem.

2.2.3 Debt Collection

A third new addition to the MLBL is the one as set forth in Article 21, concerning Restrictions on Acts of Collection. The Article reads as follows: "Persons who engage in the Money Lending Business or persons who have been entrusted by a person who engages in the Money Lending Business or by any other person with the collection of claims under the Contract for a Loan pertaining to such persons engaging in the Money Lending Business shall not, in collecting claims under the Contract for the Loan, intimidate persons, act in any of the following ways, or act in any way which may harm the tranquillity of a person's personal life or business operations:" after this follows a very extensive list of acts Money Lenders or their debt collectors are forbidden to engage in. Among these restrictions we find: The prohibition to visit, call, send facsimile or other messages to the home of the debtor

[23] Article 1 Interest Rate Restriction Act.

[24] Shusshi no ukeire, ozukarikin oyobi kinritou no torishimari ni kansuru houritsu [Act Regulating the Receipt of Contributions, Receipt of Deposits and Interest Rates] available at http://law.e-gov.go.jp/htmldata/S29/S29HO195.html. Accessed 29 June 2015.

[25] Article 5(2) Interest Rate Restriction Act.

between the hours of 9 PM and 8 AM; the prohibition to visit or contact the debtor between hours specified by the debtor himself, unless there is a valid reason given, as a valid reason the Cabinet Office Ordinance provides as an example the following: If the debtor has expressly asked the debt collectors to visit between certain hours, but repeatedly fails to show up at these given times, the debt collectors are free to visit the debtors home at other times.[26] Debt collecting activities outside of the debtor's home (such as his workplace) are strictly forbidden; as is revealing private information concerning the debtor to third parties.

These restrictions on debt collecting activities illustrate the degree of social trouble that was caused in the past, under the old MLBL by Money Lenders or their debt collectors by aggressive debt collecting activities, which from a Western point of view seem very similar to those employed by loan sharks. It is therefore not surprising that as with the other regulations raised above, there are quite severe criminal penalties set forth for those who do not adhere to these provisions. Money Lenders or their debt collectors who have found to have violated these provisions are subject to imprisonment with work for at the most 2 years, a fine of 3 million yen or less, or both.[27]

2.3 Evaluation

From the above, we can clearly see that the new MLBL and the new IRRA are certainly quite more stringent than their older counterparts. But do they actually make a difference? From the data retrievable from the Judicial Statistics available at the Supreme Court of Japan, we can start to build a preliminary answer to this question. From 2004 onwards, the number of people having to engage in personal bankruptcy etc. has been going down steadily,[28] and the introduction of these new laws has only kept this downward trend going. Furthermore, data retrieved from the Fukuoka Tenjin branch of the Lawyer Center suggests that ever since the new MLBL and the IRRA were introduced, the number of people visiting the Lawyer

[26] Ueyanagi and Ōmori (2008), p. 185.

[27] Article 47-3(1)(3) Money Lending Business Act.

[28] Supreme Court of Japan, Judicial Statistics 2001, Subdivision 99: Number of newly received bankruptcy cases; Supreme Court of Japan, Judicial Statistics 2002, Subdivision 99: Number of newly received bankruptcy cases; Supreme Court of Japan, Judicial Statistics 2003, Subdivision 99: Number of newly received bankruptcy cases; Supreme Court of Japan, Judicial Statistics 2004, Subdivision 102: Number of newly received bankruptcy cases; Supreme Court of Japan, Judicial Statistics 2005, Subdivision 102: Number of newly received bankruptcy cases; Supreme court of Japan, Judicial Statistics 2010, Subdivision 105: Number of newly received bankruptcy cases; Supreme Court of Japan, Judicial Statistics 2011, Subdivision 105: Number of newly received bankruptcy cases. The amount of yearly personal bankruptcies has gone down from 242.357 in 2003 to 100.510 in 2011, decreasing the amount of personal bankruptcies by more than 50 %.

Center and the Hou Terrace[29] concerning problems with (multiple) debt has gone down by approximately two thirds of the original amount. People were heavily relying on the services of both the Lawyer Center and the Hou Terrace to help with their budgeting problems and contacts with lawyers where litigation might be necessary.[30] It is therefore not unreasonable to deduce from this that the new MLBL has had a significant effect on the number of people involved in problematic multiple debts due to consumer loans and the number of people who were forced to undergo personal bankruptcy due to said debt problems.

The decrease in personal bankruptcies however isn't the only effect the new MLBL. Due to the abolishment of the old "Gray Zone Interest" and a serious campaign of public education about this gray zone, many people realized, with the help of lawyers and judicial scriveners specialized in consumer debt cases, that they had repaid their respective financial institutions too much, and could sue for the amount they overpaid. This resulted in a wave of litigation against the consumer credit companies, of which the Big Four (Aiful, Takefuji, Acom and Promise) took the brunt. This is only logical since the Japanese consumer loan market is an oligopoly with 60 % of the total loan balance residing with the Big Four, and 90 % percent with the top 25 firms.[31] This led to Acom and Promise going into relationships with mega-banks. The profitability of loans crashed badly and the total volume of loans went down about 20–25 %.[32]

As was apparent from the size of the legal consumer loan business before the new MLBL (in 1999, the amount of outstanding consumer loans (excluding credit card loans and mortgages) was 9.434 trillion yen[33]) it is not unreasonable to infer that a significant number of Japanese are reliant on the use of consumer credit to make ends meet on a daily basis. However, excluding a peak around 2003 (which also explains the peak in personal bankruptcies in the same year), the size of the market has only been going down, eventually dwindling to 548.4 billion yen,[34] almost half of its original size in 2010. This begs the question how the Japanese people are meeting their consumer loan needs. While the stronger regulation of the consumer loan business has had the wanted effect on the official businesses, namely not everyone can obtain a loan and it is significantly harder for people without the necessary funds to pay back their loaned amount to obtain further consumer loans to cover their needs. However, it needs to be taken into account that there is a distinct

[29] Hou Terrace is the colloquial name. The full name of this institution is the "Japan Legal Support Center". It was established as the central organization to provide legal assistance to citizens, based on the goal to "realize a society where legal information and services are accessible anywhere in the country". Japan Legal Support Center Website. What is the JLSC?. For details see http://www.houterasu.or.jp/en/about_jlsc/index.html. Accessed 22 July 2015.

[30] Interview with lawyers at the Lawyer Center suggests that before the introduction of the new MLBL and IRRA the amount of people visiting the Lawyer Center concerning debt problems made up about 90 % of the total amount of people visiting. (Date of interview: 24 February 2012).

[31] Honjo (2009).

[32] Honjo (2009).

[33] Financial Services Agency (2010).

[34] Financial Services Agency (2010).

possibility that these people, unable to obtain the money they need through official channels, are going to resort to black market loans, which cannot be the intended outcome. It is impossible to even estimate the number of people engaging in these black market consumer loans due to their illegal nature. This possibility should be underestimated, however.

The whole purpose of the MLBL, as is clear from the passage on aggressive debt collection activities, is to put a curb to risky loans with high interest and debt collection activities that put a psychological strain on the debtor. If, as a result of the very strict new regulation on the assessment of the creditworthiness of the consumer coupled with the stricter interest rate restrictions, low-income high risk debtors can no longer obtain loans through legal channels, the chance that they flock to loan sharks and the like is of reasonable size. Indeed, in the years after the promulgation of the new MLBL, voices have been raised concerning this very issue. One of the members of parliament responsible for the new MLBL, Masuhara Yoshitake, has come forth and said that the MLBL was designed with a lack of regard for factual data, leading especially to overly strict regulations concerning the assessment of creditworthiness of the customer. When compared to the old MLBL, the number of people with the actual ability to engage in consumer loans has gone down roughly 50 % in total.[35]

In closing, the Japanese new Money Lending Business Law can be evaluated as clearly reaching the goals the legislators had in mind when pushing for the renewal of this piece of legislation. That does not however preclude people from reaching out to less legal means of obtaining money because they cannot obtain it through the usual legal channels. Since no empirical data is available on this particular problem however, it is impossible to draw a conclusion concerning this.

3 Directive of the European Union: Everything Up to the Member States?

3.1 General

The Directive 2008/48/EC of the European Parliament and the Council on credit agreements for consumers and repealing Council Directive 87/102/EEC (2008) L133/66 (hereinafter: the Consumer Credit Directive) was signed and ratified by the Council on April 23, 2008.[36] The Consumer Credit Directive came into existence due to two reports on the operation of the previous Directive, Council Directive 87/102/EEC of December 22, for the approximation of the laws,

[35] Masuhara (2012).

[36] Directive 2008/48/EC of the European Parliament and of the Council of 23 April 2008 on credit agreements for consumers and repealing Council Directive 87/102/EEC (Consumer Credit Agreements Directive).

regulations and administrative provisions of the Member States concerning consumer credit (hereinafter: the old Consumer Credit Directive).[37] These reports revealed that there was a significant difference in the consumer credit mechanisms Member States employed individually,[38] on top of those set forth in the old Consumer Credit Directive as found in the laws transposing the old Consumer Credit Directive into Member State legislation.[39] This led to a situation where the internal market for consumer credit in the European Union did not function optimally. Having to take into account different Member State legislation can be seen as a significant barrier for consumer credit businesses to cross Member State lines and expand their ventures into the entire Union. The Consumer Credit Directive puts it as follows:

> The *de facto* and *de jure* situation resulting from those national differences in some cases leads to distortions of competition among creditors in the Community and creates obstacles to the internal market where Member States have adopted different mandatory provisions more stringent than those provided for in Directive 87/102/EEC. It restricts consumers' ability to make direct use of the gradually increasing availability of cross-border credit. Those distortions and restrictions may in turn have consequences in terms of the demand for goods and services.[40]

Here we find the first objective of the new Consumer Credit Directive: to "facilitate the emergence of a well-functioning internal market in consumer credit".[41] This should not come as a surprise since the origins of the European Union, as such, lie in an effort to create an internal market and the fact that this should be one of the main, objectives of this Consumer Credit Directive is therefore to be expected. A second main objective of the new Consumer Credit Directive is, not surprisingly, the protection of consumers as they engage in consumer credit contracts every day in the EU. The change of landscape in the consumer credit market is one of the big contributing factors to this objective.[42]

There are several questions to be asked here, however. For one, does a change from a minimal harmonization regime (the old Consumer Credit Directive) towards a maximum harmonization regime (the new Consumer Credit Directive) really benefit consumer protection on all possible fronts? While the Preamble certainly states so ("Full harmonization is necessary in order to ensure that all consumers in the Community enjoy a high and equivalent level of protection of their interests [. . .]"[43]), it seems unlikely that the new Directive was able to take into account all

[37] Preamble (2) Consumer Credit Agreements Directive.

[38] Ashida (2004) p. 61.

[39] Preamble (3) Consumer Credit Agreements Directive.

[40] Preamble (4) Consumer Credit Agreements Directive.

[41] Preamble (7) Consumer Credit Agreements Directive.

[42] Preamble (5) Consumer Credit Agreements Directive: "In recent years the types of credit offered to and used by consumers have evolved considerably. New credit instruments have appeared, and their use continues to develop."

[43] Preamble (9) Consumer Credit Agreements Directive.

necessary measures concerning consumer protection in the field of consumer credit and incorporate the highest level from each Member State in a piecemeal fashion. This can lead to two possible outcomes: one being a lowered standard for consumer protection (at least for those countries where consumers enjoy relatively high consumer protection thanks to stringent mandatory provisions); or a Directive lacking measures in areas key to consumer protection to ensure that the Member States are still able to enforce their own legislation as to uphold the level of consumer protection available at their national level. The wording of the preamble gives this latter option some credibility[44] but since depending on the extent to which key consumer protection concepts are left out of the Directive this could make the objective of raising consumer protection through this Directive null and void, it seems to be an unlikely motive.

A next question that needs to be asked is whether consumers themselves actually felt a new type of overarching legislation was needed for consumer credits. While businesses definitely profit from an increased harmonization of legislation to improve the ease of cross-border credit transactions, is the same true for consumers? While there is no clear answer to that question, it can be assumed that the main interest of consumers in harmonized legislation would be consumer protection. Starting from this assumption, a study by the European Research Group becomes a viable source of information.[45] To the question "Each Member state has its own regulations for consumer protection. Do you think these standards should be harmonized throughout the European Union, or not?" 53 % of respondents are in favor of a full harmonization throughout the European Union, 19 % favor partial harmonization, 10 % consider these standards should not be harmonized at Community level at all and 19 % had no opinion.[46] While this presents a positive picture of the reception of the Consumer Credit Directive amongst consumers, there remains the question whether consumers find the differentiation amongst Member State legislation to be a considerable barrier to cross-border use of consumer credit, or financial services in general for that matter. In the same study, the question "In your opinion, are there obstacles preventing consumers from using financial services anywhere in the European Union? If yes, which ones?" This question elicited the following response: 16 % of respondents found no barriers to be present, 24 % had no opinion. Of those answering yes, the obstacles ranked as follows (i) lack of information (32 %); (ii) problems due to language (28 %); (iii) too risky (22 %); (iv) poor legal protection in the event of problems (19 %); (v) bad information (18 %).[47] It is notable that legal concerns are in a fourth place, ranking

[44] Preamble (9) Consumer Credit Agreements Directive: "Member States should therefore not be allowed to maintain or introduce national provisions other than those laid down in this Directive. However, such restriction should only apply where there are provisions harmonized in this Directive. Where no such harmonized provisions exist, Member States should remain free to maintain or introduce national legislation."

[45] European Opinion Research Group (2001).

[46] European Opinion Research Group (2001), p. 60.

[47] European Opinion Research Group (2001), p. 100.

lower in total percentage than those respondents with no opinion. An updated version (2005) of the same study gives an updated but not that different view of the consumers' opinion the importance of legal framework in cross-border use of financial services.[48] To the same question, 31 % of respondents felt there were no barriers, a notable increase since 4 years earlier. The ranking of problems however hardly changed. Twenty-three percent cite lack of information, 20 % language problems, 15 % difficulties due to distance, 14 % too risky and lastly 11 % feared poor legal protection in the event of problems.[49] Together with the increase in the percentage of the population finding no barriers in cross-border usage of financial services, the amount of people finding legal protection an issue has decreased. There are no figures available for more recent years but this ranking of barriers has been relatively unchanged from 2001 to 2005.[50] From these constant results it is fair to conclude that from the consumers' point of view, legal barriers isn't the biggest problem. If cross-border usage of financial services in the EU is to be promoted and improved, the first issues to tackle seem to be language problems and lack of, or bad, information.

3.2 Text of the Directive

This subsection will highlight several parts of the Consumer Credit Directive and attempt to link them with their counterparts in the Japanese MLBL and signal those provisions that exist in either one of the legislations but are not present in the other. First and foremost, the boundaries of this Directive have to be discussed. While the Consumer Credit Directive applies to credit agreements it does not apply to amongst others the following[51]: (a) credit agreements which are secured either by a mortgage or by another comparable security commonly used in a Member State on immovable property or secured by a right related to immovable property; (c) credit agreements involving a total amount of credit less than EUR 200 or more than EUR 75 000; (f) credit agreements where the credit is granted free of interest and without any other charges and credit agreements under the terms of which the credit has to be repaid within 3 months and only insignificant charges are payable (i.e. most credit cards).[52] This is already in stark contrast with the Japanese MLBL, which puts very little limits on those credits that fall under the regulations

[48] European Opinion Research Group (2005).

[49] European Opinion Research Group (2005), p. 45.

[50] European Opinion Research Group (2004) and OPTEM (2003).

[51] For a full list please see: Article 2 Consumer Credit Agreements Directive.

[52] A limited range of articles from the Consumer Credit Directive is applicable to these types of credits, see: Article 2(3) Consumer Credit Agreements Directive.

set forth therein, for example still being applicable to mortgages, contrary to the Consumer Credit Directive.[53,54]

3.2.1 Creditworthiness of the Consumer

Next, not unlike the Japanese MLBL, the Consumer Credit Directive includes a passage that regulates the obligation of the creditor to assess the creditworthiness of the consumer who wants to engage in a credit contract with them. Unlike the Japanese MLBL however, the Consumer Credit Directive has very little to say on this subject. Article 8, which governs this obligation, merely states the following:

> Member States shall ensure that, before the conclusion of the credit agreement, the creditor assesses the consumer's creditworthiness on the basis of sufficient information, where appropriate obtained from the consumer and, where necessary, on the basis of a consultation of the relevant database. Member States whose legislation requires creditors to assess the creditworthiness of consumers on the basis of a consultation of the relevant database may retain this requirement.[55]

The following paragraph of the same Article goes on to state that if, after agreement between both creditor and consumer there should be any change in the total amount of the contract after the contract has been concluded, the creditor will update the financial information at his disposal concerning the consumer and re-assess the consumer's creditworthiness based on the new amount of the contract, before (emphasis added) any significant increase in the total amount of the contract.[56] Note that there is no mention of what exactly constitutes creditworthiness.[57] Where the Japanese MLBL (or rather the following ministerial decrees) gives very detailed and ample examples as to when a consumer is to be found in a financially solvent state to engage in a consumer credit agreement of a certain value, it seems that the Consumer Credit Directive leaves this up to the Member States themselves to enforce in their national legislation.

Taking a look at the Member States legislation, we find that in Belgium, the Law of June 13, 2010 modifying the law of June 12, 1991 on Consumer Credit (hereinafter: the Consumer Credit Law) has incorporated Article 8 of the Directive into law, but hardly any more detailed is added.[58] Article 10 of the Consumer Credit

[53] Schon (2005) p. 53.

[54] Article 2(1) Money Lending Business Law.

[55] Article 8(1) Consumer Credit Agreements Directive.

[56] Article 8(2) Consumer Credit Agreements Directive.

[57] De Muynck and Steenoot (2011) p. 24.

[58] Law of June 13th 2010 to the modification of the law of June 12th 1991 on Consumer Credit (Consumer Credit Modification Law), Article 15 reads as follows: The creditor is only allowed to conclude a credit agreement when he, taking note of the information he possesses or should possess, inter alia based on consultation regulated by article 9 of the law of August 10th 2001 concerning the Center for credit to individuals, and on the basis on information in article 10 of this law, reasonably has to assume that the consumer will be capable of fulfilling the obligations resulting from the agreement.

Law mentions that the creditor is to obtain the "correct and complete information they deem necessary to estimate the financial status and repayment capabilities of the consumer and in any case their current financial commitments."[59] While the Belgian legislators chose to impose a clear obligation for the creditor to, at the very least, investigate the current financial commitment of the consumer, there are very few detailed regulations that stipulate the creditworthiness of the consumer. In particular, the lack of a provision on when exactly a consumer is found to be able to reasonably repay the credit they are about to engage into seems to be a significant void in the legislation.

Likewise, in the United Kingdom, the Consumer Credit Act, while providing regulation on the assessment of creditworthiness of the consumer, does not, in the same line as the Directive and the Belgian legislation, make mention of any kind of standard for creditworthiness. Whether or not a person is creditworthy, in and of itself a rather subjective criterion is left completely up to the creditor.[60] Some types of credit agreement do not fall under this regulation, those being agreements made on land or agreements under which a person "pawns" an article.

The lack of specification when it comes to determining the creditworthiness of the consumer seems to be rather peculiar when seen in the light of the aims of the Directive, especially the aim of promoting consumer protection. A definition as to what constitutes creditworthiness, and at what exact threshold the consumer is deemed to be unable to pay back his loans at a normal rate, seems to be necessary here. This would not constitute a problem if the Member States would incorporate this into their own legislation, or if this was left out because Member States were already incorporating this in their national legislation before the Directive was drafted and enacted. But, as we have seen, this is not the case. Belgium is a relatively conservative country when it comes to consumer credit, having on average only 5.07 % of its GDP in outstanding consumer credit between 2002 and 2007,[61] and slightly over one consumer credit per capita.[62] Consequently, this lacuna in the legal framework might only be a problem for a small number of consumers. The UK, on the other hand, has quite a large part of its GDP in outstanding debt, on average 16.4 % between 2002 and 2007[63] and slightly over 5 % consumer credits per capita,[64] so the potential number of consumers getting into trouble because of this failure to provide a definition increases.

[59] Note: this is not an official translation, the full text of the law (in Dutch or French) can be consulted at http://economie.demoroom.be/nl/wet-consumentenkrediet/. Accessed 22 July 2015. Law of June 13th 2010 to the modification of the law of June 12th 1991 on Consumer Credit, Article 10.

[60] Consumer Credit Act 1974 c 39. Section 55B available at http://www.legislation.gov.uk/ukpga/1974/39/section/55B. Accessed 22 July 2015.

[61] Meel (2008), p. 10.

[62] Christiaens (2008), p. 52.

[63] Meel (2008), p. 10.

[64] Christiaens (2008), p. 52.

It should, however, not matter how many consumers are affected, or whether they are in reality affected or not. This is a matter of protecting the consumers, and if there is a chance that this lacuna might be used or misused to the disadvantage of the consumers then it should be filled. Note, however, that there is no evidence supporting the claim that this is the case to be found in the literature.

3.2.2 Information Required

While the Consumer Credit Directive might not specify any detailed requirements for the creditworthiness of the consumer, it is mostly aimed at ensuring that the consumer receives adequate information in order to enable him or her to make a decision in full knowledge of the facts.,[65,66] The Directive includes a "Standard European Consumer Credit Information Form" in its Annex II and all consumer credit extenders in the European Union are obligated to use this. The use of this form is stipulated in Article 5 which states that:

> In good time before the consumer is bound by any credit agreement or offer, the creditor and, where applicable, the credit intermediary shall, on the basis of the credit terms and conditions offered by the creditor and, if applicable, the preferences expressed and information supplied by the consumer, provide the consumer with the information needed to compare different offers in order to take an informed decision on whether to conclude a credit agreement. Such information, on paper or on another durable medium, shall be provided by means of the Standard European Consumer Credit Information form set out in Annex II. The creditor shall be deemed to have fulfilled the information requirements in this paragraph and in Article 3, paragraphs (1) and (2) of Directive 2002/65/EC if he has supplied the Standard European Consumer Credit Information.[67]

Following this is a list of all the information that should be included at all times when sending information about consumer credits to the consumer. This includes the following[68]: (a) the type of credit; (b) the identity and the geographical address of the creditor as well as, if applicable, the identity and geographical address of the credit intermediary involved; (d) the duration of the credit agreement; (f) the borrowing rate, the conditions governing the application of the borrowing rate and, where available, any index or reference rate applicable to the initial borrowing rate, as well as the periods, conditions and procedure for changing the borrowing rate; if different borrowing rates apply in different circumstances, the abovementioned information on all the applicable rates; (j) where applicable, the existence of costs payable by the consumer to a notary on conclusion of the credit agreement;. . . The list is very long and quite exhaustive and seems well suited to the increasing rate of consumer protection in the Union. Such a high degree of harmonization was not present under the previous Consumer Credit Directive,

[65] Preamble (19) Consumer Credit Agreements Directive.

[66] Micklitz et al. (2010), p. 383.

[67] Article 5(1) Consumer Credit Agreements Directive.

[68] For a complete list please see Article 5 (a)–(s) Consumer Credit Agreements Directive.

and it is certainly a big step in the protection of consumers' interests. Together with the transparency, comparability and comprehensibility of the given information,[69] the Consumer Credit Directive also regulates the information that has to be included in advertisements. Article 4 states that "Any advertising concerning credit agreements which indicates an interest rate or any figures relating to the cost of the credit to the consumer shall include standard information in accordance with this Article." The standard information meant in this article shall:

> specify in a clear, concise and prominent way by means of a representative example: the borrowing rate, fixed or variable or both, together with particulars of any charges included in the total cost of the credit to the consumer; the total amount of credit; the annual percentage rate of charge; in the case of a credit agreement of the kind referred to in Article 2(3), Member States may decide that the annual percentage rate of charge need not be provided; if applicable, the duration of the credit agreement; in the case of a credit in the form of deferred payment for a specific good or service, the cash price and the amount of any advance payment; and if applicable, the total amount payable by the consumer and the amount of the instalments.

Note that Article 4(4) and Preamble Article 18 that these requirements are without prejudice to the Unfair Commercial Practices Directive and are supposed to be read together with the same Directive.[70]

3.2.3 Interest Rate Restrictions

Next, to keep the comparison with the Japanese MLBL in mind, a closer look will be taken at the regulations governing interest rates on consumer credit. The Consumer Credit Directive gives, in its Annex I, a formula for the calculation of the Annual Percentage Rate of charge (hereinafter APR). This is particularly important given that before the Directive almost all Member States calculated the APR in its own way with its own formula leading to varying APRs for a loan governed by exactly the same variables in different Member States. That being said though the Consumer Credit Directive does not, at any point, mention an upper limit to the actual interest rate. This is a second point where we can find a rather significant difference between the Japanese MLBL and the European legislation. However, unlike in the above case the EU member states generally have their own respective legislation in place to deal with the possibility of extreme interest rates.

The Member States use a wide variety of interest rate regulations in their national legislation. These have been introduced for various specific reasons, although the main reason is generally consumer protection in the form of protecting borrowers of excessive interest rates.[71] Other reasons include market regulation and product regulation.[72] A limited number of European countries (Greece, Ireland and

[69] Micklitz et al. (2010), p. 385.
[70] Micklitz et al. (2010), p. 385.
[71] Reifner et al. (2009), pp. 50–52.
[72] Reifner et al. (2009), p. 54.

Table 1 APR ceilings in Belgium

Credit amount	APR ceiling
<EUR 1,250	18.5 % (since December 1st 2012)
EUR 1250 < EUR 5000	13.5 % (since December 1st 2012)
EUR 5000	10.5 % (Since December 1st 2012)

Federal Public Service Economy (2012)

Malta) have an absolute interest rate in place, limiting the application of these interest rate restrictions to specific types of credit providers or place significant limitations on their scope.[73] In Greece for example the interest rate ceiling is 6.75 % per annum, but this is not applicable to bank credit. A larger number of Member States utilize a relative interest rate ceiling. Belgium, for example, does not have an interest rate ceiling as such, but it limits the APR of consumer credit depending on the amount of the credit agreement. For all standard loans, instalment loans or deferred payment excluding mortgages, revolving credit or financial leasing, the following APR ceilings apply (Table 1):

These APRs aren't fixed; they are re-evaluated every 6 months. In the event that the reference index changed more than 0.75 points, the APR rates are recalculated. The reference index in this case is Euribor's[74] monthly average. This ceiling on APR instead of actual interest rates gives the market the opportunity to function on its own, albeit in a limited fashion compared to when no interest rate restrictions would be in place, but still to a greater extent than in countries with absolute interest rate ceilings. Lastly there are Member States that have no formal restrictions on interest rates at all, such as the UK. This does not mean however that the power to set interest rates is completely unfettered. In the case of *Paragon Finance plc v Staunton and Nash*, the Court of Appeal held that "The power given to the claimant by the mortgage agreements to set interest rates from time to time was not completely unfettered. A construction to the contrary would mean that the claimant would be completely free, in theory at least, to specify interest rates at the most exorbitant level."[75]

The choice of the Commission to not include a general interest rate restriction into the Consumer Credit Directive seems quite logical. The European Union is, market-wise a much-diversified region. The difference in national markets makes it rather hard to introduce a harmonized interest rate restriction in the European Union. Even without the economic implications in general countries with a population that are more sceptical towards consumer credit are likely going to result in having lower amounts of consumer credit because of lower demand.[76] Although the effects of interest rate restrictions on the market function of consumer credit are sometimes overestimated,[77] the existence of these restrictions might restrict access

[73] Reifner et al. (2009), p. 64.

[74] The Euro Interbank Offered Rates are daily reference rates based on the average interest rates at which a panel of roughly 50 European banks borrows funds from one another.

[75] Paragon Finance plc v Staunton and Nash, [2002] 2 All ER 248.

[76] Reifner et al. (2009), p. 328.

[77] Reifner et al. (2009), p. 326.

to credit for certain groups of people (mostly low-income high risk borrowers for lower amounts of short-term loans).[78] Although this might be seen as an actual objective of interest rate restrictions since these are the people most likely to end up in situations of (multiple) debt problems unable to pay back their loans.

In general, it can be concluded that given the situation specific to the European Union, the choice to not include a harmonized interest rate restriction in the Consumer Credit Directive is natural. The objective of the Directive is after all to harmonize the internal market for consumer credit in the Union, and overregulation has a chance of disturbing the market.

3.2.4 Penalties

It has already been noted that Japan's penalties for not conforming to the provisions set forth in the MLBL are firmly rooted in criminal law. How does the European Union deal with this? By examining the Consumer Credit Directive we find that Article 23, governing penalties states the following:" Member States shall lay down the rules on penalties applicable to infringements of the national provisions adopted pursuant to this Directive and shall take all measures necessary to ensure that they are implemented. The penalties provided for must be effective, proportionate and dissuasive."

So once again, we see the EU legislator deferring to the judgment of the Member States. This however, given the differences in markets and legislation in areas such as interest rate restriction,[79] seems to be the only possible option. A further look at the different kinds of penalties in use in the different Member States will grant a better understanding of the consumer credit market in this area. In particular, a closer look will be taken at the penalties for engaging in loans that go over the interest rate as prescribed in the national legislation. Sanctions can come in three distinct kinds. Civil sanctions, criminal sanctions and administrative sanctions. Civil sanctions usually take the form of reducing the interest back to the principally allowed rate, or declaring the contract null and void. Criminal sanctions usually take the form of a fine and/or imprisonment. Administrative sanctions usually take the form of the loss of a license to trade. Countries are free to pick the sanctions they feel are best suited for their particular legislative system and background. Belgium has opted for a mixed system, utilizing all three kinds of sanctions. As civil sanctions the Law on Consumer Credit provides for amongst others: *ex tunc* annulment of the contract or a reduction of the obligations of the consumer (to a maximum of either the price of the good or service in the case of cash transactions, or the total amount borrowed) in the case where the contract was concluded through door-to-door sales at the consumer's home or work address or if the contract was sent by mail to the consumer home or work address without an explicit demand of

[78] Reifner et al. (2009), pp. 226–237.

[79] See Sect. 3.2.3.

the consumer previous to sending[80]; in the case of exceeding the maximum APR a restriction to cash prize or the borrowed amount.[81,82] In the event of multiple sanctions available, the choice is left up to the consumer[83] (as in the case of the first cited sanction in this text, *ex tunc* annulment or reduction of the obligations of the consumer). Concerning criminal sanctions, the Consumer Credit Law provides for amongst others: a fine between EUR 26 and EUR 100.000 and a prison sentence from 8 days to 1 year for those who act as an extender of consumer credit without being a legally registered creditor[84]; on top of this the judge may declare the unlawfully obtained profits to be escheated.[85] Concerning administrative sanctions, these are limited to the suspension of one's license as a creditor, lasting maximum 1 year.[86]

The UK legislator has opted for criminal sanctions, sanctioning engaging in activities requiring a license when not a licensee with imprisonment for 2 years or a fine of GBP 400 or both. Advertising infringements and false advertising receive the same sanction.

The Final report on interest rate restrictions in the EU further has the following to say about the provided sanctions in the EU Member States[87]:

> A distinction might also be drawn between those Member States that prohibit usury in the form of judicial interpretation of a general clause. These include Germany, the Czech Republic, Estonia, Hungary, and Slovenia. In these Member States the consequences of a finding that an interest rate is "contra bonos mores" may be that the court will declare the contract null and void. In Germany the courts will permit the borrower to keep theloan but be absolved from repaying, thus acting as a deterrent to predatory lending more generally.

It is clear from the above that Member States have very different ways of sanctioning transgressions to their national Consumer Credit legislation. The reason for this is undoubtedly to be found in the differences inherent to these national legislative systems. It would be impossible for the European Union in her current form to impose sanctions upon the Member States.

[80] Article 85 Consumer Credit Modification Law.

[81] Article 87 Consumer Credit Modification Law.

[82] Reifner et al. (2009), p. 79.

[83] As per the Explanatory Memorandum to the draft bill to the modification of the law of June 12th 1991 on Consumer Credit – Parl. St., Kamer, 2001–2002, 1730/001, 46.

[84] Article 101(§1)(1)(a) Consumer Credit Modification Law.

[85] Article 103(1) Consumer Credit Modification Law.

[86] Article 106 Consumer Credit Modification Law.

[87] Reifner et al. (2009), p. 80.

3.3 Evaluation

It is clear that the Consumer Credit Directive is very different from the MLBL in nature. The combined emphasis on the harmonization of the internal market for consumer credit and increasing consumer protection seems to have been realized to a certain degree. Especially Article 4 and 5 prescribing the information obligated to be included in advertisements and pre-contractual information for consumer credit is an immense step in the right direction. The previous Directive did not harmonize this particular field and the harmonization in the new Directive gives consumers a new level of protection they can enjoy all over the European Union that was not available prior to this Directive. The ability of the consumer to be able to compare the different credit options available to him in a relatively easy fashion is a good method to make sure that people are able to engage in the consumer credit contract that fits their personal and financial circumstances the best. Consumers themselves however seem to be less content with the level of protection they are enjoying. In 2008, 51 % of consumers felt their consumer rights are protected and respected, a decrease of 3 % since the year before.[88] However, since lack of information was and still is one of the biggest barriers to cross-border shopping of goods and services, this could lead to a better working of the internal market and a greater degree of consumer protection. Any benchmark on the subject however, is still at too embryonic a stage to provide any clear data on the real effects of the Consumer Credit Directive as to the actual level of consumer protection, nor what the consumers themselves feel about the new system.[89]

The lack of a harmonized, European definition of creditworthiness of a customer however seems like a lacuna of critical size in the framework within the Consumer Credit Directive to enhance consumer protection. There is however no empirical data available on this fact and the objection can be raised that while limiting the amount of people who are able to engage in credit due to strict definitions of creditworthiness, the low-income, high-risk debtors will be unable to get credit at legitimate sources, which is the case with Japan's MLBL as noted above.[90] It goes without saying that this should be avoided at all costs, and the creditworthiness of the customer is a fine balancing act that might be better left to each separate Member State due to the different social and cultural backgrounds and fragmented market in consumer credit.[91]

On the promotion of cross-border lending and the harmonization of the internal market however, the verdict does not seem to be that positive. Although stating that there are not enough indicators to give a decent benchmark of the status of cross-border lending in the internal market,[92] the Final Report of GHK Consulting to DG

[88] Special Eurobarometer (2008), pp. 73–75.
[89] GHK (2009), p. 91.
[90] See Sect. 2.3.
[91] GHK (2009), p. iv.
[92] GHK (2009), p. 93.

Health and Consumer Protection, Establishment of a Benchmark on the Economic Impact of the Consumer Credit Directive on the Functioning of the Internal Market in this Sector and on the Level of Consumer Protection states that "Survey evidence suggests that direct border lending is insignificant and restricted, in the main, to border areas.[93]" On the contrary, most of the credit agencies and banks in the European Union are engaging in cross-border credit through subsidiaries and local branches.[94] But even in this case, the level of cross-border credit is extremely low. A 2008 survey had 40 out of 60 respondents claiming no cross-border credit activity; 11 respondents less than 0.1 %; and 6 respondents less than 1 %. This situation has only marginally improved in 2009.[95] The reasons for consumers lacking confidence in cross-border credit have stayed roughly the same since the consumer surveys from 2001 to 2005. Language barriers and lack of information still rank amongst the top reasons for consumers not engaging in cross-border purchases of goods and services.[96] It is doubtful that changes to the legal framework can increase the amount of cross-border use of financial services any more than at this point in time. Moreover, the harmonization of the internal market for consumer credit still seems to be in its infant stages. As already cited, the benchmark stated that the level of fragmentation in the internal market is still at a high level, so it can be concluded that a far-reaching harmonization of the internal market has as yet to take place. It seems unlikely that any real harmonization will take place with the current state of the market however. The large difference in types of credit products offered, market structure and size and consumer demand[97] hinder a further harmonization of the market.[98]

4 Conclusion

The landscape for consumer loans has changed quite significantly in recent decades. It is the task of the law to keep up with these changes and while facilitating business, also providing an adequate level of protection for the consumer engaging in these loans. Above, the latest iteration of legal frameworks from both Japan and the European Union have been analyzed from this particular viewpoint.

Comparing these two very different legal frameworks is no easy task. They both have very different goals: the Japanese MLBL aims at regulating the consumer credit business in a very strict way, so as to make sure that the number of people falling into multiple debts is reduced; the European Consumer Credit Directive

[93] GHK (2009), p. 40.
[94] GHK (2009), p. 41.
[95] GHK (2009), p. 41.
[96] Reifner et al. (2009).
[97] GHK (2009).
[98] Feretti (2007) p. 6.

aiming to up consumer protection in the credit industry (mostly through harmonizing the information required to be delivered to the customer at a pre-contractual stage) and harmonize the internal market.

First and foremost, which of these laws has been most successful in reaching its objective? Based on the experience after the promulgation of both pieces of legislation, the verdict seems to fall on the side of the Japanese MLBL. The number of Japanese having to engage in either personal bankruptcy or rehabilitation for persons with small debts has decreased markedly in the years following the enactment of the MLBL. Personal contact with the lawyers granting free of charge legal advice also suggests that the number of people asking advice concerning loans has gone down over 50 % since the law came into effect. The bigger loan companies have lost their overwhelming grip on the market and the loan market in itself has shrunk by around 20–25 %. The European Consumer Credit Directive on the other hand, while accomplishing part of what it set out to do has not had a level of success comparable to its Japanese counterpart. Aiming for a harmonization of the internal market, it stopped at harmonizing information available to the consumer in advertisements, the pre- and post-contractual stage. This has created a situation where, although the level of consumer protection has risen thanks to this provision, the harmonization of the internal market for consumer credit is proceeding at a lacklustre pace. Member States' credit markets are still very much fragmented; differing greatly in types of credit offered, market structure and consumer demand. While there is little that can be done from a legislative point of view to influence consumer demand, the types of credit products offered can be regulated and if the aim of the Commission is indeed to push for a far-reaching level of harmonization of the internal market, such legislation might be called for.

While differences in enforcement and sanctions for transgressions of both legislations vary widely, Japan's reason for choosing criminal sanctions is clear in the wish to weed out loan sharks and eradicate aggressive enforcement methods on the part of creditors. It is only normal that the European Union has different sanctions in its Member States, if only due to the different nature of the legal regimes in place there. There is no problem in either case here.

Along with this, the EU (and its Member States') legislation could take something away from the Japanese MLBL, especially the very strict definitions on when a consumer is found to be creditworthy. A definition of creditworthiness could not be found in the Consumer Credit Directive, or in the legislations of Belgium or the UK. While administrative rules regarding this might exist, it seems like a rather big lacuna to leave this out of legislation. If the goal is truly to harmonize the internal market and improve consumer protection, it is only logical that the definition of when a consumer is creditworthy would be the same across the Union.

In closing, while in an increasingly globalizing world, especially in an open market such as the European Union, there is a need for a further harmonized internal market, the EU Consumer Credit Directive neglects to harmonize that internal market for consumer credit to a large extent, and has up until now failed to noticeably increase the level of cross-border usage of consumer credit. While it increases the level of consumer protection, especially for cross-border credit, by

harmonizing the information available to consumers, if the goal of truly harmonizing the internal market is to be reached, several extra far-reaching harmonizing elements such as harmonization of interest rate restrictions, product offer and creditworthiness of the consumer will need to be added into the Directive.

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‘Plan-Like Architectures’ for Mutual Trust in the Cloud

Marcelo Corrales

Contents

Abstract While cloud computing is not a new technology it is a new way of providing on demand services that is continually and rapidly evolving into different business models. Cloud computing is, however, risky. It involves the processing, transferring and storing of data and databases across different jurisdictions via different cloud service providers, leaving a sense of uncertainty during the transactions. Cloud users may be unaware of the complex technical and legal issues involved. Therefore, providing a framework of trust is the responsibility of cloud providers. However, the concept of trust has many facets and its nuances are beyond the scope of what can be captured in Service Level Agreements (SLA). The main idea I would like to convey in this contribution is to provide a theoretical framework – that I call ‘Plan-like Architectures’ – that sits in between two main theories. On the one hand, the theory submitted by Scott Shapiro in his Book *Legality* where he adopts Michael Bratman’s account of human psychology that we are all

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'planning agents'. On the other, Lawrence Lessig's approach which sees the architecture of the Internet as a 'constraint' and therefore as a main regulator. The contribution suggests viewing through the lenses of the different interwoven multifaceted attitudes of trust that we encounter in the cloud computing market and argues that this should be streamlined into the SLA architectural framework. This will fill in the gap and remove some of the inherent risks and uncertainties associated with cloud computing transactions.

Keywords Cloud computing • Law and economics • Plans • Plan-like architectures • Service Level Agreements (SLA) • Mutual trust

1 Introduction

By its very nature, the study of cloud computing transformations is an interdisciplinary endeavor, drawing on complex technical and legal issues that include a variety of other social disciplines. Consequently, structuring a coherent theoretical framework requires careful scrutiny that goes beyond the capacity of any single discipline. Therefore, in order to gain a holistic understanding of these complex issues and to resolve adequately some of these problems, this chapter focuses on contributions and synergies across different disciplines such as philosophy, psychology, economics, information technology and law to create a new perspective in reacting to a problem that cannot be answered exclusively by the law.

The backbone of the theoretical framework of this work is substantiated in the inspiring theory submitted by Scott Shapiro, in his book *Legality*, where he adopts Michael Bratman's suggestion that we are all 'planning agents'.[1] By and large, this tenet refers to the collective intentions of people while carrying out a task together and it is approached from both a psychological and normative perspective. The second main theory is grounded in the Lessig (the so-called 'New Chicago School')[2] approach that sees the code of computing architectures as a constraint. I use a deductive method of reasoning or 'top-down' approach. From more general premises, I narrow it down to the more specific and combine them to identify a better framework that dovetails with SLA in the cloud.

As the plan theory deals with group formations, I think it will be easy for the layperson to understand its main principles. My conjecture here is that when we plan to use a cloud computing service, our activities will share, in a way, some elements of a planning structure. My first aim is to dwell on the philosophical theorem underlying the planning theory and its metaphysical, conceptual and

[1] Bratman (1999), p. 2.

[2] Lessig (1998), pp. 661–691.

normative questions placed in cloud computing environments. My second aim is to take the rationale behind plan dynamics or shared intention agency and plug that into the architecture design of SLA taking into account the different layers of trust that we may find in the cloud computing market. The attempt to seek answers through the prism of trust layers can be puzzling and daunting. I do not claim that the 'Plan-like Architectures' will capture all the complexities swirling around cloud transformations. However, we can always adjust the contours of this framework given the continually changing world that encompasses the cloud.

The way I conceive this model lies in between these two relevant theories that can be implemented and adjusted to the SLA frameworks of cloud services. To proceed, Sect. 1 opens with a narrative of the general foundations of law and economics. It discusses the different schools of thought featuring the main tenets of the economic analysis of law. Specifically, the section discusses the hypothesis that individuals are rational agents, its assumption on market dependence and its focus on efficiency as the social goal of the law-making process. The considerations against this backdrop and the development of these major theoretical breakthroughs provide a compelling argument to support the thesis of this work. After these background considerations, I need to explain first in Sect. 2 the rationale behind the plan theory. In Sect. 3, I expound upon the theory and I discuss how can this be extended to larger groups of participants. As a follow-up, in Sect. 4, I examine how Shapiro sees norms as plans, or what he calls 'plan-like norms', because they operate in the same way plans normally do. In Sect. 5, I combine these two approaches (Shapiro's 'plan-like norms' and Lessig's approach). It is essentially at the juncture of these two theories where the main theoretical argument of this chapter and my epistemological position in this subject matter lies. Sect. 6 discusses how attitudes of trust can influence legal systems, and; Sect. 7, explains how these different levels or facets of trust can be applied to SLA in cloud computing transactions. Finally, Sect. 8 outlines the concluding remarks of this chapter.

2 Law and Economics: Literature Review and Background Considerations

The rudiments of what it is known today as the economic analysis of law, can be traced back to the 'mercantilism' era during the eighteenth century, with Adam Smith's *magnum opus* titled: *An Inquiry into the Nature and Causes of the Wealth of Nations*[3] (abbreviated as 'The Wealth of Nations'). In this work, Adam Smith analyzed mercantilist legislation and its economic implications. He argued in favor of free trade, exalting the individual's capabilities of regulating and bargaining their own prices and services. Notwithstanding his revolutionary thinking, his experience reflected the 'pre-industrial' and 'small-scale technology' of the era and did not

[3] Smith (1776).

anticipate the rise of 'multi-national interests' and 'large-scale' technological advance[4] that we encounter today on the Internet.

The idea that individuals are fully rational and that they make choices that maximize their own individual utility found its clearer expression in the work of Jeremy Bentham in his *Introduction to the Principles of Morals and Legislation* (1780) where he argued for a utilitarian approach to morality and law.[5] This principle of utility remained in the mainstream of economics for quite a long time and it was grounded in the belief that anything that produces or promotes pain and pleasure is the guide to answer the question of what is right or wrong.[6]

However, it was not until the beginning of the 1960s, when Ronald Coase and independently, Guido Calabresi, published two seminal and stylistically innovative works: *The Problem of Social Cost*[7] where Coase analyzed the best allocation of resources in relation to liability's rules and *Some Thoughts on Risk Distribution and the Law of Torts*[8] where Calabresi observed the same phenomena. These two articles can be seen as the cornerstone for building the modern school of law and economics.[9]

'Law and Economics' is known today as a powerful legal tool, which is the dominant approach to law in the U.S. and has become increasingly influential in other countries.[10] By and large, there are three general law and economics schools as follows: (a) Positive law and economics (Chicago-style): uses economics to explain the reasons why the law is the way it is[11]; (b) Normative law and economics (Yale-style): uses economics to identify the best criteria for the most efficient and realistic policy, rule, measure, procedure, schema or model.[12] While the positive school of economics is more objective and based on real facts, the normative school of economics is subjective and based on values. The first ought to be approved or rejected, whereas the latter is based on opinions therefore does not need to be tested[13]; (c) A functional school of law and economics (Virginia-style): offers a third alternative stressing individual choice and 'market-like' mechanisms in the elaboration of laws.[14]

[4] Sutherland (1993).

[5] Bentham (1789/2007).

[6] Sandel M (2010), p. 23.

[7] Coase (1960).

[8] Calabresi (1961).

[9] Posner (1983), p. 4.

[10] Elkin-Koren and Salzberger (2013).

[11] Medema (2015), pp. 70–74.

[12] Schmalbeck (1983), p. 491; Miceli (1997). Some critics to normative economic analysis claim that it lacks the moral and ethical values such as personal integrity that are overturned by the costs and benefits analysis. See, e.g., generally Zerbe (2001).

[13] See, e.g., generally Caplin and Schotter (2010).

[14] Parisi (2004), pp. 259–272; Backhaus (2005), Introduction.

Law and Economics adopts a rather pragmatic approach and criticizes the traditional legal view that focuses on the concept of 'fairness', as in corrective justice. While, the traditional model focuses on the past and tries to correct and fix the situation retrospectively, the economics perspective, on the other hand, suggests evaluating things prospectively because the past is over and proposes to address the problem in a way that makes things less likely to occur in the future.[15]

According to the economics view, individuals are 'rational maximizers'[16] thus legal rules should address the potential effects in the future and think about the incentive structure of everyone in the society. The general principle of law and economics is to adopt legal rules thinking on the consequences *ex ante* contrary to correcting the problem *ex post*.[17]

This chapter takes an eclectic position between the Yale and Virginia Style. In a first step, it is grounded in the abovementioned theory of Ronald Coase. Coase suggests that transaction costs introduce a certain degree of uncertainty between the parties and, therefore, are relevant at every stage of the negotiation. The rationale behind Law and Economics is to try to reduce transaction costs while reaching private parties in negotiating and concluding agreements. The goal is to get as close as possible while minimizing costs.[18]

This is not to say, as many law and economics scholars have mistakenly conceived, that the initial allocation of legal entitlements does not matter from an efficiency point of view as long as the transaction costs of exchange are down to zero. This characterization has been spurred by George Stigler in his conception of the so-called 'Coase Theorem' (that in reality was never explicitly proposed by Coase).[19] On the contrary, Coase never assumed a world without transaction costs. Doing so would be to think of a utopia. His argument is based on the way resources are used. According to him, legal decisions do not affect the way resources are allocated. As he puts it: 'the delimitation of rights is an essential prelude to market transactions but the ultimate result which maximizes the value of production is independent on the legal decision'[20] and this idea is the one I am interested in applying in the context of cloud computing.

[15] Miceli (2004), pp. 2–3.

[16] Parisi (2004), pp. 262–263. According to Posner and Parisi: 'Law and economics rely on the standard economic assumption that individuals are rational maximizers, and study the role of law as a means of changing the relative prices attached to alternative individual actions. Under this approach, a change in the rule of law will affect human behavior by altering the relative price structure – and thus the constraint – of the optimization problem. Wealth maximization, serving as the paradigm for the analysis of law, can thus be promoted or constrained by legal rules'. The work of Richard Posner and Francesco Parisi (see Sandeen 2010, p. 47); See also generally Posner and Parisi (2003).

[17] See, e.g., Kornhauser (1989), pp. 37–39; The *ex-ante* and *ex-post* method of reasoning was first introduced in the field of economics by the Swedish economist and Nobel Prize laureate Gunnar Myrdal in his seminal work on monetary theory. See Gunar (1939).

[18] Coase (1960), pp. 1–44; Friedman (2000), pp. 8–18, 145–170.

[19] McCloskey (1998), pp. 367–371.

[20] Coase (2003, 2012).

It is said that cloud computing, and the Internet in general, reduce transaction costs. The impact of these effects are dramatic however not uniform. For instance, the hassles inherent to contracts remain still.[21] The Coase theory implies that the market can *potentially* resolve or at least mitigate externalities if property rights are agreed upon and clearly asserted. A crucial interpretation of the Coase theory is that an externality may be settled down not by 'regulating the externality out of existence' but by giving the parties the possibility to negotiate so that the parties involved may come to terms with the best economical solution.[22]

By and large, it was submitted that adding more actors and intermediaries to the negotiation table would increase the transaction costs however this would also contribute to 'social interface'.[23] The novel contribution of this chapter is to posit that the cloud computing market is too complex, especially for individuals and Small and Medium Enterprises (SMEs), thus by adding an intermediary with the technical expertise, legal knowledge and right tools will improve transactions. The overriding assumption lies in the fact that if SMEs could effortlessly assess the most convenient cloud provider and assert their rights through an automated procedure implemented by the Cloud Service Broker (CSB), then cloud computing transactions would increase. Legal uncertainties would be removed and this would incentivize cloud customers to participate in the cloud market.

This leads us directly to the works of Oliver Williamson who won the Nobel Prize award in the year 2009 for his analysis of 'economic governance, especially the boundaries of the firm'.[24] Williamson's research focuses on what kind of transaction should be carried out *intra* firms and what sort of transactions should be done within the market. According to him, one can either outsource the contract to an independent third party who can 'mediate that transaction', which is in a sense one of the main proposals of this contribution, or one can take that transaction out of the market and organize it inside the firms. There are pros and cons in these alternatives and the challenge of this research is to look at the viable contractual alternatives to clarify legal issues in the most successful and effective way. As Williamson notes, what we need to do is to identify the most important attributes that define those transactions and examine whether they are deemed to be easy or complicated transactions.[25]

Recent extensions to traditional law and economics theories, as explained by Neil Komesar in his book, *Imperfect Alternatives: Choosing Institutions in Law, Economics, and Public Policy,*[26] institutions, such as the political process, the adjudicative process and *the market* [emphasis added], are too large and

[21] Naughton (2013a, b).

[22] Autor (2010), p. 4.

[23] Teramoto and Jurcys (2014), p. 100.

[24] Nobel Web (2009).

[25] Williamson (1981, 1996, 2002).

[26] Komesar (1994).

complicated by nature. Therefore, he proposes a comparative analysis and careful scrutiny of the main characteristics of such institutions. This involves paying attention to how the role of each institution may predominate as a choice towards the social goal of the law-making process, and how such role may swing by from one institution to the other,[27] like a Foucault pendulum.

Komesar focuses on the potential routes that can lead to the strengthening of policy-making goals. This means that, in his 'deciding who decides' theory, he hashes out how choices are made through the selection of key institutions and how such choices should recast the Coasian approach with regards to the transaction costs and benefits. Komesar insists that this comparative approach must be 'participation-centered', which means that the analysis of such transaction costs and benefits should be carried out *within* and between institutions. He implies that looking at one single institution, such as the judiciary is a mistake and suggests a holistic interpretative approach among them.[28]

However, according to Kersch, this analysis has advantages and disadvantages. On the one hand, a comparative approach can bring together different perceptions that a 'single variable' cannot provide. On the other, narrowing down the analysis to one single institution can yield a more significant groundwork result, and such comparative analytic reasoning is thanks the literature that focuses on one particular key institution. A more significant weakness of Komesar's theory is that he limits this comparison to only three main institutions – markets, courts, and politics – and although he tries to argue that institutional choices must prevail, he seems to hint that judges should choose whether to focus on the judicial system or whether to leave it the market or to the political process. Everything seems to boil down to the rational choice of one individual, i.e., the judge. This is certainly correct for the point he tries to make that judges should have an expanded vision that goes beyond the judicial system when it comes to interpreting the law and imparting justice.[29]

Nevertheless, this interpretation may also create some limitations and boundaries to what we understand as the concept of choice, which leads us directly to another major disadvantage of his theory. Contrary to Douglass North, by focusing on the main characteristics of each institution, we are accepting a rather 'static' and rigid model with all the flaws of typical institutional stagnation. Komesar seems to obviate the dynamic role of institutions that change and evolve over time.[30]

In this respect, the word institution has different meanings.[31] For North, institutions are 'humanly devised constraints that structure political, economic and social interactions.'[32] Komesar expands the interpretation of institutions later on in his ensuing book *Law's Limit*. He realized the importance of analyzing communities as

[27] Pierce (1995), p. 941; Komesar (1994), pp. 3–6.
[28] Kersch (1996), pp. 13–15.
[29] Kersch (1996), pp. 13–15.
[30] Kersch (1996), pp. 13–15.
[31] Komesar (2013).
[32] North (1991), p. 97.

an institutional alternative and observed how the informal norms of such communities are bond to the three key institutions he considered before. Likewise, he also recognized that the role of the 'participation-centered' approach goes beyond the mere understanding of institutions but extends to the understanding of social goals and values.[33]

In *Law's Limit*, Komesar focuses again on the characteristics of the adjudicative process, however this narrow definition does not mean that the interpretation should be court centered. On the contrary, Komesar made a clear disclaimer that his approach should be construed more broadly as to embrace an understanding of its alternatives such as 'legislatures, bureaucracies and informal communities.'[34]

This last argument leads us to another striking feature, by paying special attention to informal communities and relationships, some general inferences can be drawn about 'market transactions'. As they come in a variety of forms, different tools must be employed to solve legal quandaries. As explained by Robert Ellickson, individuals of a society may solve their discrepancies without making use of the law, and as described by Stewart Macaulay, such sophisticated transactions are negotiated and solved without rigid contractual forms and outside the court rooms. This idea is also supported by Elinor Ostrom in the world that she describes as being free of bureaucracies and informally governed. It is in this world that individual property rights are disassociated with the 'tragedy of the commons'.[35]

The rationale for the integration of different institutional alternatives, although they might be imperfect by nature, offer us the possibility to look at the cloud computing market in its multidimensional level. This theoretical canvas is broad enough to encompass different aspects of the cloud market including the 'communities' or smaller institutions, which play an important role in asserting and clarifying legal issues in various ways. Influenced by Komesar's institutional choices and how its internal communities may streamline the roadblocks to the achievement of social goals, the research of this chapter has pursued this theoretical interpretation one step further. It does this by relating to the multi-layered attitudes of trust encountered in such intra-market communities. I shall describe some of these attitudes in the following sections where I briefly recapitulate the findings of recent theories submitted by Michael Bratman, Scott Shapiro and Lawrence Lessig, respectively. In the language of the previous theories employed here, the subsequent section will restate the implications of these findings for the 'Trustworthy Plan-like Architecture' approach that I intend to construct at the end of this contribution where a more purposive, market-oriented approach has been emphasized.

[33] Komesar (2001), Preface.
[34] Komesar (2001), p. 9.
[35] Komesar (2001), p. 27.

3 The 'Plan Theory': We Are Planning Agents

According to the approach of Michael Bratman,[36] one of the unique characteristics of human conduct is the capacity to act together and share our intentions in cooperative ways. This is related to the necessity of guidance and coordination in order to achieve our goals and fulfil our desires. He introduced the notion of 'plans' as a critical response to the 'desire-belief model' that relates the intention of agents to certain desires and beliefs.[37]

Proponents, who defend this theory,[38] reduce the intention of human agency to a cluster of desires and beliefs. However, this is a misleading approach. According to Bratman: 'We are planning creatures. We frequently settle in advance on plans for the future'.[39] Oftentimes, we need to make a decision among different choices that are equally attractive and engaging to realize our desires and beliefs. We also direct our intentions to achieve larger plans. Therefore, planning activity helps us to coordinate different kinds of tasks and achieve complex future goals over time *vis-à-vis* others.[40] Bratman developed a methodological planning theory that sees 'intention' as a central notion to characterize peoples' actions and their states of mind.[41]

The relation between intention and intentional action, and the differentiation between intended and expected effects of one's intention, is fundamental for two main reasons. First, they are inextricably intertwined to various human emotions, moral attitudes and legal institutions. Second, such a portrayal can help us to understand, predict and coordinate human intra-personal and inter-personal activities.[42]

As we are rational agents (at least to some extent), we tend to do things purposively and deliberately. This indicates careful consideration and conscious intention that shapes the nature and future effects of our action plan. However, since deliberation takes time, effort and other limited resources, we need the appropriate mechanisms to allow deliberation to affect the present and influence the future. This leads us directly to the need for coordination mentioned before. This latter characterization is what allows us to construct larger plans[43] from individual micro planning, to a broader and collective 'massive' macro planning.[44]

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[36] Bratman (1999).

[37] Bratman (1984), pp. 375–405.

[38] See, e.g., Audi (1973), Beardsley (1978), and Churchland (1970), pp. 214–236.

[39] Bratman (1984), pp. 375–376.

[40] Bratman (1984), pp. 379–380.

[41] Velleman (1991), p. 277.

[42] Bratman (1999), pp. 1–2.

[43] Bratman (1999), pp. 2–3.

[44] Canale (2013), p. 19.

This does not mean that plans are 'once and for all'.[45] They are 'revocable'. This means that they are not absolute, decisive and conclusive.[46] 'Such total plans are obviously beyond our limits. Rather, we typically settle on plans that are *partial* and then fill them in as need be and as time goes by'.[47] This means that plans, are in principle, 'incomplete'. This incompleteness is of utmost importance for it takes the reasoning characteristics of the agents to start with a partial, or initial plan, as a first step. Then it requires a detailed plan to fill in as a more specific course of action.[48]

Traditional views of law and economics tend to ascribe an archetype based on these forms of utilitarian 'desire-belief'[49] models of human action. Nevertheless, this view is not always true. What is interesting about Bratman's thesis is that it goes beyond models that seem to overlook these complex realities[50] where intentions play a central role. Intentions are for Bratman 'typically elements in the coordinating of plans: as such, intentions are distinctive states of mind, not to be reduced to clusters of desires and beliefs'.[51] In order to understand intentions, we must understand the complex relationship between individual commitment and its cross-temporal functionality in cooperation with others.[52]

4 From Individual Plans to Joint Plans: Shared Agency Theory

In his recent work titled: *Shared Agency: A Planning Theory of Acting Together* (2014), Bratman presented a full and updated version of his planning theory that started in 1987 with *Intentions, Plans, and Practical Reason*.[53] In this new book, he turns to a follow-up question: 'What happens to our understanding of small-scale cases of acting together…when we take seriously the planning theory of our individual agency?'[54]

This question is evidenced in very simple examples that pervade our daily lives such as: walking with a friend, dancing together with a partner, conversing with a friend, singing in duo with another person, painting a house together with somebody and performing an experiment together with a colleague.[55]

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[45] Bratman (1999), p. 3.

[46] O'Hagan (2001), p. 393.

[47] Bratman (1999), p. 3.

[48] Mohan (1990), p. 89.

[49] According to some scholars, e.g., Anscombe (1963), Goldman (1971), and Churchland (1970) 'to act intentionally is to act on desires and beliefs'. See: Fisher (2005), p. 217.

[50] Mohan (1990), pp. 89–90.

[51] Bratman (1999), p. 111.

[52] O'Hagan (2001), p. 393.

[53] Tuomela (2014).

[54] Bratman (2014a), Preface.

[55] Westerlund (2015).

Let us take the first example, walking down the streets in a crowded city takes a lot of coordination and responsiveness in order to avoid colliding with people. However, walking around many people is not the same of walking with someone in the same sense you walk together with a friend. That is, there is a big difference between walking alongside others and walking *together* with somebody. If these activities are performed alone, they involve intention and some sort of coordinated action is required as mentioned before. However, if such activities are performed in tandem with another person, they involve something more likely referred to as a 'shared intention' or 'joint intention'.[56]

Such activities can take place in large groups of people and can be performed at an institutional level in businesses, corporations or legal systems. However, to make things less complicated, I will refer in this section to what Bratman calls 'Shared Cooperation Activity' (SCA) as having only two individual agents and no hierarchical relationship. For a SCA to take place, there is a need for a mutual response to each other's intention and action. There is also a need to form a common goal despite the different reasons for the achievement of such goal.[57]

A number of prominent philosophers have theorized about this subject and suggested that there is a new fundamental element introduced when you move from the individual case to a shared activity. I will briefly state the general features of this discussion that are useful for our discussion.

According to John Searle[58] and Margaret Gilbert,[59] there is something that goes beyond a simple strategic equilibrium in cases of modest sociality. In Searle's opinion, there is a distinction between 'I-intention' and 'We-intention' attitude that cannot be reduced to a sum of individual intentions.[60] This extra and foreign element suggests there is a kind of metaphysical and conceptual discontinuity as this represents a new concept and a specific mental state.[61]

In the same vein of reasoning, in Gilbert's point of view, there is also something fundamentally new. However, in her opinion, it is not a new state of mind but the establishment of a 'joint commitment' primitive relationship that involves 'distinctive mutual obligations' between the participants.[62]

What is interesting about Gilbert's position is that she takes a normative approach (contract theory) in contrast to Bratman who takes a descriptive perspective. Gilbert uses the above mentioned walking example (shared action) to put her theory in simple terms to explain how people may enter, continue and leave acts of collective intentionality.[63]

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[56] Bratman (2013, 2014b).

[57] Bratman (1992), pp. 327–331.

[58] See generally Searle (1983, 1995).

[59] Gilbert (2006).

[60] Searle (2002), Searle (2010) and Searle (1990), pp. 401–416.

[61] Bratman (2013, 2014b).

[62] Bratman (2013, 2014a, b), p. 9.

[63] Gilbert (1990), pp. 1–14.

In her account, those people walking alongside each other constitute the 'plural subject' of a goal. Therefore, the fundamental conditions for collective conditions to exist are the following: (a) Consent in the formation of the agreement: people must be fully aware they are entering into an agreement. This agreement is sufficient to establish a group goal; (b) Obligation: this agreement creates 'obligations' among group members in order to achieve the final goal; (c) 'Right to rebuke': this obligation creates a necessary right to rebuke which endows any member of the group with a tool to make sure the goal is achieved,[64] and; (d) Consent in the revocation of the agreement: there must be a joint consent among the group members in order to cancel the agreement.[65]

Gilbert argues that the element missing in Searle's account is the previous agreement among the participants; and only if this requirement is met does it generate the obligations in the sort of 'we-intention' model submitted by him. According to Gilbert, intentions cannot be made in terms of purely internal mind-states as Searle has suggested, but rather this has to take an external form for the parties to reach an agreement.[66]

Both philosophers (Searle and Gilbert) attempted to explain the planning theory within the scope of larger institutions taking into account these new elements. The central idea is that once we add this new structure of either 'we intention' or 'joint commitment', we pave the road for a whole new theory of thinking and acting together.[67] Contrary to this view, Bratman is resistant to introduce a distinctive new element of the human mind. He believes there is no need to introduce new features when moving from the individual to the shared case. The reason for that is what in Philosophy is called 'Ockham's Razor' also known as the 'law of parsimony' (*lex parsimoniae*), which means that in the presence of several competing hypotheses, that leads to the same result, the one with the fewest assumptions should be chosen.[68]

He suggests following the 'strategy of sufficiency' by taking into account the basic resources available in the planning theory and how these elements fit together to build up a model of shared intention. This construction provides sufficient conditions for a solid form of shared intentional activity. Once the individual planning agency theory has been pre-established, the same principles can be applied as an extension to larger groups of participants and institutions, i.e. to small-scale shared agency phenomena or so-called 'modest sociality'. This is what Bratman calls the 'continuity thesis'. The eclectic position that Bratman seeks, goes beyond

[64] 'If you fail to give me what I have a right to through your promise, I have the standing, as your promisee, to rebuke you on that account. Similarly, should you threaten to break your promise, I have the standing, as your promise, to command or insist that you act as promised, and thus pressure you to perform'. See Owens (2012), p. 50; See also generally Gold (2009), p. 125.

[65] Gilbert (2007), pp. 31–49; See also Gilbert (2000); But see Sheehy (2002), pp. 377–394.

[66] Gilbert (2007), pp. 31–49.

[67] Bratman (2013, 2014b).

[68] Bratman (2013, 2014b).

the desire-belief model mentioned before and the associated model known in some other areas of social science. This approach expands the individual planning agency by emphasizing special characteristics and interrelations between individual agents and their plans.[69]

In this approach, the intention of individuals is a fundamental element that goes beyond the bounds of such desires and beliefs typical of those traditional agency models. According to Bratman: 'such intentions are embedded in coordinating plans that play basic roles in the temporally extended structures that are characteristic of individual human agency'.[70] The intentions of individuals are 'plan states' (counter to ordinary expectations). For this plan to work, one needs to organize and coordinate such course of action in the present looking into the future,[71] and because of our resource-limited agency these tend to be partial plans that need to be completed as time goes by.[72]

Human interaction needs very complex and delicate organizations that allow us to engage in these kinds of 'cross-temporal' activities. Think about the example of painting a house together with a friend. When we make the plan to paint the house on the weekend, it would make no sense to try to fill in all the details at once. In this case, we would probably arrange to meet at some point at a particular time and coordinate who is bringing the necessary tools to paint the house (e.g. ladder, brush, etc.). Additionally, we could agree and coordinate the color we want to paint the house but it would be very difficult to have the whole plan organized in advance. For example, we could schedule to have lunch or make a coffee break when we feel hungry or tired. What happens in reality is that we conceive a general idea and then we set up a 'partial' plan in order to fill them in later.[73]

This is the reason why intentions are at the heart of this discussion. Intentions are plan-states that play a systematic role to support this kind of 'diaconic' organization of activities. We said that these plan-states are partial and that we can fill them in later. The inevitable question that arises here is how do we fill them in as time goes by? The answer is very simple. In planning or intending, we have a range of different options. Sometimes these options are overlapping and we have to make a conclusive decision. Therefore, we settle on a particular option in a way that has stability over time and this is how the planning activity supports the organization over time. Furthermore, we can always draw on what Herbert Simons refers to as 'resourcefulness'. This partiality is thus grounded in the resourcefulness capacity of human agents that are able to refine or adjust their plans in a future stage.[74]

Last but not least, plans also 'constrain' your thinking. They do what Bratman calls 'filter multiple options'. For example, let's turn back to the painting example.

[69] Bratman (2014a), pp. 10–11.
[70] Bratman (2014a), p. 11.
[71] Bratman (2014a), p. 15.
[72] Bratman (2013, 2014b).
[73] Bratman (2013, 2014b).
[74] Bratman (2013, 2014b).

Now, imagine that the plan of painting together with a friend is overlapping with another family commitment. That previous plan to do something with your family imposes a constraint for painting the house with a friend. Therefore, the only solution would be to postpone the painting activity to the following weekend. What plans do in these kinds of situation is that they not only pose problems but they filter the possible solutions to the problems in order to ensure that plans 'fit' together.[75]

This theory has, admittedly, some limitations. The first problem is that the continuity thesis does not cover larger and more complex organizational structures, e.g. corporations and institutions, as they are asymmetric and do not form part of 'modest sociality'.[76] However, Bratman has also hinted elsewhere that these kinds of planning structures can be applied and expanded to other fields of work and that there is plenty of room to articulate a range of ideas associated with this investigation.[77] As far as this chapter is concerned, my pursuit is to contribute to such debate and reflect that such a basic philosophical conceptualization can be incorporated into more complex legal institutional frameworks, particularly cloud computing transactions.

This is connected to the fact raised by James Coleman in his landmark work on sociological theory *Foundations of Social Theory*,[78] where he elaborated on rational choice theories and extended to more complex forms of social phenomena, such as private and public organizations. Coleman demonstrated the links between individual rational choices with a much broader sociological conception of collective decision-making that extends towards the society as a whole.[79]

5 Plan-Like Norms: Legality

On the basis of this foregoing reconstruction, Scott Shapiro borrows Bratman's thesis and seems to follow the Yale school of normative law and economics, which is also very critical to these kinds of 'desire-belief' models. He puts forward a riveting and novel contribution to analytical legal positivism that categorizes 'plans' as a kind of norm or 'plan-like norms'.[80] He applies an analytical legal positivist methodology in a sense that he takes a neutral and independent stance

[75] Bratman (2013, 2014b).

[76] According to Bratman: 'The limitation is that my focus will be primarily on the shared intentional activities of small, adult groups in the absence of asymmetric authority relations within those groups, and in which the individuals who are participants remain constant over time'. See Bratman (2014a), p. 7; See also Tuomela (2014).

[77] Bratman (2014a), p. 8.

[78] Coleman (1998).

[79] Coleman (1988, 1998), pp. 95–120.

[80] Shapiro (2011), pp. 118 et seq.

with regard to the moral aims and principles that govern law in any given area.[81] The overarching idea that underlies this theory is that the law is tantamount to a plan. The legal activity is an enterprise of social planning.[82] Thus the legal system of a state is a very complicated and sophisticated structure that creates different types of plans that can be determined by the constitution or what he calls the 'master plan'.[83]

Shapiro focuses on the fact that a considerable amount of life's activity involves planning that guides us through the achievement of our goals. The way to interpret the law therefore is equivalent to the way we interpret a plan. How we interpret a plan is what Shapiro uses to explain his meta-interpretation theory which should contain the following factors: (a) the aim of the plan, (b) the values it attempts to achieve, and (c) the relation of *trust* between the planners and actors of the plan. This means that the legal system is not only an institution based on power but also endowed with a level of trust between public officials and citizens.[84]

Shapiro explains the reasons why and how the law can assist and monitor human behavior by means of the concept of a plan. He sees legal activity as a kind of 'institutionalized social planning', whose aim is to compensate for the dearth of other forms of planning in order to clear up doubts and solve disagreements about the moral issues that arise in our communal life.[85] The very nature of the law is to resolve these fundamental issues,[86] and, according to Shapiro, plans reduce and mitigate the deliberation costs under 'circumstances of legality', i.e., in cases of uncertainty when the society faces moral problems whose solutions are deemed to be complex, contentious and – in some sense – arbitrary.[87]

This view, in my opinion, dovetails with most law and economics paradigms. The most fundamental premises of law and economics posit that forward thinking towards the identification of correct social welfare is the key to elaboration of law and public policy mechanisms that incentivizes all relevant actors. In this sense, Shapiro's plan theory is particularly interesting and challenging as he carefully examines the patterns of the relations among individuals in a society, and he establishes a similitude with the legal system consisting of planners, plan adopters, and plan appliers.[88]

[81] Stone (2012), p. 7. Stone actually believes that the Plan Theory does not only pertain to the field of analytical legal positivism but also extends and even thrives in the context of natural law. For a full recount of positivism and the separation of law and morals see, e.g., Hart (1958), pp. 593–629.

[82] Shapiro (2011), p. 195.

[83] Shapiro (2011), p. 205; pp. 179 et seq.

[84] Shapiro (2012).

[85] Canale (2013).

[86] Shapiro (2011), p. 309.

[87] Shapiro (2011), pp. 170–173, 213–14, 217, 309, 312, 337–339, 348.

[88] Shapiro (2011), pp. 118 et seq.

6 A Plan-Like Architectural Design for the Cloud

Following the same line of thought, I claim in this section that the cloud computing market is very complex, and that the plan theory submitted by Shapiro, could be applied in order to reduce deliberation costs in circumstances of legality, in particular in SLA where the end users also face intricate, contentious and arbitrary issues. Intricate, because most end-users lack the technical expertise to understand the different choices provided in the cloud market. Furthermore, they also lack the legal knowledge to negotiate the terms and conditions of the SLA. Contentious, because the uncertainties swirling around the failure of cloud providers to assert end-users rights may give rise to future disputes and controversies. Arbitrary, since most SLA belong to the so-called 'click-wrap' or 'click-through' category where users have no possibility of bargaining.

Shapiro uses the term norm so 'one can cast one's net as widely as possible'[89] and this is the reason why I think the plan theory should not be limited and pigeon-holed exclusively under a sub-category of norms, as Shapiro explains, but rather a somewhat more elusive interpretation would grasp this concept as an extension to the four different modalities submitted by Lawrence Lessig, in particular the 'architecture' modality that he sees as a constraint. I argue that plans should be grouped as a sub-category of the architecture, especially when it comes to the Internet environment and I claim that the 'architectural design' of the SLA offered by cloud providers should facilitate the means to establish such trust with the end-users.

This idea is based on the 'New Chicago School' approach outlined by Lessig in various books such as *Code Version 2.0*[90] and *Free Culture: The Nature and Future of Creativity*[91] where he proposes four different 'modalities' that he sees as 'constraints'. These modalities are 'laws, social norms, market and *architecture*'[92] [emphasis added]. Laws are rules that make an attempt to regulate behavior. They impose penalties or punishment for behavior that is deemed unacceptable by society. They may also incentivize positive behaviors that are judged to be helpful to society. Norms are similar to laws in the sense that they also impose a conduct however the mechanism varies in a way that it is not the state but the society or the members of a community who enforce the norm on each other. Both laws and

[89] Shapiro (2011), p. 41.

[90] Lessig (2006), pp. 120–137; Appendix, pp. 340–345.

[91] Lessig (2004), pp. 121–173.

[92] Lessig (2006), p. 123; The notion of 'architecture' obviously vary in different disciplines and there are many concepts provided in the literature. Even in the computer science field there are too many definitions available. Therefore, in this paper I will refer to a widely accepted, concise and standard definition given by the Institute of Electrical and Electronics Engineers (IEEE) as follows: 'the fundamental organization of a system embodied by its components, their relationships to each other and to the environment, and the principles guiding its design and evolution.' According to Bloomberg, the people who use the system including the technology are also part of it. See Bloomberg (2013), p. 12.

norms are similar since the constraint is imposed after the infringement took place. The third modality is the 'market', which sets however a monetary constraint through a pricing mechanism. The market constraint in this case, contrary to laws and norms, is concurrent to the benefit that is sought. If you pay the price for a cloud computing service for instance, you may benefit from that service simultaneously to the exchange of the fee (constraint). This does not mean that cloud market transactions exist separately from laws and norms as these are all entrenched in one way or another.[93]

Finally, the fourth modality is 'architecture', which is the most relevant for the discussion of this chapter. Lessig's view of architecture as a constraint is taken from real life examples from the physical world. For instance a fallen bridge[94] and door locks are physical constraints, which hinder one's ability to go beyond a certain point.[95] Similarly to the market modality, the architecture has a concurrent consequence and not *a posteriori* as in the law and norm modalities. However, these four modalities are interrelated and sometimes one of them prevails to the other. For example a law may influence the architectural design of a highway by increasing the number of bumps and sign posts in order to encourage drivers to reduce speed and drive more carefully. A law may also manipulate the market behavior by imposing higher taxes on petrol so as to persuade car drivers to drive slowly, assuming that most car drivers are aware of the fact that high speed consumes more gasoline.[96]

This chapter concurs with Lessig's holistic view and balanced approach of these four modalities as a constraint stressing the paramount importance of the role the architecture plays. As he puts it, they are self-executed due to their 'automatic nature' contrary to the other three modalities such as laws, norms and markets.[97] The Internet has a different architecture as one can copy and replicate large amounts of information in an instant. According to Lessig, cyberspace 'has no nature' but rather 'a function of its design, its code'.[98] In the same way, the idea I like to convey is to inject the plan theory along with its different attitudes of trust (*see infra*) into the 'architectural design' of the SLA. This will help to display the relevant legal requirements, incorporating various legal issues currently not present such as database and ownership rights. This will help choosing an adequate cloud provider and outsource data and databases in a more reliable and automated way.

[93] Lessig (2006), pp. 314–340.
[94] Lessig (2004), p. 122.
[95] Lessig (2006), Appendix, p. 341.
[96] Lessig (2004), pp. 112–123.
[97] Lessig (2006), pp. 342–343.
[98] Lessig (2002), p. 121; Lessig (1999), pp. 501–546.

7 Plan Theory: Attitudes of 'Trust (and Distrust)' in Legal Frameworks

Before explaining the application of elements of trust within Plan Theory and how to apply this as an extension to SLA in cloud computing transactions, let me clarify that the concept of trust is very subjective. It can mean different things depending on the background, knowledge and experience of each individual. Therefore, defining in a few words the concept of trust is a Herculean task that is fraught with difficulties and controversies. For this reason, in this chapter I will limit myself to focus on explaining how the different layers of trust that we find in the cloud market institutions should be framed into the SLA.

Thus it is not the intention of this section to delve too deeply into such debate. Shapiro does not come up with a clear definition of trust himself. Arguably, this might cause ambiguity and issues for his meta-interpretative theory. Nevertheless, perhaps this definition has been left out intentionally in order to leave more room for interpretation. It seems to me that Shapiro leaves in the hands of the interpreter the task of evaluating parameters and preconditions involved in construing the concept of trust. Instead of defining the term, Shapiro characterizes issues of trust and distrust as an 'attitude' and he uses the history of the U.S. to explain this concept where the ideology of trust and distrust, or, as he puts it in more dramatic terms, the original distribution of 'faith and suspicion' formed the basis of the U.S. Constitutional Order.

This part of the U.S. legal history is precisely the same example I will refer to in this section in order to explain my argument with regard to the plan theory applied to SLA in the cloud – a point to which I return in the next section below. Before narrating this story in more detail, Shapiro clarifies that he is not a historian; therefore the same disclaimer applies here. The story might be nuanced with imprecise facts however the analogy of the story serves as a good reference to explain further how attitudes of trust and distrust can and do influence the institutional design of legal systems.[99]

A full recount of the story is not necessary for present purposes. Therefore, suffice it to say that the radical political party called the 'Whigs' played a decisive factor in the intellectual history of the revolutionary period. The Whigs influenced considerably the American political thinkers who subscribed to the classical doctrine of republicanism that believed that people could be trusted to exercise political power accordingly. To explain many years of history in a few lines, Shapiro divides it in three waves[100]:

The first way corresponds to the period that follows after the declaration of independence and is called 'demoting the executive', as it was characterized by eliminating the 'kingly office',[101] coining the words of Thomas Jefferson. In this

[99] Shapiro (2011), pp. 312–313.

[100] Shapiro (2011), pp. 313–316.

[101] Bailey (2010), p. 131.

wave, they dismantled the executive branch from its original functions and transferred many of its prerogatives to the legislative branch. This attitude of distrust towards the executive was echoed in the former regime where monarchs and aristocrats have enjoyed and presumably abused their power.[102]

In the second wave, the same attitudes of distrust have shifted away from the executive towards the legislative branch described by Shapiro as 'reining in the legislature period'. In this wave, more trust was placed in the citizens, who according to the republican view could exercise the power more responsibly. Additionally, three devices to monitor the state legislatures were given to the people, i.e., constitutions, conventions and instructions.[103]

Finally, the third wave titled 'losing faith in the people' explains how this new attitude of trust granted to the citizens failed to achieve its goal and turned to the actual distribution and symmetric separation of powers known as it is today. The current legal system might not be perfect but this historical event clearly shows how attitudes of trust and distrust may swing by from one institution to another and this is what Shapiro calls the 'economy of trust'.[104]

Another meaningful example given by Shapiro is when a society is exposed to great challenges and faces difficulties in overcoming and solving complex legal issues by themselves. Given this set up, many of the citizens would feel frustrated and powerless to confront the situation while others would think they know what to do. This lack of trust could be the result of the 'lack of character of some individuals for decision-making' or due to the 'lack of method for assuring trustworthy actors'. The first is an intrinsic lack of trust as this is coming from inside the individual. The latter has some extrinsic values as the individuals are confronted with 'issues of legality' feel confident to understand and solve these complex issues but lack the right tools to confront these situations.[105]

As seen in the above examples, plans do not only allow planners to 'compensate' and balance their lack of trust of others but they can also help them to 'capitalize' on such trust. Plans can also play a multi-fold management role as they have a variety of sizes and shapes and can be blended to form complicated networks. According to the planning theory, 'the fundamental aim of the law is to rectify these deficiencies; moreover, the law pursues this aim by managing trust through social planning'. In addition, 'the only way to respect a plan's trust management function is to defer to its economy of trust.'[106]

[102] Shapiro (2011), pp. 316–318.
[103] Shapiro (2011), pp. 318–320.
[104] Shapiro (2011), pp. 320–330.
[105] Shapiro (2011), pp. 331–352.
[106] Shapiro (2011), pp. 331–352.

8 'Plan-Like Architectures': Attitudes of Trust Applied to the Architecture Design of SLA

In the previous section we emphasized how attitudes of trust (and distrust) can swing from one institution to the other and how this oscillation can influence and change substantially the whole legal system of a country. We also suggested that such attitudes have an intrinsic and extrinsic value depending upon the confidence of each individual and whether the right tools are in place in order to tackle this situation. Finally, we said that the main idea of a plan is to compensate and balance the lack of trust. In this section I will showcase that there are various levels of trust in the cloud computing market and how these 'attitudes' can help us to capitalize on such trust.

In my opinion, attitudes of trust applied to the cloud computing environment could be grouped in the following three categories: (a) Trust of the Intermediaries, (b) Trust as a Service (TaaS), and; (c) Trust as a Design (TaaD). These three groups are explained in further detail below.

8.1 Trust as an Intermediary (TaaI)

In a first step, there is a new trend in cloud computing environments called 'Cloud Brokerage Services' (CBS) where a third party acts as a pipeline between the end-users and cloud services.[107] The CBS may only approach the parties to conclude a SLA or may also take a more active role and take part of the negotiations on behalf of the end-users bringing its infrastructure and expertise as cloud service. Similarly to the story of the birth of the U.S. Republic where attitudes of trust where swinging around different groups as described in the three waves by Shapiro, I suggest to allocate the attitudes of trust in the services provided by cloud brokers. The brokers in these scenarios could be seen as entities with higher expertise and competencies that can act as an interface and translate the technical and legal terms provided in the SLA. The broker can act as trusted third party that can negotiate and bargain the contractual terms on behalf of the end-users and help them to choose a cloud provider that can better satisfy the end-users' needs and demands. In this scenario, the role of the intermediaries could compensate for this lack of trust by deferring its trust management function to the CBS that can be seen as trusted third party.

[107] Lheureux and Plummer (2011) and Plummer et al. (2010).

8.2 Trust as a Service (TaaS)

The second view, takes into account the classical interpretation of the concept of trust in the online environment that is rooted in elements of 'transparency'. In this respect, some companies have decided to spend less time negotiating the complexities of SLA and instead have moved their SLA to a 'Trust Site'. For example, Salesforce.com has created a trust site[108] where they can make publicly available their SLA and policy framework (e.g. security policy and privacy policy). A Trust Site contains current and historical information with regard to uptime performance or any other metrics the customers need to know in order to create trust.[109] This is in my view a simple and straightforward concept in which many legal issues could be brought to create more transparency and trust between cloud providers and end-users. For example a 'data portability' policy framework could be added to the Trust Site where issues of ownership rights could be more clearly spelled out.

Another good example of this trend is the CloudTrust Protocol (CTP) where cloud users can elicit information about the elements of transparency endowed in the SLA and policy frameworks. What the CTP does is to provide further evidence of relevant information concerning the compliance, security, privacy, integrity and other elements currently being performed in the cloud. Thenceforth, cloud users will be more aware and empowered to make the right decisions and choose the cloud provider that complies and fits their needs. These 'elements of transparency' are inextricably entwined and rooted in the concept of digital trust[110] and I think it could provide a good venue for managing the economy of trust suggested by Shapiro.

8.3 Trust as a Design (TaaD)

Finally, the third mechanism to measuring and managing attitudes of trust and distrust in cloud computing agreements is to follow the architecture design approach and the trust assessors as an embedded component of the computer software. In this trust framework individual parameters to calculate trust should include a legal category (e.g. privacy and ownership rights) to define different levels of trust within the SLA. For example, the European funded cloud computing project called OPTIMIS (Optimized Infrastructure Services) has included two trust assessor components within the architectural design of its toolkit. Each component evaluates specific parameters (including legal) that are calculated for service and infrastructure providers.[111]

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[108] See, e.g., Salesforce.com.

[109] See, e.g., Aber Law Firm.

[110] See, e.g., Cloud Security Alliance.

[111] OPTIMIS Scientific Report, p. 23.

This framework calculates the level of trust an end-user may have with a service provider, taking into account two aspects: (a) the past experience between the end-user and the cloud providers (i.e. 'direct interaction'), and; (b) the behavior of the cloud service provider with other end-users and the feedback provided by them with regard to such service (i.e. 'recommended feedback'). This model takes into consideration different levels of trust and the level of preference a user may have for the quality of service and relies on the 'reputation' provided in the network. The framework includes a selection procedure (and a social networking tool in the same package) with a query system in which the end-user requests a service to be fulfilled. The system generates a list of candidates that can perform the task and calculates a set of trust values associated with the services. The end-users may select the service provider from the provided list and are free to decided whether she wants to use the cloud service or not. If so, she can submit her own rating after using the service and this is how a list of 'good' and 'bad' services are stored in a database system which is going to be used by the trust manager component for future calculations of trust values for the service. This will enable cloud users to select between good and bad service providers[112] and to compensate for the lack of trust end-users might have towards cloud service providers.

9 Conclusion

On a more theoretical level, the plan theory posits a clever and cogent positivistic theory of law. However, on a practical level, this might raise some thorny debates as to how to interpret the plan theory taking into account that the author omits a detailed explanation of the concept of trust in full details. Perhaps the elaboration of a clearer concept of trust that narrows down the scope of the meta-interpretative theory is not necessary and goes beyond the intention of this chapter. My conjecture here is take the plan theory and inject it in the overall architecture design of SLA in the cloud considering the different attitudes of trust present today in the cloud market.

What I submit in this contribution is to take into account what other law and economics theories have suggested, which is to take into account the role of other institutions and leave it to the market. In this respect, what I intend to submit here are mainly two things: (a) Take the different attitudes of trust and frame it into the SLA. This will balance and compensate for the lack of trust of end-users and capitalize on such trust; (b) Leave it to the cloud market to develop the concept of trust. This will provide more flexibility to interpret this theory and will also grant the possibility to the cloud computing market to expand and evolve into different kinds of services bringing the attitudes of trust and distrust to different levels.

[112] OPTIMIS Scientific Report, p. 23. See also Da Silva and Zisman (2012), pp. 328–343.

Adopting the words of Shapiro, 'the task of institutional design, therefore is to capitalize on trust while simultaneously compensating for distrust'. These apparent opposite attitudes of trust and distrust are like the yin and yang, they can be balanced and complement each other. This duality also lies at the foundations of different institutions including the cloud market and various branches of law such as contract law in particular in the province of SLA in cloud computing transactions. These also pose complex issues of uncertainty, similar to the 'circumstances of legality' depicted by Shapiro.

In closing, we may now turn back to the roots of the planning theory that have inspired and motivated Shapiro to elaborate further on his 'plan positivism'.[113] According to Bratman, our necessity for plans are essentially entrenched in two very general needs. On the one hand, we are 'rational agents' (at least to some extent). This means that deliberation and rational reflection helps to embody our intentions into a more physical manifestation at the time of action. Deliberation demands time and other limited resources and in my view there is a quite apparent limitation for end-users to take a rational and informed decision if the adhesion click-wrap type of outsourcing agreements available on the Internet do not provide the opportunity to choose and negotiate their rights.

On the other, we have urgent needs for 'coordination'. In order to accomplish complex goals we need to coordinate our activities with ourselves and with others. Therefore, we set our goals as 'partial plans' in the present with an eye in the future. This means that our plans are partially incomplete and subject to further elaboration and clarification until they take a better shape in the future. According to Bratman, plans work as 'framework reason' for screening and selecting the relevant options, and removing those options that are not relevant.[114]

Plans are everywhere, the same holds true for cyberspace. Users who want to use, e.g. a cloud service, must first engage in a contractual outsourcing agreement (SLA). This agreement is often too complex for them and is presented on a 'take it or leave it' basis. Either you subscribe to the predefined terms or you don't. However, if we take the institutional design of the cloud market and we take the different attitudes of 'TaaI', 'TaaS', and 'TaaD' to manage the economy of trust at different levels we can 'capitalize on trust while simultaneously compensating for distrust', as Shapiro puts it. This approach will, in my view, yield significant results for cloud computing transactions.

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[113] Shapiro (2011), p. 178.

[114] Celano (2013), p. 153.

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